# THE FEDERAL RESERVE AS AN ENGINE OF *DE*FLATION (*sic!*)

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## Introduction

Although the Fed's open market purchases of securities (always net) affect only the short end of the yield curve *directly*, through the transmission of risk-free bond speculation they will affect the rest of the yield curve *indirectly*. Thus the entire spectrum of interest rates will keep falling in consequence of the Fed's open market purchases of Treasury bills (or equivalent). This is a powerful if unrecognized force in the economy causing a chain-reaction as follows:

(1) risk-free bond speculation causes interest rates to fall,
(2) falling interest rates cause a severe erosion of capital throughout the productive apparatus,
(3) erosion of capital causes a falling trend in prices,
(4) falling prices further increase the downward pressure on interest rates.

Thus a vicious spiral of falling interest rates and falling prices is engaged, threatening to push the economy into the abyss of deflation. Mainstream economics lacks a valid theory of speculation. Hence it has a blind spot, failing to see the destructive nature of open market operations.

## Risk-free bond speculation

Typically, bond speculators carry on interest arbitrage along the entire (normal) yield-curve. They sell the short maturity and buy the long, hoping to capture the difference between the higher long rate and the lower short rate of interest (borrowing short and lending long). This arbitrage is not risk-free *per se* as it has the effect of flattening, and possibly inverting, the yield curve. As a result of

inversion it is turned from a rising curve into a falling one, while turning the speculators' profits into losses.

However, as a direct result of the open market operations of the Fed (introduced clandestinely and illegally in the 1920's through the conspiracy of the US Treasury and the Fed, long before the practice was legalized *ex post facto* in the 1930's), interest arbitrage has been made risk-free. Astute bond speculators with their long leg in the bond market can profitably mimic Fed action in the bill market with their short leg. This never fails. Speculators know that, sooner or later, the Fed has to answer nature's call and will go to the bill market as a buyer in order to replenish the money supply. This is their signal to sell. On rare occasions the Fed would be a seller. This is their signal to buy.

This copycat action is an inexhaustible source of unearned profits for the speculators. Thanks to the Fed's open market purchases, they are always able to replace their fast-maturing bills with fresh ones so as to maximize their bond/bill spread. The more aggressive the Fed is in increasing the monetary base, the wider the spread and the greater the bond speculators' profits will be.

## Absolute bad faith

After the F.R. Act of 1913 was quietly overthrown when Congress was not looking, the Fed has been revolutionized. According to the original Act the earning assets of the F.R. banks were to be restricted to real bills, that is, short term commercial paper originating in the production and distribution of consumer goods. *Treasury paper was not listed in the Act as an eligible asset*. This was not an oversight. No part of F.R. credit outstanding was supposed to be backed by government debt. If a F.R. bank was found short of eligible paper in balancing its note and deposit liabilities, it did not matter how much the overflow of Treasury bills was in its portfolio, it had to pay stiff and progressive penalties.

The conspiracy between the U.S. Treasury and the Fed is to be seen in the fact that the former has 'forgotten' to collect the penalty from the latter. Indeed, why should the Treasury penalize its best customers for buying its staple product? By 1920 you could not find a real bill in F.R. portfolios with a magnifying glass. Nor was a serious effort made to return to the norms of the original Act after the end of the hostilities in starting rediscounting bills once more.

The conspiracy has gone right to the heart of the U.S. monetary system. In 1913 legislators were assured that they were voting for a commercial paper system that could never become an engine of monetizing government debt. Should it try, it would be confronted with unacceptable losses. Later, when time came to legalize the illegal practice, the introduction of open market operations was presented as an innocent house-keeping change, a technical matter relating to banking practice. The fundamental issue, the wisdom of allowing the Fed to

monetize government debt, was hushed up. Congress, let alone the general public, was never given a chance to scrutinize or debate it. Monetization of government debt was legalized through the back door, through chicanery, and through absolute bad faith. It was made the centerpiece of the money-creating process, in a complete reversal of the intention of the original Act. Is it any wonder, then, that the new monetary system born in sin has brought disaster to the nation in due course?

## Nature abhors risk-free speculation

Critics focus their criticism on the way the Fed creates money through sleight of hand. But there is a much larger issue here that goes unnoticed and has escaped attention. Open market purchases have made it possible for the Fed to usurp unlimited power in suppressing the rate of interest on *all* maturities through the transmission mechanism of risk-free bond speculation, while maintaining the illusion that it had only a very limited power of influencing the overnight rate of interest. The impression created is that the world can rest assured that all other rates are true market rates. Nobody took the trouble dispelling this illusion. Nobody has investigated the consequences of bond speculation in the wake of open market operations. The 'innocent house-keeping change' opened up a bottomless pit for the national economy, as it has granted unlimited power to the Fed to suppress all interest rates along the yield curve, all the way to zero.

Just as nature abhors vacuum, it also 'abhors' risk-free speculation. It exacts an exceedingly high price from violators, sometimes after a long delay, when retribution is least expected.

The punishment for opening Pandora's box of risk-free speculation was devastating, as demonstrated by the Great Depression of the 1930's. In that episode risk-free speculation made bond prices rise and interest rates fall beyond any reasonable limits. Speculators abandoned the commodity market as too risky, and flocked to the bond market where all bets were on the house. Commodity prices fell, along with interest rates, through the whole spectrum. The consequences were apocalyptic.

## Falling interest rates as a destroyer of capital

My thesis that falling interest rates destroy capital across the board is admittedly controversial. I would welcome its examination 'without fear and favor' by a competent and unbiased panel. We must look at two related effects of falling (as opposed to low but stable) interest rates:

- *(i)* the increase in the liquidation value of debt,
- *(ii)* the fading of depreciation quotas.

The proposition that the bond price varies inversely with the rate of interest is uncontroversial and universally accepted. It describes the effect from the point of view of the creditor. Yet people find it hard to comprehend the equivalent proposition describing the very same effect from the point of view of the debtor, namely, that the liquidation value of debt varies inversely with the rate of interest, in particular, lowering the rate of interest will increase the liquidation value of debt. There is no difference between the meanings of the two statements. The bond price is just the liquidation value of debt evidenced by the bond. *Falling interest rates make the burden of debt increase.*

The depreciation quota of a producer good is an accounting tool revealing how much of its value is being 'used up', and needs to be replaced through amortization, in any particular year. It is comparable to the annual yield of capital invested in a bond. When looked at in this way, it becomes clear that falling interest rates should make the revision of depreciation quotas upwards mandatory. If this rule is ignored, there will be a shortfall in amortization. Sufficient funds will not have been set aside to pay for the purchase of the replacement at the end of the useful life of producer goods.

Present accounting standards ignore both effects *(i)* and *(ii).* This is the cause of concealed capital erosion acting insidiously. Losses are masked as profits, and phantom profits are paid out as dividends and managerial compensation. The process of capital erosion is accelerated. Inevitably, the result is deflation, depression, or worse.

We have seen that open market operations of the Fed serve as a powerful deflationary force in the economy causing interest rates to fall and capital to erode. We shall now see that falling interest rates cause prices to fall as well. It engages a vicious spiral pulling the economy into the abyss.

## Erosion of capital causes a falling trend in prices

The erosion of capital affects all producers, some of whom will succumb while others will fight for survival by trying to get out of debt. They will aggressively cut prices in the face of weakening demand.

Herein we have a classic example of central bank action being counter-productive. The central bank wants to snatch the economy from the jaws of deflation by increasing the money supply. Its preferred method is the open market purchases of short-term government securities. But through the transmission of risk-free bond speculation interest rates keep falling for all maturities. Capital invested in production is eroding faster as a result. The burden of debt is increasing. Producers are squeezed. They try to get out of debt by selling more of their product. In desperation they cut prices, but to no avail. The vicious circle is complete.

## The Austrian theory of the boom-bust cycle

The suppression of the rate of interest through monetary policy and the resulting malinvestments made by entrepreneurs is a central theme of the Austrian School of economics. Our analysis is in the same tradition. In exposing the actual transmission mechanism that converts the suppression of short term rates into the suppression of the longer term rates, it carries the analysis further. It points out that open market purchases of the Fed make bond speculation risk-free with the result that all interest rates will fall simultaneously.

It turns out that it is not necessary to bring in the malinvestment argument. After all, entrepreneurs could learn from past experience and fine-tune their investments taking the distortion in the rate of interest into account. Could the bust be avoided if they did? Our explanation of deflation and depression in terms of destruction of capital, brought about by the falling interest rate structure, avoids any reference to possible malinvestments and is, therefore, superior.

## The Achilles heel of Keynesianism

Our destruction of capital argument also has the advantage that it reveals the Achilles heel of Keynesianism preaching, as it is, the dangers of 'oversaving' and 'underconsumption'. These concepts are vacuous. There is no reason why a society should not be able to satisfy the needs of those of its members who must be net savers (typically the juniors), and those who must be net consumers (typically the seniors). The Achilles heel of Keynesianism can be found in its treatment of capital, in particular, in ignoring the danger of capital erosion. Keynesianism is oblivious to the fact that, if capital consumption occurs for any reason, then the resulting deficiency must be compensated for by the accumulation of new capital. Without it society cannot continue living at the same level of comfort and security. If it tries, it makes the crisis of under-capitalization even more critical.

The greatest mistake of Keynesianism is to teach that the cause of the Great Depression was falling prices due to oversaving. *But falling prices were not the cause: they were the effect. The cause was falling interest rates*, for which the fiscal and monetary policies advocated by Keynes were directly responsible: the unbalancing of the budget, inordinate increases in debt, and the monetization of government debt by the central bank. The Keynesian idea that open market operations will not and cannot have devastating side effects has become a dogma. This dogma must be discarded. *Open market operations do have consequences.*

### Deflation or hyperinflation?

A frequently asked question is whether the international monetary system based on irredeemable currency is facing a deflation similar to that of the 1930's, or whether it is facing a Zimbabwe-type hyperinflation.

A relentlessly increasing money supply is not the only prerequisite for hyperinflation. There is another: the lack of suitable outlets for the bloated purchasing power. As risk-free bond speculation made possible by open market operations shows, no matter how much purchasing power is being created by the world's central banks, speculators will always find rising bond values safer to bet on than on rising commodity values. In the absence of wars, or civil wars, destroying stores of consumer goods as well as the park of capital goods to produce, the forecast is deflation, not hyperinflation.

It follows that in combating deflation the Obama administration is resorting to measures that are ineffective, if not outright counter-productive. In particular, more government debt is poison for the economy. Its monetization by the Fed will only feed bullish bond speculation (and possibly bearish commodity speculation) while doing nothing to rebuild the impaired capital base of industry and finance. Bullish bond speculation is responsible for the falling interest-rate structure and destruction of capital. The economy needs to be stimulated, yes, but increased government spending is the wrong way to that goal.

The right way is through stable interest rates, more savings, and the accumulation of more capital.

If it were not so tragic, one could rub in the irony that Keynesianism, in trying to push the world into the pit of inflation, has only succeeded in pushing it into that of deflation — the very same pit it was so anxious to avoid.

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### Reference

*The Revisionist Theory and History of Depressions*, paper circulated at the Santa Colomba Conference of 2009, see the website www.professorfekete.com.

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## Professor Fekete's Australian Seminar

Time is passing and anyone wishing to attend this November's seminar in Canberra is invited to contact Marcus Matthews at feketeaustralia@gmail.com to organise their ticket.