FIAT CURRENCY: DESTROYER OF CAPITAL

Captains of American industry should issue a Mayday call

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Summary for the busy executive

The true story of de-industrialization in America has never been told. The boat of American industry has collided with the iceberg of falling interest-rate structure. The damage to capital is great and the boat is sinking. Auto manufacturing could go the way of TV and VCR manufacturing that went down in the 1980's without the captains knowing what has hit them. Commentators blamed the demise on Asian sweatshops, on American consumer preference for services, and on the alleged rigidity of foreign exchange rates. These explanations reflect warped official thinking as well as the false teachings of mainstream economics. The true explanation can be found in the phenomenon of 'linkage' that translates falling interest rates into falling prices. There is a vicious process of destroying industrial capital under a falling interest-rate structure. This observation also shows the way out. Remedy is to be found not in more flexibility of foreign exchange rates but *a return to the system of fixed exchange rates.* The only known way to stabilize interest rates is an immediate return to the gold standard. During this presidential election year we have, for the first time in half-a-century, the possibility to debate the merits of the gold standard, thanks to Dr. Ron Paul's candidacy for the Republican nomination. The challenge is enormous. Conventional wisdom maintains that falling interest rates are good for capital. They are not. They are lethal. Fiat currency is the destroyer of industrial capital.

Financial capital: vampire of productive capital

Fiat currency is a thoroughly toxic agent as it insidiously destroys capital through the destabilization of the interest rate structure. More precisely, the capital of industry is surreptitiously siphoned off to enrich bond speculators. Financial capital has become the vampire sucking the blood of productive capital. Here is what happens. The rate of interest measures the marginal productivity of capital. As I shall point out, capricious changes in marginal productivity, whether up or down, destroy productive capital to no better end than to prop up and perpetuate a reactionary and unconstitutional monetary regime that has the effect of exploiting savers, producers, and consumers alike for the benefit of simonious politicians, corrupt bankers, and parasitic bond speculators.

A primer on productivity

There is a great deal of confusion in the public's mind about productivity. For example, it is widely assumed that an increase in the marginal productivity of capital is beneficial to society. This is wrong. Just the opposite is true. An increase in the marginal productivity of capital means that a lot of industrial plant and equipment has become submarginal, are idled, making their labor complement superfluous. Unemployment is the result. Some people who understand this believe that the opposite, decreasing marginal productivity, is beneficial to society for the opposite reason: formerly idled plant and equipment are now pressed into service, relieving unemployment. Wrong again. Under globalization decreasing marginal productivity means driving capital abroad in search for cheap labor. Industrial capital and jobs are being exported. Unemployment becomes chronic.

Fiat currency drives capital and jobs abroad

It is a mistake to blame „Asian sweatshops" for increasing unemployment. America has coexisted with cheap Asian labor for its entire history. The latter was a benefit rather than a threat to American prosperity under the gold standard. It only became a threat under fiat currency, since gyrating interest rates caused the divorce of American capital and labor. Capital goes abroad to look for a new labor partner. As it migrates, well-paid American jobs migrate with it never to come back. Notice that the exportation of American jobs would not have occurred if the interest-rate structure in America had been stable, as under the gold standard, bonding the partnership between labor and capital.

Marginal productivity

Let's see what is meant by marginal productivity and expose the popular misconceptions about it. Each individual plant and equipment has its own productivity. It can be calculated as the annualized percentage of increase in value added: output minus input. We rank all plants and equipment in existence according to increasing productivity. Those at the low end of the productivity spectrum will be left idle since the opportunity cost of employing them would be too high. There is a cut-off point marking the *marginal item* in the productive apparatus of society. It is that (variable) piece of equipment or individual plant that is still employed in productive activity, but all others with a lower productivity are idle. The productivity of the marginal item is called the *rate of marginal productivity of capital* (for short, marginal productivity). If marginal productivity increases, productive plant and equipment become submarginal and get laid off, resulting in a divorce between labor and capital. The labor complement of submarginal capital also gets laid off causing unemployment. On the other hand, as marginal productivity falls, certain previously submarginal plants and equipments will become productive again — in theory. In practice, however, capital is looking for new labor partners. Since it is not committed to remarry its previous partner, under our fiat currency system capital will migrate abroad in search of cheap labor. In effect, both industrial capital and jobs are exported.

The rate of interest

Marginal productivity is determined by the rate of interest. The latter is that rate at which the stream of income payments from coupons plus the payment of principal at maturity amortize the (variable) market price of the bond. This means that the rate of interest is determined by the bond market. Hence, it is a market phenomenon. Moreover, it varies inversely with the bond price, since the present value of an income stream varies inversely with the rate of interest (or, saying it differently, capitalizing the same stream of payments at a lower rate of interest results in a higher capital value).

Clearly, bonds compete with industrial capital as an investment outlet to produce income. Because of this competition marginal productivity can be identified with the ceiling of the rate of interest. To see this in more detail look at the arbitrage of the capitalists. They will not let the two rates deviate from one another. If the rate of interest is higher, they will sell industrial capital and put the proceeds into higher-yielding bonds. Even if they can't sell, at the very least they stop production and capital maintenance, abolish depreciation quotas and use the savings to buy the low-priced bond. If consequently the rate of interest drops, that is, bond prices rise, then capitalists take profit in selling the bond, buy new industrial plant and equipment and start production again. Either way, the arbitrage activities of the capitalists will close the gap between the rate of interest and the rate of marginal productivity.

Opportunism of Keynes

Keynesianism is no science. It is sheer opportunism trying to forge political capital out of bad-mouthing the gold standard and the regime of fixed exchange rates. It advocates the management of the national currency, ostensibly to manage the national economy for the benefit of society. In fact it is running the national economy into the ground. Keynesianism is based on the insane but appealing concept that driving the international value of the national currency down is beneficial to the export industry. It ignores the fact that even if you could derive ephemeral advantages through this ploy of „beggaring thy neighbor", the fact of deteriorating terms of trade could not be talked out of existence. If America exported x and imported y having the same value of z dollars, then after the devaluation of the dollar by, say, 50 percent, America would have to pay for importing y the sum of $2z$ dollars. In other words, America has to export *twice as much* of x in order to import just the same amount of y as before devaluation. America's terms of trade has *deteriorated* by a factor of 2. Worse still, the terms of trade for America's competitors has *improved* by a factor of 2. America is selling its national wealth on the cheap. Far from enriching the country, devaluation is impoverishing it. No wonder America has been on skid row ever since it has embarked on a policy of perpetual dollar-devaluation euphemistically called the floating dollar. Keynesianism is an unreconstructed mercantilist system. It is hard to see how mainstream economists and financial journalists have found it possible to treat it with respect.

The culprit: destabilization of interest rates

Keynes attributes deflation and depression to the 'contractionist tendencies' of the gold standard. He says the gold standard puts a squeeze on prices. The government should relieve tightness in the economy by deficit spending, and the banking system should monetize the resulting government debt. This is called 'contra-cyclical monetary policy'. Keynes correctly recognizes the cumulative effect in the contraction of the economy once prices start falling, but he attributes it to the wrong cause: the vanishing of private demand which he wants to compensate with stepped-up public spending. In reality, the industry's loss of pricing power and the subsequent downwards spiral of prices is *not due to vanishing demand. It is due to the weakening of capital structure, bankrupting producers.* To see this we have to provide a more sophisticated analysis of the effects of destabilizing interest rates than hitherto given.

The gold standard is sacrificed in order to make unbridled government spending possible. In Keynes' one dimensional world this may have the effect of increasing prices, but it is all to the good as it is thought to revive the economy. However, the world is not one-dimensional and abolishing the gold standard has another effect: increasing interest rates. Bond prices and interest rates are destabilized.

What caused the Great Depression?

Keep in mind that there was no bond speculation under the gold standard. None whatever. Mainstream economists disingenuously stone-wall this fact, thereby doing great disservice to the cause of science. They have blocked research on the detrimental consequences of the removal of the gold standard. Nobody has exposed the cause: destabilization of interest rates, and the effect: the Great Depression. The Keynesian dogma that it was caused by a deflation-prone gold standard is almost universally accepted.

However, the very opposite is true: the Great Depression was caused by *sabotaging* the gold standard. When the ownership of and trade in gold was banned by F.D. Roosevelt in 1933, the biggest competitor of government bonds, gold, was forcibly removed. Bond prices rose and interest rates fell precipitously. As we shall presently see, prices are bound to follow interest rates down. Falling prices triggered a downward spiral. The depression was on. *The root cause was the ban on gold ownership*. Mainstream economics is stone-walling that fact as well.

Paying out phantom profits

We shall now show how falling interest rates translate into falling prices. Contrary to conventional wisdom, falling interest rates squeeze profits. Mainstream economists teach that falling rates are salubrious to business. However, they fail to distinguish between a *low* and a *falling* interest rate structure. *Falling interest rates reveal that past investment in physical capital has been made at too high a rate in view of lower rates now available. The difference between the two rates hits the profit margin, and hits it badly.* There is no way getting around the fact that falling interest rates make the cost of servicing debt contracted earlier more onerous. The present value of debt rises as a consequence of falling interest rates. Firms with zero debt are not exempt either. The value of industrial capital falls across the board as new capital could now be financed at lower rates.

Relaxed accounting standards under fiat currency allow firms to get away without reporting capital losses in the balance sheet incurred in the wake of fluctuating interest rates. However, a loss is a loss, reported or unreported. If the loss is not reported, the firm is paying out phantom profits in dividends, compounding capital losses and hastening collapse.

Linkage

Critics find the statement that the present value of debt rises as the rate of interest falls counter-intuitive. Yet it is just the flipside of the statement that the market price of a bond rises as the rate of interest falls — a mathematically and statistically well-established fact of life.

Critics also object saying that losses in the liability column are offset by gains in the asset column. Falling interest rates, while increasing the present value of debt (hence causing capital losses) also increase the present value of future earnings which, they say, generate capital gains. The trouble with this argument is that it ignores the accounting rule that prohibits putting value on assets higher than historic costs, forcing the accountant to disregard any increase in anticipated future earnings. He has no choice: the accountant must charge the increased cost of potential liquidation against assets without making allowance for increased future earnings due to falling interest rates.

As profits are squeezed, firms are forced to retrench. They reduce inventory, causing prices to fall. We conclude that falling interest rates translate into falling prices. This is the missing link that all the great theorists on interest from Eugene Böhm-Bawerk to Knut Wicksell have missed. They observed the operation of *linkage* as it forced interest rates to follow — apart from leads and lags — the same path upwards or down as do prices. They could even prove that rising or falling prices caused interest rates rise or fall, and that rising interest rates caused prices to rise, too. But for all their efforts they failed to find the missing piece of the jigsaw puzzle: the proof that falling interest rates caused prices to fall as well. Our argument above furnishes the missing piece. This, we believe, is a major break-through in theoretical economics, making nonsense out of Keynesianism.

Why aren't airline wreckages investigated?

As linkage is activated, falling interest rates pull down prices. The deflationary spiral is on. Falling prices squeeze profits more. Many firms see their capital melt away. They fold in spite of falling interest rates.

The same forces that worked in the Great Depression are also at work today. When interest rates switched from rising to falling mode in the early 1980's latter-day Icarus, the airline industry, was flying high. There was no Daedalus around to warn Icarus that he was flying too high, in view of being one of most capital-intensive industries. Falling interest rates were considered an incentive to increase operational altitude. Airlines went into debt to the hilt in financing spanking new fleets of planes. Then airlines, like Icarus, started falling out of the sky one after another. Among the victims were the American flagship, Pan American, as well as Swissair, envy of the industry and widely considered the best-managed airline that has ever cruised the skies. What caused these and other airlines to nose-dive just when they were getting ready to enjoy the 'benefits' of falling interest rates? Plenty of *ad hoc* reasons were offered, none of them convincing.

Airlines were blown out of the sky because falling interest rates wiped out their capital. Governments take great pains to investigate the wreckages of *airliners* meticulously. Experts find and reassemble even the smallest pieces of the wreckage in a hangar in search for clues of the cause of the crash. This effort is praiseworthy. There is much to be learned from each and every disaster. Curiously enough, governments *never* investigate the wreckages of *airlines,* lest the true causes of the air disaster be learned. The true causes are: the regime of fiat currency, and our faulty accounting system that allows the suppression of capital losses due to falling interest rates. So much for Keynesianism as a government ideology.

This example also illustrates that capital gains in the asset column can't compensate for capital losses in the liability column. Why did Swissair fall out of the sky if it could capitalize its higher future earnings due to falling interest rates? Because it couldn't: before it would have been able to collect the expected higher earnings, it had crashed (financially, anyhow).

Risk-free profits in bond speculation

Keynes' recipe makes the profits of bond speculators risk free. Contra-cyclical monetary policy calls for open-market purchases of bonds by the central bank. This makes central bank action predictable. Bond speculators take advantage of it and preempt central bank buying. They buy the bonds first, only to dump them at higher prices later, after the central bank has completed the purchase of its own quota. Risk-free profits create an artificial demand for bonds, and a falling tendency in interest rates. They are responsible for deflation. Under the gold standard interest rates and bond prices are stable, and there is no risk-free speculation.

Contra-cyclical or counter-productive?

As our analysis shows, the counter-productive central bank monetary policy is responsible for the falling interest-rate structure, the deflationary spiral, and the depression. Keynes' so-called contra-cyclical monetary policy turns out to be an unmitigated disaster. The central bank wants to combat falling prices through open-market purchases of bonds. But the new money it creates in the process does not flow to the commodity market to prop up prices there as hoped for by the central bank. Instead, it flows to the bond market where speculators, teased by the lure of risk-free profits, use it for bullish bond speculation. Interest rates fall; linkage makes prices fall, too. The deflationary spiral continues one level higher.

Most analyst take it for granted that the decline in the value of the dollar will cause interest rates to rise. However, logic dictates that the value of dollar bonds should fall *before* the value of the dollar. That's not what has been happening. The dollar has been falling for the past few years yet bond values, as measured by the 30-year T-bond, continued their march upwards that had started in the early 1980's. The explanation is that the allure of risk-free profits sent the demand for bonds soaring so that it has far surpassed the vanishing demand for dollars. Paradoxically, there is a *rising* demand for dollar bonds and a *falling* demand for dollars. Risk-free profits in the bond market suggest that a continuation of the regime of falling interest rates, with all its deflationary implications, is more likely in the future than a new bout of price rises. Be that as it may, we can be sure that the price for central bank follies will be paid by the sacrificial lamb: the producers, regardless whether interest rates fall or gyrate.

Confusing capital and credit deliberately

In the vast literature of mainstream economics there is not one sentence written about the deleterious effects of destabilizing interest rates on the value of industrial capital. This stems from a deliberate confusion between capital and credit. In the view of mainstream economists any talk about 'capital decumulation' or the destruction of industrial capital in the wake of destabilizing interest rates is arrant nonsense. After all, both credit and capital can be created at will, by a click of the mouse. The possibility that the dissipation of industrial capital might figure among the causes of the Great Depression is not even considered.

Capital strikes back. The apparition stuns non-believers and capital-deniers. "If you don't use your eyes for seeing, then you will use them for weeping." (F.W. Foerster.)

Reclaiming our destiny from the usurpers

The market share of General Motors was 46% in 1980. Today it is 24% and falling, in spite of great improvements in productivity. Neither Ford nor Chrysler is doing any better. In 1980 the rate of interest was sixteen percent; it went as low as four. Having collided with the falling interest rate structure, the ship of industrial capital is sinking.

Captains of American industry should issue a Mayday call and rally to Ron Paul's plank to restore the gold standard in America. The writing is on the wall: the regime of fiat currency, in the maintenance of which the Federal Reserve has a vested interest, is going to finish the job of de-industrializing America — unless we reclaim our destiny from the usurpers, and return to the regime of stable interest rates.

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