

# **BONDS MAY BE DEFYING DIRE FORECASTS**

## **BUT THEY ARE NOT DEFYING LOGIC**

(Part One)

*Antal E Fekete*

New Austrian School of Economics

The title of Sy Harding's article (Gold Eagle, January 31) says it all: "Bonds Defy Dire Forecasts". But as I have been saying for years, bonds have *not* been defying logic, Greenspan's cliché "conundrum" notwithstanding. The behavior of the bond market has been consistent with Keynesianism. By his compassionate phrase "euthanasia of the rentier" Keynes meant the reduction of the rate of interest, to zero if need be, as part of the official monetary policy to deprive the coupon-clipping class of its "unearned" income. Perhaps it is not a waste of time to repeat my argument why, in following Keynes' recipe, the Fed is acting contrary to purpose. While wanting to induce inflation, it induces deflation.

The main tenet of Keynesianism is that the government has the power to manipulate interest rates as it pleases, in order to keep unemployment in check. Keynes argued that the free market economy was unstable as it was open to the swings of irrational investor optimism or pessimism that would result in unpredictable and wild fluctuation of output, employment and prices. Wise politicians guided by brilliant economists – such as, first and foremost, himself – had to have the power "to prime the pump" (read: to pump up the money supply) as well as the power to "fine-tune" (read: to suppress) the rate of interest. They had to have these powers to induce the right amount of spending needed to put people to work, to entice entrepreneurs with 'teaser interest rates' to go ahead with projects they would otherwise hesitate to undertake. Above all, politicians had to have the power to unbalance the budget in order to be able to help themselves to unlimited funds to spend on public works, in case private enterprise still failed to come through with the money.

However, Keynes completely ignored the constraints of finance, including the elementary fact that *ex nihilo nihil fit* (nothing comes from nothing). In particular, he ignored the fact that there is obstruction to suppressing the rate of interest (namely, the rising of the bond price beyond all bounds) and, likewise, there is obstruction to suppressing the bond price (namely, the rising of the rate of interest beyond all bounds). Thus, then, while Keynes was hell-bent on impounding the “unearned” interest income of the “parasitic” rentiers with his left hand, he would inadvertently grant unprecedented capital gains to them in the form of exorbitant bond price with his right.

*This single observation demolishes the entire elaborate edifice of Keynesianism.* The great quandary in the history of science is how one charlatan could mesmerize an entire profession with his quackery into somnambulance. No economist has pointed out during the intervening period of nearly four score of years, since February 4, 1936 (the day when Keynes published his *magnum opus*, *The General Theory of Employment, Interest and Money*) that the Keynesian Nirvana is built on quicksand. There were plenty of critics, of course, but none of them put his finger on the fundamental contradiction of Keynesianism, namely, that *you cannot suppress interest rates and bond prices at the same time!* They fell for the false dichotomy that there was a “trade-off” between inflation and unemployment. *The euthanasia of the rentier turned out to be the euthanasia of society.* Keynes cut the sorry figure of just one of the hopefuls waiting in line for their chance to work the miracle of having one’s cake and eat it.

The reality was worse still. The violent overthrow of the gold standard and the deliberate destruction of a stable interest-rate structure built upon it meant that *the genie of bond speculation has been let out of the bottle.* It was now free to roam about causing mischief in the world economy indiscriminately. The Keynesian managers of monetary policy in the twenty-first century “improved” on the original design of Keynes. They have made their timetable public, together with their targets of lowering interest rates. In fact, Bernanke went as far as announcing the actual amounts of bonds the Fed was going to purchase annually in order to reach his interest-rate targets.

But when you as the Chairman (more recently: Chairwoman) of the Board of the Federal Reserve announce how much face value of bonds you are going to buy

and when, then *you in effect offer bond speculators risk free profits*. All they have to do is to front-run the Fed and buy up the bonds beforehand. Thus conferring the privilege of preemption and forestallment on the speculators, he or she agrees to buy the bonds at a disadvantageous price: one enhanced by the profits of the bond speculators. Not only are their profits risk-free; they are literally unearned in the sense that bond speculators do not perform a single useful service to society in exchange for the windfall. Compare that to the gains of speculators in agricultural goods, who do perform a useful service: they alleviate a glut or a shortage occurring naturally in the wake of a bumper crop or a crop failure. Bond speculators, by contrast, profit at the expense of the public purse. *There is no value-system on which such a rip-off could be justified*, unless you make it an article of faith that the public purse was there for corrupt public servants to help themselves in the first place.

As a rule risk-free profits are ephemeral because they habitually devour their parents right after parturition. But when risk-free profits are institutionally guaranteed, as they are now, they snow-ball and become gargantuan. They are on track to destroy society, just as the avalanche is on track to destroy the village down there in the valley.

It would be hard to design a more absurd and inequitable system than that of open market operations whereby the Fed buys (or, occasionally, for window-dressing purposes, sells) government bonds in the secondary bond market. Bestowing risk-free profits on bond speculators starts an avalanche with unforeseeable consequences.

As long as the central bank is forced to observe the rules of the gold standard, bond speculators are barred from making risk-free profits. As a matter of fact they cannot make *any* profits in the bond market: under the gold standard bond prices and interest rates are stable. Bond speculation is literally unknown. The parasitic class of bond speculators is conspicuous only by its absence. The *raison d'être* for the gold standard is the stabilization of *interest rates and bond prices* – in contrast with the false tenet that mendaciously makes it the stabilization of *prices* (that is neither desirable nor possible).

*Open market operations were introduced illegally by the Fed in 1922, the year after the bubble in the market for U.S. Treasury paper burst, pricked by the interest rate that spiked, as it did in the wake of the inflationary binge aided and abetted by the post World War I Fed. A carbon-copy of that scenario is being played out before our very eyes. In consequence, the government bond market collapsed, the capital of scores of member banks were wiped out and the economy nose-dived in the 1930's. Beware! The outcome of the Fed's present bond-buying craze will, now as then, be deflation, not inflation, as expected by most people!*

The introduction of the policy of open market operations was illegal since it was not authorized by the Federal Reserve Act of 1913. Rather, the Act envisaged a central bank that was to be a passive participant in the process of credit creation. It would post its rediscount rate and then stand back, letting the commercial banks do the rest in rediscounting bills from portfolio. The Act frowned upon the idea of a central bank taking the initiative in the process of credit creation, such as unilaterally injecting Federal Reserve credit into the money market.

Without praising it unduly or undeservedly, we may observe that the Federal Reserve Act of 1913 correctly hit those Federal Reserve banks that were caught short of eligible collateral with a tough and steeply progressive schedule of fines. *Government bonds, notes and bills were classified ineligible as collateral for Federal Reserve credit.* Eligible paper was unambiguously defined as a short-term commercial bill drawn on merchandise moving to the cash-paying consumer apace (what Lloyd Mints, the mentor of Milton Friedman, later pejoratively called a 'real bill'). This fact is also suppressed in textbooks in an effort to stone-wall the illegality of open market operations.

The Federal Reserve Act of 1913 entrusted the fox with the guarding of the chicken coop. It put the U.S. Treasury in charge of collecting the fines delinquent Federal Reserve banks short of eligible paper were supposed to pay. When in 1922, as a result of the introduction of open market operations illegally, delinquency skyrocketed, the Treasury simply "forgot" to collect the fine. Why should it? It was nice to have the Fed standing by and picking up the slack when selling bonds was getting tough. The sweetheart-deal between the Treasury and the Fed conferred mutual benefits upon the conspirators. The Federal Reserve banks got theirs in the form of legalized check-kiting at the expense of the public. The process of creating

Federal Reserve credit was short-circuited, nay, it was subverted. Check-kiting was consummated as follows: by the Treasury, as it redeemed its bonds paying out Federal Reserve notes and, by the Fed, as it used Treasury bonds as collateral for its notes. The very same bonds were made redeemable in notes that had been posted as collateral security in issuing the notes! And the very same notes were paid out in retiring the bond that had been issued on the collateral security of the bonds! Such an incestuous relation had been unthinkable under the gold standard. It would have triggered a run on the banks in protest, as depositors demanded gold coins against their notes and deposits.

The seeds of the bean-stalk of unlimited debt were planted in 1935 when open market operations were retroactively legalized by an amendment to the Federal Reserve Act of 1913. This fact is also suppressed in the textbooks, in an effort to make the popping up of our Babelian Debt Tower appear as an Act of God. An Act of God it was not. It was a deliberate Act of Congress inspired by Keynesian principles.

The continuing fall of interest rates in the 21<sup>st</sup> century, in the face of an unprecedented amount of Federal Reserve credit being created through bond purchases, is far from being illogical. Nor is the continuing bull market in bonds, now a third of a century old, is a conundrum to those of us who are not infected by the bug of Keynesianism. It is fully explained by the incentive to earn risk-free profits on a continuing basis, unconditionally offered to bond speculators by the policy of open market operations. The reaction of speculators was completely left out of consideration by the authors of the swindle of open market operations. Keynes just followed them and carried the logic to its bitter conclusions. Because of this ‘oversight’ has neither been exposed nor corrected, the monetary policy of the Fed is contrary to purpose.

*The Federal Reserve sows the wind of inflation, only to reap the whirlwind of deflation!*

February 4, 2014.