BONDS MAY BE DEFYING DIRE FORECASTS

BUT THEY ARE NOT DEFYING LOGIC

(Part Two)

Antal E Fekete
New Austrian School of Economics

In Part One of this two-part series I have argued that Keynes inadvertently ignored the rule asserting that the rate of interest and the price of bonds vary *inversely* and, as a consequence, his conclusions concerning employment, interest and money are irreparably faulty.

In this second part I shall argue that the policy of open market operations of the Fed causes *deflation* rather than *inflation* as intended. The authors of the policy have inadvertently ignored its effect on bond speculation. This was true in the 20th century; it is true in the 21st century as well. The Fed's monetary policy is counter-productive. It is trying to foster inflation through its bond purchases, but what it in fact does is fostering deflation through capital destruction. It is responsible for the coming depression, just as bond purchases of central banks were responsible for the Great Depression of the 1930's.

The fact is that the policy of open market purchases makes bond speculation risk-free. Speculators forestall the central bank and front-run its bond-buying program. Gradually the central bank is losing control. Bond speculators are now in charge. The central bank is trying to call off the bond-buying campaign, in vain. Like the Sorcerer's Apprentice, it is desperately trying to find an 'exit strategy' only to realize, too late, that it hasn't got the magic word.

The interest-rate structure goes into a free-fall, causing prices to fall, too. One can see that at the heart of the problem is the fact that the central bank (deliberately or inadvertently) ignored the rule that the rate of interest and the bond price vary inversely.

The rule is not in itself controversial. All financial journalists know it. If a bond trader tries to deviate from it, it will soon go bankrupt. Why do then policy-makers and mainstream economists ignore it? Other than the misplaced iconoclastic reverence for Keynes, we may mention the overwhelming influence of the Quantity Theory of Money (QTM) on monetary policy. QTM is a deeply flawed theory that fails to distinguish between linear and non-linear phenomena. The relationship between the quantity of money and the price level is linear only under the most exceptional circumstances. The fact is that there is no causal relation between the quantity of money and the commodity price level, because money is free to flow to the financial markets instead of the commodity market, as it often does at the bidding of speculators. Of utmost significance here is the behavior of bond speculators, which both Keynes and the authors of the policy of open market operations ignored or totally misunderstood, with disastrous consequences for the world economy.

However, there is a causal relation between a falling interest rate structure and the erosion (destruction) of capital. The former is tantamount to rising bond values. The capital of an enterprise is a liability subject to periodic disbursements. *It is listed in the liability column of the balance sheet, along with debt.* This is the reason why, under a falling interest rate structure, the capital of *all* firms is subject to erosion, *a fact stubbornly ignored by Keynesianism*. Incredible as it may be, this ignorance (and not the gold standard *per se*) was the hidden underlying cause for the deflationary bias in the economy that Keynesianism was designed to overcompensate after World War I.

The erosion of capital is vicious because it is well hidden and may become obvious only when it is already too late to do anything about it. The process of destruction of capital is a direct consequence of the falling interest rate structure. Those who argue that low interest rates are salutary to business confuse a *low but stable* interest rate structure with a *falling* one. The latter, to be sure, is lethal to business.

Keynes charged that businessmen behave irrationally and can go overboard in their pessimistic appraisal of business prospects. He insisted that the cure is serial cutting of the rate of interest by the central bank. Well, let us see how falling interest rates really affect the thinking of businessmen. If you tell an entrepreneur that tomorrow the rate of interest will be lower, then he will delay his investment by one day. He does not want to face the competition of those with a lower cost of capital, due to their foresight in waiting one day longer to get a business loan. By the same token, if you tell him that a week, month, year … from now thr rate of interest will be lower, then he will delay his investment by one week, month, year, … If he expects the rate of interest to keep falling from here to eternity, then he will *never* make the proposed investment. It is just as simple as that: you will never be able to entice rational businessmen with a falling interest rate structure to invest. On the contrary, what you have to do is to convince them that you mean to stabilize interest rates. Only in such an environment would they start nibbling at investment possibilities. Now we come to the crux of the matter. The only known way to stabilize interest rates durably is to go on a gold standard. The gold standard is the best course to prevent wholesale capital destruction. It is the only monetary system that can stabilize bond prices. It is a malicious lie that the gold standard is 'contractionist', as asserted by Keynes.

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U.S. President F.D. Roosevelt embraced the faulty reasoning of Keynes and, in 1933, just a few days after he swore to uphold the Constitution, he overthrew the Constitutional metallic monetary standard of the country and confiscated the gold coins of the citizens. Then he wrote up the value of the confiscated gold and reestablished the gold standard internationally (although not domestically) based on a devalued dollar defined as 1/35 oz of gold on January 1, 1934.

Thereafter the U.S. played banker to the world… until it defaulted. On August 15, 1971 President R.M. Nixon ordered the Treasury to refuse to redeem the dollar in gold to its depositors, never mind that several international treaties anbctioned and four sitting presidents confirmed the arrangement. That day 'will live in infamy'. The U.S. unilaterally destroyed the international monetary system. The irredeemable dollar was foisted on the people of the world, regardless whether they wanted to retain the gold standard or not. Gold that belonged to people not under U.S. jurisdiction was confiscated by the U.S. This was more than just a breach of faith. It was a wanton wielding of naked imperial power. Foreign central banks were forced to take unprecedented losses in their balance sheet. Thereafter the U.S. took command of the world's resources without offering anything in exchange but the dishonored promises of a defaulting banker.

Foreign banks and foreign governments were not allowed to say as much as "ouch". Universities inside and out of the U.S. were forced to discard monetary science as it existed at the time, replacing it with the faulty and destructive monetary theories of Keynes. They had to parrot the line that it was all in the name of 'progress': the gold standard had outlived its usefulness.

Some gold still remained under the control of foreign governments. Through some arm-twisting the U.S. 'persuaded' them to sell out in order to keep the dollar-price of gold from rising. Through bribe and blackmail, the U.S. forced the Swiss Confederation to railroad through a Constitutional amendment that removed the monetary clause defining the Swiss franc in terms of gold. When questions were raised why the U.S. does not set an example in 'updating' its own Constitution, the answer was: "Do as I say, not as I do!" The truth of the matter is that policy makers in the U.S. could never muster enough moral courage to call a Constitutional convention to amend the U.S. Constitution by dropping its monetary clauses that were not in tune with Keynesian principles, lest the proposal to redefine the dollar in terms of the debt of the federal government be rejected. They would rather live with the odium that they have trampled on the Constitution.

A veritable 'brain-washing' has taken place in the world under U.S. pressure. Generations of bankers and financiers grew up and were trained to believe that world trade could be financed and capital could be accumulated and maintained safely and permanently on the basis of irredeemable promises to pay. An anti-gold psychosis was cultivated among them.

Of course, there were signs that everything was not alright. Prices (especially those of food, fuel and fodder) as well as interest rates escaped from the earth's gravitation. These episodes were explained away by *ad hoc* causes and by refusing to look at the big picture. By now the dollar has lost 99 percent of its purchasing power. Debt, private and public was exploding. By no rational calculus could it ever be paid back. Nevertheless, the show had to go on.

An army of pusillanimous scribblers and a chorus of sycophant academics sang the song praising the new millennium of irredeemable fiat paper money. Wars were started in defense of the irredeemable dollar's hegemony. Yet luck was running out. The Chinese government got tired of carrying the irredeemable American Treasury paper to the tune of trillions of dollars in its foreign exchange reserves. It started accumulating monetary gold in a big way and encouraged its subjects to do the same. The wake-up call in America would still not sound.

America is putting the world at great risk. Gold is going into hiding fast. When the dollar will no longer fetch any gold any more, the game of musical chairs will end. World trade will break down. Barter will be the order of the day. But our complex economy cannot survive on barter. It takes multilateral trade, not barter, to be able to build computers and jetliners.

America should provide monetary leadership to the world. It should open the U.S. Mint to the free and unlimited coinage of gold and silver. Incidentally, this would make money conform to the Constitution once more. This would call monetary gold and silver out of hiding. It would put an end to the growth of the Debt Tower. It would eliminate so much waste and inefficiencies from the system. It would end youth unemployment, perhaps the greatest blight caused by the regime of irredeemable currencies. There was no youth unemployment under the gold standard.

It would open up a new Golden Age of peace and prosperity.

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