IRON LAW OF THE BURDEN OF DEBT

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In my article *Growth and Debt: Is There a Trade-off?* (www.gold-eagle.com , February 12, 2009) I have stated the "Iron Law of the Burden of Debt": The liquidation value of total debt doubles every time the rate of interest is halved.

I have received several comments from thoughtful readers.

Steve Heller of the website *Golden Rule* writes:

You say: "For example, a $1000, 4% perpetual pays $40 per annum to its holder who can sell it in the secondary market at any time. The catch is that he may recover only part of his original investment if the interest rate has fallen in the meantime." This is of course incorrect; the value of the perpetual [bond] goes UP (proportionately) if interest rates have fallen, which is the whole point of the article. So this will confuse your readers, which I assume you don't want to do. A credit for my correction would be nice.

> You are absolutely right, Steve. The correct reading of the statement, as you noted, is: "the owner of a British consol (perpetual) can sell it in the secondary market at any time; the catch is that he may only recover a part of his original investment if the interest rate has risen in the meantime." Thank you for pointing out this error, thus giving me the opportunity to make the correction.

Here is a letter from a European correspondent:

Dear Professor Fekete,

I am a professional in the financial business and an avid reader (and distributor) of your writings. I would like to take issue with a few points in your latest article.

1. You say that the liquidation value of debt depends on the rate of interest. In my opinion this is wrong. If I owe $1000 to a bank, $1000 in Federal Reserve notes plus interest specified on the note will always liquidate my debt, regardless how the rate of interest may have moved away from the rate specified on the note. I believe there is even a law in New Jersey prohibiting banks from demanding more money in settlement of a loan than the face value of the note plus pro-rated interest, in case the loan is retired before maturity.

2. I believe you confuse the “liquidation” value with the “present” value of the loan, that is, the amount for which the bank could sell the securitized debt to a third party.
3. You seem to worry about the problem of doubling the present value of debt when the rate of interest is halved. This raises the question *‘cui bono?’* Take the U.S. and China. Why should the U.S. care if the present value of its debt to China doubles? The interest payment has not changed, nor has the amount due at maturity. And why should China worry? On the contrary, China should be happy. In case they wanted to sell their U.S. Treasuries, they could get twice the face value, according to your calculations.

Please regard these questions more as a feedback than a criticism. I wish you were right as, instinctively, I do like the thought that gold is the only ultimate extinguisher of debt, regardless of the outcome of this debate about the present value of total debt.

Perhaps you could give me some hints where I could find further reading material to help me understand your point.

Regards,

Mario Rossi
founder of “Umbria for Ron Paul”

Here is my answer:

Dear Mr. Rossi,

Thank you for writing. I greatly appreciate your interest in my work.

1. If as a corporate treasurer you have sold a $1000, 30-year bond and the interest is halved next day, you could liquidate that debt only if you are willing to shell out a sum closer to $2000, even in New Jersey. Nobody will sell your bond back to you for $1000, because it yields twice as much as do the new issues of the same face value and same maturity.

   I am not familiar with the laws of New Jersey governing personal bank loans, but if there is such a law, it is price fixing that will not work in the long run.
2. I am not confusing “liquidation value” with “present value” of debt. The two are one and the same, and depend on the rate of interest. What is involved here is the discounted value of the stream of payments capitalized at the current rate of interest. If the latter changes, so will liquidation value, and the relationship is inverse.
3. The U.S., China, and everybody else, ought to worry deeply about the runaway present value of total debt in consequence of serial halving of the rate of interest. Among other things, it means the sudden disappearance of liquidity. Both the U.S. and China would suffer, for different reasons, if the marketable U.S. debt became unmarketable.

   As a practical matter, the Chinese hoard of $1 trillion in U.S. paper is already dead as a doornail. It is impossible to liquidate any significant part of this investment without taking huge losses.

   As far as the U.S. is concerned, the end of ready marketability for its debt would make the sale of its future issues on the present scale very problematic, if not impossible. The only option left would be the direct monetization of Treasury debt by the Fed, but that would trigger hyperinflation in very short order.

I have been writing on the problem of the ballooning of liquidation value of debt in a falling interest-rate environment for the past eight years or so. My papers are archived on my website www.professorfekete.com .

Here is another letter from a correspondent in the U.S.:

Professor:

I have read your recent article discussing the liquidation value of debt with great interest (no pun intended). However, I was unable to follow your logic completely, although doubtless you will have a solution to my quandary.

It seems to me that your theory depends on the nature of the debt. Unless made up of perpetuals in the sense of British consols that never mature, which is clearly not the case here, the problem is hardly more than a minor irritant.

I fail to see how the U.S. public debt could be considered as equivalent to perpetuals. While it may be perpetual in the sense that it will never be paid off, it is nevertheless composed of notes, bills, and bonds, each with a specific maturity date. Therefore, since as you maintain that the debt will never be paid off, with which I agree, it will have to be rolled over and replaced by new issues with more distant maturity dates.

The extent of the increase in liquidation value of total debt will not be inversely proportional to the decrease in the rate of interest as you suggest. We can only say that the difference between the aggregate debt and the present value of streams of discounted interest payments is inversely proportional to the difference between the old and new rates, surely a much smaller quantity.

Thank you in advance for your response.

Yours, etc.,

Abe Cinderby

Here is my answer:

Dear Abe,

Nobody sees the future and we don't know at what rate the maturing debt will be rolled over if, indeed, market conditions will even allow it to be rolled over. As standard accounting practice, under these circumstances the most pessimistic assumption short of outright default must be made, which is that the aggregate debt never matures and so its liquidation value is calculated as that of the defunct British consols.

Having said that, I grant you that to a large extent the liquidation value of total debt is in the eye of the beholder. Governments naturally put a most optimistic low value on it. If chartered accountants want to stay faithful to the well-tested ethical standards of their profession, then they will apply the most pessimistic assumption. Of course, in the present situation they don't do that. Whether this is a well-reasoned decision on their part, or a result of arm-twisting, we are left to guess. There are alarming signs suggesting that the public perception is leaning towards the faithful accountant's formula in assessing the liquidation value of total debt. Government projections on the future of debt is for the birds.

You must ask yourself the question why British consols were discontinued. If they were a reasonable way to finance government under the gold standard then, from the government's point of view, they would be a trillion times more reasonable under the regime of irredeemable currency. Bonds that never mature? You just print up bank notes to pay the paltry interest a couple of times a year, surely a routine exercise with our present printing technology? Never worry about another refinancing? No greater bliss would be imaginable for a bailout-oriented government financing scheme.

British consols had to be discontinued soon after the pound sterling became irredeemable because of the public perception that, ultimately, the government will be unable to shoulder the implied runaway liquidation value of debt. The public forced the hand of the government to kill the consols. The bid/asked spread became so wide that it was no longer meaningful to talk about the market value of consols (in today's lingo, consols became a toxic asset).

Exactly the same thing is happening to the 30-year, 10-year, 2-year, 1-year government debt as well, as the world is being treated to a spectacle of shrinking maturities. The perpetual U.S. debt is not a well-thought-out construction. It is a makeshift to last only as long as the present incumbents at the Treasury do. The runaway liquidation value scares more and more investors. They know that they can never collect on their Ponzi-ticket. The marketability of government obligations is evaporating.

To be sure, that point has already been reached by the Chinese-owned portion. From the point of view of China the U.S. debt is a toxic asset. U.S. debt in Chinese hands has no definable value: any time the Chinese want to sell a sizeable amount, all bids are withdrawn. The Chinese are stuck with it. They have to wait for their money until maturity. But who knows what the purchasing power of the dollar will then be? The best the Chinese can do is to "grin and bear it." They can't even say "ouch", because this would further hasten the deterioration of marketability of their paper.

The periodic warnings from China that the U.S. government should display greater fiscal responsibility and it should follow a stricter monetary regimen sound like whistling in the dark.

Every refinancing of the fast maturing U.S. debt is a major disaster, considering the dwindling number of real investors. Entire new issues are taken up by bond speculators who are in it for the fast buck. They expect to reap risk-free profits when they turn around and dump the paper in the lap of the Fed. The Fed does not mind: it is happy to pay the blackmail, to maintain the façade of business as usual.

The perpetual debt is like nuclear fuel. There is a threshold beyond which chain-reaction sets in and the debt-tower of Babel self-destructs. Under the regime of the irredeemable dollar the value of government bonds can vaporize just as easily and unexpectedly as stock values, and there is nothing the government can do about it (short of making the dollar redeemable). When the last holder of the bag gets scared the last bubble, the U.S. government bond bubble, will have burst.

The supply of fools in the world is very large indeed, but it is not infinite as the Big Fix cowboys in Washington assume. It takes more than starting an avalanche of bailout bonds to defeat the Iron Law of the Burden of Debt.

Best,

professorfekete

Calendar of events

Szombathely, Martineum Academy, Hungary, March 27-29, 2009
Encore Session of Gold Standard University Live.
Topics: *When Will the Gold Standard Be Released from Quarantine?*
The Continuing Vaporization of the Derivatives Tower
Labor and Great Depression II
Silver in Backwardation: What Does It All Mean?
Further details: GSUL@t-online.hu
This conference is the swan song of GSUL which has been succeeded by the Gold Standard Institute, contact: philipbarton@goldstandardinstitute.com

Instituto Juan de Mariana, Madrid, Spain, June 18, 2009
Gold and Silver, Madrid 2009
gcalzada@juandemariana.org

San Francisco School of Economics, July 15-August 31, 2009
Money and Banking, a ten-week course based on the work of Professor Fekete who will be delivering 18 of the 20 lectures. Enrolment is limited; first come, first served..
The Syllabus for this course can be seen on the website: www.professorfekete.com

University House, Australian National University, Canberra, first week of November 2009
Peace and Progress through Prosperity: Gold Standard in the 21st Century
This is the first conference organized by the newly formed Gold Standard Institute.
E-mail feketeaustralia@gmail.com

Professorfekete on DVD: Professionally produced DVD recording of the address before the Economic Club of San Francisco on November 4, 2008, entitled *The Revisionist History of the Great Depression: Can It Happen Again?* plus an interview with Professor Fekete, is available from www.Amazon.com and from the Club www.economicclubsf at $14.95 each.

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