Financial Crisis: Sustaining Unsustainability

$1 Trillion more to sustain the economic crisis. G-20 message to indebted countries. "Drop Dead!"

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Theme: Global Economy

Not much substantive news was expected to come out of the G-20 meetings that ended on April 2 in London – certainly no good news was even suggested. Europe, China and the United States had too deeply distinct interests. American diplomats wanted to lock foreign countries into further dependency on paper dollars. The rest of the world sought a way to avoid giving up real output and ownership of their resources and enterprises for yet more hot-potato dollars. In such cases one expects a parade of smiling faces and statements of mutual respect for each others' position – so much respect that they have agreed to set up a "study group" or two to kick the diplomatic ball down the road.

The least irrelevant news was not good at all: The attendees agreed to quadruple IMF funding to $1 trillion. Anything that bolsters IMF authority cannot be good for countries forced to submit to its austerity plans. They are designed to squeeze out more money to pay the world's most predatory creditors. So in practice this G-20 agreement means that the world's leading governments are responding to today's financial crisis with "planned shrinkage" for debtors – a 10% cut in wage payments in hapless Latvia, Hungary put on rations, and permanent debt peonage for Iceland for starters. This is quite a contrast with the United States, which is responding to the downturn with a giant Keynesian deficit spending program, despite its glaringly unpayable $4 trillion debt to foreign central banks.

So the international financial system's double standard remains alive and kicking – at least, kicking countries that are down or are falling. Debtor countries must borrow a trillion from the IMF not to revive their own faltering economies, not to pursue counter-cyclical policies to restore market demand (that is only for creditor nations), but to pass on the IMF "aid" to the poisonous banks that have made the irresponsible toxic loans. (If these are toxic, who put in the toxin? To claim that it was all the "natural" workings of the marketplace is to say that free markets curdle and sicken. Is this what is happening?)

In Ukraine, a physical fight broke out in Parliament when the Party of Regions blocked an agreement with the IMF calling for government budget cutbacks.[1] And rightly so! The IMF's operating philosophy is the destructive (indeed, toxic) belief that imposing a deeper depression with more unemployment will reduce wage levels and living standards by enough to pay debts already at unsustainable levels, thanks to the kleptocracy's tax "avoidance" and capital flight. The IMF trillion-dollar bailout is actually for these large international banks are advising and helping squeeze these countries, so that they will be able to take their money and run. The problem is all being blamed on labor. That is the neo-Malthusian spirit of today's neoliberalism.

The main beneficiaries of IMF lending to Latvia, for example, have been the Swedish banks that have spent the last decade funding that country's real estate bubble while doing nothing to help develop an industrial potential. Latvia has paid for its imports by exporting its male labor of prime working age, acting as a vehicle for Russian capital flight – and borrowing mortgage purchase-money in foreign currency. To pay these debts rather than default, Latvia will have to lower wages in its public sector by 10% — and this with an economy already depressed and that the government expects to shrink by 12 percent this year![2]

To save the banks from losing on their toxic mortgages, the IMF is bailing them out, and directing the Latvian government to squeeze labor all the more – and to charge for education rather than providing it freely. The idea is for families to take a lifetime of debt not only to live inside rather than on the sidewalk, but to get an education. Alcoholism rates are rising, as they did in Russia under similar circumstances in Yeltsin's "Harvard Boys" kleptocracy after 1996.

The insolvency problem of the post-Soviet economies is not entirely the IMF's fault, to be sure. It is the European Community deserves a great deal of blame. Instead of viewing the post-Soviet economies as wards to be brought up to speed with Western Europe, the last thing the EU wanted was to develop potential rivals. It wanted customers – not only for its exports, but most of all for its loans. The Baltic States passed into the Scandinavian sphere, while Austrian banks carved out financial spheres of influence in Hungary (and lost their shirt on real estate loans, much as the Habsburgs and Rothschilds did in times past). Iceland was neoliberalized, largely in ripoffs organized by German banks and British financial sharpies.

In fact, Iceland (from where I'm writing this note) looks like a controlled experiment – a very cruel one – as to how deeply an economy can be "financialized" and how long its population will submit voluntarily to predatory financial behavior. If the attack were military, it would spur a more alert response. The trick is to keep the population from understanding the financial dynamics at work and the underlying fraudulent character of the debts with which it has been saddled – with the complicit aid of its own local oligarchy.

In today's world, the easiest way to obtain wealth by old-fashioned "primitive accumulation" is by financial manipulation. This is the essence of the Washington Consensus that the G-20 support, using the IMF in its usual role as enforcer. The G-20's announcement continues the U.S. Treasury and Federal Reserve bank bailout over the past half-year. In a nutshell, the solution to a debt crisis is to be yet *more* debt. If debtors can't pay out of what they are able to earn, lend them enough to keep current on their carrying charges. Collateralize this with their property, their public domain, their political autonomy – their democracy itself. The aim is to keep the debt overhead in place. This can be done only by keeping the volume of debts growing exponentially as they accrue interest, which is added onto the loan. This is the "magic of compound interest." It is what turns entire economies into Ponzi schemes (or

Madoff schemes as they are now called).

This is “equilibrium” neoliberal style. In addition to paying an exorbitant basic interest rate, homeowners must pay a special 18% indexation charge on their debts to reflect the inflation rate (the consumer price index) so that creditors will not lose the purchasing power over consumer goods. Labor’s wages are *not* indexed, so defaults are spreading and the country is being torn apart with bankruptcy, causing the highest unemployment rate since the Great Depression. The IMF approves, announcing that it can find no reason why homeowners cannot bear this burden!

Meanwhile, the democracy is being torn apart by a financial oligarchy, whose interests have become increasingly cosmopolitan, looking at the economy as prey to be looted. A new term is emerging: “codfish republic” (known further south as banana republics). Many of Iceland’s billionaires these days are choosing to join their Russian counterparts living in London – and the Russian gangsters are reciprocating by visiting Iceland even in the dead of winter, ostensibly merely to enjoy its warm volcanic Blue Lagoon, or so the press is told.

The alternative is for debtor countries to suffer the same kind of economic sanctions as Iran, Cuba and pre-invasion Iraq. Perhaps soon there will be enough such economies to establish a common trading area among themselves, possibly along with Venezuela, Colombia and Brazil. But as far as the G-20 is concerned, aid to Iceland and “doing the right thing” is simply a bargaining chip in the international diplomatic game. Russia offered $4 billion aid to Iceland, but retracted it – presumably when Britain gave it a plum as a tradeoff.

The IMF’s $1 trillion won’t help the post-Soviet and Third World debtor countries pay their foreign debts, especially their real estate mortgages denominated in foreign currency. This practice has violated the First Law of national fiscal prudence: *Only permit debts to be taken on that are in the same currency as the income that is expected to be earned to pay them off*. If central bankers really sought to protect currency stability, they would insist on this rule. Instead, they act as shills for the international banks, as disloyal to the actual economic welfare of their countries as expatriate oligarchs.

If you are going to recommend more of this consensus, then the only way to sell it is to do what British Prime Minister Gordon Brown did at the meetings: announce that “The Washington Consensus is dead.” (He might have saved matters by saying “deadly,” but used the adjective instead of the adverb.) But the G-20’s IMF bailout belies this claim. As Turkey was closing out its loan last year, the IMF faced a world with no customers. Nobody wanted to submit to its destructive “conditionalities,” anti-labor policies designed to shrink the domestic market in the false assumption that this “frees” more output for export rather than being consumed at home. In reality, the effect of austerity is to discourage domestic investment, and hence employment. Economies submitting to the IMF’s “Washington Consensus” become more and more dependent on their foreign creditors and suppliers.

The United States and Britain would never follow such conditionalities. That is why the

United States has not permitted an IMF advisory team to write up its prescription for U.S. "stability." The Washington Consensus is only for export. ("Do as we say, not as we do.") Mr. Obama's stimulus program is Keynesian, not an austerity plan, despite the fact that the United States is the world's largest debtor.

Here's why the situation is unsustainable. What has enabled the Baltics and other post-Soviet countries to cover the foreign-exchange costs of their trade dependency and capital flight has been their real estate bubble. The neoliberal idea of financial "equilibrium" has been to watch "market forces" shorten lifespans, demolish what industrial potential they had, increase emigration and disease, and run up an enormous foreign debt with no visible way of earning the money to pay it off. This real estate bubble credit was extractive and parasitic, not productive. Yet the World Bank applauds the Baltics as a success story, ranking them near the top of nations in terms of "ease of doing business."

One practical fact trumps all the junk economics at work from the IMF and G-20: **Debts that can't be paid, won't be.** Adam Smith observed in *The Wealth of Nations* that no government in history had ever repaid its national debt. Today, the same may be said of the public sector as well. This poses a problem of just how these debtor countries are *not* going to pay their foreign and domestic debts. How will they frame and politicize their non-payment?

Creditors know that these debts can't be paid. (I say this as former balance-of-payments analyst of Third World debt for nearly fifty years, from Chase Manhattan in the 1960s through the United Nations Institute for Training and Research [UNITAR] in the 1970s, to Scudder Stevens & Clark in 1990, where I started the first Third World sovereign debt fund.) From the creditor's vantage point, knowing that the Great Neoliberal Bubble is over, the trick is to deter debtor countries from acting to resolve its collapse in a way that benefits themselves. The aim is to take as much as possible – and to get the IMF and central banks to bail out the poisonous banks that have loaded these countries down with toxic debt. Grab what you can while the grabbing is good. And demand that debtors do what Latin American and other third World countries have been doing since the 1980s: sell off their public domain and public enterprises at distress prices. That way, the international banks not only will get paid, they will get new business lending to the buyers of the assets being privatized – on the usual highly debt-leveraged terms!

The preferred tactic do deter debtor countries from acting in their self-interest is to pound on the old morality, "A debt is a debt, and must be paid." That is what Herbert Hoover said of the Inter-Ally debts owed by Britain, France and other allies of the United States in World War I. These debts led to the Great Depression. "We loaned them the money, didn't we?" he said curtly.

Let's look more closely at the moral argument. Living in New York, I find an excellent model in that state's Law of Fraudulent Conveyance. Enacted when the state was still a colony, it was enacted in response British speculators making loans to upstate farmers, and demanding payment just before the harvest was in, when the debtors could not pay. The sharpies then foreclosed, getting the land on the cheap. So New York's Fraudulent

Conveyance law responded by establishing the legal principle that if a creditor makes a loan without having a clear and reasonable understanding of how the debtor can repay the money in the normal course of doing business, the loan is deemed to be predatory and therefore null and void.

Just like the post-Soviet economies, Iceland was sold a neoliberal bill of goods: a self-destructive Junk Economics. Just how moral a responsibility – and perhaps even more important, how large a legal liability –should fall on the IMF and World Bank, the U.S. Treasury and Bank of England whose economies and banks benefited from this toxic Washington Consensus junk economics?

For me, the moral principle is that no country should be subjected to debt peonage. That is the opposite of democratic self-determination, after all – and of Enlightenment moral philosophy that economic policies should encourage economic growth, not shrinkage. They should promote greater economic equality, not polarization between wealthy creditors and impoverished debtors.

At issue is just what a "free market" is. It's supposed to be one of choice. Indebted countries lose discretionary choice over their economic future. Their economic surplus is pledged abroad as financial tribute. Without the overhead costs of a military occupation, they are relinquishing their policy making from democratically elected political representatives to bureaucratic financial managers, often foreign – the new Central Planners in today's neoliberal world. The best they can do, knowing the game is over, is to hope that the other side doesn't realize it – and to do everything you can to confuse debtor countries while extracting as much as they can as fast as they can.

Will the trick work? Maybe not. While the G-20 meetings were taking place, Korea was refusing to let itself be victimized by the junk derivatives contracts that foreign banks sold. Korea is claiming that bankers have a fiduciary responsibility to their customers to recommend loans that help them, not strip them of money. There is a tacit understanding (one that the financial sector spends millions of dollars in public relations efforts to undermine) that banking is a public utility. It is supposed to be a handmaiden to growth – industrial and agricultural growth and self-sufficiency – not predatory, extractive and hence anti-social. So Korean victims of junk derivatives are suing the banks. As *New York Times* commentator Floyd Norris described last week, the legal situation doesn't look good for the international banks. The home court always has an advantage, and every nation is sovereign, able to pass whatever laws it wants. (And as America's case abundantly illustrates, judges need not be unbiased.)

The post-Soviet economies as well as Latin America must be watching attentively the path that Korea is clearing through international courts. The nightmare of international bankers is that these countries may bring the equivalent of a class action suit against the international diplomatic coercion mounted against these countries to lead them down the path of financial and economic suicide. "The Seoul Central District Court justified its decision [to admit the lawsuit] on the kind of logic that would apply in the United States to a lawsuit involving an unsophisticated individual investor and a fast-taking broker. The court pointed to questions of whether the contract was a suitable investment for the company, and to whether the risks were fully disclosed. The judgment also referred to the legal concept of "changed circumstances," concluding that the parties had expected the exchange rate to remain stable, that the change in circumstances was unforeseeable and that the losses would be too great for the company to bear."[3]

As a second cause of action, Korea is claiming that the banks provided creditor for other financial institutions to bet against the very contracts the banks were selling Korea to "protect" its interests. So the banks knew that what they were selling was a time bomb, and therefore seem guilty of conflict of interest. Banks claim that they merely were selling goods with no warranty to "informed individuals." But the Korean parties in question were no more informed than were Iceland's debtors. If a bank seeks to mislead and does not provide full disclosure, its victim cannot be said to be "informed." The proper English word is misinformed (*viz*. disinformation).

Speaking of disinformation, an important issue concerns the extent to which the big international banks may have conspired with domestic bankers and corporate managers to loot their companies. This is what corporate raiders have done for their junk-bond holders since the high tide of Drexel Burnham and Michael Milken in the 1980s. This would make the banks partners in crime. There needs to be an investigation of the lending pattern that these banks engaged in – including their aid in organizing offshore money laundering and tax evasion to their customers. No wonder the IMF and British bankers are demanding that Iceland make up its mind in a hurry, and commit itself to pay astronomical debts without taking the time to ask just how they are to pay – and investigating the creditor banks' overall lending pattern!

Bearing the above in mind, I suppose I can tell Icelandic politicians that I have good news regarding the fate of their country's foreign and domestic debt: No nation ever has paid its debts. As I noted above, this means that the real question is not whether or not they will be paid, but how *not* to pay these debts. How will the game play out – in the political sphere, in popular ideology, and in the courts at home and abroad?

The question is whether Iceland will let bankruptcy tear apart its economy slowly, transferring property from debtors to creditors, from Icelandic citizens to foreigners, and from the public domain and national taxing power to the international financial class. Or, will Iceland see where the inherent mathematics of debt are leading, and draw the line? At what point will it say "We won't pay. These debts are immoral, uneconomic and anti-democratic." Do they want to continue the fight by Enlightenment and Progressive Era social democracy, or the alternative – a lapse back into neofeudal debt peonage?

This is the choice must be made. And it is largely a question of timing. That's what the financial sector plays for – time enough to transfer as much property as it can into the hands of the banks and other investors. That's what the IMF advises debtor countries to do – except of course for the United States as largest debtor of all. This is the underlying lawless character of today's post-bubble debts.

A historical perspective

History provides a moral perspective on the need and indeed the inevitability of nations canceling their debts in one way or another – through bankruptcy in which creditors foreclose on the property of most people, companies and the government itself, or whether democracy asserts its sovereign right to keep finance in its place, and say, “You’ve made a false start. So we’ve got to start all over again. We hope you work with us to make the credit and debt system work better this time, so that we can achieve in practice what the textbooks and your public-relations think tanks promise – namely, that finance can be steered to contribute to growth rather than merely undercut it by loading economies down with the deadweight of a debt overhead.”

Ultimately, moral arguments in today’s world turn on the political question of, “What is the effect of debt, in various modes of organization?” What contributes most to economic growth? This practical question is what will determine what people want and ultimately what they think is most fair. Productive credit is fair. If a loan helps a borrower get richer, by using the proceeds to earn the money to pay back the creditor with interest and still come out ahead, then credit will be supported. But unproductive, purely extractive credit is deemed everywhere to be unfair. That is what Aristotle noticed over two thousand years ago.

We are now emerging from a financially unique period of history. Never before have people believed that the way to get rich was by running into debt. There was no optimistic term such as debt leveraging.

Government debts were war debts. Until quite recently (1980 really was the turning point), they only went into debt in war – largely, as Adam Smith explained, to conceal the actual costs from the population, by paying creditors out of taxes levied after the war had ended. Other government operations were financed on a pay-as-you-go basis. Only recently – one could call it a class war, I suppose – did governments run into debt as a result of cutting taxes on wealth and property. For most of history the only people living above subsistence levels were well-to-do landowners. So there simply was no opportunity to shift the tax burden onto labor – until around the 18th century governments began to tax essentials that consumers bought. This increased the prices of the commodities being taxed, and thus made the economy less competitive. So debtor governments became high-tax governments that tended fairly quickly dragged down their economy. (Spain in the 16th century is an excellent example of how the grandees shifted taxes onto handicrafts and agriculture, driving out economic initiative to its own former colonies in the Low Countries. The United States today could be cited also.)

Most private-sector debt was short-term trade credit, mainly to finance the exportation or domestic sale of commodities already produced. This was the essence of commercial banking since the 13th century permitted *agio* – a foreign exchange premium – to be charged as the main financial loophole around the Church’s prohibitions against usury. Only in the 19th century did long-term industrial credit develop, and it was largely equity financing.

As for individual consumers, for many centuries they have sought to avoid “mortgaging the homestead.” It took a neoliberal financial bubble organized by Alan Greenspan to convince them – indeed, panic them – into buying houses. Not to buy was to lose the chance to obtain housing whose price was rising further and further beyond their ability to earn. But as matters have worked out, the price to be paid was to enter a lifetime of debt peonage. The same may now be said for entire industrial sectors and entire nations.

NOTES

[1] “Melee at Ukrainian Parliament stalls vote needed for I.M.F. aid,” *International Herald Tribune*, April 3, 2009.

[2] Robert Anderson, “Deficit causes IMF to delay loans to Riga,” *Financial Times*, April 3, 2009.

[3] Floyd Norris, “Winning bet turns sour for big banks,” *International Herald Tribune*, April 3, 2009.