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THE NINTH PILLAR OF SOUND MONEY AND CREDIT

THE PRINCIPLE OF PRODUCTIVITY OF DEBT

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A Venetian Tale

Once upon a time a poor gondolier of Venice, having done a favor to the gnomes of the Piazza, was given a magic pepper mill that would grind out anything at a word. The gondolier, a modest man, used it only to keep flour and sugar in supply. But his brother, a wealthy salt merchant, upon learning of the mill, cajoled its secret word from the gondolier, stole the mill by night, and set out to sea for the markets in the Levant.

Eager to try his prize and fill his sacks he uttered the word, and the mill began to grind out salt. The vessel's holds were soon filled and salt began to cover the deck. The merchant now tried to stop the mill, but alas, he had forgotten to learn the other secret word. The ship began to settle, and finally sank, carrying with it the avaricious merchant along with the mill, where it still rests, at the bottom of the sea, grinding out salt.

And that, the tale concludes, is the reason why the sea is salty.

Debt mill on the Potomac

Most observers worry about the inordinate growth of the money supply. But the growth of the money supply is merely a symptom, concealing a far more serious condition: *the* *uncontrollable growth of dollar-denominated debt.* The magic mill of the Venetian gondolier has been commandeered by the masters of the Federal Reserve System. They uttered the word, and enjoyed the sight of the uninhibited outpourings of cheap credit. But the obverse of credit is debt, and the mill on the Potomac River started flooding the country with bad debt that can never be repaid. The new masters of the mill would like to stop it, but alas, they have forgotten to learn the other word. The nation's economy, overburdened with bad debt, has started sinking.

In praise of debt

Debt is not bad *per se.* Debt embodies the symbiosis between the three progressive classes of people in the economy: the savers, the producers, and the inventors. Debt is the instrument facilitating the exchange of the wealth of the savers for income. Debt is the instrument facilitating the acquisition of state-of-the-art technology by the producers, in order that they may get the highest output per input of labor and capital for the benefit of everybody. Debt is the instrument facilitating the exchange of the future wealth of inventors for present income in support of research and development. Debt alone can make possible the extension of division of labor to generations that are far removed in time. Debt alone makes the emancipation of savings possible: saving is no longer anti-social as it was when the saving of a gold coin perforce meant a contraction of demand, prices, and output. Through debt as catalyst, saving is more beneficial than spending: the present wealth and income of savers find their way to the producers and inventors, and to the socially most beneficial applications.

The danger of a debt meltdown

Debt, however, is not without its dangers. It is not unlike nuclear energy. It can be enormously beneficial if properly harnessed and constrained - but it can also be equally destructive if the harness and constraint are removed. Bad debt is like fissionable matter. It can keep accumulating unobtrusively and without any apparent bad effects up to a point. But once this critical point is reached, a meltdown occurs. Proper safeguards in debt creation are therefore imperative.

The distinction between good and bad debt is not subjective or arbitrary. The quality of debt can be gauged by its productivity. This is the ratio of the net gain in GNP (gross national product) to the gain in debt. (The net gain in GNP is the excess of additional GNP over additional debt.) If this ratio is positive, then the new debt can be serviced out of current income, and the greater the ratio, the higher is the quality of debt. If the productivity of debt is allowed to decline significantly or, worse still, to become negative, then the debt can no longer be serviced out of income, and new debts have to be incurred to meet the maturing debt. The negative ratio is a clear signal that bad debt is now breeding more bad debt. A feedback is in effect, short-circuiting the economic process. The debt-tower is growing out of control, and in due course it will self-destruct.

Debt accumulation versus capital accumulation

The Principle of Productivity of Debt asserts that the ratio of net gain in GNP to the gain in debt must never be allowed to become negative. If this principle is observed, then debt is properly harnessed and constrained, and is socially beneficial, It makes a positive contribution to economic growth and public welfare.

We have long since passed the point when debt had a positive productivity in this country. Before 1960 it took less than one dollar of new debt to produce $1 gain in GNP But in the 1960's, on average, it took $2. in the 1970's it took $5, and in the 1980's so far. It's taken $3.50 of new debt to produce the same $1 gain in GNP. The growth of bad debt is accelerating.

It should be clear that this trend cannot continue indefinitely. The new debt has no economic justification. It does not produce the income to amortize itself, let alone a spendable income. Sooner or later the fantastic debt tower will topple, and bury the economy that prefers debt accumulation to capital accumulation.

We owe it to ourselves

There are those economists who maintain that the public debt is just the other side of public investment and therefore its growth, far from alarming, is actually beneficial. The public debt need never be repaid. "We owe it to ourselves", they say pointing out that if a family goes bankrupt, it is never on account of internal family debts, but on account of debt owing to outsiders.

There has never been a more vicious misrepresentation of economic fact, The public debt is being serviced at the expense of the taxpayers, and if it will never be retired, then taxation can only grow worse. Moreover, the credit worthiness of the government can suddenly evaporate, if creditors lose all faith in the ability of the government to consolidate and eventually to retire the public debt.

Debt in the United States is presently (1985) increasing at the annual rate of 14%. Most of this inordinate increase can be accounted for by the high rate of interest, far in excess of the productivity of labor and capital. Interest payable on the debt must be created out of nothing, to keep the game of musical chairs moving. But the merry-go-round must stop sooner or later. The solution to the problem of debt is to bring down the rate of interest at once to the level of the productivity of labor and capital in this country. That part of the debt that can be serviced at the lower interest rate will be consolidated; the rest must be written off. Then creditors in the future will think twice before they lend to the government and businesses which bank on new credits to meet interest payments on old debts.