CAN WE HAVE INFLATION AND DEFLATION ALL AT THE SAME TIME?

Antal E. Fekete
Gold Standard University Live
aefekete@hotmail.com

The curse of electronic dollars

Helicopter Ben has just made a most unpleasant discovery. Earlier he has promised that the Federal Reserve will not stand idly by while the dollar deflates and the economy slides into depression. If need be, he will go as far as having dollars air dropped from helicopters.

Time came to make good on those promises in August when the subprime crisis erupted. To his chagrin Ben found that electronic dollars, the kind he can create instantaneously at the click of the mouse in unlimited quantities, cannot be air dropped. They just won't drop.

For electronic dollars to work they have to be able to trickle down through the banking system. The trouble is that when bad debt in the economy reaches critical mass, it will start playing hide-and-seek. All of a sudden banks become suspicious of one another. Is the other guy trying to pass his bad penny on to me? *In extremis*, one bank may refuse to take an overnight draft from the other and will insist on spot payment. A field day for Brink's. The clearing house is idled, and armored cars deliver FR notes and certified checks on FR deposits in both directions up and down Wall Street.

Under such circumstances electronic dollars won't trickle down. In effect they are frozen. Ultimately, they may be demonetized by the market. How awkward for Helicopter Ben. He would now have to go back to the old-fashioned and cumbersome way of inflating the money supply via the printing press. Literally.

Northern Rock and Roll

He had better, and do it double quick. The Northern Rock and roll fever may spill over across the Atlantic from England to the United States. Northern Rock is a bank headquartered in Newcastle with lots of branches in the Northern Counties. It was a high-flyer using novel ways of financing mortgages through conduits and other SIV's, instead of using the more traditional methods of building societies through savings. (SIV or Structured Investment Vehicle is euphemism for borrowing short, lending long through securitization). Now a run on the bank has grounded the high flier. As long queues in front of the doors of branch offices indicate, a world-wide run on banks may be in the offing. Bank runs were thought to be a pathology of the gold standard. In England they haven't seen the like of it since 1931 when the bag lady of Threadneedle Street went off gold. Surprise, surprise: bank runs are now back in vogue playing havoc on the fiat money world. Depositors want to get their money. Not the electronic variety. They want money they can *fold*.

There's the rub. Pity Helicopter Ben. It looked so simple a couple of weeks ago. The promise of an air drop should stem any run. It sufficed that people knew he could do it. No reason to mistrust the banks since they are backed up by air drops. Now people have different ideas. The air drop is humbug. Can't be done. Ben is bluffing. As calculated by Alf Field writing in *Gear Today, Gone Tomorrow* (www.gold-eagle.com, September 6, 2007) if only ten percent of the notional value of derivatives is bailed out by dropping $500 FR notes the pile, if notes are stacked upon one another, would be nearly 9000 miles high. Helicopter Ben hasn't reckoned that FR notes do not exist in such quantities. They will have to be printed before they can be dropped. Even if they existed, to drop them all would take years, and by that time the shaky house of cards of FR credit might be blown away. And bailing out just ten percent of the derivatives mess is a conservative estimate. You may have to bail out a lot more than that.

Devolution

What does it all mean? At minimum it means that we can have inflation *cum* deflation. I am not referring to stagflation. I refer to the seemingly impossible phenomenon that the money supply inflates and deflates *at the same time.* The miracle would occur through the *devolution of money*. This is Alf Field's admirable phrase to describe the „good money is driven out by bad" syndrome. Electronic dollars driving out FR notes. The more electronic money is created by Helcopter Ben, the more FR notes will be hoarded by banks and financial institutions while passing along electronic dollars as fast as they can. Most disturbing of all is the fact that FR notes will be hoarded by the people, too. If banks cannot trust one another, why should people trust the banks?

Devolution is the revenge of fiat money on its creator, the government. The money supply will split up tectonically into two parts. One part will continue to inflate at an accelerating pace, but the other will deflate. Try as it might, the Federal Reserve will not be able to print paper money in the usual denominations fast enough, especially since the demand for FR notes is global. Regardless of statistical figures showing that the global money supply is increasing at an unprecedented rate, the hand-to-hand money supply may well be shrinking as hoarding demand for FR notes becomes voracious. The economy will be starved of hand-to-hand money. Depression follows deflation as night follows day.

Decoupling tectonic plates

Side-by-side of deflation of hand-to-hand money there will be hyperinflation as the stock of electronic money will keep exploding along with the price of assets. You will be in the same boat with the Chinese (and the son of Zeus: Tantalus). You will be put through the tantalising water torture — trillions of dollars floating by, all yours, but which you are not allowed to spend. The two tectonic plates will disconnect: the plate carrying electronic dollars and the plate carrying FR notes, with lots of earthquakes along the fault line. No Herculean effort on the part of the government and the Federal Reserve will be able to reunite them. At first, electronic dollars can be exchanged for FR notes but only against payment of a premium, and then, not at all.

The curse of negative discount rate

If you think this is fantasy, think again. Look at the charts showing the collapse of the yield on T-bills. While it may bounce back, next time around *the discount rate may go negative*. You say it's impossible? Why, it routinely happened during the Great Depression of the 1930's. Negative discount rate means that the T-bill gets an *agio*, the discount goes into premium even before maturity, and keeps its elevated value after. This perverse behavior is due to the fact that the T-bill is payable in dollars. Yes, the kind you can fold, the kind that is in demand exceeding supply, the kind people and financial institutions hoard, the kind foreigners have been hoarding for decades through thick and thin: FR notes. Thus T-bills are a substitute for the hard-to-come-by FR notes. Mature bills may stay in circulation in the interbank market, in preference to electronic dollar credits*. Why, their supply is limited, isn't it, while the supply of electronic dollars is unlimited! The beauty of it all is that we have an accurate and omnipresent indicator of the premium that cannot be suppressed like M3: the (negative) T-bill rate. This is an indicator showing how the Federal Reserve is losing the fight against deflation.

Inverted pyramid of John Exter

The grand old man of the New York Federal Reserve bank's gold department, the last Mohican, John Exter explained the devolution of money (not his term) using the model of an inverted pyramid, delicately balanced on its apex at the bottom consisting of pure gold. The pyramid has many other layers of asset classes graded according to safety, from the safest and least prolific at bottom to the least safe and most prolific asset layer, electronic dollar credits on top. (When Exter developed his model, electronic dollars had not yet existed; he talked about FR deposits.) In between you find, in decreasing order of safety, as you pass from the lower to the higher layer: silver, FR notes, T-bills, T-bonds, agency paper, other loans and liabilities denominated in dollars. In times of financial crisis people scramble downwards in the pyramid trying to get to the next and nearest safer and less prolific layer underneath. But down there the pyramid gets narrower. There is not enough of the safer and less prolific kind of assets to accommodate all who want to „devolve". Devolution is also called „flight to safety".

An example of this occurred on Friday, August 31, 2007, as indicated by the sharp drop in the T-bill rate from 4 to 3%, having been at 5% only a couple of days before. As people were scrambling to move from the higher to the lower layer in the inverted pyramid, they were pushing others below them further downwards. There was a ripple effect in the T-bill market. The extra demand for T-bills made bill prices rise or, what is the same to say, T-bill rates to fall. This was panic that was never reported, still less interpreted. Yet it shows you the shape of things to come. We are going to see unprecedented leaps in the market value of T-bills, *regardless of face value!* You have been warned: the dollar is not a pushover. Electronic dollars, maybe. But T-bills (if you can *fold* them) and FR notes will have an enormous staying power. Watch for the discount rate on T-bills morphing into a *premium* rate!

It is interesting to note that gold, the apex of the inverted pyramid, remained relatively unaffected during the turmoil in August. Scrambling originated in the higher layers. Nevertheless, ultimately gold is going to be engulfed by the ripple effect as scrambling cascades downwards. This is inevitable. Every financial crisis in the world, however remote it may look in relation to gold, will ultimately affect gold, perhaps with a substantial lag. The U.S. Government destroyed the gold standard 35 years ago, but it could not get gold out of the system. It was not for want of trying, either, as we all know. Gold remains firmly embedded as the apex of Exter's inverted pyramid.

Vertical devolution is not the only kind that occurs in the inverted pyramid. There are similar movements that can be described as horizontal. Nathan Narusis of Vancouver, Canada, is doing interesting research on the Exter-pyramid. He noted that in addition to vertical there is also horizontal devolution. Within each horizontal layer of the same safety class there are discernible differences. An example is the difference between gold in bar form and gold in bullion coin form, or silver in bar form and silver in the form of bags of junk silver coins. Franklin Sanders in Tennessee is an expert on horizontal devolution of silver and has a fascinating study how the discount on bags of junk silver coins may go into premium, and *vice versa.* There may also be differences between FR notes of older issues and FR notes of the most recent vintage. There are obvious differences between the CD's of a multinational bank and those of an obscure country bank. The point is that movement of assets horizontally between such pockets within the same safety layer is possible and may be of significance as the crisis unfolds and deepens.

Dousing insolvency with liquidity

In a few days during the month of August central banks of the world added between $300 and 500 billion in new liquidity in an effort to prevent credit markets from seizing up. The trouble is that all this injection of new funds was in the form of electronic credits, boosting mostly the top layer, where there was no shortage at all, if anything, there was a superabundance. Acute shortage occurred precisely in the lower layers. This goes to show that, ultimately, central banks are pretty helpless in fighting future crises in an effort to prevent scrambling to escalate into a stampede. They think it is a crisis of scarcity whereas it is in fact a crisis of overabundance.

I feel strongly that this aspect of research on the *denouement* of the fiat money era has been lost in the endless debates on the barren question whether it will be in the form of deflation or hyperinflation. Chances are that it will be neither, rather, it will be *both*, simultaneously. There is a little-noticed and little-studied continental drift beween the money supply of electronic dollars and the money supply FR notes. (Continental drift of the geological variety is invisible and can only be studied with the aid of high-precision instruments.) The tectonic plate of electronic dollars will keep inflating at a furious pace, while that of FR notes and T-bills will deflate because of hoarding by financial institutions and the people themselves. The Federal Reserve will be unable to convert electronic dollars into FR notes, as present denominations cannot be printed fast enough physically in times of a crisis. If it comes out with new denominations by adding lots more zero's to the face value of the FR notes, then the market will treat these the same way as it does treat electronic dollars.

Genesis of derivatives

Alf Field (*op.cit.*) is talking about the „seven D's" of the developing monetary disaster: Deficits, Dollars, Devaluations, Debts, Demographics, Derivatives, and Devolution. Let me add that the root of all evil is the double D, or DD: Delibetare Debasement. In 1933 the government of the United States embraced that toxic theory of John Maynard Keynes (who borrowed it from Silvio Gesell). It was put into effect piecemeal over a period of four decades. But what the Constitution and the entire judiciary system of the United States could not stop, gold could. It was found that gold in the international monetary system was a stubborn stumbling block to the centralization and globalization of credit.

So gold was overthrown by President Nixon on August 15, 1971 by a stroke of the pen, as he reneged on the international gold obligations of the United States. This had the immediate effect that foreign exchange and interest rates were destabilized, and prices of marketable goods embarked upon an endles spiral. In due course derivates markets sprang up where risks inherent in the interest and forex rate variations could be hedged. The trouble with this idea, never investigated by the economic profession, was that these risks, having been artificially created, can only be shifted but cannot be absorbed. By contrast, the price risks of agricultural commodities are nature-given and, as such, can be absorbed by the speculators.

The important difference between nature-given and man-made risks is the very cause of the mushrooming proliferation of derivatives markets, at last count half a quadrillion dollars strong (or should I say weak?!) Since the risk involved in the gyration of interest and forex rates can only be shifted but cannot be cushioned, there started an infinite regression as follows.

The risk involved in the variation of long-term interest rates we may call *x*. The problem of hedging risk *x* calls for the creation of derivatives *X* (e.g., futures contracts on T-bonds). But the sellers of *X* have a new risk *y*. Hedging *y* calls for the creation of derivatives *Y* (e.g., calls, puts, strips, swaps, repos, options on futures and, with tongue in cheek: futures on options, options on options, etc.) Sellers of *Y* have a new risk *z*. The problem of hedging *z* will necessitate the creation of derivatives *Z*. And so on and so forth, *ad infinitum*.

J'accuse

We have to interpret the new phenomenon, the falling tendency of the T-bill rate accurately. Maybe the financial media will try to put a positive spin on it, for example, that it demonstrates the strength of the dollar. However, I want to issue a warning. Just the opposite is the case. We are witnessing a sea change, tectonic decoupling, a cataclismic decline in the soundness of the international monetary system. The world's payments system is in an advance state of disintegration. It is the beginning of a world-wide economic depression, possibly much worse than that of the 1930's.

We have reached a landmark: that of the breaking up of centralized and globalized credit, the close of the dollar system.

J'accuse — said Zola when he assailed the French government for fabricating a case of treason against artillery captain Alfred Dreyfus in 1893. It is now my turn.

J'accuse — the government of the United States under president Roosevelt reneged on the domestic gold obligations of the U.S. in violation of the Constitution, and violated people's property rights without due process by confiscating gold in 1933

J'accuse — academia has been pussyfooting the government by failing to point out the economic consequences of gold confiscation, namely, the prolonged suppression of interest rates that was ultimately the cause of prolonging depression**

J'accuse — the government of the United States under president Nixon reneged on the international gold obligations of the U.S. thereby globalizing the monetary crisis in 1971

J'accuse — cringing academia failed to point out the consequences of gold demonetization: price spiral of marketable commodities world-wide; roller-coaster ride of long-term interest rates, up to 16 percent per annum and down to 4 percent per annum or lower and back up again; the fact that interest rates may take prices along for the ride

J'accuse — foreign governments accepted Nixon's breach of faith without demur, apparently because in exchange for their compliance they were given the freedom to inflate their own money supply with abandon on the coattails of dollar inflation

J'accuse — the banks have embraced the regime of irredeemable currency with gusto and greatly profited from it, instead of protesting that under such a regime it was impossible to discharge the bank's sacred duty to act as the guardian of the savings of the people and the value of the inheritance of widows and orphans

J'accuse the accounting profession for their compliance in accepting gravely compromised accounting standards that convert liabilities into assets in the balance sheets of the government and the Federal Reserve.

In the words of Chief Justice Reynolds, in delivering the dissenting minority opinion on the 1935 Supreme Court decision, that upheld president Roosevelt's confiscation of people's gold, „*Loss of reputation for honorable dealing will bring us unending humiliation. The impending legal and moral chaos is appalling.*"

No less appalling, we may add, is the impending financial and economic chaos.

September 23, 2007

---

*An object lesson in negative T-bill rate is being presented as I write this on Thursday, September 20, 2007. The 30-day silver lease rate has gone to minus 0.1 percent. I wish analyst Ted Butler stopped bitching about manipulation and instead of telling fairy tales about raptors and dinosaurs explain to us what the negative silver lease rate means. My own explanation is panic short covering in silver. Normally the price of silver moves in tandem with that of gold. In case the rising price of silver lags substantially behind that of gold, negative lease rate may develop, indicating that silver is delivered faster by the lessees than the lessors are willing or able to take (for example, if the lessors assumed until the last minute that the leases will be rolled over). Under these circumstances the lessor is happy to leave the silver with the lessee even after the lease expired. This seems to explode the myth about an acute shortage of silver, so ardently spread by Butler. The rising price of silver that may well follow the panic short-covering has nothing to do with shortages. Just the opposite.

Concerning the case of a negative T-bill rate, the pinching shoe is on the other foot. Here we do have a shortage, namely, a physical shortage of FR notes in which the bill is supposed to be paid. But since the borrower is the government, there is no presumption of a default, so the mature T-bill is monetized by the market to alleviate the shortage.

** The causal connection between gold confiscation and the prolonging of the Great Depression should be clear. Gold must be seen as the main competitor of bonds. Once the competitor is forcibly removed, bond prices start rising or, what is the same to say, interest rates start falling. Linkage between falling interest rates and falling prices did the rest.