THIS IS NOT A CREDIT CRISIS – IT IS A DEBT CRISIS

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Using an analogy with ancient Babylonia as its leading theme, this viewpoint argues that the credit crisis is the symptom of an underlying problem. Fuelled by government policies, unprecedented debt levels were run up in industrialised countries over the last quarter century. Present policies of financial sector bailouts are not only an unwise use of taxpayers' money; they maintain economic structures opposed to what classical liberals such as J. S. Mill envisaged as a free-market economy.

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What the Babylonians knew

When he took office as leader of the most powerful nation on earth, his first act was to introduce a 'debt workout' for the beleaguered economy. Under his predecessors, the public financial system had produced a bad debt problem that now threatened to crush the economy. Many of his citizens had to pledge their incomes in debt servicing and financial fees. Others lost their homes and land as foreclosures were rampant. His people were looking to him for change and for relief.

No, this is not about Obama. The year was 1792 BC, the nation was ancient Babylonia and the leader was King Hammurabi. The workout was in fact a plain debt cancellation, or 'clean slate' – a social mechanism that allowed ancient civilisations to prevent their financial sectors from ruining the real economy and family livelihoods.

Recent archaeological finds of *shubati* clay tablets (ancient ledgers) indicate that Babylonia developed an extensive public financial sector. Its administrators had mastered the mathematics of exponentiation and applied compound interest rules. They used a precursor to modern double-entry bookkeeping and grasped its fundamental tenet that for every asset there is a liability, and for every credit a debit. Their economic thinkers realised that financial sector expansion would bring exponential debt growth, inevitably beyond the economy's ability to pay. Their system of financial regulation was for rulers to periodically declare a clean slate. This applied to debt denominated in barley (the household staple) which families owed to the temple-state public financial system. Households had typically run up such debts as liabilities for crop-sharing rents and water fees. In contrast, commercial debts by traders and denominated in silver were not forgiven. Ancient Babylonians recognised the difference between the consequences of commercial risk taking which traders could carry, and the consequences of financial liabilities created by public sector policy, which threatened households' livelihoods (Hudson and Van de Mieroop, 2002; Hudson and Wunsch, 2004; Wray, 2004).

You could be forgiven for mistaking the USA (or the UK, for that matter) for a debt-ridden Babylonia on the eve of a clean slate. Though 3,801 years apart, the similarities are striking. But at least the Babylonians had learnt how to deal with debt before it crushed them. At the moment, we have not. It is the elephant in the room that no one talks about.

Credit boom, debt growth

From the mid-1980s, most industrialised economies implemented financial policies that stimulated a credit boom without debt management provisions. As any Babylonian economist could have predicted, the debt overhead imposed on their real sectors has since grown unchecked and exponentially. Stimulated by public policies of generous credit facilities and artificially low interest rates, banks moved away from their traditional role of deposit takers and credit providers to households and business, and engaged in merchant banking and securities trading. In creating and trading in financial innovations such as the now-infamous collateralised debt obligations (CDOs) and similar instruments, they created serial bubbles in dotcom stocks, real estate and currency trade. All this happened not only with the tacit approval of government, but with its active support via monetary policy. Now that the grapes have turned sour, this support continues in the form of bank bailouts at the cost of real-sector employment, profit, jobs and even homes – a perversion of the clean slate philosophy. Our real problem is not that credit flows have dried up. It is that we have not even started to recognise what was central to Babylonian financial management. Debt is the problem, lack of credit is a symptom.

The size of the debt had grown out of control well before the credit crisis broke. Total liabilities from the US real economy to its financial sector amounted to only 1.5 times its GDP in 1980, but the multiple rose to 2 (1985), 3 (1996), 4 (2003) and then 4.7 (2007) (BEA, 2009). Growing 'investment' in financial assets came at the price of diverting finance from investment in US manufacturing structures from 5.5% of its GDP in the 1970s, down to 4% (1980s), 3% (1990s) and then below 2% (2000s) (ibid.). It also diminished demand for real output. US households in 2007 paid over a fifth of their after-tax, disposable income to the financial sector in debt servicing and financial fees. The USA had become an economy trying to drive with the brakes on.

Debt growth can be understood by herding behaviour, falling costs of credit during the recent boom, and the effect of compound interest, which means each loan requires additional debt creation to service it. So in a number of ways, loans beget loans and without regulation, debt growth is self-propelled. With active government encouragement, it is a swelling tide. We tried to ride that wave for two decades, but it is now time to build a dike. The flood is such that no one will keep dry feet. But at least the real economy of households and businesses should be saved from drowning.

The current debt burden was obscured for a time by the illusion of wealth during the long asset–price boom-turned-bubble of the last quarter century. Thanks to rising prices of real estate and its derivative instruments, US households' 'net worth' increased from 4.7 times disposable household income in the 1980s and 1990s to a multiple of 5.9 in 2000 and 6.1 in 2007. The inevitable end to the asset price rally came with the turnaround in the US real estate market in the summer of 2006. Sudden net negative equity-impaired households' ability to keep borrowing against asset values to keep paying for a growing debt. Bank lending came to a standstill, but not debt repayment.

The misplaced sanctity of debt

And yet it is unwise to try and pay off this debt, and so to favour banks as creditors over households and firms, their debtors. This policy relies on the image of banks as passively supplying loans demanded by the public, which must therefore now face the consequences of its choices. This image stands in stark contrast to reality. The debt was run up recklessly in a lending spree where commercial banks and central banks (foremost, the Federal Reserve and the Bank of England) worked together to keep credit flowing. There is no moral imperative for debtors in the real economy to shoulder the bulk of the costs now that the boom has turned into crisis. Neither is that feasible. The debt represents a burden far beyond what the real economy can pay off, even if it keeps trying (as it now does) for decades to come. The current attempt is futile and harmful. It drains resources away from real demand and investment and absorbs any government package intended to stimulate the real economy. This is worse than driving with the brakes on – it is like trying to start up with the brakes on. It cannot be done.

What is true for the USA is true for the global economic system. Outstanding derivatives have reportedly reached US$1.14 quadrillion worldwide (BIS, 2009). But policymakers do not seem to realise what was plain to your proverbial Babylonian economist. The credit crisis is the symptom, the debt is the cause. Without a debt workout, recovery is beyond the horizon no matter how many bank bailouts. Present policies of financial sector support are the inverse of a clean slate – they artificially maintain debt claims by keeping so many creditors in business to pursue their debtors. For all our economic sophistication, ancient Babylonians would be stunned by our lack of perception.

Classical liberalism's view of *rentier* incomes

As with all bad debts, rescheduling will be inevitable. The choice is to do it now or to do it later, after subjecting the real economy to a prolonged drain of liquidity, employment and income. So why don't we face the music?

The reason is that a debt workout will one way or another hurt financial institutions living on debt-servicing income. The current consensus is that this must be avoided since it will harm the real economy as well. But for a sizeable chunk of the merchant banking and securities management segments within the wider financial sector, this assumption does not hold water. Their business plan was simply to manipulate asset prices. Their role in supporting real-sector investment was negligible or negative and the knock-on effects of their demise on the real economy may be limited or even positive. Their relation to it was more parasitic than symbiotic anyway. Today's economists shy away from the inevitable as they are trained to think of the financial sector *in toto* as indispensable to the real economy. It needs to be protected, with no distinction between its productive and unproductive investments.

Classical liberalism had a very different view. Its vision of a free market included freedom from the burden of *rentier* income (as, for instance, enjoyed by landowners). Liberalism's intellectual giant John Stuart Mill made an important distinction between capital used productively and capital kept idle by government taxation and by *rentier* claims. Payment for such privileged asset ownership, Mill (1848) wrote,

> 'is not one of the expenses of production; and the necessity of making the payment out of capital makes it requisite that there should be a greater capital . . . than is naturally necessary, or than is needed . . . in a

> different system. This extra capital, though intended by its owners for production, is in reality employed unproductively.'

Banks today operate under a state-given privilege to create and trade financial assets. If managed well, these assets help the real economy to save, to invest, to smooth consumption and to diversify risk. But just like the landed gentry in Mill's days, the financial sector has the power to inflate asset prices, reaping windfall gains which simultaneously raise the costs of production to the real economy, so smothering its progress. When this dynamic is set in motion, those parts of the financial sector specialising in windfall gains expand rapidly and the real sector (where most jobs and profit are generated) stagnates, as has happened in the USA and UK since the 1980s. In this constellation, there is not synergy but conflict of interest between the financial sector and the real economy.

Monetary policy and the public debate have neglected this reality since the 1980s. The constructive role of finance in economic growth was widely publicised during the credit boom in textbook lore, academic research and business journalism. Its potential for draining the real economy of liquidity – the lifeblood of economic transacting – in a boom-gone-bust was under-reported, but has recently become painfully clear by demonstration. Of course, it really is age-old.

Mill (1844) already warned that, 'the inclination to borrow has no fixed or necessary limit', and that a banker responding to this by 'issuing paper which is inconvertible, levies a tax on every person who has money in his hands or due to him. He so appropriates to himself a portion of the capital of other people, and a portion of their revenue'. Mill the moral philosopher is also clear that he considers this an 'iniquity'. His problem with taxation was that it '. . . limits unnecessarily the industry of the country: a portion of the fund destined by its owners for production being diverted from its purpose, and kept in a constant state of advance . . .' (Mill, 1848). Today, a fifth of the disposable income that Americans could spend in support of the productive economy is kept 'in a constant state of advance' to the financial sector, with active government support. This implicit tax is the iniquity to be redressed.

A new policy

The drain of liquidity from the real economy to the financial sector must be decreased for a recovery to start. The important point is that it is, in Mill's words, not 'naturally necessary'. We can do without much of those financial claims, and the firms that live off them. Really, we can. This comes as a shock to economists, policy-makers and the public who have been told for decades that the financial sector is to be nurtured, and now to be saved. But this view ignored the productive and unproductive roles of the financial sector, a distinction central to classical liberal economics and its social policy. A shrinking of the financial sector – its most speculative part, preferably – by allowing bankruptcies would proportionally force it to relinquish its stifling debt claim on the real economy. That part has only loose links to real-sector investment, if any at all, and the collateral damage will be limited, certainly less than today's alarmist scenarios prompting us to pour more money into speculators' pockets. In contrast, shrinking would improve rather than impair the now bloated financial sector's ability to serve the real economy. Not all that long ago, the US economy did well with a financial sector only a third of its present size. Do we really need all of the other two-thirds?

We should move away from supporting finance *in toto*. The new policy should be to limit support to banks that serve the real economy. If some of the other financial firms specialising in asset–price manipulation go bust, this will not be the end of the world. It is, after all, what bankruptcy is for. It is a legally acknowledged and orderly debt workout mechanism and the natural consequence of commercial over-exposure. Inevitably, there will be collateral damage to investors among firms, households and pension funds. To the extent that this has real-sector repercussions via falling demand and incomes there should be provisions to compensate. This may be financed out of the liquidity withdrawn from today's blanket bank support, so it need not come at an extra cost. Most importantly in the longer term, this policy will allow the debt overhead – and the speculative part of the financial sector – to shrink back to more normal levels. This latter objective is important and is not achieved under present policies.

So let market forces work to effect a solution to the debt problem that underlies the credit crisis. As soon as a debt workout is put in place, recovery can start – but not earlier. Learn from Babylonia.

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