[The Bill Walton Show](#)

Financial Busts: Why Are We Always Surprised with Alex Pollock

Maureen:

Hi there! Good morning! Good timing! I was checking my email on another computer and it said you were waiting, so ...

Ryan:

Oh, sorry! [crosstalk 00:00:12]

Maureen:

Alright, so, let's check the settings in the video settings and make sure you have it enabling HD, and then your appearance is touched up?

Ryan:

Yep. I just checked all of it. So I'm looking at it now ... You want 16 x 9 widescreen, right?

Maureen:

Yes.

Ryan:

Okay.

Maureen:

The other thing is you audio. On your microphone, put that volume as high as you can.

Ryan:

The input volume?

Maureen:

Does it have your actual ... It obviously has your microphone set because it says "test mic" when you're in Zoom?

Ryan:

Yeah. I'm plugged into Zoom, the H6.

Maureen:

Right, okay, so underneath where it says "microphone-"

Ryan:

Input volume?

Maureen:

... input volume, put that up as high as you can.

Ryan:

Yep, all set.

Maureen:

Okay and then your output volume, whatever's comfortable for you 'cause that's what's going to be coming through you.

Ryan:

Yes, I have that set to come through my computer speakers and then I just have him turned up all the way right now and if Alex wants to edit that we can let him ... that we're comfortable for him.

Maureen:

Right. Let me see what else is there. I think that's it, as far as ... let me pin you.

Maureen:

Now, you were saying something about, you were going to record it separately?

Ryan:

I was going to if the Zoom hadn't plugged directly into my laptop. That way we had clean [thing 00:02:04] if you needed it, but the [inaudible 00:02:05] plugged right in and you guys aren't having any problems with this, I am just ... do this, if this works for you.

Maureen:

Are you hard-wired internet-wise? Or is this wire-

Ryan:

Right now it's wireless, that was the next thing I was going to do.

Maureen:

'Cause it is-

Ryan:

[inaudible 00:02:23] to it, but-

Maureen:

Right. No, that's okay. It is kind of going in and out a little bit.

Ryan:

Okay. Let me hook up our cord. Because right now I have him set just so you've got like, the pictures in the background.

Maureen:

Right. That's great.

Ryan:
And I just have to make sure our ethernet cord will reach to here, in this room.

Alex Pollock:
... to you twice.

Bill Walton:
Hi.

Ryan:
He has too much [above 00:03:06]

Alex Pollock:
Would you like me to be like this, how's that?

Bill Walton:
Yeah.

Ryan:
Yeah.

Bill Walton:
Yeah, less ceiling. Yeah, that looks good.

Alex Pollock:
Well, that my hands look big.

Ryan:
Do you want me to get a little closer?

Alex Pollock:
No, it's fine, it's a good distance. Don't get closer.

Ryan:
Okay.

Maureen:
Yeah, he's got too [inaudible 00:03:22]

Alex Pollock:
Mid-distance.

Maureen:
... above his head.

Ryan:
He's got what?

Maureen:
Too much above his head, he's got too much head room.

Alex Pollock:
There you go. That's good. Is that good?

Maureen:
Yup.

Alex Pollock:
Yeah.

Ryan:
Yep. Awesome.

Maureen:
Thank you, Ryan!

Ryan:
Yes, I am going to close the door, get out of here, I'll let you guys do your thing.

Alex Pollock:
Let's see, Ryan is halfway through this- What is this? Ham and cheese?

Ryan:
My breakfast sandwich, yep. I'm getting there.

Ryan:
I will see you guys in a little bit.

Bill Walton:
Is she a techie or is she a researcher.

Alex Pollock:
Yeah. Well she's a conference organizer.

Bill Walton:

Ah, okay.

Alex Pollock:

They make communications and things.

Bill Walton:

Okay, well-

Alex Pollock:

Is this good?

Bill Walton:

You look great.

Ryan:

Yeah, it sounds great.

Alex Pollock:

I look great? Good.

Bill Walton:

You look great, you sound great, darling, you look good.

Bill Walton:

Okay, well let's go ahead and get started. I listened to the other show, I thought we were very interesting.

Alex Pollock:

We were! Too bad we didn't record, well we'll just see if we can be equally spontaneous, and maybe we'll be even looser this time.

Bill Walton:

I think, this is an interesting thing, I've never done one twice, so we'll see what happens. Okay, let me figure out what I want to say. Maureen, are you ready for me?

Maureen:

I am ready whenever you are.

Bill Walton:

I am. You are ready?

Maureen:

Is his phone turned off?

Bill Walton:

Oh, Alex, is your phone turned off?

Alex Pollock:

I don't have a phone with me.

Maureen:

Awesome!

Bill Walton:

Even better.

Maureen:

Okay, whenever you're ready, go.

Bill Walton:

Okay.

Bill Walton:

Over the past two or three centuries, we've seen enormous wealth creation throughout the world, particularly in the West. Incomes have risen almost a hundred fold, we've lifted billions of people out of poverty, and during this same period, as you'll read in the papers, we've had financial crises, bank failures, savings loan failures, all sorts of capitalist market issues which sound very scary and seem to threaten growth and threaten prosperity. In the United States alone we've had hundreds and hundreds of crises just since the turn of the last century in 1900, which caused, as it usually does, governments to intervene, and in 2014, rather 1914 rather, we, in our wisdom, created the Federal Reserve System because of the bank panics that had occurred then.

Bill Walton:

In the thirties, John Maynor Keynes invented macroeconomics, which was really a justification for governments to intervene in the economy. In the last few decades, we've seen Sarbanes Oxley, and Dodd Frank 00:06:25. Dodd Frank at a couple thousand pages and growing as we get regulations written about it.

Bill Walton:

Is something that-

Bill Walton:

Alex, I'm going to start this over, if you don't mind. I got lost. Is that alright with you?

Alex Pollock:

It's fine with me.

Bill Walton:

Okay.

Alex Pollock:

I thought you were doing great!

Bill Walton:

I was doing great until I got stuck on Dodd Frank.

Alex Pollock:

I was waiting for the question in there.

Bill Walton:

What's that?

Alex Pollock:

I was waiting for the question.

Bill Walton:

Yeah, I know, you pause. Okay.

Bill Walton:

Alright, let me get going again.

Bill Walton:

Over the last several centuries, we've seen massive increase in the world's wealth. Thousands of people ...billions of people lifted out of poverty, and during this same time though, we've seen financial crises, bank panics, all sorts of headline issuing things that terrify us and think, "Well, maybe the world's going to come to an end because yet another panic is upon us." And yet, we always seem to persevere. Governments, though, tend to not want these things to happen. They tend not to get re-elected if everybody loses their money, so they justify ways to intervene.

Bill Walton:

So, in 1914 we created the Federal Reserve System because of bank panics. In the 1930's John Maynor Keynes invented macroeconomics as a justification for governments intervening in the economy, and in recent years, we've seen Sarbanes Oxley and Dodd Frank, Dodd Frank in all its glorious 2,000 pages. Yet, nobody that I know who seriously participates in the financial markets today believes that we've staved off the inevitable next financial crisis, despite all the regulation that's been put in place.

Bill Walton:

So, the question is, has growth occurred because of financial regulation, or despite financial regulation? With me to talk about this is a good, great old friend, Alex Pollack. Alex is a distinguished senior fellow at R Street Institute. Before that, he was with American Interprise Institute. He was CEO of the Federal Home Loan Bank of Chicago, and earlier in his career and earlier in my career he was head of the planning department at Continental Bank, where I worked for him in the seventies and we've got lots of interesting stories to talk about that experience.

Bill Walton:

Alex has written a terrific book called "Finance and Philosophy." And, really what this show is about is his subtitle: "Why We're Always Surprised." And we are. Alex, tell us about "Finance and Philosophy." Why the title?

Alex Pollock:

The title of the book is supposed to indicate the fascinating ideas that are involved when we try to think about what financial reality is. And the notion is financial reality is different from physical reality. It's a reality that's made up of human behavior, of the interaction of people's ideas, their expectations, their expectations of other people's expectations, of regulators' expectations of what people will do, people's expectation's of what regulators will do, and this nice phrase, "expectations of expectations." And because of this, the financial markets and economic behavior is fundamentally not only unknown as to its future and where it's going, but the book argues is unknowable. That is to say, this very complex, recursive, reflexive, interactive reality makes it so we can't really know what's going to happen. And, no one can know this.

Alex Pollock:

Here is a key point. The regulators in whom politicians sometimes have so much faith, and people in general seem to have an unusual and an odd faith, don't know what's going to happen, either. The very actions central banks and governments are taking, may be causing the problems. But they don't know it because of this strange and fascinating character of financial and economic reality.

Bill Walton:

I've said at the outset that we're now here in 2018, soon to be 2019, and ... But I thought we'd solved everything with Dodd Frank and the financial regulations, and we have the new and improved Basel Agreements and things like that. Are you saying that with all this work by the government to protect us from financial cycles and downturns, we may still have one?

Alex Pollock:

I think it's undeniable that there will be more than one, and a series of them stretching off into the future. Now, as long as we keep an entrepreneurial and enterprising economy, which is just the term I like the best, and the rule of law, and relatively free markets, on average, economic growth and the well-being of individuals can continue to get better and better. But they won't get better and better without cycles along the way. In the great line of Schumpeter, what he calls "capitalism," what I call the "enterprising economy makes ordinary people better and better off. It does this through a series of vicissitudes," he says. That is to say cycles and problems. And you can't stop them from coming. It's interesting to look back when the Federal Reserve was created in 1914, the controller of the currency announced that now that we have the Fed, financial crises are impossible, because the Fed will make it so they can't happen. Well, that was a bad prediction, as it turns out.

Alex Pollock:

In 1989, just to take one other example, after a huge regulatory act of Congress, FIRREA, the Financial Institution Reform Enforcement and Recovery Act of 1989, the Secretary of the Treasury announced, "This ensures that financial crises will never happen again." Of course, they did. And after each political overreaction to each financial crisis, we have the announcement that this will never happen again, but it does and one of the reasons it happens again is the very actions that are taken trying to make it not happen in the paradoxical ways of financial markets.

Bill Walton:

We've talked about this, you know, people sitting in the regulators' job are just people and they're subject to the same distortions and the same perception, the same prejudices as the rest of us are, and they have the same information a lot of players in the markets have, particularly big hedge funds. And yet, we have a lot of faith in the Federal Reserve to somehow control the economy, yet they've singularly been unable to do that for the last hundred years since its creation. We have so much faith in the Fed, what's going on here?

Alex Pollock:

There's no more foolish faith than faith in the Federal Reserve or any central bank.

Bill Walton:

Okay.

Alex Pollock:

In the book I have a chapter called "The Most Dangerous Financial Institution in the World." And that is the Federal Reserve. The reason it's the most dangerous is because in a FIAT currency system, which is what we've got, that is to say money which represents only money on the books of the central bank, also by pieces of paper floating around as currency. There's no check on what a central bank can do, and they can do things which are extremely damaging, such as set off the great inflation of the 1970's, which was hugely destructive, and triggered the 1980's collapses in various financial markets. They can set off a asset priced bubble, like a housing bubble, which they stoked in the early 2000's.

Alex Pollock:

They can supress the returns to savers, so they're basically robbing savers as they've done in the last eight years or so. They can suppress real wages through inflation, making people poorer all the time that money ... seems to be causing prices to go up, the real price of labor can be going down. So what a FIAT currency central bank can do is really seriously dangerous. And the Federal Reserve is the most important central bank.

Bill Walton:

Let's talk about what the Federal Reserve is and isn't. The Federal Reserve in terms of its organization, the human beings in that Federal Reserve, it's primarily made up of a couple thousand economists. PhDs from MIT, whatever, who build-

Alex Pollock:

I think it's [inaudible 00:15:59] said that the Federal Reserve is the largest employer of PhD economists in the world, as well as being the most dangerous financial institution in the world. These people are intelligent, well educated, they've got lots of money to spend on research and computers and data, but they have exactly no more knowledge about the financial future than anyone else, because of the nature of the financial future and its unknowability, or its radical uncertainty. So to think that they somehow know what will happen, they don't even know what the results of their own actions will be. There's always a lot of guessing and uncertainty involved, and of course, human frailty of even the most competent and intelligent people.

Bill Walton:

Well most of these people have never worked in the capital markets. They've come straight out of PhD land to work in the federal reserve or one of its branches. And they build these models-

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Bill Walton:

... over one of the one of its branches, and they build these models, and there was an office created through Dodd-Frank, Office of Financial Research and the Treasury. I don't ... you remember that. I think they just shut it down, which in their wisdom they should have. And this was something written in the Dodd-Frank, where we were never going to have another crisis because we were going to have very smart people in the treasury, similar to the Federal Reserve who are going to model the entire economy and know what the risks were here or there, and thereby being able to get ahead of it. And as one of the jobs I had for a while, I was running transition for Trump before he was inaugurated, and one of my jobs is to go into the treasury to talk about what they were doing.

Bill Walton:

I was talking with these guys in the office of financial research, and they went on for a couple hours about doing this, that, and I said, "Well, gee, if you know all this, why don't you guys go start a hedge fund and go make a lot of money because there's not a ... You're saying you can predict all this and yet there was a market to test your predictions, and why don't you go out and make a few bets and see how you do?" Of course, being academics, they didn't really like that suggestion, but that's essentially what we're talking about with the Fed, right? They're not really market participants, or haven't been there in the real world, betting their own money, or their institution's money, have they?

Alex Pollock:

They have not by and large, although the Federal Reserve, which was of course at one point in its history on the gold standard, is now on what James Grant wittily calls the PhD Standard. It now has a chairman who actually was in financial markets.

Bill Walton:

Jay. Jay Pal.

Alex Pollock:

Yeah, Jay Pal. But people who are in financial markets don't know the future either. That's why what they're doing is betting and wagering and trying to determine what are good prices to pay against an uncertain future.

Alex Pollock:

There's a funny story about the Office of Financial Research, which is that one of my friends sat next to a senior officer on an airplane from the Office of Financial Research, and he said, "when I think about what you're doing, I noticed you haven't worked on Fannie Mae and Freddie Mac, who were at the center of the housing collapse, and wouldn't it make sense, if you're trying to deal with systemic risk at least to deal with them, and talk about them, and analyze them?" And the guy said, "Oh, that'd be much too politically explosive. We couldn't do that."

Bill Walton:

Oh. Well, you know, we were talking about the creation of these agencies doing these new things. Arnold [Kling 00:19:48], who's a friend of ours, wrote about the lessons from the savings alone meltdown from the '90s-

Alex Pollock:

I cite this paper in the book.

Bill Walton:

Tell me about it. What did he tell us that he'd done wrong then?

Alex Pollock:

He wrote a wonderful paper though, which is ... it's called, I think Not What They Expected, or Not What They Intended, Not What They Intended. What he relates is after the collapse of the savings and loans, which was the last time before the 2000s, only 20 years before, the American mortgage system collapsed in the 1980s, the savings and loan based system. Only 20 years later, the Fanny Mae and Freddie Mac based housing system collapsed, so that's two collapses in three decades. That's a pretty poor record, when you think about it. Anyway, as Arnold's paper tells, after the 1980s collapse, the regulators sat down and very intelligently, and carefully, and thoughtfully, studied the problems, and drew lessons from them, and applied the lessons for what to do going forward. They had three main conclusions which were you had to have a lot more securitization. You had to have mark-to-market accounting, and you had to have risk-based capital. And every one of those things were main contributors to the next collapse in 2007 to 2009.

Alex Pollock:

So the lessons they carefully and intelligently, and plausibly, is really important. These are plausible ideas. They're not crazy, but they turn out to have been main contributors to the disaster. There's a great paper by-

Bill Walton:

Let me expound on that. More securitization means basically taking a lot of securities and bundling them into a bond, and then stripping off some of the risky parts of the bond and bundling those into yet another bond, in a re-securitization. In the end, nobody knows what they own.

Alex Pollock:

Yes. They might think they know, but they don't actually know.

Bill Walton:

Well, I remember we were at Allied Capital in 2003 or 2004, and we were buying subordinated pieces of commercial mortgage backed securities, and basically the riskiest part, and we held them on our balance sheet, which was okay because we didn't have much debt. I think 80 cents of debt for every dollar of equity, so it was a pretty strong balance sheet. Then, one time, one day the guy walked in from Wachovia, almost literally had a propeller head. He was a PhD-type himself, but he was working at Wachovia or one of the banks ... and it wasn't just one, there were several of them came in and they said, "We have figured out a way to bundle together all your riskiest securities, and put those into a bond and then sell those off, and you'll hold just a little piece of paper and you'll make a nice profit.

Bill Walton:

Well, every banker made that decision, and that's where we ended up with all this paper out there where nobody understood what they owned, and then the rating agencies, I think they called those triple A securities, didn't they?

Alex Pollock:

The senior pieces were called triple A's, yes. And the judgment ... When you tried to figure out, as an investor or a rating agency, how much loss you might take in the most senior piece that got the triple A, you had to make guesses about the underlying loans, and how they would behave. And how those ... and whether they would default. And if they defaulted, how big the losses would be, probability of default, and loss given default, as the lingo goes. But in order to do that, you had to make a guess about house prices.

Bill Walton:

Oh yeah.

Alex Pollock:

And there was this really interesting faith. And the faith was that house prices on a national average basis could not and would not go down. Well now, why did people believe that? They said they believed it because in the whole post-war era, they never went down on a national average basis.

Bill Walton:

So in these models, history started in 1945?

Alex Pollock:

History started after the war.

Bill Walton:

They more or less ignored what happened in the '30s.

Alex Pollock:

Absolutely. Well, that was so long ago. That was ... We have a problem, in general, thinking about finance. What is ancient history? Well, that's so long ago, it's ancient history, doesn't matter. And yet, these things ... permanent ...

Bill Walton:

You have a fascinating story in your ... fascinating chapter in your book about generational finance, and about how long it takes for the next generation to learn the lessons that the previous generation learned, and it goes on and on and on, because old bankers end up dead bankers, and you got fresh-faced young people in there that have never experienced the bad stuff, and so can't imagine it could ever happen.

Alex Pollock:

That's right. That's right.

Bill Walton:

In the event though, how much did house prices drop in 2000?

Alex Pollock:

27% on a national average basis. And people who were professionals in the field knew that house prices could go down. It wasn't that they thought house prices couldn't go down. But they thought they would go down only on a local or a regional basis, but that if you held a big geographically diversified national portfolio, it would average out. They know they might go down on a real basis, that is to say that inflation would go up by more than house prices. So a house price could be falling in real terms, but they believed ... or at least most people believed and said, "In nominal terms, house prices can't fall," and then they fell 27%.

Alex Pollock:

By the way, you mentioned commercial real estate, that fell even more because there was a double real estate bubble. One bubble in housing, and one bubble in commercial properties as well. In both cases, the prices fell a lot. So, one of the things I talk about in the book is a philosophical question, you could imagine Socrates buttonholing people on Wall Street instead of in Athens and saying to them, "What is a price? What is the price of an asset?" When you think about it, you realize there is no objective existence in a price. It's an ephemeral agreement. There's nothing physically real about it.

Alex Pollock:

When we realize that, we then come into another question, which is how much can a price change? And the answer is, more than you think.

Bill Walton:

As we found in 2000.

Alex Pollock:

As we found out. It can go up more than you think, and it can go down a lot more than you think. It can go down a lot more than your model says. It can go down a lot more than your worst case scenario projected.

Bill Walton:

Yeah, well this gets in something that you mentioned, the mark-to-market accounting. This is something that was very fashionable among accountants, and it may be back in fashion for all I know. I haven't followed it recently. But, essentially you own an asset, and you paid something for it, and then times change and prices fluctuate, and the accountant said, "Well, if prices fluctuate, you need to mark it down, and you need to mark it up." In some theoretical way, that's useful.

Bill Walton:

But then they implemented mark-to-market accounting ... When did that start? I think in February ... new ruling FAS 157, February 2007, where there was a radical change in marks. What happened then was the S&P fell 50%, and it fell and fell and fell, until the accounting mavens decided maybe that was a problem. And then, in March of 2009, they reversed the rule, and the S&P has been rising ever since, or more or less ever since. So what's going on here? I mean, I'm interested in how ... We're getting into something arcane about accounting, but accounting really matters because real things depend on that. You say, "What's your collateral for your loan?" I'll say, "It's the house," and you will say ...

Alex Pollock:

It's the price of the house.

Bill Walton:

It's the price of the house. So let's wander into this metaphysical world of price.

Alex Pollock:

Well, price is metaphysical in this way. And accounting is philosophically interesting. There's a whole chapter in the book about accounting, and about what does it mean to represent reality in sets of accounting numbers? And as anybody who really studies accounting knows, it gets to be very theoretical, and a set of books is in fact the result of all kinds of quite debatable philosophical decisions, which a committee ... it's another committee of people, the Financial Accounting Standards Board has decided ... and then, based on those rules, a whole lot of judgments that have to be made. So there's a really interesting question about representation and reality. It doesn't mean that you're not representing some aspect of reality, but you may be missing others.

Alex Pollock:

When you are forced to mark assets to market, and prices are fairly stable, and you're going along in a normal economic situation, they go up a little, they go down a little, that's one thing. But, when you're in a panic, and there is no real price, there's only a distressed price, say fire sale price, that might be paid by a vulture investor, then the mark-to-market becomes a really terrible idea. And, if furthermore, you have regulations that declare banks insolvent because of this mark-to-market accounting, then you accentuate the panic. So like many other things, mark-to-market accounting is an idea which is okay sometimes, and terrible in other times.

Bill Walton:

Well, you and I agree, let's be clear, this is not a morality tale of good people and bad people. This is a question-

Alex Pollock:

That's so important, Bill. That is hugely important. Thank you for underlining-

Bill Walton:

You know, because we joke about the Federal Reserve. We joke about the FASB. These are decent, smart people. They're trying to do the right thing. They're trying to fix things that they thought were broken. They come up with ideas. They implement the ideas, and sometimes it works, sometimes it doesn't.

Alex Pollock:

That's right.

Bill Walton:

And in this case, what they wrote after the lessons from the '90s, were catastrophically wrong.

Alex Pollock:

That's right.

Bill Walton:

But they were not ...

Alex Pollock:

Now, this is really, really, extremely important. This is not about bad intention. This is about inevitable mistakes, inevitable mistakes, when you're dealing with the financial and economic future. Now look, it isn't true of all kinds of future, because there are things in the universe that are quite knowable in advance, like the paths of the planets, which can be correctly known, thousands of years in advance, and there are things that can't be known, like recursive, reflexive market and economic outcomes.

Alex Pollock:

What you have is not only fine people, but extremely intelligent, extremely well educated people, backed by all kinds of other really smart people, but they often enough get it wrong. This brings up a favorite saying of mine, that you know very well, Bill, which I call [Bottoms 00:31:58] Principle, which is-

Bill Walton:

Edward Bottom, Edward Bottom, great man.

Alex Pollock:

Edward Bottom, an old boss of both of ours, who said to me one day, "Alex, it's easier to be brilliant than right." And it is so true. You can be very brilliant and not be right. And that applies to everybody. It applies to market actors, to regulators, to central bankers, to accountants, to politicians, and Bill, even to you and me.

Bill Walton:

[inaudible 00:32:29]. I keep extending that because brilliant, yeah it's true. You can be brilliant but not right, but you can be right ... often, you can be right, but you can't get out of the way of an ongoing truck-

Alex Pollock:

Very true.

Bill Walton:

And that sort of happened to a lot of people in 2007, 2008. I mean, I think a lot of us knew that this was a house built on sand, whatever the metaphor. For example, you and I worked together at Allied Capital, and we had the commercial mortgage backed portfolio, which we sold in 2005 because we could see the prices and the collateralization levels deteriorating in a way that just didn't make it a good asset to hold, and we could see a lot of risky stuff happening. And yet, even with that, you look at the accounting rules that later on afflicted everybody in finance, we got hit by that truck. So it's something to ponder as we worry about the future. You often can't get out of the way, but you can protect yourselves in ways, I suppose. One of them, personally, is not owing any money.

Alex Pollock:

Absolutely.

Bill Walton:

I mean, my savings [crosstalk 00:33:41].

Alex Pollock:

Controlling your debt.

Bill Walton:

Controlling your debt. [crosstalk 00:33:43].

Alex Pollock:

Yes, absolutely. But now, look it, what happens in the boom is exactly the opposite. What happens in the boom is you have every incentive, it seems, every short-term incentive, to run your debt. And that happens in the aggregate, in the market. That's why I ... one of the sayings in the book is increasing-

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Alex Pollock:

That's why I, one of the sayings in the books is, "Increasing leverage is the snake in the financial Garden of Eden." Running up the leverage makes everything seem more profitable, makes asset prices go up higher. In the boom phase when the leverage is rising, everybody is happy.

Alex Pollock:

It's really interesting, and we think about it in the book, who is made happy by a house price bubble? The answer is nearly everybody.

Bill Walton:

Nearly everyone, yeah.

Alex Pollock:

Really happy. Now, the only people who aren't happy are the ones who've missed out, who haven't run up their debt, who haven't jumped into the bubble. That's why I have this wonderful saying from Kindleberger, "Nothing is more upsetting to your psychological balance than to see your friend get rich." Then you say what a sucker I am. I'm missing out. Then, even the conservative people, ultimately, very often get sucked about at the top.

Alex Pollock:

I do have one-

Bill Walton:

Then you go on to say, "It's even worse when your brother-in-law is getting rich."

Alex Pollock:

Right, even worse than your friend is your brother-in-law getting rich. You'll hear about it from your wife. You tend to get sucked in at the top.

Alex Pollock:

I do have a story here. It's about Isaac Newton. Now, Isaac Newton may have been the greatest intellect in all of history, at least he's right at the top with a handful of the smartest men who ever lived.

Alex Pollock:

But, Isaac Newton in the bubble of his day, which was the South Sea Bubble of 1720, was an early investor, doubled his money, sold out at a big profit, watched the market go straight up, experienced seller's remorse, probably watched other guys getting rich and became unhappy and bought back in right at the top. The bubble collapsed, and he lost a fortune.

Alex Pollock:

Here is a great case of Bottum's principle that it's easier to be brilliant, even world historically brilliant, than right. Newton then later said in disgust, "I can calculate the motions of the heavenly bodies, but not the madness of the people." That's a nice summary of the bubble.

Bill Walton:

Yeah, that is a nice summary. I asked the question at the outset, we've had this tremendous growth in the world economy, initially in the West, now throughout the world, billions of people getting lifted out of poverty. But, we're talking about these cycles. Has this growth occurred because financial regulation has stepped in to make the economy safer, or has the growth occurred despite the regulation that's been created?

Bill Walton:

You talk about that in your chapter, you call it the Cincinnatian Doctrine which is pretty interesting. Cincinnatus was the Roman emperor who went [crosstalk 00:37:07]-

Alex Pollock:

He was a Roman aristocrat who was as the story goes on his farm when Rome was in crisis, and the barbarians were at the gate, and they made him temporary dictator. The Romans had an office which was a temporary dictatorship, and you came in and had absolute power, but it was limited to six months, renewable once for six months.

Alex Pollock:

Cincinnatus came in, took over as dictator, drove off the barbarians, saved the state. "He left the farm to save the state," is the line. When the crisis was over, he went back to his farm.

Alex Pollock:

Now, Cincinnatus was the hero of George Washington who twice in his life left his farm. Once as general to save the American Revolution, and once as President, as the most important President ever, because he created the office and, afterwards, went back to his farm. Now, George Washington was called the modern Cincinnatus.

Alex Pollock:

The theory is in the crisis, you get intervention. The trick is like Cincinnatus, how do you get the intervention to stop, so that the enterprising economy can keep on creating wealth. That it has ...

Alex Pollock:

Then we go on, there's another chapter called The Wonderful Trend and the Troublesome Cycle in which we ask the question ... Think of the truly astonishing improvement in the lives and the welfare of ordinary people, people like you and me, over the long-term. Just take since 1900, on average Americans are eight times, eight times better off than the people, say, when my grandfather was young in 1900.

Alex Pollock:

Well, this is astonishing, astonishing progress. It means in every way, in physical ways, in health, in culture, in intellectual goods that are available to us, our lives are richer and better off because of this amazing trend.

Alex Pollock:

Now, what kind of a growth rate does it take to be eight times better off in a 118 years? The answer is 2% a year. The magic 2%, if accumulated over long periods of time, which an enterprising economy will do if it has entrepreneurs, if it has scientific advance, if the knowledge is turned into innovation and into enterprises by entrepreneurs, most of whom will fail but some of whom will build the amazing progress, and the rule of law, then this trend continues.

Alex Pollock:

The book poses the question, can you have this trend without the cycles? The answer, I think is true, is no, you can't. If you want the amazing trend, you have to have the cycles, because the same fundamental force is playing that is uncertainty. Invention, innovation, entrepreneurship creates uncertainty. Uncertainty creates cycles, so you get them together.

Alex Pollock:

I speculate that if you were willing to be poor and live at the level, let's say, of a traditional peasant forever, you might have it economically and financially stable.

Bill Walton:

It strikes me listening to you, we've got a market ... If you think about financial crises, they're about money. What is it about money? Well, everybody is involved in money. Therefore, everybody cares and sees it.

Bill Walton:

But, there's other markets. There are markets, let me give you a ridiculous example. I was a baby banker in the '70s, before I worked for you, as a lender to the automobile and steel industries, and we had recreational vehicle manufacturers in northern Indiana. They went through a cycle because of the oil prices and gasoline prices where they went from thriving to dying in two short years. That was a cycle that affected only the RV manufacturers.

Bill Walton:

It occurs to me-

Alex Pollock:

They've done it again [crosstalk 00:41:42]-

Bill Walton:

... government intervention then to bail out or to re-regulate recreational vehicles.

Bill Walton:

These cycles happen in real markets as well as financial markets. It's just-

Alex Pollock:

Yes.

Bill Walton:

... we don't see the government intervention that we see in financial markets.

Alex Pollock:

Yeah, the cycles are not only financial, they're financial and economic.

Bill Walton:

I want to swing towards the Cincinnatian Doctrine, because one of the contrasts you make here is that in Wealth of Nations, Adam Smith, he believed that if there's a lot of government intervention, and this was in 1776, almost 250 years ago, he said, "Government intervention in the markets is particularly prone to creating monopolies and special privileges for politically favored groups."

Bill Walton:

We see that playing out today with Dodd-Frank. Dodd-Frank has really put a moat around the big financial institutions where if you want to be an innovative finance person because of the regulatory requirements and capital requirements, you really can't start anything new or be entrepreneurial. It's protected these banks, true?

Alex Pollock:

I have story, yes. I have a story, absolutely. The claim was that it would make so-called "too big to fail," impossible, but it has reinforced the biggest banks. The correct view that financial markets have that they are supported by the government will be and are just like Fannie and Freddie were and are and will be.

Alex Pollock:

I have a story, Bill, to tell here which you may remember. It's, what's the difference between banking and politics? The answer is banking is borrowing money from the public and lending it to your friends. Politics is taking money from the public and giving it to your friends.

Alex Pollock:

Banking subject to political direction is borrowing money from the public and lending it to the friends of the politicians. That's why government banks inevitably fail.

Bill Walton:

Well, we've seen that in Europe, in particular, where the banks are directed to own government bonds in large quantities. They're in effect financing the deficits of the European governments.

Bill Walton:

But, well, Smith goes on to say, and you quote it here, if we have these ossified, faction-driven, rent-seeking institutions what that means is that there's less new things happening, less innovation, less growth, and so it reduces the rate of wealth creation for everyone.

Bill Walton:

Then, on the other side, and this is a contrast we're seeing today, is that, Keynes, as I mentioned at the outset, invented macroeconomics as a justification for the European or, particularly, the British government to intervene in the markets in the '30s. He said, "Only the compact power of the state with its sovereign authority to compel can deal with emergency situations."

Bill Walton:

You ask an interesting question, which one of these views is right?

Alex Pollock:

I give the answer, as you know, which is that Smith is right 90% of the time, and Keynes is right 10% of the time when we're in the crisis, which is about once every 10 years. But, the driving force in the long-term is Smith, and the surviving the crisis is Keynes.

Alex Pollock:

Speaking of Keynes, of course, there are, there is a great story in the book which, if you don't mind, I will tell about Keynes' 1930 essay in which he tries to predict what economic life will be 100 years from then. In 1930, he's writing about 2030, not far off.

Alex Pollock:

Here, imagine 1930, the world is in depression. The world has had the incredible destruction of the First World War followed by a lot of chaos including economic chaos that comes from the war and, then, financial collapse. Everybody is depressed and in despair.

Alex Pollock:

Keynes writes an article and says, "Well, in a hundred years, our descendants then will be four to eight times economically better off than we are now." This is a great forecast. We're already in terms of average economic well-being, which we'll measure by gross domestic product per capita, only per capita matters for this purpose, we're already seven times better off than the people in 1930. His call is already right.

Alex Pollock:

Then, he goes on to say in this very sarcastic way, he hopes that in the future economists will be humble, competent people like dentist.

Alex Pollock:

Keynes, of course, is not humble. He's an incredibly arrogant, intellectual elitist, and he's famous in a supercilious, arrogant way, like dentists.

Alex Pollock:

Then, I point out in the book, "Now, let's compare the progress of dentistry since 1930 with the progress of economics." Now, what we find out is that dentistry, since it's actually based on science, has incredible progress in science and practice to the benefit of mankind to have good teeth. It's really admirable and has much more progress than economics has had.

Alex Pollock:

In fact, my conclusion is, you mention Keynes as inventor of macroeconomics, "Macroeconomics will never rise to the scientific level of dentistry." That's my response to Keynes.

Bill Walton:

Well, and just a bit of an addendum to that when people say they long for the old days, my two word answer to that is, "Have you thought about modern dentistry?"

Alex Pollock:

You're absolutely right, absolutely right.

Bill Walton:

Alex, we've just barely skimmed the surface of this book. We've been talking for decades about you writing this book. One of the attributes you have is you're an elegant writer with great simplicity and style and can make complex things interesting and lucid.

Bill Walton:

Consequently, we have a book here that's only 160 pages roughly, and it probably packs more into this 160 pages than dozens of books on similar topics. This is an achievement that I'm just floored, flabbergasted that it's as good as it is. I'm not surprised, but there's a lot here.

Bill Walton:

The book is called, again, Finance and Philosophy: Why We're Always Surprised. For those of you on YouTube, I'm holding it up here, so you can take notes and get onto Amazon as quickly as possible and order this book.

Bill Walton:

Alex, where can people reach you if they want to talk about this with you some more?

Alex Pollock:

I would be delighted to hear from anybody who's interested in these ideas, and they want to talk about them, and I'd be happy to get emails. I am at the R Street Institute in Washington, DC. The email is apollock@rstreet.org. That is A-P-O-L-L-O-C-K@ the letter R, the word street, S-T-R-E-E-T.O-R-G.

Alex Pollock:

It would be great to hear from anybody. These ideas I think that are embedded in finance and economics are wonderfully complex and interesting and paradoxical and fun as well as extremely important to think about.

Bill Walton:

We will have all this information on our website as well. Alex, as always, fascinating talking with you, and I look forward to our next conversation.

Alex Pollock:

Thank you very much, Bill. Thank you for all your kind comments and for having me on.

Bill Walton:

It's a great book.

Alex Pollock:

Thank you.

Bill Walton:

Okay. Thank you.

Bill Walton:

Okay, good.

Alex Pollock:

That was fun.

Bill Walton:

Yeah, it was a lot of fun. It was sort of funny trying to wander through what we talked about last time. I wish we could put together one show out of this thing. But, maybe we'll ... I may put the other one out-

PART 3 OF 3 ENDS [00:50:48]