Myrmikan Research Report

Something Wicked This Way Comes

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Excess Nonsense

> *The fact remains that our current problem is, in effect, a problem of excess worldwide savings, looking for someplace to go . . . . So what does government borrowing do? It gives some of those excess savings a place to go — and in the process expands overall demand, and hence GDP.*
>
> – Paul Krugman, May 2, 2009

Only an academic could have surveyed the global scene in 2009 – insolvent banks, small businesses unable to borrow, the unemployed tearing through savings, and the impoverished staging food riots – and diagnosed a problem of excess savings. But Paul Krugman is not the first economist to confuse excess savings with overcapacity. Here is his argument again in expanded form:

> The present capitalist system is no longer capable of functioning effectively. The reasons for this are as follows:
>
> The dynamic element in the capitalist system is investment. Since millions of people save billions of dollars annually, these billions must be brought back into the stream of spending. This can be done only through investment. When private investment is either curtailed or halted, these savings remain sterilized or inert and the capitalist system goes into a depression. Nothing can produce a normal revival of the capitalist system save a revival of investment.
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> Private investment cannot be any longer revived on a scale sufficient to absorb the savings of the people. Hence recovery through private investment is hopeless.
>
> Private investment cannot be revived because there are no longer open to savers adequate opportunities for investment.
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> Opportunities for investment are not open any longer for three chief reasons: (1) because the frontier is gone, with its opportunities for territorial expansion and the discovery of new resources; (2) because population increase has slowed down to a snail's pace; (3) because technological development has matured. That is to say, there is no longer in sight any such great inventions as the railroads, the automobile, etc., which will change all the arrangements of our social life and call for huge money expenditures.
>
> The present capitalist system is therefore incapable of recovering its energy. This is not a mere emergency condition but is a characteristic of the system which will continue indefinitely.

> For this reason we must adopt a new type of economic organization. This new type is called the Dual System or the Dual Consumptive System. Under this system the government will become the borrower of those savings funds which private business will not take. It must then spend these funds putting them again into circulation. What we must look forward to, therefore, is a long-range program of government projects financed by borrowed funds.

The preceding passage was written in 1938 by "Seven Harvard and Tufts Economists," the Krugmans of their day. The progress of the past 74 years reveals not just the absurdity that all resources had been found and all progress made by 1938, but the insanity that the Great Depression was caused by excessive savings. The true culprit, as demonstrated by Austrian economists, was artificially low interest rates in the 1920s caused by the fractional reserve banking system that encouraged excessive debt, symptomatic of savings wasted in overcapacity. Franklin Roosevelt's policies merely retarded the necessary liquidation, sapped business confidence, and prevented the re-formation of capital, prolonging a panic into a depression.

Having misdiagnosed the cause of depressions to be that private enterprise lacks the imagination of what do to with surplus capital, the eight Harvard, Tufts, and Princeton economists prescribe that the central state expropriate and deploy societal savings. This is, in fact, the central tenant of Keynes himself, as illustrated in his 1936 tome *The General Theory of Employment, Interest and Money*.

Keynes's premise is: "a properly run community equipped with modern technical resources, of which the population is not increasing rapidly, ought to be able to bring down the marginal efficiency of capital in equilibrium approximately to zero within a single generation." This is a radical statement. In a free market, it is impossible for the marginal efficiency of capital, i.e., the interest rate, to be zero because the interest rate is determined by supply of savings against the demand for capital. Zero rates would imply either that savings were infinite or else that there was no demand for capital. Since capital goods ultimately produce consumer goods, zero demand for capital implies that all economic wants and needs have been satisfied. Paradise achieved.

Of course, Keynes did not premise his theories on free markets. He recognized that it is easy to lower the monetary interest rate as a technical matter through policy measures, but he also saw the problem that no one wants to invest at a zero rates of return: "the least easily shifted element in our contemporary economy has been hitherto, and may prove to be in the future, the minimum rate of interest acceptable to the generality of wealth owners." Worse, having capitalists acting in their individual interests leads to societal disruption: "there is no clear evidence from experience that the investment policy which is socially advantageous coincides with that which is most profitable."

The obvious solution: "the euthanasia of the rentier, and, consequently, the euthanasia of the cumulative oppressive power of the capitalist to exploit the scarcity-value of capital." With the rentier dead and gone, "a somewhat comprehensive socialisation of investment will prove the only means. . . . the State, which is in a position to calculate the marginal efficiency of capital-goods on long views and on the basis of the general social advantage [must take] an ever greater responsibility for directly organizing investment."

Since the capital markets would no longer respond to consumer preferences: "The State will have to exercise a guiding influence on the propensity to consume partly through its scheme of taxation, partly by fixing the rate of interest, and partly, perhaps, in other ways." Keynes saw that once the state starts managing capital, it must manage consumption as well.

Without attribution, the lines quoted above might be dismissed as the mad ravings of a radical Marxist, but, in fact, they are the basis of economic theory at Harvard, Tufts, Princeton, the Federal Reserve, and the rest of the academic and political establishment. Over the past seventy-fives years the adherents to Keynesianism have become more sophisticated in their approach and techniques, but the program of advancing the state-control of capital remains constant. And, the more capital the state captures, the greater the need to regulate consumption.

One technique for centralizing control of capital is called "financial repression," re-examined in a March 2011 paper by Carmen Reinhardt. She defines the term to mean: "directed lending to government by captive domestic audiences (such as pension funds), explicit or implicit caps on interest rates, regulation of cross-border capital movements, and (generally) a tighter connection between government and banks." Explaining the purpose of "financial repression" Reinhardt writes:

> Low nominal interest rates help reduce debt servicing costs while a high incidence of negative real interest rates liquidates or erodes the real value of government debt. Thus, financial repression is most successful in liquidating debts when accompanied by a steady dose of inflation. Inflation need not take market participants entirely by surprise and, in effect, it need not be very high (by historic standards).

Inflation need not be by surprise as long as capital controls prevent the escape of capital, and inflation rates need not be high because, as Reinhardt points out, a negative interest rate of a mere 3% per year reduces the real value of debt by 25% of GDP over 10 years (assuming no additional deficits). Reinhardt examines the period after World War II and shows that this is the primary means by which the U.S. and other Western states retired their war debt.

Some countries already actively pursue this policy. Pension funds in Ireland were raided to finance bank bailouts; Hungary and Argentina have "re-nationalized" their private pension plans; France is changing pension rules to force a higher weighting of government bonds; and, Italy recently eliminated annual inflation adjustments for pensions exceeding €936 per month.

Others are considering repressive measures. The Financial Times reported in January: "Ms. Merkel said she would consider calls from her party colleagues for legislation to bar institutional investors such as insurance companies from selling bonds when ratings were downgraded, or fell below investment grade." In the United States, the Departments of Labor and the Treasury have held hearings on proposals to convert Individual Retirement Accounts and 401(k)s to "lifetime income" provided by the "safety" of government bonds. In other words, the $9.5 trillion in 401(k)s and IRAs risks being herded into Treasuries to fund government spending. In all of the examples above, capital is removed from the market and captured by the state, which pays a negative interest rate to the holders.

Mainstream economists have seized on Reinhardt's paper to conclude that current debt burdens pose no systemic threat. For example, Kenneth Rogoff has specifically called for 4-6% inflation for several years to reduce debt burdens. Unspoken is the effect such policies will have on the retirement plans of the baby boomers or the propensity to save.

More importantly, there is a critical difference between the 1950s and today: in the aftermath of World War II the debts were large, but deficits were small. Financial repression successfully operated to lower debt levels. But, with high deficits, as currently, financial repression does not to reduce government debt burden, but instead allows the state to continually loot the savings of its citizens by piling up ever more debt.

The Progressive's Progress

> *State intervention in economic production arises only when private initiative is lacking or insufficient, or when the political interests of the State are involved. This intervention may take the form of control, assistance or direct management.*
>
> - Benito Mussolini, 1935, *Fascism: Doctrine and Institutions*

The polite word for a titularly free-market system that redirects societal savings through the government is corporatism. Its proper name is fascism. The passage of time may have reduced the concept of fascism to a cartoonish vision of jackboots and concentration camps, but in reality it was a comprehensive economic and political system not dissimilar to the current functioning of the state in the Western world. And, the development of fascism in America has closely paralleled its rise in 19th century Europe, as illustrated in John Flynn's 1944 masterpiece *As We Go Marching*.

Flynn traced the origins of fascism in Italy and Germany in the 1860s to its culmination in World War II. Both countries began as a collection of independent provinces with weak, dysfunctional central states. Both had extensive poverty, unnoticed until the industrial revolution, and national political leaders determined to achieve progress through activist policies. Such was the support for social reform that taxes and spending rose, but tax revenues are never enough for the ambitions of social progressives. Debt is the inevitable result:

> Thus in Italy, while individuals murmured against the growing debt, they continued as members of cities or villages or farming districts to fight valiantly for their share of the spendings. The people as beneficiaries were always more powerful than the same people as citizens.

Along with continual deficit spending grew large sections of the economy dependent upon government largess. Whenever the growth in spending was interrupted, a severe crisis would emerge, and:

> Bewildered statesman turned to government debt as a device for creating purchasing power. No one approved it in principle. But there was no effective resistance because the people demanded the fruits it brought.

Inevitably governments would scramble to raise more taxes even as they found surreptitious ways to add more debt, for example:

> By 1930 Chancellor Hermann Muller was having difficulty extracting any further taxes from the citizens. He then hit upon a shabby expedient. He began to talk about more social security. Under cover of this pretense he proposed to raise the rates. But what he really had in mind was to greatly increase charges for social security much beyond its cost in order that the government might "borrow" the surplus to meet its expenses.

After a few decades, the deficit spending became not just a way to finance unaffordable social progress, but necessary to prevent an economic crash. Academic opinion shifted to support the status quo, as it always does:

> But after the [first world] war . . . the German professor of economics . . . proceeded to unfold a new theory that fell like manna from above into the bewildered treasury. The old-fashioned fear of national debt, they assured the politicos, was one of the superstitions of "orthodox" economics. The

> "new" economics had its own fresh theory. Public debt must be sharply distinguished from private debt. Public debt can be expanded almost indefinitely provided it is internally held. In fact, where a government owes merely an internal debt it can be said to be debt free. Of course, debts call for interest payments. But the taxpayers merely pay the interest to themselves.

Along the way toward centralization, certain conservative segments of society would rebel against the growth of the state, but these were also the groups most susceptible to increased military spending. And so, grand bargains were struck which allowed increased spending directed toward militarism, making disarmament efforts impossible:

> To ask an Italian statesman to agree to disarmament before the Great War would have been to ask him to liquidate the largest industry in Italy. Nothing could have been more futile than to offer such a proposal to an Italian government always on the edge of the precipice of economic disaster.

In 1850 French economist Frédéric Bastiat asked rhetorically: "If, all things considered, there is a national profit in increasing the size of the army, why not call the whole male population of the country to the colors?" The Italians and Germans could not think of a reason. Eventually, faced with continuing economic crises, and the need to expand the state still further, the leaders were forced to deploy the massive armies constructed initially for economic purposes.

The remaining essential aspect of fascism is the coordination, as opposed to control, of business by the state, distinguishing it from communism. Disputes between labor and capital characterized the early period of industrial development in Italy and Germany. In an environment of constant crisis, labor wanted stable jobs and above-market wages for its members. Capital wanted protection from the free-market through monopolistic, or at least oligopolistic, arrangements. And so, another grand bargain was struck among big business, big labor, and big government to carve up spheres of economic influence subsuming individual liberty and further reducing society's ability to create wealth.

The point of Flynn's book is that the progressive impulse allowed to operate at the state level must lead to tyranny and militarism at an accelerating pace. The violence which defines fascism from a historical perspective was merely a grotesque though inevitable conclusion of the fascist process. Blaming fascism on the activities of particularly evil men obscures its true nature: a vicious sequence that captures the idealistic impulse in its own internal logic to create the monsters of history. Indeed, the Italian character was particularly ill-suited for military adventures, and even the conceit of rigid Germanic order and hierarchy, born of two world wars, is difficult to reconcile with the fact that Germany was the last area in Europe to organize into a nation state.

Flynn wrote his book as a warning, as he viewed the Roosevelt administration as initiating America's fascist journey:

> But nations which borrow money and pile on vast national debts can go into bankruptcy whether the debts be for armaments or roads, parks and public buildings. Our government was delivering lectures on sound fiscal policy, deploring the deficits, yet planning new and more extravagant means of spending money, soothing the Haves with promises of balanced budgets and lower taxes, and stimulating the Have-nots with promises of security and abundance.

> The government was doing, in fact, what Depretis was doing in Italy between 1876 and 1887. He promised to reduce taxation and increase public works. He promised greater social security and greater prosperity. When he came to power he had no program and no settled notion how he would redeem these pledges. . . . Depretis then, for lack of any other weapon, proceeded to do what he had denounced his conservative predecessors for doing—to spend borrowed money on an ever-larger scale. . . .
>
> All this, however old, was a new chapter in American policy. When, therefore, these vast expenditures were made, the noblest and most heroic explanations were offered. Having denounced timid deficits, the administration embarked upon a program of huge deficits, but it did it in characteristic American fashion, with proclamations of righteousness as if America had suddenly discovered something new. In fact, it was called a New Deal. Actually, it was America dropping back into the old European procession.

The quotations about Europe on the preceding pages would not have resonated to Flynn's fellow Americans. It is a mark of the accuracy of his prophesy that we in contemporary America recognize intuitively as our own the economic history of fascist Europe.

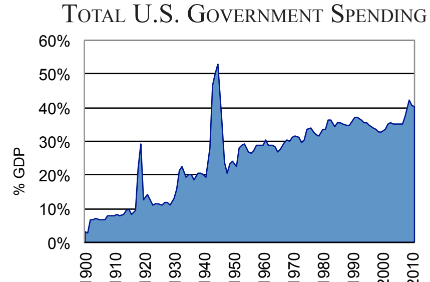
Capital Survival

Capital desires first to survive and second to grow. Yet most capital will fail on both counts. As Jim Grant wrote recently, $100 deposited in ancient Rome yielding a mere 2% per year, untouched, would now equal $2.3 billion for every man, woman, and child on earth. Why did no one think to do this? Grant asks rhetorically. In fact, nearly all of the potential $15,861,473,276,036,900,000 increase from that $100 has vanished. And, from a societal perspective, the base was not $100, but rather the full sum of ancient capital. Only an infinitesimal trace of the potential increase survives.

Capital's only chance for survival is that its master understand the economic and political contexts within which it resides. The modern economic context is Keynesianism. Its goal is the capture of private capital by the state. Americans yet would not submit to the taking of private capital by force, or confiscatory taxation, so the methods must be subtle: euthanasia – the Greek etymology means "quick and painless death."

Most investors do not understand the dynamics of financial repression: soothed by their portfolios rising in nominal dollars, their wealth nevertheless slips to the state It is a revealing fact that since 1965 the compounded annual rate of return for the S&P 500 is 9.3%, only 0.7% higher than gold's compounded return of 8.6%. Since three-quarters of the S&P's return is reinvested, compounded dividends, the real rate of return after taxes and transaction costs sinks well below that of inanimate metal hidden in a vault The state, and middlemen enabled by the state, have absorbed not just the gains on capital, but a good slice of the capital itself.

TOTAL U.S. GOVERNMENT SPENDING



The political context is creeping fascism. Government expenditures at all levels now account for 40% of GDP. The remainder of the economy is controlled by over 170,000 pages of federal regulations. Various federal agencies heavily influence the prices of assets, including stocks, bonds, and housing. National wealth perception is controlled by the state. Like their 19th century German and Italian predecessors, American politicians have discovered that the sole method of increasing national income and postponing the ever growing economic crisis is to increase deficit spending. No one approves in principle. But it is the logic driving the political bargains in Washington: tax cuts for the Haves, stimulus for the Have-nots, the capital coming from a wholly captured and repressed banking system. Savers unknowingly foot the bill.

Ominously, the political system itself is centralizing, with decisions made by ever fewer entities. The legislative executive order has dramatically increased the scope of Presidential authority. Administrative law, as deployed by the President through control of federal agencies, expands executive power still further. The Board of Governors of the Federal Reserve, appointed by the President, controls economic outcomes with no supervisory oversight. The Congress recently ceded its prime authority, to spend, to a super-committee, retaining merely a binary vote.

History testifies that centralization of power is an inexorable trend, even as the outer provinces start breaking away. Consider this terrifying statement by Peter Orszag, Obama's former Director of Office of Management and Budget:

> To solve the serious problems facing our country, we need to minimize the harm from legislative inertia by relying more on automatic policies and depoliticized commissions for certain policy decisions. In other words, radical as it sounds, we need to counter the gridlock of our political institutions by making them a bit less democratic.

Or this by President Obama, who recently defied the Constitution by making a recess appointment while the Congress was in session:

> We can't wait for an increasingly dysfunctional Congress to do its job. Where they won't act, I will.

Mussolini could not have said it better.

Technocrats like Orzag and populists like Obama do not understand or care that America has a dysfunctional government by design, reflecting the classical liberal focus on individual rights. Only a society that neuters the power of government can protect the liberty of the individual by resisting both the tyranny of the majority and the totalitarianism of a dictator.

The centralization of power allows the state to tighten its grip on capital, consumption, and liberty. The TSA, the assassination of an American citizen by the Obama administration, the recently passed NDAA that gives the President the right to suspend habeas corpus from any American he himself deems a terrorist, the proposed presidential "internet kill switch," Predator drones spying on Americans without warrants, a new bill that revokes the passport of any citizen suspected of owing the IRS more than $50,000, all are harbingers of hard fascism.

Meanwhile, the Department of Homeland Security has funded the militarization of police around the country, even though there hasn't ever been a need for this capacity: internal population control is unrelated to the threat of foreign terrorism.

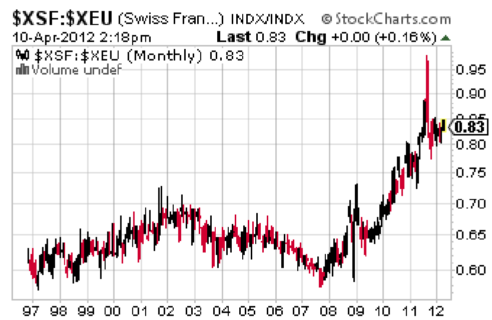
With only 5% of GDP devoted to defense, America may bypass the external militarism stage of fascism, although even Krugman wrote recently that a military build-up to defend against space aliens would be economically beneficial. It is instead possible that America will follow the European path, where the conservative bloc is too small to require placating, allowing all of the massive spending to go directly into social wealth transfer programs. In this case, the final stage will look like Greece, where the violence comes from within when the deficit spending, the organizing principle, suddenly collapses.

Charges that America is developing into a fascist state may seem hysterical or hyperbolic, but it was all foreseen by thinkers such as F.A. Hayek. As he wrote in *The Road to Serfdom*:

> [Economic] planning leads to dictatorship because dictatorship is the most effective instrument of coercion and, as such, essential if central planning on a large scale is to be possible. . . . To those who have watched the transition from socialism to fascism at close quarters, the connection between the two systems is obvious. The realization of the socialist program means the destruction of freedom.

Hungarian economist Melchior Palyi said it more succinctly: "where the Welfare State is on the march, the Police State is not far behind."

Flynn was not arguing that America of 1944 was a fascist state, nor would he consider contemporary America to be a fascist state – some of the more unpleasant aspects are still lacking. He would, however, recognize that the long march toward fascism, which began under Roosevelt, has made great progress over the decades and is accelerating under Obama.

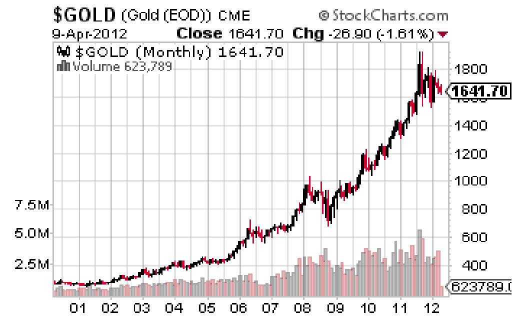


Fortunately for the investor, conditions are not yet so advanced as to allow hard control of capital. For now only the uninformed will lose their capital, by holding savings accounts, bonds, and conventional stocks, or relying on retirement funds. The more clever capital seeks to escape. In Europe, capital has been fleeing to the Swiss franc (as illustrated by the franc/euro ratio chart at right) forcing the Swiss National Bank to intervene. This will prove futile: Greek depositors are not worried about a temporary loss, given their choices. Stricter methods will be necessary.

Taking its cue from Argentina, which recently deployed currency sniffing dogs at its borders to prevent cash from escaping, Italy has placed not only dogs but cameras on its borders to record the license plates of cars leaving the country to compare against bank records. Italy also has lowered its legal limit on cash transactions from €5000 to €1000 to enhance monitoring of economic activity.

The EU is tightening its grip as well. In October EU President Barroso announced a proposal to implement "surveillance powers" to impose "individual criminal responsibility" for those guilty of "incitement, complicity, or attempts to manipulate the market." In other words, arrest warrants will be issued for those warning against the ownership of government bonds.

For Americans, the new 1099-K enforces monitoring of third party payments "to improve voluntary tax compliance." As of 2012 the IRS is also tightening reporting requirements for financial assets held abroad, while banking regulations have purposefully made handling American capital so toxic that most foreign banks will no longer accept American deposits. Even if they did, safe-havens like Switzerland and Singapore are far too small to absorb all the global credit-dollars fighting for survival. Meanwhile, the Patriot Act makes a mockery of the Constitutional right to privacy by allowing the Executive Branch to troll bank records without a warrant.



First-level thinkers run to the commodity currencies of Canada and Australia, hoping that their commodity assets will somehow back their currencies. But the momentum of that trade is starting to slow as evidence of China's massive internal debt continues to mount, and those with capital begin to realize that iron ore is a problematic store of value in a global depression. And so, having run out of all other options, investors turn back to gold, which continues to consolidate after surging to new all time highs in nearly every currency last summer. As sovereign promises decay, gold will be the only escape.

Tomorrow Belongs to Me

The best number in Robert Fosse's disturbingly brilliant *Cabaret* opens with a blond youth singing at a outdoor country cafe about Germany's bucolic past. Gradually the words turn from meadows and forests to shouts of exhortation for the fatherland to deliver world conquest, the uncertain accordion accompaniment develops into a rousing militaristic band, and the country folk assemble in formation as the youth raises his arm in the Nazi salute. Only the old man declines to participate, knowing where it leads.

The fascist process took seventy years to turn the German *volk* into Nazis. Eighty years ago Franklin Roosevelt initiated America's fascist journey. Few perceived what was happening, save those of the Old Right, such as Flynn and New York Herald columnist Mark Sullivan, who wrote in 1935:

> The country has not even a faint realization of what is taking place at Washington. By laws so numerous that even members of Congress do not follow them, so intricate that only close study can understand them, and in some cases carrying hidden meanings and unrevealed intentions on the part of the writers of the laws, there is being imposed upon our country not merely an enormous number of regulations attended by criminal penalties but actually a new system, a whole new philosophy of society and government.

Hitler wrote his exact plan in *Mein Kampf*, but few believed it, and fewer took defensive action. Keynes wrote in the German introduction of his work, published in 1936 during Hitler's fourth year in power:

> The theory of aggregate production, which is the point of the following book, nevertheless can be much easier adapted to the conditions of a totalitarian state. . . .

His theories of statist power in economics and, therefore, politics have been America's organizing principle since the New Deal. Few understand or anticipate the inevitable consequences.

In 2002, Ron Paul testified in the House of Representatives:

> The Congress and the President will shift radically toward expanding the size and scope of the federal government. This will satisfy both the liberals and the conservatives. Military and police powers will grow, satisfying the conservatives. The welfare state, both domestic and international, will

> expand satisfying the liberals. Both sides will endorse military adventurism overseas. . . . In due course the Constitution will continue to be steadily undermined and the American republic further weakened. During the next decade the American people will become poorer and less free while they become more dependent on the government for economic security.

These predictions were easy to make, given an understanding of Keynesian theory and of the tide of history that Flynn described so accurately.

Economics Nobel Prize winner Joseph Stiglitz wrote in January's Vanity Fair:

> the economy will not bounce back on its own, at least not in a time frame that matters to ordinary people. . . . What we need to do instead is embark on a massive investment program—as we did, virtually by accident, 80 years ago—that will increase our productivity for years to come, and will also increase employment now. . . . Can we actually bring ourselves to do this, in the absence of mobilization for global war? Maybe not.

Germany fell victim to this same economic fallacy. The result was World War I and then hyperinflation. They doubled down on the economic model and got Hitler.

Professor Jeremy Siegal, author of Stocks for the Long Run, wrote that $1 invested in stocks in 1802 would have grown, after inflation, to $755,163 by 2006. He expects equity markets to continue along the same exponential growth path. So do most investors. They do not understand the economic context which they inhabit. Their capital will be euthanized.

Physical gold in personal possession is the only means to preserve wealth during a systemic collapse, especially in an era of surveillance power made virtually omnipotent through technology, though even physical gold has its limits. Archaeologists continually discover gold hoards buried during the collapse of the Roman Empire, testimony that societal decline never allowed the capital to be reinvested.

Gold mining stocks will not just preserve but enhance wealth in all scenarios short of a legal collapse, which is the more likely outcome. The Western world has survived numerous credit collapses over the past few hundred years. Each round becomes more serious as increasing specialization enhances reliance on prices and clearing systems. But, in each case, the removal of debt fetters has allowed equity to grow free once more to replace the savings destroyed by bad government policy, before the inexorable rise of the state commences once again.

When the economic crisis that has been gathering strength since 1933 crashes, America will face a stark choice of whether to allow the stifling structure of government to implode, or to quicken the march toward fascism's bloodletting stages when not just capital but capitalists are euthanized.

We will make the correct choice. Except for notable examples in unionized jurisdictions and certain post-modern cities on the coasts, Americans still retain the culture of the Protestant work ethic. Americans are not yet so effete, as were the Romans at the end of their society, that the will to rebuild will fail. We are not ready to put large numbers of our citizens into gas chambers in total revulsion of civilization. Gold hoarded now will find a use after the collapse of the banking system. Non-hypothecated gold shares will provide safe passage and will increase wealth, the natural reward for sound husbandry of resources.