

TSUNAMI IN THE BOND MARKET

by Antal E. Fekete,
Professor, Memorial University of Newfoundland
March 7, 2005

Summary for the busy executive

The check-kiting scheme between the U.S. Treasury and the Fed, that has been going on quite openly for some 35 years, may have now been supplemented with another, this time between the Fed and the Bank of Japan, conducted in high secrecy. It involves the conspiratorial exchange of non-interest-bearing yen balances for interest-bearing Treasury debt in ever greater volume, *over and above* the need to finance the American trade deficit with Japan, huge as the latter may already be. The purpose of the conspiracy is to forestall a run on the dollar by other central banks and foreign exchange speculators. If my assumption about the existence of this conspiracy is correct, then the end-game of the regime of irredeemable currencies will be stretched out by another decade or so. However, that decade will not be one of inflation most observers expect. It will be one of deflation and world-wide depression which hardly anybody expects. Speculators shorting dollar-bonds will be massacred, and people in debt hoping to find relief in inflation will be squeezed out of their possessions. Reports on the demise of the bond bull have been Grossly (*sic*) exaggerated. Bill Gross, the self-styled Bond King, now talks about tsunami in the bond market with several more waves to come.

Aristotle's axiom and the history of money

The history of money can be compressed into one line: man's efforts to defeat Aristotle's axiom asserting that it is not possible for any substance to be simultaneously present at two different places. Clearly, Aristotle meant *physical* substances. *Intellectual* substances such as a promise to transfer ownership of chattel, or title to real property, can be simultaneously present in two different balance sheets. This is why governments are so enamored with paper money, another intellectual substance very different from gold money, which is a physical substance subject to Aristotle's axiom.

Stories about inspectors visiting rural banks in Scotland abound. The inspector's carriage was preceded by another, drawn by the fastest horses available in the country, loaded with gold coins to be shown to the inspector when he arrives, then to be moved post-haste to the next bank on the inspector's itinerary. In fact, companies existed to provide this important service to the banks. A worthy topic for research in economics could be the question to what extent the breeding of racehorses in England was financed by the desire of banks to defeat Aristotle's axiom. If we still had a gold standard, we would probably read about bank inspectors flying with the speed of Mach 1, preceded by another airplane carrying gold with the speed of Mach 2. By the time inspectors caught up with

progress and could also fly with the speed of Mach 2, there would be supersonic aircrafts, the development of which was financed by the banks, to fly gold ahead of bank inspectors with the speed of Mach 3.

Invention of check-kiting

Luckily for the banks this was not necessary. Irredeemable currency made flying gold back-and-forth pointless. The banks soon found a less expensive way to defeat Aristotle's axiom. They invented check-kiting which, if necessary, could be operated with the speed of light. This is how it goes. Two banks, *A* and *B*, conspire. Bank *A* issues an unbacked check payable to Bank *B*. Then Bank *B* issues a second unbacked check of similar amount payable to *A* that can be shown when the first check is presented for payment. Then *A* issues a third unbacked check of similar amount payable to *B* that can be shown when the second check is presented for payment. And so on and so forth. The game the two banks play can be continued indefinitely with the result that they have appropriated, quite fraudulently, the amount of the first check, the wages of conspiracy.

"Float" is the name of the sum total of checks in the process of clearing. It is obvious that banks *A* and *B* have tapped into the float to enrich themselves. In actual practice check-kiting is more complicated in that the two conspiring banks do not act under their own name but employ proxies in order to make detection more difficult. Naturally, the criminal code prescribes stiff penalties for this crime, a form of embezzlement. However, it is important to understand that detection is extremely difficult as the embezzled sum is extracted from a large number of accounts, and the loss suffered by any individual account holder is relatively small. Victims don't notice their loss and no complaint is lodged.

To recapitulate: check-kiting consists in issuing an unbacked check that the conspiring banks "back" with an endless string of further unbacked checks. These unbacked checks don't bounce. At the clearing house each is offset by the next. Under a gold standard check-kiting is not possible because of the existence of an ultimate means of payment, the gold coin. Individuals can protect themselves against fraud by presenting checks for payment in specie. The essence of the regime of irredeemable currency is that there is no ultimate means of payment, so the individual is deprived of protection against the crime of check-kiting.

Check-kiting made legal

Before 1968 there was a legal requirement that Federal Reserve notes be backed by gold for no less than 25 percent of their face value. To that extent the public was protected against check-kiting, as an audit could be held at any time to ascertain that the gold was there. In 1968 Congress in its wisdom repealed the legal requirement to back Federal Reserve notes by gold. After F. D. Roosevelt had made the possession of gold coins a crime by executive proclamation in 1933, the individual could no longer test checks against kiting. Nonetheless, legal requirement for gold backing provided a modicum of protection of the public against large-scale fraud.

The repeal of gold backing was said to be justified by the need that Treasury gold should not be tied up for domestic purposes but be available to pay foreign creditors of the United States in order to bolster the international value of the

dollar. This was deemed sufficient protection to domestic holders of dollar balances as well. If it was, this protection was soon taken away, too. President Nixon defaulted on the foreign-held debt of the United States three years later in 1971, and the dollar lost more than 90 percent of its purchasing power in less than 10 years.

The default removed the last obstacle in the way of the largest check-kiting scam in history. The conspirators were the U.S. Treasury, issuing obligations in the form of government debt, and the Federal Reserve, issuing obligations in the form of Federal Reserve notes and deposits. The former were supposed to be extinguished by paying out the latter, and the latter were offset in the balance sheet of the Federal Reserve banks by the former. Technically correct, but rotten to the core. A most incestuous relationship that is consummated through check-kiting.

As check-kiting between banks *A* and *B* taps into the float and victims are the account holders belonging to the same clearing house, so check-kiting between the U.S. Treasury and the Federal Reserve taps into the wealth of the nation and victims are all the producers, consumers and savers in the country.

There are several problems. First, the value of Treasury obligations is not fixed but varies inversely with the rate of interest. It could theoretically go to zero if interest rates rose beyond any limit, as indeed they threatened to do in the late 1970's. Since Treasury obligations balance the liabilities of the Federal Reserve banks, the dollar, too, is staring at the bottomless pit into which its value could fall in adversity. However, the main problem is that, although check-kiting is done quite openly, it is done in bad faith nevertheless. The U.S. Treasury and the Federal Reserve banks have neither the means nor the intention to meet their obligations value for value. Paying off Treasury debt with Federal Reserve notes, the backing of which is the same Treasury debt, is a scam to fool and plunder creditors, domestic and foreign. And among creditors we must count the poorest of the poor who has to have Federal Reserve notes to buy food for his children. It was no accident that the Big Bang marking the beginning of debt-explosion in the world occurred in 1968, the year of the legalization of check-kiting in the United States.

Federal Reserve notes may be made "legal tender" by capricious and coercive legislation, but they certainly cannot be made the "ultimate means of payment". They are the product of legalized check-kiting.

Exportation of check-kiting

An early consequence was that the foreign central bank creditors of the United States suffered huge losses as their dollar-denominated reserves were depreciating both in absolute terms and also relative to the domestic currency. Since the two most important creditors were Germany and Japan that had been vanquished in World War II and were technically still under military occupation, a little bit of arm twisting brought quick results. Losses on the books of their central banks were offset through a local version of check-kiting. The Japanese government issued special obligations to paper over the holes that the dollar default punctured in the balance sheet of the Bank of Japan. The problem was similarly "solved" in Germany. Thus the original check-kiting in the United States begot more check-kiting abroad through damage-control, which was done without much public fanfare. Financial journalists and academic experts "forgot"

to quiz the Bank of Japan and the Bundesbank about the miraculous disappearance of losses due to default on the dollar.

Virtually all critics of irredeemable currency ground their objections in the Quantity Theory of Money arguing that as the quantity of paper money increases faster than goods and services, prices will increase and paper money will eventually lose all its value. I have never accepted this simplistic explanation as it ignores the fact that paper money can buy other things beside goods and services. In particular, it can buy bonds. And to the extent it does, it could cause the exact opposite effect to that predicted by the Quantity Theory. Instead of causing inflation, it could cause deflation, and worse. Much worse. Of course, blatant increases in the money supply will alert people and they will be reluctant to buy bonds, no matter how high a figure the government prints on the interest-coupons. Still, I can't consider this an adequate protection against deflation because the loop-hole, check-kiting between central banks, remains and can trump the Quantity Theory. This is exactly the situation that we are facing right now.

More check-kiting to save the dollar

This also explains why managers of the dollar-based international monetary system chose the roundabout way to monetize government debt in preference to the direct way. They certainly had the power to inflict pure fiat money on the people of the world, that is, the dollar could be non-interest-bearing, never-maturing U.S. Treasury debt. This would bring large savings for the U.S. government that would not have to pay interest on the national debt to the extent it could be put in circulation. Arguably, a balanced U.S. budget would boost confidence in the value of the dollar like nothing else could. From the point of view of the advocates of irredeemable currency, the regime of pure fiat dollar would be superior to the present regime with its ghastly and worsening budget deficits due largely to interest payable on the national debt.

However, the managers are aware more than anybody else that pure fiat money has a record of 100 percent mortality through the sudden-death syndrome, the congenital disease of irredeemable currencies. The managers hope that, through chicanery and fraud, they could save the dollar from sudden death. They are counting on people being too stupid to see through the scam of check-kiting.

But, as the accelerating avalanche of debt in the world shows, theirs is a forlorn hope. The managers must have a contingency plan to fend off a run on the dollar by central banks and foreign exchange speculators, thus defying the sudden-death syndrome. This contingency plan involves highly secret check-kiting between the Federal Reserve and the Bank of Japan.

You can't cry "conundrum" too many times

I have no other proof than logic, and so far events have justified my theory. Bonds are defying gravity, even in the face of the Fed increasing short-term interest rates. The yield-curve is flattening as expected, but not because the intermediate and long yields are going up less than the short. It is flattening because they are *going down* in the face of the short which is *going up*. Bill Gross of PIMCO, who considers himself the best bond manager in the world, calls this extremely rare phenomenon *bull flattener*. He says it is as rare as Ahi

tuna that never hits the grill. Of course, there is an element of self-justification in this observation. Last year Bill Gross, writing at length in the widely-followed Investment Outlook of PIMCO, declared the bond bull dead. However, the dead bull, like Mark Twain reading his own obituary, talked back saying that “reports of my demise are Grossly (*sic*) exaggerated”. One should think that Bill Gross owes an explanation to his followers who might have shorted bonds based on his analysis and suffered losses as a consequence. This is quite an embarrassment for someone who likes to picture himself as the Bond King. He is seeking solace in the words of Alan Greenspan, uttered before a Congressional committee, calling the bull flattener a “conundrum”. He concludes that the Fed King sitting on his throne, scepter in hand, is no less mystified than his subaltern who should be excused for the mistake in calling the bond bull dead.

Could the Bond King be so naive? Has it not occurred to him that the wily old hypocrite on the throne, scepter in hand, might pretend to be mystified because he has a hidden agenda? His carefully selected word “conundrum” could be red herring. While publicly pretending that he does not understand it, privately Greenspan may be congratulating himself upon his success in punishing those who shorted bonds, and intimidating those who were ready to short the dollar.

Here is my solution to Greenspan’s “conundrum”. The bull flattener was deliberately inflicted upon the yield curve by Greenspan himself through his highly secret check-kiting in conspiracy with the Bank of Japan. It involves the swap of non-interest-bearing yen balances and interest-bearing Treasury debt in ever greater volume, over and above the need to finance the American trade deficit with Japan, huge as though the latter may be. The purpose of the conspiracy is to confuse the issue, thereby nipping the run on the dollar in the bud.

Bill Gross now talks about a bond market tsunami with several more waves to come. Sorry, the bear market in bonds may not be in the offing for some time to come, because of the unscheduled tsunami. Oh well, if he has made a mistake once, he can be mistaken again. But an even greater mistake was made by Greenspan himself who let the genie of tsunami out of the bottle while crying “conundrum”. Call it tsunami or call it deflation if you like, it may not be possible to put the genie back into the bottle.

As Greenspan's deceit dawns upon them, bond speculators will not let themselves be outfoxed. They will repurchase the bonds of the ownership of which they have been tricked out by the wily old fox. Worse still, they will buy more, expecting that nice back-wind from the Fed to make pyramiding risk-free. As a result bond prices will rise, interest rates will fall, and linkage will cause commodity prices to fall, too. As they do, Greenspan will have the urge to cry “conundrum” once more, this time out of genuine fear. But just as you cannot cry “wolf” too many times because the wolf will appear to put an end to your crying, you cannot cry “conundrum” too many times either.

The deflation-cat chasing its own tail

Greenspan will have a job to contain declining prices. Guess what will he do? Use helicopter drop of Federal Reserve notes, as Milton Friedman has suggested? That makes a good joke, but now the situation is deadly serious. He will try to contain deflation through the old Keynesian recipe, open market purchases of bonds, putting new money into circulation in the hope that it will

flow to the commodity market. But isn't this just the nice back-wind speculators have been waiting for to make bond pyramiding risk-free?

The deflation-cat is now ready to chase its own tail. Bond speculators buy bonds causing commodity prices to fall, which prompts open-market purchases of the Fed trying to coax speculators into buying commodities. Instead, speculators will buy more bonds, risk-free, and the vicious circle is on.

Behold the deflationary denouement of the regime of irredeemable currency.

References

Bill Gross, *Too Much!* (The weak dollar — causes and consequences), Investment Outlook, PIMCO, November 2004

Bill Gross, *I've Got to Admit It's Getting Better, Getting Better All the Time*, Investment Outlook, PIMCO, March 2005

Antal E. Fekete, [Causes and Consequences of Kondratiev's Long-Wave Cycle](#), January, 2005

Antal E. Fekete, [Stop Greenspan from Plunging America into a Depression](#), June, 2003