

GOTTERDÄMMERUNG

The Twilight of Irredeemable Debt

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Wagner's opera *Gotterdammerung* is about the twilight of pagan gods. The most powerful of the latter-day pagan gods that has been guiding the destinies of humanity for the past two-score of years is Irredeemable Debt. Before August 14, 1971, debts were obligations, and the word "bond" was to mean literally what it said: the opposite of freedom. The privilege of issuing debt had a countervailing responsibility: that of repayment.

On that fateful day all that was changed by a stroke of the pen. President Nixon embraced the woolly theory of Milton Friedman and declared the irredeemable dollar a Monad, that is, a thing that exists in and of itself. According to this theory the government has the power to create irredeemable debt — debt that never needs to be repaid yet will not lose its value — subject only to a "quantity rule", e.g., it must not be increased by more than 3 percent annually. This idea is so preposterously silly that "only very learned men could have thought of it". If the thief is thieving modestly, then he will not be detected. It never occurred to the professors of economics and financial journalists that a modest thief is an oxymoron, a contradiction in terms. How did they get to believing in irredeemable debt? The explanation is most likely found in Schiller's dictum: "Anyone taken as an individual is tolerably sensible and reasonable. But taken as a member of a crowd — he at once becomes a blockhead". Economics professors and financial journalists are no exception.

For a time it appeared that Milton Friedman was right. The world has become dedicated to the proposition that it is possible, even desirable, to expand irredeemable debt in order to make the economy prosper. Never mind the default of the U.S. government on its bonded debt held by foreigners. Never mind people victimized by theft. Thanks to the quantity rule, they will never notice the difference.

For all its seductive attractiveness Friedmanite economics is ignoring the effect of irredeemable debt on productivity. It watches debt per GDP and is happy as long as this ratio stays below 100 percent by a fair amount. However, what should be watched is the ratio of additional debt to additional GDP. By that indicator the patient's condition could be diagnosed as that of pernicious anemia. It set in immediately after the dollar debt in the world was converted into irredeemable debt. The increase in GDP brought about by the addition of \$1 of new debt to the economy is called the marginal productivity of debt. That ratio is the only one that matters in judging the quality of debt. After all, the purpose of contracting debt is to increase productivity. If debt volume rises faster than national income, there is big trouble brewing, but only the marginal productivity of debt is capable of revealing it.

Before 1971 the introduction of \$1 new debt used to increase the GDP by as much as \$3 or more. Since 1971 this ratio started its precipitous decline that has continued to this day without interruption. It went negative in 2006, forecasting the financial crisis that broke a year later. The reason for the decline is that irredeemable debt causes capital destruction. It adds nothing to the per capita quota of capital invested in aid of production. Indeed, it may take away from it. As it displaces real capital which represents the deployment of more and better tools, productivity declines. The laws of physics, unlike human beings, cannot be conned. Irredeemable debt may only create make-belief capital.

By confusing capital and credit, Friedmanite economics obliterates truth. It makes the cost of running the merry-go-round of debt-breeding disappear. It makes capital destruction invisible. The stock of accumulated capital supporting world production, large as it may be, is not inexhaustible. When it is exhausted, the music stops and the merry-go-round comes to a screechy halt. It does not happen everywhere all at the same time, but it will happen everywhere sooner or later. When it does, Swissair falls out of the sky, Enron goes belly-up, and Bear-Sterns caves in.

The marginal productivity of debt is an unimaginative taskmaster. It insists that new debt be justified by a minimum increase in the GDP. Otherwise capital destruction follows — a most vicious process. At first, there are no signs of trouble. If anything the picture looks rosier than ever. But the seeds of destruction inevitably, if invisibly, have sprouted and will at one point paralyze further growth and production. To deny this is tantamount to denying the most fundamental law of the universe: the Law of Conservation of Energy and Matter.

The captains of the banking system in effect deny and defy that basic law. They are leading a blind crowd of mesmerized people to the brink where momentum may sweep most of them into the abyss to their financial destruction. Yet not one university in the world has issued a warning, and not one court of justice allowed indictments to be heard from individuals and institutions charging that the issuance of irredeemable debt is a crude form of fraud, calling for the punishment of the swindlers issuing it, whether they are in the Treasury or in the central bank. The behavior of universities and courts in this regard could not be more reprehensible. Rather than acting to protect the weak, they act to cover up plundering by the mighty.

The inconspicuous beginnings of irredeemable debt have blossomed into a colossal edifice, a fantastic debt tower that is bound to topple upon the prevailing complacency and apathy. Actually 'tower' is a misnomer. Rather, what we have is an inverted pyramid, a vast and expanding superstructure precariously balanced on a tiny and ever-shrinking gold foundation — the only asset in existence with power to reduce gross debt. The construction has no precedent in history, and no place in theory, whether Ricardian, Walrasian, Marxian, Keynesian or Austrian. As a matter of fact, no one is analyzing the process. Research has been placed under taboo by the powers that be, lest diagnosis reveal the presence of cancer caused by irredeemability. There is no known pattern or model that would apply to its mechanism in terms of equilibrium analysis. Two negative conclusions emerge. One is that the edifice of irredeemable debt must grow at an accelerating pace as markets for derivatives providing 'insurance' to holders of debt proliferate. The insurer of debt must also be insured, as must the insurer of the insurers, and so on, ad infinitum. This is due to the fact that the risk of collapsing bond values has been created by man. In contrast, the risk of price changes of agricultural commodities are created by nature, and the futures market provide insurance, with no need to re-insure. The other conclusion is that the unwieldy size of the debt structure excludes the possibility of a normal correction: a major liquidation would dwarf the calamities of the Great Depression.

It is a delusion to think that the government can splatter debt all over the economic landscape to cover up its warts, and reap everlasting prosperity as a result. The stimulation and leverage of debt has always caused stock markets to boom, so that the impact of debt was aided and magnified by the added paper wealth which, in turn, increased the propensity to spend and borrow still more. Businessmen are supposed to be more realistic in contracting debt. Yet the pattern of increase in corporate debt has also changed tremendously. Whereas traditionally corporations used to finance their capital needs in a ratio of \$3 in debt for every \$1 in stock, in the years leading up to 1971 they issued \$20 in debt for every \$1 in stock, with the ratio sky-rocketing thereafter.

We hear arguments that economists have by now learned how to control the economy with the so-called built-in stabilizers. Debt has largely lost its sting as a consequence, we are told. For example, bank deposits can now be insured. They couldn't in the 1930's. But when the government itself is loaded with debt, and runs boom-time deficits, the built-in stabilizers may

backfire and destabilize the economy further. The government has commitments so great that its endeavor to offset a depression in our vast economy can only result in a loss of confidence. Anxious withholding of purchasing power in the private sector could far outweigh anything the government can add. To make matters worse, government income is highly dependent on a prosperous economy. The magnitude of the problem of offsetting a depression is grossly disproportionate to resources available.

One of the marks of great delusions is that nearly everyone tends to share them. It is a sorry tale — any delusion gives rise to a rude awakening in due course. Public attitudes to debt have changed so radically since 1971 that today indebtedness is practically a status symbol, instead of a shameful condition it used to be in a by-gone era. The most striking reversal in traditional American attitudes towards debt is the widespread acceptance of perpetual national indebtedness, copied by perpetual personal indebtedness — a never-ending lien on future income.

Perhaps the worst aspect of the regime of irredeemable debt is the lowest level of morals followed by governments in modern history. It is epitomized by an elaborate check-kiting conspiracy between the U.S. Treasury and the Federal Reserve. Treasury bonds, contrary to appearances, are no more redeemable than Federal Reserve notes. It's all very neat: the notes are backed by the bonds, and the bonds are redeemable by the notes. Therefore each is valued in terms of itself, rather than by an independent outside asset. Each is an irredeemable liability of the U.S. government. The whole scheme boils down to a farce. It is check-kiting at the highest level. At maturity the bonds are replaced by another with a more distant maturity date, or they are ostensibly paid in the form of irredeemable currency. The issuer of either type of debt is usurping a privilege without accepting the countervailing duty. They issue obligations without taking any further responsibility for their fate or for the effect they have on the economy. Moreover, a double standard of justice is involved. Check-kiting is a crime under the Criminal Code. That is, provided that it is perpetrated by private individuals. Practiced at the highest level, check-kiting is the corner-stone of the monetary system.

But our world is still one of crime and punishment, tolerating no double standard. The twilight of irredeemable debt is upon us. The sign is that banks are reluctant to take the promissory notes of one another. Significantly, this also includes overnight drafts. The banks know there is bad debt at large, and they don't want to be victimized by taking in some inadvertently. What the banks don't yet know, but will soon learn, is that all irredeemable debt is bad debt, and there is no way to rid the system of poison through administering more.

Redeemability of debt is not a superfluous embellishment. It has a function of fundamental importance: the proper allocation of resources to the different channels of their utilization. The obligation to redeem debt hangs as the sword of Damocles over the government, just as it does over the head of every economic participant. It compels economy and foresight. It forces balancing of income and expenditures. It adjusts claims and commitments. It limits expansion by shifting resources away from the incompetent, and away from unhealthy projects. The regime of irredeemable debt creates an escape route from commitments by the promise of eliminating the pressure of solvency. Whether it promises eternal prosperity, or it promises eternal subsidies, it does not matter. The results are the same. They consist in misleading people, enticing them to skate on thin ice, and luring them into financial adventures, private or public, which are not warranted by the ability to pay. The logical consequence is wholesale bankruptcy of individuals as well as that of the political setup. Losses breed more losses, until they become an avalanche. The present crisis is just the first sign of that denouement. More is on the way.

It is still possible to escape the catastrophe which this process would entail. The way out is to open the U.S. Mint to gold and silver, as advocated by presidential candidate Dr. Ron Paul. The logic of this remedy is that it would mobilize potentially unlimited resources, presently tied up in idled gold, and re-introduce the indispensable means of debt-retirement into the economy.

Failing to bring gold back, where are we heading? The short answer is: we are marching into the death-valley of collectivism. The alternative to re-introducing redeemable currency is that the debt-behemoth will force the imposition of a capital-levy type of taxation — à la Solon, 594 B.C.

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Session Four is to take place in Szombathely, Hungary (at Martineum Academy where the first two sessions were held). The subject of the 13-lecture course is The Bond Market and the Market Process Determining the Rate of Interest (Monetary Economics 201). The date is: July 3-6. For more information please see www.professorfekete.com/gsul.asp or contact GSUL@t-online.hu. Registration can be made by e-mail, and by payment of the pre-registration fee. The remainder of the registration fee must be paid at least 3 weeks before the session starts.

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