Demetri Kofinas: What's up everybody. Welcome to another episode of Hidden Forces, with me, Demetri Kofinas. Today we speak with Jim Grant. Jim is a legend of our financial newsletter industry. Born in the year in which interest rates made their mid-century lows, Jim seemed almost predestined for a life in finance. [00:00:30] A navy man, standing at six foot five, Jim is a giant on Wall Street. Once the editor of the Yield Column in Barron's, he would leave in 1983 to found Grants Interest Rate Observer. Two years after the risk free rate touched just under 20%, a level that seems nearly impossible to fathom in today's world of near zero, and even negative rates. Having observed, reported, and opined on markets for almost 50 years, Jim represents [00:01:00] a bastion of not only experience, but wisdom.

In this episode, we stop to listen. We stop to remember a time in which the extraordinary measures and unprecedented actions of our monetary and fiscal authorities would have seemed unimaginable. We take a hard look at money. How does the shadow of wealth find its value? How is the rate of interest determined, and what is the role of financial markets in facilitating the discovery [00:01:30] of that value? What happened in 2008, and what are the consequences realized, and yet to be discovered of those very extraordinary and unprecedented actions taken by governments around the world to douse the flames of the inflation, contain the contraction, and prevent the discovery of prices. What does the future hold in 2017?

What investments does one make, and where might one find value in these [00:02:00] oceans of uncertainty? As always, you can gain access to reading lists put together by me ahead of every episode by visiting the show's website at HiddenForces.io. Lastly, if you're listening to this show on iTunes or Android, make sure to subscribe. If you like the show, write us a review, and if you want a sneak peek into how the sausage is made, or for special storylines told through pictures and questions, then like us on Facebook, and follow [00:02:30] us on Twitter and Instagram at @hiddenforcespod.

And now, let's get right to this week's conversation.

So, Jim Grant. I am very excited to have you in my studio for the first time in four and a half years, it turns out.

James Grant: It's been that long?

Demetri Kofinas: Yes, it has. Not this studio, a different studio. In fact, you may not remember, the title ... So it was four and a half years ago that you were on a television show Capital Account. You may not [00:03:00] remember, or perhaps you do, the title of that episode.

James Grant: Refresh my memory, Demetri.

Demetri Kofinas: Honey, I Shrunk the Yield Curve. That episode was about a question that I had posed to you then, and to the audience as well, which was one of, not so much was the fed complicit in the low rate environment that we had and continue have, but the question was, was the fed the culprit prior to the crisis? In other words, was it the accommodated monetary [00:03:30] policy prior to 2008 that led to the boom of which the subsequent bust has created such perversely low rates, or is the fed today that is keeping the rates low? That's something that I will want to get into in this discussion, but I think I don't want to take our audience's knowledge for granted.

James Grant: Nor mine, I hope.

Demetri Kofinas: No, I'm not taking yours for granted. But the very first question that I have for you is let's do it top level here, which is interest rates. You are the publisher of Grant's Interest Rate Observer, you are also the [00:04:00] podcast host, I should mention of -

James Grant: To be sure.

Demetri Kofinas: ... which is pretty awesome.

James Grant: Well we all have, as you know, we all have a podcast. You have to have one.

Demetri Kofinas: It's the latest thing now.

James Grant: But you know, you're dating me, because I call my publication Grant's Interest Rate Observer. That was when we had interest rates, and I gotta tell you, they were fabulous. This was 1983, and within a year, of the founding of Grant's, you could, and some did, invest for 30 years in US Treasury securities, and earn almost 14% [00:04:30] for 25 of those 30 years guaranteed. Think about it.

Now, Demetri, so different of the times in which we live, that some people, some sentient human beings, with money are lending those mostly Euros, and some Yen, to sovereign governments deemed solvent through courtesy. They're lending these governments money, and paying the government for the privilege of taking their money for two or three or four years. Isn't that extraordinary. [00:05:00] Now you pay them now.

Demetri Kofinas: What are you talking? You're talking about negative interest rates. So let's talk about that. First of all, let's define it. You were the editor of the yields column at Barron's, correct?

James Grant: Yeah. Correct.

Demetri Kofinas: Then you started -

James Grant: Grant's.

Demetri Kofinas: Grant's Interest Rate Observer when interest rates still existed. These are things now that, there are children born today that have never seen an interest rate. Never seen an interest rate. So what is an interest rate? For those children, and for those coming of age, or even those who may have forgotten, because it's been a long time since we saw one, what is an interest rate?

James Grant: An interest rate is a cost of [00:05:30] borrowing, or of the pay for lending.

Demetri Kofinas: Or as you've said before, the price of money.

James Grant: The price of money is one way of looking at it. Interest rates, they are prices first and foremost, and they are arguably the most important prices in capitalism, certainly they are the most useful. For example, they're help to define risk. If someone pays a great deal to borrow, that person you can kind of assume, is not such a solid character financially.

[00:06:00] So interest rates help define risk. They also help to set investment hurdle rates, meaning that, you know, you feel you ought to earn something in excess of what we might call the risk free rate for taking the chance of building a plant, and manufacturing something in it. So interest rates help you define the level of profitability you want and you think you deserve for the risks you take in what you do to produce [00:06:30] something.

Then too, interest rates help you to understand the present value of future sums of money. That's called discount rate. How much is a dollar that you will receive in the year 2027 worth today, given the expectations you might have, inflation for example.

Another way of looking at rates is that they are the reward for thrift, for waiting. [00:07:00] We are impetuous we human beings, we like to have what we want, to have now, and if you choose to forgo that immediate pleasure and wait, the rate of interest might be seen as the reward for your lack of impetuosity. That's another way of looking, it's a moralistic way of looking at it.

It's funny that in this day and age of Amazon Prime and everything available at an instant, that interest rates are historically low. In fact, Demetri, I'm going to tell [00:07:30] you an astonishing fact.

Demetri Kofinas: What's that? I'm very ...

James Grant: Whether you want to hear it or not.

Demetri Kofinas: I do want to hear it.

James Grant: That is we live in a time of 5000 year firsts in the history of interest. Now interest has been a long established phenomenon, and there is a page turner called The History of Interest Rates.

Demetri Kofinas: Homer and Sylla.

James Grant: Dick Sylla is the still living coauthor, and I called up Dick, and I said, "Dick tell me, we have today negative interest rates in Europe and Japan and [00:08:00] you are an authority. You've written this book with Sydney Homer, and I've read many pages, though I confess not every single page. Tell me, have we ever before, in the recorded history of interest rates, seen a substantially negative long term interest rate?"

And he said, "No."

Demetri Kofinas: Never. Never in the history of interest rates.

James Grant: Yeah, interest rates, no?

Demetri Kofinas: Well it speaks to the expediency.

James Grant: Yeah. Yes, it was ... Well it speaks to something. I'm not sure ...

Demetri Kofinas: Well it's [00:08:30] interesting what you say, you said many interesting things. You identified many factors that go into the pricing of interest rates. One of which I find interesting and compelling, which is this notion of deferring towards the future the proceeds of today's output. The use of interest rates, the existence of interest rates motivates people to work more today than they would otherwise because they can reap the rewards of that work in the future, and so there is that component to interest rates.

James Grant: Well there's a big time element, isn't there? [00:09:00] Take today's little tiny midget interest rates, you can scarcely see them, you need very strong spectacles to make out today's interest rates. So what do they do?

Well they do two things perhaps. One is that they bring a consumption forward in time. You can, or you could, before lenders wised up, get a very cheap car loan and buy that ride you wanted today rather than wait a couple of years, because the terms and conditions were so compellingly favorable. [00:09:30] Interest to a degree stimulate, but they stimulate, arguably, not by creating something new, but by borrowing from the future.

Something else that very low interest rates do is a little subtler, and that is that they postpone the recognition of a failure in business. If you are kind of a marginal business and you are not quite making it, but almost making it, and you go [00:10:00] to your bank, and because rates are so low and because capital is so accessible, you borrow and prolong a life of an enterprise that otherwise would have gone out of business.

Think Radio Shack for example, the Onion some years ago in 2007 had a very funny piece, it was a fake interview with the then CEO of Radio Shack. The imaginary interviewer talked to the real, although imagined in this presence, CEO of Radio Shack. He said, "How do you stay in business?" [00:10:30] And the guy said, the CEO said, "You know I have no idea. How can we sell enough extension cords and strobe lights to stay in ... I have no idea how we do it. I wouldn't be sitting behind this desk in effect if I couldn't borrow the money to sustain the corporate life." So Radio Shack lived longer than it might have lived in a time of higher rates.

A friend of mine likens meaty, substantial interest rates to kind of a shot clock in basketball. You know way back when in the early 50's, there was no shot clock, and in [00:11:00] the early NBA would stage games that ended in like 15 to 12, like an adult game of keep away. People could pass the ball back and forth, the audience would either fall asleep or leave at half time and TV ratings plummeted, so they put in a shot clock to force action. And substantially real, meaning above the rate of inflation interest rates, by imposing a cost on borrowing, that's a real cost on borrowing by attaching a real value to money, I [00:11:30] say force economic action.

In that sense the very very low rates may not at all be stimulating, but rather depressing.

Demetri Kofinas: Well we're going to talk about that, because you actually had a ... You've mentioned this before but there's an article that I came across ahead of this interview in the National Review where you talk about this sort of paradox, and I think it's relevant to our discussion, especially in the context of this question that I want to get to which is ... We're talking about what interest rates are, interest rates are the price of money, they're the cost of credit. [00:12:00] Prior to the federal reserve, they existed, and they existed long since as you mentioned with Homer and Sylla. They've existed for centuries. It's not something that depends on a central bank to exist.

Let me ask you this question, and this will bring us to the question of what is the fed and what is the role of central banking. How were interest rates set prior to central banks?

James Grant: Well David Ricardo, the great early 19th century economist had a theory that interest rates really existed just as you [00:12:30] said Demetri, independently of central bank action "rates," said Ricardo, "were a reflection of the profitability of enterprise, and the more profitable business was, the higher the rate of interest that willing borrowers would pay, because it paid to borrow. Notice that, said Ricardo, that rate of interest established in the market is a reflection of the profitability of capital. Had nothing to do with the rate that the central bank charged` [00:13:00] an overnight loan, or a week long or 90 day long. This was an economic fact independent of pure monetary considerations.

Demetri Kofinas: The price of credit was the price like everything else, and it was something that banks could extend, and the extension of the credit was part of the process through which the price of credit was determined, which was the interest rate.

James Grant: Right, correct. All correct.

Demetri Kofinas: And so in this world of central banking, since 1913 until 2008, although it's gone through iterations, [00:13:30] there was a sort of a way in which interest rates were set. That has traditionally been open market operations, which is the Federal Reserve. Correct me if I'm wrong there.

James Grant: Well no, again, to borrow from the eminent late David Ricardo, rates were really never, said he, and I think I tend to agree, never exactly set, except in a very isolated part of the money market by central banks. They were set by human beings transacting, deciding what was a fair rate, what the market would [00:14:00] bear.

Now, the fed came into existence as you say in 1913, so the United States was around a long time before the coming of our central bank, and rates then were set ... The price of apples were set to a degree.

Demetri Kofinas: Were they set right away when the fed came into operation in 1914? Did they immediately ...

James Grant: No. Open market operations came soon after -

Demetri Kofinas: Soon after.

James Grant: ... the fed was founded, not immediately. If I remember correctly, I was just a trainee at the time, Demetri, [00:14:30] but if I remember correctly, open market considerations came into being because the fed needed to make money to turn on the lights and pay the help.

Demetri Kofinas: Interesting.

James Grant: They were a way of earning money for the central bank, which was then rather more independent of the government than it has since become.

Demetri Kofinas: Well it was a question that, I mean, the rationale behind the setting of interest rates is something that has always perplexed me, it's something that I've investigated in at least one interview with a former vice president of the Federal Reserve, and he was not able to give [00:15:00] me a clear answer as to why the fed needs to set interest rates, but in order to move to this point, which has to do with the mechanics of interest rates setting, sort of the traditional way that we know that the fed sets the fed funds rate, which is the risk free rates, the rate at which basically banks can lend overnight, or borrow overnight, is through something known as open market operations, which is the fed basically coming in and out of the market as need be in order to adjust the supply of money accordingly in order to make sure that [00:15:30] rates fluctuate within a certain level that they deem to be ideal, or whatever is that they've set. Is that a fair ...

James Grant: Yes, that is entirely correct.

Demetri Kofinas: Of course there has been an evolution in that, there's been forward guidance and all these other tools, these Federal Reserve tools that they've developed, but certainly since 2008 the entire model has gone out the window. The entire fed funds market has changed. Banks have ... You've talked about this at Grant's, the amount of excess reserves on bank balance sheets is [00:16:00] even more astounding to see then just the expansion of the fed balance sheet. The excess reserves, I think, have gone from roughly 1 billion to 2.2 trillion or something like that. My question really is, how do we think of interest rates today? And when I say again interest rates, I do mean the fed funds rate, which is sort of the risk rate, the foundational rate in the market?

James Grant: Well I think the way to think about rates today perhaps is to compare them with rates as they existed in the money [00:16:30] market before the advent of the fed. 105 years ago or so, before that came into existence, people would trade money market balances of the New York stock exchange as they traded common stocks. There was a post, the New York stock exchange, a money post in which people would buy and sell short term balances. That rate was very volatile. It varied according [00:17:00] to the season, it varied according to the business cycle. It was more or less a free market rate. That was then.

So today, the Federal Reserve is in the business of establishing short term money market interest rates to advance some national interest as the fed itself defines that interest. The fed is in the business to promote full employment. It's in the business to establish price stability so called in the business [00:17:30] to promote prosperity. It thinks it can do that by manipulation of one or more rates of interest. That's its essential remit.

I think thoughtful people are going to wonder why the interest rates of prices, why they should be controlled where we don't control other prices, and we have in fact in modern American history, attempted to control all prices. We did so in 1971 [00:18:00] and 1972 under the Nixon administration. Nixon imposed wage price control, a very radical step that I think is pretty universally now regarded as a pratfall, as a failure.

The question hangs in the air, Demetri, is why people persist in assuming without examining this assumption that it's a good thing to control interest rates. I'm not sure it is. I think that what we want is kind of free range farm to table [00:18:30] organic interest rates, not the hot house supermarket variety of government manipulated ones. So when I'm president of the United States, and ...

Demetri Kofinas: Or chairman of the fed.

James Grant: Or chairman of the fed, whichever comes first, I will agitate for organic interest rates we'll call them just to get the green people on board too.

Demetri Kofinas: I know this is, again, what you're best at Jim, and I think what people love to hear from you is to sort of sermonize in a way on interest rates. But you also at Grant's cover a lot of the minutia [00:19:00] in the way that the system is today. One of the things that's in the news that's now been talked about for a long time has been this notion of unwinding this balance sheet. Now, one of the ways I think about the fed balance sheet is that it's a visual representation of the financial crisis. On that balance sheet you can see the actions the fed took in 2008. You can see sort of the failures of the financial system. We've been carrying those assets on that balance sheet since 2008.

James Grant: Well to back [00:19:30] up a step or two, a balance sheet is a representation of what an entity owns and what it owes. So the fed is a bank, that's its genus and species I guess, it's a bank, the central bank, and it's balance sheets shows assets and liabilities conventionally. The assets comprise mostly treasury obligations, debt emissions of the federal government. Notes, bonds, mortgages, the like. [00:20:00] Liabilities, what it owes, well it's dollar bills, Federal Reserve notes, and deposits of banks at the fed. Those are what the fed owes others.

Now when you think about a Federal Reserve note, is that liability, what's that ... You wonder what ... Whose liability is it, it's a piece of paper, what?

Demetri Kofinas: Talking about dollars basically.

James Grant: Yeah. This is a little bit of historical echo, [00:20:30] if I reserve note, a note is promise to pay, it's a debt obligation, right? So it comes from the Federal Reserve, and it comes from the bank notes of yesteryear. A bank note was a claim on something tangible, namely on something itself. A note was a promise to pay money. What was money? Well, money was gold and silver.

So the Federal Reserve note today is the expression of the historical evolution of money from something [00:21:00] that was grounded in a tangible thing, was itself a tangible thing, money was gold, into today where money is increasingly dematerialized. You know, bitcoin, a private sector's own invention, is something you can't see, touch, heft, smell. It exists in the cloud or wherever such things exist. It's a digital expression of somebody's idea of wealth and scarcity. It's a very interesting proposition, the nature [00:21:30] of money.

But the fed's balance sheet is, just as you say, very well is a pictorial representation of the crisis. It's growth certainly is a representation of the crisis; the nature of the materials is an expression of what we all accept to be money and debt.

Demetri Kofinas: Interchangeably so in today's world.

James Grant: Yes, yeah. Well in times past, the money and debt were very separate things. Money was, as I say, people say that gold backed the dollar. No, gold didn't back [00:22:00] the dollar. Gold was the dollar. Silver was the dollar. A given number of ounces or of units of precious metal was in fact money itself. That of course has changed over the past hundred years gradually, and by degree, until you demonetized everything really except for the power of the state.

Demetri Kofinas: This is a great philosophical conversation, and it's something that I think people ought to reflect on, [00:22:30] but I'm very curious about this question about the unwinding of the balance sheet, and I bring it up why? Because we've been told that we shouldn't be concerned about the actions the fed took. If you look at the Federal Reserve balance sheet, since basically from the founding of the fed to today, to 2008, those balances have grown, but they've grown gradually with the rate of inflation and with the growth of the economy. We never saw anything like 2008, and we've been told that, yeah sure it's not something [00:23:00] that they've had to deal with before, but it's not rocket science, we shouldn't worry about the normalization of the balance sheet.

You guys have done some work at Grant's looking at this, thinking about how the feds going to go about doing it. We've heard things like caps. We know the fed pays interest on excess reserves, that goes into this whole bundle, but what is your view? Have you think at all about how the fed is going to manage this if ...

James Grant: Yeah of course. Some years ago in 2009 maybe or in [00:23:30] the early days of what we call quantitative easing, that being a fancy phrase for a really materializing dollar bills or the digital expression of dollar bills out of thin air. Fed does this in a way, we can talk about it if you like, but at the start of this program, this unprecedented program of monetary materialization ... Prestidigitation, magic making. At the start of this, Ben Bernanke, the fed chairman, got on 60 Minutes, and [00:24:00] the correspondent asked him, "Can you reverse this? Can you stop this?" It's like the sorcerer's apprentice. Are you sure that this can be stopped? He said, "Oh, certainly, we can reverse this all in 15 minutes."

Well it turns out that they really can't reverse this in 15 minutes. It's been, my time does fly, let's see 2007 was the start of our troubles, and this is 2017, that's 10 years of temporary emergency stimulus, the fed's balance [00:24:30] sheet now stands at 4.2 trillion in the day before the crisis struck, before we recognized rather, the crisis. It was what, 800 billion or so.

Demetri Kofinas: I think it's even four or five, isn't it? I think it's even more than that. What's a few extra, 300 bill.

James Grant: You have to keep up Demetri, 4.2 I think you'll find.

Demetri Kofinas: Oh is it?

James Grant: Yes.

Demetri Kofinas: Well you would know better than I. You certainly would know better than I.

James Grant: Well, somebody is going to check and my face will be red with embarrassment. What do you say we compromise, we'll call 4.35 trillion?

Demetri Kofinas: [00:25:00] What's that between friends, nothing, no problem.

James Grant: Somebody wrote something in the Wall Street Journal, I guess a while ago, reminding us we should not bat around the term trillion so glibly, a trillion being a thousand billion, which to borrow from Jake LaMotta, the middleweight champion, it's lot of money even when you say it fast.

But so the fed buys these bonds, had been buying them, or did buy them over the years in quantitative easing as [00:25:30] the program was called. Now how's the fed buy bonds? That's the place to begin. Well it buys them by creating the means with which to do it. If you and I want to go out and buy, oh say around a million dollars' worth of treasury notes that will pay us interest and sustain us in our mellow golden years, we have to get the money somewhere. We have to borrow or have saved it or steal it or something. We have to come up with the money ourselves.

Now the fed, that [00:26:00] being the central bank, is not so constrained. It created the money literally through the tapping of the key on a computer keypad. It credits the account of the seller of a bond, it says, "All right. We'll take the bond and here is the payment. We credit your account at our bank with $1 million." Tick-tick-tick. Just tick I guess.

That's the end of the transaction, that's how the [00:26:30] fed makes money. We should all be so talented at money making.

Demetri Kofinas: It does that to its broker dealers.

James Grant: Yes, through it's so called primary dealers.

Demetri Kofinas: Primary dealers.

James Grant: Yes, right. So the feds been doing that lo these many years, all these many temporary years, and it had accumulated from a standing start of what we say, 800 billion or so, a balance sheet well in excess of $4 trillion. Meaning it owns assets to the tune of more than $4 trillion.

So what do we do now? Well, it ought to, it thinks ... [00:27:00] Before we leave this sum of money, Demetri, we should might reflect on the capital that is supporting these massive assets, right? If a person seeks to go out and start a bank and acquire a lot of loans, you need what they call a cushion. You need something to absorb loss in case you miscalculate.

You typically these days, they insist, the regulators, that you have at [00:27:30] least 10 or 12, better still, $15 of capital for every $100 worth of assets. That's considered presentable. Well the fed, the fed being immune, exempt from many of these regulations that proletarians are subject to, goes out and buys securities without regard. It scarcely owns any capital, just tiny sliver of capital. In fact, part of its capital went to finance the latest highway bill a year or two ago.

Demetri Kofinas: [00:28:00] You're talking about the remits the treasury.

James Grant: Yes, well, the remits. It's earnings the treasury, but it contributed to the treasury under the act of Congress, it contributed a portion of its capital to finance highway construction. So the fed is a bank that presents the ugliest thing in finance since Medusa or something. The fed's balance sheet is a fright.

Demetri Kofinas: It's the ultimate zombie bank.

James Grant: Yeah, well, if it were a bank in competition in the real marketplace it would not be allowed to exist, that's true.

Demetri Kofinas: It would be a death [00:28:30] star.

James Grant: Yeah. Well maybe it is a death star, well said.

So how does it shrink? Well it shrinks, it would shrink if it wanted to shrink, by selling these bonds it accumulates. Or a little less, you take its time and just let them mature. Then it gets the money and it remits that money to the treasury. But notice when it does, the treasury must still borrow, and someone must buy the bonds the treasury issued, because the treasury, we call it the department of treasury Demetri, but actually we should call it the department of the debt, because there's no treasure [00:29:00] in the treasury. Not enough.

So the treasury is going to continue to borrow, and who is going to buy these bonds if not the fed? That's the question.

Demetri Kofinas: That's a great question. That actually brings us to, I don't mean to interrupt you, it brings us to a very important question, which is exactly that. If the fed were to leave, if the fed were to go away, to stop, which is what you're getting at, what would happen to the bond market?

James Grant: The bond market would continue. The bond market existed to antedated the feds, certainly, and will follow [00:29:30] the fed when the fed makes its long awaited and well deserved exit from this planet. Bonds will find buyers, but not necessarily at prevailing, very high prices. It's like everything else. I see her in the dress business, and this metaphor's going to get quickly strained, but you are making very, very fancy dresses, and you wonder what's going to happen to the dress market when you stop supporting the price of these garments through very, very [00:30:00] imaginative and persuasive advertising? Well what's going to happen? What's going to happen to this overhead supply of frocks, is the price of a frock is going to fall, right?

So there's too many dresses in proportion to the evident demand, well the excess isn't going to get burnt, or it's not going to vanish. It will get sold, but not at the hoped for prevailing price of yesteryear. It's going to get sold in a lower price. [00:30:30] Same way with bonds, I think that ... So interest rates, meaning -

Demetri Kofinas: That's the inverse relationship with between the price of a bond and its yield.

James Grant: Right, so if the price of a bond falls, that means that the interest you earned, the buyer, the safer, goes up.

Demetri Kofinas: Right, on newly issued debt.

James Grant: Right, and because you can make a deal with already existing debt to equalize interest rates across new and aged securities. All rates will go up if the fed exists and ceases buying,

Demetri Kofinas: [00:31:00] What do you think of the proposition that, absent a Federal Reserve, an economic crisis and contraction would be so extensive that even a highly indebted government running annual deficits would be considered a safe haven. Treasuries would be considered a safe have, and therefore yields would actually go down. The price of bonds would go up were the fed to just literally, let's say just blow up tomorrow.

James Grant: Well [00:31:30] we can't know, and we can't, or shouldn't dogmatize about hypothetical propositions like this, though we certainly should think about them. It seems to me that if the fed were out of business, and if there were a crisis, the people would, as they have in the past, regard the treasury as a relatively safe port in the storm. Perhaps the safest port among many ports in the storm.

The United States treasury, [00:32:00] it's evidently indestructible, try as we might. The credit of the United States is a very well founded. Not necessarily on account of the prudence or the foresight of the managers of a given political administration, because of the nature of this country. It's a great country. It's an enterprising country. It's a rich country. Many assets to sell yet. Many taxes to levy yet.

I am a forever [00:32:30] habitual, and perhaps someone repetitive critic of our monetary arrangements and of our physical arrangements, but there's no gain in saying the success of the treasury of the dollar bill itself. The dollar is the world's great currency. It's the Coca-Cola of monetary brands as we've said before. It's a pretty great brand. Try as we might to debase it, the world still wants more.

Demetri Kofinas: I think about it in the context of Japan, I mean that's the one before this interview I was trying to think about [00:33:00] and look and see and draw comparisons between the United States post 2008 and the Japanese post 1989, and I was also of course thinking, looking forward, China. Perhaps some other countries around the world that might be in that position, but no country seems to be in a position similar to China.

And so what I was thinking about -

James Grant: And thank goodness by the way.

Demetri Kofinas: It's pretty terrifying, actually.

James Grant: Yes.

Demetri Kofinas: You seem to have views on China. I heard a wise man once say once [00:33:30] that the further one is from China the more authoritative he or she sounds.

James Grant: Oh yes, well no. Expertise is reversely proportional to the distance of the authority to the subject being scrutinized. That goes without saying Demetri. But we can read income statements and balance sheets, even those produced in the far, far east.

China's debt is twice as big as its output and it's growing twice as fast, and never before seen have been the financial shenanigans that are going on in the People's [00:34:00] Republic of China. That's a fact, and that is not a fact based on fake expertise, those are simple arithmetic.

Demetri Kofinas: Tell us a little bit about those facts for those in our audience who aren't familiar.

James Grant: Well China is, what do they say, it's a thing. Within the borders of China is the greatest derangement of debt ever, and that incorporates the excesses [00:34:30] of Japan in the 1980s, it incorporates our own flights of fiscal fancy here. There's nothing like what is going on in Japan. Never has been. Sorry, in China, Japan was another one.

What do I mean? I mean that the recklessness of the lending and borrowing, the deceit and the lack of transparency of those debts, [00:35:00] the shear rapacity of the speculation, of the promoters of speculation, is historical for its time.

Demetri Kofinas: Well the Chinese, unlike the United States and unlike any other country I've looked at, even other countries like Australia or Canada, had a hiccup in credit creation, in credit growth after 2008. In China, it went parabolic. So their response to the crisis, because they have such a strong control of their banking system, was to generate more credit. Extend credit and push [00:35:30] economic growth forward.

James Grant: Well yes. So the Chinese seem bound and determined to fly in the face of every single received tenant of prudence and safe dealing in banking and lending and borrowing. Banking being a subset of lending and borrowing of course.

For example, it has been an ancient principle of banking that real estate is a very poor asset. Why? Because it is illiquid, it's difficult [00:36:00] to realize, they say. It's hard to sell in a pinch. American banking regulations prohibited banks from accepting real estate collateral starting in the 1860s when those regulations were first written.

Unwritten regulations and usages, in Britain, which got a headstart in modern finance also frowned upon real estate and mortgages as suitable banking assets. America has loosened those structures. So has Britain. Often, we've [00:36:30] done this to our pain and to our loss. In China, the heresy of real estate as a banking asset is not a heresy, it's considered best practice.

Demetri Kofinas: There's a bias towards, not even just a bias is what you're saying, it is -

James Grant: Real estate is the collateral par excellence in China of debt. People have come to accept the very dubious proposition that real estate, no matter what it might [00:37:00] yield, no matter how it might be priced, is a failed proof conservator of long term wealth. That is the belief that is infused the Chinese people.

So empty blocks of apartments rise up into the air, and the collateral is thought to be fine, and liquid. It's not. It's not fine, it's not liquid, and it is going to have a very [00:37:30] bad end.

Demetri Kofinas: When you look around the world, is China sort of top on your list for a possible source of the next crisis? I understand very much, I mean it's very much in the line of grants in the way you write, and the way you think to be very prudent and to not make prognostications, I understand without question.

James Grant: Well that's not so much prudence as it's self -

Demetri Kofinas: Experience.

James Grant: It's self-knowledge. Well no. Let me say by way of preface in consumer product warning, [00:38:00] that we do tend to be early, and got garish on excesses in Japan I think starting in ... We coined the phrase Nipponomania, and I think it was not at the top. I think it was many years before that.

So yes, we do expect a very noisy and scary and costly denouement in China. When? I have no idea.

Demetri Kofinas: And of course China is a very different situation than Japan insofar as the Japanese market was more market [00:38:30] oriented than the Chinese market. Insofar as the Chine banking sector, I mean.

James Grant: Well and China seems to have consolidated or seems to have combined the worst facets of regulated capitalism and communist micromanagement.

Demetri Kofinas: So in light of this discussion around potential sort of pitfalls, we were talking a little bit about the balance sheet, the unwinding of the balance sheet. There are many pitfalls there. There are pitfalls of course in China with the debt. One of the [00:39:00] asset classes that Grant's talks about often is gold. It's something that you've spoken about often, we've spoke about it now in the philosophical sense of its role as money and ... What do you say in your newsletter, and how do you think about gold's role as an investment and as a speculation, and what are you really speculating against when you own gold, because I know your bullish on it, and you've been bullish on it for some time.

James Grant: Yeah. Well gold is a very poor investment in the nature of it. It is money. It yields nothing. It's sterile. [00:39:30] It looks good. We all know people like that, doesn't say much. Looks good. Gold is, I think I've said this perhaps to you personally Demetri, certainly I've said it before, the price of gold, I see as the reciprocal of the world's faith in central banking. It's the opposite, or it's the other side of the coin of trust.

I once was in a small company [00:40:00] with Paul Volcker who proceeded to reflect on the curious faith that people vest in a piece of paper stamped full faith and credit, notes payable on satisfaction of debts public and private, whatever it says in the fine print of a dollar bill, people don't read that much more than they read the directions that come on an aspirin bottle, but people accept without a great deal of thought or analysis that [00:40:30] these pieces of paper, this dematerialized entry in your bank account, somehow it has an innate value. Why is that? Where does that value come from? Does it come from the stamp of the government? If the Trump administration stamps a piece of paper valuable, is everyone going to accept that? Is that self-evidently valuable?

Well, the world collectively has come, in think a remarkable degree to accept that very proposition, whether you're in France, whether you're in Japan, whether [00:41:00] you're in Brazil. People accept the value that is said to be present in government issues pieces of paper called currency. So the gold competes against that, gold being the legacy form of money, being the form of money that antedated all of these pieces of paper, that has shown itself, gold, has shown an ability over the years, the decade, the centuries, even the millennia to hold purchasing power. [00:41:30] Gold competes in the marketplace of ideas and of monetary preference against these pieces of paper. Also now competes against cryptocurrencies, things like bitcoin.

Gold has given a very, very mixed account of itself since the year 2011. It peaked at, I forget now.

Demetri Kofinas: Just under, I'm sorry, just under 2000.

James Grant: Right. 2000, under $2000 an ounce, and now it's 1260 or something. [00:42:00] The dollar bill has lost about 99.99% of its value against gold since the start of the fed in the year 1913, or effectively 1914. Gold has stood up well against any currency, but the people want performance in the here and now, and they want things that appreciate in value, and gold has not given them that satisfaction. I own it, I own the metal itself, I own the mining shares, and my strategy, [00:42:30] Demetri, is not to look at it now, because I think successfully finally persuaded myself that this is something for ...

I am investing in what I take to be, what I believe to be, an almost inevitable historical outcome. Now that's a very big fancy statement to make, but I'm investing, not speculating, I'm investing in the disappointment attending every single experiment in paper money [00:43:00] down through the ages, and I'm investing in my expectation of the failure of the most radical experiment in paper money ever seen, almost imagined.

Demetri Kofinas: Another way to say it, is besides the idea that you're shorting central banks essentially, but your bullish on gold insofar bearish on paper currency.

James Grant: Right, I am bullish on gold because it is a play against what is going on in central banks of the world.

Demetri Kofinas: And of course that is [00:43:30] not absent the policies of the central banks. In other words -

James Grant: Well it's very much about the policies essentially. But I'm also making another bet, I'm betting, by the way this word bet annoys me because I wrote in one of my books about speculating in Bernard and Baruch, that Baruch describes them, he was the presence of the august JP Morgan, and Morgan and Baruch were discussing a proposed venture capital deal, and [00:44:00] Baruch was speaking rather glibly in the presence of this giant of Wall Street, said that he would, and Morgan would contribute this, and he Baruch would bet, and Morgan stiffened, and said, "I never bet," and the interview was over.

So bet, I said bet. I shouldn't have said it Demetri, but I did say it, and I guess I'll stand by it. So what I'm betting on also, apart from the failure of these, I think, cockamamie central bank policies, I'm betting on [00:44:30] other people besides myself and two or three good friends and my grown children espousing the same idea and acting on it, and that is a very different thing. I'm betting that people who are so used to dematerialized money, they have no idea what gold is. I'm not blaming you Demetri, but I notice you have that annoying millennial look about you of youth and health.

And I'm betting that people who were not around when gold was last treated as money, that was August [00:45:00] 14, 1971, that those people too will come to see in this ancient monetary element, a store a value that is not on offer from the governments of the world.

Demetri Kofinas: I mean is it a fair assumption for me to make that, in order for that to happen, there needs to be a currency crisis?

James Grant: Yes, there does. There needs to be a currency crisis, and I think there also needs to be a demonstrated failure of the attempt by central banks to manipulate stock markets [00:45:30] and bond markets and real estate markets, and I say manipulate with ... precisely, the central banks, especially the fed, have been manipulating expectations of higher asset prices. They have used these expectations to levitate asset values to support the expansion and economic activity that we have been struggling to achieve lo these almost ten years.

[00:46:00] So this was the program that Bernanke fed to get the stock market going, get real estate markets going, get people investing, and watching their assets appreciate, and thereby inspired and emboldened people to go out and spend money.

Demetri Kofinas: The wealth effect idea.

James Grant: We used to call it trickle down, now we call it the wealth effect.

Demetri Kofinas: But in fact there can be a perverse substantiation of that. You've talked about it, I alluded to it earlier I believe. One example, simply put, is that low interest rates [00:46:30] and high levels of private debt are actually can drive many sane people to want to save more and spend less.

James Grant: Yes, yes, and they can, and too much debt can throttle business activity, it can suffocate it, which is the burden of servicing debt. Look, in the case of the United States government, interest rates, I think that the treasury is paying what, 2% or less on average for its borrowings, [00:47:00] you know down from nine or ten eons ago it seems. But if interest rates returned to the long-term average in this country's called 6%, the treasury will be paying interest on that substantial immense debts that would rival now the budget of the defense department.

Demetri Kofinas: Can you imagine that happening though within the context of having a Federal Reserve that is separate from the treasury, or would we need to see some kind of radical political shift where the Federal Reserve is sort of ingested [00:47:30] by the treasury. It comes under the treasury, and ...

James Grant: I have lived long enough to rule out nothing in markets. The idea of the 6% interest rate on 10 year treasury now seems impossible, doesn't it? It seems as if it were outside the realm of literal impossibility, but it existed in the past 15 years.

Demetri Kofinas: Early 90's for sure.

James Grant: There was a 14% treasury yield as recently as the spring of 1984, and a 10% treasury [00:48:00] yield as recently as the summer of 1987. This is not ancient history.

Demetri Kofinas: But that would be catastrophic for the government.

James Grant: Well it would be inexpedient. It wouldn't be catastrophic. And just because it's inexpedient doesn't mean it can't happen. People say, "Well that can't happen." Well, it would be better if it didn't happen, but how many things happen despite their being ...

So how might that happen?

Demetri Kofinas: Basically I want to know what does Jim Grant think, does Jim Grant have some [00:48:30] scenario or two that he considers to be, that he's imagined and thought about, the thought that maybe this, without quantifying it, is more probable than some other scenario. Is there something?

James Grant: Let me tell you a short story about how interest rates have, in the past, tended to move in time. Unlike any other asset market I know, interest rates trend, or have tended to trend, over the course of a generation. They fell [00:49:00] for the 35 or so years following the civil war in this country, they rose from 1900 and 1920 they fell to 1946, that was a quarter century, they rose slowly at first, then fast, then seemingly as if they would never ever stop rising, they rose from 1946, 1981, it was 35 years, and they have fallen, and laterally have gone sideways in the 35 or 36, [00:49:30] or whatever it's been since 1981.

What has characterized the movement of rates in the past has been a very gradual shift as the direction has kind of almost in the geological times we know, it seems as though the plates have shifted. Rates have moved up slowly, or down slowly. They tend not to spike, at least the beginning. It took, in this long, long trending [00:50:00] 35 year bearer marketed bonds, meaning bond prices went down, meaning interest rates went up. It took interest rates 10 years to move from 2.5% to 3.5%. 10 years. Not to say that's going to go the same way this time, but ...

So when I say that 6% is not impossible, it's unlikely, than all of sudden. But you know we live in a world of wonders and who knows, people have forgotten all about inflation. Governments the world over think nothing [00:50:30] of running big deficits and printing lots of money. Maybe, maybe, you know the unscripted inflation that will cause rates to move more suddenly than we have been accustomed to, imagine they could move.

Demetri Kofinas: But one way or the other, what you're essentially suggesting is that rates will continue to move, and budget deficits will continue to grow, and they will be enabled through the central banks and so ultimately this will not be a crisis of nominal budget deficits declining and government [00:51:00] cutting back nominal spending, but then in fact there will be inflation.

James Grant: I don't know that. I mean I wish you would have talked to me about 35 years ago, I knew everything was going to happen next week.

Demetri Kofinas: We have a great story that you have, I love seeing stuff that you say, Jim, or watching videos of yours. You have that great story of you in 1981, or what it 1982 when you waited in line to buy a few ounces of gold, and the lesson you learned, I love this, you said, "I learned a lesson," I'm paraphrasing you here, which was, "Never wait in line to buy anything."

James Grant: [00:51:30] Oh yes. Everyone must know this. I am happy to serve as the index case of waiting in line. It might have been, this is perhaps a little bit too evidence of personal conceit, but I like to think that I made the top in the gold market in 1980. Was January 1980 that the gold price peaked at about $850 an ounce, and it went parabolic, even as bitcoin has recently gone parabolic, it was like $400 an ounce, and the fall of 1980 ... [00:52:00] 79, and it almost doubled in the succeeding three or four months, extraordinary run.

People began to impute causation to this, they went to interpret it. Well, the gold market must know something, it must mean something. It must mean, for example, that currencies are soon to be entirely worthless. Gold wouldn't be going up except for a well-considered belief that ... Markets know things, right? They discount [00:52:30] the future.

So okay, so people had to buy gold. It became a must-do, and there were queues outside the Nicholas Deak, D-E-A-K, it was a coin dealer in lower Manhattan. And I chump fashion stood in that line, not thinking that the thing to do was to stand in no line, and to buy bonds, which, see ... In the spring of 1980 they passed 10% in yield. So they were not quite at 10, but [00:53:00] they were at 9. So you could have locked in 9%. By the way, 9% bond was ...

Demetri Kofinas: Was a 30 years?

James Grant: Yeah.

Demetri Kofinas: Wow.

James Grant: Would have seemed a very poor bargain, because by the time September 1981 rolled around, that same bond was trading well now, 70s, or ... Anyway, the yields were 15%, no 9%.

So there are any number of possible ways to make a fool of oneself in the market, but the best way, the best way, is to do what everyone else does, [00:53:30] and the most certain way of knowing that you are where you're not supposed to be is to find yourself physically in a queue to buy a hot asset.

And Demetri, I did it.

Demetri Kofinas: Well, okay, Jim, so before we wrap up, I wanted to also ask you, besides gold, which is something that you've written and spoken about for a very long time, Grant's, your newsletter, does investigate alternative investment opportunities. You look for [00:54:00] places where you might be able to get a return that is above zero.

James Grant: Right. That's how greedy we are. But we try to do in the spirit of not standing in line, we, to change the metaphor, we run toward fires.

Demetri Kofinas: You want to be right later, which I've heard you also say.

James Grant: Ah yes. This is a wonderful mumbo by Joe Robillard, who said, "Successful investing is about everyone agreeing with you later."

Demetri Kofinas: I also like this other one [00:54:30] that you said ...

James Grant: Let me flesh this out.

Demetri Kofinas: Sure, sure.

James Grant: So we wrote about Turkey in a favorable light earlier this year because the problems were well ventilated, the risks were evident, and the bargains we thought we more than compensating for the true risk associated with that very troubled country. We similarly looked at Russia during, when it was even more out of favor than it is now, we looked at a bank called Sberbank, which is a terrifically well run institution that [00:55:00] was being sold hand over fist to a few ardent buyers, the sellers were ardent. Because oil was going down because Russia was kind of a nation built around a big gas station, and people thought Russia was going out of business.

These are the things, we try to look for opportunities where others see risk principle. We tried to look at risk where others see a sure thing. So that's the plan, Demetri.

Demetri Kofinas: [00:55:30] The quote I was going to say is, the other one I've heard you say, which is, "I certainly don't ever want to find myself saying I used to be rich."

James Grant: That's a line I borrow from a friend of mine who is the wealth management business at Brown Brothers Harriman.

Demetri Kofinas: Old firm.

James Grant: Old firm, and still a general charter ship.

Demetri Kofinas: George Bush's press cup, Bush I think.

James Grant: Yes. A friend told this story, think it was a young banker there, and some Texan came in with a lot of dough and said just what you said. "Son, [00:56:00] saddest words of the language, I used to be rich."

I can think of seven words actually, but points survives the exaggeration.

Demetri Kofinas: So Jim, I really appreciate having you on, I know I didn't know exactly I wanted to do this, because every time we've have a conversation on air it's always been about sort of the philosophy of interest rates. I knew we had more time, and I wanted to try and see if we could give some people some actionable intelligence, and maybe also prod you on some other things. It was my attempt to do that, but it was really wonderful having you on, I certainly enjoyed it. I think you're a very funny guy. [00:56:30] I've actually mentioned to our audience before how wonderful your conferences are, and you actually have one coming up!

James Grant: Oh! Well.

Demetri Kofinas: Great opportunity!

James Grant: Yes, they're all the best one ever, but the one coming up on October 10th is going to feature the conversation between me and Alan Greenspan.

Demetri Kofinas: A certain Alan Greenspan.

James Grant: Yeah. I'll ask him how he looks back at his time on the fed, and what he makes of the institution of paper money, and what he thinks of the world of bitcoin and like that.

Demetri Kofinas: That's fascinating. I'm [00:57:00] very excited for that. I actually had Sebastian Mallaby on this program a few episodes ago.

James Grant: Ah!

Demetri Kofinas: Yes. The entire episode was devoted to Alan Greenspan. We covered his 1969 speech to the American Statistical Association where he talked about the wealth effect and asset price bubbles. So we explored the Alan Greenspan that existed prior to the Nixon campaigns, and the Ford, and everything else. It is fascinating, is a very fascinating individual to study and I'm very jealous that you have the very [00:57:30] fair opportunity to interview him. That's going to be very excited.

How long are you going to have him there? Are you going to have him in chains? Is he going to be locked down? How are going to keep him there?

James Grant: I'm going to get my money's worth.

Demetri Kofinas: That's exciting. All right, so Jim, thank you for coming on, I really do appreciate it.

James Grant: Right. You are entirely welcome. I'm always happy in your company, Demetri, whether it's theatrical or ...

Demetri Kofinas: That's right, you came to was it 12th Night you came to, or Midsummer Night's Dream?

James Grant: Midsummer Night's Dream.

Demetri Kofinas: You came to Midsummer Night's Dream. I really appreciated that.

James Grant: Not sure if your listeners appreciate the fact that [00:58:00] you are a theatrical presence as well as a journalistic one.

Demetri Kofinas: I appreciate you very much, that's very kind of you, and it was great seeing you there as well, so thank you so much for coming on.

James Grant: You can't see it, listeners, but we shook hands. I'm going to shake hands with the engineer too, watch this. Okay.

Demetri Kofinas: All right, thank you so much.

And that was my episode with Jim Grant. I want to thank Jim for being on my program. Today's episode was produced by me, and edited by Stylianos Nicolaou. [00:58:30] For more episodes, you can check out our website at HiddenForces.io. Join the conversation on Facebook, Twitter, and Instagram at @hiddenforcespod, or send me an email.

Thanks for listening, and see you next week.