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THE REVISIONIST THEORY AND A HISTORY OF DEPRESSIONS

Written by:

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Meet Professor Antal E. Fekete, Professor of Money and Banking at the San Francisco School of Economics

The editors of the Daily Bell are pleased to present this special report prepared by Dr. Antal E. Fekete – an esteemed author, mathematician, monetary scientist, and educator. He was born in Budapest, Hungary, in 1932, and graduated from the Eötvös Loránd University of Budapest in mathematics in 1955. He left Hungary in 1956. He immigrated to Canada and was appointed Assistant Professor at the Memorial University of Newfoundland in 1958. In 1993, after 35 years' of service he retired with the rank of Full Professor. After retirement from active duties in 1995, Professor Fekete was Resident Fellow at the Foundation for Economic Education in Irvington-on-Hudson, New York.

Dr. Fekete is a proponent of the gold standard and a critic of the current monetary system. His work falls into the school of free-market economic thought led by Carl Menger and, more recently, Ludwig von Mises. His advanced understanding of monetary and economic issues has enabled him to spawn a 'next generation' of critical thought that advances the traditional Austrian view of how a free-market monetary system could work most efficiently. And this is most apparent in his support of the Real Bills Doctrine. Often misunderstood in principle, free banking differs from the purist view of a mandatory 100% gold reserve monetary system; it remains a source of continued, low-key controversy within the free-market community.

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THE REVISIONIST THEORY AND HISTORY OF DEPRESSIONS

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Note: This paper is an up-dated version of one 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.

An accounting principle, the Law of Liabilities, asserts that a firm ought to carry its liabilities in the balance sheet at their value upon maturity, or at liquidation value, whichever is higher. This Law has been ignored by present accounting standards, thereby contributing to massive deflations and depressions through the destruction of capital, and the rise of the liquidation value of debt, in the wake of monetary policy making the rate of interest fall.

The Book-Keeper's Dilemma

One of the plays of George Bernard Shaw branded "unpleasant" by the playwright himself is titled 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, another "most unpleasant" play could be written entitled The Bookkeeper's Dilemma. The protagonist, a chartered accountant, finds himself in conflict with the letter and spirit of bookkeeping set out by Luca Pacioli (fl. 1450-1509). As a result of compromising the high standards of the accounting profession, the bookkeeper becomes the destroyer of Western Civilization. This play is, in fact, being written by history right now.

Finest product of the human brain

Luca Pacioli taught mathematics at all the well-known universities of Quattrocento Italy including those of Perugia, Napoli, Milan, Florence, Rome, and Venice. In 1494 he published his Summa de Aritmetica, Tractatus 11, which is a textbook on bookkeeping.

The author shows that the assets and liabilities of a firm balance 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 arithmetic. It was the invention of what we today call double-entry bookkeeping, 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 cornerstone of double-entry bookkeeping. Oriental (Chinese) and Middle-Eastern (Arab) civilizations might 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 ambitions 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 System (the Fed) in the United States, the chief engine of monetizing government debt, followed a decade later by the illegal introduction of the Fed's 'open market operations'. The latter has made bond speculation risk free, ultimately driving down interest rates to near zero and resulting in the destruction of capital. Just how the monetization

of government bonds has led to a hitherto unprecedented, even unthinkable, corruption of accounting standards is a question that has never been addressed by professional organizations or impartial scholarship before.

Bonds and the Wealth of Nations

In order to see the connection, we must recall that any durable change of 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 variations 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 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. 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 occur only in the wake of a natural disaster such as an earthquake, flood, or crop failure. Remarkably, these disasters 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 losses through paying the increased costs of servicing capital due to higher interest rates.

Everyone was prompted to work and save more diligently 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 that 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, but when general mobilization was ordered in 1914, it was put into jeopardy by the manner in which belligerent governments set out to finance their war efforts. These governments wanted to perpetuate the myth that the war was popular and that 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. War bonds were issued in unprecedented amounts and 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.

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 issuing bonds would offer this 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 had put their faith in the government would not be allowed to suffer losses. The banks, guardians of the people's money, could regard government bonds as their most trusted earning assets. 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, thus making the refinancing of bonded debt impossible and creating a dilemma for the accounting profession. According to an old bookkeeping rule going back to Luca Pacioli that we shall refer to here as the Law of Assets, assets must be carried in the balance sheet at acquisition value, or at market value, whichever is lower. In a rising interest-rate environment, the values of bonds and fixed-income obligations are falling, and these falls must be faithfully recorded in the balance sheets of the bondholders.

There are essential reasons for the Law of Assets. 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, thereby inviting credit abuses to the detriment of shareholders and depositors. If the abuses went on for a considerable period of time, they could lead to the downfall of the bank. In an extreme case, if 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 temptation and stay away from dubious adventures, in the absence of the Law of Assets the balance sheet would be an unreliable compass for guiding the firm through turbulence, materially increasing the chance of making an error. Managerial errors could compound, and the result could 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 based on the assumption that 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 establishment of the Fed 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 from Paul. Nor is the taxing power of governments absolute. Financial annals abound with 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 rule may be a disadvantage. Putting a value on bonds higher than what they would fetch in the market is a fool's game. 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 more rude.

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 that if they insisted that the Law be enforced, they would be called "unpatriotic" and made scapegoats to be held responsible for the weakening financial system. Demagogues would charge that they were undermining the war effort. Alternatively, if the accountants allowed 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 might follow, 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 not an exaggeration to say that the present unprecedented financial crisis is a 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 of 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 and therefore no one denouncing the new regime as dangerous and unethical. The underhanded changes in accounting practice have opened a 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, to say nothing of other great depressions to follow.

Law of Liabilities

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. Because 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 governments, banks, and other firms from understating their liabilities, which might indicate 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 voices 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 have 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 is indicated. In this world of crime and punishment, even the slightest error brings with it a penalty in its wake. 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 would still be justified. Alternative uses for the resource could 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 true financial position, then the loss ought to be realized. To see this point clearly, consider losses due to an 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 should be clear that if this accounting procedure is not used, then all subsequent income statements are inaccurate. Losses would be reported as profits and phantom profits might be paid out as dividends, thereby weakening the financial condition of the firm, and possibly rendering the balance sheet meaningless by compounding the original error.

Exactly the same principle could be applied if the loss was due not to accidental fire but to a fall in the rate of interest. The way to recognize the loss is analogous. A new entry in the asset column must be created under the heading "capital fund to cover shortfall due to capitalizing interest payments at a lower rate" with an equivalent entry in the liability column to be amortized through a stream of payments out of future income. This procedure is not an exercise in pedantry. It is the 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 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 bookkeeping that I have perused (although I have seen the Law of Assets in older textbooks that have been discarded). But I shall argue that both Laws follow 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, where the government allowed 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 Japanese banks, including those that not so many years ago were among the world's ten largest, to understate the value of their liabilities. Hence they could eventually report their 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. A previously vibrant national economy has been brought to its knees, creating deflation, depression, or worse. The cancer of depression has been metastasizing across the Pacific through the yen-carry trade, foolishly encouraged by the Fed 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 urge to follow Japan's jump into the abyss of the Black Hole of zero interest. The result, perfectly predictable, has been 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 desire to suppress the rate of interest by hook or crook. However, their efforts have been counter-productive. The usuriously high rates charged on loans in pre-capitalistic times were not due to an alleged greed of the usurers, but 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 have 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 difficult 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. (The practice was later legalized through ex post facto legislation.) 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 Fed by purchasing the bonds beforehand. After the Fed has bought its quota, speculators could dump the bonds and pocket their profits. 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. 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 matches this misinterpretation of the value of open market operations 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 economists. They ignored the fact that the only competitor for government bonds, gold, had been knocked out through confiscation, or the threat thereof, as well as other measures of intimidation. When, finally, Britain and the United States left the gold standard, government bonds were freed from their only competitor. The value of those bonds started to rise, making interest rates fall and causing prices to follow suit. The Great Depression was self-inflicted. Governments in their zeal fired the policeman cordoning off the Black Hole of zero interest to prevent interest rates from falling in.

Speculators were quick to understand that removing the policeman 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, both measures worked towards establishing a falling rate trend.

Paying out phantom profits

Superficial thinking may suggest that if the rise of interest rates is bad for the economy, then their fall is good. 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 for them.

My critics hold that falling rates are always beneficial to business and that 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. This fact ought to be registered as a loss in the balance sheet, and 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 will wonder what has hit them. Their downfall will be due to insufficient capital. They will not understand that they have failed to augment their capital in the face of falling interest rates. In a falling interest rate environment, all firms are affected by the elusive process of capital destruction. This principle was true in the 1930's; it is still true today. Incidentally, this principle 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! After all, the Fed has the printing presses to create dollars with which any liability can be liquidated, however large.

Cause: falling interest rates – effect: falling prices

American producers are not so fortunate. 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. The cause of deflation is not falling prices: it is falling interest rates. The fall in prices is the effect. Let's spell out how this mechanism works. As interest rates fall, a vicious spiral is set in motion: lower rates sending prices lower, and lower prices sending 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 bankrupts 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. 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 its 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 Fed's 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 - a lesson from the revisionist theory of depressions that has been ignored by economists.

Putting bank ratios in the vise

As the current global banking and credit crisis shows, the destruction of the capital of the producing sector goes hand-in-hand with the destruction of the capital of the financial sector. Falling interest rates shrink bank capital across the board without the shrinkage being detected. All banks are weakened simultaneously. They should have augmented their capital or reduced their assets in the face of falling interest rates. They have 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 the right and on the left. 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 on them that, in fact, what they were paying out in the form of dividends and compensation were phantom profits. These payments compounded the problem of capital erosion. By 2008, the banks had 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 Fed 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 Fed 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 became irresistible. At that point the deflationary spiral got out of control.

The reality 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 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 would keep for the next forty years. Now the U.S. is the largest debtor nation in the world, and 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 as 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 than there was no derivatives tower then, whereas we have one now that threatens the world economy when it topples. Only the tip of the derivatives iceberg has been identified by the captain of this 'unsinkable' Titanic, 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 the policy-makers as they desperately stick to their long-since discredited Keynesian nostrums. Every measure they propose is counter-productive. 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. To be sure, the world suffers from blood poisoning caused by irredeemable currency. This problem has to be addressed first.

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 on 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 Fed must be outlawed and risk-free speculation in bonds must be stopped, as 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 rehabilitation is unlikely to happen because it would be too 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 the social fabric threatens the survival of our civilization.

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 of whether America can reclaim control over its destiny, saving Western Civilization in the process.

APPENDIX (Follow-up insight):

THE VICIOUS SPIRAL OF FALLING INTEREST RATES
As a Causal Factor of Deflation

Dear Mr. South:

Thank you for writing. You ask me to shed more light on the causal relationship between persistently falling interest rates and deflation, which is described in my article The Revisionist Theory and History of Depressions.

Let me fix the meaning of the word "linkage" as the correlation, subject to leads and lags, between the price level and the rate of interest. If you analyze it, you will come up with four propositions:

(1) rising prices induce rising interest rates

(2) rising interest rates induce rising prices

(3) falling prices induce falling interest rates

(4) falling interest rates induce falling prices

The first three propositions are uncontroversial. I shall focus on (4): as interest rates fall persistently, they will ultimately result in a fall in the price level, that is synonymous with Gibson's Paradox.

I establish this correlation by showing that falling interest rates destroy capital through increasing the liquidation value of debt. You have objected to my contention by stressing that falling interest rates also increase the present value of assets financed by that debt, which purportedly compensates for the increase in the liquidation value of debt in the balance sheet. However, the firm will benefit from the increase in the present value of assets only if it is still around to collect the additional income. It may not be. If it is bankrupted by the increased debt burden, then the question of being helped by an increase in the present value of assets is academic.

What we are talking about here is accounting principles. In the balance sheet you must report assets at acquisition value, or at market value — whichever is lower but, at the same time, you ought to report liabilities at their value at maturity or at liquidation value — whichever is higher. It is clear that there is no compensation for the increase in the liquidation value of debt. The capital destruction is real. We have no right to assume that the firm will benefit from a higher present value of its assets.

Now here is the chain of causation leading to a falling price level. Persistently falling interest rates destroy capital. A key point in my argument is that the firms are not aware that their capital is being seriously eroded and they do not replenish capital impaired by falling interest rates. Capital destruction is an insidious process. Firms cheerfully report losses as profits and blithely pay out phantom profits in dividends and in compensation, weakening the capital structure further. Producers have to sell more if they don't want to sink deeper into debt. But selling more is not possible in a falling interest-rate environment except, perhaps, at fire-sale prices. Why? Because all firms are trying to do it at the same time, since all of them are subject to the same squeeze on capital simultaneously. As a

result, producers lose pricing power. Competition, which is a constructive force only as long as firms have an adequate capital base, has become destructive.

To summarize, persistently falling interest rates bankrupt productive enterprise that could not extricate itself from the clutches of debt, which had been contracted earlier at higher rates. The debt becomes ever more onerous as its liquidation value escalates past the ability to carry it. Thus the squeeze on capital imparts a falling tendency to the price level, causing serial bankruptcies in the economy among the producers. The cause of deflation is not falling prices: it is falling interest rates. Falling prices is the effect.

Consider now the vicious spiral: as interest rates fall, they send prices lower. Then lower prices send interest rates lower still. Why? Well, the producers are squeezed by the lower prices. They cry out for more money. The central bank obliges. It creates more money through its open market purchases of bonds. This gives an opportunity to bond speculators to earn risk-free profits: all they have to do is to front-run the central bank in buying the bonds first, and to dump them into the lap of the central bank at a higher price afterwards. True, the central bank has accomplished its mission: there is more money in circulation as a result of its intervention in the market. But, alas, the new money is not going to the commodity market, or to the stock market, or to the real estate market, to bid up prices there, as the central bank had hoped it would. Rather, it is going to the bond market, where the fun is. Bond speculators grab the new money and buy more bonds for the risk-free profit which is theirs for the taking. Bond prices rise further. The result is: still lower interest rates. The loop in the vicious spiral is now repeated at a lower level.

The central bank set off the vicious spiral of collapsing interest rates but, once it started, the spiral would feed upon itself and run its full course. The central bank couldn't stop it, except by stopping the inflation of the money supply through open market purchases of bonds.

Please note: none of this would happen under a gold standard as it makes interest rates stable and bond speculation non-existent.

I hope this will help to clarify the causality nexus involved in the vicious spiral of falling interest rates and deflation.

Professor Fekete

May 2, 2009.

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Welcome to the Intersection of Free-Market Economics and Investment Profitability

My name is Albert Kessler and I am proud to be the chairman of one of the most unique publishing houses in all the world, Appenzeller Business Press AG (ARBP). ARBP is located in the scenic Swiss region of Appenzell - one of the last bastions of free market thinking, culture and tradition. Appenzell is renowned for its free market traditions, respect for personal liberty, rejection of government intervention and reverence for Austrian economic principles.

Still to this day, Appenzellers gather each year in the village square to take part in one of the world's oldest and purest forms of direct democracy, the Landsgemeinde. It's a centuries old tradition that happens just minutes from our offices. Eligible citizens meet openly in the village square to decide on laws and expenditures by the council. Everyone can debate a question. And those in favor of an issue signify their vote by simply raising their arm in the air for all to see.

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Sincerely,

Albert Kessler
Chairman, Appenzeller Business Press AG

P.S. Thank you for taking the time to read through this Special Report. We are confident you find many practical ideas and useful solutions that can help empower you to a make better-informed social, political and financial decisions.