AN UNHAPPY NEW YEAR

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An unhappy anniversary

Another forgotten anniversary that haunts the nation is the re-establishment of the gold standard in the United States by the Roosevelt administration on January 1, 1934. What? -- you may ask incredulously. Roosevelt re-introducing the gold standard in the United States? You had better believe it. That's exactly what he did. He fixed the statutory price of gold at $35 per ounce 75 years ago. This price was observed until 1971 as it was also incorporated in several international treaties, and confirmed by the solemn promises of several presidents following Roosevelt. It is a great pity that Roosevelt-worshippers frown upon the idea of following the leader. They should demand a return to the gold standard now, 75 years after Roosevelt showed the way out from the economic quagmire.

To be sure, this is an unhappy anniversary. Roosevelt's gold standard was bad. He discriminated against American citizens so outrageously that the evil dictators of the day dismissed the idea of duplicating Roosevelt's measures in their own fiefdoms. Roosevelt's gold standard denied Americans the right to demand gold at the statutory price in exchange for Federal Reserve notes. Worse still, criminalization of the ownership of gold stayed on the books. At the same time, under Roosevelt's gold standard, the Swiss, for example, could routinely take Federal Reserve notes to a Swiss bank and exchange it for gold at the statutory price (even though, after 1936, they could no longer get gold for their own paper currency at the statutory price!) Surely this was a national dishonor: the American government discriminating against its own citizens, giving monetary rights to foreign nationals that were denied to Americans, in clear violation of the letter and the spirit of the Gold Standard Act of 1900, let alone the American Constitution.

Pigs making monetary policy

Nor is it possible to argue that the American government continued to serve the interest of the American people after March, 1933, when Roosevelt confiscated gold belonging to the American people, only to write up its value from $20.67 $35 per ounce a few months later, allegedly "in the interest of the national economy". This great government of this great nation, stealing from its own citizens in the national interest? And selling the loot abroad at a high mark-up? Where will it all end? Never mind the Constitutional prohibition on confiscation without due process. Never mind that the Constitution does not recognize fiat money. Never mind that the only kind of money the Constitution recognizes is silver and gold. Just ask simple questions about basic morality. The moral standard of the U.S. government in its dealings with its own citizens has reached an all-time low, as shown by the new norms set in the monetary field.

This land of free men was turned into an Animal Farm where pigs have been running wild and making monetary policy for the past 75 years. It is small wonder that men of utter depravity, like Bernie Madoff, could operate Ponzi schemes unobserved and with impunity for as long as he did. Just how long could the legal system stand up to assaults of this width, this depth, and this magnitude? The name Bernie Madoff reads like the Biblical writing on the wall, suggesting that ours is a Madoff dollar; ours is a Madoff Social Security; and ours is a Madoff Medicare. What basis for optimism is there for the next 75 years? To find out, let's review the past 75 years.

Stabilizing interest rates

Rotten as the New Monetary Deal was from the point of view of the American citizen, the system it established has ensured prosperity for the post-World War II era. That is, until it was disrupted by a second episode of overthrowing the gold standard in 1971 which, regrettably, was not followed by a second episode of rehabilitation.

Roosevelt's gold standard, for all its negative aspects, has succeeded in stabilizing interest rates. This was a major feat. There is only one way to stabilize interest rates: by setting up an international gold standard. And for a very simple reason, too. Gold is the ultimate extinguisher of debt, the only one there is. Governments can legislate to have legal tender, they can legislate to make ownership of gold a crime; but they cannot legislate to make their own debt serve as the ultimate extinguisher of debt. If they prevent gold from discharging this function, then debt will start proliferating until critical mass is reached. The debt implosion that follows is bound to wipe out prosperity. This is the God-ordained role of gold in the monetary system.

A stable interest rate structure is not to be confused with *falling* one. The former is a great blessing; the latter is a great scourge. It took 36 years after

1971 to find out how the difference feels on the hide. *Falling interest rates mean falling prices and falling employment*. Quite possibly, with a lag. They mean serial bankruptcies. They mean deflation and depression.

Cassandra's gift

The role of Cassandra is a thankless one. She was the daughter of Priam, king of Troy and his wife, Hecuba. Hers is one of the great stories of antiquity. Cassandra fell asleep in the temple of Apollo, and the god fell in love with the sleeping beauty. He offered to give her the ability to see the future if she were to return his love. She promised to do that, but when time has come to deliver on the promise, she reneged. The god Apollo was furious, but there was no way for him to take back the gift of clairvoyance. The best he could do was to make other people to disbelieve her prophecies. And it so happened that, when she predicted the rape of Troy by the Greeks after the ten-year siege, she was ridiculed, discredited, even declared insane by the Trojans.

I may be forgiven if I feel like Cassandra. Having published my predictions on the Internet for the better part of this decade, I have been disbelieved and ridiculed. (I have not yet been declared insane.) I have warned that the Federal Reserve's policy of relentlessly suppressing the rate of interest will lead to a disaster. I have consistently argued that a falling interest-rate structure is corrosive on capital. Having destroyed capital it will destroy employment. Having destroyed employment it will destroy prosperity. It will be the cause of serial bankruptcies. I was talking about the black hole of zero interest that tears limb from limb in swallowing all creatures approaching it. I specifically mentioned the example of the American auto industry as being the next likely major victim of the deliberate policy of driving interest rates ever lower. Rather than helping American auto-makers, falling interest rates have denuded the auto industry of its capital.

Financial capital not spared

Let me pause here to make a confession. If anything, I did not see far enough to realize all the consequences of the Federal Reserve's driving the economy into the black hole of zero interest. I failed to see the simultaneous destruction of *financial* capital. I thought that the devastation would be confined to *productive* capital. In fact, I thought that the banks were the beneficiaries of falling interest rates. They were the vampire sucking the life-blood of the producers. The financial sector was siphoning capital away from the accounts of the producing sector. I should have seen that exactly the same argument applies to financial capital as to productive capital. They are both being destroyed piecemeal by the falling interest rate structure.

The present banking crisis is the result of wiping out the capital of the financial sector, through the same process that has wiped out the capital of the producing sector: the Federal Reserve's deliberate and declared policy to drive down interest rates. The banks could have saved themselves if they had just kept picking the fruits of capital gains on their bond portfolio. Bond values have appreciated in the wake of falling interest rates. Pocketing capital gains plus clipping coupons could have been a very profitable pastime for the banks still. But in their infinite greed they were not satisfied. They coveted more. They had recourse to 'securitizing' toxic garbage and started peddling it, world-wide, as Madoff was peddling his Ponzi tickets. That was their undoing. As long as securitized garbage was kept in their balance sheets, the dirty little secret was safe. But when it was put into circulation, the scandal could no longer be kept under the bushel. "Look, Dad, the banks have no capital!" Following the cry of the little boy, other spectators at the parade, too, could see that the emperor had no clothes.

Obama will not rock the boat

I was not so naïve as to expect that the rank and file of mainstream economists would give credence to my predictions. After all, these gentlemen cut their teeth by chewing on the Keynesian bunk that it is the sacred mission of governments 'to turn the stone into bread' by driving interest rates down, if need be, all the way to zero.

More surprising was the reaction of labor leaders and the captains of the auto industry. They treated me with thinly veiled contempt, refusing even to take the trouble of going through my logical argument point by point. In this argument there was nothing offensive to labor or to capital. My offensive comments were concerned with Keynesian dogmatism and the government's embracing it without even a perfunctory critical examination. Apparently, the leadership of labor and the captains of industry are just as committed to the error of Keynesianism as the government. They will live to regret their obtuseness.

It gives me no pleasure to say, on this unhappy New Year's Eve, that "I've told you so". The world is at the brink of the worst economic collapse ever, wiping out capital and employment indiscriminately. What makes this occasion especially unhappy is that the incoming administration of Mr. Obama, rather than starting from an ideological *tabula rasa* (clean slate) as it should, has already committed itself to the same destructive Keynesian ideology and Keynesian policies that are responsible for the financial and economic catastrophe in the first place. The Secretary of Defense appointed by president Bush is not the only one who will keep his post. Foxes in charge of the chicken-coop at the Treasury will also be reappointed. There is not the slightest hint of an impending critical reappraisal to find responsibility at the highest echelons of

the Treasury and the Federal Reserve for the gross mismanagement of the economy.

The same program of driving interest rates down to zero will be continued uncritically. The road-map has already been spread out for all to see. Having driven the short term rate of interest to the ground, the Fed is now set about the business of driving down medium and long term rates as well. Ben's helicopters stand ready to take off and bombard the U.S. economy back into the Stone Age with freshly printed, crisp Federal Reserve notes.

Evils of bond speculation

I have started Gold Standard University Live, now defunct, to resurrect the study of the role of gold in the economy, in particular, its inevitable interaction with the rate of interest. Mainstream economics has completely (not to say criminally) ignored the consequences of the systematic destruction of the gold standard by the government. The enormity of one of the consequences stands out in particular. The effects of speculation on the rate of interest have been deliberately ignored.

Clearly, speculation was not a problem under the gold standard. Interest rates were stable and speculators left them alone. No profitable bets could be made on their variation. But when currencies were cut adrift from their gold moorings, their future value has become uncertain, and interest rates started bouncing up and down madly like a yo-yo. Naturally, speculators welcomed the new game as manna from heaven. It opened up a new casino where bets could placed on the future course of bond prices. The result was predictable: speculators were betting that interest rates would keep trending upwards or, what is the same to say, bond values would keep trending downwards. Speculators could drive up interest rates to double digits, and some more. Understandably, they did not think that the U.S. government could maintain the purchasing power of the irredeemable dollar, once the gold prop was removed and discarded.

Open market operations

This unintended consequence of destroying the gold standard was not welcome news in Washington. The Federal Reserve got busy to prove the speculators wrong, by driving down the rate of interest. As one U.S. senator put it, "we have to make the speculators burn their fingers right to the armpit!" In addition to vengeance, there was also the ideological legacy of Keynes that animated monetary policy, and has become the earmark of our age.

There was more. Back in the early 1920's the Federal Reserve launched a new policy of monetizing government debt. To be sure, the practice was illegal. Government bills, notes, and bonds were not included in the list of eligible paper

that could be held against the note and deposit liabilities of the Fed, as stated in the Federal Reserve Act of 1913. If and when a Federal Reserve bank, having fallen short, had to have recourse to backing its note and deposit liabilities by its holdings of government debt instead of eligible paper, stiff and progressive penalties were supposed to be collected by the Treasury. That made the practice of monetizing the debt of government prohibitively expensive.

But what if the Treasury "forgot" to collect the penalty? Well, that would be too bad, a severe bout of absent-mindedness -- but that's just what an accomplice in the conspiracy to undermine the monetary order would do.

The new fraudulent practice was called 'open market operations'. (It was legalized *ex post facto* in the 1930's.) Economists have failed to analyze the effect of open market operations on bond speculation. "See no evil, hear no evil, speak no evil." I leave the problem to future researchers to find out whether economists made an error of omission, or whether they knowingly became accomplices to the conspiracy of the Treasury and the Fed in a scheme to the aggrandize the power of the federal government.

Here is what happens when the Federal Reserve resorts to open market operations to buy government bonds as the preferred means to increase the money supply. Bond speculators are very much alive to the need of the Fed to make periodic trips to the open market to buy the bonds. They lie in wait for the Fed. They want to preempt it; they want to buy the bonds first. Later, they would dump them in the lap of the Fed, making risk-free profits in the process at the expense of the public. The Fed does not mind being ambushed. It condones the risk free profits of the bond speculators. It all comes to the same thing: lower interest rates by hook or crook.

Destruction of bank capital

With the open market operations of the Fed providing a dependable tail-wind, the sails of speculators are bulging. The unison bullish response to monetary policy by the speculators has the effect of steadily driving down the rate of interest. The Fed could report to the boss: "mission accomplished".

Nobody bothered to investigate the question whether the symbiosis of the Fed and bond speculators (mostly banks) might somehow have a detrimental effect on the economy. It certainly looked like a brilliant scheme of creating positive value out of nothing -- nay, out of *negative* value! Nobody has raised the objection that there "ain't no free lunch", that in our world strict conservation laws govern and draw a line between what is possible and what is not. In particular, it is not possible to create value out of nothing. Any appearance to the contrary must involve the destruction of value somewhere else.

Indeed, creating bond values out of nothing has coincided with the destruction of capital. Capital consumption is an insidious process. It has no

obvious symptoms. If anything, like narcotics, it has a euphoric effect on the economy. Its role is to desensitize the victim before picking his pockets. It may fatten the wage envelope, widen profit margins, jack up managerial compensation, but all that is charged to the capital account. As long as there *is* a capital account, that is. Trouble bursts on the economic scene when the bottom of the capital barrel has been scraped clean. Of course, by that time it is too late. Nothing can be done to stop the rot.

This is what we have experienced in the fateful year of 2008. While the capital of the banking industry was eroding, there was a feeling of euphoria, a sense of weightlessness, the exhilaration of levitation as capital consumption has given banking operations an extra lift in defying gravity. But no sooner had the last crumbs of consolidated capital disappeared than gravity came back with a vengeance and the banking industry fell out of the sky. *All banks, at the same time*. It was not a consequence of local mismanagement. It was not primarily a consequence of too lenient lending standards, it was not primarily a consequence of reckless risk-taking. It would have been a statistical oddity if all banks had bankrupted themselves at the same time. There was a common cause: the erosion and ultimate destruction of capital.

Recapitalizing banks with irredeemable debt

The U.S. Treasury has embarked on a policy of recapitalizing the banking industry with credits based on issuing more irredeemable debt of the U.S. government. This feeble-minded ploy has apparently been endorsed by the Obama team waiting in the wings. It may well work for a time. More specifically, it may work as long as foreigners continue to accept the irredeemable promises of the U.S. government in exchange for real goods and real services. But since foreigners are themselves in deep financial and economic trouble, concerted action of central banks to use the irredeemable debt of the U.S. as the ultimate extinguisher of debt is not promising, to say the least.

I am not predicting that the world's payments system will collapse in a matter of a few weeks. I can see a prolonged agony ahead for the dollar. The dollar is on a life-support system, powered by the ongoing bull speculation in bonds. Virtually all non-conformist observers predict that the bond market is doomed and it is already on its last leg. They expect that bond values will fall into the abyss, followed by the dollar. When economic forecasters show such a high degree of unanimity, it is a warning that unfolding events will follow a different script.

The sudden death of the bond market is not a scenario that appears a likely outcome. Bond speculators have been enjoying a bull market for 25 years. They are well-heeled financially, sitting on mountains of paper profits. They are not yet ready to cut and run. After all, theirs is the only bull market in town, the

only game of musical chairs still going strong, after the dot-com, the real estate, the stock market games had the music stopped on them.

Madoff Economics

The 'grapes of wrath' are ripening in Academia. Having exiled monetary science, agents of Madoff Economics (*alias* mainstream economists) have exposed society to untold dangers. All the people are going to be put through the wringer indiscriminately. No one will be spared.

What means Madoff Economics? It is the economics of "garbage in – garbage out". It features the central economic doctrine of Keynes that capital is for window-dressing purposes only. The smart guy does not need capital. The guy who is even smarter can milk previously accumulated capital for his own purposes.

For the first time we shall witness global destruction of capital in an advanced economy. The fabric of society is breaking down. Madoff Economics will continue to have a monopolistic influence in the councils of government. Adventurers will continue to be in charge, and will continue to display utter lack of responsibility for the damage they are causing to society. The script will be played out in full, to the bitter end. There will be no *tabula rasa* after Inauguration Day. Pigs will continue running Animal Farm, making monetary policy, until the fruit trees are picked bare of fruit, the barns are swept clean of grain, with nothing left in the cupboards or in the cookie jars.

Calendar of events

Szombathely, Martineum Academy, Hungary, March 27-29, 2009
Encore Session of Gold Standard University Live.

Topics: *Is There Life after Backwardation?*
Will the Gold Standard Be Released from Quarantine?
The Vaporization of the Derivatives Tower
Labor and the Unfolding Great Depression

Further announcements will be made at the website:
www.professorfekete.com

San Francisco School of Economics, July-August, 2009
Money and Banking, a ten-week course based on the work of Professor Fekete, who will be in attendance. The Syllabus of this course is can be seen on the website: www.sfschoolofeconomics.com

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