HEDGING NON-GOLD INVESTMENTS WITH GOLD

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Ladies and Gentlemen:

The cliché that the present credit collapse is "the greatest financial crisis since 1929" is the understatement of the century. One measure of the crises is the ratio of gross private debt to nominal GDP. This ratio captures the idea how many years of current output it would take to retire outstanding debt. In these terms, the crisis is truly unprecedented. The world plunged into the present crisis with far greater debt than the debt outstanding at the time when it plunged into the Great Depression in 1929. Add to this the qualitative change in the structure of debt. The most exotic of the Roaring Twenties era debt was brokers' margin lending on the stock purchases of clients. Today, in addition, we have: (1) derivative instruments valued up to one quadrillion dollars, (2) adjustable-rate mortgages, (3) the unquantifiable off-balance-sheet activities of financial institutions, and (4) the junk-bond activities of private equity firms. The unwinding, or should I say unraveling, of this financial esoterica will greatly increase the underlying debt. The momentum of change in the debt-tower will insure that debt — and bankruptcies — will continue to rise even as the economy contracts.

The greatest amplifier of the debt burden: falling interest rates

I won't beat around the bush and say it without hesitation that the greatest underlying cause of the present crisis is the ongoing destruction of capital induced by the falling interest-rate structure. Economists and accountants are still blind to the fact that falling interest rates amplify the burden of debt. According to Fischer's Paradox: "*The more debtors pay, the more they owe*". In this single sentence we have the essence of deflation. Payments of the debtors are discounted at the lower current rate of interest — not at the higher rate at which the debt was originally contracted!

This may be the nightmare that keeps Ben Bernanke awake and his printing presses in high gear. All in vain: falling prices defy the printing presses. Last year the fall in CPI was the steepest since 1932 at 2 percent. Forget monetarism, forget the Quantity Theory of Money. Forget Friedman. Call it Fekete's Paradox if you will: *"The more the Fed tries to pump up commodity prices with its printing presses, the more they will fall"*. The explanation of this paradox is found in the contrarian behavior of the speculators. Yes, they will snap up the newly printed dollars and run with them. But run they will in the wrong direction. They run not to the commodity market as hoped by Bernanke, but to the bill market where the fun is. They front-run Bernanke and his team. They effectively corner the market for T-bills before Bernanke can buy his quota, without which he cannot print more dollars. Then speculators turn around and feed the T-bills to the Fed *on their own terms.* Thus the Fed's effort to induce inflation will fail — just as the effort of the Bank of Japan to pump up prices was a dismal failure in 2002.

Greenspan surfing the tsunamis

In a testimony to Congress Alan Greenspan has described the financial crisis as a "once-in-a-century credit tsunami". His simile is as misleading as it is inappropriate, on at least two counts. First, geologists do understand the cause of a tsunami; Greenspan and other policy-makers do not understand why the global financial crisis has occurred. Second, while geologists understand tsunamis, they do not cause them. In contrast, policies implemented at the Fed and at the Treasury are directly responsible for the financial tsunami. Worse still, policy-makers fight the destructive effects of the tsunami with means that can only be described as counter-productive. They make the crisis worse, not better.

They had encouraged a debt-financed speculative bubble in asset prices that created a 25-year illusory prosperity but was doomed to burst, ushering in a self-aggravating economic downturn. They are utterly ignorant about the role of capital

and debt in the productive process. They believe that credit can replace capital, so that capital destruction can be repaired with more credit expansion. The vast majority of their colleagues at the universities are not any better informed, either.

Gold as the ultimate extinguisher of debt

If we accept the thesis that exorbitant debt and the destruction of capital is at the root of the present crisis, then we'll be directed to the solution of the problem. The solution is gold. The reason why there can be no resolution of the crisis without gold is two-fold.

(1) *Gold is the only form of capital that is immune to destruction under any circumstances*.

(2) *Gold is the only ultimate extinguisher of debt.*

I shall deal with the first reason in a moment. Here I just point out that when a debtor repays his debt by handing over Federal Reserve notes to his creditor, the debt is not extinguished. It is merely transferred to the Federal Reserve bank that issued the note. Transferring debt is not the same as extinguishing it. One reason for the present plight of the world is that for the past forty years gold, the only ultimate extinguisher of debt, has been forcibly prevented by the U.S. government to discharge its debt-extinguishing function. As a consequence the debt-tower has kept growing, rain or shine. Conversely, until policy-makers at the Fed and the Treasury will understand that there is no substitute for gold in taming the debt-monster, their tinkering at the edges will keep making the global debt crisis worse.

Unfortunately, the news is not good in this regard. Bernanke is a dyed-in-the-wool chrysophobe. He would hardly be competent to make the necessary changes that would restore gold as the ultimate extinguisher of debt in the international monetary system.

Here I come to the point of my talk. What can the individual investor do to make sure that his investments will not be completely wiped out in the coming financial Armageddon?

Gold as the only form of capital that cannot be destroyed

In wartime capital destruction normally presents itself as physical destruction of plant, equipment, and products at various stages of production. By contrast, in peacetime, capital destruction takes place on paper, through the consolidation of balance sheets. Take the simplest case when a bankrupt economic entity is

overtaken by another in order to save whatever can be saved. Clearly, that part of the assets of the latter that have a counterpart in the liabilities of the former cannot be saved. It will be wiped out.

It follows that no asset that also occurs as liability in the balance sheet of a counter-party is safe against destruction through consolidation — even if that counter-party is the government. We must remember that every government experiment with irredeemable currency in history has been an abysmal failure.

In the extreme case, when the balance sheets of all economic entities are consolidated in a holocaust, and all paper assets are wiped out, gold is always a survivor: the only asset that cannot be destroyed through inflation, through deflation, or through any other malady of the monetary system.

This means that gold, and only gold, qualifies as an instrument of hedging paper assets. Every investor owes it to himself to provide an adequate level of insurance against risks that prey upon the value of paper investments. But unless this insurance consists of physical gold held by the investor himself on his own premises, it will be ineffective.

Trading insurance makes no sense

This also shows that the attitude of most investors with regard to gold is faulty, not to say foolish. They keep talking about the "performance" of gold. They trade gold: buy it when they expect the gold price to rise; they sell it when they expect the gold price to fall. Many of them are finished with gold saying that "the bloom is off the roses". This attitude is akin to that of the property-owner who thinks that he is saving money by canceling his insurance coverage hoping to reinstate it later. It never occurs to him that it may not be possible to reinstate, if the external conditions change drastically.

The best policy concerning insurance is to buy it and "forget about it". No regrets if the occasion to collect insurance compensation never arises. It is not a loss: it should be looked at as a gain.

A simple gold-accumulation plan, aiming at a gold hedge equivalent to 10-15 percent of net worth, with monthly additions will suffice, with the proviso that it is preferable to increase the hedge when the gold price is down.

Gold investors typically get nervous as they listen to rumors that the volatility in the price of gold indicates that the value of gold has become unstable. They forget that it is not gold that is unstable, but the dollar in which the gold price is quoted. Gold has been, is, and will be the paragon of stability. Ultimately, the price at which you have purchased your hedges is unimportant.

Tips for hedging

Buy anonymously and don't talk about it. Don't worry that you can't sell anonymously: you are not going to sell, just like you are not going to cancel your fire insurance policy as long as you own the house. Don't worry about capital gains taxes on your gold that you hold as hedges against paper assets. Since you never sell, you never incur a tax liability. There is no way the government can impose or collect taxes on paper profits. At any rate, those so called profits on your gold hedges should never be considered as profits. They should be looked at as advances on payments of insurance compensation for anticipated losses. It would be foolish to take these "profits" and spend them. Those losses may disappear, together with the gold profits, creating the impression that your hedges don't work. They do, but the results have to be interpreted correctly. Spending gold profits is tantamount to canceling the insurance policy prematurely. The big test is still ahead. The crisis is not over, not by a long shot.

The shape of things to come

The world lives in a delusion. It sets great stores on Keynesian nostrums, hoping that public debt-financed government spending, or inflating the money supply will resolve the crisis. They won't. The first-mentioned Keynesian remedy will fail because replacing private debt with public debt means jumping from the frying pan into the fire. A true solution must reduce total debt. The second-mentioned Keynesian remedy will fail to induce the intended inflation because the newly created money just won't go where the Fed would like it to go: to the commodity, real estate, and stock markets. Instead it will go to the bond market to facilitate bond speculation: borrowing short and lending long, putting a downward pressure on the yield curve. Alternatively, it will be used to retire private debt. In either case, the result will be deflationary, not inflationary.

As the decrease in debt reaches a threshold, it will have two immediate consequences. One: unemployment will skyrocket. Two: the financial system will self-destruct in a spectacular fire-work that will make the fact obvious to one and all. Concerning the first consequence, the U.S. must face the situation squarely that during the boom years it has dismantled much of its industrial park producing consumer goods for the mass market. It no longer has the factories needed to employ the armies of unemployed people that will be laid off in the financial sector: at brokerages, real estate agencies, insurance companies, not to mention banks.

Concerning the second consequence, it must be stated that the U.S. financial system is bankrupt already: it self-destructed during the long-drawn-out decline of interest rates to zero. This bankruptcy is camouflaged by the wholly misconceived measure of allowing the banks, pension funds and insurance companies to cook their books. They can only balance their books through the trick of overstating the value of their assets and understating the value of their liabilities. The government and the accounting profession are accomplices. Not only do they fail to prosecute violators of the accounting code, they even cheer them on and encourage others to do the same. Worst of all, they set the example. The Fed carries dead assets such as mortgage-backed bonds with no bid and no market at a positive value.

Revaluation of gold

The nation is lulled into a false sense of security. When the truth dawns on the nation that the American financial system is working without capital (following in the footsteps of the Japanese banks that have been brain-dead for over a decade), the shock will greatly aggravate the crisis. It would be better to let the truth come out now, so that the process of re-industrializing the country and recapitalizing the financial system by an appropriate revaluation of gold could start without delay.

The alternative to the revaluation of gold, seriously suggested by some respectable economists, is a complete debt-jubilee, that is, forgiving any and all dollar-denominated debt, starting with the government debt through mortgages and corporate debt, all the way down to the short-term liabilities of banks, including bank deposits. This is, of course, the ultimate shock-therapy with all the unknown consequences that it may bring with it in its train. Nobody knows how the unfairly dispossessed creditors, including all the pensioners and holders of life insurance policies will react. Nobody knows what the unjustly enriched debtors will do with their godsend, the transfer of unencumbered assets to their possession. Maybe bloodshed in the streets can be avoided. Maybe not. The still unsolved problem of unemployment strongly suggests the latter.

At any rate, why take the risk, when this dormant asset, gold, has been lying around fallow for some forty years and is waiting for rehabilitation. It has the two prerequisite properties that fit the need just like the glove fits the hand: the ultimate extinguisher of debt, and capital indestructible *par excellence*. With a proper revaluation of monetary gold, much of the existing debt-burden could be alleviated and new productive capital could be accumulated.

I am not suggesting that sufficient wisdom presently resides in the leadership of the world to see this. But as their false remedies will be tried, and one after the

other will backfire, the ultimate solution to the crisis, gold-revaluation, would dawn on the world.

Let's face it: the only reason why this plausible solution to the long-festering problem of runaway debt has not been applied already is sheer envy. Those who saw in gold only a "barbarous relic" would always look with envy at those who saw in gold the ultimate extinguisher of debt and the only indestructible form of capital. They would do everything in their power to deny the latter any benefit of their superior foresight.

Calendar of Events

Seminar at the Martineum Academy, Szombathely, Hungary, March 25-29, 2010

Is the Global Financial Crisis Over?

Sponsored by the Gold Standard Institute, with the participation of Darryl Schoon, Rudy Fritsch, Sandeep Jaitly, Peter van Coppenolle, Nathan Narusis, Professor Fekete. Among other topics, there will be a presentation of the latest research on the gold basis, the world's pension and insurance woes due to the destruction of capital in the financial sector, still unrecocnized by the mainstream, and an exclusive business idea **how to turn the ridiculously undervalued "legal tender" gold coins to your advantage**.

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