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Economic Pathology, Six Cases

by Don Paarlberg

Physicians focus on human ailments; apparently the healthy human body has limited interest for them. When a patient sees a doctor, the doctor's question, voiced or implicit, is "What's your problem?"

Economists, on the other hand, generally assume a healthy economy. They abstract from forces alien to their own discipline, such as psychology, politics, ethics, and sociology. They postulate an ideal system, with everything explained by supply and demand. They assume an equilibrating model, with natural forces correcting any deviations from normal. Their postulate is that the market is always right. In effect, they assume an economy with a temperature reading of 98.6 degrees, and no broken bones.

Institutional economists, a dissident group of which I am one, constitute perhaps 5 percent of the members of the economic profession. They admit the various social sciences, including psychology, into their system. They reject the assumption that the prevailing state of the economy is that of good health. They lack precision but they excel in relevance. They would rather be roughly right than rigorously wrong.

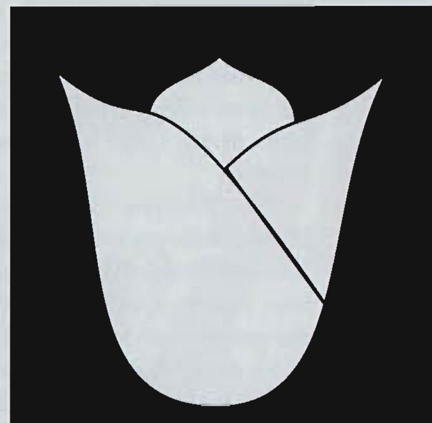
Some people collect stamps. Others collect buttons or old cars or cut glass. I collect cases of economic pathology, the deviant market behavior that confounds the mainstream economist's assumption of equilibrium. I cite six such cases:

- The tulip mania in the Netherlands in 1634.
- Financial speculation in France during John Law's inflation, 1716 to 1720.
- Charles Ponzi's pyramid scheme of 1920.
- The Florida land boom of the mid twenties.
- The Great Depression of the 1930s.
- The Jerusalem artichoke ripoff in the Midwest, 1981 to 1983.

Tulip mania

In the 17th century, the Dutch people went bonkers, to use a modern phrase, over tulip bulbs. Prices rose and speculation was rampant. The rarest specimens sold for thousands of florins, and soon the madness spread throughout the country. Prices continued to rise, leading to anticipation of further increases. As the tulip frenzy mounted and other economic activities slowed, estates were mortgaged to permit the owners to participate in the constant rise in the price of tulip bulbs; new buying power pushed prices yet higher. In a day when barter was still a large element in exchange, a "Viceroy" bulb sold for an assortment of oxen, pigs, sheep, rye, wheat, wine, beer, butter, cheese, and house furnishings. A "Semper Augustus" bulb (with vertical red and white stripes over a bluish inner hue) sold for about as much as the Viceroy, in cash plus a carriage and horses.

A Dutch shoemaker finally succeeded in producing the specimen most sought of all, a black tulip. He sold his treasure to a grower from Haarlem for 1,500 florins. Immediately the buyer dropped the bulb to the floor and stamped on it, reducing it to a pulp. The Haarlem grower had produced a black tulip of his own and wanted no competition. Monopolizing the market was as attractive then as now.

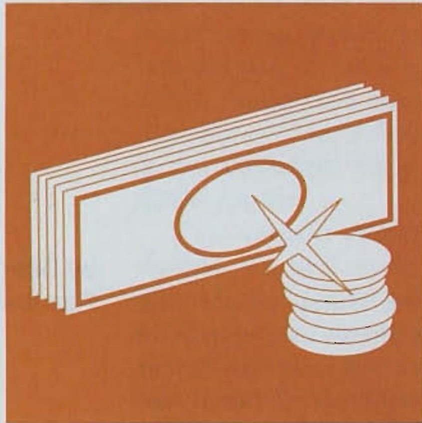


The reckoning finally came when anticipation of further price increases collapsed. Psychology was the dominant element. Great families were ruined, fine old merchant firms were thrown down, and it was years before commercial

life in Holland recovered. After a flight of fantasy, the market again became rational. It was like a return to earth after being in orbit. Pathology gave way to rationality.

John Law's inflation

John Law, originally from Scotland, is said to be the father of paper money, but this is a dubious label. Like the litter of a vagrant dog, paper money has many fathers.



In 1716, John Law established a Banque Générale in France with a capital stock of 6 million livres, the stock bearing 4 percent interest. The bank was authorized to make loans, to receive money on deposit, to discount commercial paper, and to issue paper notes that were redeemable in gold on demand.

The Banque Générale helped the government meet its debts and thus demonstrated the utility of a paper currency. John Law's reputation was mightily enhanced. Throughout France, people dressed like him and sought to emulate his manner. Had he stopped at that point, he would have been celebrated rather than reviled by history. But this success was not enough for him.

In 1719, the Banque Générale organized under its auspices a colonization company named the Companie des Indes Occidentales. Its capital was increased nineteen fold. The company obtained from the Crown a grant of the Province of Louisiana which, it claimed, was rich with gold, silver, and precious stones. Actually, the subsoil of Louisiana consisted not of gold, silver, or diamonds, but of soggy mud. The good people of France were reluctant to colonize this alleged El Dorado; the courts sentenced prostitutes, beggars, and criminals to Louisiana. One wonders whether Jean Laffite, the notorious scoundrel celebrated by the New Orleans Mardi Gras, had these people among his ancestors.

The Banque Générale became the Banque Royale, with enormous windfall profits to the stockholders. Dividends were promised at 12 percent, later raised to an incredible 40 percent. Law faced the problem of how to pay dividends on the stock of his unproductive company. He solved this problem with the revenues obtained by trebling the sale of stock to new buyers, a ploy used by Charles Ponzi 200 years later.

Then, in 1720, Law's bank put into circulation one billion livres of paper money, nine times the amount of the year before. Shares in his bank rose in price to forty times their normal level. Shares were bought on margin; a buyer could put up as little as 10 percent of the cost and had twenty months to pay off the balance. Shares could be sold within a month, before any payments came due. A waiter made 30 million livres; a chimney sweep made 40 million livres during his lunch hour.

John Law was famous. He was made the first (and only) Duc de Arkansas. His religious beliefs were negotiable; he converted from the Protestant to the Catholic faith to qualify himself for a cabinet position.

The collapse came for no other reason than that it could not continue. Any speculation that is based on an anticipation of further price increases rather than on the earning power of the asset is ultimately doomed to failure. Those who watch the price advance of their favorite stock in the New York Market instead of examining the price/earnings ratio may do well to take notice.

In 1720, the Prince of Conti sent a huge bundle of notes to the bank to be redeemed in hard currency. The redemption was made but seriously depleted the gold reserve. Confidence was weakened. There was a rush to redeem paper notes. On one night in July 1720, 15,000 frantic people were tightly wedged in the Rue Vivienne, trying to exchange their paper for gold. Sixteen people died of suffocation.

By the autumn of 1720, both paper currency and stock certificates had become worthless. Excess notes were publicly burned, leading the sardonic Voltaire to comment, "Paper currency has now been restored to its intrinsic value."

A ditty of the day portrays the lot of one speculator:

My shares which on Monday I bought
Were worth millions on Tuesday I thought.
So on Wednesday I chose my abode;
In my carriage on Thursday I rode;

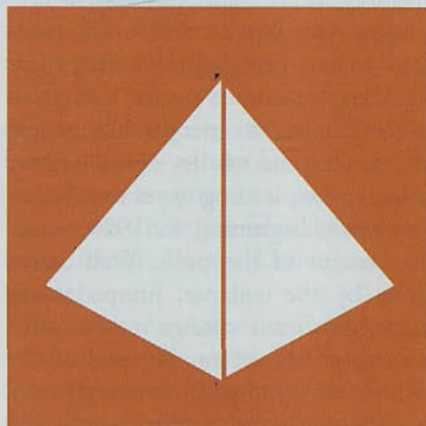
The collapse came for no other reason than that it could not continue. Any speculation that is based on an anticipation of further price increases rather than on the earning power of the asset is ultimately doomed to failure.

To the ballroom on Friday I went;
To the workhouse next day I was sent.

On October 10, 1720, the French government formally marked the end of John Law's experiment. It declared that, as of the beginning of November, the use of gold and silver would be resumed in all commercial transactions. Notes stopped circulating, coins came out of hiding, and by December the country had returned to a specie basis. When the bad money was banished, the good money replaced it. France took the cure and replaced economic pathology with economic health.

Charles Ponzi's pyramid scheme

The preceding cases of economic pathology reflected aberration of the market system; those who exploited this system had their ethical flaws but generally were not outright crooks. Now for the case of an outright crook—Charles Ponzi.



Ponzi was born in Italy with the name Bianchi and eventually migrated to the United States. He started as a con man in a firm that helped his fellow Italians transmit their American earnings to loved ones in Napoli and Palermo. Some of his transfers have not arrived to this day.

Then came a rubber-check episode, and a prison term for forging signatures. Following his time in prison, Ponzi learned that he could buy up, for nearly nothing, International Postal Reply coupons from some benighted country whose currency had collapsed, the coupons being redeemable in postage stamps in some strong-currency country. He could wholesale the stamps to business firms at a discount.

The first step was to form a seemingly solid firm, which he did, naming it the Securities and Exchange Company. Actually, his firm was a facade. The International Postal Reply coupons provided a front for Ponzi's pyramid scheme. There never were enough of these International Postal Reply coupons to fuel Ponzi's financial empire. The public was offered an attractive deal: hand over your cash to the company and after ninety days you get back your original stake plus 40 percent interest, allegedly the profit from Ponzi's resale of his bogus coupons.

Soon the word got around and business boomed. Cash flowed in. Ponzi's Securities and Exchange Company lifted its rate of return on ninety-day notes to 100 percent. How did he do it? Just as John Law did with his bank shares; the inflow of new money permitted the repayment of the customers' cash outlay plus payment of the fabulous interest rate.

But the Massachusetts State Banking Commission finally closed down the Hanover Trust, the bank on which Ponzi had been writing his checks. And the *Post* dug out Ponzi's earlier career, the aliases, the disappearing transfers, the bum-check episode, and the stretch in jail. The auditors revealed that the whole operation was absurd. Ponzi's Securities and Exchange Company was at least $3 million in the red. The roof fell in. Ponzi was confronted with the charge of using the mails to defraud, with conspiracy, grand larceny, bankruptcy, and civil suits. Again, Ponzi went to jail.

What have we here? A story of financial chicanery? A tale of public culpability? A pattern for other potential crooks? A record of the ultimate triumph of justice? As in a multiple-choice question, it is all of the above.

The Florida land boom of the 1920s

During the mid twenties came the Florida land boom. Miami, Miami Beach, Coral Gables, the East Coast as far north as Palm Beach, and cities over on the Gulf side were all struck by a speculative bubble. Florida land was divided into building lots and sold for 10 percent down payment. Most buyers did not expect to build and live on the lots they bought; they intended to resell at a higher price. And for a time, prices worked themselves higher.

What was loosely called seashore was in fact five, ten, or fifteen miles from the Atlantic. Charles Ponzi, mentioned earlier, developed a subdivision, near Jacksonville, approximately sixty-five miles west of the city. Bare lots within forty miles of Miami were sold for as much as $100,000 in today's money. Bona fide seashore sites, at today's price level, brought from $140,000 to half a million dollars. These prices were for the site alone, bought to resell rather than to build on.

In a little-known chapter of his life, William Jennings Bryan, the Great Commoner, was for a

time enlisted in the task of selling what amounted to swampland.

By the spring of 1926, the supply of new buyers had begun to fail. In the autumn of 1926, two hurricanes struck. The worst of the two killed 400 people, tore the roofs from thousands of homes, and piled tons of water and elegant yachts into the streets of Miami.

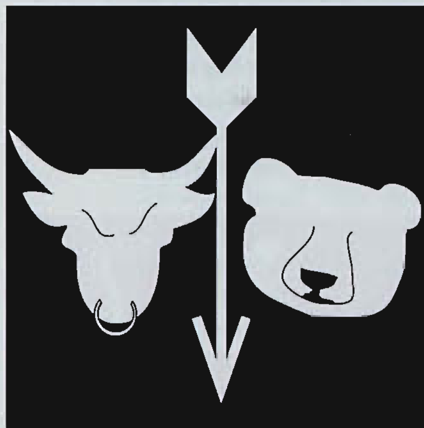
The end had come. By 1928, bank clearings in Miami fell to 13 percent of their 1925 level. Farmers who had sold their land at handsome prices had witnessed its resale for double, triple, or quadruple the price at which they had sold. Some of these farmers got their land back through a whole chain of subsequent defaults. Sometimes reclaimed property was equipped with eloquently named but useless streets having sidewalks and street lamps, with taxes and assessments amounting to several times its current value.

Analyzing the market by looking only at the variables specified by mainstream economic theory is like analyzing love by taking into account only hormonal secretions.

Is the market always right, as my economics professor told me fifty years ago? Does it give proper signals as to how resources should be produced and consumed? I once believed so, and in most cases it does. It is when the mainstream economic theory fails to function that the institutional economist becomes concerned.

The Great Depression

No other event so shook the confidence of mainstream economists and the public as did the Great Depression. This enormous catastrophe was not foreseen, nor was there any accepted explanation of it, nor was there an agreed corrective.



Traditional economic theory had postulated an economic order that was equilibrating; it was thought to have natural shock absorbers. Economic oscillations, it was believed, served a useful purpose. Whereas prosperity and its attendant inflation were thought to provide incentives for launching needed new enterprises, deflation and recession purportedly shook out inefficient enterprises and improved the economic health of the country. In this analysis, nothing special was to be done during a downturn; it was the system's way of pruning off the inefficient. The 1929 to 1932 downturn, however, broke through the constraints that were supposed to confine it. The economy plunged into something like a freefall, defying conventional economic theory.

During the 1920s, the New York stock market had been moving upward, an increase unwarranted by economic behavior, an increase based on anticipation of further increases.

The onset of the Great Depression is usually dated from Black Thursday, October 24, 1929. The price of stocks began to decline, bringing the anticipation of further decline. People dumped stocks, leading to margin calls. Rather than pay the margin calls, people sold more stocks, driving the market down farther, uncovering stop-loss orders, leading to yet more sales. During the three years beginning in 1929, stock prices fell to 16 percent of the peak. Wall Street speculators, ruined by the collapse, jumped from skyscraper windows. For some strange reason, public interest was sharply focused on the level of the window from which they jumped. Seemingly, the greater the stress, the higher the window.

Santayana tells us that "those who cannot remember the past are condemned to repeat it."

I have personally tabulated forty-three different published explanations for the Great Depression, each of which was sufficiently credible to be brought into print by a reputable publisher. My own view is that when pressure came, the jerry-built credit structure collapsed like a house of cards, and the economy with it. The supply of money fell by one-third. The crying need was for more money to lubricate the wheels of trade; when money is lacking, trade grinds to a halt. But members of the Federal Reserve System, worried about inflation, willingly allowed the money supply to shrink. What we really needed was a syndicate of several thousand counterfeiters scattered throughout the country, each turning out some millions of dollars in paper currency to make up for the deficit caused by the collapse of the financial system. There were indeed some counterfeiters who were thrown in jail, a triumph of law over economics.

Under the pressure of a faulted credit system, the money supply shrank, prices fell, farms failed, factories shut down, jobs disappeared, foreign trade dwindled, banks went into receivership, mortgages

were foreclosed, bankruptcies multiplied, equities vanished, tax revenues shriveled, and the incumbent administration was voted out of office. I was in my twenties during this terrible decade, farming in northern Indiana. The events are indelibly etched in my memory.

The Great Depression dragged on for ten years, with alternative revival and retreat, until it was halted by the insatiable demands of World War II. War, itself a form of pathology, replaced the pathology of the Depression.

The Jerusalem artichoke ripoff

The Jerusalem artichoke is neither an artichoke nor is it from Jerusalem. How it got its name is a mystery. It has long been a troublesome weed growing as tall as a man and producing gnarled tubers which have the appearance of small hand grenades.

A decade ago, there came a surge of interest in some new farm crop to supplement those midwestern staples, corn and soybeans. Jerusalem artichokes were put forward as the fulfillment of this need. Allegedly, they could be used as a feed, a food, a source of alcohol for energy, and a sugar crop. Promoting the new crop were three professedly born-again Christians from the upper Midwest, Fred Hendrickson, James Dwire, and the Rev. L.D. Kramer.

In 1981, the American Energy Farming Systems of Marshall, Minnesota, formed by these three men, began promoting the crop. Involved were religious zeal, flawed science, bombastic hype, and plain chicanery, in approximately equal portions. Fantastic profits were indicated, up to 100 times the gross revenue that could be expected from growing corn. A thousand farmers attended a promotional meeting at Marshall. Farmers participated by signing a binding contract to purchase 1,000 pounds of seed stock per acre from the company at $1.20 a pound, making an outlay for seed alone that came to 100 times the per-acre cost of seed corn. The company signed a nonbinding contract to buy the crop at an unbelievably high price. For a few of the early farmer participants, these fabulous returns were in fact realized. There was no commercial market for Jerusalem artichokes; the purchased crop was intended for sale as seed stock to be sold to more farmers, to be planted and sold for the production of more seed stock, to be sold to yet more farmers for planting yet more acres. Such enthusiasm for a crop for which no commercial use existed attests to the occasional ascendancy of psychology over economics.

Nationwide, from thirty states and several Canadian provinces, thousands of farmers paid millions of dollars to get in on the plan. In Indiana alone, eighty-nine farmers paid an average of a thousand dollars apiece. The plan was a rerun of the Ponzi pyramid scheme. Hendrickson, Dwire, and Kramer systematically milked the company for personal gain. The firm lasted three crop years and then collapsed. Fred Hendrickson, former vice–president and secretary of the company, was sentenced to six months in jail land was fined $200,000. Dwire also was jailed for six months. Kramer, the most crafty of the three, was found guilty of theft and theft by swindle. All three were reduced to poverty and disgrace. Farmers received no compensation for their losses; the company had been drained dry.

When the company broke, the existing stock of tubers was offered commercially, but the alleged market for food, feed, alcohol, and sugar proved to be nonexistent.

The visible reminder of the episode is some volunteer Jerusalem artichokes which escaped the ill-fated harvest, persisting as weeds in the corn and soybean fields that regained the acreage from the artichokes.

Lessons

What can be learned from this recital of six broken dreams? Have we learned a lesson? Will markets henceforward deport themselves in a rational manner? Can psychological excesses be purged out of the economy? Santayana tells us that "those who cannot remember the past are condemned to repeat it." So long as greed and culpability are part of the human makeup, we are likely to repeat these aberrations. We can only recall the old adage: "If it seems too good to be true, it probably is." C

■ For more information

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