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The Financial War Against Iceland

Being defeated by debt is as deadly as outright military warfare.

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Iceland is under attack – not militarily but financially. It owes more than it can pay. This threatens debtors with forfeiture of what remains of their homes and other assets. The government is being told to sell off the nation's public domain, its natural resources and public enterprises to pay the financial gambling debts run up irresponsibly by a new banking class. This class is seeking to increase its wealth and power despite the fact that its debt-leveraging strategy already has plunged the economy into bankruptcy. On top of this, creditors are seeking to enact permanent taxes and sell off public assets to pay for bailouts to themselves.

Being defeated by debt is as deadly as outright military warfare. Faced with loss of their property and means of self-support, many citizens will get sick, lead lives of increasing desperation and die early if they do not repudiate most of the fraudulently offered loans of the past five years. And defending its civil society will not be as easy as it is in a war where the citizenry stands together in coping with a visible aggressor. Iceland is confronted by more powerful nations, headed by the United States and Britain. They are unleashing their propagandists and mobilizing the IMF and World Bank to demand that Iceland not defend itself by wiping out its bad debts. Yet these creditor nations so far have taken no responsibility for the current credit mess. And indeed, the United States and Britain are net debtors on balance. But when it comes to their stance vis-à-vis Iceland, they are demanding that it impoverish its citizens by paying debts in ways that these nations themselves would never follow. They know that it lacks the money to pay, but they are quite willing to take payment in the form of foreclosure on the nation's natural resources, land and housing, and a mortgage on the next few centuries of its future.

If this sounds like the spoils of war, it is – and always has been. Debt bondage is the name of this game. And the major weapon in this conflict of interest is how people perceive it. Debtors must be convinced to pay voluntarily, to put creditor interests above of the economy's prosperity as a whole, and even to put foreign demands above their own national interest. This is not a policy that my country, the United States, follows. But popular discussion in Iceland to date has been one-sided in defense of creditor interests, not that of its own domestic debtors.

Ultimately, Iceland's adversary is not a nation or even a class, but impersonal financial dynamics working globally and domestically. To cope with its current debt pressure, Iceland must recognize how uniquely destructive an economic regime its bankers have created, through self-serving legislation and outright fraud. With eager foreign complicity, its banks have managed to create enough foreign debt to cause chronic currency depreciation and hence domestic price inflation for many decades to come.

To put Iceland's financial dilemma in perspective, examine how other countries have dealt with huge debt obligations. Historically, the path of least resistance has been to "inflate their way out of debt." The idea is to pay debts with "cheap money" in terms of its reduced purchasing power. Governments do this by printing money and running budget deficits (spending more than they take in through taxes) large enough to raise prices as this new money chases the same volume of goods. That is how Rome depreciated its currency in antiquity, and how America managed to erode much of its own debt in the 1970s – and how the dollar's falling international value has wiped out much of the U.S. international debt in recent years. This price inflation reduces the debt burden – as long as wages and other income rise in tandem.

Faced with an unprecedented explosion of debt obligations – many of them apparently fraudulent, and certainly in violation of traditional credit practice – Iceland has turned this inflationary solution inside out. Instead of permitting the classic credit cure of inflating the currency, it has created a dream economy for creditors, preventing the classical escape from debt. Iceland has found a way to inflate its way *into* debt, not out of it. By indexing debt to the rate of inflation, it has guaranteed a unique windfall for banks that vastly increases what they receive in a "down market," at the expense of wage earners and industrial profits. Linking mortgage loans to the consumer price index (CPI) in the face of a depreciating currency and heavy balance-of-payments drain to foreigners can have only one result: destruction of Iceland's society and its traditional way of life.

Iceland needs to repudiate this debt bomb. Under present policy its debts will never lose value, because they are indexed to inflation. This in turn is being caused in large part by foreign debt service collapsing the currency, raising import prices and thus causing even larger debt payments in an endless treadmill. The economy shrinks, wages fall and assets lose value, yet debt obligations continue to grow and grow. The resulting evisceration of wages, living standards and consumer spending will further shrink the economy – a prescription for economic virus that threatens to plague Iceland for many decades if it is not reversed now. Capital formation will plunge as consumers lack money to spend. Many may not have enough to survive. The economy will be "crucified on a cross of gold," to use William Jennings Bryan's famous phrase in the 1896 American presidential election when he advocated an inflationary coinage of silver to alleviate debt pressure on U.S. farmers and labor.

Another side to the discussion?

Despite having spent the past half-century focusing on countries with balance-of-payments problems, even I find Iceland's uniquely self-destructive financial regime shocking. Before you dismiss my candor, I should offer a short personal résumé so that you understand that my conclusions are based mainly on having been an insider to the game of imperial-style plundering of nations for forty years. In the mid-1960s I was the balance-of-payments economist for the Chase Manhattan Bank and then for Arthur Anderson, and later for the United Nations Institute for Training and Research (UNITAR). I have taught international economics at the graduate level since 1969, and now head an international group on economic and financial history based at Harvard. In 1990 at Scudder Stevens and Clark, I organized the world's first sovereign-debt fund. All these jobs involved analyzing the limited ability of debtor countries to pay – how much could be extracted from them through foreign-currency loans and how much public infrastructure was available to be sold off in a voluntary virtual foreclosure process by countries willing to submit to creditor-dictated rules.

I first wrote about monetary imperialism in the 1970s in my book *Super Imperialism.* It should have been entitled "Monetary Imperialism" because it detailed how replacing gold with paper dollar IOUs for trade and balance-of-payments deficits in 1971 allowed the United States to exploit the rest of the world without limit. Phasing out gold payments among central banks in favor of fiat paper money allowed the United States to run up massive debts equal to its cumulative payments deficit, far beyond its ability to pay. It currently owes over $4 trillion, while running a chronic trade deficit with enormous overseas military spending, financed entirely by other countries through their central banks. This is euphemized as the "international monetary system."

I also was an advisor to the Canadian government in the 1970s. My main work was to write a monograph explaining why countries should not borrow in foreign currencies, but should monetize their own credit for domestic spending and investment. In recent years I have taught in Latvia and given this same advice to its officials. I provide this background because it has obvious relevance to Iceland's financial situation today. It has broken the cardinal rule of international finance: Never borrow in a foreign currency for credit that you can create freely at home. Governments can inflate their way out of domestic debt – but not out of *foreign* debt. That is a large part of the problem that Iceland now faces.

The main thrust of my comments therefore will focus on the international dimension of Iceland's debt problem, especially with regard to its relations with Europe. It therefore is relevant to look at what is happening in today's "expanded Europe." As the financial press has been reporting, post-Soviet economies have met with disastrous results after having moved to join the European Union during the past decade. The recent riots of debtors, farmers and labor union members from the Baltics to Hungary are symptomatic of the deep economic woes surging over these countries. Resentment is growing that instead of helping them industrialize and become more efficient, Europe and its Lisbon Treaty simply handed matters over to its bankers, who looked at these countries simply as credit customers to be loaded down with debt – not for loans to build up manufacturing and the infrastructure sorely needed by these countries, but loans mainly against existing real estate and infrastructure collateral already in place. That is the quickest way to make money, after all – and finance traditionally has lived in the short run.

This problem was bound to arise, given Europe's postindustrial faith that whatever increases "wealth" – even by the trick of puffing up real estate and other asset prices – is as productive as building new industrial capacity and infrastructure. The result of this ideology was a set of bubble economies built on debt-financed real estate and stock market inflation. Such bubbles always burst at some point. Only belatedly are nations re-discovering the classical axiom that the only way to pay for imports on a sustainable basis is to produce exports.

Unfortunately, neither foreign banks nor European advisors encouraged this. Their policy de-industrialized the post-Soviet countries, which financed deepening trade deficits by borrowing in foreign currency against their real estate. The Baltic States borrowed euros, sterling and Swiss francs, mainly from Swedish banks to finance a real estate bubble, while Hungary and its Central European neighbors borrowed heavily from Austrian banks. Their economies are shrinking now that their casino economies gambling on asset-price inflation have burst. Rental income and hence property prices are plunging, and exchange rates are following suit. This makes a foreign-currency mortgage cost more than local property is yielding. The result is widespread mortgage default, causing severe losses for Swedish and Austrian banks.

Bad real estate debts also are pulling down banks in the two leading creditor nations, Britain and the United States. Real estate prices, stock market prices and employment are going down in a straight line unprecedented even in the Great Depression of the 1930s. This has turned the neoliberal financial dream of “creating wealth” by inflating asset prices, by creating credit without actually increasing tangible capital formation (wages and living standards) into a nightmare. Just as individuals can’t live off a credit card forever, neither can nations. As any classical economist knows, societies that only manufacture debt are unsustainable. Casinos may be fun places to visit (customers pay by losing their money), but no place to live. The same is true of casino economies.

No help from the EU or the current global economy

The European Union is not in a position to offer much help in solving Iceland’s financial problems. The continent’s integration in the 1950s was pioneered by social democrats and pro-industrial idealistic capitalists such as Konrad Adenauer and Charles de Gaulle hoping to end the continent’s internecine wars forever. They succeeded, by forming the seven-nation Common Market in 1957. But further European expansion occurred largely on the financial sector’s terms. That is the source of problems fracturing “old” and “new” Europe today. It is the context in which Iceland’s debt problem is now being played out.

It seems natural enough for people to pay debts that have been taken on honestly. The normal expectation is that people will borrow – and banks will make loans – only for sound investments, ones that are able make a profit enabling the debtor to pay back the lender with interest. This is how banks have worked for many centuries – hence, the image of the prudent bankers who says “no” to any questionable deals brought before them.

At least that was the old way of doing things. Almost nobody anticipated a world in which bankers would create credit irresponsibly, leading to the massive defaults we are seeing throughout the world today. In the United States, for example, no less than a third of home mortgages have fallen into a state of Negative Equity. That is to say, the mortgage exceeds the market price of the real estate pledged as collateral. The U.S. national debt has tripled during the past year, from $5 trillion to $15 trillion as a result of financial bailouts including the government taking on the $5.2 trillion mortgage-packaging giants, Fannie Mae and Freddie Mac. A single insurance company, A.I.G., has been slated to receive a quarter-trillion dollars of bailout money, and a single bank, Citibank, has received over $70 billion and still counting. The stocks of these hitherto financial giants have fallen to just pennies, and Congress is now debating whether finally to nationalize them and wipe out their stockholders and even their bondholders.

In Britain much the same has occurred. Sitting in the lounge of Heathrow airport last month, I watched the hearings on BBC where members of Parliament expressed amazement that the most seriously affected banks were not led by bankers but by marketing men. Their job was not to calculate prudent loans, but to sell as much debt as possible, without regard for the debtor's ability to pay. The result is that the Bank of England – like the U.S. Treasury – is printing new bonds whose interest charges will have to be paid by taxes on labor and industry.

How can Iceland be expected to cope in this kind of financial environment? To get a perspective on what would be a dystopian future, one may look at the dress rehearsal for the so-called financial "reforms" played out in the 1990s in Russia and other post-Soviet countries. These are reforms that creditors – including the European banks, I'm sorry to say – now wish to impose on Iceland. In Russia, life expectancies sharply declined, while health, prosperity and hope withered as outside forces imposed austerity measures and high interest rates. Russians woke up to find that the devastation of the reforms foisted on them were as severe as the Second World War in reducing population, destroying industry, spreading disease and losing control of their economy. Living standards plunged, especially for retirees, while employment prospects closed for the young. Much the same occurred throughout the former Soviet Union.

This policy remains the "fix" for debtor countries: Sell off assets for pennies on the dollar to kleptocrats across the globe, and gut the nation's social welfare programs just at a time they are needed most. By contrast, look at the nations calling most loudly for Iceland to pay the loans made by global speculators and arbitrageurs. They include the largest debtor nations, headed by the United States and Britain, led by politicians who never would dream of imposing such hardship on themselves. While cutting their own taxes and increasing their own government budget deficits, these nations are attempting to extricate financial tribute from smaller, weaker countries that they can bully, as they did to Third World debtors in the 1980s and '90s.

Dismantling industrial capitalism

This is a crisis that calls for blunt truths. What creditor nations and their international financial institutions are promoting is not capitalism as traditionally understood. Instead of helping industrialize the countries to which they extended credit so as to make them viable and self-reliant with new means of paying for their imports – and indeed, paying the debts taken on to rebuild their productive capacity – European planners oversaw the dismantling of manufacturing.

Even worse, they did so in a way that empowered a neo-feudal set of financial oligarchs. Indebted economies have been turned into a gaggle of casinos, with special games (*e.g.*, opaque financial instruments such as credit-default swaps) reserved exclusively for insiders. Even to get into this game, one must be at last a millionaire, signing legal releases that one can afford to lose the entire investment and still survive economically. The European Union thus adds insult to injury by presenting its financial agencies euphemistically as donors bringing aid. They turn out to be the same ideologues that have crippled industrial capitalism across the globe by proliferating debt-leveraged gambles that have redistributed wealth upwards wherever they have operated.

This policy creates debt peonage for most citizens, above all in the newer countries seeking to join the European Union. Even in the richest nation on earth – the United States – nearly half of all citizens now have no net worth, and the gulf between the wealthiest 10 percent and the rest of society has widened geometrically since 1980. This is the unfair system that the world's top creditors would export to Iceland – if they can convince its voters to accept neoliberal debt pyramiding as a way to get rich. The recent riots throughout the post-Soviet states suggest that this plan is not working. Their populations are now feeling how deeply the so-called financial reforms (*e.g.*, financial deregulation) promoted by European banks and the Lisbon Agreements have polarized their economies.

Recognizing the enemy within

The only defense against such disastrous policy is to recognize that there are better alternatives. It simply is not possible for today's astronomically indebted economies to "work their way out of debt" with the old trick of inflating the money supply. Trying to do so will collapse the currency's exchange rate and divert so much revenue to pay creditors – and transfer so much property out of local hands – that a new kind of post-capitalist, non-production/consumption economy will be created, one less and less able to be self-reliant and independent, to say nothing about being just and sustainable.

Iceland's financial crisis today is less an issue of international law as of outright lawlessness perpetrated by the purveyors of so-called free market democracy. Nations pressing Iceland for payment impose one set of laws for others while following quite a different set for themselves. Preaching to Iceland about international law, the United States and Great Britain themselves have broken the clearest of international laws – those against waging aggressive war. Their propagandists are skillful at using the language of capitalism and morality, yet they are neither capitalist nor moral. Their financial strategy is to play an ages-old psychological game. Make countries like Iceland feel guilty about being debtors rather than recognizing they have been victims of an international Ponzi scheme. In a nutshell, the game is to lay down "laws" for debtors in the form of destructive austerity programs fashioned by irresponsible and indeed, parasitic creditors. This "aid advice" ends in outright asset stripping, both public and private.

Asset stripping to pay debts has caused collapse time and again in history, but is strangely downplayed in today's academic curriculum as an "inconvenient truth" as far as vested financial interests are concerned. Income is siphoned off by a scheme that is elegant and simple. Hapless victims – and now entire economies, not just individuals – are maneuvered onto a debt treadmill from which there is no escape. Creditors pile on credit and let the debts grow at the "magic of compound interest," knowing that their loans cannot be repaid – except by asset sell-offs. No economy's productivity can keep pace with exponentially compounding debt. Whatever was owned (and indeed, financed originally by public debt but now paid off) is stripped away for interest payments that never end. The aim is for these payments to absorb as much of the surplus as possible, so that the national economy in effect works to pay tribute to the new global financial class – bankers and money managers of mutual funds, pension funds and hedge funds.

The product they are selling is debt. They build up their own wealth by indebting others, and then forcing sell-offs to buyers who take on their own debt in the hope of making asset-price gains as property prices are impossibly inflated relative to the wages of living labor. This has become the new, euphemistically dubbed post-industrial form of wealth creation – a strategy that is now collapsing economies throughout the world.

The role of the United States

The United States has trapped other countries into a nightmarish system in which they have little practical choice but to recycle their excess balance-of-payments dollar inflows back to the United States, mainly in the form of loans to the U.S. Treasury. When foreign central banks receive dollars for their exports (or for the sale of their companies), they are limited in what they can do with these dollars. The U.S. Congress will not let them buy up important domestic companies or resources, and will not part with U.S. gold holdings. So foreign central banks are obliged to buy Treasury bonds – or, as the supply of these bonds has run out (being limited by the domestic budget deficit), mortgage-backed securities issued by the now-public Fannie Mae and Freddie Mac packagers of subprime mortgages. These two semi-official agencies were formally nationalized last year after a series of financial frauds and disastrous investments wiped out their capital, obliging the U.S. Government to step in and mollify governments from China to Israel whose central banks had been recycling their surplus dollar inflows into these securities.

Icelanders should keep one basic principle uppermost in their minds. The United States is the world's largest debtor nation, and will never repay its own foreign debt. Over and above its presently outstanding four trillion dollars, its Treasury intends to keep on issuing new paper IOUs in exchange for the goods, services and real assets of China, Japan and other creditor nations – until governments stuck with these paper dollars turn their back on this Madoff-Ponzi scheme (note that these schemes always are named for American operators), recognizing what Adam Smith explained in *The Wealth of Nations:* No nation has ever repaid its debts. Small nations like Iceland, along with small taxpayers in wealthy countries, may be coerced with propaganda, mind games and outright threats into paying – until they have no assets left to hand over. But the big boys are above the law. They control the courts (which often rule without much regard for the actual law), just as they write history and newspaper coverage – and business school curricula – to serve their own interests.

The second important principle is how radically today's post-capitalist order has inverted traditional ways of making money. Instead of making profits on new capital investment, the easiest path to quick riches in today's global financial system is to foreclose at pennies on the dollar, and make a "capital gain" by flipping property onto world financial markets that are being inflated by central banks. While financial spokespersons promise that "there is no such thing as a free lunch," today's hit-and-run financial bubble, fraud and insider privatizations culminating in public-sector bailouts ("socializing the risk" while privatizing the profits and capital gains) – has become all about obtaining a free lunch.

Iceland's zero-sum financial gamble

But it is a zero-sum gambling game, with losers on the other side of the table from the winners. One party's gain is another's loss – and indeed, this kind of game ends up shrinking the economy by diverting resources away from real investment in tangible capital formation. Unlike industrial capitalism, which employs labor and invests in capital equipment to turn raw materials into salable commodities, today's post-industrial financialized system only offers the virtual (and temporary) wealth of asset bubbles. Its financial managers claim to be acting in the tradition of classical economists and share their concept of free markets, but in actuality they have been part of an intellectual fraud that depicts their system as something other than the financialized wealth extraction on the real economy of production and consumption that it is. Financialized wealth is extractive, not productive. That is because loans, stocks and bond securities are claims *on* wealth, not real wealth itself.

This is the context in which today's financial war against Iceland is being waged. Homeowners are paying tribute, not in the form of taxes to an invading occupying force, but in interest to local sponsors of the debt pyramiding that has got Iceland into such deep trouble, and to the international creditors and enablers of this over-financialization of the economy. The nation's public domain, its land and geothermal resources, its tourist industry and public assets are being eyed by foreign creditors as prey to be seized in the way that has occurred in many Third World countries. It is what ruined Turkey and Egypt in the late 19th century and brought down other kingdoms for centuries before that. Yet many Icelanders are heading into this future voluntarily, as if it somehow is fair rather than an exercise in predatory finance led by nations that have shown no willingness (or ability) to pay their own international debts.

Nations know when they are being attacked militarily. Defense forces fight to prevent invaders from seizing their land and imposing tribute. No country would think of welcoming a foreign army to do what William the Conqueror did to England after 1066. He ordered his accountants to compile the Domesday Book within thirty years (it was ready by 1086), calculating the rental value of English land in order to tax it for the Crown.

That is how most of Europe's kingdoms were created. The rent was paid to the companions of military warlords, and their heirs ruled as absentee Lords for nine centuries. They quickly moved to keep what started out as royal revenue for themselves, celebrating this as the victory for free-market "democracy" in the Magna Carta liberatum (1215) and subsequent Revolt of the Barons (1258-65). Today, these lords of the land and those who have bought their property have run up mortgage debt, paying creditors what formerly was paid first as taxes and then taken as rent.

What took centuries to achieve in feudal Europe is now being threatened in Iceland, compressed into the space of just a decade or so. And in many ways this financial situation doesn't make sense – unless one looks through history to see how the same tragedy has happened again and again.

The United States, Britain and the International Monetary Fund ("the global investment community") are couching their demands for draconian austerity policies in the language of capitalism. But what they actually are promoting is a financial system that threatens to end in debt peonage, not democratic capitalism. Across the globe, from the Baltics to Hungary in Europe, and indeed from Russia to China, riots and wildcat strikes recently have broken out to protest this post-capitalist financial dynamic. It already has destroyed the industrial capacity of debtor countries subjected to the cruel austerity programs imposed by the IMF as acting agent for the global financial class. This merely repeats what the British did in India. Industrial growth has been replaced with a financialized real estate bubble. The "final stage" of this dynamic is to foreclose and sell off the assets of debtors at giveaway prices. Talk about democracy from the financial elite is a public-relations cover story. Their "magic of compound interest" sales pitch threatens to destroy entire nations.

Fortunately, this need not happen in countries that do not impose debt leveraging on themselves, but only in countries that let the public utility of money and credit creation be privatized in the hands of a cosmopolitan financial class. Iceland still has an alternative future before it, if voters recognize this in time. But to achieve the better future that most of its citizens want, it must understand the predatory debt trap into which it has fallen – or more accurately, been pushed by believing in the same illegitimate financial doctrine that has ruined Russia and other post-Soviet economies, as well as Third World countries before them under decades of IMF "austerity plans" designed to stifle domestic growth (and competition) and economic stability to pay foreign creditors. History provides tragic examples – the aftermath of World War I, and England itself in the centuries of its seemingly perpetual wars with France.

Industrial economies reverting to "tollbooth economies"

The world is plunging "back to the future," to an epoch of neo-feudalism and debt peonage. It is a travesty of the promise of industrial capitalism as it seemed to be evolving on the eve of the 20th century and the Progressive Era of social democracy. What was not recognized was the financial time bomb implanted in the DNA of Europe as it evolved out of the Middle Ages.

As European feudalism gave way to the formation of nation-states, most kingdoms became dependent on foreign loans to fight their wars – starting with the Crusades, whose looting of Byzantium provided an enormous influx of gold and silver. This is what broke down Church bans on usury. Once governments paid interest to elite Church orders such as the Templars and Hospitallers, it became permissible for banks to join in lending at interest – to kings, the nobility and the merchant classes as major customers.

The birth of international post-medieval banking proved disastrous for many family banks that foundered on what turned out to be bad loans to the leading powers of early Europe, from Spain to France and England. The historian Richard Ehrenberg notes that Spanish bankruptcies "occurred at intervals of about twenty years – 1557, 1575, 1596, 1607, 1627, 1647," often being rationalized by pious allusions to Church prohibitions against usury. England declared bankruptcy under Edward III in 1339, and Charles II shut down the Exchequer in 1672 and suspended payment on its floating debt. Wiping out debts was the only way to retain basic economic and political relations and national independence. In view of this long experience, England's advice to Iceland today is in the character of "Do as we say, not as we ourselves have done and are doing."

Central banks were formed to advance credit to governments, and commercial banks to help finance the Industrial Revolution's expanding trade and related infrastructure spending, mining and shipping, capped by infrastructure monopolies such as canals, railroads and ports, and later by fuel and power. The medieval epoch's "primitive accumulation" – the extraction of revenue by military seizure – was replaced by the more peaceful and seemingly civilized practice of creditors appropriating the economic surplus by making interest-bearing loans, and by foreclosing on property when the interest charges could not be paid.

In recent years financial managers have persuaded many countries to sell off public enterprises like their water or energy supplies, mainly to raise the money to pay debts or to cut taxes on the highest wealth brackets. This sale of the "commons" by naïve, myopic leaders (and the "useful idiots" promoted by financial lobbyists to be their economic advisors) turns debtor countries into "tollbooth economies" in which basic services become a vehicle to extract greater and greater portions of national income and wealth for the benefit of the few. This is the antithesis of "free markets" as classical economists understood the term. They are markets designed and controlled by the financial sector to appropriate for itself the surplus produced by labor and tangible capital investment.

To promote this siphoning off of surplus income, the rich have funded extensive disinformation (propaganda) campaigns around the world. Their tactic is to use familiar and revered ideological terms such as "free markets," "economic democracy" and "fairness" to win the hearts and minds of the population while actually imposing a set of policies in stark contrast to Enlightenment ideology, classical political economy, Progressive Era reform and 20th century social democracy – the ideals of freedom-loving peoples everywhere. Financial lobbyists have spent billions of dollars spent on public-relations think tanks to achieve this ideological con job. They have endowed business schools and gained control of government agencies to promote their creditor-oriented point of view, headed by central banks to serve as the ideological wedge for today's anti-democratic forces. This is the ideology that has pushed much of the Third World into poverty since the 1960s, as well as today's tragically debt-ridden post-Soviet economies.

Financial warfare

Finance seems at first sight to be quite different from outright warfare. Everyone knows well enough that invading armies do not come on friendly terms. Foreign navies and troops are not welcomed, even if they promise to help build up the economy by constructing new roads and bridges (the better for their tanks and troops to travel on), hydropower and geothermal stations to export electricity (keeping the earnings for themselves), hotels and spas for themselves and foreigners to enjoy (and keep the rental incomes and site values), and create detailed statistical analyses (such as the Domesday Book alluded to above) to manage the economy in their favor.

Today this financial strategy has become multilateral. The IMF acts as enforcer for global creditors to appropriate the income of real estate, national infrastructure and industry as a financial boondoggle. What is remarkable is that countries throughout the world are losing their economic and fiscal independence peacefully – at least it is peaceful when target countries do not fight back. (Chile, Cuba and Iran are object lessons for the punitive economic sanctions imposed on countries that do not accept today's predatory economic ethic.) Financial conquest is thus more covert than military warfare. It relies more on the educational and psychological dimension, and is most successful when the victim does not even realize it is being attacked.

But the effects are as devastating on human life as what Russia suffered at the hands of Western "reformers" in the 1990s. The financial austerity imposed by creditor-run regimes shortens life spans, reduces birth rates, and increases labor flight, suicide rates, disease, alcoholism and drug abuse. Just as war kills an economy's males of fighting age (25-35), financial austerity drives them to emigrate to find work. This is why U.S. investor Warren Buffett has called collateralized debt obligations (CDOs), credit default swaps and similar debt-leveraging instruments "weapons of mass financial destruction."

Consider the role of banking in this neo-feudal order. Banks do not create credit to finance manufacturing – that is done mainly out of retained earnings and equity. Banks create credit primarily to lend against collateral already in place – loans that simply extract money from the economy. This is an inherently destructive act, one that is anti-capitalist in the sense that it undercuts industrial growth in favor of interest extraction and short-term speculative gains.

The trick is to get this policy welcomed as if it were progress, as "post-industrial" rather than a lapse backward. Only today is it becoming apparent that the collateral-based lending of banks "creates wealth" mainly by inflating asset-price bubbles, especially in real estate. Bankers calculate how much debt a given flow of residential or commercial real estate income can support, and create enough credit to make a loan large enough to absorb this surplus revenue. Bankers do the same with industry by lending corporate raiders enough money in take-over "junk" bonds to turn profits into a flow of interest payments for themselves, and with capital gains for the raiders. Central banks fuel this process by swamping economies with easy credit (that is, debt) that keeps the financial sector fat while impoverishing the increasingly indebted nation.

Finance thus is the historical antithesis of property, sanctifying its own right to expropriate indebted property owners. Originally denounced by Christianity, Judaism and Islam, interest-bearing debt has sanctified itself as the predominant form of wealth. This is not what the classical economists and democratic political reformers expected to see. They explained how to avoid this economic dystopia by appropriate government tax policy and regulation to minimize the economic role and political power of post-feudal bankers and *rentiers.* (*Rentiers* are people who live off interest and rents, that is, off absentee incomes paid on a regular basis. A *rente* was a French government bond paying interest at regular intervals; the idea was extended to landlords.)

How banks and the financial sector gained dominant power

This supremacy of the banks and the financial sector took thousands of years to achieve. It was not easy to overthrow traditional social values and to impoverish so many economies by subordinating customary property relations with legal priority for creditors. Iceland only recently has come under this kind of financial attack by creditors operating globally. Bankers managed to convince ambitious fortune-seekers that the way to wealth and economic growth lay in debt leveraging, not in staying free of debt. Selling debt as their product, banks and speculators at the world's financial core needed to prepare for what they must have known would lead to economic collapse and destroyed economies throughout history. They prepared the path to ruin by ideological engineering aimed at shaping how populations think about history, so as to accept debt pyramiding as a good economic strategy.

As an example of their warped thinking, consider an attractively priced home. Would you rather own 100% of a home free of all debt with a market value of 100,000 euros if free of debt – or, would you rather own 60% of the same home at an inflated market price valued at 250,000 euros? In the second scenario you would have 50,000 euros of "surplus wealth" (60% x 250,000 = 150,000 euros, compared to 100,000 in the first example). People across the globe have been convinced that the second scenario represents "wealth creation." What is overlooked is that the higher-priced home carries interest charges on its higher market price. This charge would amount to 6,000 euros a year, or 500 euros a month, at 6% interest. The same property is worth more, but includes a much larger debt overhead – income for the financial sector.

In Iceland – but nowhere else – home mortgages have a uniquely bad twist. Creditors have managed to protect the weight of their claims on debtors by indexing mortgage loans to the nation's consumer price inflation (CPI) rate. Each month the debt principal is increased by the CPI increase – and so is the interest charge. During 2008 that index rose by 14.2%, so a 100,000-euro mortgage at the start of 2008 would have grown to 114,230 euros by yearend. These monthly adjustments also would added an entire percentage point onto the interest payment – an extra 100 euros to be paid to creditors monthly, in addition to the growing principal to be amortized. Talk about making money without effort …!

Such heavy debt charges would shrink any economy, and that is what is happening in Iceland. Prices for real estate declined by an estimated 21 percent for housing in 2008. So in the above example, the market price of the house worth 100,000 euros at the beginning of the year would have been worth only 79,000 at yearend, while the mortgage would have grown by 14% to 114,230. This would have plunged the homeowner 35,000 euros into negative equity – a remarkable 35% change.

In every other country, investors lose out when prices decline for real estate, stocks and bonds, while creditors find the purchasing power of their loans eroded by inflation. That is how most countries have “inflated their way out of debt” for many centuries. But Iceland’s creditors have created a system in which their position actually is improved as the rest of the economy suffers inflationary price erosion. Their claims rise in proportion to the rate at which consumer-price inflation eats away at wages and business profits. Where is the sense in this?

What makes this so ironic is that the purpose of calculating the consumer-price index in all countries has been to support consumer income. It was to protect wage earners and retirees against inflation eating away at their ability to maintain their standard of living. That is why in the United States, Social Security retirees receive an annual cost-of-living adjustment based on the CPI. But Iceland inverts this political aim, protecting the claims of creditors against debtors (and hence against most wage-earners). The creditor’s objective is to maximize the power of debt over living labor. That is the literal meaning of “mortgage:” a “dead hand” of the past over the present, of past wealth and credit over the living. For Iceland the debts run up during the “wealth creation” phase of the financial bubble are to be left in place and even grow at an accelerating rate reflecting the pace of currency depreciation and hence import prices and consumer prices generally. Debtors lose out as prices plunge for the homes they own, while creditors maintain their economic grip intact and even strengthen their hand by increasing their take.

Turning economic power into political power

Creditors in most countries have been able to turn their economic power into political power with the aim of shifting the tax burden off themselves and onto labor and industry. The final *coup de grace* occurs when they get the government to bail them out from their losses on bad loans. In the United States, Congress has tripled the national debt in less than a year to bail out creditors with little thought of helping debtors, or even of prosecuting the massive financial fraud involved in its subprime real estate bubble and the sale of junk mortgages to gullible foreign buyers.

Iceland’s citizens will own a smaller and smaller proportion of their homes as its banks become the main claimants on the nation’s property value. By subjecting Iceland to this unique kind of financial squeeze, Icelandic policy stands in diametrical contrast to that of the United States. The U.S. policy is to stabilize its economy and avoid depression by writing down debts to bring them in line with today’s lower market prices and, more specifically, to bring carrying charges on mortgage debt within the ability of homeowners to pay no more than 32% of their income. Other countries also are writing down their debts to bring them in line with the ability to pay. But Iceland is subjecting its own homeowners and consumers into debt deflation and plunging them into Negative Equity status – by law!

The only way its banks can succeed in this ploy is to keep Iceland’s voters unaware of what is happening in the rest of the world – and indeed, to block the government from drawing up a balance sheet of the nation's debts, a roster of whom these debts are owed to, and a calculation of the economy's ability to pay.

Iceland's present policy will lower disposable income for homeowners and other debtors – the great majority of its citizens – while wealth gushes to the top of the economic pyramid, to those who are creating as much credit as they can find borrowers for. The result is not what former Federal Reserve chairman Alan Greenspan and President George W. Bush claimed to be creating in America – an "ownership" society. It really is a "loanship" society, an economy of ersatz assets in which debt pyramiding – owning less and less of a home or other asset – seemed to be a strategy for growing richer instead of the debt trap it is. Has Iceland fallen into a similar semantic trap?

Pensions and retirement

As in the United States, Iceland has convinced labor to "prefund" its retirement. The idea is to save up in advance, so as to provide for retirement in a purely financial way. Of course, the most important way to support retirees is to see that they can afford the basic goods and services needed to live. To the extent that "financializing" an economy ends up eroding the "real" economy, pension funding – and government Social Security funds (regressive taxes that enable the Treasury to cut taxes for the higher wealth brackets) – tends to shrink the economy rather than provide for the expansion in output needed to support an aging population. As matters stand, pension savings are mobilized to increase the volume of interest-extracting debt and fuel financial bubbles (as in America's "pension-fund capitalism" that pushed up stock markets in the past). Pension savings works against employment most visibly when they are lent to corporate raiders who pay off their bondholders by downsizing the work force and squeezing more "productivity" out of the remaining employees. Economic "growth" under such circumstances takes the form of a financial and property-sector overhead, not growth or stability in living standards or the capacity to produce.

Allowing economies to be crippled with interest payments was unthinkable until recently. To achieve so radical a break in the public's idea of prosperity and self-reliance, it has been necessary for creditors to wipe out knowledge of how legal systems have been amended to put creditor interests above those of debtors over the past eight centuries – and how the leading classical economists and Enlightenment cultural and religious leaders sought to subordinate creditor interests to those of growth and prosperity for the economy at large. But the new banking class has been clever enough to hire the best propagandists money can buy while remaining blind to the havoc they are wreaking with people's lives.

The debt game

Like many people, Icelanders tend to think of debt in personal terms, as if creditors are neighbors much like themselves. The normal thing to do when problems arise would be to sit down and reach a common agreement. But Iceland's creditors are impersonal billion-dollar financial conglomerates, and creditor-debtor relations under such conditions are inherently adversarial, as anyone who has had a recent disagreement with a bank can attest. Whatever creditors can gain in today's highly politicized, legalistic and ideological tug-of-war will be the debtor's loss. And the magnitude of Iceland's prospective loss threatens to plunge its economy into depression for generations, turning it into a Third World oligarchy, or worse, a dictatorship. The price of paying its debts thus threatens to be loss of its national identity and a loss of its future.

The trick is to fool debtors into thinking that "free markets" means paying one's debts. Creditors can succeed in letting debt leveraging and "the magic of compound interest" empty out economies only by diverting attention from what Adam Smith and other classical economists warned against. For them, a free market was one free of debt – especially foreign debt. In *The Wealth of Nations* (especially Book V, chapter 3), Smith warned against creditors becoming "free" enough to disable the ability of governments to protect citizens from creditors – especially the Dutch, who were the major investors in British monopolies created to be sold to pay for that nation's seemingly eternal wars with France. The problem was that creditors sought to extract the wealth of nations for themselves, not to create wealth. Their greed was destructive to society as a whole, because it was easier to simply strip assets than to create real capital.

That is the problem with creditors historically. They tend to care only about how to extract as much as they can, as quickly as possible. "A creditor of the public, considered merely as such," wrote Smith, "has no interest in the good condition of any particular portion of land, or in the good management of any particular portion of capital stock. As a creditor of the public he has no knowledge of any such particular portion. He has no inspection of it. He can have no care about it. Its ruin may in some cases be unknown to him, and cannot directly affect him." The problem obviously is worst with absentee creditors.

Smith concluded: "When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid. The liberation of the public revenue, if it has ever been brought about is by bankruptcy; sometimes by an avowed one, but always by a real one, though frequently by a pretended payment."

Adam Smith's portrait is engraved on England's £20-pound note, and Andrew Jackson on the US $20 bill. The irony is that Smith denounced public debts and urged wars to be financed on a pay-as-you-go basis so that people would feel their burden – and stay out of debt. As for Andrew Jackson, he closed down the Second Bank of the United States, accusing bankers of ruining the nation and seeking to destroy democracy. Bankers and finance therefore leave something important out of the account when it comes to the views of their own patron saints of democratic free markets.

As noted above, creditors for many centuries now have suffered bankruptcies when foreign countries default. That is the norm, not the exception. Yet today's popular media greet every new default as "unanticipated" and "surprising," as if it were not the bankers' fault that they failed to understand the market's inability to pay. Dumbed-down economics textbooks chime in with their inbred ignorance voiced by the financial sector's proverbial "useful idiots" prattling about "equilibrium" and "automatic stabilizers." These un-learned academics are useful to the bankers because of the passion with which they proclaim that all debts should and can be paid by suitable “adjustments” (including what turns out to be economic and demographic collapse). The question being asked with a straight face is: If it is the fault of victims rather than the bankers, then is it not proper for governments to bail out the banks?

The tacit assumption is not that bankers’ exorbitant greed is achieved at the expense of the economy at large, but that the financial sector’s prosperity is a precondition for the economy to grow. The bankers try to cap matters by trotting out poor retirees (like the widows and orphans of old – presumably those living on “fixed incomes” in the form of trust funds) whose meager savings should be supported. Doing so just happens to save the financial oligarchy of billionaires at the top of the economic pyramid, but not the proverbial victims.

The use of human shields such as union members concerned about the investments of their pension funds to protect the wealth of the kleptocrats is likewise shameless. Wall Street sages in the United States, for example, shed crocodile tears over the fate of the working people suffering from the stock market collapse, knowing full well that financial assets are heavily concentrated at the top of the economic pyramid, with workers having, only a meager share of those stocks and bonds. Ignored is the fact that the government could bail out failing pension funds (like Social Security) directly at just a small fraction of the cost of propping up the assets of the affluent.

Likewise, the volume of government bailout money for the financial sector ostensibly to deal with the subprime mortgage crisis – about $13 trillion during 2008-09 – clashes with the fact that the total value of mortgage debt owed by all households in the entire United States is only $11 trillion as of yearend 2008! The bailout funds ended up being used mainly to buy other banks to create even larger financial conglomerates “too big to fail,” to pay executives whose greed for short-term gains and bonuses caused the financial meltdown, and to pay dividends to stockholders to support their stock price and hence the value of stock options that financial managers gave themselves. The closest parallel to this scandal is the “watered stock” practices of Wall Street’s railroad barons and other financial manipulators in the late 19th-century Gilded Age.

There was a time when banks hesitated to make loans irresponsibly, that is, beyond the ability of debtors – and entire national economies – to generate a surplus to pay their creditors. My job as balance-of-payments economist for the Chase Manhattan Bank in the 1960s was to calculate how much export earnings and other foreign exchange the major Latin American countries could generate. Their balance-of-payments surplus represented how much they could afford to borrow. The aim of New York banks was to lend Third World countries money to absorb their entire economic surplus. From the bankers’ point of view, that was what a national surplus was for – not to sustain higher living standards or invest in becoming economically self-sufficient, but simply to pay creditors. And “wealth” was defined as the capitalized value of the entire economic surplus they could generate – discounted at the going rate of interest, as if it all could be paid as debt service, so that the entire surplus would be paid to carry the debt.

This certainly is not a model of human progress. But it was that decade's version of "wealth creation," and it is the concept of "wealth creation" in terms of the market value of debt-financed asset prices that Alan Greenspan would foist on the United States in the 1990s to convince it that an asset bubble was the path to postindustrial wealth, not the road to debt serfdom.

So Adam Smith was right. Today, creditors and bondholders care about foreign economies only to the extent that they can charge interest that will absorb their entire economic surplus. Until recently, creditors thought that lending more than can be repaid would be "irresponsible." Not any more.

Political checks and balances on the economy

The best path for nations is to put their own economic growth before the interests of creditors. For many generations this ethic supported a set of political checks and balances that kept the growth of international debt in terms considered to be tolerable – much too heavy by the free-market standards of Smith and John Stuart Mill, but not so high as to prompt widespread defaults and debt repudiation.

This ethic has changed in recent years. Countries have accepted creditor propaganda that debts are a "point of honor," much as the poor believe that paying their debts – even when they are in negative equity – is the "honest thing to do." Obviously this ethic is not self-applied to the world's largest financial institutions or real estate speculators. But Iceland accepted it in what is a characteristic of small, closely-knit communities where the word of neighbors is their bond. The root of Iceland's ethic is mutual aid and prosperity for all. It is a fine, highly socialized attitude, and therefore tragic that it has helped lead the nation to fall prone to the snake oil of debt peonage.

Political leaders who fail to recognize the fact that checks and balances are a proper function of government are liable to sacrifice their nation's hope for economic growth and rising living standards in a vain attempt to pay creditors. Such attempts must be in vain, because "the magic of compound interest" is a cruel myth: In reality every rate of interest implies a doubling time, and no economy's "real" growth ever has been able to grow exponentially at a fast enough rate to pay the debts that keep accruing interest.

In today's deregulated environment where "the sky's the limit," these accruals have been recycled in yet new loans. These then are packaged and resold, loading the economy down with more and more debt that so far has been almost impossible to track. And to cap matters, financial speculators then place trillions of dollars of bets on whether the debts can be paid or not, and how much their market prices are likely to change. What was supposed to be a financial system designed to fund new capital investment to produce more and raise living standards has turned into a casino economy – where gamblers are staked by the bankers to play the debt game, with the government standing by to make the winners "whole" in cases where the debtors have lost too much of their play-money to pay up.

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

Every economist who has looked at the mathematics of compound interest has pointed out that in the end, debts cannot be paid. Every rate of interest can be viewed in terms of the time that it takes for a debt to double. At 5%, a debt doubles in 14½ years; at 7 percent, in 10 years; at 10 percent, in 7 years. As early as 2000 BC in Babylonia, scribal accountants were trained to calculate how loans principal doubled in five years at the then-current equivalent of 20% annually (1/60th per month for 60 months). “How long does it take a debt to multiply 64 times?” a student exercise asked. The answer is, 30 years – 6 doubling times.

No economy ever has been able to keep on doubling on a steady basis. Debts grow by purely mathematical principles, but “real” economies taper off in S-curves. This too was known in Babylonia, whose economic models calculated the growth of herds, which normally taper off. A major reason why national economic growth slows in today’s economies is that more and more income must be paid to carry the debt burden that mounts up. By leaving less revenue available for direct investment in capital formation and to fuel rising living standards, interest payments end up plunging economies into recession. For the past century or so, it usually has taken 18 years for the typical real estate cycle to run its course.

Nations that have not paid their debts

Let us draw up a roster of nations that have annulled their debts – or run them up with no intention of paying. The list starts with the world’s largest debtor, the United States. Its government owes $4 trillion to foreign central banks. A moment’s thought will show that there is no way it can pay, even if it wanted to do so. The United States is running a chronic trade deficit, on top of which is a deepening outflow of military spending. In addressing this chronic living beyond the nation’s international financial means, American diplomats are almost the only ones in the world who conduct international diplomacy the way that textbooks assume that all countries should do: They act purely and ruthlessly in their own national interest. This interest lies in getting the proverbial free lunch, by giving IOUs for other countries’ real resources and assets, with no intention or ability to pay.

U.S. officials already have suggested that this debt be wiped out. Their plan would convert it into “paper gold.” Foreign central banks would simply stamp their U.S. Treasury bonds “good only for payment among central banks and the International Monetary Fund.” No other nation would be allowed to wipe out its debts in this way. Only the debtor at the center would be able to continue issuing debt-money without foreign constraint.

To be sure, U.S. diplomats have freed countries from debt when they have a political reason to do so. The most famous modern example of an economy-wide debt cancellation is that of Germany in 1947. The Allies cancelled German personal and business debt, on the ground that most were owed to former Nazis. The only debts left on the books were current wage-debts that employers owed to their work force, and basic working balances for companies and families.

A generation earlier, in 1931, the Allies wiped out Germany’s reparations debt stemming from World War I, and negotiated a moratorium on their arms debts to the United States. The world’s leading governments realized that keeping these debts on the books would collapse the global economy. But by the time they reached this conclusion it already was too late. The combination of Inter-Ally arms debts owed to the United States and the reparations debts imposed by the Allies largely to pay America already was one of the major factors pushing the world into a depression.

The U.S. economy was collapsing under the weight of its domestic debt pyramiding. Other countries had used less debt leveraging, but all ended up writing off large swaths of real estate and business debts during the Depression Years. By the time the Second World War ended in 1945, most countries were free of debt. Prices reflected direct production costs, with minimum diversion of revenue to pay banks, absentee property owners and other *rentiers.*

In the postwar period the World Bank lent dollars for governments to build infrastructure – only to turn around a generation later and help loot what it had financed. After Mexico and other Latin American governments announced that they were insolvent in 1982, U.S. diplomats organized a debt write-down in the form of "Brady bonds." By 1990, Argentina and Brazil had to pay 45% on new dollarized foreign debt, and Mexico paid 23%.

Having stuck Third World countries with debts beyond their ability to pay, the IMF and World Bank used their creditor leverage to force governments to impose draconian austerity plans that had the effect of preventing growth toward industrial and agricultural self-sufficiency, thereby also crushing prospects for competitiveness. The IMF and World Bank then demanded that debtor countries sell off their public infrastructure, land, subsoil rights and other assets to pay the debts that these institutions sponsored so irresponsibly. (If IMF loans were not simply irresponsible, then they knowingly crippled debtor-country economies.) It is an age-old story of conquest, now accomplished without conventional warfare.

Two thousand years ago Rome stripped Asia Minor and other provinces and colonies of money using military force. Its financial oligarchy then translated their economic power into political power, destroying democracy and bringing on centuries of Dark Ages. The historical lesson is that economies taken over by creditors are plunged into depression as predatory lending strips away the surplus, leaving nothing remaining for subsistence, let alone capital renewal. This prevents nations from paying their debts, leading to widespread foreclosure, an extreme polarization of property and wealth, and impoverishment of its people. The ensuing lack of prosperity ends up crippling the ability to sustain a military overhead, and such countries tend to be conquered, as the Goths overran Rome. Outsiders always were at the gates – but it was the hollowing out of Rome's domestic economy that left it prone to conquest.

Most recently, creditor-sponsored *dirigiste* takeover of national economic and social institutions has turned Russia, the Baltic States and other post-Soviet economies into neoliberal kleptocracies, driving skilled labor abroad in tandem with capital flight. Latvia is being pushed back toward subsistence life on the land. Creditor mismanagement is the most important problem that any country today should strive to avert.

Creditors play the terrorism card

9/11 signaled the beginning of a new power grab in the United States and Britain. U.K. officials have used anti-terrorist legislation to seize Icelandic assets abroad. What makes this so ironic is that throughout history it has been creditors who have used violence against debtors, not the other way around. I know of only one exception, and it did not involve bloodshed: Jesus overthrew the tables of the moneychangers in Jerusalem's temple. It is the only record of a violent act in his life.

Psychologists have explained the creditor proclivity for violence by the tendency for *rentiers* to fight for unearned income – inheritance, or other "free wealth" that they have obtained without effort of their own. People who work for a living and are able to support themselves believe that they can survive, and so there is less of the kind of panic that creditors and other free lunchers feel at the thought that their extractive revenue may end. They fight passionately against the prospect of having to live on what they produce or earn by their own merits. So the last thing that *rentiers* really want is a free market. In a shameless irony, they tend to accuse populations of being terrorists if they seek to defend themselves against predatory creditors and land-grabbers!

Describing creditor violence, Plutarch describes how Sparta's king Agis IV and his successor Cleomenes III sought to cancel the debts late in the 3rd century BC. The city-state's creditors murdered Agis, drove Cleomenes to suicide in exile, and killed Sparta's next leader, Nabis – and then called in Rome to fight against pro-debtor democracies throughout Greece. Livy and other Roman historians describe how a century later, in 133 BC, the Roman Senate responded to the Gracchi Brothers attempt at debt and land reform by pushing the democratic Senators over the cliff to their death, inaugurating a century of bloody civil war.

In the 19th century the United States sent gunboats to collect debts from Latin American countries, installing collectors at the local customs houses. England applied similar imperial force to ruin India, Egypt and Turkey, stripping their assets with debt and plunging their populations into poverty that persists to the present day. More recently, America's hand in the violence that overthrew Chile's elected president Salvador Allende has continued this policy. Having south to isolate the Soviet Union, Cuba and other countries that rejected creditor-oriented rules and *rentier* property interests, the United States then capped its Cold War victory over the Soviet Union by promoting a flat-tax regime that imposed the fiscal burden entirely on labor and industry, not on finance and real estate. Instead of being democratized, the post-Communist countries were steered directly into oligarchic kleptocracies that ran up rising debts to the West.

This is just the opposite of the free markets that were promised them back in 1990-91. Instead of economic growth, the "real" economy of production and consumption shrunk, even as foreign financial inflows inflated property prices for housing and office space, fuel and public utilities. Real estate and utility services hitherto provided freely or at subsidy to the economy at large were turned into a predatory vehicle for foreigners to extract income, putting the domestic population on rations, much as what occurs under military occupation.

Yet the public media, academic centers and parliaments have persuaded populations that this is part of a natural order, even the product of how a free-market is supposed to operate, rather than a retrogression back to quasi-feudal institutions. The simplistic idea is that making money is itself "capitalist" *ipso facto*, regardless of whether industrial capital is being created or dismantled and stripped.

How hard times affect people

Public health reports throughout the world document how lifespans shorten as economic inequality and poverty increase. The moral is that "debt kills," by impoverishing and destroying populations. Those who try to defend themselves are branded as terrorists by their financial predators. Malthus's population doctrine, after all, was composed to rationalize the free lunch of his landlord class, and World Bank policies to reduce the populations of indebted Third World countries likewise was the natural complement to the financial asset stripping it endorsed. Fewer people to feed, clothe and house in a situation where investors seek mainly the public enterprises for whose construction governments have already run into foreign debt, plus land and resources supplied by nature rather than by human labor.

Nowhere is the violence of creditors more pronounced than in their destruction of education, especially economic studies and knowledge of history. The first act of the Chicago Boys (University of Chicago monetarists, headed by Nobel Prize winner Milton Friedman) in Pinochet's Chile after the 1974 military coup was to close down every economics and social science department in the nation, except for the monetarist stronghold at the Catholic University where they held sway. The idea was to strip academia of any alternative point of view. Matters are not much different in other countries. At a post-Keynesian economics conference in Berlin on "financialization" last November, I heard many complaints that alternative views to Chicago School orthodoxy were unable to get a hearing in the leading European academic journals. And just this March at the Eastern Economic Association's annual meeting in New York City, I heard similar complaints that alternative economic ideas were excluded from the major refereed journals in which aspiring academics must gain entry in order to be promoted to tenure track jobs at most U.S. universities. An intellectual Iron Curtain has been lowered by dysfunctional "free market" orthodoxy. Evidently a free market in ideas is anathema to financial free marketers. With such strong intellectual control, of course, overt violence is unnecessary.

Such intellectual intolerance is in the DNA of the creditor mentality because it cannot withstand awareness and understanding of its destructive effects. The "miracle of compound interest" is not achievable in practice beyond the short run. To pretend that it may form the basis for a sustainable model of wealth creation does violence to rationality and economic logic. This is why the economic theory that creditors prefer – and subsidize – is learned ignorance propagated by useful idiots. Its role is to distract attention from society's most important economic dynamics, those of finance and property polarization via debt, evidently on the premise that what is not seen or analyzed will not be regulated or taxed. One is reminded of Baudelaire's quip: "The devil wins at the point where he convinces people that he does not exist." A "free market" for *rentiers* thus is one "free" of alternative ideas.

That is the political function of mainstream economic theory today. And to cap matters, the creditor-oriented worldview does similar violence to the teachings of world's major religions.

Christian endorsement of debt cancellation and Clean Slates

From at least as early as 2400 BC it was normal for Sumerian and Babylonian rulers to annul the population's personal and agrarian "barley" debts upon taking the throne for their first full year of rule. In addition to annulling these debts, Mesopotamian Clean Slates freed bondservants and restored self-support land to former owners who had forfeited their crop rights to foreclosing creditors. The Babylonian word for these Clean Slates was *andurarum*, and Jewish law adopted them with the cognate Hebrew word *deror*. But by the first millennium BC, kings had come to represent local oligarchies, so Mosaic Law took Clean Slates out of the hands of rulers and placed them at the center of Judaic religion in the Jubilee Year of Leviticus 25. Like Babylonian law, it cancelled personal debts, freed bondservants and restored land tenure to its "original" holders.

Debt cancellation is at the heart of the laws of Exodus, Leviticus and Deuteronomy calling for debts to be cancelled periodically, and to liberate indebted bondservants. Ezra and Nehemiah describe how they returned from Babylon to restore order by canceling the debts – and re-discovering the Book of Deuteronomy. But creditor oligarchies were on the rise throughout the Mediterranean region in the centuries that followed. By the time of Jesus the mainstream of Jewish leadership had mounted an attack on the Jubilee Year, endorsing Rabbi Hillel's *prosbul*, a legal clause by which creditors forced debtors to sign away their rights to debt annulment at the Jubilee. In his first sermon, Jesus sought to retain the Jubilee year by unrolling the scroll of Isaiah and announcing that he had come to proclaim the Year of Our Lord.

The Jewish oligarchy appealed to Rome to crucify Jesus. As he and his followers gained adherents by advocating debt forgiveness, Rome used violence against them. But Christianity grew by creating communities of mutual aid. Upon achieving political power, the new religion's most important economic achievement was to outlaw debt bondage throughout Western civilization. However, the idea of a Clean Slate had to be postponed until the Day of Judgment at the end of history.

As creditors drove the post-Roman economy into a Dark Age, Christians banned the charging of interest altogether, even on commercial "silver" loans. Ancient languages had no words to distinguish "interest" from "usury." This distinction was drawn only in the 13th century, as Church theologians applied the term "interest" to commercial loans in which "silent backers" advanced money to entrepreneurs. It was permissible for bankers to charge a foreign-exchange *agio* premium (that typically included an interest charge in practice), as long as the charge could be justified by their own labor and related outlays to provide money-transfer and loans. However, mortgages loans and personal loans were deemed usurious. The 13th-century Churchmen treated usury as theft and hence in violation of the Eighth Commandment: "Thou shalt not steal."

From antiquity through medieval European times, most theft took the form of usury, getting debtors to forfeit collateral they had pledged in exchange for emergency funds. Thomas Aquinas and Martin Luther in 1516 warned that this practice destroyed cities much as a worm destroys an apple from within its core. John Calvin in 1565, the last year of his life, likewise defined usury and fraud as theft on a plane with highwaymen and robbers. This ethic produced a line of development extending down to only a generation ago as Western law became more humane toward debtors. Debtors unable to pay are no longer turned into bondservants to their creditors, and debtors' prisons have been closed down. Bankruptcy laws permit individuals (and corporations) to annul debts when they cannot pay.

But this eight-century-long historical trend is now being confronted with an anti-Enlightenment threatening to reverse it. In the United States, credit card companies have given enormous sums of campaign contributions to politicians willing to rewrite the bankruptcy laws to make home mortgage debts permanent and beyond the power of judges to write down. Wealthy individuals with more than one home can have their own mortgage debts on these properties written down, but homeowners with just a single residence are confronted with a lifetime of debt peonage. This is just the reverse of ancient law that protected the self-support land of citizens, but not their townhouses and other surplus property.

Credit without oligarchy

Most societies throughout history have sought to provide credit legally in ways that do not permit creditor oligarchies to emerge. Today's creditor advocates are at war with the spirit of this idea. And in taking this position, they reject the thrust of the Enlightenment's anti-usury laws, classical political economy's distinction between productive and sterile investment, the St. Simonian attempt at financial reform, and the Progressive Era's attempt to mobilize national credit to fund productive industrial investment rather than being extractive, benefiting only the few. The classical idea of economic freedom itself was formulated as the antithesis to feudal-epoch finance. And the ideal of freedom from predatory finance is what is being threatened today, as if society has forgotten how long and hard the reform struggle has been.

The fight to end debt bondage and debtors prisons took many centuries to achieve its humanitarian objective. Handel's *Messiah* is a staple of the Christmas and Easter season celebrating the life and teachings of Jesus Christ. What has been forgotten is the context in which Handel arranged the first performance of this oratorio in Dublin, on April 13, 1742. It was a charity concert for the benefit "of the Prisoners in several Gaols, and for the Support of Mercer's Hospital in Stephen Street, and of the Charitable Infirmary on the Inn's Quay." Enough money was raised to free a hundred and forty two prisoners. The oratorio's text accordingly contained references to "breaking bonds asunder" and "casting away yokes," recalling the early Christian belief that the Messiah's reign would bring liberty (Hebrew *deror* or debt cancellation) and release (Greek *aphesis*) from debt bondage. The "redeemer" was literally the redeemer from debt.

This recalls the original, literal meaning of the Lord's Prayer. It refers not only to forgiving sins and sinners in the abstract, but specifically to “forgive us our debts” – a translation distorted in much modern reading. “Sin” was the word for “debt” in all Indo-European languages: *Schuld* (the root of German *sollen* and English *should*), and *devoir*, the root of English *debt*. It meant obligation – referring in ancient practice to the obligation of an offender to make good payment to atone for his offense, as in European *wergild* tradition. The original debts were not paid *to* the rich, but *by* them, for manslaughter or physical *wergild* injury to their victims (who typically had to settle for payment rather than taking revenge). Today’s offenders disrupting social harmony are wealthy creditors, but society is paying money *to* them, not fining them. Seen from the ancient perspective, it is as if indebted society owes retribution to the rich. No wonder the spirit of modern religion has so thoroughly overturned that of its origins!

It therefore seems remarkable that in our own epoch – strained as it is by unprecedented and questionably created debt overhead that reduces not just individuals but entire nations to debt servitude – no major opposition has appeared on religious grounds. Churches have avoided the issue that was the cornerstone of so much of their earlier concern, and moved toward other concerns rather than remaining on the high ground of alleviating the debt burden.

Back to basics, and a call for transparent statistics

The classical economics of Adam Smith and John Stuart Mill, the Progressive Era reforms and Social Democracy are rooted in the moral philosophy of the 17th- and 18th-century Enlightenment. The labor theory of value can be traced from the 13th-century Schoolmen via John Locke to Adam Smith and the Scottish Deists, via David Ricardo’s isolation of economic rent (what Mill called the “unearned increment” that landowners and others receive “in their sleep” rather than through their own labor) as an element of price in excess of cost-value. The distinction between intrinsic value and market price led to socialist and progressive theories of a just society free of economic privilege, free of prices in excess of socially necessary costs of production and of *rentier* income and wealth without effort.

The common thread in these ideas is that people deserve to receive the fruits of their labor. This means bringing prices in line with actual labor-costs of production. It also means that one’s wealth should be limited to only what one creates – not land and natural resources, or monopoly privileges to extract income via control of roads, the right to create money and other natural monopolies. The aim of social reform for many centuries has been to purge capitalism of its legacy of absentee *rentier* property ownership patterns and creditor-oriented laws inherited from medieval times. The way to do this is to treat banking like transportation and the broadcasting spectrum, as a public utility to form a just fiscal base, not something to be privatized so that individual *rentiers* can tax society at large for what rightly is a public utility.

Beyond creating a travesty of international law, *rentier* interests have turned seemingly empirical statistics into a fictitious set of accounts that understate actual returns to the finance, insurance and real estate (FIRE) sector and the magnitude and information on land and other wealth ownership and distribution. Recent U.S. news has seen a fight by Wall Street to count short-term trading gains in stocks, bonds and financial derivatives as “capital” gains taxed at only a fraction of wages and profits. The financial managers in charge of national statistics likewise describe economy’s largest asset category, real estate, in largely fictitious economic terms. U.S. Federal Reserve statistics on asset values meanwhile depict the rise in real estate prices not as higher land valuation – which the land-price maps of major cities show to be the cause of rising prices, fueled by an exponentially expanding pyramid of credit relative to a fairly fixed land area – but as “replacement cost” of buildings. The inflation of real estate prices is assigned to “capital,” not land. This enables real estate owners to avoid paying income tax by depreciating their property as if it is wearing out, not rising in value. Buyers can start writing off the price of an already written-off building as soon as they buy it, treating its “wearing out” as a tax credit – even though older buildings bring a premium over today’s cost-cutting construction practices. This write-off, of course, is not granted to homeowners, only to absentee owners.

In the sphere of financial wealth, banks have fought truth-in-lending regulations for years in order to conceal the real interest rate their customers are having to pay when all the fees and other charges are added on. They are fighting tooth-and-nail against “mark to market” accounting practices that would oblige them to let depositors and investors know how much their assets actually are worth – and hence, how much they have lost by irresponsible gambling. Whereas economic textbooks claim that a precondition of market efficiency is full knowledge of the market (otherwise, how can a market be deemed to be provide informed choice?), the financial sector always has fought tooth and nail against realizing this condition in practice.

Today the financial sector claims that the U.S. crisis was brought on not by bad investments by bank conglomerates and pension funds or misleadingly high credit ratings given to securities belatedly admitted to be junk, but by banks having to admit that the collateralized debt obligations (CDOs) and credit-default swaps they had been selling to global investments were in fact worthless from the outset. On March 12, 2009, the U.S. Congressional subcommittee in charge of financial reporting backed the bank lobbyists in “freeing” them from having to reveal their actual condition and (lack of) value of the securities they have been pawning off. As a *New York Times* reporter summed up the issue: “Next time you hear a banker denounce mark-to-market rules, ask if he runs his business that way. Will he offer you a mortgage loan based on what you think your home should be worth, which you can repay only if you make a lot more money than anyone will pay you? … maybe that is not such a good idea. The banks already tried that, with liars’ loans. Those loans did not work out so well.”[1]

This helps explain why every new press release of bad financial news is greeted with the adjectives “unexpected,” “surprising,” “unforeseeable,” “once-in-a-century” and kindred terms. The financial sector seeks to free itself from criticism rather than taking the blame for having plunged headlong over the debt cliff. It can succeed in this economic fiction in proportion to the degree to which the public can be blocked from understanding just what is going on and how the financial sector gains at the expense of the economy at large. Shaping popular perception becomes the name of the game, and statistics are depicted as “empirical” reality rather than the result of intensive lobbying to promote politicians willing to back a distorted economic roadmap.

The problem goes to the very foundation of economic theory. Any set of statistics reflects categories in economic theory, and in recent years the Chicago School has taken the lead in what is now a nationwide trend to exclude the history of economic thought from the academic curriculum. One can get all the way through a Ph.D. without having surveyed the evolution of classical economics from the Physiocrats through Adam Smith, John Stuart Mill and the Progressive Era reformers. The essence of social reform throughout the Enlightenment, and indeed extending all the way back to the Church Schoolmen is no longer taught – the distinctions between earned and unearned income and wealth, and productive and unproductive (or "sterile") employment and investment. Post-classical thought insists that all income is productive in proportion to whatever it earns – including the collection of economic rent or extortion of monopoly super-profit, or financial charges for interest and credit card fees, and the exorbitant salaries and bonuses that financial managers pay themselves. All revenue – and therefore, all wealth – appears to be "earned." By *their* definition. This denies the concept of "investment in zero-sum activities that merely transfer income into the unproductive sector's pockets, in contrast to creating income.

As a guide to policy reform, classical economics aimed at creating an economic and fiscal system that would bring market prices in line with technologically necessary costs of production. All such costs ultimately are reducible to labor. The necessary complement to the labor theory of value (adjusted for different grades of labor, the cost of their education and the linkage between wage levels and productivity) was the analysis of economic rent – an institutional add-on reflecting property ownership patterns, financial charges and taxes, not inherent costs of production. The classical reform program was to minimize the cost of production and of living, making economies more competitive by purifying industrial capitalism and removing its remaining feudal legacies, above all the right of hereditary absentee owners (landlords) to siphon off a rental charge for access to land for sites supplied by nature and given value by local public spending (*e.g.*, "location, location, and location," as real estate agents explain matters to prospective buyers) – and the right of bankers to charge for creating credit that governments could freely create themselves.

Fighting against progressive reforms, banks and other financial institutions have sought to preserve their special privileges by law, minimizing taxes on themselves by shifting the burden onto labor and industry. What they have achieved by financializing economies is (1) to raise the cost of living and the cost of doing business; (2) to free their major customers – mortgage borrowers – from taxation so as to leave as much surplus as possible available to be paid as interest; (3) to collect revenue hitherto used to finance the public sector by capitalizing it into interest charges and to inflate the price of housing and other real estate and privatized monopolies; (4) to effectively shift taxes onto labor and industry, thereby raising prices and undermining the competitive power of financialized economies. This is a travesty of classical "free market" policy. It is a policy for predators that mainly burdens economies with high interest and fees while also making the tax burden more oppressive while they reap the benefits.

John Maynard Keynes believed that the proper task of governments was to prevent over-indebtedness from leading to economic depression. He concluded his *General Theory* (1936) with a call for "euthanasia of the *rentier.*" Hoping to make credit productive, not extractive, his followers have advocated making banking a public utility so as to steer debt creation to fund growth in the means of production, not economic overhead by inflating property bubbles. Radical as this may appear today, this was the aim of the 19th century classical economists, and underlay the financial reforms that shaped the 20th-century economic takeoff. Only quite recently has the global financial press rediscovered this logic in the wake of today's bubble meltdown. In a recent *Financial Times* column, Martin Wolf pointed out that in view of the huge bailouts that banks are demanding from the government to make the industrial economy and labor force pay for their losses, "banks are not commercial operations; they are expensive wards of the state and must be treated as such." He concludes: "The UK government has to make a decision. If it believes that costly bail-out must be piled upon ever more costly bail-out, then the banking system can never be treated as a commercial activity again: it is a regulated utility – end of story. If the government does want it to be a commercial activity, then defaults are necessary, as some now argue. Take your pick. But do not believe you can have both. The UK cannot afford it."[2] Neither can Iceland or any other country.

Backed by global creditors, the IMF wants to keep its power

But the financial sector is fighting back. Its global lobbyist, the International Monetary Fund, has sought to consolidate financial control of economies irreversibly. Article VIII of its charter, drawn up in a period of reaction against the blocked currency practices and tariff protectionism of the 1930s, rules that once a country has removed controls on its "current account" transactions, it is not legal to re-impose any new controls. The current account is defined to include not only import and export trade in goods and services, but also interest on foreign debt and the remittance of profits on foreign-owned investment. In the 1930s, interest payments were conceptually integrated with credit and debts on capital account. But in the 1940s the IMF and other countries changed their balance-of-payments accounting formats away from this logic.

Ostensibly aimed at freeing trade, the IMF's Article VIII in reality created "free capital movements," that is, the ability of financial gangs to freely raid currencies such as occurred in the 1997 Asian crisis and similar speculations. Governments were not permitted to protect their currency and exchange rates by limiting such raids or erecting barriers to predatory credit and destructive debt (or from U.S.-subsidized agricultural exports, for that matter). The legal effect of the IMF's ruling was to block governments from regulating their financial sector, despite its *rentier* role as a public utility. For Iceland, this means that the government cannot keep the nation's international debt within the economy's ability to carry. The most basic criterion for national sovereignty thus is ruled illegal!

In practice, nearly every country has simply added the interest accrual onto its national debt balance each year. Nominally, it "borrows the interest," but the effect is more like an accrual than a true new loan. Over time these public debts grow at an exponential rate – far in excess of the "real" economy's rate of growth, a recurring theme in today's post-classical economies.

Lessons for Icelandic financial policy

The first thing that Iceland needs to do is to realize that it is under financial attack from outside as well as from within – by foreigners supported by a domestic banking class. To succeed, these creditors are trying to convince the population that all debt is productive, and that the economy benefits to the extent that its net worth rises (the price of assets in excess of debt). The fatal error is the assumption that prices will never go down, and if they do, debts should be left in place even when this causes negative equity. To their erroneous way of thinking, a price plunge (recession or depression) is an accident that happens once in a century, not the inevitable result of debts growing at compound interest without a concurrent increase in earning power to pay higher prices and interest.

This deceptive mythology is capped by a mind game being played with Icelandic voters. The game is to promote the myth that there is no alternative but to pay the debts that a few insiders have rung up, debts that accrue interest when they go unpaid. This myth can be dispelled by recognizing that the volume of debt payments being demanded is beyond the country's capacity to pay. The financial strategy is to postpone awareness of this fact as long as is possible, so as to proceed with the foreclosure and voluntary pre-bankruptcy sell-off of national assets to pay creditors. The one question that creditors do not want to be asked is, "Just how do you propose that we should pay you?" Creditors hesitate to come right out and answer, "By shrinking your economy, by shifting your wealth and property into the hands of a small and shrinking financial oligarchy, and by pricing your labor and industry out of world markets as a result of the heavy financial charges built into your pricing system." They prefer to act "surprised" when economic *force majeur* obliges economies to replace defined-benefit pension programs with "defined contribution" plans in which all that workers know is how much they pay into the plan, not what they will end up with.

Iceland as a model test case for economic justice

The realization of the impossibility of paying its debts while maintaining a fair society with a financially level playing field in which people live by what they produce (rather than a debt peonage society headed by creditors) will help Iceland confront reality sooner rather than later. Some form of Clean Slate moratorium should be inevitable. The extent cannot be known until an accounting of who owes what to whom is made. But as a sovereign nation, Iceland can apply whatever economic laws it wishes, as long as these do not discriminate specifically against foreigners. (That can be the result of a general law, as long as foreigners are subject to the same laws as domestic citizens.)

Global creditors will complain mightily, hoping to convince Iceland to let finance make itself an extra-legal sector, beyond the scope of national law to regulate – or to tax. The aim is to place financial dynamics beyond the ability of legal systems throughout the world to contain or otherwise control, so as to make debt collection autonomous from democratic regulation. To achieve this victory, financial interests seek to dismantle the power of governments to limit the ability of creditors to engage in predatory lending and foreclosure. Financial lobbyists accuse government power of being a "road to serfdom," whereas in reality only governments can protect populations from creditor-imposed debt peonage.

As another tactic in today's debt crisis, creditors are trying to rush matters. The United States provides an object lesson in the pitfalls of not giving the government enough time to reason things through so as trace how the losses came to be suffered. Treasury Secretary

Paulson represented the interest of his own firm, Goldman Sachs, in ramming through an $800 billion “bailout” giveaway package to Wall Street’s leading investment bankers. The sum included $180 billion dispersed so far to A.I.G. to pay speculators in derivatives (including $12 billion to its largest counterparty, Paulson’s own firm,), and $45 billion for Citigroup to pay its counterparty gamblers on the winning side of casino-style bets.

95% of American voters opposed this giveaway. The Treasury Secretary made the usual glib promises that this package would be used largely for debt relief and mortgage renegotiation. It was all a lie –which Mr. Paulson clearly knew to be a lie, because the terse three-page draft law he sent to Congress demanded that no government or law enforcement agency could punish financial lying under his program. The bankers took the money and ran. They used the money to pay themselves enormous bonuses and dividends to stockholders in a vain effort to support the stock price – and to buy smaller banks so as to create yet more giant financial conglomerates “too big to fail,” that is, too big to fail without bringing the entire U.S. financial system crashing down.

Unfortunately, a rush to judgment will give money to bankers irrecoverably. They then will do like U.S. Federal Reserve Chairman Ben Bernanke has done, and wring their hands and offer crocodile tears of apology. Such talk is costly! American voters are now angrier than ever at the government for voting this giveaway.

On national television on March 15, Mr. Bernanke used a false analogy already popularized by President Obama. He asked what people should do if an irresponsible smoker let his bed catch fire so that the house burn down. Should the neighbor say, “it’s his fault, let the house burn”? This would threaten the whole neighborhood, Mr. Bernanke said. The implication, he said, was that economic recovery required a strong banking and financial system.

But banking houses are not in the same neighborhood where most people live. In effect the United States is taking over houses that have not burned down, throwing out their owners and occupants to turn over to the culprits who burned down their own house. To Mr. Bernanke the “solution” to the debt problem is to get the banks lending again. They are to lend enough money so that their clients can borrow the money to pay them the stipulated interest charges. The aim is a return to “normalcy,” defined as new exponential growth in the volume of debt – more of the bubble economics that has just crashed all around us!

Iceland can lead the way

This clearly is not something that Iceland can afford. In fact, the United States cannot afford it either, as much real estate already has sunk into negative equity so that banks are not going to be willing to lend in any event. Fortunately, Iceland’s situation is so extreme that it may be saved even from the thought of creating yet new debt. It can face the financial problem and start to write down the debt overhead, to bring it in line with the economy’s ability to pay or in many cases simply write it off altogether.

First, Iceland needs to take a census of the magnitude of debts owed at home and abroad, and of the institutions to which these debts are owed. Second, it needs to assess the economy's ability to pay these debts. This was the principle on which the world's creditor nations founded the Bank for International Settlements in 1931, to assess Germany's capacity to pay. Reference must be made both to the magnitude of debt relative to current price trends for the collateral supposedly backing this debt, and to the economy's ability to produce a domestic-currency and foreign-exchange surplus over and above basic needs, including capital replenishment to grow at historical rates over time.

By insisting on a fully transparent financial analysis of who owes how much to whom, Iceland can toss the ball back into the creditors' court and ask the bankers to explain just how they propose that Iceland should pay – and what they anticipate will be the economy-wide effect of such payment. How much can Iceland afford to pay in the next few years without losing its democratic home ownership and property ownership patterns and without abandoning its social democratic public policies? How can Iceland pay its debts without bankrupting itself, abandoning its social democracy and polarizing its hitherto homogeneous population between a tiny creditor oligarchy and the rest of the population? The island is in danger of creating a new ruling class that will control its destiny for the next century. Again, Adam Smith warned that financial oligarchies act with concern only for how much they can extract, not what they can help produce. They are not good forward planners and do not act responsibly because it is easier for creditors to strip assets than to create new capital.

In taking this position Iceland will simply be following the moral philosophy laid down by every major religion and every body of ancient and modern law as a core principle: the idea that credit must be kept within the ability to pay. It is obvious enough that global lenders have extended credit far beyond Iceland's ability to pay. For over two centuries the United States has an excellent tradition in how to deal with this problem. Already in the colonial period New York State enacted the Fraudulent Conveyance law, which has remained on the books ever since New York joined the new nation. The problem it faced was British creditors and speculators coming to upstate New York to cheat local farmers out of their rich, well-situated land. The ploy was to extend a loan to a needy farmer, and then call it in just before harvest-time when the debtor lacked the money to pay. Alternatively, the speculator might simply lend more than the farmer could afford to pay even under normal conditions. So New York blocked this predatory practice by passing a law saying that if a bank or other creditor made a loan without knowing just how the debtor was to repay it, the loan would be declared null and void. It would be wiped off the books.

This law received considerable attention in the 1980s when Drexel Burnham and its emulators began providing junk-bond credit to corporate raiders. Companies defended themselves by pointing out that the only way that these high-interest bonds could be paid was by breaking up the target company and downsizing its labor force. But most of all, the law has international relevance. Most U.S. bank consortia have a New York City lead bank negotiate with Third World governments and other foreign borrowers. So far, none of these debtors have sought to annul their loans on the ground that the only way they can pay is to sell off their public enterprises and other government assets. But the enabling legislation is there, and provides an excellent model for Iceland to emulate. By pursuing this policy Iceland would achieve the kind of economic freedom defined by the classical economists – a market free of technologically unnecessary overhead charges, headed by surplus extraction by a vested oligarchy.

For financial interests, by contrast, their idea free market is one that leaves them free to do the economic planning “free” from government regulation and democratic constraint on their extractive, predatory credit and foreclosure practices. Wherever they have gained sway they have shrunk economies. Since the 1960s their proxies at the IMF and World Bank have imposed austerity programs on Third World countries, extending foreign-currency loans whose effect has been to make these countries more dependent and driven them even deeper into debt. In the post-Soviet economies since 1991, financial strategists have focused on prying away public enterprise, selling it off or using it as collateral for loans. The result of “financializing” these economies has been to provide a free field for predatory vested interests in league with globalized domestic financial oligarchies. In sum, the neoliberal model victimizes debtors, preventing them from paying their debts. Instead of funding new capital formation, it strips economies of their assets and empties them out. Ultimately this drags down the creditor economies themselves, as occurred in ancient Rome, medieval Spain, and the United States and Britain in the Great Depression (not to mention what is unfolding today).

Iceland is facing a bold con job. Should it feel obliged to pay countries that have no intention of ever paying their own debts? To get paid, creditors must convince their prey to accept the falsehood that debts can and indeed should be paid. The lie is that they can be paid without dismantling social democracy, selling off the public domain and polarizing society between creditors and debtors.

The point of reference should be Iceland’s broad long-term picture – the economy’s survival and growth prospects for the future. Foreign-currency loans should be denominated in domestic currency at written-down (and de-indexed) interest rates, or repudiated outright. The guiding principle should be to annul debts taken out under terms that are destructive and extractive.

As for the nitty-gritty of negotiating a resolution to Iceland’s debt crisis, the nation needs to re-frame the terms of the debate by removing fictitious assumptions that have no basis in reality. The first trammel of the mind is the assumption that Iceland needs to negotiate in a way that wins the creditors’ approval in a compromise. It is not possible for any fair agreement to be reached in this way. Any negotiation between creditors and debtors is adversarial, and creditors have spent many decades refining demagogic public relations ploys to divert attention to abstractions about “fairness.” A typical ploy is to ask whether it is fair for some debtors to receive larger write-offs than others. Is it fair for the most highly indebted individuals to gain the most – more than people who were more responsible? The aim here is to inflame popular resentment that some debtors will get a bigger write-off than others (and some debtors are indeed as as guilty as the perpetrators who sold them on the idea that home prices only go up), so as to blame the poor and most highly indebted rather than reckless creditors.

The real issue is the health of the overall economy. The parties seeking the most are not the most indebted individuals, but the largest creditors. Their aim is to increase their dominion over the rest of society. Above all, their aim is to maximize the power of debt over labor. The worse the economy does, the stronger the creditor position will grow. This is a recipe for economic suicide that will lead to outright debt peonage as domestic depression intensifies. Creditors everywhere else in the world are writing down their claims for payment to reflect plunging property values. Iceland has an opportunity to make itself a model test case for economic justice. What better time to post the basic principle of what is to be saved – an unsupportable debt burden that must collapse in the end, or a society's survival? Will the government defend its citizens from financial predators, or turn the economy over to them? That is the question.

NOTES

[1] Floyd Norris, "The Problem? Bankers Point to the Rules," *The New York Times*, March 13, 2009.

[2] Martin Wolf, "Big risks for the insurer of last resort," *Financial Times*, March 6, 2009.