REVISIONIST VIEW OF THE GREAT DEPRESSION Part Two

Antal E. Fekete

Professor, Memorial University of Newfoundland
St.John's, Canada A1C 5S7

E-mail: aefekete@hotmail.com

III. INVISIBLE PILFERAGE

The Pharaoh's Treasure

According to the ancient Greek historian Herodotus the treasure of no Egyptian pharaoh was comparable in either size or value to the enormous hoard of Rhampsinitos. His treasury was housed in a huge stone building adjacent to the palace, and it was considered burglar-proof. The door was sealed by the pharaoh's personal seal and manned around the clock by armed guards. Rhampsinitos was present in person every time the seal was broken and the building entered. Therefore it was extremely disturbing when the pharaoh discovered that his treasure was being pilfered, albeit without any sign of unauthorized entry into the building. To find out what was going on the pharaoh caused a trap to be placed inside to catch any would-be thief as he was approaching the treasure-bins. To his utter amazement, on his next visit the pharaoh found that, while the trap had done the job of catching the would-be thief, yet this did not help him one iota to solve the mystery. More treasure was missing, together with the head of the would-be thief. There was no sign showing how the missing objects had been spirited out of the building. The identity of the thieves could not be established. It appeared as if someone had supernatural power to enter the building invisibly and pilfer the treasure without leaving any trace.

Pilfering the Wealth of Nations

The Great Depression seems to have presented a similar mystery. Productive enterprise came under pressure to liquidate debt and inventory, so excruciating had the debt-burden become. Those firms that could not liquidate fast enough were themselves liquidated. The Wealth of Nations was decimated as scores of once flourishing firms were going bankrupt. Nobody suspected that the loss of wealth might be due to plunder and pilferage. For a time governments bought nostrums prescribed by Keynesian and Friedmanite soothsayers to prevent similar disasters from happening in the future in the belief that the

destruction of wealth was due to natural causes. But as depression struck Japan in spite of taking the prescription, and as other countries appear also to succumb to the Japanese disease, the peddlers of nostrums became suspicious as being impostors. In the absence of an acceptable theory explaining the Great Depression the danger of future depressions looms larger than ever in the horizon.

Our revisionist view presented here for the first time suggests that, far from being due to natural causes, the Great Depression was unquestionably the result of plunder and pilferage. The Wealth of Nations was being pilfered invisibly. Those responsible couldn't be caught because the thievery involved no physical movement of property. Whenever a dead body was found (such as that of LTCM, or that of Enron), the head was missing and the investigation could proceed no further. Public opinion has been lulled into the false belief by the economists' profession and by the financial media that there was in fact no pilferage, the phenomenon must be explained by the idiosyncrasies of the capitalist system of production.

Capital Consumption

It is a daunting task trying to change a consensus that has been nurtured through generations. Yet we must not shrink from exposing the crime if we know who the culprit is, even if our evidence will be laughed out of court. Here is our analysis. The thievery involved no physical transfer of property; it involved book-keeping transfers from the balance sheet of the productive sector to that of the financial sector. The root cause of the wholesale bankruptcy of productive firms was not the falling price structure (although it certainly helped) but, primarily, the falling interest-rate structure. As interest rates fell, bond prices rose, and with them rose the present value of debt. This caused the cost of servicing productive capital already deployed to rise as well. However, no allowance for the increased costs was made in the balance sheet. There was no recognition of the fact that falling interest rates caused the liquidation-value of firms to snowball, materially adding to liability. In other words, there were losses that were never realized and no charges to income against them were made. Moreover, this was the practice across the board. The failure to realize losses in the national economy meant that society has been consuming capital over a period of time. In the end productive enterprise was operating on the strength of phantom capital. Not only was capital consumption universal affecting all firms engaged in productive enterprise, it was going on unnoticed. The viciousness and violence of the reaction, when it finally came, was unprecedented. Productive firms were falling right and left, regardless of the demand for their products. Firms that were certified as being sound one day would go bankrupt the next. One of the lessons of the Great Depression is that capital consumption is the most treacherous form of credit abuse that may plague society, chiefly because it can go on unnoticed for so long before anyone can recognize it. Corrective action, when it comes, is too late. This highlights the importance of maintaining the highest accounting standards. Any attempt at compromise is a crime not only against the shareholders, but against society as a whole.

Once we have identified capital consumption as the cause of the Great Depression, the focus must be shifted to the question why the rate of interest was falling as long and as much as it did, making capital consumption possible. To be sure, without such a prolonged and pronounced fall in interest rates there would have been no universal mistake in accounting. Here we have to refer to chronology in order to establish the direct responsibility of politicians, in particular, the responsibility of one person, F.D. Roosevelt. The banks in the United States lay prostrate between Election Day, November 1932, and Inauguration Day, March 1933. As a consequence of the economic boom of the "roaring twenties" interest rates were steadily increasing, and bank capital was greatly weakened by the proliferation of non-performing loans. Rumors had it that Roosevelt, the Democratic candidate for the presidency would, in spite of his repeated pledges during the campaign to the contrary, "go off" the gold standard and devalue the dollar. There was a run on the banks. People wanted to withdraw their savings before the monetary mischief was sprung upon the nation. They trusted neither the integrity of the banks nor that of the politicians - not entirely without reasons as one might add in retrospect. Some revisionist historians even go as far as suggesting that rumors of devaluation were deliberately planted by Roosevelt himself. He did want the banks to fail so that upon inauguration he could declare a state of emergency and assume dictatorial powers. (Note that these allegations of revisionist historians have no bearing on my argument. Be that as it may, it is a fact that Roosevelt made himself unavailable during the interregnum, and refused to deny the rumors of an imminent devaluation, in spite of repeated appeals from Hoover.)

Wiping out Negative Net Worth

In the event, shortly after inauguration Roosevelt closed the banks. Later most of the banks were reopened and given a clean bill of health but, in reality, they were in a very sorry state rather similar to that of the Japanese banks today. They had a negative net worth. There were huge holes in their balance sheets. They could open for business only by virtue of the government's connivance allowing bank inspectors not to enforce the accounting rule that assets be carried at market value in the balance sheet. The banks had a strategy to wipe out negative net worth by mending the holes in their balance sheet - a Herculean task. On the assumption that interest rates would fall further, they could keep buying government bonds to let capital gains in the bond portfolio take care of capital insufficiency.

There was just one problem with that strategy. It was the risk that interest rates may turn around and start rising This would not only hurt the banks, it would turn the bond market into a "killing field". Field where the banks would be slaughtered. There were plenty of reasons, too, why interest rates could indeed turn around and start rising again. There was the continuing threat of devaluation of the dollar. There was the added threat of a huge inflation. (In the fullness of times, both threats became a reality.) There was a flight of capital from the country. The banks could not have concocted a riskier strategy to save

their skin. But there was a godsend, turning the risky bet into a safe one. The risk threatening the banks' strategy was removed by a Presidential Proclamation.

Save the Banks, Ban Gold

Roosevelt called in gold coinage. He made trading in and owning gold (in forms other than jewelry) a crime. What has all this got to do with the banks' strategy for survival? Here is the connection, which has never been adequately explained by scholarship. The risk that interest rates might turn around frustrating the banks' strategy to wipe out negative net worth was eliminated by Roosevelt's ban on gold hoarding. Predictably, the ban had a deflationary effect on the economy as it started a downward spiral in the rate of interest. Before the ban those who wanted to manage their liquid wealth most conservatively would park it in gold. After the ban they were forced to park it in government bonds. The captive clientele for government bonds guaranteed that bond prices would keep rising, and interest rates would keep falling, for several years to come. The banks were given the green light to go ahead with their massive bond-speculation scheme. An orgy of speculation in the bond market followed.

Everybody knows about the bull market in stocks in the 1920's. Reams of books have been written on that subject. But nobody has ever heard about the bull market in bonds in the 1930's. Yet it is a fact that the volume of the latter surpassed that of the former by a factor of ten. The banks made obscene profits in the form of capital gains in the bond portfolio. For the next six years, while interest rates continued to fall, the banks and other firms in the financial sector got fabulously rich, while firms in the productive sector were being put through the wringer. The banks' profits were more than enough to wipe out negative net worth. Banks that had been technically bankrupt at the beginning of the decade were in ultra-strong financial position by the end of the decade.

Financial Vampirism

However, the banks' newly found wealth did not come out of nothing. It was not newly created wealth. It was existing wealth that was siphoned off the balance sheet of productive enterprise forcing it into bankruptcy in consequence of this financial vampirism. We may do well to remember that the banks' pilfering the Wealth of Nations was possible because of the falling interest-rate structure which, in turn, was engineered by the crudest form of government intervention in the market: the unconstitutional confiscation of the people's gold without due process.

This is not to suggest that Roosevelt was an accomplice or a stooge of the banks, or that he declared his ban on gold hoarding for the purpose of bailing out the banks. It is possible that there was a fortuitous coincidence. We may never know, and it does not matter. The fact remains that tampering with gold is tantamount to tampering with

interest rates. It is a most dangerous expedient as it may have many unforeseen and untoward consequences.

This, then, is the revisionist view of the Great Depression. Without the gold ban the recession that started with the 1929 stock market crash would have been over by 1932. With the gold ban, the recession was turned into the greatest depression of all times. The man who was celebrated as savior ridding the nation of the curse of depression was in fact the one who had brought the disaster about. He pulled the gold trigger that released the murderous forces of bond speculation to prey upon the productive sector. It heralded the continuing fall of the rate of interest. Bond speculators, first and foremost the banks among them, were listening and got ready to move in for the killing. The vultures picked the bones of productive enterprise clean. And all this was done under the veil of anonymity. Nobody guessed that the Great Depression was a happy time for some. Well, for the bankers it was time for popping corks. Not only was their skin saved, but they became so strong financially that they could thereafter dictate government policy.

Don't Entrust Your Money to Desperadoes

Thus the chief culprit and the only beneficiary of the Great Depression was the banking fraternity. They profited from the disaster devastating the world economy. I now pick up the thread I left off in part two, and continue my discourse on the consequences of relaxing accounting standards. It was a colossal mistake to reclassify insolvent banks as merely "illiquid" and letting them open their doors for business. An illiquid bank, by definition, is one that can be considered solvent only by virtue of relaxing accounting standards, allowing the bank to carry an asset (usually a government bond) at acquisition price, regardless how low the current market price of that asset may have fallen. Why is this a mistake? Well, illiquid banks are desperadoes ready to take unreasonable risks with the people's money entrusted to their care. Illiquid banks have nothing to lose but their stigma of being insolvent. They should be closed down by bank inspectors without hesitation. Any compromise in relaxing accounting standards is foolish in the extreme. It invites great dangers affecting not only shareholders and depositors, but society as a whole. It is hard to imagine a dictum more insane than the one: "Bank X is too big to fail".

Cui bono?

We have argued that the Great Depression of the 1930's was caused by illiquid banks in the United States as they became the engine of an unprecedented speculative orgy in the bond market to drive down interest rates. We could also argue that the depression in Japan today is caused by illiquid Japanese banks as they have become the engine of another huge bull market in bonds to drive the rate of interest to zero.

There is more to this story than revisionist history. Our insight may help explaining the passing scene of our day. For the time being, there is no ban on gold hoarding today. But

it is apparent that the gold market is being manipulated, possibly with government connivance. In trying to understand an unexpected or puzzling historical event, historians used to ask the key question: *cui bono?* (who is the possible beneficiary?)

It ought to be understood well that gold manipulation (i.e., conspiracy to keep the price of gold permanently in a low range) is deflationary. Just as Roosevelt's ban on gold hoarding, the present exercise in gold manipulation also has the effect of restricting demand for physical gold. The result is the same: interest rates keep falling, and for the same reasons. Liquid capital all over the world is seeking out the 'next best' alternative to gold as a conservative investment medium. It will find it in the form of government bonds. Once more, a captive market for government bonds has been created. As bidding for bonds continues, interest rates keep falling. Bond speculators are invited to jump on the bandwagon: the risk that interest rates might turn around and start rising, thereby frustrating the speculation, has been reduced by the gold manipulation. Before our very eyes (and not everyone has eyes to see this sort of thing) there is an orgy of bull-market speculation in bonds that started twenty years ago. The end may not be in sight yet. In 1980, interest rates in the United States were around 16 percent per annum. They have come down to around 5 percent. If the example of Japan is any guide, they still have a long way to go. American interest rates could follow the Japanese into the abyss. Why not? The mechanism to link the two rates is already in place. It is called the yen-carry trade. The speculator sells the Japanese bond and buys the American. This amounts to borrowing yens at zero percent (or thereabouts), converting the proceeds into dollars and lending them at 5 percent. The reward? Almost 5 percent - not bad for shuffling paper. Clearly, the effect of the yen-carry trade is to drive down the rate of interest in America, too.

The consequences of a falling interest-rate structure today are no different from those in the 1930's. There is capital consumption in the productive sector. There is a stealthy transfer of wealth from the productive to the financial sector. *Cui bono?* Why, for the benefit of the banks, of course. American and Japanese banks. Banks of any stripe or color. The worst part of it all is that the public is still in the dark about the invidious consequences of falling interest rates. It is told a tale about free markets deciding bond values and the value of gold. The ominous fact, however, is that both markets are rigged. They are like a casino where the dice are loaded for the benefit of the house.

$ 100 trillion worth of hot air

The truth is that there is no public benefit in bond, foreign exchange, and gold speculation. None whatsoever. The world could still go on without any of this trading, and no one would be any worse off. The overwhelming majority of the people, including all savers and producers, would be better off. Interest and foreign exchange rates were so stable under the regime of the gold standard that no speculator in his right mind would hold bonds or foreign exchange in the hope of speculative gain. Today not only do we have speculation in bonds and foreign exchange; since 1971 we have also allowed

speculators to construct derivatives markets on the top of the bond , foreign exchange, and gold markets. The combined volume of these derivatives markets has snowballed and its size has hit and surpassed the $100 trillion mark! No misprint here. There is commitment to pay compensation for the fluctuation in the value of $100 trillion worth of paper. (Never mind that there is isn't nearly as much paper in existence, not even if we include the scum of the junk bond market.) For centuries before 1971, the grand total of paper so 'insured' was exactly $ 0 (zero dollar). In other words, in 1971 the world all of a sudden developed an insatiable appetite for insurance. In thirty years the world came up with $ 100 trillion worth of 'insurables' to bolster security. What security? Maybe financial security? No, we can't very well say that, not after the collapse of Enron, and not after the dollar having lost 90 percent of its purchasing power during the same thirty years. Then physical security, perhaps? No, not physical security. Not after the destruction of the twin towers of the World Trade Center, and not in the middle of a drama in two acts: oil war against Iraq. Then what kind of security is it that the insuring of $ 100 trillion represents? Search as you may, but you will find only hot air. The world was a much better and safer place for hundreds of years with stable interest and foreign exchange rates, and with a stable gold price, and without any insurance on hot air. Had it kept them that way, it could have earmarked funds for the eradication of poverty, hunger, diseases, illiteracy, or for any other noble cause.

The $ 100 trillion dollar market in derivatives created by the big American banks serves no purpose consonant with the interest of the national or world economy. It serves one purpose only: the aggrandizement of the profits of the financial sector, at the expense of the productive sector. The big American banks were as insolvent twenty years ago as the Japanese banks are today. Then they started their desperate bond-market gamble, trying to drive down interest rates. They badly needed capital gains in their bond portfolio to mend the enormous holes in their balance sheets. The gamble has paid off. Today the American banks are in a better financial shape. However, a high price for saving the banks' skin was paid by the productive sector. American firms producing hardware have been put out of business. Solid jobs in the productive sector were eliminated and replaced by soft jobs in the service sector. The plight of the American breadwinner who is now flipping hamburgers instead of pouring molten steel (and who may soon be out of any job) is in direct consequence of the orgy in bond speculation. Nor is this all. The depression in Japan may not stop at the Pacific. It may well portend to engulf America and the rest of the world.

Bond Speculation is No Zero-Sum Game

I am well aware that the sum $ 100 trillion is a 'notional' amount. We are not talking about $ 100 trillion worth of bonds being traded. We are talking about the combined stakes of bond speculators who have placed bets on the rate of interest, and want to profit as if they have owned bonds in that amount. But the profits, provided the speculators' bet comes off, are not 'notional'. They are payable in cold cash. Suppose, for the sake of argument, that most of the bets call for lower interest rates. In other words, most

speculators would buy bonds as they expect their value to rise further. (This is a plausible assumption. No doubt this is exactly what Japanese banks scrambling to get out of bankruptcy are likely to be doing right now.) If interest rates did in fact go down and the price of bonds did go up, say 1 percent, then the speculators' profit would be $ 1 trillion in cash. Who is going to pay that?

Economists will tell you that the profit of one speculator is the loss of another. Don't buy that. It is arrant nonsense. It would be true only if speculation were a zero-sum game. This is the case for stabilizing speculation dealing with risks created by nature, for example, in the futures markets for agricultural commodities. Here speculators make money by resisting the formation of price trends. As there is no consensus whether the formation of an up-trend or a downtrend is more likely, speculators will be betting on either side of the market. But in markets where risks are man-made, speculation is not a zero-sum game. This is the case of destabilizing speculation. For example, in the market for bonds and its derivatives speculators make money by inducing and then riding price trends. They are on the same side of the market, which is practically always the winning side. Remember, speculators can influence the outcome by throwing their weight around. (Try to do that against the blind forces of nature!)

Why are risks in the bond market man-made? Because under the gold standard interest rates were stable. There was little risk that bond values might change. Risks were injected artificially when politicians forcibly removed the gold standard.

But if the profit of the speculator who bet on higher bond values and won is not paid by another speculator on the other side of the bet, then who is paying it? This is a crucial question and we must answer it very carefully. The other side of the bet was probably taken by a banker for hedging rather than speculative purposes. He sold the bond in order to hedge his exposure in lending money to productive enterprise. His is a neutral position with regard to the bond market. He has a straddle: the loss on one leg is cancelled out by the profit on the other leg of the straddle. The loss is passed on to the party on the other side of the hedging banker's bet. Therefore, ultimately, the losers paying the $ 1 trillion profit to bond speculators are the firms in the productive sector. They are sitting ducks in this speculative game. They have no choice. They must carry the risk of owning productive capital, without which there will be no consumer goods for you, for me, or for any other member of society. The foregoing argument demonstrated conclusively that as speculators drive down the rate of interest to zero, the value of productive capital is surreptitiously siphoned off the balance sheets of the producers and will show up as capital gains in the balance sheets of bond speculators. Firms in the productive sector are condemned to bankruptcy for the benefit of parasites. This is the essence of depressions.

Monument to Folly

The $ 100 trillion derivatives market is a monument to the folly of man. Derivatives trading serves no purpose other than benefiting a parasitic class, that of the bond

speculators, chief among them the banking fraternity, at the expense of the productive sector. Producers meekly accept their role of sacrificial lamb. They do so because they lack understanding of what is happening to them, just as lambs herded in the slaughterhouse do.

This exposes the enormity of the folly of having destroyed the gold standard thus allowing interest rates to fluctuate. Thereafter bond speculators would, whenever the opportunity presented itself, drive down the rate of interest all the way to zero while, in the best tradition of vampires, they suck the life-blood out of the producers. The $ 100 trillion monument ought to be our reminder that bond speculators are hell-bent to plunge the world into a depression once again, as they did in the 1930's.

Unless governments can muster their brain- and will-power, demolish that monument, stop the deadly game, and stabilize interest rates once more by opening the Mint to gold.

March 13, 2002

Note. This paper is based on a series of talks with the same title given by the author at Sapientia University, Csikszereda, Romania, in March, 2002.