The Gold Standard

The journal of The Gold Standard Institute

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Editorial

The current Greek tragedy, covered again in this issue by Orpheus who is living through the nightmare, brings into focus the latest manifestation of the socialist dream. The collapse is the usual ignominy of corruption, hunger, homelessness and social breakdown.

Greece is now footing the bill for two decades of self-inflicted socialism. The pain is about to get much worse, whether or not they stay in the Eurozone. Their "rock-star" finance minister describes himself as a "Libertarian Marxist". If the quote is correct he is a very confused man.

In defence of Greek politicians, it should be noted that the people freely elected them in full knowledge of their flawed vision.

What is so compelling about the socialist doomsday cult? True, sometimes it dwindles in appeal, but always to burst forth again in all its doleful anti-glory.

At its base is the dream of a world of equality; not equality of opportunity, but of standard of living. Socialism holds to the belief that if one man eats caviar and another baked beans, then that is an inequality, which of course is true.

Those who work and produce and understand not just the virtues, but also the material advantages of freedom know that these different foods are representations of different values created in the marketplace; definitely unequal, but just as definitely fair.

This vital piece slotted into the jigsaw of understanding is what eludes the socialist. Socialists do not understand that wealth is created; they believe that it is harvested. It can be easily understood that if wealth is not created, but 'just there' for the gathering, then a sort of case could be made that a centralised body should be charged with gathering and distributing the booty and that all people should receive a fair share.

And this is what socialists do believe. This is why they confiscate 'the means of production' – even toilet paper factories and supermarkets in Venezuela, but their socialists are exceptionally silly.

Schools need to hold classes on wealth creation; with demonstrations on the mechanics of precisely how new wealth is created. This would shine a light on the enormous costs in terms of not only time and self-discipline, but also the personal sacrifice and commitment that precede the creation of wealth.

If children were brought to an early understanding of wealth-creation, then the reason why some eat caviar and others baked beans would become crystal clear. Try to take a young child's toy away and you will quickly discover that they have a very natural and sound understanding of property rights. While 'Wealth Creation' is unlikely to ever appear on the curriculum of government schools, there are still many private schools.

It truly would be valid. Even some proponents of the free market cannot clearly explain this mechanism. If intelligent people struggle, then no wonder the socialist grip on reality is so tenuous.

Philip Barton
President, Gold Standard Institute

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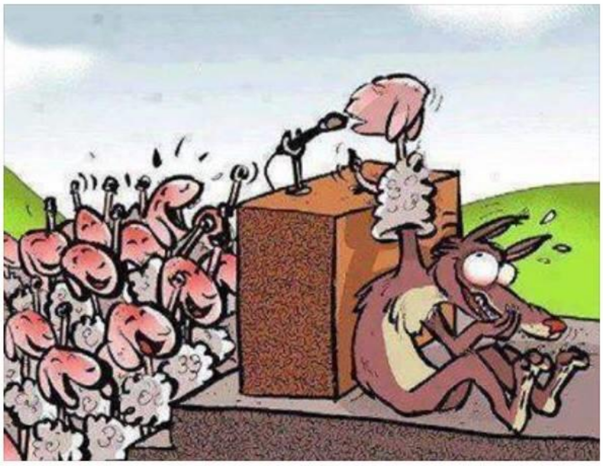
CNN: Divers discover large cache of Arab Gold coins (the State confiscates the lot!)

Vulgus vult decipi, ergo decipiatur

"The crowd wants to be deceived, so let it be deceived."
Petronius (Roman satirist from the first century AD)

Who wins the elections? Why, the one who best diagnoses what the majority of electorate wants to hear and promises (in a believable way) to deliver. Never mind if later few, if any at all, of the promises materialize or if disaster strikes; the throne is occupied and new cards up the sleeve can win the day.

This is a timeless axiom expressed by Petronious 2000 years ago, and followed by any really power thirsty, would-be leader of a nation, fighting his way to power through elections that is; not a coup d'état.



There are two key abilities he/she should possess; a) to diagnose what most voters desire b) to be a charismatic demagogue, ruthless enough to promise what-you-wish.

No doubt this strategy has been employed by all high caliber thugs through the centuries to rule the masses so they can profit themselves.

In Democracy (at least the modern times version) someone is elected as captain of a nation usually for four years. The thinking is simple. What does it take to be elected? It just takes what the majority of voters want to hear, never mind being demagogic or misleading. The objective is to be elected.

Shooting at the wrong enemy. It's not the debt stupid.

I have a debt of 10,000 Euros. Is this a big debt or a small one? Common logic implies that the answer is: it depends on your income. If I have zero annual income, then this is a huge debt, if I have a 10,000 annual income this is heavy but manageable, if I have 50,000 it is a small one.

The entire political literature, from the outbreak of the crisis and afterwards was focused on the wrong issue: the size of the debt. No discussion for the culprits which are **the country's two fundamental problems:** a) the income which is required to service the debt, and b) the mechanism which creates debt.

However, this literature was only for internal consumption. Any foreigner being an objective observer might be wondering:

Why Greece, a state so endowed by nature, with such creative people, has only 185 billion Euros GDP?

Why the Netherlands, which has an area a third of Greece and half the country is marsh, struggling for centuries to avert the waves of the Atlantic threatening to swallow it, has 800 billion Euros GDP?

Why South Korea had half the GDP of Greece in 1961, and in 1981, a time when we started the socialist transformation of society, South Korea had a GDP of only 71 billion dollars while today it enjoys a monstrous 1.4 trillion out of which are 600 billion in exports?

Why the economic history of Greece is debt laden and highlighted by reoccurring failures/ bankruptcies?

Why the Greek state is a profligate one that serially spends more than it collects?

These questions should be dealt with by the Greek politicians primarily but also by the Greek voters to be sure. Certainly not now that Greece is lingering at the edge of the abyss. Self-appraisal should have occurred long ago.

How many of us Greek comrades sensed the upcoming bankruptcy, when the self-appointed right wing/libertarian party of "Nea Dimocratia" that was in power for four years, between 2006 and 2009, borrowed about 85 billion proclaiming the rebirth of the nation?

How many of us Greek comrades have realized that from 1981 to date, Greece has received 660 billion in Euro loans, 290 billion in Euro net subsidies and 26 billion as Euro interest-free investment subsidies? Add on top of those, a debt haircut of another 120 billion Euros and the bill shows a mind boggling amount of 1.1 trillion Euros by the end of 2012. Divide that by the population and you come up with roughly 100,000 Euros per person, a staggering per capita amount that could transform Greece to Switzerland in steroids.

Despite this Niagara inflow of money, we destroyed our national engine of production and ended up bankrupt. Why?

One would expect that the outbreak of the crisis would lead us all in front of the mirror and to stay there until each had defined his/her role in the national tragedy; for acting or omitting to act, for participating or abstaining. Indeed, we went in front of the mirror, coquettishly stared at ourselves, and ruled: you're a cool dude! Others are to blame!

The political parties of all stripes (with few exceptions), got the message. They unearthed a scapegoat: The MOU (Memorandum of Understanding) we had to comply with in order to receive IMF and EU financing was the new scapebugaboo.

Never mind that the MOU explicitly mentioned measures which the political parties proclaimed in their pre-election programs, but never respected once in power!

Never mind that no one bothered to read it!

Never mind that <u>none</u> of the structural reforms mentioned in the MOU were implemented!

On the other hand easy policies, banned by the MOU, were introduced, namely tax increases on a large scale that stalled growth and turned away any new investment! Here lies the great responsibility of Troika (a committee supervising the implementation of the memorandum) who accepted these poisonous tax increases without insisting on a strict observance of the MOU.

The masses needed someone/something to put the blame on and it was found. The anti-MOU delirium reached its apex. The main contenders of recent elections figured out how well the story was selling and embraced it. No party was fool enough to miss the opportunity!

All these politicians, self-labeled as rebels but actually of the charity-begging variety, united under the anti-MOU umbrella and declared war against something that was never the enemy.

Our lending partners have made it clear sine 2012: "*Forget the debt, we will refinance! Your debt is an accounting entry. We shall lend the money to service it.*"

(By the way that's what we always did. The Greek taxpayer has never paid a penny to repay debt. Each expiring bond was paid by the issue of a new one.)

"You shall continue to do so" was the advice from EU and IMF. *"But at long last proceed with the necessary structural reforms to break away from the underdevelopment swamp you are stuck in: Modernize the public sector, install IT everywhere, create a national real estate registry, define uses of land, remove any taxes in favor of third party interests, set free all privileged professions, simplify your legislation, accelerate justice procedures, streamline all state social security institutions, stop allowing people to retire at the age of 50, facilitate the establishment of private companies, remove the 500 licenses necessary to start any business, digitize all public records!"*

The previous government did none of the above.

What can we expect from the new government?

More of the same and even worse. They are making big noise asking for debt deletion, debt haircut, debt repayment elongation, and anything related you can think of. They have convinced the electorate that if they reach these goals, austerity will magically disappear.

Let's suppose that their wildest dreams come true and our lenders agree to delete everything and never deal with us again. The two real problems of the country will still be there.

By Martin Turner

The country will remain unproductive burdened with thousands of useless public institutions that the new government aspires to increase.

The state insurance-pension funds will keep on blinking red with existing and forthcoming 50 year old pensioners mounting. You don't have to be Einstein to figure out that a 2,500,000 working force -most of them part timers - cannot provide for the pensions of 3,000,000 pensioners.

Existing businesses will continue to suffer from preposterously high tax rates. The announced new tax *"on all transactions conducted through all types (public, private or cooperative) of credit institutions"*, as the main "SY.RI.ZA" tool to bring more money in the state coffers will deliver another death blow to the private economy. Who in his sane mind will invest in Greece when the tax rate in neighboring countries is one fifth of ours?

All State property will remain sterile as all privatizations will freeze and trade unionists will come back in charge.

The state still represents 65% of the formal economy, comparable only to former Soviet states. Is it possible for the country to continue functioning by following the Soviet model? Are people who cannot distinguish between cause and effect suitable to govern? The same people who are pounding the table saying that it was the MOU that led to bankruptcy and not vice versa.

Therefore we are spending all our ammunition fighting the wrong enemy. Thanks to inflation, the debt will shrink in 50 years' time. If the proper foundations are laid for the private sector to flourish, Greece's growth will take off and the debt to GDP ratio will quickly fall below 60%, easy to cope with.

What will continue to be unbearable, if the status quo remains intact, is the Greek state itself; it's the life of anyone undertaking a business initiative; it's the life of the unemployed people, because when you shoot the entrepreneurial spirit you kill all hope for people finding a job; it's the life of the youngsters because they shall be required to work for peanuts and make contributions to favored unions pensioners pocketing 2000 Euros per month; it's the life of the housewives, as distortions in the economy and unfair taxes will keep product prices high while incomes fall; it's the life of every citizen, every taxpayer.

The enemy is but one: STATISM with all its offshoots: partisanship, state-unionism, populism.

Who will declare war against it?

The weakest link. "A chain is only as strong as its weakest link."

Wrong.

The Euro was indeed a vulnerable chain when the prospect of a Grexit first surfaced some 4 years ago. Since then, under the leadership of Germany, the core European nations have structured resilient barriers around the Euro. Should a Grexit happen now, the Euro chain will become stronger by getting rid of its weakest link. Sure, short term turbulence may arise caused by speculative derivatives, losses for Greek bond holders etc. But the overall medium to long term impact on the Euro will be positive. The rotten link of the chain won't threaten its strength. It will also serve as a painful lesson to other naughty members of the EU of what lies ahead for them should they fail to maintain good housekeeping of their state budgets.

Besides, it is the writer's belief that the significant retreat of the Euro's exchange rate during the last six months was the market's anticipation of a possible (maybe highly so) Grexit. If a Grexit happens now or in the near future, the remaining horses, all of them stronger than Greece, will speed ahead in relief and the Euro will recover. If not, the Euro will trade horizontally or lower until the markets make out that the Greek situation improves or deteriorates.

The fact that the Euro itself is infected by fiat money disease, is another topic. We are now talking fiat versus fiat. Heck, the world is chock full of them.

A cunning jerk (somersault)?

Until the writing of this missive, the results of the negotiations, mutually agreed upon, between the new government and the European commission are as follows:

- Rename of "Troika" to "Institutions".
- Rename of the "MOU" to "Program".
- The total acceptance by "SY.RI.ZA" of the requested structural reforms.

It is of no surprise that a new instrument has been devised among the social media crowd: the jerkometer.

Implosion ahead?

A key factor to take in to account, for understanding the Greek issue, is the internal structure of "SY.RI.ZA", the party presently in power. "SY.RI.ZA" is a coalition of numerous leftist groups, some of them "groupuscules" covering all shades of red.

Starting from deep red, the hard-core communist faction was initially formulated in 2013 from people who are editors of the newspaper "Revolution" and the magazine "Marxist Voice".

At the other end, the light, low fat socialists exist. These guys joined "SY.RI.ZA" after "PA.SO.K", the socialist kiosk previously housing them, was irreparably disgraced by scandals and corruption that came under public scrutiny.

During the recent alignment of "SY.RI.ZA" with the requests of our lenders, the former complained loudly demanding the overthrow of the party's leaders, while the latter supported the party's policy.

A possible implosion of "SY.RI.ZA", transforms the Greek political environment into quicksand with consequences hard to foresee at present.

Petronius axiom has wrapped the world!

Beyond Greece, isn't the whole world being deceived for the last 100 years on the money issue?

We are now talking about "*Mundus vult decipi, ergo decipiatur*" *(Google translate: "The world so wants to be deceived").* Individuals sell their labor, physical or brain, companies sell their products, nations sell raw materials and precious resources, all for paper tickets on which numbers and figures are printed.

No intrinsic value whatsoever.

There is no doubt the heads of money printing factories are thankful to Petronius for his wise advise.

For how long the farce will keep dancing on world stage? Maybe until permanent backwardation encompasses all gold futures contracts.

It might be (Ed – 'will be') too late to save the day by then.

Orpheus

A Salvo in the Battle for the Gold Standard

I wrote what I thought was a fairly simple article for Forbes on Tuesday. I noticed that some people really got it, and they were very excited. However, others were skeptical or asking questions that went into the weeds. The former tells me that I said something important, but the latter says that I said it in a way that not everyone could relate to.

I started with the observation that many people argue (vehemently) that money should be defined as the medium of exchange. In the US, the dollar is used to purchase everything. Therefore the dollar circulates as the medium of exchange. Therefore the dollar is money. Q.E.D.

The catch is that the dollar only circulates because the government forces it to circulate, and forces gold not to. This means that the very concept of money is under the control of the government.

Ayn Rand noted that force is not essentially about a physical push, or a bullet hitting flesh. She said, "Force and mind are opposites…" She added, "To force a man to drop his own mind and to accept your will as a substitute, with a gun in place of a syllogism, with terror in place of proof, and death as the final argument—is to attempt to exist in defiance of reality."

She showed that force is an attack on the mind. Literally, the gun takes away your ability to see reality clearly and use logic to arrive at the best possible outcome. Instead, you must think and do as you are told. The insidious process she described is at work with the concept of money. The very concept of money has been perverted.

In most cases, people can see that government has no power to change reality, or alter the laws of physics. But in this case—by the leverage of a broken concept—many people assume that government has indeed the power to make concepts into what it wishes.

George Orwell once wrote about this.

Debt paper is not money, no matter who issues it. The government has no power to transform water into wine, or debt paper into money. I don't think anyone is explicitly arguing that it has this power. I think their error is to gloss over why the dollar circulates, and just insist that, "well, it circulates therefore it is money."

Thus, the government is granted the power to turn paper into gold, though the mind skitters away from openly admitting this conclusion.

The consequence to accepting the dollar as money is to think that gold *goes up*. As I often say, in reality, gold is going nowhere. It's the dollar that is going down. But if the dollar is money, then the prices of all things are measured in dollars. And so, we think gold goes up. Because that's the only way to frame it if the dollar is money.

If gold goes up, then one has made a *profit*. That's right, one *makes money* for doing nothing, just holding a lump of metal. Where does such a free lunch come from? No time to explore that contradiction today. Let's stay focused.

It may not be fair, but we have a capital gains tax that applies when an investment, commodity, or asset goes up. If you buy something for $1,000 and sell it for $1,500, then you have a $500 profit. You must pay tax on that income. There are no exceptions that I am aware of: antique Ferraris, stocks, bonds, bitcoin, copper, houses, etc.

And this is where the concept of money gets real.

The government has several ways of forcing gold not to circulate, of making us use their debt paper as if it were money. One of them is the capital gains tax on gold. You see, if you barter—remember, gold is not money, just a commodity—gold for a car then the government considers that to be a sale of gold at the current market price. If that is higher than what you paid when you bought, then you owe capital gains tax.

This tax makes it far too expensive to use gold in transactions, not to mention the ledger you would have to keep. So gold is forced out of circulation (and into private hoards). Gold is for holding, not for using as money.

I have been arguing that this bad tax provision ought to be repealed. And that's the crux of the problem.

Am I just a crony, like every other crony, asking the government for a special favor and preferential treatment? Is the whole point of repealing the tax on gold so that gold speculators can make more *money* on their gold trades?

This was essentially the allegation of one Arizona legislator, who asked why gold should be treated differently than other *investments*.

If the dollar is money, then there is no good answer to this question.

To advocate for special privileges that benefit one's own purse is to fight for cronyism (also known by its older name, fascism). This is not a principled position. Nor is it a sympathetic one. Everyone has a mental picture of a fat cat, seeking to engorge himself at public expense. Once we're into that box, once we're perceived that way, we're doomed. No matter what "blah blah blah" comes out of our mouths, it will be seen as self-serving and hypocritical. And rightfully so.

Huh? Rightfully so?!? Yes. If we concede that the dollar is money, gold is a commodity, and if we concede that gold is going up, which means we make a profit, and if we demand not to be taxed on that profit, then we are no different than any other special interest group seeking favoritism. We are no different than any other rent seekers.

What is a principled free marketer to do? Well, if you cling to the notion that the dollar is money, then you are disarmed. You have to concede that gold should be taxed just like other assets. You can lobby to eliminate all capital gains tax, but that's about it. Good luck with that. I will cheer you, but don't expect victory any time soon.

I remind you of two things. One, tax keeps gold from circulating. In other words, the gold tax is the key to socialized money. We can never have a free market in money if gold is penalized with a tax every time the dollar loses value. Two, as Ayn Rand showed, the moral is the practical. Your belief in this bad definition of money is what keeps you from effectively fighting for a free market in money.

There is much more to say about the topic of money and credit, to support the case that gold is money. In this article, I just wanted to focus on this one issue, because I think the error is an important one. I expect gold's enemies, as they begin to mobilize and organize, will be cunning enough to see the vulnerability and go for the jugular.

If we want to win, we will need to be armed properly for the fight. This is a battle for ideas, and the most important weapons we can wield are concepts. Preferably razor sharp concepts. Let's get it right, starting with a clear understanding of the dollar and of gold.

Keith Weiner
President, Gold Standard Institute USA

You Cannot Eat Gold

Perhaps the most absurd and stupidest argument offered by the anti-gold crowd against using gold as money is that gold has no value because one cannot eat it, wear it, or live in it. This claim can be made of paper money and especially electronic money, which is most of today's money. It can be said of most things that people use.

Gold is eatable. When consumed, gold has anticancer properties, aids in repairing damaged arthritic joints, reduces various emotional problems, and helps blood circulation. It is used in medicines and alternative remedies. It is used to decorate expensive high-society cakes.

Gold can be used to make clothes. Traditionally, crowns of monarchs have been made of gold alloy. Ancient, and not so ancient, priests wore gold laden garments. Most wedding rings are gold alloy. A large quantity of gold is used for jewelry.

Gold can be used to build structures. A house can be built using gold bricks. Such a house would be extremely expensive and highly energy inefficient. Gold foil or sheet can be used to veneer siding or to cover roofs of buildings.

One can use the same argument about paper money: it cannot be eaten or worn or used as a building material. Like gold, it can be eaten and worn. Nevertheless, paper money has little or no nutritional value. Depending on the composition of the paper and ink, it could be hazardous if eaten. Also, like gold one can build a house with it. When paper money becomes worthless, it has been used as wallpaper.

However, how does one eat, wear, or build with electronic money, which make up the bulk of today's money, flowing through some unknown computer at some unknown location? If one wants to use the cannot-be-eaten-or-worn argument against a type of money, they should hurled it against today's electronic money and not against gold.

The argument that one cannot eat, wear, or build with gold is often used as an attempt to show that gold has no value in-and-of itself. The anti-gold crowd often claims that if it were not for gold's monetary use, which it has not had since 1971, at least not formally, gold would be useless with little or no value. What is left unmentioned is its growing use in a growing electronic device market. If gold has no value beyond its monetary use, why did it not become cheaper than gravel when its monetary use ended? This argument against gold is stupid and is intended to deceive.

Thomas Allen
http://tcallenco.blogspot.com.au/

The Austrian National Bank Gold

One has long gotten used to national banks treating the people's gold as if they were the owners rather than the guardians. Lies concerning storage and physical inventory have become routine for our "lenders of last resort".

That tiny little Austria may even top these sorry goings-on may surprise many, but not the seasoned Austrian citizen. It has tradition in this country that everything that belongs to the people is regarded as their own by the ruling classes. This is the hallmark of a hidden but nevertheless real dictatorship. It masquerades as a democracy with the help of two political parties, that are not independent of each other but rather form an unholy alliance to divvy up power, jobs and national wealth amongst themselves.

A recent telling example of this dictatorial behaviour is supplied – again – by the national bank. At last year's press conference (May 2014) they boldly proclaimed that the general accounting office had monitored the physical gold stock. A proper check, however, never took place. Attending journalists were told that physical stocks were present as listed in the balance sheet; all stocks had been counted and found correct in size and quality.

The now released report of the general accounting office states something else entirely. To start with, we now know exactly how the audit in London was held (where most of the Austrian gold is stored). The Austrian auditors were invited for a spot check only. In advance, they had to submit a list of 300 (out of 14.300) gold bars from which a sample of 60 was drawn. These were subjected to an ultrasound test that the auditors were allowed to witness at arm's length. Thus, the auditors were demoted to mere spectators, which they spelled out a number of times in their report. (In stark contrast, the audit of the 33.4 tons stored at the Austrian Mint in Vienna went without a hitch.)

The 2-day farce of a London audit was considered perfectly above board by the national bank grandees and they proceeded with their boldfaced lies that everything was in order.

Austria owns – or rather, has owned – 280 tons of the precious metal, the biggest part of which is stored abroad, partially for good reasons. The share held in the Bank of England vaults in London has more than doubled since 2009, despite Austria decreeing in 1999 (along with several other European countries) to physically repatriate as much as possible of the national treasure. The argument in favour of London holds that gold should be stored at an international trading centre for convenience's sake, but surely not in these large quantities.

To make matters worse, the national bank failed to mention that more than 20 per cent (62 tons) of previously physical reserves had in the meantime morphed into receivables. Only the auditing report revealed this astonishing fact and turned the national bank leaders into confirmed liars.

Why one should lend gold in turbulent times like these and after so many negative experiences worldwide is beyond comprehension. It stands to reasons that the national bank put the interests of other states, banks and democratically illegitimate entities such as the IMF over the interests of their own people, the rightful owners of the gold reserves. But what incentives did these interest groups offer to the Austrian national bank or what did they use to bring on pressure on the bank to betray their righteous stakeholders?

The national bank committed several mistakes that can no longer be rectified. The audit report has brought these facts to the fore and tarnished the bank's reputation. Naturally, the Gold Standard Institute called for the resignation of the governor and the entire board. Further, we demand that all facts be revealed. Due to the obstacles put in its way, the general accounting office could not uncover the true extent of the shenanigans. Still, the audit managed to create public awareness of the misdemeanours long suspected by experts. The next months should reveal more.

Thomas Bachheimer
President of the Gold Standard Institute Europe

Falling Interest Causes Falling Wages

Interest rates have been falling for over three decades. Conventional economics has two things to say about this. One, *inflation expectations* are falling. Monetarists believe that the interest rate is set based on bond traders' predictions of future price increases. Two, if employment and GDP are weak, then the central bank should increase the money supply. By increasing the money supply, it will cause rising prices, and somehow that causes workers to get hired. Federal Reserve Chair Janet Yellen wrote a paper defending this absurd claim (which I criticized).

Monetary policy is actually putting the hurt on labor. Let's look at why.

Workers are employed by businesses, so we must look at the incentives that push on businesses. Businesses constantly face a choice among several alternatives. They choose based on the desire to make profit and avoid losses. Monetary policy affects their decisions, because it distorts the profitability of every path.

Consider one common tradeoff: hiring labor versus buying expensive tools. Management decides based on which costs less. The more expensive a tool, the more attractive it becomes to hire workers and vice versa. Since most companies borrow when they buy tools, the most immediate cost of a tool is the monthly payment. When the rate of interest falls, the monthly payment falls as well. This puts downward pressure on employment and wages (I wrote about this here).

A falling interest rate impacts the wage by a subtler, but more powerful process. In a recent article, Professor Antal Fekete describes it:

> *"First we dwell a little longer on the problem of the present value of a cash flow (defined as the sum of individual payments discounted at the prevailing rate of interest, each for the period of time between now and when it becomes payable in the future.) Since the rate of interest is being cut, discount at a lower rate is involved. Therefore the present value of the cash flow is increased…*
>
> *What does this mean for the terms of trade of those who need a cash flow for survival, such as all pensioners and all wage earners? Well, the price they have to pay for the cash flow is just its present value. Any cut in the rate of interest by the central bank affects them adversely. Their terms of trade deteriorates. For example, if the rate of interest is cut in half, then they have to pay twice as much for the same cash flow as before the cut. In practical terms this means that wage earners have to work roughly twice as hard to continue earning wages at the same level…"*

Let's take a step back and cover some essential background material and then we'll get back to this point. One differentiator of Fekete's economics is in his concept of the loan. Others think of it as an exchange of present goods for future goods, but he had an insight. The essential characteristic of a loan is that it involves an exchange of wealth and income. Fekete describes one party, often a retiree, as having cash but not income. The other party, typically an entrepreneur, has income but not cash. The deal benefits both.

The retiree needs the income to buy groceries, without consuming his life's savings. Earning interest provides him an income for the rest of his life, without fear of outliving his savings. The entrepreneur wants to build a business without having to waste years saving up for the investment. Borrowed capital enables him to quickly build productive capacity. This new production will increase his income.

We can think of the loan as the purchase of an income stream. Cash up front is traded for an income paid over time. By definition, and by nature, the amount of cash paid is equal to the value of the stream of payments to be made in the future. The value of this series of future payment is **not** simply the arithmetic sum. It is the sum of the *present values* of those payments.

Let's look at the concept of the *present value* of a future payment. Suppose someone will pay $500 one year from today. Do you value it at $500 right now? No, a future payment is always *discounted*, to compensate for locking up the cash for a year, and of course the risk of nonpayment. We need a way of determining how much $500 in one year is worth today. To calculate the discount, we use the prevailing interest rate. If the interest rate is 10%, then this $500 payment is discounted by $50. It is worth $450 today.

The value of a future payment rises if the interest rate falls. For example, if the interest rate falls 5%, then the discount is only $25. That makes the payment worth $475 today. If this is not clear, then it may help to think through a few examples. Consider payments due years in the future. This idea—that present value varies inversely with interest—is a key principle.

Changes in the value of a loan are zero sum. If the rate of interest falls, then the lender gains at the expense of the borrower. This conclusion is counterintuitive and thus controversial, but it should not be. The income stream is worth more. This is the loss suffered by the borrower, and the gain enjoyed by the lender.

For example, here is a 5-year loan at 10% interest. If payments are made annually, then each is $263.80.

Table 1: Loan Amortization

Year	1	2	3	4	5
Start Balance	$1,000	$836.20	$656.02	$457.82	$239.80
Interest	$100	$83.62	$65.60	$45.78	$23.98

The straight arithmetic sum of five $253.80 payments is $1,319. However the present value of the loan is less than that, because each future payment must be discounted. Here's what that looks like.

Table 2: Discounting each payment

Year	1	2	3	4	5	**Total**
Payment	$263.80	$263.80	$263.80	$263.80	$263.80	$1,319
Present Value	$239.82	$218.02	$198.20	$180.18	$163.80	$1,000

The present value of the income stream works out to be exactly the amount of the loan. The first table shows the loan amortization, with an annual $263.80 payment covering current interest plus fully amortization. The second table shows the discounting of each payment. This is an elegant validation of the theory.

Now, let's look at what happens if the prevailing interest rate drops to 5%. The loan payments don't change. However, the present value of those payments does.

Table 3: Discounting at a lower interest rate

Year	1	2	3	4	5	**Total**
Payment	$263.80	$263.80	$263.80	$263.80	$263.80	$1,319
Present Value	$251.24	$239.27	$227.88	$217.03	$206.69	$1,142

Discounted at only 5%, the same payments have a higher net present value—14.2% higher.

A loan with a longer term is more sensitive to changes in interest rate. The present value of a 10-year loan, for example, increases by 25.6% with the same change in interest rate.

The great economist Ludwig von Mises was aware of the impact of interest on long duration loans. He looked at the combination of two extremes, zero interest and a perpetual income stream. He wrote:

"If the future services which a piece of land can render were to be valued in the same way in which its present services are valued, no finite price would be high enough to impel its owner to sell it. Land could neither be bought nor sold against definite amounts of money…"

In other words, at zero interest the present value of land is infinite (as land produces income in perpetuity). For a perpetual income, each halving of the interest rate doubles the present value.

Accounting shines a spotlight on this phenomenon. However, it's no moot abstraction. The loss to the borrower is real. No one would argue that the capital gain of a bondholder is somehow unreal. They should not argue against the loss of the bond issuer. It is the loss of the latter which provides the gains of the former.

Proper accounting should always match reality. So what, in reality, is going on?

Another way of thinking of the present value is the burden of debt. The more the rate falls, the more the debt load bears down on the borrower. The present value of an income stream is what any investor would pay to buy it. It is also what the debtor must pay to liquidate it.

Sometimes the best return for the owners is to sell the firm. However, that often requires paying off the debt. If that's impossible, then the best option is off the table. The inability to liquidate debt causes many problems. So long as an enterprise has a dollar of debt, it's an overhang. The lower the interest rate falls, the larger the overhang grows.

Let's tie this all back to the worker. We can now see the connection between the wage and the loan. Both are an income stream, a set of payments to be made in the future. As with the loan, the present value of wages *rises* when interest *falls*. The employer is doubly squeezed, once by the increasing burden of debt, and twice when burden of wages increases too.

Something has to give. Either the worker must work harder, or else the employer must cut his pay. It's a simple matter of survival for the employer. No firm can remain in business for long, if it allows liabilities to rise unchecked.

If productivity cannot be increased, and wages cannot be decreased, then the business must cut costs elsewhere. Often this amounts to substituting one form of capital loss for another, such as neglecting maintenance or research.

Now we're ready to revisit the tradeoff of labor and capital, and tie our thesis together. The wages of labor are a series of future payments, but the price of a machine is paid up front. As the interest rate falls, the present value of *both* rises. That is, the present value of wages rises and the present value of the machine rises also.

When interest falls, wages subtract from the enterprise value and machines add to it. How perverse is that? How would you respond, if you were managing a business?

The central banks may say that increasing the money supply causes rising wages and increased employment. However, they increase money supply via bond purchases. This pushes bond prices up, which is the same think as pushing the interest rate down. It causes irreparable harm to employers, and consequently, to workers.

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