REVISIONIST THEORY OF DEPRESSIONS

CAN IT HAPPEN AGAIN?

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Those who refuse to learn from history are bound to repeat it

It is amazing how fast events unfold in the present crisis. When we picked our subtitle "Can It Happen Again" for this talk just a few months ago, it was merely an afterthought, looking at a remote possibility. Now, on this Election Day, we are in the midst of an unacknowledged depression possibly worse than that of the 1930's. The financial mayhem on Wall Street is spilling over every other street in America, nay, in the whole world. In all likelihood job losses currently reported are only the tip of a monstrous iceberg.

When Olivier Blanchard, the IMF's chief economist, was asked the question whether the world was sinking into another Great Depression, he confidently replied that the chance was "nearly nil". He added that, after all, we have learned a couple of tricks in the intervening 80 years.

So we have, indeed, a couple of Keynesian tricks, and a few more Friedmanite nostrums — while we were made to forget the accumulated economic wisdom of the ages. But we have not learned what mistakes, made by policy-makers, have caused the Great Depression of the 1930's. And we certainly have not learned how to avoid the same mistakes again.

Keynesian and Friedmanite precepts rule economics, with no quarter given to traditional economics that has been exiled. It looks like the fulfillment of the prophecy: "those who refuse to learn from history are bound to repeat it".

Promises to pay which the Treasury and the Fed are neither willing nor able to honor

For the past eight years or so, in my writings and lectures, I have been advocating what I call the "revisionist theory and history of the Great Depression." In the cacophony of Keynesian and Friedmanite propaganda on promoting the Brave New World of irredeemable currencies, my message was lost. Keynes and Friedman, for all their disagreements on the details how to "manage" the national and world economy, were in solid agreement on their categorical rejection of metallic monetary standards, that is to say, money based on positive rather than negative values. Our present monetary system, universally acclaimed by academia and media as the 'wave of the future', is based on negative values: the value of debt. Keynes and Friedman both have put the blame for the Great Depression on the "contractionist propensities" of the gold standard. And that is all that's being taught at virtually all universities around the globe about the causes of the Great Depression.

The proposition is put under official taboo that *there is no valid defense for giving the Fed and the Treasury the privilege to issue promises to pay which they are neither willing nor able to honor* (except insofar as they honor them as part of their the check-kiting conspiracy).

Bonds minus gold equals interest rates halved again and again

My revisionist thesis is simple: the truth is the exact opposite of the officially upheld economic doctrine. The cause of the Great Depression was the forcible removal of gold from the international monetary system, including the suspension of the gold standard by Great Britain in 1931, and the confiscation of the gold coins of the citizens of the United States in 1933.

To see this clearly we have to contemplate the main role played by gold in the monetary system which is this: gold is the only asset that can successfully compete with government bonds for the savings of people with a conservative frame of mind. As long as gold is available as an alternative to bonds, the public purse is controlled by the people. If they don't like government profligacy, they can sell their bonds and stay invested in gold. This is the only message that those in power would read or understand: the rise in the cost of borrowing by the government. The rate of interest goes up. The red lights in the corridors of power start flashing.

Confiscation of gold means cutting the wire to those red lights. It means the removal of the only effective competition of government bonds, gold coins. In the absence of gold government bonds have a captive market. They enjoy a monopoly. The government can afford to ignore all criticism of its monetary and fiscal policies. It can do with the public purse as it pleases. Conservative bondholders no longer have a choice: they have to buy and hold the bond. The public purse is no longer controlled by the people. The government can cause the public debt to go to any high level. The government can cause the cost of its own borrowing to fall to any low level. In formula: bonds minus gold equals interest rates halved, and halved, and halved; again, and again, and again:

$$B - G = (\tfrac{1}{2})^n p$$

Keynesians butt in: “Hey, wait a minute, that’s just it. Isn’t this a good thing to have? Isn’t it a wonderful thing to turn the stone into bread; to abolish scarcity, by making capital abundant through a low interest-rate policy?”

Confusing a *low* with a *falling* rate of interest

Nobody denies that a low interest-rate structure, brought about by a high rate of voluntary savings, is a great blessing to society. What we face here is a fatal confusion of *low* with *falling* interest rates. If the fall is prolonged, then the net effect on the economy is lethal, as *it causes the destruction of capital* which, unless checked in time, could bring the entire economy to a screeching halt.

Capital destruction is a subtle process which even the victims themselves are unable to diagnose. The suggestion that *pari passu* with falling interest rates the market price of bonds rises is uncontroversial. It is an undeniable fact of the markets. It follows that as interest rates keep falling, bond speculators reap constant capital gains, a reward not for saving but for gambling. Their gains do not come out of nowhere. They are siphoned off from the capital accounts of the producers. Entrepreneurs are unsuspecting. They don't know what has hit them when they find their enterprise denuded of capital. The last thing they suspect is falling interest rates which they welcome, like everybody else, as a relief. Whatever it is, relief it is not. It is the kiss of death.

Liquidation value of bonded debt

To see the causal relation clearly, let us go through the process of capital destruction step-by-step. As the name suggests, "liquidation value" is the lump sum it takes to liquidate debt, should it be necessary to retire it before maturity — for example, in case of mergers, acquisitions, takeovers, shotgun marriages, not to mention nationalization. The point is that as the rate of interest *falls*, the liquidation value of debt *rises*. Rise it must, because the stream of interest payments, originally set when interest rates were higher, is now being capitalized at a lower rate. Since it represents a lower value, it falls short of liquidating the debt.

For example, when I repatriated to Hungary and sold my house with a mortgage in Canada, the bank would not accept the balance remaining in settlement. It insisted on my paying a 'penalty' arguing that the prevailing rate of interest was now lower, and the liquidation value of my mortgage higher. In other words, I suffered a capital loss on account of falling interest rates.

Here is another example. When the rate of interest falls, the market immediately bids up the price of bonds. The higher bond price represents the higher liquidation value of the underlying debt. Creditors will not let debtors off the hook, unless they can take an extra pound of flesh for their consideration. If this is deemed unjust, then complaints should be lodged with the gods, who ordained that man be mortal. As is well-known, for immortal gods a future stream of payments need not be discounted, and full credit is given for each and every installment. On Mount Olympus, the rate of interest is zero.

Unfortunately, however, man is not immortal. For him, the rate of interest is positive. It is for this reason that falling interest rates, far from alleviating the burden of debt, aggravate it.

Open market operations of the Fed

The grand scheme to make interest rates fall artificially started by the Fed's breaking the law in the 1920's. Open market operations were introduced clandestinely as a way to inject new money into the economy. The Fed was to enter the open market to buy government bonds, paying for them with newly created dollars.

It is important to understand that open market operations are illegal. They were not authorized under the Federal Reserve Act of 1913. In fact, the Act specifically stated that government bonds were ineligible for the purposes of collateral in backing Federal Reserve notes and deposits. Eligible collateral was confined to gold and real bills. Open market operation were 'legalized' *ex post facto* only later, in the 1930's, and the practice went on to become the chief engine of inflation through the monetization of government debt on a massive scale. It should be noted that retroactive laws are not recognized by the U.S. Constitution.

Open market operations, apart from being illegal, are no less a hare-brained scheme. Authors responsible for developing this illegal practice have been ignorant of its effect on speculation, and the effect of the resulting speculation on the rate of interest. Bond speculators are very much alive to the Fed's need to make periodic trips to the open market to buy the bonds. They lie in ambush to preempt it. They buy the bonds first, only to dump them in the lap of the Fed at a profit later. In effect, bond speculators get a free ride at public expense. They pocket risk free profits. The entire playing field of the national economy becomes tilted, favoring parasites and penalizing producers.

This is the fatal flaw in the Keynesian edifice: the chrysophobic (anti-gold) monetary system has a built-in instability manifested by the unopposed bull speculation in the bond market. The net result is an interest-rate structure that is persistently drifting lower. Keynesians pretend that their idol has made a discovery in justifying deficit spending made possible through open market operations, thus benefiting mankind. But as my analysis shows, the goodies distributed by Keynesian economics are not costless. They come at the expense of society's accumulated capital. Capital dissipation is masked by the euphoria of free lunch and pork. The damage to society dawns on the people later. By then it is too late to stop the rot. Irreparable damage has been done. The capital of society has been destroyed. Everybody is made to suffer because of Keynesian profligacy, justified under false pretenses.

The banking panic of the 1930's

The Great Depression was not caused by the vanishing of demand, as suggested by Keynes. It was caused by the vanishing of capital. Nor was the destruction of capital confined to the producing sector. It affected the financial sector as well. From 1930 to 1933 more than *nine thousand* banks closed their doors for good in the United States. Depositors and shareholders lost about $2.5 billion. As a share of the economy, that would be the equivalent of $340 billion today.

Economic historians give credit to Franklin Delano Roosevelt for meeting the banking crisis head-on. Only a few days after he was inaugurated as president in March, 1933, he declared a bank holiday and ordered all the people under the jurisdiction of the United States to surrender their gold coins. Although Roosevelt promised to return the gold after the banking crisis has subsided, this promise was apparently made in bad faith. No sooner had he confiscated the gold than he marked up its value, leaving people with paper worth 56 percent less. This neat piece of presidential chicanery was called "devaluation of the dollar in the national interest."

Old Coppernose

Yet it was plain stealing, nothing less, as the great blind senator from Oklahoma, Thomas P. Gore, had told the president in his face in the Oval Office. Senator Gore, moreover, in a debate on the Senate floor, also said this: "Henry VIII approached total depravity as nearly as imperfections of human nature would allow. But the vilest thing that Henry ever did was to debase the coin of the realm!" Old Coppernose, as he was nicknamed, did not confiscate the people's gold coins. He merely diluted them. When the gold wash wore thin, the effigy of Henry on the coin revealed a copper nose underneath. People suffered a loss as a result of this royal chicanery, to be sure, but at least they could keep their coin and have a good laugh at the expense of their sovereign.

Keynesian chrysophobes were jubilant. Roosevelt was their hero. They celebrated the advent of synthetic money and credit, laying great stores on the 'rational' management of the national currency. The money supply was expanded and deflation halted. At least so the fable said. In reality, Roosevelt was pouring oil on the fire. Capital destruction got a new boost. As I have already explained, interest rates continued their free-fall as the only competitor to government bonds, gold, had been eliminated. Keynesian economists got the fallen god, the gold standard, to kick around. No one thought that the fallen god could, phoenix-like, rise from its ashes in the fullness of times and have retribution.

Ominous parallels

It is hard to avoid seeing parallels to the current situation. Interest rates have been falling for 28 years from 16 percent in 1980 to 4 percent today. Capital destruction has taken a great toll on the producing sector, causing a large part of American industry fold tent and seek salvation overseas where wage rates are lower. As far as the financial sector is concerned, up until recently it appeared that the banks have escaped the death-trap of capital destruction. Well, we now know that they have not. Banking capital, just like industrial capital, has also been destroyed by the relentless fall of interest rates.

Banks no longer trust one other's promises to pay, because they suspect that their counter-party has no capital backing those promises. Banks are walking dead men, artificially propped up by the Fed and the Treasury, anxious to avoid the blame for inaction that ushered in the Great Depression in 1930. They are working hard to keep credit flowing. But the financial situation they face is incomparably more difficult than that of the 1930's. This is not an illiquidity crisis. This is a solvency crisis. It is due to an insidious destruction of capital.

The Fed and the Treasury are trying to recapitalize the banks by infusion of new capital in the form of freshly created Federal Reserve credit. Incidentally, the Fed is just one of the walking dead men. It does not have the collateral necessary to create new credit to the tune of $700 billion. The Treasury has to donate the Fed the bonds *directly*. The last time this imprudent departure from the principles of sound central banking has been invoked was during World War II, when the exigencies of war finance were used to justify the bypassing of the open market. The vexing question is whether irredeemable promises by the Fed and the Treasury are sufficient to jump-start banking in the United States.

There are no contingency plans for the mobilization of gold reserves to recapitalize the banks. Gold is the ultimate liquidator of debt, toxic and non-toxic. Why not use the ultimate liquidator, if we really mean business in eliminating toxic debt from the system, and if we really want to proceed with the task of deleverage to shrink the bloated balance sheets of banks? Well, the ideological obstacles are insurmountable.

Sword of Damocles

But the real difference between now and the 1930's is the incredible deterioration in the credit of the United States, which makes the present situation far more dangerous. The international credit of the United States in the 1930's was very strong. You were looking at the greatest creditor country in history. Today, four score years later, you are looking at the greatest debtor country in history, in need to borrow abroad to pay interest on its outstanding debt, in addition to borrowing in order to maintain consumption patterns. A large part of the debt is held by foreigners, not under the jurisdiction of the United States, and certainly not subject to its taxing power. This is the sword of Damocles hanging on a thin thread. At the drop of the hat sources of foreign credits could run dry. Nobody knows what will happen then.

Yet the dollar is not in immediate danger. Superficially it is strong and getting stronger. Treasury bonds are in great demand as the "flight to safety" continues. For a couple of years, maybe a little longer, the dollar will hang on "by the skin of its teeth".

But the writing is on the wall: the strong dollar will be beaten down by the U.S. government in the course of the trade war, to revive American exports. In addition, the bill for the unprecedented bailouts will come in soon enough. The government deficit will reach stratospheric heights. When the critical mass is reached and the threshold of tolerance in total indebtedness is surpassed, the run on the dollar will become inevitable. In the meantime, serious challenges to the hegemony of the dollar may be presented from friends and foes alike. This is an explosive situation. We are on uncharted waters, aboard a rudderless ship.

Worst of all, we lack leadership. Those in charge of our monetary and fiscal system are dyed-in-the-wool Keynesians and Friedmanites. They have grown up on Keynesian and Friedmanite bunk no longer applicable in the 21st century. They were caught completely by surprise by the fast unfolding of events. They do not understand what is happening to this country, let alone the world, nor do they have any idea how further damage can be prevented. The only trade they know is to cut interest rates; to print more money, rain or shine, and airdrop it from helicopters indiscriminately. Their compass, economic forecasting, the pride of mainstream economics, has turned out to be tea-leaf reading. The only people who predicted this maelstrom were non-conformist economists beyond the pale. They will not be allowed to kick in the ball.

The outlook is bleak indeed. Keynesians and Friedmanites will continue at the helm. Their faulty perception will prompt them to throw even more bad money after bad money. They will beat down the ‘strong’ dollar. There will be competitive depreciation of currencies world-wide, an echo of the trade wars and beggar-thy-neighbor policies of the 1930’s. At the end of the road lie the ruination of the world’s monetary and payment system, economic cooperation, and division of labor.

The ”blame-it-on-the-gold-standard game” is over

We have been told that deflations, depressions, bank runs, massive unemployment, wholesale bankruptcies can only happen under the gold standard. In a modern, government-managed economy, equipped with scientific money-creating techniques, bolstered by the fine-tuning management of demand, these ills of society have been relegated to the history books.

A few months of the year 2008 exploded the myths nurtured for much of the twentieth century. The stark reality is that we have not conquered scarcity with interest-rate suppressing techniques. We have not succeeded fine-tuning the national economy with monetary and fiscal policy. We have not learned how to combine high wages with high employment. We cannot turn the stone into bread. We have only been tinkering at the edges, pretending that we can ladle out riches to all comers by government fiat.

This is not a subprime crisis. This is not a real estate crisis. This is not even a dollar crisis. *This is a gold crisis*. The gold standard was sabotaged in 1933 when the U.S. government reneged on its domestic gold obligations, and again in 1971 when it reneged on its international gold obligations. The gold standard strikes back — with a lag measured not in years but in decades.

How naïve it was to believe that the gold standard could be abused and exiled with impunity! How dense it was to think that under the regime of irredeemable currency basic freedoms can be maintained! How insane it was to embrace the notion of legal tender as the ticket to a bright future!

Events of this fateful year 2008 have dumped Keynesian and Friedmanite economics to the garbage heap of science, where Marxian economics, astrology, alchemy, and many other discredited and discarded theories, the names of which have by now faded from memory, already rest.

The sooner the world leadership realizes this, the better.

By the same author:

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Calendar of events

Canberra, Australia, November 11-14, 2008

Gold Standard University Live, Session Five. (This is the last session of GSUL since our sponsor, Mr. Eric Sprott of Sprott Asset Management, Inc., has withdrawn his support saying that in his opinion the results do not justify the expenditure. Come along and judge for yourself.) This 4-day seminar is a *Primer on the Gold Basis — Trading Tool for Gold Investors, Marketing Tool for Gold Miners, and Early Warning System for Everybody Else.*

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Canberra, Australia, November 15, 2008

Panel Discussions: *The chickens of 1933 and 1971 are coming home to roost and take out bank capital.*

Inquiries: feketeaustralia@yahoo.com

Szombathely, Martineum Academy, Hungary, March 2009

Panel Discussions: *When Will the Gold Standard Be Released from Quarantine? The Vaporization of the Derivatives Tower.*

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