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Not so fast, Joseph Schumpeter

"In Fed And Out, Many Now Think Inflation Helps," was the page-one headline to which readers of *The New York Times* awakened—some of them with a jolt—on Sunday. In certain intellectual and policy-making circles, the story said, inflation today is courted like an old flame. "Weighed against the political, social and economic risks of continued slow growth after a once-in-a-century financial crisis," the Harvard economist Kenneth Rogoff was quoted as saying, "a sustained burst of moderate inflation is not something to worry about."

Inflation in an age of miracles is the subject under discussion. The 21st century is a time of wonders and prodigies. Is it the sum total of human knowledge that tickles your fancy? Log on to Google. The world's greatest songs, symphonies, pictures, poems and images from the 1955 World Series? Lurking—somehow—in the same miniature electronic device are those delights and more. Craft beers, electric toothbrushes and Amazon.com: Don't you wish you could show them to Benjamin Franklin?

But, of course, there's a catch. Material progress lights the way to lower production costs and hence to lower selling prices. More efficient production and cheaper transportation and more accessible labor mean everyday low and lower prices; it's seemingly inescapable. Or it would be inescapable if not for modern monetary methods. To keep the CPI rising and asset prices leaping, the central bankers print money—"deflation" protection, they say.

"If inflation is lower than expected," Charles L. Evans, president of the Federal Reserve Bank of Chicago, warned an audience in Madison, Wis., last month, "then debt financing is more burdensome than borrowers expected. Problems of debt overhang become that much worse for the economy." In other words, the Fed must resist the progress of the age. Lower costs, hence lower prices, threaten the stability of our heavily encumbered finances. Proverbially, some people can't stand prosperity. It seems that we leveraged Americans can't stand progress.

At the *Grant's* Conference last week, Paul Isaac, founder of Arbiter Partners, mentioned the passing of a whole class of defensive stocks: utilities, big banks and newspapers, among them. Not so long ago, you could tell yourself that stable industries could not be disrupted. But one by one, these commercial oaks have fallen to human ingenuity (or to leverage, in the case of the big banks, an especially combustible kind of human ingenuity). The late Joseph Schumpeter, famous coiner of the phrase "creative destruction," should be alive to see it.

As we read the newspapers—rather, the Web sites—creative destruction will keep right on raging. We wonder how much money printing it will take to neutralize, for instance, the self-driving car, a.k.a. autonomous vehicle, or AV. Sergey Brin, founder of Google, predicts that the AV will be a reality in four years. The Eno Center for Transportation speculates that it will be a mass-market item by 2022. And a boon and a blessing it will be, says Eno: "AVs have the potential to fundamentally alter transportation systems by averting deadly crashes, providing critical mobility to the elderly and the disabled, increasing road capacity, saving fuel and lowering emissions." According to a 2011 study prepared for the American Automobile Association, U.S. motorists drive themselves into 5.5 million accidents a year at a cost of more than 30,000 fatalities and $300 billion.

But wait, Charles L. Evans: The AV would likely devastate the property and casualty insurance business and throw a million or more professional drivers out of work. As long ago as 1998, notes colleague Charley Grant, the then-CEO of Progressive Corp., Peter Lewis, warned of the possibility of "the end of auto insurance. . . . [A]t some time in the future, there will be so many fewer, less severe auto accidents that it will disappear."

Fifteen years later, Progressive—now with a market cap of $15.8 billion—still derives 98% of its property and casualty premiums from personal and commercial auto coverage. "It's not as if management is unaware of the potential for a shake-up—Progressive's 10-K mentions AV technology as a risk factor—but anticipating an impending wreck and getting out of its way are two separate issues," Grant notes. "Nor are insurance companies the only businesses exposed to this prospective vehicular upheaval. Would fewer accidents reduce the demand for spare parts and repair services? If so, Advance Auto Parts would likely command an earnings multiple lower than today's 19. Would we still need the 1.6 million truck drivers who were on the road in 2010?" And how much QE would it take to compensate for the loss of aggregate demand that the unemployment, or re-

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deployment, of such a vast assortment of resources could bring about?

A cure for cancer, too, could set the Fed on its ear. No such breakthrough is imminent, as far as we know. But Andrew Lo, the brainiac MIT economist, along with Jose-Maria Fernandez, also of MIT, and Roger Stein of Moody's, have conceived an ingenious new approach to financing cancer research.

"That biomedicine is far more advanced today than even a decade ago is indisputable," the three note, "but breakthroughs such as molecular biomarkers for certain diseases generate many new potential therapies to be investigated, each of which requires years of translational research at a cost of hundreds of millions of dollars and has a substantial likelihood of failure." Venture capital isn't up to the task of providing the necessary funds, they observe. Nor—to judge by the paltry 4.2% average annual return, counting reinvested dividends, of the New York Stock Exchange Arca Pharmaceutical Index over the past 10 years—is the stock market. Let us mobilize the securitization market instead, the three propose.

Would you, gentle reader, say "yes" to the opportunity to invest $200 million for 10 years in a cancer research project that, if successful, would deliver $2 billion of profits over a 10-year patent life? Bear in mind that the chance of success is perhaps 5%. Blending that unlikely event with the highly likely probability of failure yields an expected return of 11.9% per annum—with a standard deviation of returns (i.e., risk) of 423.5%. "No thanks," would be the correct response to the sales call.

Consider another approach. If one invested in 150 programs simultaneously—requiring $30 billion in capital—the probability of a single success would leap to 99.95%. The expected return would remain the same—11.9% per annum—but the standard deviation of returns would decline to 34.6%. Still risky, but significantly less so than the first example. And in the securitization structure that Lo et al. propose, some investors could choose a bond-like return, others an equity-like return and still others something in the middle. Does this bring to mind a 2007-vintage CDO? Well, the financial engineers reply, don't blame the structures, blame the people who abuse them.

Anyway, as we see the situation, Lo et al. are on to something. And let us say that if the hypothetical marriage of big money with smart science bore fruit in the shape of a cure for the disease that kills 580,000 Americans a year, what a blessing! Yet—for a certain number of drug makers, oncologists, hospice workers and life insurance companies—what a bother! Commercial disruption coupled with the prospect of extended longevity would confront the Fed with the contradictions of its M.O.

Should the Bank of Yellen (let us say) nudge interest rates higher? The now vastly enlarged population of healthy pensioners can't live indefinitely on zero percent. Or should the Federal Open Market Committee double down on ZIRP and QE? The too-high rate of unemployment coupled with the too-low rate of inflation would seem to demand even more of what hasn't worked.

So here's to progress. Long may it reign—if, that is, it's OK with the Fed.

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