THE MARGINAL PRODUCTIVITY OF DEBT

Why Obama's Stimulus Package Is Doomed to Failure

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Paper mill on the Potomac

The paper mill on the Potomac is furiously spewing up new money. According to the manager of the mill, as indeed according to the Quantity Theory of Money, this should stop prices from falling and the economy from contracting.

In this article I present an argument why this conclusion is not valid. On the contrary, I shall show that new money created on the strength of a flood of new debt, is tantamount to pouring gasoline on the fire, making prices fall and the economy contract even more. The Obama administration has missed its historic opportunity to stop the deflation and depression inherited from the Bush administration because it entrusted the same people with the task of damage-control who had caused the disaster in the first place: the Keynesian and Friedmanite money doctors in the Fed and the Treasury.

Watching the wrong ratio

The key to understanding the problem is the *marginal productivity of debt,* a concept curiously missing from the vocabulary of mainstream economics. Keynesians take comfort in the fact that total debt as a percentage of total GDP is safely below 100 in the United States while it is 100 and perhaps even more in some other countries. However, the significant ratio to watch is *additional debt to additional GDP*, or the amount of GDP contributed by the creation of $1 in new debt. It is this ratio that determines the *quality of 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.

Conversely, a serious fall in that ratio is a danger sign that the quality of debt is deteriorating, and contracting additional debt has no economic justification. The volume of debt is rising faster than national income, and capital supporting production is eroding fast. If, as in the worst-case scenario, the ratio falls into negative territory, the message is that the economy is on a collision course and crash in imminent. Not only does more debt add nothing to the GDP, in fact, it causes economic contraction, including greater unemployment. The country is eating the seed corn with the result that accumulated capital may be gone before you know it. Immediate action is absolutely necessary to stop the hemorrhage, or the patient will bleed to death.

Keynesians are watching the wrong ratio, that of debt-to-GDP. No wonder they constantly go astray as they miss one danger signal after another. They are sailing in the dark with the aid of the wrong navigational equipment. They are administering the wrong medicine. Their ambulance is unable to diagnose internal hemorrhage that must be stopped lest the patient be dead upon arrival.

Melchior Palyi's early warning

In the 1950's when the dollar was still redeemable in the sense that foreign governments and central banks could convert their short-term dollar balances into gold at the fixed statutory rate of $35 per ounce, the marginal productivity of debt was 3 or higher, meaning that the addition of $1 in new debt caused the GDP to increase by at least $3. By August, 1971, when Nixon defaulted on the international gold obligations of the United States (following in the footsteps of F.D. Roosevelt who had defaulted on its domestic gold obligations 35 years earlier) the marginal productivity of debt has fallen below the crucial level 1. When marginal productivity fell below $1 but was still positive, it meant that total debt (always 'net') was rising faster than GDP. For example, if the marginal productivity of debt was ½, then $2 in debt had to be incurred in order to increase the nation's output of goods and services by $1. An increase in total debt by $1 could no longer reproduce its cost in the form of an equivalent increase in the GDP. Debt lost whatever economic justification it may have once had.

The decline in the marginal productivity of debt has continued without interruption thereafter. Nobody took action, in fact, the Keynesian managers of the monetary system and the economy stone-walled this information, keeping the public in the dark. Nor did Keynesian and Friedmanite economists at the universities pay attention to the danger sign. Cheerleaders kept chanting: "Gimme more credit!"

I learned about the importance of the marginal productivity of debt from the privately circulated Bulletin of Hungarian-born Chicago economist Melchior Palyi in 1969. (There were altogether 640 issues of the Bulletin; they are available in the University of Chicago Library). Palyi warned that the tendency of this most important indicator was down and something should be done about it before the debt-behemoth devoured the economy. Palyi died a few years later and did not live to see the devastation that he so astutely predicted.

Others have come to the same conclusion in other ways. Peter Warburton in his book *Debt and Delusion: Central Bank Follies ThatThreaten Economic Disaster* (see references below) envisages the same outcome, although without the benefit of the concept of the marginal productivity of debt.

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 debtthere is, was exiled from the monetary system. Still, it took 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 to zero and went negative 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 necessarily cause economic contraction. Capital is gone; further production is no longer supported by the prerequisite quantity and quality of tools and equipment. The economy is literally devouring itself through debt. The message, namely 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 characterized president Obama's plan to spend nearly $2 trillion to push the U.S. economy out of recession as "road to hell". There is absolutely no reason to castigate Mr. Topolanek for this characterization. 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. In consequence more spending on stimulus packages would only stimulate deflation and economic contraction."

Hyper-inflation or hyper-deflation?

Most critics the Obama plan suggest that the punishment for the bailouts and stimulus-packages will be a serious loss of purchasing power of the dollar and, ultimately, hyperinflation, as evidenced by the Quantity Theory of Money. However, the quantity theory 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, relying on the concept of marginal productivity of debt, predicts that it is not hyperinflation but a vicious deflation which is in store. 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 in order to pay the higher prices much as though they would have liked to do. The newly created money has gone into bailing out banks, and much of it was diverted to continue paying bloated bonuses to bankers. Very little, if any of it has “trickled down” to the ordinary consumers who are squeezed relentlessly on their debts contracted in the past.

It follows that price rises are unsustainable, as the consumer is unable to pay them. As a consequence the retail and wholesale merchants are also squeezed. They have to retrench. Pressure from vanishing demand is passed on further to the producers who have to retrench as well. All of them are experiencing an ebb in their operating cash flow. They lay off more people, aggravating the crisis further as cash in the hand of the consumers is diminished 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 the people who are desperately scrambling to get out of debt. Businessmen in general 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/loss statement eating into capital that has to be replenished as a consequence. 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 use new money, made available by the Fed, to expand their activities further in bidding up bond prices. They pre-empt the Fed: buy the bonds first before the Fed has a chance; then turn around and dump them in the lap of the Fed. This activity is risk-free. Speculators are 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 long dated Treasury issues during the next six months, and probably much more after that. Speculation on falling interest rates becomes self-fulfilling, thanks to the insane idea of open market operations of the Fed making bond speculation risk-free. Deflation is made self-sustaining. (For another view of risk-free bond speculation, see the article by Carl Gutierrez’ in *Forbes* mentioned in the References below.)

Note also the crescendo of the dumping of equities and the desperate attempt to redeem toxic assets by private parties, sending the demand for cash sky high. The dollar, at least the Federal Reserve note variety of it, will be increasingly scarce. Rather than falling through the floor as under the hyper-inflationary scenario, the purchasing power of the dollar will soar. You say that Ben Bernanke and his printing presses will take care of that? Well, just consider this. The market will separate vintage Federal Reserve notes from the new issues with Bernanke's signature on them. In a classic application of Gresham's Law people will hoard the first, bestowing a premium on it relative to the second variety, which will fall by the wayside.

Bernanke can create money but cannot make it flow uphill

Already some tip sheets openly advise people to hoard Federal Reserve notes in amounts up to twenty-four months of estimated household expenditure, while cleaning out all deposit accounts. Depositors are urged to forget about the $250,000 limit on deposit insurance, which is rendered literally worthless as the resources of the F.D.I.C. have been hijacked by Geithner and diverted to guaranteeing the investments of private parties that were foolish enough to buy into toxic debt at the behest of the Obama administration.

Karl Denninger envisages unemployment in excess of 20%, with cities going "feral" as showcased by downtown Detroit (see References below).

What has all this got to do with the marginal productivity of debt? Well, once it is negative, any further addition of new debt will make the economy shrink more, increasing unemployment and squeezing prices. Bernanke can create all the money he wants and more, but he cannot make it flow uphill.

Bernanke is risking something worse than a depression

The newly created money will follow the laws of gravity and flow downhill to the bond market where the fun is. Risk-free bond speculation will further reinforce the deflationary spiral until final exhaustion occurs: the economy will collapse as a pricked balloon. Instead of hyperinflation and the destruction of the dollar, you've got deflation and the destruction of the economy.

Denninger says that the "death spiral" will lead to fire sales of assets in a mad liquidation dash and, ultimately, to the collapse of both the monetary and political system in the United States as tax revenues evaporate. He opines that probably not one member of Congress understands the seriousness of the situation. Bernanke is risking something much worse than a Depression. He is literally risking the end of America as a political, economic, and military power.

Indeed, the financial and economic collapse of the last two years must be seen as part of the progressive disintegration of Western civilization that started with government sabotage of the gold standard early in the twentieth century. Ben Bernanke, who should have been fired by the new president on the day after Inauguration for his part in causing irreparable damage to the American republic may, in the end, have the honor to administer the *coup de grâce* to our civilization.

References

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