…WITH A 36-YEAR LAG

(Part 2 of 2)

The way to resolve the credit crisis: Recapitalize the banks with gold

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Privatizing profits, socializing losses

The 0.7 trillion dollar bailout plan of Treasury Secretary Paulson must be seen for what it is: a scheme to privatize profits while socializing losses. The scare tactics with which he was trying to railroad it through Congress has failed and the world is better for it. The malady has to be diagnosed properly. I summarize the popular diagnosis in five points.

(1) The bursting of the housing bubble has led to a surge of defaults and foreclosures which has, in turn, led to a plunge in the value of mortgage-backed securities — assets which are in effect capitalized mortgage payments.
(2) These losses have left many banks short on capital account. Their problems were compounded by the fact that as their capital ratios were shrinking, rather than reducing their debt exposure they aggressively increased it.
(3) "Leveraging" is the word to describe the deliberate shrinking of capital ratios, i.e., making smaller capital support a larger amount of risks. Aggressive leveraging was characteristic of the pre-crisis boom.
(4) When they recovered after the dizzying ride, banks needed a microscope to read their capital ratios and they reacted in a predictable way. They were unwilling (unable?) to fulfill their mission to provide the credit that the national economy needs for its day-to-day operation.
(5) As a defensive measure financial institutions have been belatedly trying to pay down their debt by selling assets, including mortgage-backed securities, but as they were doing it simultaneously, they drove down asset prices. This has damaged their balance sheets even more. A vicious circle is engaged that some call the "paradox of de-leveraging."

Capital destruction

I should hasten to say that I disagree with this popular diagnosis which puts the cart before the horse. My diagnosis, described in the first part of this article, identifies the destruction of capital as the cause, and the credit crisis as the effect.

The problem goes back to the U.S. government foolish decision to destabilize the interest-rate structure (and, hence, bond prices) in 1971. As a consequence, long-term interest rates shot up to 16 percent per annum by the early 1980's, from where they started their long descent that still continues.

Falling interest rates destroy capital as they raise the liquidation-value of debt contracted earlier at higher rates. By 'liquidation value' is meant the sum that will liquidate the debt, should it be necessary to pay it off *before* maturity. In a falling interest-rate environment it will take a *larger* sum to retire the same debt. Why? Because the scheduled stream of interest payments is now capitalized at a *lower* rate of interest and, therefore, it falls short in liquidating the debt.

This means that, paradoxically, falling interest rates do not alleviate but *aggravate* the burden of debt. All observers miss this point as they blithely assume that debt is automatically refinanced at the lower rate. It is not. Falling interest rates create a deficiency on capital account since it takes a bigger bite to service existing debt than originally provided for, and the deficit is made up at the expense of capital. Over-leveraging is not the cause; it is the effect. What it shows is that the banks do not pay heed; they persist in error. They simply ignore shrinking capital ratios. This ultimately causes wholesale bankruptcies, leading to the vicious downwards spiral.

The banks should have made provision to compensate for eroding capital as interest rates were falling. None of them did. None of them understood the insidious process of capital erosion in the wake of declining interest rates. They reported losses as profits. Then they were hit by the negative feedback: capital eroded further. When the truth dawned upon them, it was already too late.

Interest rates have been falling for the past 28 years. The liquidation value of outstanding debt has been increasing by leaps and bounds. It reached the tipping point in February, 2007 as indicated by the unprecedented jump in the price of credit-default swaps. It revealed that any further decline in the rate of interest would plunge bank capital into negative territory. At this point capital dissipation stops: there is nothing more left to dissipate. For the banks, this is sudden death.

No commentator could explain *why banks have all run out of capital at the same time, while making obscene profits*. My explanation is simple. There have been no profits, obscene or otherwise. The banks were paying out phantom profits in the belief that their capital accounts were in good shape. They weren't. The banks were unaware that the falling interest rate structure has been making inroads on their capital. Since all banks have been working with microscopic capital ratios as a result of 28 years of capital erosion, the failure of one single bank would trigger the 'domino-effect' on the rest.

Why gold?

This puts the role of gold into high relief. Had gold been retained as a component of bank capital, credit-default swaps would have never been invented. Gold is unique among financial assets in that it has no corresponding liability in the balance sheet of others. *Gold is the only financial asset that will survive any consolidation of bank balance sheets*, in contrast with paper assets that are subject to annihilation (e.g., when the bank is consolidated with its counterparty holding the liability side of that asset). Suppose we consolidate the balance sheets of the global banking system. Then all assets will be wiped out *with the sole exception of gold*. But since the global banking system as it is presently constituted has no gold assets, under any consolidation the banks will be denuded of assets while note and deposit liabilities to the public remain. This is why the regime of irredeemable currency is susceptible to collapse that could be violent, taking place with lightening speed. It can also be seen that trying to save banks from collapsing through consolidation, mergers, takeovers, and shotgun marriages is pouring oil on the fire: it accelerates the meltdown of bank capital, rather than retarding it.

Implosion of the derivatives monster

My thesis also explains the explosive growth of the derivatives markets. First round insurance against decline in the value of bonds in the banks' portfolio can be had by selling bond futures. Those writing first-round insurance need to cover their assumed risk in the form of second-round insurance, they do so by selling call or buying put options on bond futures. But those writing second-round insurance also need to cover their risk: they do it in the derivatives market by purchasing credit-default swaps. The point is that an infinite chain of credit-default swaps is being built on every bond in the banks' portfolio, as shown by the derivatives monster's more than doubling in size every other year, already having reached the size of *one half quadrillion dollars* and still counting.

Why is the derivative monster so dangerous? Because it is subject to implosion that could destroy an inordinate amount of bank assets. If the derivatives tower is consolidated, then its value collapses to zero as claims are wiped out by counter-claims. It is possible that this implosion has already started, but the banks (and their supervisory agencies) keep the lid on this information to avoid a world-wide panic. The earth quakes badly under the foundations of the Derivatives Tower of Babel. Its toppling may be imminent. If gold had been retained as a component of the bank capital structure, then there would have been no derivatives monster to fret about.

Those who explain the proliferation of derivatives by the popularity of "dry swaps", that is to say, swaps created for the sole purpose of speculative profits they promise in view of their ultra-low price-to-reward ratio, are wrong. All those credit-default swaps were purchased by actual insurers insuring actual risks going with bond ownership, in trying to hedge their own risks.

Recapitalizing banks with gold

The credit crisis could be solved through the recapitalization of banks with gold. The Treasury should pledge to match subscriptions of new private capital, in gold, at the ratio of two to one. This means that two gold shares of capital stock subscribed by the private sector (individuals, firms, and institutions) shall invite one share of capital stock subscribed by the Treasury. Gold subscribed by the private sector should be constitutionally guaranteed against capital levy and confiscation.

There is no better use to which Treasury gold can be put which has been foolishly idled for the past 36 years. What is needed is the mobilization of gold hoarded by the Treasury, as well as of gold hoarded by the private sector. The trouble is that much of the privately owned gold is in hiding and won't surface for reasons of lack of confidence in the monetary system. But as soon as there is a market for the shares of the recapitalized banks, private gold can be coaxed out of hiding and made to participate actively in the great task of rebuilding world credit.

Capital stock of the recapitalized banks would pay dividend, in gold, at the rate of one tenth of one percent per annum to stockholders, exempt of all taxes. This would make it possible, even for people of modest means, to acquire gold earning a safe return in gold. The maliciously false propaganda of the past decades that gold is a sterile asset in that it earns no interest is easy to refute. Gold has been lent and borrowed at interest (facetiously called the 'lease rate') without interruption, in spite of its so-called 'demonetization' by the government. In fact, the gold rate of interest is the benchmark on which all other interest rates are still based, after adding a risk-premium reflecting the risk that the monetary unit may lose its gold exchange value.

The tax-exempt feature of dividends has great merits to recommend it, especially if no other exemptions across the economic landscape are granted. You could look at it as society's protection of widows and orphans, and other members of society who are unable to fend for themselves in a competitive environment, to live in dignity away from the hurly-burly of the investment world.

What is the use of recapitalizing banks with irredeemable promises to pay? It has been tried for the past 36 years; it doesn't work.

No chain is stronger than its weakest link

The newly recapitalized banks must offer their old assets for sale to the public, in exchange for the gold shares of capital stock, through competitive auctions. In this way the true value of the old paper assets can be determined, and whatever can be salvaged will be salvaged. The market for bank assets, presently frozen, would be made liquid once more. If a bank wants to retain a part of its old assets in the balance sheet, it must bid for it in the same way as if it were buying from another bank through competitive auction. If an asset cannot be disposed of in this way, then it must be written off. Any delay in validating bank assets through the sieve of competitive auction will only prolong and deepen the crisis.

The 'securitization' of bank assets was an idiotic strategy motivated by the fraudulent idea that in lumping sub-prime assets together with valid assets would somehow impart value to the former, and the marketability of the product would be enhanced. This, of course, is just a ploy to cheat the buyer. It is like trying to make a chain containing a weak link stronger by adding any number of strong links. The weak link must be replaced with a strong one. No chain can be stronger than its weakest link.

The re-liquefying of bank assets is a first order of business in the present runaway global credit crisis. We are past the point that the wild-fire can be localized. Mobilization of gold is the only way.

Save the pension funds!

This crisis is a warning, possibly the last one, that the recapitalization of banks with gold cannot be further postponed without risking the total collapse of the financial system. If there was some hope that the Treasury might have a contingency plan to mobilize gold in case of a crisis such as this, the Paulson bailout plan has dispelled it. When the moment for the 'break-the-glass' rescue plan has arrived, what did we find behind the broken glass? More irredeemable promises to pay, to augment bank capital. All chaff, no grain.

Global credit collapse would bring enormous hardship in its train for ordinary people who have worked hard and saved hard through a lifetime only to see the fruits of their efforts going up in smoke. The result could be total social chaos and lawlessness. At risk are all the insurance companies, pension funds, money market funds. Also at risk is the taxing power of the government, as a prostrate economy won't be able to bear the tax burden, but will spawn a grey economy that finds ways to evade taxes. The rejection by the U.S. House of Representatives of Paulson's bailout plan can be viewed as a taxpayer revolt. Is it the first, with more to come?

Close of Keynes' and Friedman's system

Understandably, it will be hard for policy-makers, academia and media, and the accountants' profession to admit that they have been wrong all along about gold and its essential role in the economic bloodstream and in accounting. They have fallen victim to the charm of John Maynard Keynes, the prankster who invented the idea that gold was a barbarous relic, and the gold standard was a 'contractionist fetter' upon the world economy. Now we have proof that the blame for the contraction should be assigned, not to the use but to the *misuse* of gold. The debt collapse is the burial ground for Keynesianism.

After Keynes was gone, policy-makers, academia and media, and the accountants' profession fell under the spell of another visionary and adventurer talking with a forked tongue, Milton Friedman. He was fond of posing as a free-market man, but in promoting irredeemable currency he did more than anybody, save Keynes, to destroy the free market. Friedman promoted the spurious idea that gold is superfluous in the international monetary system as floating foreign exchanges rates can mimic the operation of the gold standard and will balance the trade accounts. But as the record shows, Friedmanite nostrums have ruined the dollar, as well as the once flourishing and peerless American productive apparatus.

Politicians, academia and media, and the accountants' profession must swallow their pride and get the confession off their chests that their prognostication, policies, and advice about gold have been in error. If they fail to do this, and continue to block the way of gold to make a return to the economic bloodstream, then their responsibility for the suffering caused by the credit collapse in this country and in the world will be total. They will be shown as doctrinaire wreckers of human cooperation under the system of division of labor, who muzzled their critics and usurped unlimited power, while paving the way to a world disaster akin to that of the Bolshevik revolution.

After the close of Marx' system, the close of Keynes' and Friedman's system is inevitable. But the wounds they have caused would take a long, long time to heal.

The mission of Gold Standard University Live is to do the research that academia refused or was forbidden to do: find out the consequences of ousting gold from the monetary system by the U.S. government, following its 1971 default on the Treasury's gold obligations. Unfortunately our sponsor, Mr. Eric Sprott of Sprott Asset Management, Inc., has withdrawn his financial support saying that our "results do not justify the expenditure". I am forced to terminate the sessions. Our last activity will be a panel discussion on the present credit crisis to be held in Canberra, Australia, on November 15, 2008, under the title: *The chickens of 1933 and 1971 are coming home to roost and take out bank capital.* I invite you to come and contribute to the success of Gold Standard University Live with your questions and comments. At any rate, the sessions will be taped and the DVD's made available to the public, along with the conference proceedings.

Calendar of events

New York City, October 16, 2008
Committee for Monetary Research and Education, Inc., Annual Fall Dinner.
Professor Fekete is an invited speaker. The title of his talk is:
The Mechanism of Capital Destruction.
Inquiries: cmre@bellsouth.net

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

Reference

Is Our Accounting System Flawed? — It may be insensitive to capital destruction
www.professorfekete.com May 23, 2008.

October 3, 2008