Thinking the Unthinkable: A Debt Write Down, and Jubilee Year Clean Slate

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We have reached the point where it may finally be able to break through the membrane of cognitive dissonance that has been blinded people. The very first course in economics –starting in high school, followed up in college and then refined in graduate school – should explain to students why it is false to believe the advertisement that Wall Street has been trying to sell for the past half century: The deceptive promise that an economy can get rich off the mathematical "magic of compound interest."

The unreality of this promise should be immediately apparent by looking at the math of exponential growth. Already at the time of the American Revolution, financial economists were popularizing the contrast that Malthus soon would imitate in his population theory: Debts grow at "geometric" rates, while the economy itself grows only "arithmetically," in a slower and more linear way.

All that is needed is to put this idea together with the basic balance-sheet definition: One person's savings are lent out to become other peoples' debts. So the "magic of compound" interest to savers means an equal "magic of exploding debt" to somewhere else in the economy. And inasmuch as creditors insist on protecting themselves from inevitable default by possessing collateral, it is natural that most of the economy's debts are owed on its largest asset: land and buildings. This explains why mortgage debts have become repayable and "gone toxic."

The "magic of compound interest" refers to the tendency of savings to double and redouble exponentially, with a matching rise in what debtors owe on the other side of the balance sheet. These mathematics have been operated throughout history, ever since the charging of interest was invented in Sumer some time around 2750 BC. In every known society, the effect has been to concentrate wealth in the hands of people with money. In recent years, one's own money is not even necessary to do this. The power to indebt others to oneself can be achieved by free credit creation. However, the resulting mushrooming exponential growth in indebtedness must collapse at the point where its interest and other carrying charges (now augmented by exorbitant late fees, bounced-check fees, credit-card costs and other penalties) absorb the entire economic surplus.

This is the point that has been reached – and passed – today. It has been developing for

many decades. But there is a great reluctance to accept the fact that debts cannot be paid. “The poor are honest,” as one banker explained to me, and believe that “a debt is a debt” and must be paid. (This is not what Donald Trump, Bear Stearns or A.I.G. believe, but they are at the top of the economic pyramid, not its base.)

Numerous publishers turning down my proposed books on the subject over the years. As they have explained to me: “Nobody wants to read how the bubble will break – at least, not until after it bursts. Can’t you write a book on how you can make a million dollars off the coming economic collapse? That would be a winner, Prof. Hudson. But to tell people that they can’t put aside savings and pay for their retirement ‘in their sleep’ is like telling them that they will have bad sex after the age of 50. It’s a no-seller. Come back when you have good news.”

These are the words I’ve been hearing since the mid-1980s. I’ve spent much of my time looking through history to read up on how the failure to wipe out the debt overhead led to the collapse of Rome’s imperial republic, and to the Ottoman Empire as what was known as “the spoiling of Egypt” and “the ruin of Persia” toward the end of the 19th century. I’ve also published a series of four colloquia by assyriologists and archaeologists describing how earlier, from about 2500 to perhaps 300 BC, Babylonian and other Near Eastern rulers kept their citizens free and preserved their landholdings by annulling personal and agrarian debts when they took the throne – a true “tax holiday” – or when economic or military conditions warranted a general Clean Slate. (The series was funded and published by Harvard’s Peabody Museum and is now available from CDL Press.)

These Clean Slates were adopted literally, almost word for word, in the Biblical Jubilee Year if Leviticus 25. Even the same Hebrew word, *deror*, was used for the Babylonian *andurarum* proclaimed by rulers of Hammurapi’s dynasty from 2000 to 1600 BC. So it is remarkable to me that men claiming to be Christian leaders today should ignore the fact that in the very first sermon that Jesus gave, in Nazareth (Luke 4:14-30), he unrolled the scroll of Isaiah 61 and promised that he had come “to proclaim the Year of the Lord,” the Jubilee Year. That was the literal “good news” that the Bible preached, as the Dead Sea scrolls have abundantly illustrated.

Yet it is a sign of the power of creditor ideology that even the essence of this founding document of Western civilization has been ignored by a distorted view of what early Christianity, Judaism and other religions were all about. Hardly surprising. Luke’s passage on this founding sermon of Jesus concludes by pointing out that “all the people in the synagogue were furious when they heard this. They got up, drove him out of the town, and took him to the brow of the hill on which the town was built, in order to throw him down the cliff.”

Down the cliff! This is where the revolting right-wing Roman senators drove the followers of the Gracchi brothers on the Senate hill, in an exercise of political violence that prevented Rome from granting debt relief toward the end of the second century BC. Livy, Diodorus, Plutarch and other historians of the epoch attributed the prospective fall of the Roman Empire to its harsh creditor-oriented debt laws. But today, historians publish books

speculating that perhaps the problem was lead piping or lead goblets for their wine, or disease, or imperial overreaching, or superstition – anything but the cause to which the Roman historians themselves pointed.

We are still living with the consequences of Rome's oligarchic revolution. That is what makes this week's Congressional hearings on the $700 billion giveaway so important. First with military force and then via debt bondage and serfdom, Rome bequeathed to Europe a property-based, creditor-oriented body of law. But since the 13th century, country after country has shifted the balance back to favor debtors – to save them from literal debt bondage, from debtor's prisons, from permanent indebtedness, to give them Clean Slates on an individual level.

Handel arranged the first performance of *The Messiah* as a benefit to raise money to bail debtors out of Irish debtors' prisons, and every year the oratorio was repeated for that charitable purpose. Martin Luther warned about the mathematics of compound interest as the monster Cacus, devouring all. Yet Luther's denunciations of usury are excluded from his collected works in English, and are available in this language only in Vol. III of Marx's *Capital* and Book III of his *Theories of Surplus Value*. The discussion of interest and banking has become so marginalized that even when I taught money and banking at the New School in New York City in the late 1960s and early '70s, it was not part of the core curriculum but treated as a special topic. (Fortunately, that is not the case where I am now happily situated at the University of Missouri in Kansas City. But it took a long time to get here.)

Behind this shift in legislative choice was the perception that no economy can keep up with the burden of debts growing at exponential rates faster than the economy itself is growing. No economy can grow at steady exponential rates; only debts can multiply in this way. That is why Mr. Paulson's $700 billion giveaway to his Wall Street colleagues cannot work.

What it *can* do is provide a one-time transfer of wealth to insiders who already have been playing the debt-credit system and siphoning off its predatory financial proceeds to themselves. The Wall Street bankers, brokers and fund managers to whom I've been speaking for many decades all know this. That is why they pay themselves such large annual bonuses and large salaries each year. The idea is to take as much as you can. As the saying goes: "You only have to make a fortune once in a lifetime." They have been salting away their fortunes year after year, mainly in hard assets: real estate (free of mortgages), fine furniture, boats and trophy art.

Their plan now is for icing on the cake – to take Mr. Paulson's $700 billion and run. It's not a "bailout of the financial system." It's as giveaway – to insiders, to sell out all their bad bets. Companies across the board will get rid of their bad mortgages, and also their bad car loans, furniture time payments, credit-card loans, student loans – all the debts that any competent actuary could have told them never could have been paid in the first place.

This is not what Treasury Secretary Paulson is acknowledging, and shame on him for it. Last

Friday, Sept., he was joined by Fed Chairman Ben Bernanke singing in unison an advertising jingle for America's new kleptocracy that rings so false that Congress and the American public must hear the off-notes. London's *Financial Times*, as well as a host of Europeans realize it. That is what has been driving the dollar's exchange rate this week. It seems easier for foreigners to recognize the threat to turn American democracy into a rapacious kleptocracy.

This change always is sudden, arranged under emergency conditions. Those with a 12-year memory will see George Bush as playing the role of Boris Yeltsin in Russia in 1996, paying off his campaign contributors by giving them all the economic surplus that the government could expropriate in the notorious "loans for shares" plan applauded and supported by Clinton Treasury Secretary (and current Obama advisor) Robert Rubin. (The moral: do we have a Putin in our near future to lock in the anti-democratic coup?)

How ironic all this is! Back in the 1970s there was theorizing that the Russian and American economies were converging. The idea was that both were moving toward more centralized state control, state financing, state subsidy, and a military-industrial complex. Nobody expected the convergence to occur Yeltsin-style in government giveaways to insiders to create a new group of financial billionaires – the "seven bankers" under Yeltsin in 1996, and Mr. Paulson's Crony Capitalist gang today.

Let's look at the euphemisms as an exercise in Orwellian doublethink. Mr. Paulson defended his "troubled asset relief program" (TARP) by claiming that "illiquid mortgage assets … have lost value … choking off the flow of credit that is so vitally important to our economy." The credit that is "so vitally important" has taken the form of bad loans. Contra Mr. Paulson's pretense, the problem is not that they are "illiquid." If that were the problem, it would be merely temporary. The Federal Reserve banks are designed to provide liquidity – on good collateral, of course.

As Financial Times columnist Martin Wolf noted on Wednesday, Sept. 24, the problem is that the face value of mortgage loans and a raft of other bad loans far exceeds current market prices or prices that are likely to be realized this year, next year or the year after that. They are packaged into what the financial press rightly calls "toxic." The bailout is not efficient, he writes, "because it can only deal with insolvency by buying bad assets at far above their true value, thereby guaranteeing big losses for taxpayers and providing an open-ended bail-out to the most irresponsible investors."[1] "The simplest way to recapitalise institutions," He concludes, is "by forcing them to raise equity and halt dividends. If that did not work, there could be forced conversions of debt into equity. The attraction of debt-equity swaps is that they would create losses for creditors, which are essential for the long-run health of any financial system." This is the key: if debts cannot be paid, then creditors must take losses.

These bad loans are toxic because they can only be sold at a loss – if at all, because foreign investors no longer trust the U.S. investment bankers or money managers to be honest. That is the problem that Congress is not willing to come out and face. Many of these loans are outright fraudulent. And they are being sold by crooks. Crooks who work for banks. Crooks who use accounting fraud – such as the fraud that led to the firing of Maurice

Greenberg at A.I.G. and his counterparts at Fannie Mae, Freddie Mac and other companies engaging in Enron-type accounting.

This is not what the magic of compound interest promised. But it is where it had to end up, with mathematical inevitability. It was an advertising come-on for Wall Street money managers and promoters of "pension-fund capitalism" (or "peoples' capitalism" as it was called in Chile by the Chicago Boys working for General Pinochet's murderous regime, and Margaret Thatcher's Conservatives in England). The promise is that if people consign these funds to individuals who make much, much more than they do but have the survival-of-the-fittest advantage of being much, much more greedy, they will receive a perpetual doubling of interest. That is how retirements for American workers are still supposed to be paid – by magic, not by direct investment. Prospective retirees are supposed to ensure a good life by investing savings in loans to corporate raiders who fire, lay off, downsize and outsource these very workers. The trick is to persuade employees to hand retirement funding over to financial managers whose idea was to make money *off* the economy by extracting interest and dividends off workers, homeowners and companies being bought on debt leverage. In the final analysis it is debt leverage by itself that is supposed to fuel capital gains.

This has led to madness. The maddest solution of all would be for the government to give the extractive financial sector even *more* money – funds that no private lenders have been willing to provide, not even vulture funds. No private firm has been able to discover what Mr. Paulson and the unfortunate Mr. Bernanke are sanctimoniously promising: that a viable deal, even an almost money-making one, can be made by buying junk now and waiting for "the economy" to make it good.

Just what is "the economy" that is supposed to perform this remarkable feat, if not its mortgage debtors and corporate debtors? The government is to do what law enforcement officials have moved to prevent Countrywide Financial and other predatory lenders from doing: squeezing exploding Adjustable Rate Mortgages and "negative equity" mortgages out of debtors, on terms that often were bait-and-switch to begin with. Private companies could be challenged and their array of penalty fees thrown out of court. But perhaps Congress can craft a law imposing these harsh terms on voters. It is not as if we live in a system where people vote their self-interest.

Promises that "taxpayers" will be able to recover a large part of this money are a fiction. If there were a hope of recovering this money, then investors abroad – foreign buyout funds, foreign banks, foreign sovereign wealth funds – would have been willing to buy Bear Stearns, Lehman Brothers, A.I.G. and other companies at *some* price. But they wouldn't touch this at any price.

Why then should the U.S. Treasury pay three times as much as the Iraq War for money that will end up being lost after paying off the gamblers from their own bad bets. These are the bankers who already have placed all the risk onto their clients and, by lobbying to rewrite the bankruptcy laws, onto debtors. As matters now stand, the $700 billion is to be used to finance this year's annual bonuses, this year's million-dollar salaries and sales commission, and to contribute yet more to the retirement funds for the golden parachutes that financial

managers have siphoned off to provide a safety net for themselves. So we are back to the basic motto these days: "You only have to make a fortune once in a lifetime." Now is the time to make these fortunes as big as they're going to get. Because it's all down hill from here.

Why the banks won't lend

Here's why the government giveaway logic is fallacious: It's a giveaway, not a bailout. A bailout is designed to keep the boat afloat. But the existing Wall Street boat crafted by the investment bankers seeking to unload their junk *must* sink. The question as it sinks is simply who will be able to grab the lifeboats, and who drowns.

There is a reason why the banks won't lend: Housing and commercial real estate already are so heavily mortgaged that there is no rental value available (over and above operating expenses, current taxes and debt service) to pledge to the banks. It *still* costs more to buy a house than to rent it. *No* increase in the amount of credit, short of hyper-inflation can cure this. No lowering of interest rate, will lead banks to risk making a bad new loan – that is, a loan that probably will go bad and end up with the bank taking a loss after the borrower walks away or defaults.

Does Congress know what it is being told to do? Suppose that "taxpayers" are to squeeze money out of the "toxic" junk mortgages they buy from the investors that have bought these bad loans. The only way to do so would be for real estate prices to be raised to even higher levels. This means an even higher proportion of take-home pay by prospective homeowners.

Mr. Paulson realizes this. That's why he's directed Fannie Mae and Freddie Mac to inflate real estate prices all the more. At least, by the existing mortgage-holders to get paid off by existing debtors selling to the proverbial "greater fool." The hope in Mr. Paulson's plan is that there are enough "greater fools" with enough money to borrow from yet more foolish *new* mortgage lenders. Only Fannie Mae, Freddie Mac and the Federal Housing Agency are willing to make such foolish loans, and that is only because they are being directed to act in a foolish way by Mr. Paulson.

Here's the problem with following Mr. Paulson's orders and lending yet more: Every major real estate advisor on record has forecast a further drop of between 20 to 30 percent in property prices over the coming twelve months. This is now the standard forecast. It means that over and above the five million arrears and foreclosures that Mr. Paulson acknowledged already are on the books, yet more families are to give up the fight by this time next year. Is the $700 billion giveaway fund to try and recoup by evicting them too from their houses – to pay the "taxpayer" enough to bail out Countrywide, Washington Mutual and other predatory lenders for loans that state Attorneys General have accused of being fraudulent?

For the government to even begin to recover some of the value of the $700 billion in junk mortgages it has bought would force new homebuyers to pay even *more* of their income to the banks. And if they do that, they will have *less* income to spend on goods and services.

The domestic market will shrink, and tax revenues will fall at the state, local and federal levels. The debt overhead will deflate the economy, causing shrinkage all down the line.

So here’s where the cognitive dissonance comes in: It is necessary, even inevitable, for the volume of debt to come *down* – not up – to restore equilibrium. The economy was well on its way to preparing the ground for this last week. As Alan Meltzer of the American Enterprise Institute (of all places!) explained on McNeill-Lehrer, Merrill Lynch was able to be sold at 22 cents on the dollar; and the economy survived Lehman Brothers and Bear Stearns being wiped out.

Such debt writes-offs are a precondition for writing down America’s mortgage debts to levels that are affordable. But Mr. Paulson’s plan is to fight *against* this tide. He wants the Wall Street to keep on raking in money at the expense of the economy at large. These are the big banks who lobbied Congress to appoint de-regulators, the banks whose officers paid themselves enormous bonuses and gave themselves enormous golden parachutes. They were the leaders in the great disinformation campaign about the magic of compound interest. And now they are to get their payoff.

The pretense is that not to pay them off would threaten “the economy.” The reality is that it only would stop their predatory behavior. Worse than that, for the economy at large a government take-over of these bad loans would prevent the debt write-down that the economy needs!

It gets worse. If Congress should be so destructive as to buy out $700 billion of bad loans (for starters), the sellers will do just what Russia’s kleptocrats did. They will take their money and move it abroad to a “hard” currency country. This will help collapse the dollar. Up will go gasoline costs and prices for other imports. America will be turned into a Russian-style post-Soviet economy, having endowed a new domestic kleptocracy of insiders, who use some of their gains to finance the campaigns of American Yeltsins such as McCain.

So let us admit that the economy has been taking a wrong track for a number of decades now. As John Kay noted : “When the dust settles, many banks and hedge funds will have lost more money on their trading activities in the past year or so than they had made in their entire history … The pursuit of shareholder value damaged both shareholder value and the business.”[2]

I worry that Wednesday’s jump in the Dow Jones average signals that the big betters have decided that there is a good chance of the vast giveaway going through. The Republican protests seem to me to aim not so much at really stopping the measure, but on going on record that they opposed it – before they voted for it. When the public wakes up to the great giveaway, the Republicans can say, “It was a Democratic Congress that did it, not us. Read our anguished protests.” Everyone is trying to cover themselves. With good reason.

Don’t let them speak on behalf of voters and then act against the economy, claiming that

they are trying to save it. A giveaway of unprecedented magnitude would cripple it for as far as the eye can see.

[1] Martin Wolf, "Paulson's plan was not a true solution to the crisis," *Financial Times*, September 24, 2008.

[2] John Kay, "How we let down the diligent folk at the Halifax," *Financial Times*, September 24, 2008.

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