THERE IS NO BUSINESS LIKE BOND BUSINESS. STILL.

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In 2010 I published an article under the title *There Is No Business Like Bond Business* (www.professorfekete.com, January 18). In it I argued that the widely expected collapse of the U.S. Treasury bond (hereafter T-bond) market just would not happen. I also gave my reasons why analysts have failed to understand this. They missed the fact that the 30 year old bull market in T-bonds has been fuelled by risk-free bond speculation. Speculators buy the bonds in the open market, turn around to drop them in the lap of the Fed at a profit. They 'front-run' the well-advertised and widely anticipated 'open-market operations' of the central bank. The strategy to pre-empt the Fed's open market purchases of bonds works especially well when the printing presses are revved up in an effort to fend off (real or imaginary) deflation.

Gary North gave me the honor of commenting at length on my errors, see: Antal Fekete's Fantasy-Land Monetary Theory of Hyperinflation That Creates a Bonds Boom and Falling CPI, www.marketoracle.co.uk, February 12, 2010. I have not offered a rejoinder to North's malicious comments as it is my policy never to dignify my detractors that way. But since other comments on my thoughts have also appeared that observe the rules of diplomatic intercourse and common courtesy, I thought that an update on the inflationary/deflationary debate and my take on the future of the dollar might be timely.

Note that in the intervening two-year period none of the widely promoted hyperinflationary scenario materialized and, short of a hot war involving the Middle East, is not likely to materialize in the foreseeable future. This, in spite of unprecedented money-creation in the United States and elsewhere in the world. Most observers are puzzled about it. They shouldn't be. The T-bond market is still alive and kicking, never mind the view that by the courtesy of the Fed it is doing overtime on the life-support system. Commentators point out that all the bonds sold end up in the balance sheet of the Fed that is pretty well the only T-bond buyer left. I would call this statement a poetic exaggeration. Speculators' appetite for risk-free bond speculation has not abated. The fact that bonds keep landing on the balance sheet of the Fed is in perfect conformity with my script. Speculators did buy them for one and only one reason: they wanted to dump them on the Fed as quickly as possible. That's their business: illegitimate arbitrage between the bond market and the money market for risk-free profits.

Borrow short to lend long.

The suggestion that interest rates have bottomed marking the beginning of hyperinflation is preposterous. Just the opposite is true. Deflation is going full steam ahead, thanks to risk-free bond speculation bidding up bond prices ever higher and pushing interest rates ever lower. The Fed is no longer in charge, although it wants you to believe otherwise. Instead, the Fed is scared stiff as every one of its attempts to re-ignite inflation has failed miserably. The Fed cuts a sorry figure of an engine driver who is desperately trying to slow down the runaway train by pulling and pushing levers that are no longer connected to anything.

Detractors criticize me for suggesting that falling interest rates ultimately cause falling prices. I stand by my statement which is amply supported by historical evidence going back to the French Revolution. The price level and the rate of interest have moved in tandem and in the same direction, if due regard is paid to leads and lags. Sometimes the price level leads and the rate of interest lags, at other times the rate of interest leads while the price level lags. Theory fully confirms history. You must see that persistently falling interest rates, ultimately although not immediately, cause prices to fall. The reason is that a falling interest-rate structure erodes and eventually destroys capital. I get a lot of flak for insisting on this one. However, denying it would be tantamount to denying that falling interest rates cause bond prices to rise. As they do, falling interest rates obviously cause the burden of debt *to increase*. Admittedly paradoxical, but it is true nevertheless. Businesses go bankrupt without realizing what has hit them. Everybody, economists, financial journalists, central bankers urge them to be patient because in the long run the falling trend will make interest rates so low as to render business profitable once more. The trouble is that, as John Maynard Keynes famously remarked, in the long run they will all be dead, financially speaking. They will go bankrupt before the promise is fulfilled. The same fate awaits their competitors who feel good when they jump in and finance their investments at the lower rate. This is the cat chasing his own tail all over again.

We are approaching the point where businessmen become so desperate that they try to save themselves by initiating price wars. Nobody sees this coming as everybody is mesmerized by the unprecedented injection of new money into the economy, and everybody believes in the false religion of the Quantity Theory of Money. But then, nobody saw the coming collapse of housing prices either, still less pointed out its causal relationship with the perennially falling interest rate structure.

I have never denied that the collapse of the regime of irredeemable currency could take the form of a hyperinflation. However, we would be hard put to find an historical example of a hyperinflation that was not preceded by war or civil war destroying supplies and production facilities. On the other hand, we know that a depression could often push the government into a shooting war. It is a fact, not yet admitted by historians, that the Allied Powers welcomed (not to say *encouraged*) Hitler's provocations as they gave them an excuse to start World War II. They hailed the war as their savior from a depression that they were unable to control. In 1939 it was still unthinkable that the United States could join the fray in Europe without Congress declaring war first. Roosevelt had to provoke the Japanese to attack Pearl Harbor in order to get his much-wanted war. Today, the president can start wars anytime, anywhere in the world at pleasure, and a pre-emptive attack on Iran is badly itching. If such an attack materializes, all bets on a deflationary scenario are off. But in the absence of a shooting war, continuing deflation, that is, falling interest rates *cum* falling price level, is in the cards. The reason is the fact, still unrecocnized, that risk-free bond speculation renders all the machinations of the Fed to engineer inflation ineffective, nay, counter-productive. The Fed thinks that it is fomenting inflation when in fact it has become the main engine of deflation.

How is it possible that all those think-tanks (spending zillions of dollars on so-called research) have not been able to uncover the truth of my proposition? The reason, as I see it, is the counter-intuitive nature of the mathematical fact concerning fixed income securities, namely, the fact that a *decrease* in the rate of interest *increases* the burden of debt on the issuers of bonds. The reluctance of the mind to admit this is all the more curious as the equivalent statement, that the bond price moves inversely with the rate of interest, is allowed to pass unchallenged. The intuitive but false conclusion that a decrease in the rate of interest eases the burden of the debt springs from the misconception that the reduction takes effect immediately on all outstanding obligations. But as the more accurate name 'fixed- income security' makes it abundantly clear, bond issuers do not benefit that way. They must continue laboring under the burden of a higher interest load than that is available to new borrowers. Incidentally, this is the most damning condemnation of the regime of irredeemable currency that is the culprit for the destabilization of the interest-rate structure. It just does not stand the comparison with the stable interest regime of the gold standard. The dollar-standard rewards and penalizes without regard to merit. It tends to penalize virtue and to reward vice. As it does, it erodes and ultimately destroys capital.

Is the T-bond market corrupted? Without a doubt. Is it about to topple over? Far from it. Interest rates will continue to fall well below the rate of monetary debasement. Speculators will keep buying the bonds regardless of their unreasonably high price, because they know that bond prices will keep rising further, *ad infinitum*, and that they will always have an eager buyer to whom to sell at a profit: the Fed. In addition, the T-bond market enjoys a cozy shelter in foreign central bank portfolios.

The Privateer (April, 2012, issue #702) describes the police action upholding this arrangement as follows. "The over-indebted country, in return for being bailed out, is given an unvarying set of rules by the IMF. It has to erase or at least greatly lessen its budget deficits; it has to stop trying to prop up its currency on the markets; it has to give priority to its international creditors; it has to tighten financial regulations; it has to accept IMF 'supervision'. *The use of the nation's foreign exchange reserve to meet its debt is forbidden.* The Asian crisis of the 1990's was a perfect example of this. Throughout that crisis the message from the U.S., the lending banks and the IMF was the same: *We'll let you get away with almost anything.* ***But don't you ever contemplate helping yourselves by selling your U.S. Treasury debt.*** The U.S. Treasury debt was and still is sacrosanct. It is the foundation of the entire global regime."

As a result we have the anomaly that even if the dollar loses most of its purchasing power, its standing as a global reserve currency will remain largely unaffected. There is no reason to believe that the powers-that-be will stop using this successful recipe in the near future. The dollar is far from being a push-over.

May 11, 2012.

Part One: Marginalism

1. Marginal utility and unit price
2. Marginal productivity of capital
3. Marginal productivity of labor
4. Marginal productivity of debt
5. The marginal object and the marginal subject
6. From price to spread: arbitrage
7. Menger's concept of marketability

Part Two: The Theory of Value

8. Can value be measured?
9. Is constant marginal utility of gold contradictory?
10. Is paper money a present good or a future good?
11. The Gold Standard (unadulterated and Rothbard's so-called 100 percent gold standard)
12. Menger and the Quantity Theory of Money
13. The wisdom of Adam Smith
14. Spontaneity of real bill circulation

Part Three: Interest *versus* Discount

15. Where gold certificates cannot deputize for gold coins
16. Market process and the determination of the rate of interest
17. The meaning of zero interest and zero discount
18. Gold and Interest
19. Marginal time preference and marginal productivity of capital
20. The discount rate and the marginal productivity of social circulating capital

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It is meant for those, including beginners, who are interested in the theory of money, credit, and banking, with *special emphasis on the current financial and economic crisis.* Previous courses ***are not a prerequisite***.
For further information or in order to register for the course you can get in contact with the organizers Ludwig Karl and Wilhelm Rabenstein via mail (nasoe@kt-solutions.de) or phone (+49 – 170 – 380 39 48 , before calling please consider a possible time lag).
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