

# THE COUNTER-PRODUCTIVE MONETARY POLICY OF THE FED

## Sowing Inflation, Reaping Deflation \*

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### Introduction

Typically, bond speculators carry on interest arbitrage along the entire yield curve. They sell the short maturity and buy the long, hoping to capture the difference between the higher long rate and the lower short rate of interest (borrowing short and lending long). This arbitrage is not risk-free *per se* as it has the effect of flattening the yield curve. As a result the normal yield curve could get inverted unexpectedly, that is, turned upside down, making the rising curve into a falling one while turning the speculators' profit into a loss.

However, as a direct result of the policy of open market operations, introduced clandestinely and illegally in 1922 through the conspiracy of the US Treasury and the Federal Reserve (Fed), long before the practice was legalized *ex post facto* in 1935, interest arbitrage was made risk-free. Astute bond speculators could thereafter preempt Fed action profitably. It never fails. Speculators know that sooner or later the Fed will have to go to the bill market to buy in order to boost the money supply. They will buy beforehand. On rare occasions the Fed would be a seller. Then speculators, perhaps acting on inside information, will sell beforehand. This copycat action is an inexhaustible source of risk-free profits. Thanks to the Fed's open market purchases speculators are assured that they will always be able to dump the bonds at a profit which they have bought pre-emptively. The more aggressively the Fed persists in its effort to increase the monetary base, the greater the bond speculators' profits will be.

### Absolute bad faith

Following the 1921 disastrous collapse in the value of U.S. Treasury bonds the ongoing conspiracy between the U.S. Treasury and the Fed was formalized in 1922. The policy of Open Market Operations by the Fed was inaugurated. Ever since federal reserve credit has routinely been created on the collateral security of the debt of the United States government. Thus the Federal Reserve (F.R.) Act of 1913 was overthrown without fanfare while Congress was looking the other way. As a result the Fed has been subverted. According to the original Act collateral for the note and

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deposit liabilities of the F.R. banks were to be restricted to real bills, that is, short term commercial paper originating in the domestic production and distribution of consumer goods. *Treasury paper was not listed in the Act as an eligible asset.* This was not an oversight. No part of F.R. credit outstanding was supposed to be built on government debt. If a F.R. bank was found short of eligible paper in balancing its note and deposit liabilities, it did not matter how great an overflow of Treasury bills it might have in its capital accounts, it was fined according to a stiff and progressive schedule of penalties for deficiency of collateral.

The conspiracy between the U.S. Treasury and the Fed started in 1914, almost on the same day the twelve F.R. banks opened their doors for business. The decision was made at the highest level by President Wilson that the Fed be diverted from its original mission and be put to use in financing the war effort of the Entente Cordiale. Naturally, this was kept secret as it violated both the Neutrality Act as well as the F.R. Act of 1913. The latter ruled out any and all purchases of foreign bonds, especially war bonds. The Treasury was the go-between in providing F.R. credit to the belligerents. The American public opinion that was strongly opposed to the European war was not informed about the monetary war-mongering.

The conspiracy is to be seen in the fact that the Treasury has ‘forgotten’ to collect the penalty from the Fed. Indeed, why should it penalize its best customer for its staple product? This was the greatest failing of the F.R. Act of 1913: it put the fox in charge of the chicken coop.

By 1920 you could not find a real bill in the portfolios of the F.R. banks with a magnifying glass. Instead, they were chock-full of Treasury paper. Nor was a serious effort made to return to the norms of the original Act after hostilities ended in 1918. Real bills were not allowed to make a come-back by the victorious Entente powers.

We can safely ignore the colorful stories how in 1913 the Fed was conceived on Jekyll Island by a group of malevolent bankers with an agenda to enslave the world as mythological. The F.R. Act of 1913 was *not* a malevolent document, although it obviously had warts. The conspiracy between the Treasury and the Fed was an unintended consequence, resulting from an unfortunate oversight of lawmakers.

This oversight was most skillfully exploited by the sworn enemies of sound money. The dagger went right to the heart of the U.S. monetary system. In 1913 legislators were assured that they were voting for a commercial paper system that could never become an engine of monetizing government debt. Should the F.R. banks ever try, they would be confronted with unacceptable losses. Sadly, it did not turn out that way.

When in 1935 the illegal practice was legalized retroactively through an amendment to the F.R. Act of 1913, the introduction of open market operations was presented as an innocent house-keeping change, a technical matter relating to the banking practice of releasing funds to and draining funds from the banking system. The fundamental issue, the folly of allowing the Fed to monetize government debt, in itself an unconstitutional act, was hushed up. Congress and the public were never given a chance to scrutinize the matter. They were led astray. Monetization of government debt was legalized through the back door, through chicanery and absolute bad faith. It was made the centerpiece of the money-creating process, in complete negation of the intention of the original Act (which made the production and distribution of consumer goods in most urgent demand the centerpiece of the money-creating process). Is it any wonder, then, that the new monetary system born in sin has brought disaster to the nation one hundred years later?

Critics focus their demur on the way the Fed creates money 'out of thin air' through sleight of hand. But there is a much larger issue here that has escaped attention. The policy of open market operations has made it possible for the Fed to usurp *unlimited* power in suppressing the rate of interest on all maturities through the transmission mechanism of risk-free bond speculation, while maintaining the illusion that it had only a very *limited* power — that of influencing the overnight rate of interest. The impression created is that the world can rest assured: all other rates are true market rates. Nobody took the trouble to dispel this illusion. (The fig-leaf was shed only recently: Quantitative Easing openly embraces direct purchases of T-bonds and agency paper such as those of Fanny Mae and Freddy Mac by the Fed.)

### **Falling interest rates as a destroyer of capital**

Open market operations make for a regime of falling interest rates. My thesis that falling (as distinct from low but stable) interest rates destroy capital across the board is admittedly controversial. I would welcome its examination 'without fear and favor' by a competent and unbiased panel that could also examine the superiority of "self-liquidating credit" over credit based on government debt (that could be called, tongue-in-cheek, "self-perpetuating debt").

We shall look at three destructive effects of a rate cut:

- (a) the increase in the liquidation value of debt,
- (b) labor's deteriorating terms of trade,
- (c) the fading of depreciation quotas.

The proposition that the bond price varies inversely with the rate of interest is uncontroversial and universally accepted by friend and foe alike. It describes the effect from the point of view of the creditor. Curiously, people find it hard to

comprehend the equivalent proposition describing the very same effect from the point of view of the debtor, namely, that the liquidation value of debt also varies inversely with the rate of interest. In particular, a rate cut *increases* the cost of liquidating debt before maturity. Liquidation value is what the debtor must pay if he wants to retire his debt ahead of schedule. As this liquidation value is now higher, *falling interest rates make the burden of debt increase*. For example, if the rate of interest is cut in half, then according to the rule of thumb the liquidation value of long term debt is doubled (that is, to liquidate the debt will cost twice as much as it did before the cut).

To recapitulate: both the bond price and the burden of debt vary inversely with the rate of interest. Why is it that a fall in the rate of interest increases the market price of the bond? Well, nobody will sell an 'old' bond at face value after interest rates have been cut. The owner will demand, and the investor will pay, a higher price. The reason for this is simple: 'new' bonds that are now being issued produce a *lower* yield. The *higher* coupons of the old bond must be worth something. The bottom line is that the cost of the same cash flow has gone up. You must pay more for the same yield. For example, if the rate of interest is cut in half, then you will have to pay twice as much to generate the same cash flow as you have paid before the cut.

Current book-keeping practices ignore the deleterious effect of a rate cut as it increases the burden of debt across the board. Nay, falling interest rates are disingenuously hailed as a blessing designed to help business. It is to the eternal shame of the "dismal science" that it has let this colossal propaganda lie pass without challenge.

### **The present value of cash flow**

Having established (a), the increase in the liquidation value of debt, we now turn to (b), labor's deteriorating terms of trade as a consequence of suppressing the rate of interest through the policy of open market operations. First we dwell a little longer on the problem of the present value of a cash flow (defined as the sum of individual payments discounted at the prevailing rate of interest, each for the period of time between now and when it becomes payable in the future.) Since the rate of interest is being cut, discount at a lower rate is involved. Therefore the present value of the cash flow is increased. For example, if the rate of interest is cut in half, then the present value of a cash flow continuing indefinitely doubles.

What does this mean for the terms of trade of those who need a cash flow for survival, such as all pensioners and all wage earners? Well, the price they have to pay for the cash flow is just its present value. Any cut in the rate of interest by the central bank affects them adversely. Their terms of trade deteriorates. For example, if the rate of interest is cut in half, then they have to pay twice as much for the same cash flow as before the cut. In practical terms this means that wage earners have to work

roughly twice as hard to continue earning wages at the same level. As far as pensioners are concerned, their pension fund is devastated. It can no longer support the cash flow they have enjoyed before the cut. Clearly, there is going to be a most serious deterioration in the standard of living for a large segment of society as a result of open market purchases of government bonds. This reveals the most cruel aspect of open market operations: it hits the weakest members of society hardest.

### **“Quantitative Squeezing”**

The process undermining the value of money as it is trying to buy a cash flow is not well-understood. It reflects the failure of the public education system. This failure is not an accident. The powers-that-be under the regime of irredeemable currency have a vested interest that the public be condemned to total ignorance on this matter. If the public realized what was going on, there would be blood in the streets.

Take a typical wage earner selling his own labor, namely, exchanging it for a cash flow (that he needs to keep body and soul together). The cash flow represented by his wages is grievously undermined by the policy of Quantitative Easing. One's ability to do profitable work is quasi-wealth. It may well be the only asset the laborer has. The value of this quasi-wealth is rendered inferior every time the rate of interest is cut. For example if it is cut in half, the quasi-wealth of the laborer is halved as well.

We may visualize the laborer as running on a treadmill the speed of which has just been boosted, say, by 100 percent. Now he has to run twice as fast just to stay abreast. If he wants to retain the value of his labor, he must work that much harder. Karl Marx called it *exploitation*. **There is no more insidious exploitation of human labor than giving the central bank unlimited power to manipulate the rate of interest downwards through open market purchases of government bonds,** mockingly called 'Quantitative Easing'. It had better be called 'Quantitative Squeezing' of labor.

### **The 'haircut' of the rate cut**

Squeezing labor is not an idle theoretical construction. It is very real indeed. The deterioration in labor's terms of trade is clearly shown by the fact that banks withdraw contract offers on mortgages whenever rates of interest are cut. Monthly payments as prescribed by the 'old' mortgage contract amortize more slowly under the lower interest-rate regime, so the debt could not be retired on schedule. The 'new' mortgage contract features inferior terms for prospective clients (although this fact is usually obfuscated by the bank). Maturity is put off or, if this is not an option, then higher monthly payments are inflicted on the new clients. Recall that the mortgage contract is an asset of the bank, the liquidation value of which has just been increased by the rate cut. The bank itself is being squeezed (think of the losses it is suffering on

its portfolio of fixed-rate mortgages and other fixed-rate loans). No wonder that the bank is trying to pass on as much of its losses as it can to its clients, often deceitfully, by pressing them to refinance their fixed-rate mortgage at the lower rate to their detriment.

We must realize that in the case of a rate cut the best course of action is to stay with the original fixed-rate mortgage. It is definitely not to refinance at the lower rate! The source of confusion is that a rate-cut is dressed up as if it were helping the homeowners to cope with the financial burden when the exact opposite is the case!

In truth, the value of the cash flow of wages has been rendered inferior by the rate cut. It has lost so much of its debt-liquidating power. QE pushes labor deeper in debt and ZIRP (Zero Interest Rate Policy) means *perpetual bondage* for labor. It is modern slavery. 21<sup>st</sup> century slaves may well 'own' their homes, their cars, their freezers, etc., but their mortgage debt, their auto-loans, their credit card debt are just so many evidences of indenture of slavery with absolutely no hope of emancipation under QE and ZIRP.

“We wuz robbed. Dunno by who.” Well, I do. All laborers have been and continue being pilfered and plundered by the regime of irredeemable currency in allowing the central bank to reduce the rate of interest to zero and beyond through open market purchases of government bonds. Every rate cut is a 'haircut' for labor. Shame on the profession of economists for not exposing the culprits, thus becoming an accomplice in the crime.

A self-employed worker putatively uses depreciation quotas on his tools, modest as they may be which, as we shall see in a moment, are subject to fading. Thus self-employed workers are hit twice by the suppression of interest rates through the policy of open market operations. First they are hit on the wage account, secondly, on account of the fading depreciation quotas.

*All* wage earners are ferociously squeezed by the policy of lowering interest rates through the open market operations of central banks. Worst hit are the *marginal* wage earners. They are plunged into the hopelessness of permanent unemployment. There is a trade-off between taking on additional debt at the lower rate peddled by the central bank, and firing the marginal worker. Employers find it to their advantage to replace marginal workers with additional machinery installed and financed under ZIRP. Their collective labor contracts become more burdensome (in the same sense as the bonds they issued at the old rate have become more onerous) in the new lower-rate environment. Worse still for labor, its bargaining power has been grievously undermined through the policy of Quantitative Easing. Employers push for renegotiating their collective agreements in order to reduce wage rates to reflect the reduction in the rate of interest. If that fails, they will fire their marginal workers and

will apply the cash flow freed up thereby to service additional debt to be used to automate the enterprise or otherwise reorganize it. Either way, the marginal worker is eliminated for good. Unemployment increases across the board as a result.

Much has been made of squeezing labor through the central bank's deliberate inflationary policy. Meanwhile no notice has been taken of the far more insidious central bank policy squeezing labor: QE, ZIRP, and the rest. Union leaders, are you listening?

There is a growing recognition by the establishment of the built-in deterioration of the wage structure, as reflected by a recent essay in the *Foreign Affairs* magazine (an organ of the Council of Foreign Relations), at least in so far as the need for compensation for the damage caused by central banks is concerned. The amazing title of the essay is: *Print Less But Transfer More: Why Central Banks Should Give Money Directly to the People* (see References below).

### **Who will replace producer goods after they are shipped to the scrapyards?**

Back to the subject (c) of fading depreciation quotas we may first note their similarity to the fixed coupons of a bond and the fixed wage rates. When the rate of interest is suppressed, there is an upheaval undermining the value of all three. The coupons attached to a bond constitute a cash flow the value of which has been undermined by the rate cut. Wages of laborers also constitute a cash flow the value of which has been likewise undermined. Now we shall see that, no less, depreciation quotas also constitute a quasi-cash flow the value of which has been undermined as well. Thus *we are confronted with a systematic plundering of society through the deliberate suppression of interest rates*, that is, through the policy of open market purchases of government bonds by the central bank. It is incredible that while the plunder has been going on unobserved for almost a hundred years, the profession of economists has taken note neither of the wisdom of the framers of the F.R. Act of 1913 in outlawing F.R. credit based on government debt (as the Act before the 1935 amendment has done), nor of the untoward consequences of the policy of open market operations: (a), (b) and (c). We shall now see that the fading of depreciation quotas is a consequence of the policy of open market operations.

The depreciation quota of a producer good is an accounting tool revealing how much of its value has been 'used up' over time, due to wear and tear in production, and how much money needs to be put aside to amortize that loss in any particular year. If the rate of interest is pushed down by the central bank, then there is a setback in the amortization schedule. Just as the fixed coupons of the bond – in the absence of refinancing – are no longer able to amortize the loan in the new lower interest-rate environment (because amortization has been slowed down by the rate cut, as we have seen it in the case of mortgages), so also the quasi-cash flow of fixed depreciation

quotas □ in the absence of deploying new capital □ are insufficient to guarantee the replacement of the 'used-up' portion of old capital. When looked at in this way it becomes clear that falling interest rates ought to make an upward revision of depreciation quotas mandatory – just like the value of the interest coupons of the bond ought to be adjusted upwards in the wake of falling interest rates, if it is our wish that the market value of the bond (or mortgage) have the same debt-liquidating power in the face of falling interest rates — as I suggested in my 2008 paper *Is Our Accounting System Flawed?* (See References below.) If this aspect of the policy of open market operations is ignored, then there will be a shortfall in amortization across the board. Sufficient funds will not have been set aside to pay for the replacement of producer goods when they are ready for the scrapyard.

### **Capital destruction**

Current book-keeping practice ignores this effect of falling interest rates. Thereby the renewal of worn capital is rendered impossible. *This is capital destruction.* The same principle also applies to capital deployed in finance, in particular, in the banking business. Bank capital that is adequate in a stable interest-rate environment is no longer sufficient in a falling interest-rate environment □ as banks in the U.S. and in Europe have found out to their chagrin.

Scandalous as though these omissions in book-keeping practice are, present accounting standards ignore both effects of the policy of open market operations and the subsequent fall in the interest-rate structure: (a) increases in the liquidation value of debt, (c) the fading of depreciation quotas. Observe the insidious process of concealed capital erosion acting on all businesses simultaneously and indiscriminately. Losses are masked as profits, phantom profits are paid out as dividends and managerial compensation. The process of capital erosion is accelerated by the policy of suppressing interest rates further. Inevitably, the result is deflation, depression or worse, such as breakdown in law and order. Quantitative Easing and any other benign-sounding monetary policy measures aiming at suppressing the rate of interest camouflage the wholesale destruction of capital in the productive and financial apparatus of society. Neither Keynes nor Bernanke understood this process.

We have seen that open market purchases of the Fed are a powerful deflationary force in the economy as they cause interest rates to fall and capital to erode. We shall now see that, with a lag, open market operations are also bound to cause commodity prices to fall. In time, a vicious spiral pulling the economy into the abyss will be engaged.

### **Erosion of capital causes a falling trend of prices**

Erosion of capital affects all producers, some of whom will succumb while others will fight for survival by scrambling to get out of debt. They will aggressively cut prices in the face of weakening demand. Herein we have the classic case of counter-

productive central bank action. The central bank wants to snatch the economy from the jaws of deflation by increasing the money supply. Its preferred method is the open market purchases of short-term government securities. But through the transmission of risk-free bond speculation interest rates keep falling for all maturities. As a result capital invested in production is eroding faster. The burden of debt is increasing. Workers are squeezed. Producers are squeezed. They try to get out of debt by selling more of their product. In desperation, they cut prices but to no avail. Consumers, including workers under squeeze, hold out for more price cuts. They postpone their purchases wherever they can. Demand collapses — as eloquently described by no less of an authority than Keynes himself.

Although the fact is ignored by most economists, speculation plays a major role in the formation of prices. A falling price trend in commodities that started through the erosion of capital is further amplified as speculators redeploy funds from the commodity to the bond market where irresistible risk-free profits are available — not offered to commodity speculators. This is a powerful albeit unrecognized force in the economy triggering a chain-reaction as follows:

- (1) risk-free bond speculation gives the initial impetus for interest rates to fall,
- (2) falling interest rates cause a severe erosion of capital throughout the productive and financial apparatus,
- (3) erosion of capital triggers a falling trend in prices,
- (4) falling prices further increase the downward pressure on interest rates.

Then the cycle repeats itself.

Thus a vicious spiral is engaged: falling interest rates and falling prices chase one another downwards, threatening to push the economy into deflation. Mainstream economics lacks a valid theory of speculation. Hence it has a blind spot and fails to see the destructive nature of open market operations. It completely misses the fact that bond speculators will not stay idle while the show of open market operations put on by the central bank is played out.

### **Austrian theory of the boom-bust cycle**

The suppression of the rate of interest through monetary policy and the resulting malinvestments made by entrepreneurs is a central theme of the business cycle theory of the post-Mises Austrian school. Our analysis is in the same tradition. But in exposing the actual transmission mechanism that extends the suppression of short-term rates to suppression of the entire spectrum of interest rates we carry the analysis further. The New Austrian School points out that open market purchases of the Fed make bond speculation risk-free with the result that *all* interest rates will fall. It is not necessary to bring in the malinvestment argument. After all, entrepreneurs

could learn from past experience. They might realize that rate cuts are detrimental to their interest and they might fine-tune their investment strategy to take the artificial suppression of the rate of interest by the central bank into account. Could bust be avoided if they did? Our explanation of deflation and depression in terms of destruction of capital automatically brought about by the falling interest rate structure avoids any reference to malinvestments and is, therefore, superior.

### **Achilles-heel of Keynesianism**

Our destruction-of-capital argument also has the advantage that it exposes the Achilles heel of Keynesianism preaching, as it is, the dangers of ‘oversaving’ and ‘underconsumption’. These concepts are vacuous. They are claptrap. There is no valid reason why society should not be able to accommodate the needs of those of its members who must be net savers (typically the juniors), and those who must be net consumers (typically the seniors). The Achilles heel of Keynesianism is found in the treatment of capital, especially in the total negligence of the danger of capital destruction. Keynesianism is oblivious to the fact that if capital consumption occurs for any reason, then the resulting deficiency must be compensated for through the accumulation of fresh capital. For example, if physical capital is impaired through fire devastating the plant, then the lost value due to fire damage must be written off in the capital accounts of the balance sheet of the firm. In order to escape permanent damage to efficiency, replacement must be made through a periodic reduction in the income statements. The ledger is brought back into balance through entering the present value of the cash flow derived from these reductions.

### **Sweeping the loss under the rug and kicking the garbage upstairs**

The point is that exactly the same procedure ought to be followed if the loss originated not in a plant fire but as a result of a reduction in the rate of interest. Capital ought to be written off in the capital accounts reflecting the loss caused by the reduction. Replacement ought to be made as follows. Enter the present value of the cash flow derived from a downward adjustment in the income statements into the balance sheet. As observed above, the accounting profession (apparently with the connivance of the government) fails to do that and the loss of capital due to the reduction in the rate of interest goes unreported. It should be clear that sweeping losses under the rug and kicking the garbage upstairs will not work as a permanent arrangement. The garbage will come crashing down from the attic in due course. Firms live in a fools' paradise. The day of reckoning dawns when the entire capital has been consumed. Such a day, it should be recalled, dawned in 2007 when Lehman Brothers' denuding of capital was discovered. No proper diagnosis was made, losses were papered over and the regime of capital consumption through QE was resumed with a vengeance. Another day of reckoning, possibly even more devastating, is

approaching. Society cannot continue living at the same level of comfort and security with capital so seriously impaired as ours is due to QE. If it tries, it makes the crisis of under-capitalization even more critical. Keynesianism is helpless as it has confused credit and capital, in particular, credit expansion and capital accumulation.

### **Cause or Effect?**

The greatest mistake of Keynesianism is the tenet that the cause of the Great Depression was falling prices due to oversaving. *But falling prices were not the cause: they were the effect. The cause was falling interest rates*, for which Keynesian fiscal and monetary policies were directly responsible: unbalancing the budget, inordinate increases in overall debt, monetization of government debt by the central bank. Keynes' idea that open market operations cannot and will not have devastating side effects has become a dogma. This dogma must be discarded forthwith. Open market operations do have consequences, and these consequences are catastrophic.

Here is how open market operations of the central bank make bond speculation risk-free, thus causing destruction of capital across the board. Speculators figure out when the central bank is due to make the trip to the open market to purchase its next quota of bonds. They forestall the central bank by purchasing the bonds beforehand, with the idea of dumping them later with a hefty markup. Bond speculators keep pocketing risk-free profits to which they are not entitled as they have not performed any useful service. Rather, they have caused great harm. Bond speculation progressively replaces monetary policy as the driving force behind suppressing interest rates. It may frustrate “exit strategy” and “tapering”. The central bank is rendered helpless in facing raging deflation. In the worst-case scenario, risk-free bond speculation will disable the brakes on the runaway car careening downhill and crashing headlong into deflation. These aspects of open market operations are completely missed by economists (Austrian economists not excepted).

### **Deflation or hyperinflation?**

A frequently asked question is whether the international monetary system based on irredeemable currency is facing a deflation similar to that of the 1930's, or whether it is on course towards a Zimbabwe-style hyperinflation. Most sound-money observers conclude that the latter is the case. However, a relentlessly increasing money supply is not the only prerequisite for hyperinflation. There is another: lack of suitable outlets for the bloated purchasing power. As risk-free bond speculation made possible by open market operations shows, no matter how much purchasing power is being created by the world's central banks, speculators will always find rising bond values

less risky to bet on than betting on rising commodity values. In the absence of wars

(civil wars) destroying stores of consumer goods as well as the park of capital goods producing them, the forecast is deflation, not hyperinflation.

In combating deflation the Fed resorts to counter-productive measures. More government debt is poison for a weak economy. Monetization of government debt will only feed bullish bond speculation and bearish commodity speculation, while doing nothing to rebuild the impaired capital base. Bullish bond speculation is responsible for the falling interest-rate structure and destruction of capital, to say nothing of the coming collapse of prices. Increased government spending is the wrong medicine. The right medicine is stable interest rates, more savings, frugality in public spending, and the accumulation of more capital. If it were not so tragic, one could rub in the irony that Keynesianism in trying hard to push the world into the pit of inflation has only succeeded in pushing it into the pit of deflation — the very same pit it was studiously trying to avoid.

### **Nature abhors risk-free speculation**

According to a Latin proverb, *natura abhorret vacuum* (nature abhors a vacuum). We may add that nature also abhors risk-free speculation in eliminating it just as quickly as it eliminates a vacuum. When on occasion the opportunity for risk-free speculation arises, the very action of speculators quickly removes that opportunity. Only the earliest bird get the worm. However, as we have seen, conditions for the perpetuation of risk-free speculation may be brought about institutionally short-circuiting nature. This is the case with the open market operations of the central bank that frustrates the natural order of things. But nature cannot be abused forever. Sooner or later she will come out on top.

According to another adage

“Whom the gods may want to punish,  
First of all will make them go mad”.

That's the fate of the present leadership at the Fed. Men and women in charge of monetary policy exercise their usurped power in a way that is downright counter-productive.

*They sow inflation and reap deflation.*

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## Notes

### 1. Thank Heaven for Helicopter Ben

In 2002, in his first major policy speech after joining the Board of Governors of the Federal Reserve, Ben Bernanke spelled out that the only sensible solution to the country's massive debt problem was more debt, lots more. He was going to engineer an unprecedented inflation, quite oblivious of the deflationary consequences.

*„If the Treasury issued debt to purchase private assets and the Fed then purchased an equal amount of Treasury debt with newly created money, the whole operation would be the economic equivalent of direct open market operations in private assets...essentially equivalent to Milton Friedman's famous „helicopter drop of money”...*

He did not elaborate how his hare-brained scheme would rain money on people made permanently unemployed by the Fed's open market purchases of government bonds

under Quantitative Easing. Now we shall look at the other side of the same coin, from the point of view of the beneficiaries of the Fed's policy. The text printed in italics below is copyrighted material quoted from *Stansberry's Investmen Advisory, October, 2013*, [www.stansberryresearch.com](http://www.stansberryresearch.com). (Permission for reproduction is hereby gratefully acknowledged.) It is tongue-in-cheek, it is clever, it is vitriolic. It is in the form of a prayer addressed to Ben Bernanke the demigod, put into the mouth of a super-rich individual as he is boarding his private airplane, noticing that the cost of jet fuel has again been increased.

*Dear Ben, thank you so much for providing us nearly limitless risk-free ways of growing our capital. Please, never for a minute doubt your ability to „help the economy” by printing more money, thereby making us so, so much wealthier. Never consider whether or not it's fair or proper for the government to impoverish millions so that the very privileged few can gain so generously. And never worry that what you have done will some day lead to a massive inflation and a collapse of the paper money system. While gas prices are making it more expensive to fly this jet, we understand the need to do our part. You can count on us, dear Ben. Amen.*

*Meanwhile, the people whom Ben fleeced □ the workers, the savers, the few Americans left with simple industry and thrift, the kind of folks who would never have believed the government would actively try to hurt them □ have been wiped out. They have seen the real value of their wages, savings, standard of living decline by huge amounts...*

*Bernanke gutted the dollar. He gutted the middle class. He gutted the savings of millions. And he greatly impoverished our country.*

*And yet, despite it all, Ben Bernanke is still being proclaimed a hero of the Republic. „When faced with potential global economic meltdown, he has displayed tremendous courage and creativity,” said Barack Obama at a White House news conference. „He took bold action that was needed to avert another Depression”...*

## 2. About the author

Professor Fekete is a lifelong student of the phenomenon of interest. His theory eliminates the chasm between the time-preference school and the productivity school of interest. According to him the rate of interest is not monolithic but varies between a floor and a ceiling. The floor is determined by marginal time preference; the ceiling is determined by the marginal productivity of capital. Long before it could push the floor down to zero, the central bank will be frustrated in its rate-cutting fervor by the marginal bondholder. He would divest himself of all of his bond holdings and keep the proceeds in gold. He would release his gold only if the central bank desisted and let the rate of interest find its floor once again (known as the *Fullarton Effect*, after John Fullarton 1870-1849, who correctly rejected the Quantity Theory of Money, a line of thinking later followed by Carl Menger). Thus there is an inevitable nexus between gold and interest. It is not possible to stabilize the interest-rate structure without allowing a free flow of gold between the banking system and the general public. This effect works regardless whether a gold standard is formally adopted or not.

With due apologies to Horace we sign off with this thought: *Aurum expellas furca, tamen usque recurret* (You may drive gold out with a pitchfork, yet return it still will; *c.f.: Epistles, Book I, x, line 24.*)

**3. Synopsis.** Open market purchases of government debt by the central bank is a destructive deflationary policy in that: (a) it increases the liquidation value of debt, (that is, the cost of liquidating debt ahead of schedule), thus increasing the debt burden; (b) it makes labor's terms of trade to deteriorate and unemployment to increase indiscriminately across the board; (c) it causes the fading of depreciation quotas, thus contributing to the destruction of capital. It constitutes a systematic plundering of savers, producers and laborers. Whether it is done deliberately or unwittingly, it plunges the nation — and the world — into cataclysmic depression. Beyond that, it contributes to the decline, possibly the fall, of our industrial civilization.

**4. German version of this article** can be found in the publication:

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