PREMATURE OBITUARIES

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It is open season for wild monetary prognostications. More premature obituaries on the dollar have been posted on the Internet. For example, see Jim Willie's *The US Dollar Paper Tiger* (Gold-Eagle, January 11) with epitaphs like "the U.S. dollar rising to the cemetery", or "dollar death dance". Or see another article, Jeff Nielsen's entitled *Maximum Fraud in U.S. Treasurys* (Gold-Eagle, January 3). It betrays maximum misunderstanding about keeping the dollar on a life-support system. It assumes that the Fed and the U.S. Treasury are fighting tooth and nail to keep the value of government debt high lest it collapse in want of support from Japan, China, and other countries.

These views hang the picture upside down. In actual fact, the Fed and the U.S. Treasury desperately want to beat down the value of the dollar. The greatest obstacle frustrating their effort is the stubbornly high and still increasing value of U.S. Treasurys. Captains of the world's monetary system are yanking levers and twisting throttles which are no longer connected to anything. The captains are no longer in control. Yet they continue to wave their batons feverishly and pretend that the orchestra is paying attention. They want Jim Willie, Jeff Nielsen and everyone else to believe that the falling interest-rate structure is the outcome of their deliberate monetary policy. In fact, the Fed and the U.S. Treasury are trying to stop the rate of interest from falling further. They instinctively realize the threat of falling interest rates brings deflation and depression in its train. *The dollar is much too strong, contrary to the wishes of policy-makers.* It is not so easy to beat down the value of the dollar as suggested by Keynesian textbooks, even if you have the key to print shop where the presses are running. The dollar's strength prevails in spite of the withdrawal of Chinese and Japanese support of the U.S. bond market, and in spite of the destructive monetary policies of the American guardians of the dollar.

This observation reveals the prevailing profound misunderstanding about the nature of this financial crisis. To set the matter right, in this article I shall recapitulate the argument that I have been presenting on the Internet for the past ten years.

Where Keynes went wrong

At the heart of my theory is speculation, the main driving force of the huge oscillating money flows between the commodity market and the bond market. It can, and often does, overrule official monetary policy.

It is well-known that Keynes had a poor understanding of speculation. His occasional excursions to the pits resulted in significant financial losses for him. No more successful was he as a theorist. For example, he introduced the concept of *normal backwardation* as the main underlying feature of the futures market. He insisted that in buying futures contracts speculators demand — and receive — compensation for their services as 'insurers' in return for carrying the price risk that owners of physical commodities and first order financial assets are unable or unwilling to carry. First order financial assets such as stocks, bonds, foreign exchange, mortgages must be carefully distinguished from higher-order financial assets such as futures and options on first order financial assets, options on futures, options on options on futures, and so on and so forth *ad libitum*. Keynes did not live to see the rise of higher order financial assets. He called the insurance premium speculators pocket when their contracts mature 'normal backwardation'.

Backwardation is the name for the market condition under which futures are offered at a discount relative to physicals. Keynes is putting things upside down. The futures market, far from being an insurance-operation, is in fact a market for warehousing services. The warehouseman buys the physicals and sells the futures as a matter of arbitrage. But he can do that only if the future price is at a *premium* over the cash price. This condition is known as *contango*, which is the exact opposite of backwardation. For example, at harvest time cash wheat is plentiful and contango is robust. The elevator operator, our warehouseman, is buying cash wheat against selling wheat futures. In doing so he performs a useful service to society: that of warehousing and rationing the wheat supply until the next crop comes around a year later. The premium, the difference between the futures price and the cash price is his fee for the service. To create this arbitrage opportunity was the main justification for starting futures trading in wheat and in other agricultural commodities in the 19th century, when the monetary unit was a positive rather than a negative value. Notice that nature is responsible for the fluctuation in the price of agricultural commodities: weather, unforeseen natural disasters, climes and other things over which man has no control.

All this has changed when, at the behest of Keynes, governments exiled gold from the monetary system and embraced a negative value, debt, as the monetary unit. As an immediate consequence a lot of new futures markets sprang up, chief among them the futures market for foreign exchange and the bond market. In these the cause of fluctuation was no longer nature. Instead of nature-created risks, here futures trading addressed artificial risks created by man. Keynes blithely assumed that futures trading would have the same stabilizing effect on the price of these financial assets as it did in on the price of agricultural commodities. This was his worst blunder. When man or a committee of men rather than nature calls the shots, speculation becomes *destabilizing.* The nature of speculation has changed beyond recognition. In the first scenario when nature alone calls the odds all speculators start with equal chances. No combination of bets is capable of changing the odds. This is no longer the case when risks are man-made. In this case speculation assumes the character of gambling. Here speculators (gamblers) are matching their wits against that of the house. Here, given a bottomless purse, a combination of bets can indeed change the odds. The gamblers can even beat the house. We have seen it happen time and again: speculators in foreign exchange or bonds won and the government or the banks had to take huge losses.

The Law of Vanishing Contango

It would be more reasonable to talk about *normal contango* than about *normal backwardation*, the obsession of Keynes. Backwardation in many ways is an anomaly. If and when it occurs, it indicates scarcity. In case of scarcity there is no need for warehousing. Keynes got it all wrong.

The problem of warehousing applies to gold *par excellence*, which owes its status as the monetary commodity (independently of the wishes of governments and banks) to the size of *stocks* which are large relative to *flows* which are meager. The stocks-to-flows ratio of gold is a high multiple, in contrast with that of copper, for example, which is a small fraction for reasons of its fast declining marginal utility.

If gold is forcibly divorced from money by order of the government, or to say it differently, if a negative value such as debt is foisted upon society as the new monetary unit, then the price of gold will fluctuate inviting speculation and gold futures trading. The gold futures market, if it is to function at all, must be a contango market. Otherwise it would give an opportunity to speculators to make risk free profits (they would buy gold futures at a discount and sell cash gold at a profit). That would immediately eliminate the discount on gold futures (making a mockery of Keynes' normal backwardation.) However, in the case when gold is scarce as a result of flight from paper currencies, *permanent backwardation of gold* puts in an appearance. This sounds the death knell of the regime of irredeemable currencies.

Not only did Keynes misunderstand speculation, but he also completely misconstrued the God-ordained role of gold in society. He did not see that variable foreign exchange rates would ultimately undermine paper currencies and bond values due to gold hoarding. Moreover, vanishing confidence in foreign exchange rates and bond values could be directly measured in terms of vanishing contango. Ultimately, all monetary gold would be driven into hiding. The biblical writing on the wall "*Mene tekel upharsin*" (you have been put on the scale and found wanting) would become reality in a literal sense.

Ever since gold futures markets started trading in the early 1970's, they were subject to the Law of Vanishing Contango. It was never properly understood by the so-called experts or by anyone else. While nobody could predict when contango would go into permanent backwardation, it is certain that when this ominous event happens, the music stops and the game of musical chairs is up. Mainstream economists ignore the problem of *permanent backwardation* in gold. *They do it at their own peril.* Keynesian/Friedmanite economics is going to be shipwrecked on the reef of permanent backwardation. Irredeemable paper currencies which they have spawned will be ignominiously wiped off the face of the earth.

Economic resonance

When at the behest of Keynes foreign exchange rates were deliberately destabilized, a couple of other ominous things happened. Most importantly, interest rates were also destabilized that made an old phenomenon, the Kondratiev long-wave cycle self-boosting, leading to runaway-vibration. As may be recalled, this rather rare physical phenomenon caused the Tacoma suspension bridge in Washington state plunge into the river in 1940. Parcels of energy bombarding the bridge in gusting winds resonated with one of the characteristic harmonic frequencies of the bridge. As a result total energy, rather than dissipating harmlessly, kept piling up. It ultimately overwhelmed the statics of the bridge. Engineers have forgotten to take runaway resonance into account when the bridge still existed only as a blueprint. Likewise, designers of the regime of irredeemable currency have failed to consider economic resonance. Runaway vibration exists in economics whether recognized or not. It can destroy currency and bond values just as it can destroy bridges.

I describe the present economic crisis in terms of economic resonance. The economy experiences oscillating money-flows between the commodity market and the bond market. When money flows from the bond market to the commodity market, we witness the inflationary phase of the cycle. Inevitably, rising interest rates accompany this phase. At the top of the cycle the money-flow will reverse itself and will go from the commodity market to the bond market. This is the deflationary phase of the long-wave cycle that, no less inevitably, is accompanied by falling interest rates. These huge money-flows are driven by speculation. There is a linkage between the price level and that of interest rates compelling them to move in the same direction (always subject to leads and lags). *Furthermore, the two resonate.* It is altogether too naïve to suggest that the government is equipped to control the phenomenon of economic resonance. As the story of King Canute shows, tides of the sea cannot be turned back by royal proclamation.

For centuries the Kondratiev cycle has been kept on a leash. Resonance was always damped so that vibration could never reach runaway levels. Neither prices nor interest rates were allowed to grow indefinitely. At one point the policeman would stop their march and turn them back. The policeman was none other than the gold standard.

The regime of irredeemable currency fired the policeman and resonance has become self-boosting. Runaway vibration is in the making. When the energy level of the self-boosting system overwhelms centripetal forces, the system snaps like a broken chain, releasing the surplus energy most destructively. This is the substance of every crack-up boom. Like Mises, I also object to the use of the word hyperinflation, albeit for a different reason. It suggests that the phenomenon is *linear* and follows the laws of the Quantity Theory of Money. The more money is printed, the higher do prices go. However, we are here facing highly *non-linear* phenomena. Our economy is torn to pieces by runaway vibration. We are victimized by the self-destruction of the monetary system subjected to oscillating money-flows boosted by the resonance of fluctuating interest rates resonating with fluctuating prices.

The vampire of risk free bond speculation

Another ominous thing happened when, at the behest of Keynes, foreign exchange rates were deliberately destabilized. Monetary policy has become counter-productive. When the central bank intervenes in the market to control the rise of interest rates, it inadvertently makes prices fall; and when it intervenes to stop prices from falling, it inadvertently makes interest rates rise. The upshot is that the central bank intervention, rather than tempering movements, aggravates them.

Once more, the source of the trouble is Keynes' poor understanding of the dynamics of speculation. Whether combatting inflation or whether combatting deflation, the central bank has only one policy tool, namely, *printing more money*. Keynesian economics pretends that the central bank operates *in vacuo*. It can assume away any and all side effects. But there is one side effect it certainly cannot wish away, and that is bond speculation that follows the central bank like the shadow follows the thief. The bond market is huge, exceeding the equity market in size more than ten-fold. Equally huge is its speculative following.

When the central bank wants to control rising interest rates, then it goes into the open market to be a net buyer of Treasury bonds. Inevitably, speculators want to preempt the central bank. They strive to buy the bonds first, dumping them into the lap of the central bank at a higher price afterwards. Speculators are making risk free profits. The central bank is helpless. It has to pay the speculators' price.

Likewise, when the central bank wants to control falling prices, it goes into the open market to be a net buyer of Treasury bonds. Speculators will gratefully take the new money so created. Of course, the central bank wants them to buy commodities to prevent prices from falling. However, speculators have a better idea. They go to the bond market where the fun is. Commodities are too risky for their taste, especially when they can make risk free profits in bonds. The risk free profits speculators make are made possible by Keynesian monetary policy.

This is the fundamental flaw of Keynesian economics. At the present junction the Fed is buying bonds to combat deflation. Bond speculators know this, will buy the bonds first, driving down interest rates in the process. The result is more deflation, not less. The Keynes-inspired central bank action is counter-productive. Policy-makers are blind and don't see this. They stick to their self-defeating monetary policy. They actually become the quartermaster general of the depression they are trying to avoid. As if cursed by a particular kind of madness, policy makers saddle society with the vampire of risk-free speculation. They turn the constructive energy of stabilizing speculation into a most destructive kind of energy: destabilizing speculation. The problem cannot be cured because bond speculation cannot be eliminated. It should be clear that as long as the world does not succumb to a military conflagration such as a world war destroying supplies of goods and production facilities, the danger is not inflation as predicted by the Quantity Theory of Money. The danger is deflation due to risk free-profits with which Keynesian economics inadvertently tickles speculators.

It is suggested that the world is facing an imminent inflationary collapse of the dollar for reasons of over-issue. But what the world is getting is a deflationary collapse of the economy, as a result of the obtuseness of academic economists and policy-makers sold on Keynesian economics. They fail to see in the collapse of the rate of interest the inherent destruction of capital. Businessmen are lethargic. They know that making new investments while interest rates keep falling is suicidal. No matter how low interest rates may go, their competitors who invest later will have the advantage of investing at lower rates still.

Destruction of the wage fund

The German economist Heinrich Rittershausen (1898-1984) predicted the horrendous unemployment that was to hit the world economy in the 1930's in terms of the destruction of the *wage fund*. He pointed to the failure after World War I to rehabilitate the real bill market. The victors in their conceitedness ignored the fact that the wage fund, out of which workers could be paid *up to 91 days in advance of the sale of merchandise they are producing,* was part of the volume of circulating real bills. When the bill market was destroyed in consequence of the deliberate decision not to allow real bill circulation to return after hostilities ended, the wage fund was destroyed along with it. There was no one to advance the funds out of which wages could be paid for labor whose product has not been and may not be sold for up to 91 days. But workers could not wait 91 days to buy food, clothes and shelter for themselves and for their offspring. In the absence of a wage fund employers had no choice but to lay off their employees.

Rittershausen was ignored by economists in the Anglo-Saxon countries. His message is still being ignored in the world today. But make no mistake about it, unless gold bill trading is rehabilitated soon, the world will face a new wave of unemployment far worse than that of the 1930's. This also confirms the deflationary diagnosis for the present crisis.

The majority of hard-money analysts call for a hyperinflationary collapse of the dollar. Their analysis is faulty. Like a cornered rat, the dollar is capable of putting up a vicious fight for survival. In the words of Mark Twain, all the obituaries on the dollar are premature. The dollar is not a push-over. A yen-yuan coalition (or any other combination of existing or yet to-be-invented fiat currencies) cannot send it into oblivion.

To say that the dollar is strong is not the same as saying that is also healthy. In fact the irredeemable dollar is terminally ill. The reason for this is its departure from constitutional money. The Constitution mandates a metallic monetary system for the United States. Nothing shows the bad conscience of our monetary leadership more clearly than the fact that they could never muster up enough moral courage to propose a Constitutional amendment giving the federal government the power to establish a monetary unit based on negative values such as debt.

Cheerleaders for fiat money in academic circles, in the media, and in financial journalism will not be able to live down the shame that will be their lot when the world economy collapses. The excruciating economic pain that people will suffer as a consequence will be their responsibility. The break-down in law and order will be their fault. As history and logic conclusively prove, fiat money is not a viable monetary system. It is prone to succumb to the sudden death syndrome. Whether caused by inflation or whether caused by deflation, sudden death is assured.

It should not be beyond the wit of human intelligence to see this coming and fend off the disaster by making a timely return to sound money, based on a monetary unit of a positive value as mandated by the American Constitution.

January 19, 2012.

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