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Michael Hudson

On finance, real estate and the powers of neoliberalism

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Debts that can't be paid, won't be

April 10, 2012
By Michael

An excerpt from a paper published for the conference Paradigm Lost: Rethinking Economics and Politics. I am speaking to this paper in Berlin this week. The full paper can be downloaded from their website (PDF).

A common denominator runs throughout recorded history: a rising proportion of debts cannot be paid. Adam Smith remarked that no government ever had repaid its debt, and today the same can be said of the overall volume of private-sector debt. One way or another, there will be defaults – unless debts are paid in an illusory fashion, simply by adding the interest charges onto the debt balance until the sums finally grow to so fictitious a magnitude that the illusion of viability has to be dropped.

But freeing an economy from illusion may be a traumatic event. The great policy question therefore concerns just how the various types of debts won't be paid. The choice is between forfeiting property to foreclosing creditors, or writing debts down at least to the ability to pay, and possibly all the way down to make a fresh start. Somebody must lose, and their loss will appear on the other side of the balance sheet as another party's gain. Debtors lose when they have to forfeit their property or cut back other spending pay their debts. Creditors lose when the debts are written down or go bad.

The balance of gains and losses in such foreclosures depends – in narrow accounting terms – on the value of collateral being transferred. But from an economy-wide perspective the resolution of a debt overhead needs to be looked at as a long-term dynamic. Any such analysis turns on the role of specific classes of debtors and creditors within the economy – the 99% and the 1%, the "real" economy and the financial sector. It is not simply a matter of what contracts say ("A debt is a debt, and all debts must be paid.") The effect of debt on the economy's overall cost structure is most important – including the international dimension cited earlier with regard to the extent to which debt service and debt-leveraged housing prices and other output increase the cost of living and doing business.

Writing down debts reduces the overall economy's financial costs. Keeping debts on the books retains these costs. So when the financial sector (or the 1%) insists on maintaining the debts that have been run up – and supporting the debt-leveraged price of real estate pledged as collateral – securing its past "savings" gains are incompatible with maintaining a viable economy. The debt overhead becomes an expense that must be shed if the economy is not to shrink – and if it does shrink, more debts will go bad and a deteriorating spiral will set in.

Perception of this long-term macroeconomic dynamic is what has led the past few centuries of legal trends and political ideology to favor indebted labor and industry, and indebted governments as well. It explains why debtors' prisons have been closed, and bankruptcy laws become increasingly humanitarian to enable debtors to make a fresh start. This idea of clean slates is only recently being extended to the economy-wide scale, starting with government debts to global creditors.

Today's financial trend threatens to reverse this pro-debtor reform tendency. Without acknowledging the economic and social consequences, the "business as usual" approach is a euphemism for sacrificing economies to creditors. It seeks to legitimize the disproportionate gains of banks and their rentier partners who have monopolized the past generation's surplus. And it is to protect these accumulations that the FIRE sector has spent part of these gains to become the dominant voice in government, including the courts, as well as academia. The aim in practice is to impose austerity and economic shrinkage on the private sector, while the public sector sells off its assets in a voluntary pre-bankruptcy.

The internal contradiction in this policy is that austerity makes the debts even harder to pay. A shrinking economy yields less tax revenue and has less ability to create a surplus out of which to pay creditors. Debt repayment is not available for spending on current goods and services. So markets shrink more.

This is not an inevitable scenario. Governments are sovereign with regard to their creditors. They still posses the alternative power to wipe out the debts – along with the savings that are their counterpart on the opposite side of the balance sheet. The German Currency Reform of 1948 remains a model. But it calls for creditors to take a loss.

This has happened again and again in history for the past five thousand years. Until recently it was the normal result of financial crashes – the final stage of the business cycle, so to speak. But as economies have been financialized, creditors have gained political power – and also the power to disable realistic academic discussion of the debt problem. What they fear most of all are thoughts of how to avoid today's arrangements that have given them a free lunch at the rest of the economy's expense.

Tags: Debt, neoliberalism, rentier, tax cuts

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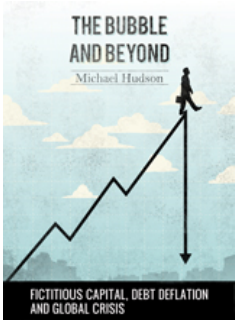

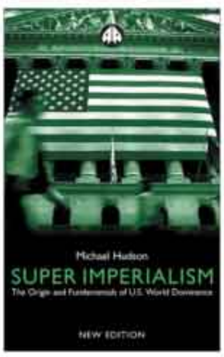

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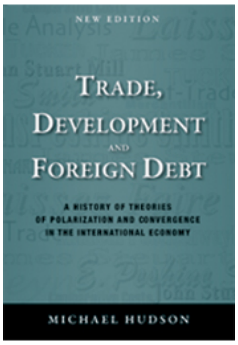

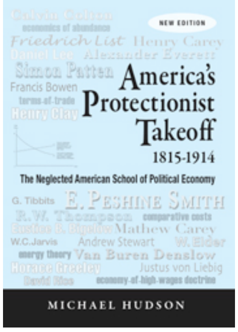

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