A CRITIQUE OF THE QUANTITY THEORY OF MONEY

Further evidences of the onset of Great Depression II

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In my previous paper *The Revisionist Theory and History of Depressions* I argued that persistently falling interest rates cause an erosion of capital, unseen but nonetheless lethal. Producers are squeezed and try to survive by cutting prices. Lower prices add to pressures lowering interest rates, and a vicious spiral is set in motion. Thus money-creation by the Fed has a little-noticed deflationary side-effect to it, that may ultimately overwhelm the inflationary effect, in spite of predictions by the Quantity Theory of Money.

Money out of the thin air?

Detractors of our fiat money system (myself *not* included) are fond of saying that "the Fed is creating money out of the thin air." If that were true, then the Quantity Theory of Money (QTM) might be valid implying that the present runaway money-printing exercise would indeed lead to hyperinflation before long. How could anyone suggest that the denouement will be deflationary after all?

I maintain that the Federal Reserve banks are *not* creating money out of the thin air. In fact, they must first post collateral with the Federal Reserve Agent (who is not under the jurisdiction of the Fed but under that of the government). Only after the collateral has been posted can they create a commensurate amount of Federal Reserve notes and deposits. Typically, the collateral is U.S. Treasury bills, notes, or bonds, purchased in the open market on behalf of the Fed's Open Market Committee.

Because open market purchases of Treasury paper have consequences, we must examine them before passing a judgment on the validity of the QTM. Such an examination is always side-stepped by the devotees of the QTM. What are those consequences? They are the effect of open market operations on the rate of interest. Since open market purchases of the Fed involve bidding up the price of government obligations which varies inversely with the rate of interest, we can say that they will make interest rates fall. (To be sure, on occasion, the Fed may be a seller of Treasury paper but, on a net basis, it has been a buyer every single year.)

This means that the regime of irredeemable currency, depending as it is on the open market operations of the Fed for its existence, imparts a definite bias to the interest rate structure establishing a *falling trend*, whereas interest rates would be stable in the absence of that regime. This in itself is a condemnation of irredeemable currencies as they introduce an unwarranted bias into the economy favoring debtors and spenders while punishing creditors and savers. In addition, it favors the financial sector at the expense of the producing sector. Falling interest rates, as opposed to low but stable ones, are detrimental to productive capital.

Thus we have two effects to reconcile as a consequence of money-creation by the Fed: an inflationary and a deflationary one. We cannot say which of these two forces will ultimately prevail without digging deeper.

Risk free bond speculation

In the actual case there are other important forces at play, which are induced by the Fed's open market purchases. We have to take into account bond speculation, a permanent fixture on the monetary firmament since 1971 when the U.S. government defaulted on its gold obligations to foreign governments and central banks. (There was *no* bond speculation before, for reasons having to do with the lack of sufficient variation in the rate of interest, making such speculation unprofitable.) Analysts and financial writers hardly ever consider bond speculation as a factor in the money-creating process. For this reason alone, their predictions are practically always worthless.

The fact goes virtually unrecognized that *open market operations render bond speculation risk free*. All the speculators have to do is to second-guess the Fed. They know that the Fed must be a net buyer. They know the identity of the agents the Fed is using to execute its purchase orders, and stalk them. Speculators study the same monetary statistics which the Fed itself is using to determine the timing of its open market purchases. Can the Fed outsmart speculators? Hardly. The Fed is run by bureaucrats and their trading losses are 'on the house'. By contrast, the speculators risk their own fortune. They are certainly smart enough to detect false-carding on the part of the Fed. Even if we assume that they have no inside information (which is a rather naïve assumption), the speculators can easily front-run the Fed's open market purchases.

The presence of risk-free bullish bond speculation imparts a huge additional bias to the economy, virtually guaranteeing a falling interest-rate structure, as demonstrated by the past quarter of a century, during which interest rates have been driven down from the high teens to close to zero. It may distort the ultimate outcome of this latest tragic experimentation with irredeemable currency. No longer can it be taken for granted that the denouement of unlimited money-creation will be hyperinflation with the Federal Reserve notes rapidly losing purchasing power. On the contrary, it could be an unprecedented deflation with the Federal Reserve notes being hoarded by the people, firms, and institutions as their purchasing power is actually increasing (in fact, they are already being hoarded by foreigners in the second and third world countries in unprecedented amounts). The dollar will not be the first among irredeemable currencies to be annihilated in this latest hecatomb of currencies. It will be last one.

Price wars

The QTM is a linear model that may be valid as a first approximation, but fails in most cases as the real world is highly non-linear. My own theory predicts that it is not hyperinflation but a vicious deflation which is in store for the dollar. Here is the argument.

While prices of primary products such as crude oil and foodstuffs may initially rise, there is no purchasing power in the hands of the consumers, nor can they borrow as they used to do in order to pay the higher prices much as though they would like to do, to support it. The newly created money is going into bailing out banks, much of it being diverted to continue paying bloated bonuses to bankers. Very little, if any of it has "trickled down" to the ordinary consumer who is squeezed relentlessly on his debts contracted when interest rates were higher.

It turns out that the price rises are unsustainable as the consumer is unable to pay them. They will have to be rescinded. Retail merchants will start a damaging price war underbidding one another. Wholesale merchants are also squeezed. They have to retrench. Pressure from vanishing demand is further passed on to the producers who have to retrench as well. All of them experience ebbing cash flows. They lay off more people. This aggravates the crisis further as cash in the hand of the consumers diminishes even more through increased unemployment. The vicious spiral is on.

But what is happening to the unprecedented tide of new money flooding the economy? Well, it is used to pay off debt by people desperately scrambling to get out of debt. Businessmen are lethargic; every cut in the rate of interest hits them by eroding the value of their previous investments. In my other writings I have explained how falling interest rates make the liquidation value of debt rise, which becomes a negative item in the profit-and-loss statement eating into capital of businesses. Capital ought to be replenished but isn't.

Worse still, there is no way businessmen can be induced to make new investments as long as further reductions in the rate of interest are in the cards. They are aware that their investments would go up in smoke as the rate of interest fell further in the wake of "quantitative easing".

Self-fulfilling speculation on falling interest rates

The only enterprise prospering in this deflationary environment is bond speculation. Speculators corner every dollar made available by the Fed, and use it to expand their activities further in bidding up bond prices. They have been told in advance that the Fed is going to move its operations from the short to the long end of the yield curve. It will buy $300 billion worth of longer dated Treasury issues during the next six months. It is likely that it will have to buy much more after that. Speculation on falling interest rates becomes self-fulfilling, thanks to the insane idea of open market operations making, as it does, bullish bond speculation risk-free and bearish bond speculation suicidal. Deflation is made self-sustaining.

Investors are urged by the Treasury and the Fed to invest in the toxic assets of the failing banking system. They are offered incentives if they do, making it appear that speculating in toxic assets has been made risk free as well. So the choice before the investors is either investing in toxic assets for which there is no market, or invest in Treasury paper which bond speculators and foreigners are scrambling to get. Naturally, they will choose the latter. They don't want to be taken for a ride by the Treasury and the Fed. The idea to offer incentives to investors to make them buy toxic assets is preposterous.

Marginal productivity of debt

Another way to understand the problem is through the *marginal productivity of debt*. This is the ratio of *additional GDP to additional debt*, or the amount of new GDP contributed by the creation of $1 in new debt. It is this ratio that determines the *quality of total debt*. Indeed, the higher the ratio, the more successful entrepreneurs are in increasing productivity, which is the only valid justification for going into debt in the first place. The concept is due to the Hungarian-born Chicago economist Melchior Palyi (1892-1970), although its name has been introduced after he died.

Palyi started watching this ratio in the United States in 1945. Initially it was 3 or higher, meaning that every dollar of new debt contracted contributed $3 to GDP. However, subsequently the ratio went into a decline and twenty years later it was around 1. Palyi ran a weekly column in *The Commercial and Financial Chronicle* entitled *A Point of View*. On January 2, 1969, he publicly warned president-elect Nixon in his column that the country is adding $2 in debt for every $1 increase in GDP (in other words, the marginal productivity of debt is ½).

> “Does Mr. Nixon realize the kind of ‘heritage’ he is taking over? That he is supposed to keep up a rate of economic growth or even improve on the same, a rate that stands or falls with an utterly reckless mortgaging of the future?... Presently, the volume of outstanding debt is rising faster than the gross national product… True, most of the new debt — other than that of the federal government — has a ‘counterpart’ in real assets: homes, automobiles, plants and equipment, etc. But their value in dollars is unpredictable, while the debts are due in a fixed number of dollars…
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> “Trading on the Equity was the earmark of the 1920’s. The ‘House of Credit Cards’ broke down as the first cold wind — a serious decline in commodity prices — hit the structure of artificially inflated values of real estate and equities. The more debt had been piled up, the higher went the stock market. And so it goes today, only more so. A new generation of operators has arisen, one that has not witnessed as yet a wholesale debt-liquidation. The experience of the fathers is lost on the sons. The dream of Eternal Prosperity is replaced by the mirage of Perpetual Inflation. More is at stake than mere economics. A ‘new frontier’ has captured the imagination: ‘Young man, go in debt!’ Debt has become a status-symbol — in addition to being a prime source of riches. Automobile sales hit new records because millions of Americans buy (on down payment) new cars before they have finished paying for the old ones… True, to some extent rising living standards reflect extraordinary technological progress. But the ultimate base is, largely, the ability **not** to pay — to rely on the ability to borrow ever more.”

As we know, in 1969 president Nixon did not listen to sound advice. As president Obama forty years later, he appointed dyed-in-the-wool Keynesian and Friedmanite advisers. The concept of marginal productivity of debt is curiously missing from the vocabulary of mainstream economists. They are watching the wrong ratio, that of the GDP to total debt, and take comfort in the thought that by that indicator ‘there is lots more room’ to pile on more debt. As a consequence, the marginal productivity of debt went into further decline. This was a danger sign showing that additional debt had no economic justification. The volume of debt was rising faster than national income, and capital supporting production was eroding fast. If, as in the worst-case scenario, the ratio fell into negative territory, the message would be that the economy was on a collision course with the iceberg of total debt and crash was imminent. *Not only does more debt add nothing to the GDP, in fact, it necessarily causes economic contraction, including greater unemployment.* Immediate action is absolutely necessary to avoid collision that would make the ‘unsinkable’ economy sink.

The watershed year of 2006

As long debt was constrained by the centripetal force of gold in the system, tenuous though this constraint may have been, deterioration in the quality of debt was relatively slow. Quality caved in, and quantity took a flight to the stratosphere, when the centripetal force was cut and gold, the only *ultimate* extinguisher of debt there is, was exiled from the monetary system. Still, it took about 35 years before the capital of society was eroded and consumed through a steadily deteriorating marginal productivity of debt.

The year 2006 was the watershed. Late in that year the marginal productivity of debt dropped below zero for the first time ever, switching on the red alert sign to warn of an imminent economic catastrophe. Indeed, in February, 2007, the risk of debt default as measured by the skyrocketing cost of CDS (credit default swaps) exploded and, as the saying goes, the rest is history.

Negative marginal productivity

Why is a negative marginal productivity of debt a sign of an imminent economic catastrophe? Because it indicates that any further increase in indebtedness would inevitably cause further economic contraction. Capital is gone; production is no longer supported by the prerequisite quantity and quality of tools and equipment. The economy is literally devouring itself through debt. The earlier message, that unbridled breeding of debt through the serial cutting of the rate of interest to zero was destroying society's capital, has been ignored. The budding financial crisis was explained away through *ad hoc* reasoning, such as blaming it on loose credit standards, subprime mortgages, and the like. Nothing was done to stop the real cause of the disaster, the fast-breeder of debt. On the contrary, debt-breeding was further accelerated through bailouts and stimulus packages.

In view of the fact that the marginal productivity of debt is now negative, we can see that the damage-control measures of the Obama administration which are financed through creating unprecedented amounts of new debt, are counter-productive. Nay, they are the direct cause of further economic contraction of an already prostrate economy, including unemployment.

The head of the European Union and Czech prime minister Mirek Topolanek has publicly said that the plan to spend nearly $2 trillion to push the U.S. economy out of recession is "road to hell". There is no reason to castigate Mr. Topolanek for his characterization of the Obama plan. True, it would have been more polite and diplomatic if he had couched his comments in words to the effect that "the Obama plan was made in blissful ignorance of the marginal productivity of debt which was now negative and falling further. In consequence more spending on stimulus packages would only stimulate deflation and economic contraction."

President Obama, like president Nixon before him, missed an historic opportunity in not ordering a complete change of guards at the Treasury and at the Fed. Now the same gentlemen who have landed the country and the world in this unprecedented débâcle are in charge of the rescue effort. The QTM, the corner stone of Milton Friedman's monetarism, is the wrong prognosticating tool. The marginal productivity of debt is superior as it focuses on deflation rather than inflation.

The financial and economic collapse of the past two years must be seen as part of the progressive disintegration of Western civilization that started with the sabotaging of the gold standard by governments exactly one hundred years ago when in France and in Germany paper money was made legal tender. The measure was introduced in preparation to the coming war, so that the government could stop paying the military and the civil service in gold coins, starting in 1909.

Fed Chairman Ben Bernanke, who should have been fired by the new president on the day after Inauguration for his part in causing the cataclysm, a couple of years ago foolishly boasted that the government has given him a tool, the printing press, with which he can fight off deflations and depressions, now and forever. The reference to the GTM is obvious.

Now Bernanke has the honor to administer the *coup de grâce* to our civilization.

April 15, 2009

Reference

The Revisionist Theory and History of Depressions, see:
www.professorfekete.com

Calendar of Events

Instituto Juan de Mariana: Madrid, Spain, June 12-14, 2009

Seminar with Prof. Fekete on Money, Credit, and the Revisionist Theory of Depressions
For information, contact: gcalzada@juandemariana.org

OroY Finanzas & Portal Oro: Madrid, Spain, June 18, 2009

Gold and Silver Meeting Madrid 2009
For information, contact: preukschat_alex@hotmail.com or
gcalzada@juandemariana.org or
http://www.portaloro.com/aemp.aspx or
info@portaloro.com

San Francisco School of Economics: A Series of three Investment Seminars:

July 25; August 1; and August 8, 2009

The Gold and Silver Basis; Backwardation; Trading Gold in the Present Environment; Wealth Management under the Regime of Irredeemable Currency. Given by Professor Fekete and Mr. Sandeep Jaitly of Soditic Ltd., London, U.K. Enrolment is limited, first come first served. For more information, see: www.sfschoolofeconomics.com

San Francisco School of Economics: July 27-August 7, 2009

Money and Banking, a 20-lecture course given by Professor Fekete. Enrolment is limited; first come, first served. The Syllabus for this course can be seen on the website: www.professorfekete.com, see also: www.sfschoolofeconomics.com

University House, Australian National University, Canberra: first week of November, 2009

Peace and Progress through Prosperity: Gold Standard in the 21st Century

This is the first conference organized by the newly formed Gold Standard Institute.

For further information, e-mail: feketeaustralia@gmail.com ,

On the Gold Standard Institute, e-mail philipbarton@goldstandardinstitute.com

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