THE MECHANISM OF CAPITAL DESTRUCTION

Antal E. Fekete
Gold Standard University

Address at the Annual Dinner of the
Committee for Monetary Research and Education, CMRE

on October 16, 2008
New York City

Madam President, Ambassador Middendorf, Distinguished Guests, Ladies and Gentlemen:

Happy Birthday CMRE!

It was 75 years ago, in 1933, that the predecessor of CMRE, the *Economists' National Committee on Monetary Policy* was formed by a group of monetary scientists in response to the Roosevelt Administration's emergency measures such as suspending the gold standard and devaluing the dollar. The Committee pointed out that abandoning the gold-standard violated sound economic and moral principles, let alone the Constitution. Strong protests were lodged calling attention to the dangers involved in the regime of irredeemable currency, which invites management based on political opportunism or expediency, rather than on economic and market forces. The Committee also pointed out that monetary and fiscal measures designed to create purchasing power artificially not only served to perpetuate existing maladjustments, but could be expected to lead to new ones. The mission of the Committee was to study all pertinent issues in the field of money and credit, and to expose the weakness of unsound monetary proposals such as lowering interest rates or raising prices by fiat, monetizing the government debt and merging all monetary and fiscal control in the hands of a single authority.

In 1971 the successor Committee, CMRE, took over the torch holding it high as a beacon, and to spread light into the dark corners of the conspiracy of the U.S. Treasury and the Federal Reserve System. CMRE pointed out the economically and socially harmful consequences of currency manipulation through unsound monetary and fiscal practices.

Ladies and Gentlemen, please sing along with me “Happy Birthday To You!”

Cassandra’s plight

Sad to say, as it turns out, the 75th anniversary is an unhappy one: CMRE’s Cassandra-role has come full circle. As you may recall Cassandra, the youngest daughter of King Priam of Troy, fell asleep in the temple of Apollo. The god was enamored with her beauty. He promised to teach her the art of prophecy in return for her love. She accepted the offer, but when it was her turn to deliver, she reneged on the bargain. Feeling double-crossed, Apollo was outraged. But it was too late now: there was no way to “un-teach” Cassandra. Still, the god thought of a way to revenge her: to the gift of prophecy he added the curse that, though Cassandra always spoke the truth, nobody would ever believe her.

CMRE’s fate is similar: the jealous gods stopped people from believing her dire predictions which were dismissed, even ridiculed, by the mainstream. Now, as some of these predictions have come true and credit collapse is a reality, the drama is unfolding before our very eyes. We are not reading history: we are living it. The global banking system has run out of capital and is in ruins, bringing the world to the brink of abyss.

Remember the great antagonists at CMRE dinners of old: Hans Sennholz and John Exter? Sadly, they are no longer with us. Their endless debates centered on the question whether it will all end in a hyper-inflation or a hyper-deflation. Now we know: we are going to have the worst of both worlds. The global banking system is disintegrating in hyper-deflation; the irredeemable dollar will survive only to succumb to hyperinflation later. In the meantime, it will be depression that may eclipse the Great Depression of the 1930’s.

My task here tonight is to point out the ultimate causes of the crisis, and to describe a viable resolution — if my Cassandra prophecy is not drowned out in the cacophony surrounding the collapse of the economy.

Destabilization of interest rates — wrecker of productive capital

The problem goes right back to the U.S. government's foolish decision to destabilize interest rates by cutting the dollar adrift from its gold moorings in 1971. It was a case of declaring bankruptcy fraudulently. The unintended consequences of the default were most serious, even though academia and media refused to analyze them. They blithely assumed that the U.S. was free to renege on its international gold obligation with impunity.

As a consequence of the default interest rates shot up to 20 percent by 1980, from where they started their long descent that still continues.

The public's perception is that declining interest rates are good for you, and they are good for the economy. Not so long ago academia and media were ecstatic in singing the praise of Alan Greenspan and his Fed for bringing about the Nirvana of the regime of falling interest rates.

This perception is a colossal mistake. A falling interest-rate structure is lethal. It is an insidious destroyer of capital. It means that wealth is stealthily siphoned away from the capital accounts of the producers, in order to enrich the latter-day pirates, the bond speculators who make obscene profits in the falling interest-rate environment.

As is well known, falling interest rates and rising bond values march in lock-step, albeit in opposite directions. We are all familiar with the fate of TV manufacturers and steel-makers in America. What has hit them? Well, their capital was destroyed by the relentless fall of interest rates. The writing is on the wall concerning the fate of the auto-makers. What is ailing them? The same thing: the fading of their capital. Well-paid jobs in car-manufacturing will also migrate to Asia, leaving the only jobs, hamburger-flipping that cannot be outsourced, for the American workers.

Destabilization of interest rates — wrecker of financial capital

For a time it appeared that capital devastation was confined to the productive sector, that it would spare the financial sector. After all, the latter was ready to try any and all innovations, fair and foul, in order to squeeze the last drop of profits out of the system by juggling mortgages, bonds, and equities. One of these innovations was derivatives, in particular, credit-default swaps.

The present crisis did not start in August, 2007, as widely assumed. It started half-a-year earlier, in February, when the price of credit-default swaps (essentially the premium on insuring bond values) took off like a rocket. It dawned upon the world that the financial sector had no immunity to capital destruction. Bank capital has been devastated just as insidiously as productive capital has.

Falling interest rates mean that bank capital has been financed at rates far too high. The resulting shortfall in capital should be compensated in the balance sheet by repeated injections of new capital. If banks fail to do this, then they are paying out phantom profits in dividends and compensation. They pile more losses upon losses. When they run out of capital, as sooner or later they must, capital dissipation stops, for there is nothing left to dissipate. For the banks it means sudden death.

The wrecker's ball of swinging interest rates

You may have seen the wrecker's ball in action. It is lowered into the building through the roof. Once inside, it is made to swing wide enough to knock down the opposite walls. The action of swinging interest rates on the economy is similar. Rising rates destroy capital by rendering it submarginal. Falling rates, on the other hand, destroy capital by raising the liquidation-value of debt, making it an unbearable burden on the firm.

Interest rates have been falling for the past 28 years. The present banking and credit crisis is a direct consequence of this prolonged fall. A glance at the interest rate chart will convince you of that. It shows a fairly stable curve leading up to 1971. At that point the swinging of the wrecker's ball started, driving the rate of interest to unprecedented extremes, first up, then down.

Liquidation value of bonded debt

Falling interest rates destroy capital in a way that is more subtle than destruction through rising rates. The liquidation-value of debt, contracted earlier at higher rates, rises. ‘Liquidation value’ is the lump sum it takes to liquidate debt, should it be necessary to retire it *before* maturity — for example, in case of takeovers, mergers, shotgun marriages, bankruptcies, or the nationalization of the banking system. The point is that as the rate of interest *falls*, the liquidation value of debt *rises*. Why? Well, the stream of interest payments now has to be discounted at a *lower* rate. Therefore at maturity it falls short of liquidating the debt.

Here is a familiar example, the liquidation value of bonded debt. When the rate of interest falls, the market immediately bids up the price of bonds. The higher bond price represents the higher liquidation value of the underlying debt. The fall in the rate of interest, far from alleviating the burden of debt, aggravates it.

Bank capital has been eaten away by the fall of interest rates. The impairment has been ignored and, after 28 years of negligence the global banking system stands denuded of capital. Those shareholders who can read balance sheets see through the fancy values banks are putting on their assets. They dump the stock before bank capital goes all the way to zero.

This is not a real estate crisis, nor is it a sub-prime crisis. This is a crisis caused by the destruction bank capital across the board, through the wrecker’s ball of swinging interest rates. In the final analysis, it has been caused by exiling gold from the banking system.

Dissipating capital under false pretenses

People tend to have a religious faith in the Fed’s miraculous power to create something out of nothing. They think that the Fed is above capital requirement and accounting rules. They think that the Fed is above the law. They dismiss the idea that the Fed, too, can suffer from capital inadequacy, or that it may not be able to escape the ill effects of falling interest rates.

The Federal Reserve Act (as amended) explicitly forbids the Treasury from participating in the earnings of the Fed. The purpose of this provision is to retain the undivided surplus in the Federal Reserve System to meet emergencies precisely like the present crises. The conspiracy of the Treasury and the Fed ignores this provision of the law. Year in and year out the Fed remits about 90 percent of its earnings to the Treasury under false pretences, calling it the "franchise tax on Federal Reserve notes". No sooner had the Treasury received the remittance than it spent the proceeds, and more, on consumption. As a result, the Fed is left with no undivided surpluses and no cushion to fall back on in hard times. And the Treasury has debt far greater than it has resources to retire. This high-handed disregard for the law is motivated by the desire to foster a public image of the Fed as an institution with supernatural powers. The Fed has the magic wand and can wave it to solve any problem by throwing money at it. In this view the Fed is not a bank, but the embodiment of divine power.

The printing press is sputtering

Chairman Ben Bernanke is given to boasting publicly that the government has given the Fed a tool, the printing press, with which it can print any amount of currency necessary to stop any deflation and any depression.

I submit that the Chairman is wrong. The printing press is not everything. The Fed has to operate under the same rules as all other banks. It has to have capital; it has to have an unimpaired balance sheet; it has to observe capital ratios. Above all, the Fed has to put up collateral before it can print new Federal Reserve notes, or create new Federal Reserve deposits. The fact is that the Fed, in addition to dissipating its earnings decades after decades after decades, has also been digging its own grave by pushing interest rates ever lower. Its capital has been destroyed just as that of all other banks. Right now it is near the point that it cannot put new currency into circulation in want of collateral. *The printing press is sputtering.* The magic wand is broken.

Dead man walking

The Supplementary Financing Program of the Paulson-Bernanke duo means that, *in preparation for the $700 billion bailout, the Fed is given securities by the Treasury* ***directly****, bypassing the open market*. The last time this imprudent departure from the principles of sound central banking has been invoked was during World War II, when the exigencies of war finance were used to justify the bypassing of the open market.

But what does it all mean in practical terms, if we strip away the jargon created in order to mystify the public? It means that the Fed, just like all other banks, has virtually zero capital. It means that the Treasury must recapitalize the Fed by giving it $700 billion worth of newly issued securities. It also means that the bad assets of the banks, some of which have been absorbed into the balance sheet of the Fed, are monetized through the back door.

But the worst part is that the Fed is now a dead man walking, propped up by conspirators who want to conceal from the people the fact of its demise. This is just the latest of conspiracies between the Treasury and the Fed. In creating a central bank in 1913, the government usurped powers not granted to it under the U.S. Constitution. One successful usurpation calls for another. Now, 95 years later, the government is frantically trying to resurrect its creature, the Fed, from the dead.

Lipstick on a pig

One expert observer, Thomas Szabo, calls the $700 billion bailout "*putting lipstick on a pig*", in the form of the Supplementary Financing Program. Szabo does not beat around the bush. He tells it as it is: *The Federal Reserve is bankrupt, and the U.S. Treasury Department quietly rescued — actually, took over — the world's largest central bank on September 17, the day the Supplementary Financing Program was announced, which was nothing less than a clandestine federal bailout, a* de facto *takeover of the Federal Reserve*. Szabo, who was a practicing auditor for 8 years, has gone on record in saying that the Fed, if it were an ordinary business enterprise, would have had to file for bankruptcy.

Why gold?

If gold had been retained as a component of the banking system, there would have been no need to invent credit default swaps, and the unprecedented destruction of bank capital would have never occurred. Gold is unique among financial assets in that it has no counterpart as a liability in the balance sheet of someone else. *Gold is the only financial asset that will survive any consolidation of bank balance sheets.* Gold will not be netted out, like paper assets are, in case of mergers, acquisitions and takeovers. The rescue effort is administering one wrong medicine after another. Consolidation of banks through mergers and takeovers is not the way to go. Cutting interest rates is not the way to go. These measures make the condition of the patient worse, as they accelerate the process of destroying capital.

All the measures to check the burgeoning credit crisis that have been proposed and put into effect are based on misdiagnosis. The shriveling capital ratios are not due to loose lending standards or to a reckless increase of bank assets. They are due to the destruction of bank capital through falling interest rates. Recapitalizing banks with irredeemable promises to pay will not solve the problem.

Resolution: recapitalize banks with gold

The long-term solution is the recapitalization of the banking system with gold. This means the issuance of new gold-denominated bank shares. It means mobilizing the U.S. gold reserves for the backing of the note and deposit liabilities of the Federal Reserve banks. The new shares of the recapitalized banks will then circulate in trading the old assets of the banks.

This will accomplish at least two things. First, the banks will be recapitalized in such a way that takeovers, mergers, acquisitions will not endanger bank capital as they do now. Second, there will be a reliable norm to value the old banking assets. Those of them that can be salvaged will be salvaged, and will once more become marketable. The rest can go to the garbage dump of history, to join the Continentals, the Assignats, the Reichsmarks, and the toxic assets of the 1930-33 banking crisis.

Troubled *Ass* Relief Program (TARP)

Unfortunately, our leaders don't have the wisdom and the moral fortitude to admit that they have been wrong all along about gold and its role in the financial system. Just last Saturday President Bush announced, before the finance ministers of the G-7 nations, that he is making a *volte-face* in discarding his earlier concept of buying toxic bank assets, and is embracing the concept of buying into the "intoxicated banks" themselves. In plain English, he is turning his Troubled *Asset* Relief Program into a Troubled *Ass* Relief Program (no pun intended). No thought is given to recapitalizing banks with gold, the ultimate liquidator of debt.

Ladies and Gentlemen, be prepared. The earth is shaking, the Debt Tower of Babel is toppling and, it will bury prosperity underneath the rubble. The Titanic of the once proud American banking system has collided with the iceberg of falling interest rates, and is sinking.

Sauve qui peut!

Calendar of events

Santa Clara, California, November 3, 2008
Santa Clara University, hosted by the **Civil Society Institute**
Professor Fekete is the invited speaker. The title of his talk is:
*Monetary Reform: Gold **and** Bills of Exchange.*
Inquiries: ffoldvary@scu.edu

San Francisco, California, November 4, 2008
Economic Club of San Francisco
Professor Fekete is the invited speaker. The title of his talk is:
The Revisionist Theory and History of the Great Depression — Can It Happen Again?
Inquiries: ifkbischoff@yahoo.com

Canberra, Australia, November 11-14, 2008
Gold Standard University Live, Session Five. (This is the last session of GSUL since our sponsor, Mr. Eric Sprott of Sprott Asset Management, Inc., has withdrawn his support saying that in his opinion the results do not justify the expenditure. Come along and judge for yourself.) This 4-day seminar is a *Primer on the Gold Basis — Trading Tool for Gold Investors, Marketing Tool for Gold Miners, and Early Warning System for Everybody Else.*
Inquiries: feketeaustralia@yahoo.com

Canberra, Australia, November 15, 2008
Panel Discussions: *The chickens of 1933 and 1971 are coming home to roost and take out bank capital.*
Inquiries: feketeaustralia@yahoo.com