Questions …

Daily Bell: Thank you for taking time to share your views with readers of the *Daily Bell*.

Prof. Fekete: It is my pleasure.

Daily Bell: Prof. Fekete, you are not directly aligned with any hard-money factions that we can see, at least not at this time. The Misesians in America have been having great success arguing for greater economic and personal freedom. But you may differ with them on fractional reserve banking. Do you think, as they apparently do, that fractional reserve banking is based on fraud and so it is involved in criminal activity?

Prof. Fekete: My difference with the position of the Ludwig von Mises Institute, first and foremost, centers on Adam Smith's Real Bills Doctrine.

When the wholesale merchant delivers supplies to the retail merchant, he attaches the bill marked: "terms 90 days net". The retail merchant endorses the bill in writing across its face "I accept" and returns it to the wholesale merchant, who could now use the *same bill* in paying his own suppliers. This method of payments is called "discounting real bills" as the payee discounts the face value by the number of days remaining to maturity at the going discount rate. Of course, at maturity, the retail merchant pays the face value in full when the bill is presented to him for payment.

According to the Real Bills Doctrine of Adam Smith (1723-1790) real bills finance the production and distribution of fast-moving consumer goods *without the need to invade the pool of savings*. The doctrine is valid even in an economy where there are no banks, whether central or not. The consumer goods must be in *most urgent demand* in order to enable the real bill drawn on it to circulate *spontaneously* and thus to gain limited monetary privileges. Real bills are *non-inflationary* as they appear simultaneously with the emergence of new merchandise, and disappear as the underlying merchandise is removed from the market by the ultimate, gold-paying consumer, in less than 91 days. This, incidentally, is the length of the seasons of the year. With the change of the seasons the character of consumer goods in the greatest demand will also change.

When commercial banks have later appeared on the scene, real bills became their *most liquid earning assets.* Saying it differently, real bills are *self-liquidating* as they mature into the gold coin surrendered by the ultimate consumer.

In so far as the term "fractional reserve bank" refers to a commercial bank that keeps its reserves in the form of gold coins and real bills, it is preposterous to suggest that it is involved in a criminal activity. It just substitutes its own credit for the commercial credit that exists independently in the form of real bills. The credit of the bank is more negotiable in the sense that it has higher name-recognition. To discount a real bill you need to be knowledgeable about the often intricate production process that has given rise to it. The circulation of bank credit does away with this need.

I have never been able to make my opponents agree to the proposition that we have to discuss the spontaneous circulation of real bills first, before we are ready to discuss fractional reserve banking. Incidentally, Mises himself admitted that real bills did circulate in Manchester spontaneously before the Bank of England opened its branch in Liverpool.

Cultists at the Mises Institute would love to attack Adam Smith directly, but they realize that they don't have the prerequisite intellectual capital to do it. They are barking up the wrong tree. They condemn all fractional banking reserves whether real bills or fake bills. They simply miss the point what constitutes good commercial banking.

Daily Bell: Do you have any areas of agreement with free-bankers such as George Selgin and others who use the Scottish banking interregnum as evidence that free-banking – private fractional reserve banking -- can work and has worked historically?

Prof. Fekete: Yes, I agree with them that private fractional reserve banking can work and has worked historically, provided that the earning assets of the banks are confined to real bills, to the exclusion of anticipation bills, accommodation bills, treasury bills, and any other kind of fake bills. Out of spontaneous real bill circulation sprang both the Discount House and the Acceptance House. As far as the origin of commercial banking is concerned, one can think of the latter as the predecessor of the "bad" commercial bank that is ready to monetize any and all accommodation bills, provided that collateral in excess of face value is posted; and the former as the predecessor of the "good" commercial bank that monetizes only solid real bills that need no collateral at all.

Daily Bell: Is there something about gold and silver that is genetic? Do you believe that humanity's interaction with gold and silver is so ancient that it constitutes a biological impulse? That it is "in the genes"?

Prof. Fekete: No. Gold and silver owe their monetary role to their property that they are the most marketable goods in existence. In more details, gold is most marketable in the large, and silver is most marketable in the small. The first property is synonymous with "most liquid", the second with "most hoardable". With advances in metallurgy making molar processes more affordable, the hoardability of gold has caught up with that of silver, justifying the movement to replace bimetallism with gold monometallism.

No biological impulse is needed to explain all this, unless you refer to the fact that man is mortal, and he knows it, and he needs savings (hoarded metal *par excellence*) that he can draw down in his twilight years to make up for the deficit in his earning power, and to provide for his excess needs due to fragile health.

Daily Bell: Where do you stand on the issue of a free-market gold and silver standard? Our reading of history is that absent official interference, sophisticated societies revert automatically to a market-based standard that includes both metals. Gold is usually utilized for industrial and banking purposes, while silver is the people's money. The ratio between the two metals helps people detect manipulation as well.

Prof. Fekete: I don't know what you mean by "free market" gold and silver standard. Is there any other? I submit that both gold and silver money were born spontaneously, without any assistance from the government as a midwife, through a process of "snow-balling" marketability, as so admirably explained by Carl Menger. It is another story that kings later hijacked the process of monetizing these metals for their own purposes, and fostered the childish belief that the value of gold and silver coins was due to the sovereign's effigy struck upon them, rather than the superb marketability of the monetary metals: gold and silver.

You are reading history correctly: our sophisticated economy, if it remains reasonably free, will embrace the monetary metals once more, as the regime of irredeemable currency is increasingly in an advanced state of decay.

If I may make a slight correction, gold is less of an industrial metal than silver but more of a metal of which jewelry is made.

You may be right when you assume that the bimetallic ratio helps people detect manipulation of the price of the monetary metals by the government. In modern times the success of this manipulation tends to coincide with the *rising*, and failure with the *falling* of the Au/Ag price ratio.

Daily Bell: Economists are fond of speaking of fiat money, but some believe that the world remains on an unofficial gold standard observed privately by the monetary elite no matter what the public pronouncements are. Is there any truth to this?

Prof. Fekete: There is no unofficial gold standard, just as there is no woman who is "a little bit pregnant". It is another question whether the "monetary elite", and some governments such as those of China and Israel, may be big clandestine hoarders in anticipation of a greater monetary role for gold in the future, or in setting up an insurance fund in case the threat of a monetary catastrophe becomes an established fact, noting that such a threat has returned for the second time in less than a generation. One can only speculate but, at least in the case of China, the cat has been let out of the bag. We now know that China is the biggest hoarder of silver in all history, and is determined to become a substantial hoarder of gold. As Chairman Mao has said, power grows out of the barrel of a gun — we may add that the bullets must be made of gold in order to be effective. Pity the Americans who may have the gun but believe in paper bullets.

Daily Bell: Where do you stand on the issue of monetary metals and market supply? If gold and silver become scarce in a free-market economy, would the scarcity disappear as hoarders release progressively more of their stores as the price rises? Or would the scarcity be alleviated by mines reopening in response to higher prices – or both?

Prof. Fekete: The monetary metals are by no means scarce. On the contrary, they command the highest stocks-to-flows ratio of all the commodities. This is what makes them monetary metals. Gold's ratio is estimated to be 50, meaning that it would take 50 years to reproduce the existing stocks at present rate of production. By comparison, the same ratio for copper is estimated to be ⅓, meaning that marketable stockpiles correspond to 4 months' production.

Any impression of scarcity of monetary metals is an optical illusion. Perceived scarcity only demonstrates the decay of the monetary system. Gold appears scarce for one reason only: the wild monetary experimentation of the leading countries with irredeemable currency. It is futile to expect that hoarders will release more of their stores as the price advances, or that the mines will increase their output of gold. On the contrary, they will hang on and release less and less of their stores. The mines will save their best ore reserves for better times as they see that a monetary catastrophe is imminent. Note that such a catastrophe will be *unprecedented in history*. Irredeemable currency has never been a global phenomenon. It was always a local phenomenon, the hope of weak governments that they can continue living forever in financial backwater comfortably. When their hope turned out to be a pipe-dream, there were always countries around that stayed the course of monetary rectitude, remained on the gold standard, and were able to extend a helping hand. No such luck this time.

I deplore that Switzerland, caving in to the indecent pressure from the U.S. government, railroaded through a change of the Swiss Constitution dropping the mandatory backing of the liabilities of the Swiss National Bank with gold. This reminds me of the tale of Aesop about the wolf that has lost his tail in an unfortunate encounter with a trap. He wanted to persuade his fellow wolves that they should also get rid of this "barbarous relic", and have that useless appendage, their tail, cut off. Sorry to say, the Swiss government exhibited far less common sense than the assembly of wolves in Aesop's tale. It pointed out to the tailless wolf that his case would have been more persuasive if it had been made *before* his loss.

Daily Bell: Is there any evidence that hoarders of gold and silver behave as you suggest, and not as common sense would dictate? After all, it is a universal feature of the commodity markets that the longs take profits periodically as prices keep rising.

Prof. Fekete: Yes, indeed, there is: the behavior of the gold basis. Basis is the difference between the nearby futures price and the spot price. Contango is the name for the condition whereby the basis is positive; while backwardation indicates a negative basis: higher spot price and lower futures price. Whenever supplies are adequate, contango obtains and the basis indicates what the carrying charges are such as interest, cost of storage and insurance. Backwardation always and everywhere indicates a shortage of the physical metal. Therefore, normally, gold should never be in backwardation, i.e., the futures price should always be higher than the spot price. The basis may be substituted by a spread, i.e., the difference between the price of a distant and a nearby futures contract.

Right now, the gold basis is at a critical inflection point, suggesting that gold may plunge from permanent contango to permanent backwardation *for the first time ever*. On April 21 Dan Norcini published charts showing the dramatic collapse of the April 09/June 09 and of the April 09/Dec 09 gold spreads at the Comex. The former went from $6.50 at one point to $0.60 now. The charts indicates that gold is on its way to backwardation later this year. Backwardation in gold is an extremely rare phenomenon with the most serious implications. It shows that supplies of physical gold are drying up as hoarders and the mines are increasingly withdrawing their offer to sell. It is like a chain reaction, at the end of which *gold is not for sale at any price*.

The basis is an extremely sensitive market indicator, far more important and accurate than the price itself which comes through a "very noisy channel". What is more, the basis, unlike the price, cannot be manipulated. Unlike the price, *the basis never lies.*

The gold market behaves differently from other commodity markets because gold is a monetary metal. Unlike other commodities, gold hoarding is not inhibited by declining marginal utility. When market participants expect an imminent collapse of the monetary system, their preference is to hoard the monetary commodities, gold and silver. This explains backwardation.

Daily Bell: Is deflation an economic good in the sense that it can rectify monetary maladjustments?

Prof. Fekete: Certainly, you can say that deflation is nature's cure for man-made inflationary excesses, if only policy-makers would allow the cure to do its benevolent and beneficial work. Instead, they try to prevent it by hook or crook, and pour gasoline on the fire by madly increasing the money supply and total debt. Compounding abuses with more abuses never works, and the longer the needed adjustment is delayed, the more pain it would eventually cause.

Daily Bell: Can the current paper money system stand, or is it on its last legs?

Prof. Fekete: Since the eruption of the financial and economic crisis in 2007 we may take it for granted that the regime of irredeemable paper money is on its last legs. However, it may take several more years of agony, because of the colossal ignorance of people concerning money. For example, most people with a better than average grasp of the theory of money expect that the dollar will succumb to hyperinflation. They will be disappointed. The dollar will put up a tough fight and in the end it will self-destruct, not through inflation but through deflation.

Daily Bell: Can you expand on this issue? What makes you suggest that hyper-inflation is not in the cards?

Prof. Fekete: Producers will, of course, try to raise prices as the dollar is weakening further. However, people are not in the mood to spend. If they come into possession of money, they will use it to repay their debts. They have no savings to fall back on in case they lose their jobs. In the absence of buying price increases will have to be rescinded (as they have been in the case of crude oil, for example) causing many a producer to go bankrupt.

There is a new factor that plays an important role, not present in previous episodes: the parallel existence of electronic dollars and Federal Reserve notes. Only a small portion, less than ten percent, is in the form of the latter; the rest is electronic money. People at home and abroad hoard only dollars that *they can fold*. It is physically impossible to print them fast enough to replace electronic dollars that the people, firms, institutions and foreign governments may decide to reject. The velocity of circulation of paper dollars is falling to zero while that of electronic dollars is rising beyond any limit. This splitting of the money supply into two components of divergent velocities spells deflation. The component with increasing velocity will have to be written off. The Fed is helpless as the hoarding of its notes assumes unheard of proportions.

Daily Bell: Can the Fed really sterilize the monetary system as Ben Bernanke and others contend?

Prof. Fekete: If by "sterilization" you mean isolating the exploding money supply from exploding prices, my answer is that Bernanke does not want to do that. In fact he is desperately but unsuccessfully trying to induce a rise in the price level, even at the risk of a price explosion. But to no avail: all the new electronic money he is creating goes into debt liquidation and speculation on the long side of the bond market. None of it goes to bid up commodity prices, or the prices of industrial shares, or the price of real estate.

There is a vicious spiral: the more money Bernanke creates, the more rampant bond speculation becomes, the higher bond prices go, the lower interest rates fall, the lower price-level falls, prompting more money-creation by Bernanke, etc.

Why do falling interest rates necessarily induce lower prices? Now here is the rub: because *falling interest rates destroy capital through increasing the liquidation value* *of debt.* I have a whole new theory on that: the revisionist theory of depressions. My main thesis is that a falling interest-rate structure increases the burden of debt (just the opposite that you would intuitively expect!) thereby causing producers to go bankrupt in droves. You can find the details on my website.

Daily Bell: Does the current crop of central bankers fully understand the interaction between paper money and the failure of civil society? Could it be that they understand it yet they ignore it and knowingly support a destructive system anyway?

Prof. Fekete: Probably they do, but the only thing they care about is protecting their turf. The politicians have given them unlimited power that they exercise by creating unlimited amounts of currency. They have used this power to wreck the world economy. Now they want to retain that power to do "damage control". They are not going to give up unlimited power voluntarily. They fully exploit the weakness of the political system that is entirely in thrall to their "expertise". Why should they admit that Keynesian and Friedmanite fiscal and monetary policy has been a dismal failure? Rather, they pretend that, as a result of continental drift, the fault-line gives way, producing an earthquake ten point strong on the Richter scale. Who is better qualified than they are to handle the disaster?

Daily Bell: Is the International Monetary Fund destined to manage a global currency? Or is it being used as a stalking horse to provide pressure for other possible solutions, such as regional monetary systems (a euro region, an amero region, a yen region)?

Prof. Fekete: Whatever ambitions the IMF may have, it is irrelevant. Yes, they probably want to rearrange the deck chairs aboard the *Titanic*, but it makes no difference. The ship is on a collision course with the iceberg. The incompetence of bureaucrats at the IMF is appalling. What they are worried about most is the problem how to get rid of the life boats and life savers (read: the IMF gold reserve) that may come handy for the survivors after the *Titanic* has sunk.

Daily Bell: Is the Internet having an effect on the elite's ability to maintain a paper money standard?

Prof. Fekete: Most certainly it is, in the negative sense of the word. The elite thought that it would suffice to discard the gold standard in the United States, never mind the Constitution. They thought that through their control of money they could also control the press and the media. There was no need to tamper with the right to free speech and the freedom of the press, which would have alarmed people far more than the demonetization of gold. And guess what? The elite had a most docile press and media that made them feel cozy and comfortable.

How wrong they were! Here comes the Internet through which you can air the most devastating condemnation of the activities of the elite, without putting up one dollar in capital to do so! The endless lies about irredeemable currency can now be refuted. Truth will out. The Internet will ultimately neutralize and even bankrupt the servile press.

Daily Bell: What will the world look like in ten years – from an economic standpoint?

Prof. Fekete: It is not possible to say. The elite could put the economic program of Hitler into effect if it belatedly decides to suspend civil rights, including free access to the

Internet. But it is also possible that even such a *coup* will remain ineffective in a decentralized society with individualistic traditions going all the way back to its foundations, such as we have in the United States. Make no mistake about it: the fight over gun-control laws is *not about curbing violence* — criminals will always be able to get guns whatever the laws may say. It is *about curbing the right of the people* to reject a government that tries to govern by trampling on the Constitution.

If "we, the people" come out on top in this tug-of-war with a totalitarian government, then the future of the world should be very bright. All you have to do is to force the U.S. government abide by the Constitution. And I mean both *the letter and the spirit* of the Constitution.

Daily Bell: Can you expand on the issue of monetary consolidation? Fiat money needs constant consolidation and enlargement to maintain pretence of solvency in our opinion. If by some chance the current system does survive, is a single global currency inevitable?

Prof.Fekete: The only conceivable single global currency is the international gold standard, because it decentralizes power to the utmost. The individual is empowered through his role of deciding whether to buy or to refuse to buy. He casts his ballot *printed on gold,* and not just once in every other year but *several times every single day*. Producers and merchants will have to defer to the individual's wishes. Under any other monetary system producers and merchants will defer to the wishes of the issuer of currency.

Daily Bell: What can people do to protect themselves at this time?

Prof. Fekete: Other than praying and hoping, they could get out of debt and keep accumulating gold and silver coins, buying on every weakness in the price. They could also hoard Federal Reserve notes and the notes of the Swiss National Bank of small denominations, in amounts corresponding to their needs for up to two years. To keep money on deposit in a bank is not advisable under any circumstances. And, let's not forget, they should cash in on their life insurance policies.

Daily Bell: What is the biggest single issue that even the American Misesians fail to grasp at this time – historically or otherwise?

Prof. Fekete: It is their insistence on Rothbard's so-called 100 percent gold standard, an untenable theory that leaves the problem of elasticity of the stock of purchasing media completely out of consideration. In this way the Mises Institute runs the danger that its gold standard, if put into effect, will seize up during the first Christmas shopping season, and Keynesians and Friedmanites will return triumphantly saying: "We've told you so!"

The cause of the Great Depression of the 1930's, to a large extent, was the failure of the victorious powers to reorganize world trade on the basis of the Real Bills Doctrine after World War I. This bottled up world trade and made the gold standard utterly inelastic. What we need is a gold standard that is made elastic through the circulation of real bills.

Daily Bell: What endeavors are you involved in that you may want to point out to our audience? What's most important to you that you would like our audience to be aware of and support?

Prof. Fekete: Gold should not be considered as an investment outlet or an item for speculation. It should be looked upon the same way as you look at your fire insurance policy: you buy it, lock it up in a safe, and hope that your house will not burn down.

Above all we should train ourselves to think in terms of gold units (gram, Troy ounce) when we estimate our net worth, annual income, and future needs — to the exclusion of dollars or francs. This is not as easy as it sounds. Instinctively we tend to think in terms of paper units. It takes self-discipline to get away from this habit.

If you have gold, you are a trustee of the world's future. You have the only form of capital that can survive a financial Armageddon. You should take this trusteeship seriously and prepare yourself for exercising it properly when time comes.

Daily Bell: What are the most important – seminal -- works of yours that you would encourage everyone to read? Where can they be found?

Prof. Fekete: I am going to give a twenty-lecture academic course on Money and Banking at the San Francisco School of Economics in California, from July 27 to August 7 later this year. The syllabus is posted on my website. I hope that my book covering the same ground will come out this year, which will also include my criticism of Mises.

Daily Bell: Finally, give us your best estimate of where is gold headed, pricewise, over the near and longer term.

Prof. Fekete: I don't like that question, because it obscures the fact that higher gold prices only mean a lower value of irredeemable currencies. People tend to bemoan that the gold price is not rising fast enough to their taste. They have the wrong perspective. From mine, a slowly rising gold price is a blessing in disguise as it gives you more time and opportunity for further scale-down purchases of the monetary metal.

An explosive rise in the gold price would be very damaging for most people, because they are quite unprepared. Universal suffering around you would not be conducive to your desire to lead a peaceful life and to enjoy your newly-found riches.

On the gold price let me just say this. Gold is still cheap considering its purchasing and employing power at the beginning of the Modern Age. There is no reason why it should not have a comparable purchasing and employing power when the dust settles.

Daily Bell: On behalf of all of our readers we thank you for sharing your views with us and hope to hear from you again soon. And we encourage all readers to visit YOUR SITE and consider learning more about your work.

Prof. Fekete: And I thank you for the opportunity to discuss these grave problems of our time. In passing I would like to draw your attention to the newly established Gold Standard Institute and its website www.goldstandardinstitute.com .

This interview was conducted by Scott Smith. In addition to writing special reports, such as this Swiss Perspective, Scott is also a contributing editor to the TheDailyBell.com.