HOW TO STOP THE DEPRESSION

An interview with

Antal E. Fekete

Professor of Money and Banking, San Francisco School of Economics

Asking questions is Jorge Nascimento Rodrigues,
Executive Editor, *Portuguese and Brazilian Management Review*

Q.: *What are the main roots of the present economic and financial crisis?*

A.: There is only one main root, the same as that for the Great Depression in the 1930's: destruction of capital. Erosion or consumption of capital has been going on unnoticed for decades. The process ends when there is no more capital left to consume. After the seven fat years, a period of seven lean years must commence.

Capital erosion is not natural nor is it inevitable. Rather, it has been inflicted upon the world economy by the unmindful and irresponsible monetary policy of the United States in deliberately driving the rate of interest to zero.

Falling interest rates, which are lethal, must be carefully distinguished from *low but stable* interest rates, which are salutary. A falling interest rate structure, foisted upon the world by the Americans obsessed with the idea of preserving the hegemony of the dollar, works insidiously and unobserved. As the rate of interest falls, the liquidation value of debt rises. Far from *decreasing* it, falling interest rates *increase* the burden of debt. Economists, chartered accountants, and bank examiners do not recognize the concept of liquidation value of debt, let alone its inverse relationship to the rate of interest, although it is exactly the same inverse relationship that is well-recognized to exist between the market value of a bond and the rate of interest. As the interest rate falls, creditors refuse to accept the face value of the bond in settlement of debt. At the lower rate the income stream of coupons falls short of amortizing the face value of the bond. To compensate for the shortfall the market value of the bond must be increased. Accordingly, creditors bid up the market price of the bond. If debtors want to get out of debt before it matures, then they will have to pay the market price exceeding the face value of the bond. This conclusively proves that the fall in the rate of interest increases the liquidation value of debt.

As soon as the liquidation value of liabilities less assets surpasses capital, the firm becomes insolvent. Its capital is gone. It can no longer attract credit. This is what has happened to the banks in the U.S. and the U.K. This is what has also happened to the American auto industry, and all the other American industries now extinct.

Those who dismiss my analysis of the present crisis in terms of capital destruction as an improbable single-cause explanation of a complex phenomenon must answer the following question. What are the statistical odds that the banks, financial institutions, as well as the three big automakers go bankrupt all at the same time? Well, the odds are virtually zero, unless they fail due to a single cause.

Q.: *Has Japan served as a 'testing ground' to combat stagnation-deflation or as a 'lab' experimenting with the cure for stop-and-go economic growth for the last two decades?*

A.: Your suggestion that Japan has been used as a 'lab-experiment' how to combat deflation through suppressing interest rates all the way to zero is interesting. But as the results of this experiment convincingly show, lowering interest rates is no cure for deflation, but poison for the economy. Lower interest rates reinforce deflation, making it worse. Japan should have ignored advice from the American money-doctors and follow independent monetary and fiscal policies. Instead, Japan embraced the prevailing blend of Keynesian and Friedmanite bunk and plunged headlong into a sea of deficits and debt. As a result, the plight of the country is prolonged. It is highly doubtful that the American money-doctors will learn from the failure of their Japanese experiment. But then, as Poor Richard's Almanach says, experience runs an expensive school, but fools will learn in no other.

Q.: *Are credit bubbles and busts typical of the capitalistic system of production? Has the manipulation of the money supply and the rate of interest by central banks been around since early times, or it is a more recent innovation of policy-makers?*

A.: Credit bubbles and busts have nothing to do with the capitalistic system of production; they have everything to do with the suppression of the rate of interest by the government through its agent, the central bank. In the beginning the central bank was a relatively tame institution. It even denied that it is equipped or called upon to manipulate the money supply or tamper with the rate of interest except, perhaps, the overnight rate. Later unscrupulous politicians emboldened the central bank to grab unlimited power under the regime of irredeemable currency. To be sure, the power to print currency is unlimited power.

The real turn of events came with the clandestine and illegal introduction of 'open market operations' by the Federal Reserve banks (Fed) in the early 1920's. The 1913 Charter of the Fed disallowed the monetization of the government debt and penalized violations by levying heavy and progressive fines. But as time went on, the Treasury 'forgot' to collect the fine and, in the end, the *fait accompli* forced Congress to legalize the Fed's practice of purchasing Treasury bonds in the open market and using them as collateral for its note and deposit liabilities *ex post facto*.

With this Act the principle of limited government was thrown out of the window. Equally serious was an unintended consequence that remained hidden for half a century but burst upon the scene with full force after 1971 when the gold standard was finally overthrown. Bond speculation that resulted from this measure was confined to a playing field that was far from level. It gave a bias to bull as opposed to bear speculation. Bull speculators, armed with the knowledge that the Fed was in need of buying more bonds preempt the purchase in buying the bonds first, dumping them into the lap of the Fed later, thus pocketing risk-free profits. Now the sky was the limit to which speculators could bid up bond prices. The gates to the black hole of zero interest were thrown wide open, as shown by events of the past thirty years. As I have already explained, the main root of depressions is not vanishing demand as suggested by Keynes, but vanishing capital caused by the deliberate suppression of interest rates.

Q.: *Are 'quantitative easing' and the regime of near-zero interest rates a good medicine? Or will they fail to solve the credit crisis as it turns out that their impact on the real economy is nil?*

A.: 'Quantitative easing' is an empty slogan designed to cover up the black hole of zero interest gobbling up the world economy. Consider that the total outstanding debt is in fact *perpetual debt*, because under the regime of irredeemable currency total debt can only grow but never contract. Even if all debtors could repay their loans, debt would still not be extinguished. It would be merely transferred to the banks and, ultimately, to the government.

Consider also the fact that the liquidation value of perpetual debt *doubles* every time the rate of interest is *halved*. So when under the slogan 'quantitative easing' the rate of interest is serially cut in half from 4% to 2, then from 2% to 1, then from 1% to ½, then from ½ % to ¼ , and so on, the liquidation value of debt will double from $1 trillion to 2, then from $2 trillion to 4, then from $4 trillion to 8, then from $8 trillion to 16, and so on. Soon you will be talking real money in the quadrillions of dollars. Mind you, this is just increase due to falling interest rates; additional debt assumed through bailouts would be extra.

The world has already passed the point where one more straw breaks the back of the camel, as witnessed by the collapse of the banking system. The next step is breaking the back of the dollar. 'Quantitative easing' is guaranteed to accomplish that, although it is impossible to say when.

The whole idea that the government can keep halving interest rates serially with impunity is insane. Bernanke and Geithner don't know what they are doing and saying. 'Quantitative easing' has another arm, 'quantitative backlash', operating with a high leverage. Not only will 'quantitative easing' have zero impact on the real economy; it will bankrupt the U.S. government due to the serial doubling of the liquidation value of government debt.

You need gold in the world's monetary and payments system because gold is the only *ultimate extinguisher of debt*, without which total debt becomes perpetual debt and the fast breeder of debt starts spinning out of control. As a consequence, the world will be sucked into one or the other of the two black holes: that of zero interest (deflation) or that of infinite interest (hyperinflation).

Q.: *Are we witnessing a repetition of the Weimar policy madness? Can we have deflation first, followed by the surprise of a hyperinflationary period?*

A.: Weimar Germany was hit by hyperinflation in 1923; then it was hit again by deflation seven years later, in 1930, when 8 million workers, or about one half of organized labor, were laid off. You may say that it is typical for deflation to follow hyperinflation. The world is ill-prepared for what may be unfolding before our eyes, namely, as you suggest, in a reversal of the typical order, deflation is followed by hyperinflation. Most observers' forecast is that the dollar will soon succumb to hyperinflation ignited by the bailouts. Put me down in the deflation column. My forecast is: deflation now, hyperinflation later.

The important thing is not the trillions spent on bailouts, but the quadrillions in increase in the liquidation value of outstanding debt, thanks to the serial halving of interest rates. There are actually two camels: the banking system and the dollar. The last straw has already broken the back of the first camel. Straw is still being loaded on the second.

Q.: *In Europe, and also in the U.S., analysts are pruning the idea of the nationalization of the banking system as a measure to prevent its complete meltdown. Even the Russian President is making jokes at the expense of the West about 'financial socialism'. What do you think about nationalization, the creation of 'good banks' and 'bad banks', and the 'reverse securitization' of toxic assets?*

A.: Nationalization is no solution to the banking crisis. It would do no more good than shuffling deck chairs on the sinking Titanic. The meltdown of the banks was not caused by the banks *per se*. It was caused by government sabotage of the gold standard. The idea of separating the assets of failing banks and dumping the toxic part on a 'bad bank' is utterly imbecile. Toxic assets should be written off outright and their securitization should be cancelled, not reversed. Securitization of mortgages and other bank loans was fraudulent in the first place as it was based on the false premise that the strength of a chain is determined by its *strongest* link.

As every child knows, it is determined by its *weakest* link.
There can be no 'good bank' under the regime of irredeemable currency. If you want to have good banks around, then you will have to reintroduce cancer-fighting gold corpuscles into the monetary bloodstream. A diseased monetary bloodstream, which irredeemable currency is, will contaminate even the best of 'good banks'.

Q.: *What is your recommendation for an emergency package?*

A.: The emergency package pushed by the Obama administration is going to fail. It consists of the same nostrums that have landed the world in the present depression in the first place: the relentless pumping of money into the economy in order to drive down the rate of interest.

To be sure, the banks and industrial enterprise must be recapitalized. But to accomplish this something more substantial is needed than the irredeemable promises of a government that is the largest debtor in the world, let alone the fact that it is bankrupt itself, whose future tax receipts on the present scale become ever more illusory. *The banks and industry must be recapitalized through the remobilization of the world's monetary gold that has been lying idle for the past 35 years.*

This feat can be accomplished through a plan that may be put into effect unilaterally even by a smaller country such as Portugal, which I shall use here as an example. Suppose the Mint of Portugal is opened to the unlimited coinage of gold. The standard gold coin weighing one ounce, 9999 fine (bearing no denomination) would be paid out by the Mint to the bearer of the same quantity and quality of gold (a modest seigniorage charge may be made to cover the cost of minting).

The Bank of Portugal must by law tariff the standard gold coin at a value no lower than that of its gold content as determined in the open market. In other words, the monetary value of the standard gold coin must be adjusted upwards every time the gold price makes a new high. As an aside I note that at present the Federal Reserve still tariffs gold at $42.22, while in the market gold fetches more than twenty times that amount. This idiotic policy is one of the chief causes of deflation in the world today.

In case the gold price falls, the Bank of Portugal may leave the monetary value of the standard gold coin unchanged, or it may adjust it downwards with a lag. In either case there would be a gold flow to the Mint, and ever more standard gold coins would get into circulation as businessmen take advantage of profit opportunities presented by the favorable valuation of gold in Portugal.

The effect of my plan is that capital will start flowing to Portugal in the form of monetary gold from the rest of the world, *but without suppressing the rate of interest.* Portugal will be a most attractive place where to invest. It will escape deflation and the disastrous unemployment hitting other countries – except, of course, countries that follow Portugal's monetary leadership and open their Mint to gold.

If an oil-producing country adopted my plan, then competition will force all the others to follow suit. Trade in crude oil would be billed and financed through gold devices. That would stabilize the price of oil, as well as the price of other world-class goods. At present these prices are unstable precisely because the value of the irredeemable dollar financing world trade is increasingly uncertain.

The new payments system emerging in this way would fall short of a fully-fledged international gold standard, as central banks would retain their power to tariff the standard gold coin according to their own national priorities. If a country wanted to increase domestic employment, it would raise; if it wanted to curtail capital inflows, it would lower the tariff. In either case gold would serve as an outside currency against which the domestic currency could be devalued or revalued *without triggering competitive currency devaluations.*

Later, when the dust settled, leading countries could come together and agree on a new international gold standard in abrogating the power of their central banks to change their tariffs on the standard gold coin. This would mean a return to the system of fixed exchange rates which the world so foolishly abandoned in 1931 and, again, in 1971.

One objection to my plan, that the scheme is inflationary because of the remonetization of gold involved, can be safely dismissed as disingenuous. Policy-makers at the Federal Reserve have been desperately trying to induce inflation, only to make deflation getting ever more entrenched.

Another possible objection is that in paying for imported gold the real wealth of the country would pass into the hands of foreigners. While there is a grain of truth in this to the extent that exports reduce the wealth of a country, Portugal could show something for it in the form of increased gold reserves and a decline in unemployment. What can China show for its immense transfer of wealth to countries absorbing its exports? A pile of I.O.U.'s, that's what, that may ultimately be worth no more than the paper it is printed on. Under my plan it could show an increase in its gold reserves that China needs and badly wants. Incidentally China, by the logic of its position as one of the world's great exporting countries, is a likely candidate to adopt my plan. Otherwise it would face a horrendous unemployment and social unrest which the Chinese Wall may no longer be able to contain.

Continuing ostracism of monetary gold may mean plunging the world into a new Dark Age, the crumbling of civilization, vanishing law and order, mass starvation, the impoverishment of rich and poor alike. It may trigger an uncontrollable mass migration from East to West and from South to North of unruly millions in search of a place underneath the Sun.

The Obama White House has been hijacked by a reactionary clique of Keynesians and Friedmanites before the new president even had a chance to take stock. They are doctrinaires who would never admit that they have made a fatal mistake when they promised permanent prosperity, a world free of bank runs, panics, domino-style bankruptcies, mass unemployment and depressions, provided that they were allowed to quarantine gold and to manage the rationing of synthetic credit as they see fit. Now they want to be in charge of salvaging the train-wreck, the result of their sabotaging the natural monetary order based on a positive value, gold, rather than a negative value, debt.

Unless the world can extricate itself from the murderous grip of these unscrupulous saboteurs by putting gold back into monetary circulation, we are all doomed.

February 2, 2009.