## Chapter Twelve

# MODERN MONETARY THEORY

*Thus, the task is not so much to see what no one yet has seen, but to think what nobody yet has thought about that which everybody sees.*

*—Arthur Schopenhauer*

In previous chapters I showed how the political and cultural landscape had changed to allow for much more aggressive intervention to create jobs at the expense of people's concerns about deficits, inflation, and the dollar. The parallels gave me confidence that recovery would take hold and that the main analytical emphasis should be on interest and cap rates since the supply-demand relationship for apartments looked quite favorable. We saw a combination of dramatically reduced supply, soon-to-be-improving demand fundamentals, positive demographics, banks with no interest or capacity to make construction loans, and rents far too low to justify building new apartments. To us, these factors appeared to be coalescing in a very favorable way for apartment owners. Financing became much more conservative, with Freddie Mac and Fannie Mae being the only viable lenders. The increasingly focused lending to only substantial firms with strong track records could only be positive for CWS.

The initial focus of this chapter highlights the thinking of Marriner Eccles, the Federal Reserve chairman from November 1934 through July 1951, and how applicable that was to what Federal Reserve chairman Ben Bernanke was contending with during the depths of the Great Recession. This analysis attempts to create some insight into what would happen to interest rates in the future as we were determining the right prices to pay for properties and how we should finance the properties in our portfolio, including new acquisitions. Finally, it was critical to understand the differences between then and now and to see if there were modern-day thinkers to whom I could turn to make sure we were correctly analyzing where we were and where we were headed in the context of today's modern monetary system.

We were in unusual times between 2008 and 2010 (and still are to an extent today) with the Fed "printing" trillions of dollars and the government spending all those stimulus dollars. It was valid to be worried about what this would do to inflation and interest rates. After all, logic would suggest that we'd have to see rates go higher as we were accumulating all of this debt, and the scale of the deficit was simply beyond human comprehension.

How could we ever hope to repay the accumulated debt? Why would people like the Chinese and other foreigners continue to buy our debt when they saw us debasing our currency through all the spending and money printing? It was an important question for me to ponder dispassionately, but there was so much political and ideological noise. One way of answering this question was to first go back to the 1920s and 1930s and then overlay some more modern thinking to help generate an understanding of the government's reaction function and the monetary system.

The reaction functions in the 1930s were very similar to what took place during the Great Recession. Spending increased significantly, the banking system was bailed out, and the Federal Reserve was loose in its monetary policy (until 1937) and kept interest rates low for many years. Similarities of thinking existed among Marriner Eccles (the Federal

Reserve chairman during the Depression years), Ben Bernanke (a student of the Great Depression), and now Janet Yellen. After reading a number of Eccles's speeches, I came to realize how close Bernanke's thinking was to his. The difference is that Eccles was much more blunt about his views, which had changed dramatically since he took over as chairman of the Fed, as opposed to Bernanke, who seemed to be trying to navigate through turbulent political and social waters. Bernanke knew that what needed to be done to bail out the banks and provide large fiscal stimuli was not always tasteful, so he had to tread lightly.

Eccles was a private sector businessman from Utah who was a millionaire by age twenty-two. He was also a very successful banker. During the Great Depression he lent his skills and knowledge to the government by helping to create the Emergency Banking Act of 1933 and the Federal Deposit Insurance Corporation. As the magnitude of the crisis became more and more apparent, Eccles's views started to evolve and change. I will cite a few powerful excerpts of speeches he gave that helped convince me not only that the government would have to take a very powerful and active role in helping us to get out of the Great Recession, but that the Fed would have to step in much more aggressively to be the buyer of last resort and would keep rates down for a very long period of time.

Eccles shifted from a free market fundamentalist to one who realized that the government had an important, stabilizing role in the economy. The massive collapse in industrial production, GDP, and employment in a few short years made him question everything he had previously believed. From my perspective, Eccles has the best definition of what "sound money" should be. He said in a radio speech on June 4, 1935:

> We have sound money when our system behaves in such a way as to help rather than hinder the full and efficient use of our productive resources. We have sound money when the energy and skill of American workers, the productive capacity of our great industrial plant and equipment, and

> the fruitfulness of our land and natural resources are used in such a way as to make our real income of goods and services as large as possible, not merely for a few prosperous years followed by a period of idleness and want, but for year after year of enduring stability. This, it seems to me, should be the criterion of the soundness of money, and not the amount of gold that is stored in the vaults of the Treasury.

Eccles also expressed some strong views against the idealistic, Hooverian notion that through traditional American thrift and hard work we can pull ourselves out of the Depression. This is how he debunked the notion that we only need to rely on the private sector without needing government involvement:

> The theory of hard work and thrift as a means of pulling us out of the depression is unsound economically. True hard work means more production but thrift and economy mean less consumption. Now reconcile those two forces, will you? . . . There is only one agency . . . that can turn the cycle upward and that is the government. The government . . . must so regulate . . . the economic structure as to give men who are able, willing, and worthy to work the opportunity to work, and to guarantee to them sustenance for their families and protection against want and destitution.

Part of the problem why the private sector could not be relied upon to get us out of the problem was due to over-saving:

> It now appears that, when surplus funds are saved or accumulated, whether by corporations or individuals, they go into the capital market and provide more facilities and produce more goods and provide more transportation than the

> people as a whole are able to buy; in other words, creating a situation where productive capacity gets out of balance with consumer buying-power, so that we have the paradoxical situation of an economy of abundance with millions of people out of work and idle factories and unused goods as the flow of money stops and slows up.

Finally, for those who were outraged by the bailout of Bear Stearns, AIG, Merrill Lynch, Fannie Mae, Freddie Mac, and others, this is what Eccles had to say in terms of why such actions need to be done during times of extreme financial dislocation:

> Thus the emphasis would be taken off the variable yardstick of fluctuating market values and put where it belongs: on true worth, measured over a longer period and by broader experience. At a time when the normal security and money markets are demoralized, the Reserve System is the only means whereby liquidity can be provided, because it can convert sound but temporarily unmarketable assets into money.[1]

I am struck by the parallels to what we were contending with during the Great Recession. Although I now see how Eccles analyzed the situation and responded, there were differences in how the monetary system was organized then versus now. The most important is that we are no longer on a fixed exchange rate regime. Today, the US dollar floats against most of the currencies of the world. I wanted to make sure that I understood to the best of my abilities how our system truly worked to make sure that I didn't automatically assume that, despite the parallels and similar policy responses in the 1930s, the system would respond in

1. Board of Governors of the Federal Reserve System, Eccles, Marriner S., and Federal Reserve Board, *Statements and Speeches of Marriner S. Eccles*, 1934–1951, https://fraser.stlouisfed.org/title/?id=446.

the same way if it had changed in meaningful ways. It was now time to turn to some modern-day wise men. These turned out to be Richard Koo and Warren Mosler (and a number of his disciples).

A lightbulb went off after reading Richard Koo's *Balance Sheet Recession*. It led me to realize that large deficits were nothing to fear in the midst of the Great Recession, but they were absolutely necessary in the face of massive deleveraging by households as a result of the housing crash and rapidly increasing unemployment. Koo utilized the sectoral balances approach created by Wayne Godley—a methodology that proves that investments and savings must equal each other in any economy.

There are four major sectors of the economy: households, businesses, government, and trade. Typically businesses and government are in deficit while households save, and trade is in deficit. During the housing boom, some of the traditional roles reversed. Households (the traditional savers) went into deficit, while corporations (the traditional spenders) began saving substantially. With corporations continuing to save, capital coming into the country via the capital account surplus, and households now needing to save due to the collapse of their largest asset (their homes), this left only one entity that could spend if the economy was to avoid a deflationary collapse. That entity was the federal government, especially since state governments were cutting back spending, along with households.

One of the important realizations that I came away with after reading Richard Koo's *Balance Sheet Recession* is that the only way to avoid a deflationary collapse in the economy was for the federal government to step in very aggressively and bring spending to the table when so many other parts of the economy were in a savings mode. And while some found this ideologically distasteful, it was important for me to begin to evaluate it in a dispassionate manner. I've found that ideology is an investor's biggest enemy, since it brings bias and inflexibility to the table at times when open-mindedness, flexibility, and creativity are needed to try and figure out what is going on.

Having realized that we were going to have trillion-dollar deficits as far as the eye could see, I then had the following questions to contend with for our business:

- Would this be good for the economy, and would it create an economic floor that would allow businesses to hire people?
- As people were hired, would new households be formed, and would they become renter households because the single-family home market was in such disarray?

Assuming the answers were yes, the name of the game would be renting, since that would allow for people to build their savings and their creditworthiness. It would allow them to have mobility and flexibility, not being tied down to an illiquid, expensive asset such that they couldn't move to where the new jobs were.

But from our standpoint, it was important for us to be able to keep answering the two most important questions that were easy to ask but not so easy to answer:

1. What's going to happen to my net operating income?
2. What's going to happen to my cost of capital?

The answers to my earlier questions led me to believe that the net operating income had a healthy future once the economy started to recover. New apartment construction was at fifty-year lows, and there was not going to be new development for a while. The demand fundamentals clearly favored apartments. And as previously discussed in the cap rates section, there was some historical precedent for cap rates being in the 5 to 6 percent range, despite many investors thinking they should be much higher due to the tremendous amount of uncertainty prevalent in the economy. This belief was also predicated on interest rates not rising. This was clearly a minority view, given the concerns that all of the federal spending and monetary stimulus would inevitably lead to inflation. But would it?

I can't overstate how important it was to get this right, because if one were fearful about rates rising, then one would be more conservative in the bids one would make to purchase properties, despite being bullish about NOI prospects. In addition, it would also influence borrowers to lock in longer-term, fixed-rate loans to take interest-rate risk off the table.

On the other hand, if one felt that rates would not only stay stable but also have a reasonable likelihood of dropping, then one could bid more aggressively for properties and utilize variable-rate financing to take advantage of the stable-to-declining rates; variable-rate loans are typically 1 to 2 percent lower at origination versus the prevailing fixed-rate loans. If this advantage not only remains in place but widens as rates drop, then this can generate significantly higher returns for leveraged investors, since a 1 to 2 percent per year difference can translate to 2 to 5 percent per year higher equity returns, depending on the leverage.

I often joke that I have three kids: Jacob, Ariella, and LIBOR (the London Interbank Offered Rate, a widely used benchmark for interest rates). I have been fascinated by the history of interest rates for a very long time, because it is such a critical part of generating excess returns or avoiding underperformance for real estate investors. The reflexive reaction of industry participants to only using fixed-rate debt has often produced returns quite a bit less than those willing to expose themselves to interest-rate risk via variable-rate loans. My research has shown that investors would have been far better off being variable over the last thirty years or so versus fixed, and that most people end up paying too much of an insurance premium for taking interest-rate risk off the table. They unknowingly have increased operational risk, because the higher debt service results in the requirement to have a higher level of revenue to break even. There is no free lunch.

I don't remember how, exactly, but after reading Koo's *Balance Sheet*

*Recession* I stumbled upon "Modern Monetary Theory" (MMT). It is an out-of-the-mainstream philosophy (or viewpoint, or theory) that explains how the monetary system works in today's modern, digital age. A few blogs and a couple of ebooks helped me get my arms around principles of Modern Monetary Theory, including *Pragmatic Capitalism*, *Mike Norman Economics*, *Mosler Economics*, and (to a lesser extent) *The Big Picture Blog* and *Naked Capitalism*. Warren Mosler is really the father of MMT—a brilliant, iconoclastic individual, a very successful investor, and author of two very important books: *Seven Deadly Innocent Frauds* and *Soft Currency Economics* (both of which I recommend).

As I began to research MMT, I started to think, "Wow, this has all the answers!" Yet there was so much hostility and anger from monetarists, Austrians, and free market fundamentalists about what the Federal Reserve was doing (versus what MMT said was needed). MMT predicates itself on the belief that once you have a fiat currency—a currency backed by absolutely nothing and supplied by a treasury or government that has a monopoly control over that currency—there is no obligation for it to be converted into another currency or commodity. That currency has value, because taxes (which are required to legally live in the society) have to be paid in that currency. Therefore the currency will always have value, and it can be used as a medium of exchange, because people will always need to get that currency to pay their taxes.

It is important to note that in this modern age, where spending is really managed by keystrokes on computers and is reduced to a string of electronic ones and zeros moving around the world, there's very little physical money actually circulating. So when the government writes a check to pay its workers or suppliers, it does not need to borrow or raise money from taxes in order to spend. It is hard for people to understand how money can be created apparently out of thin air, so they worry unnecessarily about, "Oh my gosh, how are we going to be able to fund this deficit?"

The reason why Treasury bonds and bills exist is essentially to give owners of those securities the ability to earn more interest by holding them for longer periods of time. The Treasury determines how much money it is going to raise in an offering not by how much it really needs to run the government, but by what it considers to be the right amount of reserves to have in the banking system. And it can clear those excess reserves by issuing Treasury securities.

So, basically, banks can take money that's sitting there earning barely more than zero percent interest (and is accessible at any time) and they can exchange those reserves for longer-term, guaranteed instruments at 2 or 3 percent for ten years. Treasury securities give them many options to choose from in order to meet their needs. So once again, it is more about reserve management than it is about the government needing taxes or borrowing to fund itself. It just enters keystrokes on the computer.

So what are taxes for, then, if not to fund the government? There are two major reasons for taxes:

1. To control inflation. If the economy is too hot, then taxation can be used to withdraw buying power from the economy.

2. To control savings (i.e., capital that is not being circulated). Tax policy can be utilized to discourage savings and encourage direct spending in areas of the economy that have a social good. I'm not here to comment on what's good or bad; just to explain the philosophy behind MMT.

## Dread the Fed

From our business point of view, it is important to know what this means for interest rates. Let's look at an analogy from Cullen Roche, the proprietor of Pragcap.com (Pragmatic Capitalism): "Imagine a dog on a leash. It can call the shots for a while if it wants to (and if the owner lets it). But if it strays too far, or gets too out of control, the owner can simply yank the leash and stop the dog dead in its tracks. And that's the Federal Reserve."

The Federal Reserve has absolute control over short-term interest rates. In fact, if the Fed did not intervene, then the excess reserves in the economy or in the banking system would be such that they would continuously be lent out at a short-term rate approaching zero. It's somewhat complicated to explain why, but that's what would happen. So the Fed intervenes (based on its policy objectives) to make short-term interest rates nonzero. I will expand on this in the chapter "Go Variable, Young Man."

For longer-term interest rates, this is where the leash analogy really comes in. Suppose the Fed has certain policy objectives to keep stable inflation in the context of full employment. It can use its bully pulpit to tell the market, "Look, this is where we want rates to be. You can go ahead and buy bonds and at higher yields, but we've got a pretty powerful tool (our money printing presses) to buy unlimited quantities of these bonds. So don't get too cocky, because we can move rates either lower or higher, or we can sell all these securities."

In a nutshell, the Fed can take action or merely threaten to take action based on its vastly superior buying power.

Putting all that together, I came to the conclusion that there was going to be no material movement in rates—particularly on a short-term basis. In fact, the Fed came out and said that they probably wouldn't move until unemployment is at 6.5 percent or below and the inflation rate is at 2.5 percent or below, and my own analysis convinced me that this wouldn't happen for a while.

While everyone was fearful of interest rates going higher and desperate to fix at a lower rate for the long term, I remembered that we had always gotten burned by following the consensus. In the past we found it very difficult to get out of ten-year loans when we saw very aggressive pricing for our assets or if interest rates fell, so after looking very carefully at the situation, I came to the conclusion that short-term interest rates were going to stay low for a very long period of time. We would be well compensated for borrowing on a variable-rate basis while others were borrowing on a fixed-rate basis. This strategy would allow us to go in with a starting rate advantage of at least 1.5 percent per year, assuming interest rates didn't move for a while. And we would have much greater flexibility to do something different with our debt or property after the first year.

This strategy paid off. LIBOR stayed in a very, very low range (between roughly twenty and thirty basis points) for a few years (and still is the case as of this writing). Meanwhile, fixed-rate loans were higher than the rates we were paying.

The following is adapted from a 2011 analysis that applied many of MMT's principles to what was taking place at the time. The long quoted excerpts that follow are from the book *Since Yesterday: The 1930s in America* by Frederick Allen Lewis. I found such striking parallels between then and now with regard to the economic, political, and social climate that it helped me greatly in terms of helping me to anticipate the Obama administration and Congress's reaction functions. The economic carnage and societal outrage in the aftermath of the outrageous lending decisions and business practices of the financial sector necessitated very aggressive government intervention via spending, regulation, and the pursuit of those who committed grievous offenses.

## A Political Calculation

> The economic system had pulled out of its sinking spell of 1929–33 only to become a chronic invalid whose temperature was lower now in the mornings but showed no signs of returning quickly to normal. Americans were getting used to the fact that nine or ten million of their fellow-countrymen were out of work. . . . The economic headquarters of the country had not only moved from Wall Street

> to Washington, but apparently had settled down there for an indefinite stay. . . . No major decision could any longer be made in Wall Street without the question being asked, "What will Washington say to this?"
>
> All this development of the Federal power the Republicans viewed with loud alarm; yet with such an air of inevitability did the growth take place that one wondered whether the Republicans, should they come to power, would be able to reverse the trend. It seemed likely that the difference between the two parties would be that one of them, in moving toward the concentration of power in Washington, would move with the throttle open; the other, with the brakes on . . . Surely, the visitor from Mars would have said, these parties which so denounce each other are virtually as Tweedledum and Tweedledee. . . . Bitterly the campaign progressed. Not since 1896, certainly, had public feeling run so high over an election. To hear angry Republicans and angry Democrats talking, one would have supposed the contest was between a tyrant determined to destroy private property, ambition, the Constitution, democracy, and civilization itself, and a dupe of Wall Street who would introduce a fascist dictatorship.

I was convinced in 2011 that all roads were leading to Washington, DC, as they did in the 1930s (and as Allen so eloquently described). With this being the case, it was important to have a sense of where things were headed, because most major industries, and especially housing, were going to be impacted by decisions coming out of the Capitol. From a CWS perspective, decisions regarding how the record postwar deficit was handled would have an indirect impact on the supply and demand for apartments and borrowing costs.

I will work backwards and tell you how I think the story would unfold from my 2011 vantage point and will then provide you with more details to support my assertions.

Here were the "givens" as of 2011:

1. The private sector was cutting its debt load, especially the financial sector.
2. Households needed to rebuild their savings.
3. Housing remained oversupplied as foreclosures continued to take place in large numbers.
4. Monetary policy was nearly impotent, with short-term interest rates at near 0 percent.
5. Inflation was very tame given global overcapacity, especially with regard to labor.
6. Tax rates were relatively moderate on a historical basis, so there was less impact from cutting them.
7. There were approximately 13.3 million people unemployed.

There was no choice but for the federal government to fill the hole created by the deleveraging (debt reduction) by issuing new Treasury securities (deficit spending) to prop up demand in the economy and to provide more savings (Treasury securities) to households.

I know this sounds heretical, but we had to come to terms with the fact that blood was being drained from the US economy by debt repayment and by a desire for more savings (which constitutes a leakage of spending out of the system). So the last thing we needed to do was apply leeches (tax increases) to the patient in order to drain more blood or reduce the flow of blood (cutting spending) when there was enormous savings and demand deficiency. The only way to shrink the deficit would be through growth, and we could not achieve growth through tax increases and spending cuts. Those could only occur down the road once

US households and consumers had rebuilt their balance sheets and had enough confidence to spend and invest. This would mean, in turn, that businesses could invest and hire, passing the baton from the public sector to the private sector. In the meantime, deficits would help keep demand more elevated in the US economy and provide additional savings (US Treasuries) to a savings-deficient household sector mired in overleveraged real estate, stagnant incomes, a weak job market, and tight credit. It would take many years to achieve the handoff to the private sector, and if we worried about the deficit we risked running into the same problem that FDR faced when he sought to balance the budget in 1937, which precipitated a terrible recession that gave up approximately 67 percent of the growth (in industrial production) that had been achieved in only nine months from the bottom of the Great Depression.

My concern about the effects of deleveraging on the American economy was echoed in early 2012 by one of the largest and most successful hedge fund firms, Bridgewater Associates. In a January 3, 2012, *Wall Street Journal* article about Bridgewater, the following points are conveyed which reinforce the deleveraging thesis:

> Robert Prince, co-chief investment officer at Bridgewater, and his managers at the world's biggest hedge fund firm are preparing for at least a decade of slow growth and high unemployment for the big, developed economies. Mr. Prince describes those economies—the US and Europe, in particular—as "zombies" and says they will remain that way until they work through their mountains of debt.
>
> "What you have is a picture of broken economic systems that are operating on life support," Mr. Prince says. "We're in a secular deleveraging that will probably take fifteen to twenty years to work through and we're just four years in."

> In Europe, "the debt crisis is [a] long ways from over," he says. The economic and financial morass will mean interest rates in the US and Europe will essentially be locked at zero for years.[2]

Yet, despite what I thought was the solution (i.e., keeping the spigot open) I didn't believe the political will existed to do this at the levels we needed. Austerity and deficit reduction seemed to be the publicly stated intentions of both political parties. If this truly came to pass, then I believed it would result in a more slow-growing economy than would otherwise be the case, and would also lead to continued low interest rates for many years to come. For this reason, a fair number of our more recent financing decisions had been to select variable-rate loans. This may seem odd, given how attractive fixed-rate loans were and that short-term interest rates had nowhere to go but higher. As stated earlier, however, there are some distinct advantages with variable-rate financing:

- There are much lower-cost prepayment penalties, providing us with greater flexibility in the event we want to sell or refinance the property.
- With fixed-rate loans we would require buyers to assume the financing, which lessens the buyer pool because most purchasers prefer to structure their own financing rather than having it forced on them.
- These loans also have conversion features that allow us to switch to a new, fixed-rate, longer-term loan if we think it makes sense at the time.
- There is typically a 1 to 2 percent starting rate advantage versus the prevailing fixed-rate alternative at the time the loan is

2. Tom Lauricella, "Bridgewater Takes Grim View of 2012," *Wall Street Journal*, Jan. 3, 2012, http://online.wsj.com/articles/SB10001424052970204368104577136531481564726.

> originated. We thought this advantage should remain in place for at least two years based on stated Federal Reserve policy of holding rates where they were through at least mid-2013. Indeed, this was the case, as we all now know.

What could move short-term rates higher? Albert Einstein said, "Everything should be made as simple as possible, but not simpler." In the spirit of Einstein, I think it simply comes down to jobs, and job growth is very difficult to generate when the private sector is deleveraging (cutting its debt burden). Based on my research, I realized that the economy had become much more "financialized." Whether we like it or not, we have been heavily dependent on Wall Street, and I think this is one of the reasons behind the 2011 Occupy Wall Street movement. When humans feel powerless and perceive themselves to be at the mercy of ignominious forces, they want to lash out and regain some sense of power, control, and dignity. There has also been a stunning and unprecedented drop in financial debt since 2008, as a result of the near-cataclysmic collapse in the global financial system that began with the subprime mortgage debacle that spread to housing, the stock market, high-yield debt, and finally Europe. Why is this important? Because the more "financialized" we have become, the more connected our job creation has been to the growth of debt in the financial sector.

When financial debt grows, the unemployment rate drops; and when it contracts, unemployment expands . . . until both exploded in opposite directions with the global financial meltdown that commenced in late 2007. Although the bleeding has stopped, if Prince of Bridgewater is correct, then we still have another ten years or so to go before the deleveraging ends.

## What Has Filled the Void?

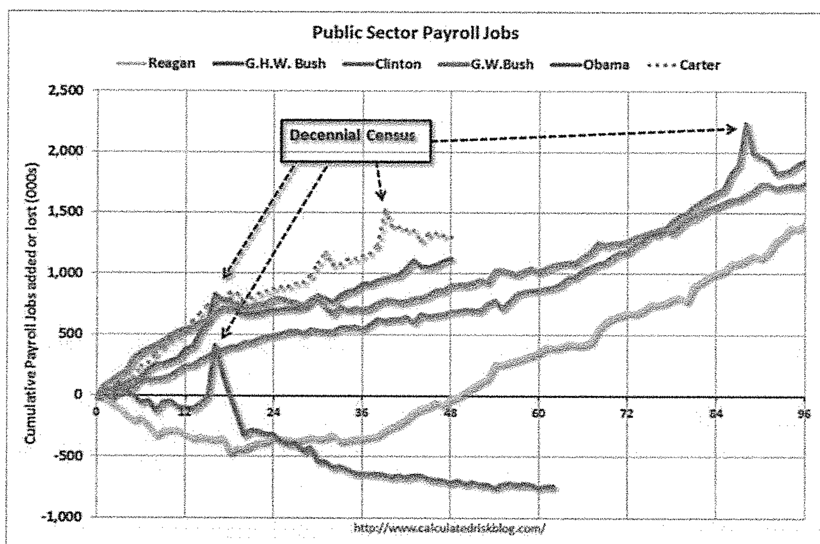
With such drastic debt reduction occurring in the private sector, something had to fill the void, lest we spin into a deflationary vortex of depression. This is where the federal government stepped in with unprecedented post–World War II spending. It is for this reason, as previously mentioned, that I began this chapter with excerpts from the extraordinary book *Since Yesterday: The 1930s in America*, as I believe there is no better parallel to today than what took place in the 1930s, which was preceded by the boom of the 1920s, akin to our 2000–2007 period. I attempt to look at the world as realistically as I can, I study history to find the best parallels, and I do my best to assess how things will unfold. My aim is to determine what we can best do to prosper from the circumstances (or to avoid the risks that may materialize). Earlier I stated that we needed to continue to keep the spending spigot on to avoid spiraling downward economically and, ultimately, socially.

It doesn't take a really keen observer to see that when unemployment goes down, so does federal government borrowing; and when unemployment goes up, so does federal government borrowing. This should convey to those worried about the deficit that the solution is simple: get people working again. More jobs mean more tax revenues, heightened economic activity, and less expenditure on unemployment insurance plus the other collateral costs of people being out of work (i.e., crime, health problems, psychological issues, and hunger).

In 2011 I asserted that we had a large deficit because of a jobs problem, and not the other way around. The only way to reduce the deficit was through economic growth and (this is where the analysis comes back to our borrowing strategy) low interest rates for a long period of time. Interest rates kept lower than the rate of economic growth would allow us to grow our economy much more rapidly than the rate of growth of our debt, while still allowing us to rack up huge deficits over the next five to ten years or so to cushion the blow of private sector deleveraging. By suppressing interest rates, the Federal Reserve could do its share to keep the cost of borrowing low for the federal government—so that it could carry out an orderly transition back to the private sector over the next decade, to once again become the engine of growth.

What about inflation? It was nothing to worry about given the tremendous excess capacity we had in the global economy, especially when it came to labor.

So what was I worried about and continue to be worried about today? Austerity! The following chart shows how much the Obama administration has cut public payrolls relative to other administrations. This has been something that has held the economy back more than would otherwise be the case if public payrolls had followed a similar trajectory as other presidents.




As apartment owners we would expect mild austerity to keep more people renting, to allow for interest rates to remain low, and to enable us to continue to increase rents provided there is not a meaningful increase in supply of new apartments. Overall, I am hard pressed to think of an industry as well positioned as ours to benefit from an environment of mild austerity.

I will sign off from this chapter with one more excerpt from *Since Yesterday*, to draw a parallel from the past that I think is still relevant today. It illustrates why large deficits will be with us for many years to come, whether we like it or not:

> Throughout these early years of the New Deal the levels of prices and wages and the structure of corporate and private debt were being artificially supported by government spending—or, to put it another way, by the failure of the government to levy high enough taxes to take care of the spending. If it had been possible for the law of supply and demand to work unhindered, prices and wages—and the volume of corporate and private debt—would theoretically have fallen to a "natural" level and activity could have been resumed again. But it was not possible for the law of supply and demand to work unhindered. In a complex twentieth-century economy, deflation was too painful to be endured. Hoover had set up the RFC because the banks couldn't take it; Roosevelt had set up the Federal relief system because human beings couldn't take it.