

## STUPID WAGER OR CLEVER PRESTIDIGITATION?

“*Heads — you win; tails — I lose.*” Such is the message the Fed sends to bond speculators. But why would the Fed offer such a stupid wager? Read on.

The Fed is trying to bribe bond speculators with risk-free profits. That’s how the Treasury/Fed check-kiting conspiracy makes sure that there will always be plenty of buyers for government debt, regardless of the size of offering.

Ten years ago I started writing about my theory that, wittingly or unwittingly, the Fed has become the quartermaster general of the coming deflation and depression. I offered a logical, closely argued reasoning for this thesis. My argument had to do with the contention that the open market operations of the Fed make bond speculation risk-free, which explains the perpetual bull market in bonds. Bond speculators, knowing that the Fed must needs buy bonds in order to keep the money supply growing, front-run (or, to use the old-fashioned term: pre-empt) the Fed’s open market operations. They buy the bonds beforehand, and pocket risk-free profits when they sell them to the Fed. Speculators will allow the bond price to fall only so much. Then they show up as buyers for another ride of the escalator upstairs.

Incidentally, my theory also gives the *coup-de-grâce* to Keynesian and Friedmanite economics. Keynes, and later Friedman, advised governments to discard the gold standard thus destabilizing foreign exchange. That would give them free hand to pursue monetary policy — euphemism for the license to engineer unlimited depreciation of the currency. Scarcely did they consider that their scheme was to back-fire. They were shooting for inflation only to bag deflation. They wanted *rising* prices; instead, they got *falling* prices.

A falling interest-rate structure engenders a falling price-level structure. It is most destructive to the economy. It devastates existing capital and blocks the accumulation of new capital. The 30-year old regime of falling rates destroyed the once flourishing American industry forcing it to flee the country. There is no chance to accumulate new capital as long as interest rates keep falling. Continuation of this trend will cause excruciating pain to those producers who remain. They will not be able to compete with newcomers who carry a much smaller burden, thanks to their lower cost of capital. The squeeze of the old-guard producers will show up in the falling price level. The “grapes of wrath” — the seeds of which were planted by Keynes and Friedman — will come to full maturity when hoards of angry and hungry unemployed people will roam from city to city and country to country.

It is not the Fed who is in the driver’s seat. It is the bond speculator. The Great Depression was not due to *low demand for goods*, as argued by Keynes. It was due to *high demand for bonds*, courtesy of speculators who understood the dynamics of the bond market better than policymakers did. The GFC is just a repeat performance.

Check-kiting is the name for the conspiracy, typically between two banks, to tap the float (the mass of checks in the process of clearing). The conspiring banks send one another third-party checks that lack any backing whatsoever. They cover the liability of one unbacked check by crediting the other, *ad infinitum*. It is similar to wildcat banking in Scotland in the 17<sup>th</sup> century, when the coach hired by the banks carrying gold was front-running the coach carrying bank inspectors from one bank to the next. Small wonder the inspectors found the gold reserve of every bank on their beat in good shape. Check-kiting is a crime to defraud the public dealt with by the Criminal Code. Except, that is, when practiced by the Treasury and the Fed, in which case it is called monetary policy.

Let us bypass the question on what valid grounds do the Treasury and the Fed issue liabilities which they have neither the inclination nor the means to honor. The practice boils

down to clever prestidigitation: to mislead the public into believing that the Emperor *does have* clothes. He is cheered on by an enthusiastic crowd of bond speculators praising the garment. Until... until... a naughty little boy starts howling: “Gee whiz, Dad, the Emperor is stark naked!”

Suppose the Fed wants inflation and thinks that the best way to go about it is to keep buying bonds *ad nauseam* and call the practice by the acronym QE-X. The belief that pumping up the money supply through unlimited bond purchases by the central bank will bring about rising prices is a tragic mistake. A higher price level will never be achieved in this way. Bond speculators will have a field day. They would just buy the bonds in any amount. A vicious spiral of falling interest rates is engaged that, like the black hole of zero gravitation, will suck in and gobble up the world economy. Keynes and Friedman were hoping for inflation they *could* control; instead they got deflation they *could not*. They cut the tragic figure of the Sorcerer’s Apprentice who stole the Master’s password to turn on the spigots, but he has forgotten to steal the *other* password to turn them off when enough is enough.

Having been a lonely voice crying in the wilderness for ten years, I am still in a minority of one. Most economists expect Fed action to cause inflation (according to some, hyperinflation). The few who dare mention the d-words, deflation and depression, hasten to add that, of course, this would *follow* hyperinflation, not *precede* it. Same as in Zimbabwe. Reports from that unhappy country say that it has 90% unemployment after the worst hyperinflation on record.

I am the only one saying that the U.S. is not Zimbabwe, and for the U.S. the forecast is deflation first, hyperinflation afterwards — at least until the prestidigitation in the bond market is exposed.

Seldom do I get a tail-wind in the form of newspaper reports confirming that there is, after all, such a thing as front-running the Fed’s open market operations, that bond speculators do indeed buy the bonds only to dump them in the lap of the Fed at a hefty premium. I have certainly never ever expected the New York Times to provide that tail-wind. Well, on January 10, 2011, that bastion of central planning published an article from the pen of Graham Bowley. It quotes Josh Frost who is in charge of buying hundreds of billions of dollars of Treasuries for the Fed: “*We are looking to get the best price we can for the taxpayer*”. Then the article goes on to quote an authority on bond trading, Louis V. Crandall, chief economist at the research firm Wrightson ICAP, who flatly contradicts Frost: a buyer of \$100 billion a month is always going to pay the worst (highest) price. “*You can’t be a known buyer of \$100 billion a month and get a good price.*”

In my papers I have commiserated with traders of the Fed facing, as they are, hungry lions in the arena bare-handed. The latter are the bond speculators who, unlike the former, are not working for wages. They work for profits. (If the profits happen to be risk free, so much the better.) True, the loss the Fed’s traders habitually make is not *their* loss. They are passed on to the taxpayers with a shrug. It is the taxpayers’ blood that is spilled so valiantly.

This reminds me of the object-lesson offered by George Soros. He made mincemeat of the traders of the Bank of England some years ago who were trying to fend off his serial attacks to sell the British pound short. Soros took the traders to the cleaners and, to rub it in, he bragged about it in his book. No need to feel sorry for the forex traders of the Bag Lady of Threadneedle Street. It was not their blood anyway that was flowing so abundantly. It was the blood of the British taxpayers.

I didn’t know the identity of the Fed’s traders facing the hungry lions. Now I do, thanks to the New York Times. They are babes in Toyland. All three of them are in their 20’s. Their only prior experience in trading comes from playing Monopoly. One of them is still a student at NYU. According to the story in the NYT, “most days” they talk to the big banks. How is that for guarding against conflict of interest? Their supervisor, Josh Frost lives in

Brooklyn and every morning he takes the subway to commute to work. As one may figure, not for too long. Wonder how one gets such a rags-to-riches job at the Fed? Well, take the example of Josh Frost's boss, Bryan P. Sack, age 40. In 2004 he co-authored a paper with Ben Bernanke, the future chairman of the Fed and another economist about "unconventional measures for stimulating the economy in extraordinary times" — by buying Treasuries in batches of hundreds of billions of dollars. "We didn't know then that some day the Fed would be putting it to test" — Brian is quoted as saying.

The best part of it all is that the line between success and failure is hopelessly blurred. If the rate of interest goes down in consequence of Fed action, then: "hooray, we're dead on with targeting inflation. And that's good news". If, on the other hand, the rate of interest goes up, then: "hooray, the economy is turning around. Rates have risen for the very reason we were hoping for: investors are more optimistic about the recovery. It is a good sign."

The fact that in the meantime the economy is wiped out, gets lost in the noise of loud self-congratulation.

### References

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### ANNOUNCEMENT

#### New Austrian School of Economics

Course Two at the Martineum Academy in Szombathely, Hungary,  
from March 5 through 13, 2011. Title of the course:

#### **ADAM SMITH'S REAL BILLS DOCTRINE AND SOCIAL CIRCULATING CAPITAL**

What makes this course especially topical today is the fact that more and more hints are being dropped about the possible rehabilitation and restoration of the gold standard — following the ignominious collapse of the irredeemable dollar. However, *a gold standard without its clearing house, the bill market, is not viable* and itself is liable to collapse in short order — as it did in the early 1930's. The level of public ignorance about the necessity of a clearing house is appalling. It is made that much worse by a tottering banking system. We have an urgent message: only gold standard *cum* real bills can restore prosperity to the world, in view of the fact that *we have to write off the world's banking system as a total loss*.

This is the second in a four-course series on Austrian Economics, a branch of economic science based on the work of Carl Menger (1840-1921). 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*. The complete program consists of four courses (10 days, 20 lectures each). Completion of each course will earn one credit. Participants who have accumulated four credits get a diploma signed by Professor Fekete. Course One that was given in 2010 *is not a prerequisite*. It is available on DVD for purchase.

All scholarships have now been awarded.

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