THE REVISIONIST THEORY AND HISTORY OF DEPRESSIONS

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An accounting principle, the Law of Liabilities, asserts that a firm ought to carry its liabilities in the balance sheet at its value upon maturity, or at liquidation value, *whichever is higher*. This Law is ignored by present accounting standards. The result is a rise in the liquidation value of debt, erosion of depreciation quotas, and wholesale destruction of capital under a falling interest-rate structure caused by a faulty monetary policy, hailed as the savior, but which should be condemned as the destroyer. Recognizing the Law of Liabilities may help us to understand deflations and depressions better.

The Book-Keeper's Dilemma

One of the plays of George Bernard Shaw branded "unpleasant" by the playwright himself is entitled *The Doctor's Dilemma*. The protagonist is a physician who comes into conflict with the Oath of Hippocrates (fl. 460-377 B.C.) He has developed a new treatment for a fatal disease, but the number of volunteers for the test-run exceeds the number of beds in his clinic. Unwittingly, the doctor finds himself in the role of playing God as he decides who shall live and who shall die.

By the same token a "most unpleasant" play could be written entitled *The Book-Keeper's Dilemma*. The protagonist, a chartered accountant, finds himself in conflict with the letter and spirit of book-keeping as set out by Luca Pacioli (fl. 1450-1509). As a result of compromising the high standards of the accounting profession, the book-keeper becomes the destroyer of Western Civilization. This play is, in effect, being written by history right now.

This is an updated version of my paper written a year ago: *Is Our Accounting System Flawed? – It may be insensitive to capital destruction.* Up-dating was prompted by events during that fateful year. In several passages I had to change the subjunctive mood to the indicative: the hypothetical depression has, unfortunately but not unpredictably, become an actual depression.

Finest product of the human brain

Luca Pacioli taught mathematics at all the well-known universities of Quattrocento Italy including that of Perugia, Napoli, Milan, Florence, Rome, and Venice. In 1494 he published his *Summa Arithmetica*, Tractatus 11 of which is a textbook on book-keeping. The author shows that the assets and liabilities of a firm must balance out at all times, provided that we introduce a new item in the liability column that has been variously called by subsequent authors “net worth”, “goodwill”, and “capital”. This innovation makes it easy to check the ledger for accuracy by finding that, at the close of every business day, assets minus liabilities is equal to zero. If not, there must be a mistake in the calculation.

But what Pacioli discovered was something far more significant than a method of finding errors in the arithmetic. It was the invention of what we today call double-entry book-keeping, and what Göthe has called “the finest product of the human brain” (*Wilhelm Meister’s Apprenticeship.*)

Why was this discovery so important in the history of Western Civilization? Because, for the first time ever, it was possible to calculate and monitor shareholder equity with precision. This is indispensable in starting and running a joint-stock company. Without it new shareholders could not get aboard, and old ones could not disembark safely. There would be no stock markets. The national economy would be a conglomeration of cottage industries, unable to undertake any large-scale project such as the construction of a transcontinental railroad, or the launching of an intercontinental shipping line.

The invention of the balance sheet did to the art of management what the invention of the compass did to the art of navigation. Seafarers no longer had to rely on clear skies in order to keep the right direction. The compass made it possible to sail under cloudy skies with equal confidence. Likewise, managers no longer have to depend on risk-free opportunities to keep their enterprise profitable. The balance sheet tells them which risks they may take and which ones they must avoid. It is no exaggeration to say that the present industrial might of Western Civilization rests upon the corner-stone of double-entry book-keeping. Oriental (Chinese) and Middle-Eastern (Arab) civilizations would have outstripped ours if they had chanced upon the discovery of the balance sheet first. By the same token, the continuing leadership of the West depends on keeping accounting standards high and isolated from political influences.

Barbarous relic or accounting tool?

There is cause for concern in this regard. For the past 75 years the West has been fed the propaganda line, attributed to John Maynard Keynes, that the gold standard is a “barbarous relic”, ripe to be discarded. The unpleasant truth, one that propagandists have ‘forgotten’ to consider, is that the gold standard is merely a proxy for sound accounting and, yes, for sound moral principles. It is an early warning system to indicate erosion of capital. It was not the gold standard *per se* that politicians and adventurers wanted to overthrow. They wanted to get rid of certain accounting and moral principles, especially as they apply to government and banking, that had become an intolerable fetter upon their ambition for aggrandizement and perpetuation of power. Historically, accounting and moral principles had been singled out for discard before the gold standard was given the *coup de grâce.*

The attack on accounting standards and on the gold standard was heralded by the establishment in 1913 of the Federal Reserve (F.R.) System in the United States, the chief engine of monetizing government debt followed, a decade later, by the illegal introduction of ‘open market operations’. Open market operations were not authorized by the F.R. Act of 1913. In fact, progressive penalties were levied on F.R. banks that could only cover their liabilities incurred upon issuing F.R. credit by assets in the form of U.S. Treasury paper.

‘Eligible paper’ was defined in the Act as short-term commercial bills of exchange, to the exclusion of Treasury bills, notes, and bonds. The F.R. Act was later amended legalizing open market operations *ex post facto*.

Bond speculators were quick to realize that risk-free profits could be made by pre-empting the F.R. banks’ purchases of Treasury paper in the open market. Bullish speculation, risk-free, in Treasury bills, notes, and bonds ultimately drove down interest rates to near zero, resulting in the destruction of capital, as explained below. Just how the monetization of government debt has led to a hitherto unprecedented, even unthinkable, corruption of accounting standards — this is a question that has never been addressed by impartial scholarship before.

Bonds and the Wealth of Nations

In order to see the connection we must recall that any change in interest rates has a direct and immediate effect on the value of financial assets. Rising interest rates make the value of bonds fall, and falling rates make it rise. As a result of this inverse relationship the Wealth of Nations would flow and ebb together with the variation of the rate of interest. Benefits and penalties would be distributed capriciously and indiscriminately, without regard to merit. It follows that the world economy needs a ‘flywheel regulator’ to keep interest rates stable or, more precisely, to let the increase in the Wealth of Nations impart a rather gentle and slow falling trend to interest rates.

That flywheel regulator was the gold standard before it was forcibly removed and discarded by irresponsible politicians trampling on the Constitution of the United States. Under the gold standard the rate of interest was stable and violent contractions in the Wealth of Nations were unknown. A lasting increase in the rate of interest could only occur in the wake of a natural disaster such as an earthquake, flood, or crop failure. Remarkably, these were cushioned by the spreading of the impact from the stricken country to the community of gold standard nations. War destruction would also cause the rate of interest to rise. In all these cases a higher rate of interest was beneficial. It had the effect of spreading the loss of wealth due to destruction of property more widely, easing the burden on individuals. Those segments of society, or those countries, that were lucky enough to escape physical destruction had to share in the loss through paying the increased cost of servicing capital due to higher interest rates. Everyone was prompted to work and save harder in order that the damage might be repaired quickly and expeditiously. As the rate of interest gradually returned to its original level, the Wealth of Nations expanded. Once again, everybody shared equally as the lower interest rate benefited all through the reduction in the cost of servicing capital.

It is not widely recognized that the chief eminence of the gold standard is not to be found in stabilizing the price structure (which is neither desirable nor possible). It is to be found in stabilizing the interest-rate structure. By ruling out capricious and disturbing swings, the Wealth of Nations is maximized.

The gold standard ruled supreme before World War I. It was put into jeopardy when general mobilization was ordered in 1914 by the manner in which belligerent governments set out to finance their war effort. These governments wanted to perpetuate the myth that the war was popular and there was no opposition to the senseless bloodshed and destruction of property that could have been avoided through better diplomacy. The option of financing the war through taxes was ruled out as it might make the war unpopular. The war was to be financed through credits. In more details, war bonds were issued in unprecedented amounts, subsequently monetized by the banking system. Naturally, these bonds could not possibly be sold without a substantial advance in the rate of interest. Accordingly, the Wealth of Nations shrank even before a single shot was fired or a single bomb dropped.

Sinking fund protection

Under the gold standard bondholders were protected against a permanent rise in the rate of interest (which in the absence of protection would decimate bond values) by the provision of a sinking fund. In case of a fall in the value of the bond the sinking fund manager would enter the bond market and would keep buying the bond until it was once more quoted at par value. Every self-respecting firm selling its bonds would offer sinking-fund protection.

Even though governments did not offer it, it was understood and, in the case of Scandinavian governments explicitly stated, that the entire bonded debt of the government would be refinanced at the higher rate, should a permanent rise in the rate of interest occur. Bondholders who have put their faith in the government would not be allowed to suffer losses. Banks, the guardians of the people's money, could regard government bonds as their most trusted earning asset. They were solid like the rock of Gibraltar. Such faith, at least in Scandinavian government obligations, was justified. The risk of a collapse in their value was removed. Governments, at least those in Scandinavia, occupied the moral high ground. The money they borrowed belonged, in part, to widows and orphans. They took to heart the Scriptural admonition and did not want to bring upon themselves the curse pronounced on tormentors of widows and orphans.

Law of Assets

However, there was a problem with war bonds issued by the belligerent governments. They were quickly monetized by the banking system making the refinancing of bonded debt impossible. This created a dilemma for the accounting profession. According to an old book-keeping rule going back to Luca Pacioli that we shall here refer to as the Law of Assets, *an asset must be carried in the balance sheet at acquisition value, or at market value, **whichever is lower***. In a rising interest-rate environment the value of bonds and fixed-income obligations are falling, and this fall must be faithfully recorded in the balance sheet of the bondholder.

There are excellent reasons for this Law. In the first place it is designed to prevent credit abuse by the banks and other lending institutions. In the absence of this Law banks could overstate the value of their assets that might be an invitation to credit abuses to the detriment of shareholders and depositors. If the abuse went on for a considerable period of time, then it could lead to the downfall of the bank. In an extreme case, when all banks disregarded the Law of Assets, the banking system could be operating on the strength of phantom capital, and the collapse of the national economy, to say nothing of the world economy, might be the ultimate result. For non-banking firms the danger of overstating asset values also exists, and can serve as an invitation to reckless financial adventures. Even if we assumed that upright managers would always resist the temptation and stay away from dubious adventures, in the absence of the Law of Assets the balance sheet would be an unreliable compass to guide the firm through turbulence, materially increasing the chance of making an error. Managerial errors could compound and the result could again be bankruptcy.

Economists of a statist persuasion would argue that an exception to the Law of Assets could be safely made in case of government bonds. The government's credit, like Caesar's wife, is above suspicion. The government will never go bankrupt. Its ability to retire debt at maturity cannot be doubted. As a guarantee these economists point to the government's power to tax. However, the problem is not with paying the face value of the bond at maturity, but with the purchasing power of the proceeds. By that standard, the U.S. government is guilty of partial and concealed default on every single 30-year bond it has sold since the opening of the doors of the F.R. banks for business in 1914. Currency depreciation is a more subtle and,

hence, a more treacherous form of default. Governments, however powerful, cannot create something out of nothing any more than individuals can. They cannot give to Peter unless they have taken it from Paul first. Nor is the taxing power of governments absolute. Financial annals abound in cases where taxpayers have revolted against high or unreasonable taxes, sometimes overthrowing the government in the process. If the taxing power of governments had been absolute, then they could have financed World War I out of taxes. Bondholders would have suffered no loss of purchasing power, at least not on the victors' side.

It is true that governments as a rule do not go bankrupt, but this may be a disadvantage. Putting a value on bonds higher than what they would fetch in the market is a fool's paradise. Governments could use methods, fair or foul, to stave off the ill effects of their own profligacy. Awakening could be postponed, but it would be made that much ruder.

A strict application of the Law of Assets would have made most banks and financial institutions in the belligerent countries insolvent. The dilemma facing the accounting profession was this. If accountants and book-keepers insisted that the Law be enforced, they would be called "unpatriotic" and be made a scapegoat held responsible for the weakening financial system. Demagogues would charge that they were undermining the war effort. On the other hand, if the accountants allowed the banks to carry government bonds in the asset column at acquisition rather than at the lower market value, then they would compromise the time-tested standards of accounting and expose the bank, and ultimately the national economy, to all the dangers that follows from this, not to mention the fact that they would also draw the credibility of the accounting profession into question.

Illiquid or insolvent?

The story how the accounting profession solved the dilemma has never been told. It may be a safe assumption that the dilemma was solved for it by the belligerent governments in prohibiting the public disclosure of the banks' true financial condition. A new accounting code was created, far more lenient in adjudicating insolvency. The Law of Assets was thrown to the winds, replaced with a more relaxed one allowing the banks to carry government bonds at face value, regardless of true market value, as if they were a cash item. A new term was invented to describe the financial condition of a bank with a hole in the balance sheet punctured by the falling value of government bonds. Such a bank was henceforth considered "illiquid", but still solvent. Never mind that the practice of allowing the illiquid bank to keep its door open was a dangerous course to follow. It had far-reaching consequences, including a threat to the very foundations of Western Civilization. It was a death sentence on the gold standard with a stay of execution. It was throwing the gates open to wholesale currency debasement world-wide. It is no exaggeration to say that the present unprecedented financial crisis is another delayed effect of the unwarranted relaxation of accounting standards back in 1914.

While I cannot prove that a secret gag-rule was imposed on the accounting profession, I am at a loss to find an explanation why an open debate on the wisdom of changing time-honored accounting principles has never taken place. Apparently there were no defections from the rank and file of accountants in denouncing the new regimen as dangerous and unethical. The underhanded changes in accounting practice have opened the primrose path to self-destruction.

The dominant role of the West in the world was due to the moral high ground staked out by the giants of the Renaissance, among them Luca Pacioli. As this high ground was gradually given up, and the commanding post was moved to shifting quicksand, rock-solid principles gave way to opportunistic guidelines. Western Civilization has been losing its claim

to leadership in the world. It comes as no surprise that this leadership is now facing its most serious crisis ever.

The chickens came home to roost as early as 1921 when panic swept through the U.S. government bond market. All banks found that their capital was seriously impaired as a result of the panic. Financial annals fail to deal with this crisis (exception: B. M. Anderson's Financial and Economic History of the United States, 1914-1946, posthumously published in 1949, see reference at the end). Nor was it given the coverage it deserved in the financial press. Information was confined to banking circles. An historic opportunity was missed to mend the ways of the world gone astray in 1914. It was the last chance to avert the Great Depression of 1930 already in the making, to say nothing of other great depressions to follow.

Law of Liabilities

Purely by using a symmetry argument we may formulate another fundamental principle of accounting: the Law of Liabilities. It asserts that *a liability must be carried in the balance sheet at its value at maturity, or at liquidation value,* ***whichever is higher***. Since liquidation would have to take place at the current rate of interest, in a falling interest-rate environment the liabilities of all firms are rising. The reason for this Law is to prevent the government, banks, and other firms from understating their liabilities that would spell a great danger to the national economy. This danger has been completely disregarded by the profession of the economists, as it has by that of the accountants.

Economists have failed to raise their voice against the folly of allowing the interest-rate structure to fluctuate for reasons of political expediency, implicit in the application of both Keynesian and Friedmanite nostrums. It is possible that the reason for this failure was the fatal blind spot that economists appear to have in regard to the danger of overestimating national income in a falling interest-rate environment.

The proposition that a firm ought to report liabilities at a value higher than the amount due at maturity whenever the rate of interest falls is, of course, controversial. Let us review the reasons for this crucial requirement. If the firm is to be liquidated, then all liabilities become due at once. Sound accounting principles demand that sufficient capital be maintained at all times to make liquidation without losses possible. If the rate of interest were to fall, then, clearly, earlier liabilities had been incurred at a rate higher than necessary. For example, if an investment had been financed through a bond issue or fixed-rate loan, then better terms could have been secured by postponing it. A managerial error in timing the investment had been made. This is a world of crime and punishment where even the slightest error brings with it a penalty in its train. Marking the liability in the balance sheet to market is the penalty for poor timing. If the investment had been financed out of internal resources, the penalty was still justified. Alternative uses for the resource would have generated better financial results.

Even if we assume that the investment was absolutely essential at the time it was made, and we absolve management of all responsibility in this regard, the case for an increase in liability still stands. After all has been said and done, there is a loss that must not be swept under the rug. If the balance sheet is to reflect the true financial position, then the loss ought to be realized. Any other course of action would create a fool's paradise.

To see this clearly, consider losses due to accidental fire destroying physical capital not covered by insurance. The loss must be realized as it is necessary that the balance sheet reflect the changed financial picture caused by the fire. That's just what the balance sheet is for. The proper way to go about it is a three-step adjustment as follows:

(1) Create an entry in the asset column called "capital fund to cover fire loss".

(2) Create an equivalent entry in the liability column.
(3) Amortize the liability through a stream of payments out of future income.

It is clear that if the accountant failed to do this, then he would falsify all subsequent income statements. As a result losses would be reported as profits and phantom profits would be paid out as dividends. Not only would this weaken the financial condition of the firm, but it would also render the balance sheet meaningless, which may compound the error further.

Exactly the same holds if the loss was due not to accidental fire but to a fall in the rate of interest. The way to realize the loss is analogous. A new entry in the asset column must be created under the heading "capital fund to cover shortfall in capitalizing interest payments, and shortfall in depreciation quotas, due to the fall of the interest rate", against an equivalent entry in the liability column, to be amortized through a stream of payments out of future income. *This is not an exercise in pedantry*. It is the only proper way to realize a loss that has been incurred as a result of the inescapable increase in the cost of servicing productive capital already deployed, in the wake of a fall in the rate of interest. Ignoring that loss would by no means erase it. It may well compound it.

The effect of falling interest rate on depreciation schedules

When a firm acquires a capital good, it adds its value to the asset column of the balance sheet, while charging the same amount to the liability column. The liability must be amortized during the productive life of the asset. In other words, asset values are subject to depreciation, set forth in the depreciation schedule, specifying depreciation quotas year by year and item by item. Asset depreciation and liability amortization are the opposite sides of the same coin.

If the rate of interest is stable, then the depreciation schedule is fixed. However, if the rate of interest falls, the depreciation quota will be insufficient to do the necessary amortization. At the end of the productive life of the asset there will remain an unamortized liability. The depreciation schedule, in exactly the same way as a bond sold, is a liability of the firm which increases whenever the rate of interest decreases, as explained above.

If adjustment is not made, then, according to the Law of Liabilities, the balance sheet will falsify the position of the firm by showing assets of zero value at positive valuation. Worse still, the profit/loss statement is also falsified, masking losses as profits.

Therefore it is incumbent on the accountant to rewrite the depreciation schedule by increasing depreciation quotas to reflect the fall in interest rates, regardless whether the purchase of the asset was financed through issuing debt, equity, or through funds generated internally. There is an increase in liability that has to be amortized by a further charge against future income.

Present accounting standards ignore the need to revise depreciation quotas upon a fall in interest rates. They allow firms to pay out phantom profits as dividends. The result is: destruction of capital which remains hidden. The balance sheet and the profit/loss statement cease to be a faithful guide to show the real picture. The larger the asset values involved are, the greater capital destruction is. Note that all firms are hit simultaneously by the erosion of capital, which makes the crisis more acute when the day of reckoning dawns, that is, when capital destruction can no longer be concealed.

The example of Japan

I anticipate a torrent of criticism asserting that there is no such a thing as the Law of Liabilities in accounting theory or practice. I submit that I have no formal training in accounting, or in the theory and history of accounting. Nor do I recall having seen the Law of

Liabilities in any of the textbooks on book-keeping that I have perused (although I have seen the Law of Assets in older textbooks that have long since been discarded). But I shall argue that either Law follows the spirit if not the letter of Luca Pacioli. Affirming one while denying the other makes no sense. Every argument that supports one necessarily supports the other. The Law of Liabilities is a mirror image of the Law of Assets, arising out of the perfect logical symmetry between assets and liabilities. Ignoring either Law is a serious breach of sound accounting principles, possibly with grave consequences.

Consider the example of Japan, allowing the rate of interest to fall practically all the way to zero during a fifteen-year period. Present (in my opinion deeply flawed) accounting rules allowed companies and banks in Japan (including those banks that not so many years ago were among the world's ten largest) to understate their liabilities. Hence they could report losses as profits. Wholesale capital consumption and destruction was the result, without anybody realizing what was going on. Japan now has to live with a brain-dead banking system operating on phantom capital. The economy has been brought to its knees spelling deflation, depression, or worse, as indeed it seems to be happening right now. The cancer of depression has been metastasizing across the Pacific through the yen-carry trade, foolishly encouraged by the F.R. and the Bank of Japan as a way to push interest rates even lower in the United States.

Rather than analyzing the Japanese example and drawing the appropriate conclusions, policy-makers in the U.S. had an irresistible itch to follow Japan's jump into the abyss of the Black Hole of zero interest. The result, perfectly predictable, is catastrophic. Yet the lesson has not been learned: after successfully massaging the short end of the yield curve to zero, on March 18, 2009, the Fed announced that it has set out to massage the long end as well.

Historic failure to recognize the Law of Liabilities

Even if the fact were established that the Law of Liabilities has never been spelled out in any accounting code going back all the way to Luca Pacioli, we should still not jump to the conclusion that there is no justification for it. A convincing argument can be made explaining why the Law of Liabilities has escaped the notice of upright and knowledgeable accountants in the past with the consequence that it has never been codified. Historically, rising rather than falling rates have been the rule in spite of the fact that, since time immemorial, the powers-that-be have shown a persistent bias favoring debtors at the expense of creditors, as demonstrated by their efforts to suppress the rate of interest by hook or crook. However, this effort has been counter-productive. The usuriously high rates charged on loans in pre-capitalistic times were not due to an alleged greed of the usurers. They were due to the usury laws themselves. Charging and paying interest had been outlawed, but the result was not lower interest on loans as the authors of the usury laws had foolishly anticipated. On the contrary, the result was rates higher than what the free market would have charged. The excess represented compensation for risks involved in doing an extra-legal business transaction.

Even though the usury laws were later repealed, other anti-business measures have remained on the books that resulted in keeping interest rates higher than they would have been in the absence of government interference. For these and other reasons, traditionally, the problem was not falling but rising rates. In such an environment the Law of Liabilities remained inoperative and was easily overlooked. It is hard to discover a law that has been inoperative through all previous history.

Revisionist history of the Great Depression

The picture changed drastically when the Fed started its illegal open market operations. Thereafter falling rates became a regular feature of the landscape. Speculators were happy to jump on the bandwagon of risk-free profits. They could easily preempt the F.R. by purchasing the bonds beforehand. After the F.R. banks have completed the purchase of their quotas, speculators could dump the bonds and pocket profits they have earned risk-free. The net result was a falling interest rate structure.

The undeniable fact is that the opportunity for risk-free profits from bond speculation due to the introduction of open market operations was a major cause of the Great Depression. It enabled bond speculators to siphon off wealth from the capital accounts of producers surreptitiously. Yet to this day textbooks on economics hail open market operations as a refined tool in the hands of monetary authorities "to keep the economy on an even keel". Only one other mistake economists have made does match this in enormity. Textbooks blame the Great Depression on the "contractionist bias" of the gold standard. The truth is just the opposite. A second major cause of the Great Depression, in addition to the Fed's illegal open market operations, was the government's sabotaging of the gold standard in preparation for its overthrow, as I shall now explain.

The persistent fall of interest rates in the 1930's has never been fully explained by the economists. They ignored the fact that the *only* competitor for government bonds, gold, has been knocked out through confiscation, or the threat thereof, as well as other measures of intimidation. In the absence of intimidation the marginal bondholder practices arbitrage between the bond market and the gold market. He will sell his bond, a future good, and keep the proceeds in gold, a present good, if the rate of interest falls below his time preference rate. Conversely, if the rate of interest bounces back, he will buy back his bond at a profit. This is the mechanism to regulate the rate of interest by time preference. Clearly, it breaks down when the gold standard is removed.

Indeed, when Britain (in 1931) and the United States (in 1933) left the gold standard, government bonds were freed from their only competitor. Bond values started to rise, making interest rates fall, causing prices to follow suit — as I shall explain below. The Great Depression was self-inflicted. Governments in their zeal fired the policeman, the gold standard, that was supposed to cordon off the Black Hole of zero interest to prevent interest rates from falling in. Speculators were quick to understand that this also meant the removal of the ceiling on bond prices. For the first time ever, there was an opportunity to bid bond prices sky-high. Speculators abandoned the high-risk commodity markets in droves and flocked to the bond market to reap risk-free profits made available by the regime of open market operations. You cannot understand the Great Depression without understanding how speculators reacted to the forcible removal of gold, the only competitor for government bonds, from the scene.

Thus the Great Depression had a dual cause: (1) the illegal introduction of open market purchases of government bonds by the Fed, and (2) the unconstitutional suspension of the metallic monetary standard by the government. Both measures worked to destabilize interest rates, more precisely, they both worked towards establishing a falling trend.

Paying out phantom profits

Superficial thinking may suggest that if the rise of interest rates is bad, then their fall is good for the economy. Not so. A falling rate is even more damaging than a rising one. I am aware that my thesis is highly counter-intuitive. I have been challenged by many other economists who deny the validity of my contention. They argue that if the present value of future income is lower when discounted at a higher rate, then it must be higher when discounted at a lower

rate of interest. We may admit that this statement is true. However, obviously, the firm has to be around to collect the higher income. Many of them won't be as they succumb to capital squeeze caused by the very falling of the rate that is supposed to be beneficial to them.

My critics hold that falling rates are *always* beneficial to business and it is preposterous to suggest that they aggravate deflation. These critics confuse a *falling* structure of interest rates with a *low but stable* structure. While the latter is beneficial, the former is lethal. When interest rates are falling, the low rates of today will look like high rates tomorrow. A prolonged fall creates a permanently high interest-rate environment. This paradox explains the reluctance of the mind to admit that falling rates spell deflation and, in an acute case, depression.

Falling rates mean that businesses have been financed at rates far too high and they carry assets in the balance sheet at inflated values, due to their failure to revise depreciation quotas upwards. This fact of falling rates ought to be registered as a loss in the balance sheet, and ought to be compensated for by an injection of new capital. If businesses choose to ignore the loss, and they merrily go on paying out phantom profits in the form of dividends and executive compensation, then they will further weaken their capital structure. When they finally plunge into bankruptcy, they wonder what has hit them. They don't understand that they have failed to augment their capital in the wake of falling interest rates. Their downfall is due to insufficient capital. In a falling interest rate environment all firms are affected by the elusive process of capital destruction. This was true in the 1930's; it is still true today. Incidentally, this also explains why American producers have been going out of business in droves since the mid-1980's, resulting in the export of the best-paying industrial jobs to Asian countries such as China and India where labor costs were lower.

The U.S. government is apparently unconcerned about the fact that the liquidation value of its debt is escalating by several orders of magnitude due to falling interest rates. It has increased a thousand-fold during the past 25 years, due to this one cause alone! This non-chalance is explained by the fact that, after all, the Fed has the printing presses to create dollars with which any liability of the government can be liquidated, however large.

***Cause*: falling interest rates – *effect*: falling prices**

American producers are not so fortunate. They don't have a printing press to make their debt burden lighter. They have to produce more and sell more if they don't want to sink deeper in debt. But selling more may not be possible in a falling interest-rate environment except, perhaps, at fire-sale prices. What this shows is that *the cause of deflation is not falling prices: it is falling interest rates. Falling prices is the effect.*

Let's spell it out how this mechanism works. As interest rates fall, a vicious spiral is set in motion. Lower rates send prices lower, and lower prices send rates lower still. Bond speculators take advantage of the opportunity created by open market operations. They front-run the Fed in buying government bonds first. The resulting fall in interest rates bankrupt productive enterprise that could not extricate itself from the clutches of debt contracted earlier at higher rates. The debt becomes ever more onerous as its liquidation value escalates past the ability to carry it. In addition, inadequate depreciation quotas undermine the financial structure of all firms, as explained above. The squeeze on capital causes wholesale bankruptcies among the producers.

While they clearly have the power to put unlimited amounts of irredeemable currency into circulation, central banks have no power to make it flow in the "approved" direction. Money, like water, refuses to flow uphill. In a deflation it will not flow to the commodity and real estate markets to bid up prices there, as central bankers have hoped. Rather, it will flow downhill, to the bond market, where the fun is, bidding up bond prices. As the central bank

has made bond speculation risk free, the bond market will act as a gigantic vacuum cleaner sucking up dollars from every nook and cranny of the economy. The sense of scarcity of money becomes pervasive.

In feeding ever more irredeemable currency to the money market the central bank cuts the figure of a cat chasing his own tail. Contrary to the universal delusion that goes by the name "Quantity Theory of Money", more fiat money pushes interest rates lower and falling interest rates squeeze producers more. They cut prices in desperation and cry out for the creation of still more fiat money. To be sure, they get what they ask for. But their medicine turns out to be their poison. The creation of new money has a cost, namely, the F.R. banks' open market purchases of government bonds and the concomitant bull speculation in the bond market. Producers are squeezed further and are forced to make more price cuts. The vicious spiral is on.

The interest rate structure and the price level are linked. Subject to leads and lags, they keep moving together in the same direction. Falling interest rates sooner or later induce falling prices. This is the lesson from the revisionist theory of depressions, a lesson that has been ignored by economists.

Putting bank ratios in the vise

As the current global banking and credit crisis shows, destruction of capital was not confined to the producing sector. Falling interest rates shrank bank capital across the board of the financial sector as well, without the shrinkage being detected. All banks were weakened simultaneously. They should have augmented their capital or should have reduced their assets *pari passu* with falling interest rates. They had done neither. In a mad pursuit of high leverage they embarked upon a policy of increasing assets in the face of capital erosion. Bank ratios have been put in the vise: they are squeezed on both sides. They are squeezed on the liability side because the liquidation value of liabilities stands to be revised *upwards*; but they are also squeezed on the asset side because the value of assets stands to be revised *downwards*.

At first, the banks thought they were making fabulous profits. It was only later that it dawned upon them that, in fact, what they were paying out in the form of dividends and compensation were phantom profits. This compounded the problem of capital erosion. By 2008 the banks have reached the stage, more or less simultaneously, where all of their capital was wiped out. The credit crisis burst upon the scene with elemental force.

Through its open market operations the F.R. has, unwittingly, generated a deflationary spiral that ultimately bankrupted not just the producing sector, but the financial sector as well. Like the Sorcerer's Apprentice, the F.R. started the march to the Black Hole of zero interest, but did not have a clue how to stop it when the pull of the Black Hole has become irresistible. At that point the deflationary spiral got out of control.

The onset of Great Depression II

It is nothing short of frightening to see how policy-makers in the U.S. have misread and misinterpreted the danger signals warning of an imminent collapse of the financial system and the economy, and how they continue to prescribe the wrong medicine. We must face the fact that the present crisis is far worse than that of 1929. For one thing, the economy is so much larger making the collapse more damaging. Even more serious is the increasing debt burden that the collapsing economy is no longer able to carry.

The credit of the United States was incomparably stronger in 1929. Eighty years ago this country was the largest creditor in the world, a position it was to keep for the next forty years. By now the U.S. is the largest debtor nation in the world that needs to borrow money to

pay interest on its debt. The tipping point was the year 1971 when the dollar was formally made an irredeemable currency. During the last forty years a colossal dissipation of wealth, unprecedented in history, has taken place. It was mostly unseen since it was papered over by an artificially fed boom in consumption. It is altogether futile to expect that the American consumer will pull up the world economy with his renewed spending if given the necessary pump-priming followed by sufficient stimulus.

Today the greatest creditor nation in the world is China. Is it realistic to expect that the Chinese consumer will take over the role traditionally played by the American consumer, given the fact that his government is a prisoner of Communist ideology?

We are still far from the trough of this depression, officially labeled a 'recession'. At the trough the devastation will be far greater than that experienced in 1932, if for no other reason that there was no derivatives tower then, whereas we have one now that threatens the world with toppling. Only the tip of the derivatives iceberg has been identified by the captain of this 'unsinkable' Titanic, but not the invisible submerged part. He is oblivious of the fact that the inevitable collision will take place at greater depths.

Worst of all is the blockheadedness of policy-makers as they desperately stick to their long-since discredited Keynesian nostrums. Every measure they propose is counterproductive. They seem to be unaware of the truism that pump-priming is useless if there is no water in the well. Likewise, there is no point in stimulating an organism that suffers from blood poisoning. One has to treat the disease first. In this case blood poisoning is caused by irredeemable currency that hasn't got the prerequisite quality to act as the ultimate extinguisher of debt. As a result, the world suffers from "debt poisoning". Thus the problem is to remove the cause of poisoning, irredeemable currency, from the system, before any other therapy can be made effective.

How to stop Great Depression II?

We have to stop the march to the Black Hole of zero interest. Restoring sound accounting standards is imperative. It is most unfortunate that the first tentative step in this direction, the compulsory marking of bank assets to market, will probably be rescinded as the authorities cave in to the vicious agitation of the bankers. Observers still have their blinkers on and cannot see the capital destruction caused by the failure to carry liabilities in the balance sheet at liquidation value. We must stop turning a blind eye to the deleterious effect of a falling interest rate environment on capital deployed in support of production. Open market operations of the F.R. must be outlawed and risk-free speculation in bonds stopped. They have been the chief cause of deflation as demonstrated by the pull of the Black Hole of zero interest.

The gold standard must be rehabilitated in order to abolish the inadmissible monopoly of government bonds. Some say this is unlikely to happen because it would be too painful. However painful, the alternative is many times more painful. The alternative spells a total breakdown of law and order due to unacceptable levels of unemployment, much worse than that experienced in the 1930's. The unraveling of social fabric threatens the survival of our republic and our civilization.

Self-liquidating credit has not been used since the outbreak of World War I. Bills of exchange with short maturity, payable in gold, drawn on fast-moving consumer goods in high demand, should be reintroduced as the means of financing multilateral world trade in preference to bilateral.

The key is in the hand of the U.S. government. It is the same key that was used to lock the U.S. Mint to silver in 1873, and to gold sixty years later, in 1933. By using it now to open

the U.S. Mint to both silver and gold, the U.S. government can effectively cordon off the Black Hole of zero interest to prevent further damage.

At stake is nothing less than the question whether America can reclaim control over its destiny, saving Western Civilization in the process.

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Note

This paper has been submitted to the Santa Colomba Conference on the International Monetary System to be held at the Palazzo Mundell, July 10-12, 2009.

June 29, 2009