REVISIONIST VIEW OF THE GREAT DEPRESSION

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I. INTRODUCTION

Fly in the Ointment

There are two standard views of the Great Depression of the 1930's. Keynesians maintain that the capitalist system is, by its very nature, prone to overproduction and, in the absence of government intervention, excessive inventories will periodically lead to falling prices and to growing unemployment which will further compound the collapse in demand. They advocate public works financed, if need be, by massive deficit spending. The central bank must be instructed to buy up all the government bonds that the market is unwilling to absorb. According to the Keynesian view in the early 1930's the current economic fetish, the balanced budget, prevented an increase in public spending to boost demand. Thus, then, faulty fiscal policy is to be blamed for the economic collapse that followed. On the other hand Friedmanites maintain that, although the central bank should churn out new money at a steady rate, something that even a "clever horse could be trained to do", yet the Federal Reserve was issuing money erratically. Sometimes it issued too much as in the stock-market frenzy of the 1920's, and sometimes too little as after the stock-market collapse in the 1930's. In the latter episode the economy was squeezed through a shortage of money causing prices to fall. Thus, then, faulty monetary policy is to be blamed for the economic collapse that followed.

For some time it has been increasingly clear that both views fall short of the mark. The Friedmanites ignore the fact that while the central bank has the power to issue money at any preconceived rate through open market purchases of bonds, yet it is utterly powerless to determine how this money shall be used by market participants. Commodity speculation is not the only use to which newly created money can be put. Another possibility is bond speculation which instead of raising the prices of goods will raise the prices of bonds or, what is the same to say, will lower interest rates. Thus the sorcerer, the central bank, finds itself in competition with its apprentices, the bond speculators, and control will shift to the latter. On the other hand, the Keynesians ignore the fact that financing public works is a depressant on enterprising exuberance. Entrepreneurs are not prepared to compete unconditionally with the government for funds to finance projects. They want to be convinced that theirs will be profitable before they commit funds to increase inventory and productive capacity. Deficit spending by the government brings profitability of enterprise into question.

Although superficially these two approaches to the problem appear to argue from different angles, they are in fact the same, if in different disguises. Both the Keynesians and the Friedmanites advocate the application of the same nostrum: central bank purchases of bonds, for the same purpose: to suppress the rate of interest for political ends. But there is a fly in the ointment prescribed by quacks of either persuasion, namely, the bond speculator. The so-called fiscal and monetary stimulus to boost demand is a myth. Either stimulus, rather than boosting demand for commodities, shall only boost speculative demand for bonds. If the bond speculator knows that tomorrow the central bank will buy bonds in the open market, then he will buy bonds today. Come tomorrow, he wants to feed them to the central bank at a hefty price advance.

Loading the Dice

Here is the description of the process in more details. The bond market is destabilized by the extraneous demand for bonds for purposes other than saving, in particular, for political purposes. There is an increase in the volatility of bond prices, and a corresponding increase in the volatility of interest rates. Bond speculators, dormant while the interest-rate regime is stable as under a gold standard, will come to life with a vengeance as soon as volatility appears. Individual speculators as well as financial institutions will duly note that big money is to be made by trading (as opposed to holding) bonds. There is more. In the new casino (the bond market) the dice are loaded. Those armed with this intelligence can take advantage of a free ride to riches. How? Since the central bank is a buyer practically all the time and hardly ever a seller, the risk inherent in bond speculation has been eliminated, or at least greatly reduced, by the so-called contra-cyclical monetary policy. All the speculator has to do is buy before the central bank does, and sell afterwards. Little wonder that speculation will snowball and become rampant, exceeding even the worst excesses of the earlier stock-market speculation.

Stabilizing or Destabilizing Speculation?

The observation that both the Keynesian and Friedmanite nostrums (allegedly suitable to prevent depressions) are counter-productive in that they aggravate rather than alleviate the crisis, has been ignored by economists. They accept the conventional wisdom that speculation tends to dampen volatility in any market. However, this generalization is patently false. One must distinguish between two kinds, stabilizing and destabilizing speculation, according as it deals with risks created by nature, or with risks created by man. The thesis that speculation is smoothing out fluctuations is true only of the first variety, for example, speculation in market for agricultural commodities. With regard to the second, speculation in markets dealing with risks created by man (including risks created by governments and central banks) fluctuations will increase as a result of speculation. For example, in the bond market more speculation means more volatility, not less, as speculators seek to induce and ride price trends, rather than resisting them. They do not act randomly as speculators in the commodity markets do. Bond speculators march in lockstep.

Falling Interest Rates Squeeze Profits

We shall see that bond speculation has a pivotal role in the genesis of depression and deflation. The buying of bonds for speculative purposes tends to depress interest rates. The mechanism that transmits the fall in the interest-rate structure to a fall in the commodity price structure is the rising bond price. It makes the present value of debt rise. As it does, the liquidation-value of enterprise also rises. Here is a paradox: falling interest rates squeeze the profits of productive enterprise. This is also the missing link economists have failed to find: the rise in the liquidation-value of enterprise causes an uncontrollable increase in the cost of servicing capital deployed in production. As costs increase, profits fall. We conclude that the squeeze on profits is not caused by the falling price-structure as previously assumed. Falling prices are themselves an effect, not a cause. The real cause is the falling interest-rate structure which reveals that productive capital has been financed at rates far too high. As a result of the squeeze, profits are turned into losses. Many firms fail, taking others down with them in a domino-effect as receivables get harder to collect. Demand collapses, prices fall.

The central bank is desperately trying to apply damage-control by putting more money into circulation. However, more money is just oil on fire. It is not flowing to the commodity markets as expected. It flows to the bond market where the action is. By bidding up bond prices to ever higher levels bond speculators push the rate of interest to ever lower levels. This puts further pressure on profits and makes more productive enterprise fail. A vicious circle is set into motion. As already mentioned, once Keynesian fiscal policy and/or Friedmanite monetary policy have become official, bond speculators face virtually no risk. Central bank intervention will provide a nice tail-wind to make their sails bulge.

Stealthy Wealth-Transfer

It is not hard to identify the chief culprit of bond speculation. It is the banking fraternity trying to rebuild bank capital that has been devastated during the preceding boom. The banks suffered huge capital losses in the bond portfolio, thanks to the relentless rise in interest rates. Further serious losses were sustained in the investment portfolio due to the proliferation of non-performing loans, in consequence of commercial borrowers having become over-extended in the face of rising interest rates. Now the rate of interest is falling, and the banks once more have the upper hand. Bankers are determined to make most of it.

The point is that the wealth of failing productive enterprise does not go up in smoke during the depression, as it has been wrongly assumed by earlier writers. It is being siphoned off and will show up as capital gains in the banks' bond portfolio. In this revisionist view, the Great Depression appears to have been caused by a massive wealth-transfer from the productive sector to the financial sector, denuding the former of its capital. The stealthy wealth-transfer has been made possible in the first place by the destabilization of the interest-rate structure. For this, mistaken government policies caving in to anti-gold propaganda and agitation for unlimited deficit-spending are squarely responsible.

Collapse of Demand or Collapse of Production?

In the second part of this essay we shall put the patience of the reader to test by a detour to discuss some fundamental book-keeping principles. This will be necessary for a full understanding of the stealthy wealth-transfer from the productive to the financial sector, that would never be possible if the balance sheets of individual firms in the productive sector showed the true financial picture at all times and the accounting profession raised the alarm about the ongoing capital consumption. But in a falling interest-rate environment the balance sheet ignores the huge increases in liquidation-value and the corresponding destruction of capital, of which all productive firms are suffering. Worse still, phantom profits are being paid out which further eats into capital, ultimately leading to the downfall of the productive sector of the economy.

In the third part, out of these elements we construct the revisionist theory of the Great Depression, and warn of the consequences concerning the present falling interest-rate environment in which the same forces are again at work. The conclusion is that causes of the Great Depression are to be found in the fatally relaxed accounting standards, the creation of the Federal Reserve banks in 1914, and the destruction of the gold standard in 1933. They interacted to cause wholesale capital destruction in the productive sector. It was not the collapse in demand that caused the collapse of production, as asserted by the currently fashionable Keynesian and Friedmanite orthodoxy. It was the exact opposite: the collapse in production causing the collapse of demand. As pointed out already, the collapse in production occurred in response to the invisible destruction of capital due to the falling interest-rate structure which, in turn, was engineered by the bond speculators, chief among them the banking fraternity.

II. THE BOOK-KEEPER'S DILEMMA

The Finest Invention of the Human Brain

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 by one the number of beds in his clinic. Unwittingly, the doctor finds himself in the role of playing God to decide who shall live and who shall die. By the same token, Shaw could have written the "most unpleasant" play of them all entitled The Book-Keeper's Dilemma. In it the protagonist, a chartered accountant, finds himself in conflict with the norms and rules of book-keeping as set out by Luca Paciuoli (fl. 1450-1509). As a result of compromising the high standards of the accounting profession, the book-keeper will unwittingly become the destroyer of Western Civilization.

Luca Paciuoli taught mathematics at most universities of Quattrocento Italy including those of Perugia, Napoli, Milan, Florence, Rome, and Venice. In 1494 he published his Summa Arithmetica. Tractatus 11 of that work is a textbook on book-keeping. In it the author shows that the assets and the liabilities of a firm will exactly balance out, provided that we introduce a new item in the liability column that has been variously called by subsequent authors "net worth", "goodwill", or "capital". This innovation makes it easy to check the ledger by finding that, at the close of every business day, assets minus liabilities is exactly equal to zero. Otherwise there must be a mistake. But what Paciuoli discovered was something far more significant than a method to find errors in the arithmetic. It was the invention of what we today call double-entry book-keeping, and what Goethe has called "the finest product of the human brain" (cf. 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 couldn't get aboard and old ones could not disembark safely. Stock markets, mergers, acquisitions would not be possible. The national economy would be a conglomeration of cottage industries, unable to undertake any large-scale project such as a transcontinental railroad construction or 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 have to rely on clear skies in order to keep the right direction. The compass has made it possible for them 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 what 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 on the corner-stone of double-entry book-keeping. Oriental (Chinese) or Middle-Eastern (Arab) Civilizations would have outstripped ours if they had chanced upon the discovery of the balance sheet first.

Barbarous Relic or Accounting Tool?

For the past 70 years the world has been fed the propaganda-line that the gold standard is a "barbarous relic", ripe to be discarded. The unpleasant truth, one that propagandists have 'forgotten' to mention, is that the gold standard is merely a proxy for sound accounting (as well as moral) principles. It was not the gold standard per se that politicians wanted to overthrow, but certain accounting and moral principles 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 the corruption of the gold standard were heralded by the establishment in 1913 of the Federal Reserve System, the engine for monetizing government debt. Just how the monetization of government bonds led to a hitherto unprecedented, even unthinkable, corruption of accounting standards - this is a question that has never been addressed by impartial scholarship before.

In order to see the connection we must recall that any durable change in the rate of interest has a direct and immediate effect on the value of all financial assets. Rising interest rates make the value of bonds fall, and vice versa. But while a rise makes the Wealth of Nations shrink and a fall in the rate of interest makes it expand, the benefits and penalties are distributed capriciously and indiscriminately, without regard to merit. This was hardly disturbing under the gold standard as the rate of interest was remarkably stable and the corresponding changes in the Wealth of Nations were negligible. A lasting increase in interest rates could only occur in the wake of a national disaster such as a flood, earthquake, or war. In all these cases higher interest rates were beneficial. They had the effect of spreading the loss of wealth due to the destruction of property more widely. Those segments of society that were lucky enough to escape physical destruction still had to share the loss through the increased cost of servicing capital due to the higher rate of interest. Everybody was prompted to work and save harder in order that the damage might be repaired more quickly and expeditiously. As interest rates gradually returned to their lower level, the Wealth of Nations expanded. Again, everybody would benefit through the reduced cost of servicing productive capital. It is not widely recognized that the chief eminence of the gold standard is not to be found in a stable price structure (that is neither possible nor desirable) but in a low and stable interest-rate structure, maximizing the Wealth of the Nations, while ruling out capricious and disturbing swings in it.

The gold standard ruled supreme before World War I. But once general mobilization was ordered in 1914, it was put at risk 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 effort through taxation was ruled out as it might make the war unpopular. The war had to be financed through credits. In more details, war bonds were to be 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.

Tormenting Widows and Orphans

Under the gold standard bondholders are 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 market and keep buying the bond until it was once more quoted at par value. Sinking fund protection was offered by every self-respecting firm issuing bonds. Even though governments did not offer it, it was understood and, in the case of the Scandinavian governments explicitly stated, that in case of a permanent rise in the rate of interest the entire bonded debt of the government would be refinanced at the higher rate. Bondholders who had put their faith in the government would not be allowed to suffer a loss. The banks, guardians of the people's money, could regard government bonds as their most trusted earning asset. Such faith, at least in the case of 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. They had borrowed money which, in part, belonged to widows and orphans. They took to heart the admonition and did not want to bring upon themselves the Biblical curse pronounced on the tormenters of widows and orphans.

The Law of Assets

But there was a problem with war bonds issued by belligerent governments. These bonds 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 Paciuoli that we shall here refer to as the Law of Assets, an asset must be reported in the balance sheet at acquisition price, or at the market price at the time of reporting, *whichever is lower*. In a rising interest-rate environment the value of all financial assets such as bonds and fixed-rate obligations are falling, and the fall must be faithfully recorded in the balance sheet. There are excellent reasons for this Law. In the first place it is designed to prevent credit abuse by banks and other lending institutions. In the absence of this Law banks could overstate the value of their assets that could be an invitation to credit abuses to the detriment of shareholders and depositors. If the credit 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 might be the result. For non-banking firms the possibility of overstating asset-values also existed and could similarly serve as an invitation to reckless financial adventures. Even if we assume that upright managers would always resist the temptation and would not intentionally get involved in such adventures, in the absence of the Law of Assets the balance sheet would still cease to be a reliable compass to guide the firm, 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 safely be made in case of government bonds. The government's credit, like Caesar's wife, is above suspicion. The government's ability to retire debt at maturity cannot be doubted. As a guarantee, these economists point to the government's power to tax, as well as to its right to seigniorage in the process of issuing money. However, the problem is not with the nominal value of government bonds at maturity, but with the purchasing power of the proceeds. Currency depreciation is a more subtle and hence more treacherous form of default. The government, however powerful, cannot create something out of nothing any more than an individual can. It cannot give to Peter unless if has taken it from Paul first. Nor is the taxing power of the government absolute. Financial annals abound in cases where taxpayers revolted against high or unreasonable taxes, thereby causing the overthrow of government and forcing the cancellation of bonded debt. If the taxing power of the governments had been absolute, then World War I could have been financed out of taxes, and no loss of purchasing power to bondholders through debt-monetization would have occurred.

A strict application of the Law of Assets would have made most banks and financial institutions in the belligerent countries technically insolvent. The dilemma facing the accounting profession was this. If accountants insisted that the Law be enforced, then they could be considered "unpatriotic", and be held responsible for the weakening financial system of the country. Demagogues could charge that the accountants were undermining the war effort. On the other hand, if they allowed the banks to report government bonds in the asset column at acquisition-value rather than the lower market value, then they would compromise the time-tested standards of accounting and expose the firm, and the economy, to all the dangers that may follow from this, not to mention the fact that they would also bring the credibility of their profession into question.

Insolvent or Illiquid?

The story of how the accounting profession solved the dilemma has never been told. It appears a safe assumption that the dilemma was solved for it by the belligerent governments in making it clear that public disclosure of the banks' true financial condition would not be tolerated. Nor could a public discussion of the subtle changes in accounting theory, following those in accounting practice, be entertained. These included the throwing of the Law of Assets to the winds, replacing it with a new and more relaxed one allowing the banks to report government bonds in the asset-column at acquisition value, regardless of true market value, as if it were a cash item. A new term was introduced in the dictionary to describe the financial condition of the bank with a hole in its balance sheet, provided that it could still meet the new relaxed criteria for solvency. Such a bank was henceforth called "illiquid". We shall see below why the practice of allowing illiquid banks to keep their doors open is a dangerous course to follow, as it has far-reaching consequences threatening, as it may, the very foundations of Western Civilization. (The recent scandal involving the American giant Enron is in fact a scandal involving the entire accounting profession, which stems from the unwarranted relaxation of accounting standards back in 1914.)

While I am in no position to prove that a secret gag-rule was imposed on the profession, I am at a loss to find an explanation why an open discussion of the wisdom of changing time-honored accounting principles has never taken place. Apparently there were no defections from the rank and file of the accounting profession denouncing the new regimen as unethical and self-defeating. These underhanded changes in accounting standards have opened the primrose path to self-destruction. The dominant role of Western Civilization in the world was due to the moral high-ground staked out by the giants of the Renaissance, among them Luca Paciuoli. As this high-ground was gradually given up and the commanding post was moved to shifting quicksand, and as 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 facing the most serious challenge of its history.

The chickens came home to roost in 1921 when panic swept through the U.S. government bond market. Financial annals fail to deal with this panic (exception: Benjamin M. Anderson's posthumous Financial History of the United States published in 1949). Nor was it given the coverage in the financial press it deserved. Information was confined to banking circles where the panic hit hardest. Clearly, it was in the interest of the government and the banks to hide the news under the bushel. There was an unprecedented peace-time jump in long-term interest rates, causing devastation in the market for long-term U.S. government bonds. Upright bankers looked at bond quotations in disbelief and desperation. The strongest pillars of their balance sheet were subjected to an unprecedented meltdown, taking place before their very eyes.

The crisis of 1921 was swept under the rug as the Federal Reserve banks stepped in the breach and shored up the balance sheet of their member banks. An historic opportunity was missed to mend the ways of the world that had gone astray in 1914. It was the last opportunity to avert the Great Depression, already in the making.

The Law of Liabilities

Purely by using a symmetry-argument we may formulate another fundamental principle of accounting, the Law of Liabilities. It states that a liability must be reported in the balance sheet at its value at maturity, or at its 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 height of liabilities of all firms are rising. The possibility of a simultaneous rise in the liabilities of all productive firms represents a great danger to the national economy. This danger has been completely disregarded by the economists' profession. As we know, 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 economists appear to have in regard to the danger of overestimating national income in a falling interest-rate environment.

The proposition that a firm must report liabilities at a value higher than that 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 has to be liquidated for whatever reason, then of course all liabilities become due immediately. Sound accounting principles demand that sufficient capital be maintained at all times to make liquidation without losses possible. If the interest rate were to fall, then clearly earlier liabilities had been incurred at a rate higher than necessary. For example, if an investment was to be financed through a bond issue or a fixed-rate loan, then better terms could have been secured by postponing the investment. In other words, a managerial error in timing has been made. This is a world of crime and punishment, and even the slightest error brings a penalty in its train. The increase of liability in the balance sheet is just the penalty for managerial error. If the investment had been financed out of internal resources, penalty is still justified. Alternative uses for the resource would have brought better financial results.

But even if we assume that the investment was absolutely necessary to make 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 still is an obvious loss due to the fact that servicing investment must be made at a rate higher than that available in the market. This loss ought to be realized if we want the balance sheet to continue to reflect the true financial position. Any other approach would create a fools' paradise. To see this more clearly we may point out that these losses are analogous to losses due to an accidental fire destroying physical capital which the insurance company for whatever reason fails to cover. The loss still has to be realized, as it is absolutely necessary that the balance sheet reflect the changed financial picture caused by the fire. The proper way to go about it is a three-step adjustment as follows:

(1) Create an entry in the asset-column called "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, that is, if he failed to realize the loss due to fire, then he would falsify future income statements. As a result, phantom profits may be paid out (or losses may be reported as profits). Not only would this weaken the financial condition of the firm, but it would also render the balance sheet meaningless, which may lead to further errors.

Exactly the same is true if the loss was due not to fire but a fall in the rate of interest. The way to realize the loss is analogous. A new entry must be created in the asset-column called "fund to cover overpayment in servicing capital, made necessary by a fall in the rate of interest", against the creation of an equivalent entry in the liability column, to be amortized by a stream of payments out of future income. This is not an exercise in pedantry. It is the only proper way to realize a real loss which has been, I repeat, 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 not erase it, while it might certainly compound it.

The Historic Failure to Recognize the Law of Liabilities

I anticipate a torrent of criticisms asserting that there is no such a thing as the Law of Liabilities in accounting theory and 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 many older books that have long since been discarded by practicing accountants as well as professors of accounting). But I shall argue that either Law follows the spirit, albeit, perhaps, not the letter of Luca Paciuoli. Affirming one while denying the other makes no sense. Every argument that supports one necessarily supports the other. There is a perfect logical symmetry between the two Laws, arising out of the symmetry of assets and liabilities in the balance sheet. Ignoring either Law is a serious breach of sound accounting, possibly with extremely grave consequences. For example, if the rate of interest keeps falling for an extended period of time, as it has in Japan for almost a decade now, then present (in my opinion, deeply flawed) accounting standards will allow losses to be reported as profits. The resulting wholesale capital destruction, which the country may not realize until it is too late, could bring the national economy to its knees spelling depression, deflation, or both (as it seems to be occurring in Japan right now).

Even if the fact can be established that the Law of Liabilities has never been spelled out in any official accounting code going back all the way to that of Luca Paciuoli, we should still not jump to the conclusion that there is no justification for it. A convincing argument can be made explaining why this Law might have escaped the notice of upright and knowledgeable accountants in the past, with the consequence that the Law has never been codified. For centuries, the powers that be have shown a persistent bias in taking the side of the debtors' class against that of the creditors', as demonstrated by their desire to suppress the rate of interest by hook or crook. However, this effort has remained counter-productive before the advent of open-market operations. Indeed, 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. The charging and paying of interest had been outlawed. The result was not zero interest as the authors of the usury laws had foolishly hoped. 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. For these and other reasons, the problem traditionally was not lower or falling rates. It was higher or rising rates. But the Law of Liabilities remains inoperative in such an environment. Furthermore, when open market intervention of the central bank came into vogue with the establishment of the Federal Reserve System, the United States was still on the gold standard which set a limit to the lowering of interest rates for political purposes. The Law of Liabilities continued to be inoperative. It is hard indeed to discover a Law that has been inoperative all through previous history.

The picture changed decisively in the 1930's when agitation against the gold standard started in earnest. Britain abandoned the gold standard in September, 1931, and the United States, in March, 1933. Finally, the last obstacle has been removed, and the door to suppressing the rate of interest for political purposes through central-bank open-market purchases of bonds was thrown wide open. Interest rates were falling throughout the 1930's. Considering its magnitude, the fall appears to be unprecedented by historical standards. Thus, then, we have the first instance ever in history that the Law of Liabilities could become operative. I think it did. The proof is that the Great Depression did indeed take place.

(Final Part next week)

March 6, 2002

Note. This paper is based on a series of talks with the same title given by the author at Sapientia University, Csikszereda, Romania, in March, 2002.