THE DECOY OF THE FALLING DOLLAR

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A consensus is building among market observers that bonds defy all logic. The falling dollar should make dollar bonds fall, too. After all, bondholders stand to lose a large part of the value of their original investment as a result of the depreciating dollar. Yet the bull market in bonds that started almost 25 years ago is still intact. The following comments may help put some of the logic back. As a preliminary I would like to remind readers that a bull market in bonds is the *sine qua non* of the deflationary spiral under the Kondratiev cycle. Pimco's Bill Gross is premature in writing the obituary of the bond bull. Other observers' opinion that a dramatic rise in interest rates, which appears to be imminent, is likely to serve as the trigger for the Kondratiev winter is probably wrong as well. On the contrary, I shall argue that a continuation of the bull market in dollar-bonds will do that particular trick. I consider any weakening in dollar-bond prices a bear-trap.

Here are my premises. The perspective on the bond and foreign exchange markets is distorted by the smoke-screen surrounding a gigantic speculative scheme known as the yen carry-trade. This is how it works. The Japanese are printing yens, not to support productive enterprise but to finance speculation. Next, the ball is in the Fed's court. The Fed obliges and prints dollars, again not to support productive enterprise but to serve as a drop-off point for speculators. Japanese interest rates being so low, speculators can borrow yens at around 1.5%, sell them for dollars to be invested in US Treasuries yielding 4 to 5%. The speculators pocket the difference without performing any useful service whatsoever. The yen carry-trade is firmly in place, allowing the US debt markets to defy gravity. The question is when this scandalous charade might end. To answer it observers look at another key market, that of the dollar, and conclude that the obvious bear market will spell the end of the yen carry-trade. As the dollar falls, the Japanese and the Chinese may threaten to start dumping it and to put an end to its reserve currency status. Only a dramatic rise in interest rates may save the dollar as the world's reserve currency.

This is where I take issue with the conventional wisdom of those observers who, like myself, think that the deflation threat is serious. What they miss is the fact that *the bear market in the dollar actually helps rather than hurts the yen carry-trade*. The terms of trade for those who sell yens to buy dollars is improved immensely by the fall of the dollar. The yen carry-trade can be described as arbitrage with short leg in the yen bond market and long leg in the dollar bond market. Profits on the long leg increase far more than losses on the short as a result of the dollar-devaluation. The faceless bond speculators are sitting on a huge pile of profits already that have been accruing for a quarter of a century. They can well-afford to prevent Humpty-Dumpty (read: the dollar) from having a great fall from its perch as a reserve currency. This particular cash cow can be milked yet for quite a bit longer with careful husbandry. It would be a folly to let it be slaughtered just at the time when milk (and honey) output is at peak.

What I am suggesting is that bond speculators are calling the shots, and central bankers willy-nilly play balls with them. The alternative is sudden death. Without bond speculation the regime of irredeemable currencies would have come to a sad end thirty years ago. Speculators well-understand the dynamics of competitive currency devaluations. The present round started ten years ago when the yen was devalued 50%. In the intervening years the ruble collapsed along with other Asiatic currencies. Right now it is the turn of the dollar. It will be interesting to watch whether and when the euro will succumb to the temptation, as I predict it will, in spite of the brave talk we are hearing from Brussels. This is just a replay of the 1930's with the yen playing the role of the leading currency. To recapitulate, if the yen carry-trade was profitable during the last ten years of a weak yen, then it would be a hundred times more profitable during the next ten years of a strong yen.

It is a mistake to look at the falling dollar as the result of the profligacy of the American consumers, and a direct outcome of the American trade deficit. This is just a decoy. Admittedly, it is a clever one as far as decoys go. It is designed to divert attention away from the real culprit, which is the yen carry-trade and its obscene profits. The falling dollar is part of the big picture of competitive currency devaluations, or of the even bigger picture of the Kondratiev cycle. But let us not forget that at the same time it is a powerful booster for the yen carry-trade. Let the public buy the nonsense of Milton Friedman that the falling dollar is just the manifestation of the adjustment mechanism balancing the American trade account. Or let it buy the equally fallacious Quantity Theory of Money predicting that the dollar will be printed into worthlessness. The truth is that *there is an insatiable demand for dollars, especially for falling ones, by bond speculators.*

According to the 19th century French economist Frederic Bastiat, economics is a game of distilling what you don't see from what you do. In the present case what you see is the American trade deficit, which can easily be blamed on the appetite of the gluttonous American consumer. What you don't see is the accumulating profits of the faceless bond speculators, sucking the life-blood from the world economy. This is exactly the same point that was missed in the Great Depression of the 1930's by all economists. They are going to miss it again. The world is going to repeat all the mistakes it made then, because it has allowed the government and the economists' profession to fabricate a theory of the Great Depression that puts the blame squarely on the gold standard. The price has to be paid for pushing gold out, not just from the monetary system, but also from the research agenda of universities and think-tanks!

It is not hard to predict the further course of the ongoing depression if you can divine the strategy of the faceless bond speculators. They will definitely want to keep the irredeemable dollar as a reserve currency for as long as it serves their purposes, which may be for another decade or so. The dollar is not going to have a precipitous fall. It will decline further, but the decline will be controlled. The important decline determining the course of deflation, however, is not that of the dollar, but that of the American rate of interest as it follows in the footsteps of the Japanese with a ten-year delay. The twin deficits will continue to baffle commentators who are too dim-witted to understand that they have fallen victim to clever prestidigitation.

It reflects woolly thinking to talk about a repetition at this stage of the Volcker-miracle, 1980 vintage, in saving the dollar from sudden death by applying the shock-therapy of high interest rates. In the present situation *the real miracle will*

be to save the dollar by a falling rather than a rising interest-rate structure. Remember, 1980 marked the blow-off phase of the inflationary spiral, and the beginning of the deflationary. Right now the world is entering the depths of the deflationary spiral, and vintage therapy is out of place.

I define inflationary spiral under the Kondratiev cycle as the decades-long rise of prices and interest rates, and deflationary spiral as their similarly long fall. Interest rates may lead and prices may lag, or the other way round. The important thing is the linkage. Prices and interest rates are inevitably linked. Linkage epitomizes a huge oscillating money-flow back-and-forth between the bond and the commodity market. When the money-tide begins to flow at the commodity market and ebb at the bond market, we have the inflationary spiral. When the tide is reversed and it flows at the bond and ebbs at the commodity market, we have the deflationary spiral.

These tides must run their course. They are too powerful to be diverted by contra-cyclical monetary policy. Central bank intervention is counter-productive. It acts only to prolong the cycle and to make it even more devastating. During the inflationary spiral the main worry of the central bank is the high and rising rate of interest. To combat it, the central bank resorts to open market purchases of bonds in order to put money into circulation, hoping that it will flow to the bond market to bid up prices there. But speculators know better, and they divert the flow of money to the commodity market. Prices rise. Linkage will then make interest rates rise more, contrary to the wishes of the central bank.

During the deflationary spiral the main worry is low and falling prices. To combat it the central bank once again resorts to open market purchases of bonds in order to put money into circulation, hoping that it will flow to the commodity market to bid up prices there. But speculators forestall the central bank in buying the bonds first. Interest rates fall. Linkage will then make prices fall more, contrary to the wishes of the central bank. To recapitulate, in the inflationary phase of Kondratiev's cycle the central bank wants to bring down interest rates but, instead, causes prices to rise which leads to still higher interest rates. In the deflationary phase it wants to raise the price level but, instead, causes interest rates to fall which leads to still lower prices. The contra-cyclical policy of Keynes backfired in either case, because Keynes was ignorant of the linkage.

Some years ago I put forward a new theory of Kondratiev's long-wave cycle* revealing its cause as the fluctuation in the propensity to hoard. This fluctuation is in turn caused by the centuries-old wrong-headed policy of banks, aided and abetted by the government, in obstructing the flow of the gold coin to the saver whenever he finds the rate of interest unacceptably low. The flow of gold in and out of the banks is the mechanism whereby the saver regulates the rate of interest under a gold standard. You cannot take away the saver's right to control bank reserves with impunity. Gold is the natural conduit for hoarding. If you obstructed gold hoarding, the saver would have recourse by hoarding other marketable goods. This would, however, have some serious side effects. It would generate the Kondratiev cycle with its devastating flow of money back-and-forth between the bond and the commodity market.

The tide of money in the commodity market triggered a tsunami in 1980 when it dawned upon owners of commodities that their hoards could no longer be financed at high interest rates in view of high prices. When they panicked and ran to the exits, most were trapped. A painful process of

decades-long inventory liquidation began. We are at the stage right now where businesses must reduce high inventories at falling prices, while speculators make a killing in bonds.