

GREENSPAN HAS TAKEN THE HORSE TO THE WATER:

But can he make it drink?

by Antal E. Fekete,
Professor, Memorial University of Newfoundland
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Letter to a reader commenting on my theory of the Kondratiev long-wave cycle

Dear Mr. South:

Thank you for writing. You don't find my theory consistent with the facts. I understand this and I also see the reasons why. My theory aims at taking speculation fully into account, which neither financial journalism nor academic publishing presently does. They treat speculation as you would a sleeping dog. Just let the sleeping dog lie. Yet speculation is everything but a sleeping dog. Its volume has been increasing exponentially since 1971, and right now it is spinning out of control. Small miracle that it hasn't blown the financial world to pieces. I quote from your letter:

"Although I read your theory of the Kondratiev long-wave cycle with great interest, I cannot say that I find it consistent with observable facts. Commodity prices over the last five years have risen WITH bond prices, that is, IN THE FACE OF falling interest rates, just the opposite of what your theory is predicting. Your theory is counter-intuitive, to say the least. While there is an infinite supply of bonds and currencies under fiat regimes, the supply of commodities is certainly finite. A theory that places them on equal footing cannot be right. We must take supply and demand dynamics in terms of its effect on prices and interest rates into account. I wonder if you can direct me to a fuller discussion of these ideas, since I am confused about some of the qualifications you make."

There is no fuller discussion of my theory than what you and I hereby provide. For this reason I welcome your criticism and invite others, too, to participate. I have defined inflationary and deflationary spirals under the Kondratiev long-wave cycle in terms of the huge oscillating speculative money-flow to-and-fro between the bond market and the commodity market, and not in terms of the effect of such a flow on prices and interest rates. There are other factors affecting prices, to be sure, first and foremost, as you point out, scarcity. And, true enough, should it offer serious resistance, speculation would be trumped by scarcity.

However, supply/demand is nothing but a figment of the imagination unless it includes *speculative* supply/demand which, rightly or wrongly, also participates in the price-discovery process. Speculators have no firm commitment to the long or the short side of the market. They may change sides at the drop of the hat, sometimes rationally, at other times not so rationally. Moreover, speculators can sell short, that is, sell commodities that they haven't got, nor do they know how they are going to get. Their motto is "sell now, worry later". The point is that speculation is capricious. Therefore the notion of supply/demand does not stand up to scientific scrutiny. It is an antiseptic concept having validity only in an environment free of the virus of speculation. Such an environment was approximated by the regime of the gold standard which successfully confined speculation to areas where it could do only good and no harm: to markets where supply was controlled by nature, not by man, such as markets in agricultural commodities. In these markets speculation is always *stabilizing*, and it makes sense to talk about supply/demand. But in markets where supply is controlled by man (read: government), speculation is necessarily *destabilizing*. Speculators risking their own funds can easily outsmart bureaucrats on salary, risking public funds. What are we to make of "supply" in the forex market where nimble speculators regularly forestall the central bank by selling forward before its agent can even pick up the telephone? Or what are we to make of "demand" in the bond market where nimble speculators regularly forestall the central bank by buying forward before its agent can even click on the "buy" button of his monitor? These hare-brained schemes of central-bank intervention in the markets are not serving any purpose beyond making speculation risk-free, thereby allowing speculators to tap into the public purse. One of the chief merits of the gold standard is that it is the only way to make it impossible for speculators to have a free ride at public expense.

Supply/demand is a deliberate oversimplification that may be applicable in fair weather, but is mercilessly blown away by the first storm. Under these circumstances an analysis of the Kondratiev long-wave cycle must be based on insight one can gain into the thinking of big-time speculators, and not on the spurious concept of supply/demand.

It is well-known that Greenspan&Co. does worry about deflation. In fact, they have made it clear that to combat deflation they can, and will, pump unlimited amounts of money into the economy, certainly by conventional means through open market purchases of bonds but, if need be, also by unconventional means such as through helicopter-drop of FR notes. Speculators are listening. While they do not take the helicopter-drop idea seriously, they are certain that *for them* manna *will* fall from heaven in the form of risk-free speculative opportunity. They know that the Fed is going to buy bonds in the open market in an effort to combat deflation. All they have to do is to buy the bond *before* the Fed does. Why should they buy commodities, however attractive the idea may be? Scarcity or no scarcity, there is risk in buying commodities, namely the risk that you may be left holding the bag.

The Fed has already pumped an enormous amount of money into the economy. In other words, Greenspan has taken the horse of speculation to the commodity-pool of water. Can he now make the horse drink? We can be pretty sure that the horse will drink. Moreover, drink it will heartily, but *from another pool*, the bond-pool of water. The bond market is the place where the fun is, where speculation is as nearly risk-free as it can ever be.

All the more is this true right now, given the strong yen. The weak dollar is the perfect smoke-screen to camouflage nefarious bond speculation that is going to drain the last drop of strength from the economy. In markets where the risks are created by man, not by nature, speculation is no longer a zero-sum game. No longer is it true that the gain of one speculator is the loss of another. When the nemesis of bond and forex speculation was unleashed by the authors of the irredeemable dollar, the entire wealth of the United States was put on the gaming table and into the jackpot to taunt speculators. Far from declining the bait, the discriminating speculator has accepted the challenge. He is placing the bet, except he may bet against the wishes of his "handlers". He may bet in the bond market when his handlers want him to bet in the commodity market, and conversely.

This is exactly what he does in the present situation. The discriminating speculator engages in the yen-carry trade, that is, arbitrage from the yen bond market to the dollar bond market. He borrows yens at 1 percent, exchanges them for dollars to buy US bonds yielding 5. The purpose of the exercise is to drive up the price of dollar-bonds to the unheard-of heights of yen-bonds. Note the double-whammy. In addition to the unearned income of 4 percent the speculator will pocket huge capital gains after bond prices appreciate. Better still, the rising yen turns the double-whammy into a *triple-whammy*. The falling dollar makes the terms of trade for the speculator improve. He can now control a larger slice of the nicely appreciating bond-pie per unit of borrowed capital than before. True, he will have a loss on the short leg of the trade, namely, loss due to the rising exchange rate. In percentage terms this loss is in the order of one-digit. He reckons with that. But profits on the long leg, the portfolio of dollar-bonds, are in the order of triple-digit. With these odds, why should he care about losses on the short leg?

Many of my readers have a difficult time to understand how the yen-carry trade can be profitable while the dollar is falling. "Borrow yens, a rising currency? Are you out of your mind? This is a ticket to guaranteed losses!" These comments only go to show the inherent ingenuity of the yen-carry trade as it frightens away potential competition. Not only does it offer a fantastic profit opportunity; it also offers obscurity in which those profits can safely be made. The best profit-opportunity is the one that only one in a million can detect!

To recapitulate, the Fed's well-advertised strategy to combat deflation is going to backfire through the cunning of speculators. They will not buy commodities as expected. Instead, they will buy dollar-bonds thereby making interest rates to fall *even in the face of a weak dollar*. As I have discussed elsewhere in full details, "linkage" will translate falling interest rates into falling prices. The Fed will have made deflation worse, not better, by its misguided intervention.

You have taken me to task in pointing out that as far as the eye can see there are price increases; price decreases are nowhere to be seen. I am not going to argue that prices of agricultural goods are already at depression level. Nor am I going to argue that the low prices offered by Wal-Mart on made-in-China gadgetry, and the falling price of computers and paraphernalia, are very much part of deflation. I just call attention to the fact that big multinational companies are losing pricing-power. Companies don't respond in the traditional way, by beefing up capital. Quite to the contrary, they thin it out. That is to say, they redeploy capital from production into bond speculation, euphemistically called "consumer finance". General Electric that pioneered the move out of production into speculation is now followed by General Motors. This redeployment of capital

is responsible for outsourcing and the loss of well-paid industrial jobs in the United States which are replaced by low-paid service jobs. The trouble is that these service jobs won't last. When the workers are at the end of the rope and can no longer refinance their mortgages to get spending cash, the hamburger-flipping jobs will go the way of the tool-making jobs. The signs portending deflation are all-around for those who have eyes to see.

Fed governors have found it necessary to shout from their rooftops that, yes, they do have contingency plans to combat deflation. So far so good, but what about contingency plans to combat inflation, and hyperinflation to boot? Here we meet with deep silence. The Fed is not saying how it plans to meet the emergency if the dollar hits skid-row and foreign holders of dollars start crying that the Emperor has no clothes. Let me tell you that the Fed's silence on its ability to combat hyperinflation is extremely ominous. It is not that the Fed may have no contingency plans to meet such an emergency. It is that the plans it has are unorthodox, unethical, and they can only work clandestinely. They cannot succeed in the light of the day. *The Fed plans to trap bond-bears and other speculators shorting the dollar.*

Here I stumble into conjecture, hypotheses that nobody can prove or disprove because of the tight secrecy surrounding the plan. It is risky business to make conjectures about the clandestine operations of a government agency, but we are forced to take this risk in view of the web of lies the Fed weaves around itself.

The Fed's contingency plan is essentially a check-kiting scheme in conspiracy with the Bank of Japan. The Fed swaps interest-bearing Treasury debt for non-interest-bearing yen balances *over and above* its needs to finance the trade deficit. As the Fed buys the bonds in the open market, it will pull the rug from underneath the bond-bears, and speculators shorting the dollar will burn their fingers right to the armpit. How do we know that this is what the Fed is planning to do or is already doing? By a process of elimination. Short of making the dollar gold-redeemable, and throwing all ethical considerations aside, this plan offers the best chance for saving the dollar from the sudden-death syndrome, the congenital disease of all irredeemable currencies. Note that the Fed's plan is basically the elevation of the yen-carry trade to official status. It eliminates the risk on the short leg since there are no borrowing costs. The yens are not borrowed, they are simply created on the balance sheet of the Bank of Japan. The rate of interest on dollar loans will continue to fall. Speculators will be forced to cover their short positions on the dollar with a loss; survivors will go long. Here is the perfect example of "running on empty". Just as check-kiting can tap into the pocket-book of everybody using the bank's services, this plan of the Fed taps into the public purse. It plunders all the savers and all the producers in the United States in order to save the immoral regime of irredeemable currency.

Note that the Fed's contingency plan to steer away from hyperinflation is essentially deflationary. It is designed to massacre all short sellers of dollars mercilessly by relentlessly pushing interest rates further down. The trouble with this plan is that it makes bond speculation on the long side of the market risk-free. If you now recall that speculators frustrate the Fed's anti-deflationary measures by speculating, risk-free, also on the long side of the bond market, then you will understand why I am inclined consider the deflationary scenario as more likely than the inflationary, at least for the rest of this decade, but possibly for the next one as well.

Be prepared for further mind-boggling increases in the money supply as the Fed is desperately pumping liquidity into the economy. Contrary to expectations the dollar will not get much weaker, and may indeed get stronger because the new money, rather than flowing to the commodity market as the handlers of the speculators would hope, is flowing to the bond market where speculation has been made risk free by the Fed's foolish policies. The deflationary spiral under the long-wave Kondratiev cycle is far from over, in spite of appearances. Please understand I don't suggest that you invest in bonds. I just suggest that you... well... fasten your seat belts...

Yours, etc.