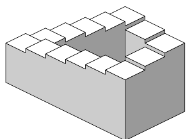
Pimco goes full goldbug

Bond shop calls gold money, debt and the dollar paradox, what did they do last time?



Here we were, all these years, nibbling around the edges, coyly alluding to dysfunction of central bank price-fixing and hinting at gold's utility in monetary affairs, but only at the edges, for outright gold buggery is, frankly, not exactly good for business. Then, out of nowhere, comes Pimco to put us to utter shame. A very good piece[1] by Harley Bassman earlier this month likens current monetary policies, in terms of both efficacy and decorum, to a wet t-shirt contest in Daytona. The massive flow of liquidity into bonds and banks and financial assets may improve the appearance of certain things, but this is more optics than substance. He then goes on to suggest that the Fed use its infinite balance sheet instead to buy gold because, well, gold is money.

Ok, Bassman did not use that precise comparison (we find ourselves playing catch-up *with a bond shop* and are not ashamed to reach if we have to), but he really did say that the Fed should buy gold. This amounts to a normalization of the debate and we feel it is meaningful and may prove significant. As Keynes said, markets are all about judging the judges and by this, at least one more judge has come over to the dark side.

Stepping back, the problem that Western monetary authorities now grapple with is that there is too much debt relative their economies' underlying capacity to get out from under it. As Bassman puts it: "[T]here are only two avenues out of a debt crisis – default, or inflate." Robert Frost in the same vein mused: "Some say the world will end in fire / some say in ice…" After Lehman, if we needed Lehman to illustrate the point -- we know the world will not end in ice, we know that there will not be a bone-crushing default. We can cite analytic reasons here (credit, like the universe, is fundamentally dissipative, and doesn't run reverse) but this is best left for another piece. Rather, look at the empirics: devaluation (fire) is *always* the preferred method of screwing creditors. Boil the frog slowly or boil the frog not-so-slowly, but boil the frog.

In 1934, hungover from the credit binge of the roaring '20's, Roosevelt decided to boil the frog quickly and did so by introducing the Gold Reserve Act (GRA). As he then put it: "In working toward our broad objective, the American currency was first taken off what is commonly known as the Gold Standard. Later, by an Act of Congress and by Presidential Proclamation, it was restored to a gold standard on a different weight of gold." It is never referred to as such anymore, but this act amounted to a devaluation, no different than the devaluation of the Thai Baht in 1997 or the Argentine Peso last year. Outside the Anglo-American axis, this happens all the time.

Figure 1: *The 1920's saw the advent of consumer credit, or installment plans, as they were known back then, and consumers, with a little help from advertisers, lapped it up. The seeds of the subsequent depression are sown in the credit expansion phase and once expanded, credit becomes very difficult to contract. There are some interesting reasons for this but suffice it so say, devaluation — stiff the creditors — is almost always the resolution. Western economies have indulged themselves in a credit feast for the last forty years and, as it becomes apparent that the cycle has crested, monetary authorities now flail about with their NIRPS and ZIRPS trying to figure out to what to do about it. The mental blockage stems from a monetary system where devaluation is literally inconceivable.*

Reference is made to this period and rightly so for the GRA is now largely forgotten even as it was arguably the most effective plank of the New Deal. Also largely forgotten is the fact that, in a series of lawsuits, the Gold Reserve Act was contested all the way to the Supreme Court. Creditors had written into private contracts a "specie clause", entitling them to collect gold *in lieu* of dollars should those dollars ever be revalued. What is interesting here is that whole notion of devaluation was sufficiently present-in-mind to write the clause in in the first place. Everyone back then knew it was a risk, just as now creditors of far-away sovereigns do too. That's why there is such a thing as Dollar-denominated bonds.

We now live on a Dollar standard, a self-referential system of measurement. A meter is defined as being the distance light travels in some fixed fraction of a second. A calorie is defined as being the amount of energy to raise one gram of water by one degree. By contrast, a Dollar is defined as being, well, a Dollar. One could point to the USD Index and its six constituents as a

[1] "Rumpelstiltskin at the Fed", Pimco Viewpoints, April, 2016.

measure of “what the Dollar is worth”, or indeed the CRB Index and its 19 components, but this only speaks to our point, to the diffuse and ineffective definition of “what a Dollar is”. There is no Yen or Euro Index that defines or values these respective currencies and nor do you hear of copper being defined as a function of the USD and 18 other commodities.

In such a framework today’s market participants can’t possibly conceive of a devaluation of the dollar, for there is no context in which the devaluation is possibly conceivable. In order to devalue, *there must be something to devalue against*. The dissolution of Bretton Woods in 1971 when Nixon de-pegged the Dollar from gold in 1971 amounted to the dissolution of our monetary reference system. Post Nixon, devaluation is an Escher-like paradox. That’s the problem.

Having the Fed go buy gold, as Bassman suggests, would certainly be good for the gold price and, by consequence, good for this author’s PA. But we are not sure this fixes the problem. Rather, you fix the problem by having the Fed buy *and sell* gold. Make a market: bid X, offered at Y. This solves the external reference frame problem. With a stroke, we’d know what a Dollar was worth, we’d know what a Dollar *was*.

It is fair to object: defining a Dollar in terms of gold is to simply define gold in terms of the Dollar — what does this do to short-circuit the hall of mirrors? But consider that the above ground gold stock growth has tracked global GDP for millennia. The inputs of gold production — labour, raw materials, energy, etc. — track broader production costs generally and, on the flip side, it also captures the deflationary impacts of innovation (cyanide, heap leaching, etc, saw production rise.) Gold is the monetary equivalent of the speed of light.

On February 18, 1935, the Gold Reserve Act was confirmed by the Supreme Court. Everything – wheat, equities, labour – went up. This was not the whack-a-mole, beggar-thy-neighbour approach that this game of interest-rate footsie fosters, wherein one country’s gain (devaluation) was another country’s pain (overvaluation). Rather, it was the price framework itself that shifted and, by consequence, the debt burden lifted. Behold the front page of the NYT the next morning: “Business Surges Forward.” What would a Yellen or a Draghi pay for that now?

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"The contention that these gold clauses are valid contracts and cannot be struck down depends upon the assumption that private parties and States and municipalities may make and enforce contracts which may limit that authority (constitutional authority of Congress). Dismissing that untenable assumption, the facts must be faced.

"We think that it is clearly shown that these clauses interfere with the exertion of powers granted to the Congress * * *."

ON GOVERNMENT OBLIGATIONS.

"We conclude that the joint resolution of June 5, 1933, in so far as it attempted to override the obligation created by the bond in the suit, went beyond the Congressional power."

"The Congress * * * is endowed with certain powers to be exerted on behalf of the people in the manner and with the effect the Constitution ordains."

"Having this power to authorize the issue of definite obligations for the payment of money borrowed, the Congress has not been vested with authority to alter or destroy those obligations."

"Plaintiff has not shown or attempted to show that in relation to buying power he has sustained any loss whatsoever. On the contrary, * * * payment to the plaintiff of the amount which he demands would appear to constitute not a recoupment of loss in any proper sense, but an unjustified enrichment."

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Gold decisions and reactions on pages 12 to 17 inclusive.

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The majority and the minority agreed only on one point—that the gold-clause repeal in government contracts was unconstitutional. But the majority offered no redress to the litigating contract-holders, on the ground that no damage had

Figure 2: *The front page on the NYT, February 19, 1935, the day after the Supreme Court ruled in favour of Congress’ decision to affirm the Gold Reserve Act. Some snippets Yellen would drool over: “The devaluation of the Dollar places domestic economy on a new basis”; “Business Surges Forward”; “Impetus Given to Trade”; “Rapid Spread to All Lines of Merchandise is Expected within the Week”; “Rush Sends Stocks Soaring in London.” Go QE* that. *We include this image expanded in the Appendix.*

Certainly, monetary authorities have to do *something* and no choices look all that appealing. Negative interest rates are certainly no less bizarre than a managed devalution, which is what we are talking about, and likely far less effective. But they have to do something.

We enclose in the Appendix the speech that Roosevelt was to have been given should the decision of the Supreme Court not go his way, a speech that was (obviously) never heard; it is a fascinating portal into the mindset of the times. Clearly, it was always about stiffing the creditors. History will repeat, although pigs will likely fly before Western monetary authorities facilitate, invested as they are in “modern theory.” Rather, the market, including “unfriendly” Central Banks (Russia, China, etc.), will likely force their hands and do the job for them. Either way, Bassman and his colleagues at the bond shop might be careful what they wish for….

Douglas Pollitt
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Toronto, Ontario
May 11, 2016

Appendix A: The Speech Roosevelt Never Gave

The following is the text of a "fire side chat" that Roosevelt was to give should the Supreme Court have ruled against his legislation to devalue the Dollar. In a word, he would have ignored the ruling. More interestingly, however, is his view that creditors should be the ones getting stiffed. Also, just to note, the President suggests the currency rose by 60% — this overstates the appreciation by a fair bit. And at any rate, since that time, the currency has depreciated by about 99% if we use as a measuring stick the price of the NYT — 2¢ — upon which the favourable ruling was announced the following day.

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Two years ago the welfare of all our citizens in every section of the United States was endangered by increasing bankruptcies and bank failures. In the short space of the previous three and one half years the purchasing power of the dollar had increased about sixty per cent. This meant that debtors of all kinds, individuals, associations, institutions, corporations, municipal, county, state governments and the Federal Government itself, were being called on to pay their creditors in currency worth sixty per cent more in purchasing power than the money which had been loaned to them.

When the debts were originally incurred, the lender expected to get back the same kind of dollars with approximately the same purchasing power that he had loaned. The borrower expected to pay back the same kind of dollars with approximately the same purchasing power that he had borrowed. That was the essential understanding in every contract for the repayment of money loaned.

But on the day of my inauguration, any attempt to collect in substance one hundred and sixty cents for every dollar owed would have brought universal bankruptcy.

During the past twenty-three months we have moved rapidly toward establishing and maintaining a dollar of stable purchasing power. We have brought about present dollar value which is within twenty per cent of what it was when the majority of debts, private and governmental, were incurred. All of our legislation of the past two years has been aimed at creating a currency of sound and standard purchasing power and then maintaining it.

In working toward our broad objective, the American currency was first taken off what is commonly known as the Gold Standard. Later, by Act of Congress and by Presidential Proclamation, it was restored to a gold standard on a different weight of gold.

The decisions of the Supreme Court are, of course, based on the legal proposition that the exact terms of a contract must be literally enforced. Let me for a moment analyze the effect of the present decision by giving a few simple illustrations:

First, in the case of the railroad bonds: Regardless of whether maturing bonds are owed by a bankrupt railroad or a solvent railroad, the bondholder is by this decision entitled to demand that the railroad pay him back, not the $1000 which he paid for the bond, but—$1690. Yet when he bought that bond he did not expect to get a clear net profit of $690 in addition to the sum of $1000 which he had invested.

It is unconscionable, not only for the individual investor to reap such a wholly unearned profit, but also to impose such a burden on shippers, travelers and stockholders. In fact, if the letter of the law is so declared and enforced, it would automatically throw practically all the railroads of the United States into bankruptcy.

Second: The principle laid down today in the railroad case applies to every other corporation which has gold bonds outstanding, driving many another huge enterprise into receivership! It must be applied likewise to the obligations of towns, cities, counties, and states; and these units of government, now working bravely to meet and reduce their debts, would be forced into the position of defaulters.

Third: Consider the plight of the individual who is buying a home for himself and his family and paying each month a specified sum representing interest and reduction of the mort-

-tage. If there is a gold clause in his mortgage—and most mortgages contain that clause—this decision would compel him to increase his payments 69% each month from now on, and perhaps to pay 69% more on some payments already made. Home owners, whether city workers or farmers, could not meet such a demand.

Consider now the other two decisions relating to government obligations on gold notes, gold certificates and gold clause bonds. An old lady came to see me the other day. She is dependent heavily on the income from government bonds which she owns; and her total income is about $800 a year. She owns $10,000 of government gold clause bonds. Under this new decision she would be entitled to ask the Treasury for $16,900. Being the right type of citizen, she volunteered to tell me that she does not consider herself entitled to more than the $10,000 which she had saved and invested.

The actual enforcement of the gold clause will not bankrupt the Government. It will increase our national debt by approximately nine billions of dollars. It means that this additional sum must eventually be raised by additional taxation. In our present major effort to get out of the depression, to put people to work, to restore industry and agriculture, the literal enforcement of this opinion would not only retard our efforts, but would put the Government and 125,000,000 people into an infinitely more serious economic plight than we have yet experienced.

Finally, I again call attention to the fact that the total of debts secured by contracts containing a gold clause amounts to at least one hundred billion dollars which is a very large proportion of our total property value of all kinds. To meet this contract debt, there exists in the United States a total of about eight and one half billion dollars of gold and in all the rest of the world—Europe, Asia, Africa, Australasia, and the Americas—there is not more than twelve billions in gold. I do not seek to enter any controversy with the distinguished members of the Supreme Court of the United States who have participated in this (majority) opinion. They have decided these cases in accordance with the letter of the law as they read it. But it is appropriate to quote a sentence from the First Inaugural Address of President Lincoln:

> "At the same time, the candid citizen must confess that if the policy of the government, upon vital questions affecting the whole people, is to be irrevocably fixed by decisions of the Supreme Court, the instant they are made, in ordinary litigation between the parties in personal actions, the people will have ceased to be their own rulers, having to that extent practically resigned their government into the hands of that eminent tribunal."

It is the duty of the Congress and the President to protect the people of the United States to the best of their ability. It is necessary to protect them from the unintended construction of voluntary acts, as well as from intolerable burdens involuntarily imposed. To stand idly by and to permit the decision of the Supreme Court to be carried through to its logical, inescapable conclusion would so imperil the economic and political security of this nation that the legislative and executive officers of the Government must look beyond the narrow letter of contractual obligations, so that they may sustain the substance of the promise originally made in accord with the actual intention of the parties.

For value received the same value should be repaid. That is the spirit of the contract and of the law. Every individual or corporation, public or private, should pay back substantially what they borrowed. That would seem to be a decision in accordance with the Golden Rule, with the precepts of the Scriptures, and the dictates of common sense.

In order to attain this reasonable end, I shall immediately take such steps as may be necessary, by proclamation and by message to the Congress of the United States.

In the meantime, I ask every individual, every trustee, every corporation and every bank to proceed on the usual course of their honorable and legitimate business. They can rest assured that we shall carry on the business of the country tomorrow just as we did last week.

Appendix B: The front page of the NYT for February 19, 1935.

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