CAN THE SECOND COMING OF PAUL VOLCKER SAVE THE DOLLAR?

Thoughts on the eve of high level talks in Beijing

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History replaying

One of the most frequently asked questions from my readers is the title above. Conventional gold-bug wisdom holds that in 1979 the new Chairman of the Federal Reserve, Paul Volcker, raised interest rates drastically, thereby putting an end to the galloping inflation then raging, and aborting the bull market in gold. Volcker's high-interest policies are credited with the feat of turning the dollar back from the brink where it looked into the chasm of worthlessness, the chasm into which the French *assignat*, the German Reichsmark, and the Chinese yuan (of 1949 vintage) among countless other national currencies have fallen. Conventional wisdom goes on to conclude that Bernanke, hopelessly committed as he is to a regime of low interest rates, will be fired. A new chairman with the outlook and resoluteness of Volcker will be named who will repeat the feat of his tall, cigar-smoking predecessor, in saving the dollar once more in a nick of time. History will replay itself.

Lessons of Kondratieff

My view of the events then and now is quite different. History is not made by men, tall or short; rather, events are the product of cycles, in particular, Kondratieff's long-wave cycle (K-cycle). By that standard the situation we find ourselves in now is diametrically opposite to that thirty years ago. In 1977 the world was approaching the end of an upswing in the K-cycle that had started in 1947. It took prices and interest rates to unprecedented heights. Now we are approaching the end of a downswing in the K-cycle. As a rule turning points in the K-cycle are calamitous events, resembling a blow-off. So it was in 1979. At that time interest rates and prices were sky-rocketing and hyperinflation appeared likely. But these events were just a smoke-screen camouflaging an incipient deflation that burst on the scene unexpectedly, bringing dramatically lower interest rates, wide-spread bankruptcies, and the folding of firms that have lost pricing-power. This deflation has not run its course yet. The worst is still in store.

The replay of history in 2007 will be similar except with the opposite signature. Interest rates are still declining, and so are prices adjusted for inflation. Deflation is being imported into the United States from Japan, through the mechanism of the carry-trade. It appears to confirm and surpass Bernanke's worst fears. Lethargy is spreading. Businessmen decline to take the loans offered at historically low rates. Production keeps contracting; unemployment may follow with a lag. We may even see, *horribile dictu*, some genuinely falling prices! Yet these events could be just a smoke-screen camouflaging an incipient hyper-inflation that would wipe out the dollar for once and all.

The China-enigma

I admit that China is in the position to render these predictions worthless. She could initiate a cascading of the dollar here and now, wiping out its value before a deflationary scenario could unfold. To the extent that this is a real possibility, my deflationary predictions are, of course, conditional on the outcome of the recent negotiations in Beijing. However, I would expect that Treasury Secretary Paulson and Federal Reserve Chairman Bernanke would cut a deal. Most likely the deal would save the dollar from an ignominious collapse just now. The dollar would get a new lease on life. All this would be in keeping with my motto: “expect the unexpected”. The U.S. will go to any length, pay any price, and meet any challenge to defend the dollar. On the other hand China has the power, and the skill, to extort a bribe. No bribe is too high. After all, it is just a matter of printing it, Bernanke-style. Considering the alternative, it is still cheap.

This is not to suggest that China is not in an incredibly strong bargaining position. She is. Even after a complete collapse of the dollar that could cost China up to $1 trillion, her economy could emerge relatively unscathed, more so than any other economy on the face of the globe. Inflations and deflations could rage around; China could feel safe inside of a cocoon of autarky. She has done it before; she can do it again. You say that China cannot insulate herself from a world-wide depression? Oh yes, she can. By allowing the wage level to creep up, she could keep producing for her domestic markets without any major setback. China has the potential to absorb everything what she can produce domestically.

True, it is no fun to write off as worthless a $1 trillion bank account. This is why a deal between China and the U.S., vastly favorable to China, is the most likely outcome of the current negotiations under way in Beijing. It would be naive to expect that details of the deal will be revealed to the public. But we may guess that no genuine progress towards stabilization would be made.

Bond conundrums

I think most commentators on the bond market got it wrong. They take it for granted that any new bonds issued by the U.S. Treasury will be received negatively from now on, in view of the fact that the saturation point for dollars at large, in their opinion, has now been reached. The only thing foreigners consider worse than owning dollar balances is owning dollar bonds: promises to pay dollars in the future. Yet the bond market shows irrational exuberance in the face of persistent dollar weakness, even in the face of dollar-devaluation as part of the deal now being cut in Beijing. If there has ever been a true conundrum, the bond market it is.

A typical commentary is Peter Schiff’s, dated December 8, on “So what is really holding up the bond market? It could be foreign central bank buying; Fed monetization; hedging by the mortgage industry; speculative hedge-fund strategies; a combination of all these factors; or something entirely different. However, whatever the prop may be, it will not be there forever. The longer it remains, the bigger the deluge will be when it finally gives way. The bond market is in fact a powder-keg. The fuse is lit; we just don’t know its length. But when it blows, carnage in the bond market and, by implication, in an economy addicted to low rates will be brutal.”

No, I don’t think the fuse has been lit. What then is the explanation of the mystery? It is the $400 quadrillion derivatives market growing exponentially. That’s what. It represents a latent demand for new bonds, unlimited quantities of it, so that the game of musical chairs could go on and on. Moreover, demand is further fueled by the carry trade. The carry trade sells the high-priced Japanese bonds and buys the low-priced U.S. bonds. As I have pointed out, it is the mechanism whereby deflation is imported from Japan to the United States. This arbitrage results in a narrowing of the interest-rate spread. But that spread is still far from disappearing and, as long as it is positive, the carry trade will thrive and interest rates in the U.S. will keep falling. Bond speculation on the long side of the market will continue, giving further boost to the game of musical chairs. All this means deflation, even depression. Bernanke will keep stoking its fires by printing more dollars, hoping that the new money will go into commodity speculation, ending the

depression. It won't. The new money will go into bond speculation, deepening the depression. That's where smart money is made. In the bond market. On the long side. This is what makes the depression feed upon itself.

It is not likely, although neither is it impossible, that China will pull the rug from under the bond market. The game of musical chairs will probably go on, possibly for several more years. The sky is the limit for derivatives, and for the monetization of the U.S. government debt.

Part of that scenario is the price of gold. It will not be allowed to escape the gravity of earth, as it would do in the absence of clandestine official intervention. Although they will be able to limit the rise in the gold price, the powers-that-be will not be able to limit the rise in its *volatilility*. Gyrations of gold will assume galactic dimensions, increasing uncertainty in its wake. Enormous fortunes will be made — and lost — both by the bulls and the bears betting that "the trend is their friend".

The second coming of Paul Volcker is a myth. In 1979 the United States was in a much stronger financial and economic position than it is now and it could take the strong medication of high interest rates without danger of succumbing to the 'sudden death syndrome'.

Presently, the United States economy is on a life-supporting system. China's hand is on the switch. Paul Volcker's regimen of high interest rates would be tantamount to turning the switch off.

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