Wealth Creation, or a Ponzi Scheme?

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Last week the Good Lord evidently realized that not enough people had been reading Hyman Minsky's explanation of how financial cycles end in Ponzi schemes – the stage in which banks keep the boom going by lending their customers the money to pay interest and thus avoid default. So He sent Bernie Madoff to dominate the news for a week and give the mass media an opportunity to familiarize newspaper readers and TV watchers with just how Ponzi Schemes work. What Mr. Madoff did was, in a nutshell, what the economy as a whole has been doing under the moniker "wealth creation."

If the media were able to wait until as late in the financial collapse as last week to provide helpful diagrams about how Ponzi schemes need to keep on growing exponentially, it is simply because bad foreign financial news is not deemed newsworthy in North America. But Europe has been having its own run-throughs, headed by Spain – which by no coincidence is now experiencing the biggest real estate bust outside of the post-Soviet economies.

The best case study occurred two years ago. On May 9, 2006, Spanish police raided 21 homes and offices of Afinsa Fienes Tangibles SA, the world's largest postage-stamp dealer, and rival firm, Forum Filatélico. They charged eleven men with running a $6.4 billion pyramid scheme that took in some 343,000 investors – 1 percent of Spain's entire population, making the fraud one of the largest in Spanish history.[1]

An economy either is in trouble or has lost its sense of balance when investors shy away from tangible capital formation in favor of buying postage stamps and similar collectibles. Unlike machinery and technology, stamps do not produce real goods and services. They have long since been printed and sold by the government, and will never be used actually to mail letters. However, stamps have shown themselves to be a great vehicle to attract savers who think that buying them can produce an exponential earnings growth – or more technically, "capital" gains, if we can stretch economic terminology far enough to call a stamp collection "capital."

If value resulted merely from scarcity, then postage stamps, coins and master paintings all would seem to increase almost automatically over time, just like most land does. But these trophies of wealth do not promote rising production, consumption or living standards. As stamps do not earn money by employing labor to produce goods and services, their price gains are neither profit nor capital gains as classically understood. They are what economists call a windfall.

The Spanish postage-stamp scheme seems to have taken off in 2003, the year in which Spain's free-market conservative government deregulated public insurance and oversight for non-financial investment funds. Afinsa Group bought two-thirds control of the New Jersey stamp and coin auction house Greg Manning and merged it with the Spanish auctioneer

Auctentia to create Escala as the world's third largest auction house (after Sotheby's and Christie's). Escala moved its operations to New York City and listed its stock on the Nasdaq over-the-counter market. Despite the stock market's lethargic trend, the company's earnings showed such rapid growth that in just three years its share price soared from under $5 to $35, tripling in 2005 alone.

Afinsa's purchases accounted for 70 percent of Escala's profits, thanks largely to the fact that as its Spanish parent's sole supplier, Escala marked up its stamps by a reported 1,150 percent, out of all proportion to the usual 25 percent. Afinsa thus was carrying stamps for which it paid 58 million euros on its books at €723 million, over ten times their catalog values – which are fictitiously high in any case, being published mainly for the benefit of stamp dealers to give their customers the idea that they are getting a good buy. But as Forum Filatélico's chairman, Francisco Briones, explained to a reporter from London's Financial Times: "It was 'normal' to charge clients such inflated prices because of the services provided . . . including the custody and conservation of stamps."

Afinsa paid its stamp investors an annual rate of 6 to 10 percent interest, beating most competing yields as the global financial bubble was pushing interest rates steadily downward. (Spanish government bonds paid only 3.5 percent.) To build up trust, Afinsa gave its clients post-dated checks for the gains that were promised. It also promised to buy back the stamps it sold, at the original price. This gave an appearance of liquidity to the normally illiquid market in stamps, fine arts and other collectibles, where 25 percent commissions to auction houses are normal. These ploys convinced the majority to simply re-invest the money to buy yet more stamps, which the company held in its offices ostensibly for safekeeping and preservation.

Money poured in, giving stock-market investors in Escala much higher returns than the stamp-buying customers nominally were receiving. As one news report remarked, why buy stamps and coins when you can invest in companies dealing in them?[2] But within a week of the arrests, Escala's stock plunged below $4 a share.

The denouement came shortly after Lloyd's of London withdrew from a €1.2 billion policy to insure Afinsa's stamps. One of its experts noticed that if $6 billion really had been invested, it would have bought up all the investment-grade stamps in the world many times over. The fact that stamp prices did not reflect any such extraordinary buying implied that few bona fide stamp transactions occurred at all, and there had been a massive over-billing.

As matters turned out, most of Afinsa's stamps had no investment value. This explained why there were no receipts for transactions with Escala. The police found €10 million in €500 banknotes (worth about $650 each at the exchange rate of $1.30 per euro) by breaking open a newly plastered wall at the Madrid home of Afinsa's main stamp supplier, Francisco Guijarro. What they could not find were any receipts for the stamps that he allegedly bought. And despite the remarkably high markups charged for curating the stamp collection, it was rife with phonies, as Lloyd's had suspected. Concluding that the bills Senor Guijarro had sent to Afinsa were just a cover for a money laundering operation, the prosecutors charged the family members and officers who controlled Afinsa with embezzlement, money laundering, tax evasion, fraudulent bankruptcy, breach of trust and forgery.

The arrests recalled memories of a more famous U.S. fraud involving postage stamps some 86 years earlier, in 1920, by Charles Ponzi – the man who bequeathed his name to history in the form of Ponzi pyramid scheme. He is reported to have arrived in Boston in 1903 with only $2.50. Not speaking much English, he took menial jobs. Fired as a waiter for shortchanging customers, he moved up to Montreal and became an assistant teller in an Italian immigrant bank. It grew rapidly by paying double the normal 3 percent rate of interest on savings accounts, but failed when its real estate loans began to go bad. The bank's attempt to give the impression of solvency seems to have given Ponzi the idea of paying interest out of new deposit inflows rather than actual earnings.[3] As long as clients felt they were receiving interest regularly, they tended to be calm about the principal balance.

Ponzi was sent to a Canadian prison for forgery, and then was jailed in Atlanta for trying to smuggle Italian immigrants into the United States. After his release he moved back to Boston and got a job selling business catalogs. A Spanish customer sent him a postal reply coupon, which allowed its holder to buy stamps in foreign countries for return mail rather than using domestic currency to buy a stamp.

Prices for these coupons were long out of date, having been set in 1907 by the International Postal Union. World War I drastically shifted exchange rates, enabling buyers to pay a small amount in Britain – or even less in Germany with its depreciated currency – and obtain a return stamp order that was good in the United States.

The markup on these tiny postal orders was large. An American penny could buy foreign stamp orders that could be converted into six cents in U.S. stamps, for a 500 percent profit. The problem was that it would take a truckload of such postal orders to make serious money. A million-dollar investment would involve a hundred million penny coupons – which then would have to be converted into stamps and sold in competition with the U.S. Post Office, presumably at a discount, mainly in immigrant neighborhoods.

Focusing on the principle of arbitrage rather than such laborious implementation, Ponzi explained that he could make a 400 percent gain after expenses. He promised that investors could double their money in 90 days, pretending to take due account of the costs and shipping time from Europe to America. When his Securities Exchange Company paid early investors the high returns he had described, they spread the word to others. Ponzi's inflow of funds rose from $5,000 in February 1920 to $30,000 in March, and $420,000 by May. By July an estimated $250,000 a day was flowing into his firm, mainly from small investors who let their book credits build up rather than taking out their money. Some people put their life savings into the plan, and even borrowed against their homes.

Ponzi spent most of the money on himself, buying a mansion and bringing his mother over from Italy. The financial reporter Clarence Barron (publisher of Barron's) noted that if he really had invested the money as he told his investors he had done, Ponzi would have had to purchase 160 million postal reply coupons. Yet the post office reported that few were being bought at home or abroad, and only 27,000 were circulating in the United States.

Federal agents raided Ponzi's offices in August, but did not find any postal reply coupons, just as Spanish police did not find investment-grade postage stamps in the scheme's 2006 replay. Ponzi was sentenced to prison yet again, but jumped bail and tried to make some quick money selling Florida real estate. He soon was recaptured, and was deported back to Italy upon his release in 1934.

What Ponzi sold was hope, pandering to peoples' unrealistic desire to believe that a new way to make easy gains had been discovered, with no visible upper limit as to how long gains can persist in excess of the economy's own rate of growth. It is a measure of how much harder it is to make returns in today's world – and hence, how little hope needs to be excited – that whereas Ponzi promised to double his investors' money every three months, the Spanish stamp scheme paid only a 6 to 10 percent annual return. Neither fraud actually made any trading gains or profits, but simply paid investors out of new money coming in from fresh players. New inflows were treated as earnings. That's how pyramid schemes work.

It was almost as if the Spanish operators had read one of the biographies of Ponzi that began to appear as observers noticed the common denominators between the global financial bubble of the 1990s and earlier bubbles. These bubbles provide a classic contrast between the real wealth of nations and what the business press these days calls "wealth creation" that simply takes the form of rising asset prices – "capital gains," most of which are land-price gains.

No doubt stamp collectors would have viewed the bidding up of stamp prices as wealth creation if it actually had occurred. But all it would have achieved was to inflate the price of old stamps, much as the world's growing ranks of billionaires were bidding up prices for master paintings and modern art, designer furniture and beachfront homes. If all the economy's savings went into Rembrandts and Picassos, their price obviously would soar, just as putting $6 billion into postage stamps would have established higher plateau levels for stamp prices.

The flow of funds into any category of assets bid up their prices. This is true most of all for land, one of the most universal economic needs and conspicuous-consumption status measures. But does this really "create wealth"? Do market prices reflect use values, living standards and the progress of civilization?

The requisite characteristic for such price gains is indeed scarcity, but not so much that there is not enough for large numbers of buyers to make a market. If psychological utility is the key, "scarcity" has value only as a compulsive acquisitive character – wealth addiction. It means having what other people lack, with connotations of denial. Most money in search of mere scarcity is not going into trophies of the nouveau riches, but into the world's most abundant yet also most universal scarce resource: land. Nature is not making any more of it, and global warming in fact threatens to take away thousands of miles of prime seashore sites. Yet everyone needs land to live on, making it the object of personal and business saving par excellence. Even in today's postindustrial economies, land and its subsoil wealth represent the largest components of national balance sheets.

But inasmuch as land cannot be manufactured, savings cannot increase its supply by active investment. This poses a traumatizing problem for economists. National income statistics count any money spent that is not consumed as saving. Following John Maynard Keynes, they define saving as equal to investment. This sows the seeds of confusion with regard to the character and preconditions of economic growth. Can we really call it "wealth creation" when society directs its savings merely into speculation rather than into building up productive powers or living standards?

Classical economists vacillated over treating land as a factor of production or as a legal property right to extract a tollbooth around a given site and levy an access charge much like a user-tax. A factor of production contributes to production and income as more income is invested in it. A rent-yielding property reduces the economy's flow of income. In the latter case land is part of the institutional property system, not the technologically based production sector of the economy.

What is beyond dispute is that real estate is highly political at the local level. Urban development tends to be shaped by insider dealing and public infrastructure spending to increase local property prices and lobbying to obtain low tax appraisals. It is axiomatic that the more economically powerful a source of wealth becomes, the greater its political power to lobby for special tax advantages. At the national level, real estate uses part of its revenue to back politicians who give it a widening wedge of special income-tax favoritism.

In the financial sphere, every bubble has been led by governments. Bubbles need to be orchestrated by opinion makers, topped by public officials giving a patina of confidence. The "madness of crowds" is a euphemism designed to divert blame away from governments onto the public. In the United States, Alan Greenspan played the role of public bubblemeister similar to that which Walpole had played in England's South Sea bubble and John Law in France's Mississippi bubble nearly three centuries ago, in the 1710s.

Today's balance sheets confuse bubble wealth with real capital formation. "Investment" has become whatever accountants say they are. So have asset and debt values, given today's leeway for financial fiction. The practice of "marking to market" permits accountants to project hypothetical gains at astronomical rates of interest, or trivializing by discounting, applying purely mathematical functions that have lost all connection to realistic rates of growth. The result is that the financial sector itself has become decoupled from the "real" economy.

The tragedy of our time is that saving today is being diverted in ways that are decoupled from real capital formation, but merely add to the economy's debt and property overhead. To distinguish wealth from overhead, this book starts with real estate, and then reviews the stock market, advance saving for pensions and health care via a flow of funds into the stock market to create capital gains. My aim is to show how different the actual economy is from what economic textbooks teach. Economic statistics have been hijacked to the cause of special-interest pleading. All but lost from sight is the common weal.

Suppose that Ponzi actually had bought International Postal Orders, and that the Spanish stamp companies actually had invested $6 billion in rare philatelic items and coins, driving up their price to create paper gains for the investors. To whom would they sell, in order to take their gains? (This is the proverbial "greater fool" problem.) More to the point, how positive would have been the broad economic effect of such asset-price inflation?

The recent stock market and real estate bubbles are much like pyramid schemes in the sense that what is bidding up stock and property prices is an exponential inflow of new money from pension plans and mutual funds (for shares) and bank credit (for real estate). Venture capitalists are "cashing out" while corporate managers exercise their stock options.

Suppose that mortgage-packaging companies are honest in their appraisals of current price trends. The real estate bubble is nonetheless speculative and postindustrial. The analogy is found when financial managers endorse government policies that encourage the inflation of price for stocks and bonds, stamps and coins, Rembrandts and modern art by claiming that this creates wealth and hence, by definition, pulls living standards and culture onward and upward.

What is wrong with this picture? For starters, it fails to define value as distinct from price, windfall and capital gains as distinct from earned income. It also neglects the fact that market prices rise and fall, but the debts remain in place. And when debts cannot be paid, savings are wiped out.

On May 9, 2006, the price of Escala shares fell by half as news of the police raids spread. By Friday its stock was down almost 90 percent. On Monday it jumped by 50 percent, from $4.34 at Thursday's close to $9.45 a share. Hedge funds were making and losing money hand over fist, dwarfing the gains and losses made from stamp trading. A veritable market in crime, punishment and beating the rap was in play.

What does this have to do with true capital formation? Individuals are getting rich while the economy is polarizing between creditors and debtors, property owners and rent-payers. Unproductive investment occurs when it takes the form of windfall "capital" gains, and when it involves going into debt for real estate, stocks or bonds, or "collectibles." Unproductive credit occurs when commercial banks make loans that merely finance the purchase of property, companies or financial securities already in place.

Two centuries ago, French followers of Count Henry St. Simon outlined an industrial system that was to be based mainly on equity financing (stocks) rather than debt (bonds and bank loans). Their idea was to make industrial banking a kind of mutual fund, so that claims for payment (and hence, the value of savings) would rise and fall to reflect the economy's earning power. The industrial banking that developed largely in Germany and central Europe differed from the short-term Anglo-American collateral-based trade credit and mortgage lending. But since World War I, global financial practices have been more extractive than productive.

The consequence has been that debts on the economy-wide level have grown more rapidly than the ability to pay. Instead of reducing this debt overhead by earning their way out of debt, economies have sought to inflate their way out of debt. However, the mode of inflation is not the familiar rise in consumer prices, much less wage inflation. Rather, it is asset-price inflation, emanating largely from the United States. Since the gold-exchange standard gave way to the paper dollar standard in 1971, the U.S. economy has become unique in being able to create credit – and foreign debt – without constraint. The result has been an unparalleled growth in debt relative to income, production and wages. This "debt pollution" has been likened to environmental pollution. It is the financial equivalent of global warming.

We have entered an era in which financial markets resemble the stamp-buying funds. Governments have replaced industrial growth with purely financial wealth creation in the form of a real estate and stock market bubble. This has turned the economic universe upside-down relative to what the classical writers expected to result from the technological progress unleashed by the Industrial Revolution and its parallel agricultural, commercial and financial revolutions. Property and credit have become costs instead of a benefit, institutional forms of rent- and interest-extracting overhead rather than helpful inputs.

Notes

[1] "Spanish dealers raided in stamp probe," "Fears grow for lifetime savings" and "World of collecting comes into focus," Financial Times, May 10, 2006, and "Stamp groups 'ran Spain's

biggest scam,'" ibid., May 12, 2006. See also "Stamp-Selling Firms Charged With Fraud By Spain Authorities," The Wall Street Journal, May 12, 2006.

[2] Escala Trades Up, MSNBC.com, May 16, 2006: Rich Duprey, "Investors buy into the auction house's claim that it avoided criminal charges"; THE MOTLEY FOOL, MSNBC, May 10, 2006: Rich Duprey, "Escala Is Stamped Out: The company's stock falls more than 50% after a raid by Spanish authorities," and "Afinsa denies 'insolvency' claim," BBC, May 11, 2006.

[3] See Wikipedia, "Charles Ponzi," based mainly on Mitchell Zuckoff, Ponzi's Scheme: The True Story of a Financial Legend (Random House: New York, 2005).

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