Debt and War

Last week marked the tenth anniversary of the collapse of the Lehman Brothers investment bank and the subsequent onset of the global financial crisis. What caused the crisis, how was it addressed and how has it continued to affect us up to the present day?

The 2008 crisis was caused by reckless lending. Low interest rates made mortgage payments more affordable and enabled people to borrow more money to buy homes. This increased borrowing in turn pushed up home prices. People on the sidelines who saw their neighbors growing rich through real estate price inflation jumped in and boosted prices even more. Banks, able to create credit from nothing, were happy to lend.

Until, that is, it became apparent that some of the loans would never be repaid. As banks became fearful of the quality of the assets held on their books, they stopped lending money to businesses and other banks in case they needed it themselves to write off bad debts. The financial system froze up and businesses, without access to the credit necessary to operate, began to go bankrupt.

To revive lending and avert economic disaster, central banks around the world agreed to buy the banks’ non-performing loans at full face value and grant them unlimited additional credit at near-zero percent interest. These extraordinary measures worked. No other major banks faced bankruptcy and confidence returned to the financial system.

However, the bad debts didn’t disappear – they just moved from bank balance sheets onto the balance sheets of the world’s central banks. Meanwhile, the trillions of dollars, euros, yen and yuan printed up by the central banks to buy them flowed through the banks to fuel a renewed bout of speculation which has pushed global bond, stock and real estate prices to new all-time highs.

Essentially, a crisis caused by too much lending and speculation was solved (at least in the short term) by enabling even more lending and speculation. Central bankers hoped that the additional lending would jump-start spending and income. If the growth in income could be made to exceed the growth in debt, the world’s debts would become more manageable over time.

However, as the chart demonstrates, debts have continued to grow faster than income in the years since the Lehman collapse. To try to reverse this imbalance, governments have attempted to boost domestic income by waging currency wars and trade wars.

Currency wars occur when a country deliberately makes its currency cheaper in relation to other currencies to both encourage exports and discourage imports. The problem, though, is that while a devaluation of your currency may boost exports, employment and income for a brief period, in time your trading partners will retaliate in kind and eliminate your advantage. While the U.S. dollar fell to its lowest level in almost 40 years in 2011, in the years which followed the Chinese, Japanese and Europeans responded with their own competitive devaluations. In the end, currency wars do not lead to the sustained income growth needed to resolve debt crises.

In the face of the failure of currency wars to deliver the necessary growth in income, governments began waging trade wars instead. Imposing tariffs on imported goods would appear to be a good way to make imports more expensive than domestic goods and thereby reduce import demand while boosting domestic employment and income. However, just as with currency wars, in time your trading partners will retaliate in kind. So, while Donald Trump is busy slapping tariffs on Chinese imports, China is busy imposing tariffs on American goods. In the end, trade wars are no better than currency wars at delivering sustained income growth.

Unable to boost income, countries could also restore balance by reducing their burden of debt. Historically, debts have most commonly been forgiven in the aftermath of war. At the end of WWII, the German Reichsmark was worthless. Consequently, so were all debts and assets denominated in Reichsmarks. Freed from the burden of servicing old debts, post-war Germany rapidly rebuilt itself in what came to be known as the German economic miracle.

However, only a madman would recommend war, with all its attendant horrors, be employed as a means of reducing a country’s debts. While in the 1920s and 1930s the world’s great powers waged currency wars and trade wars before finally stumbling into a catastrophic shooting war, we need not complete the same sequence today.

As the economist Dr. Michael Hudson points out in his soon-to-be-released book “...And Forgive them their Debts: Credit and Redemption”, periodic debt jubilees were an accepted feature of pre-modern economic life. If we are to restore our economy to balance, we need to establish our own mechanism for regular debt forgiveness. Undoubtedly the banking system to which our debts are owed will resist any attempt to do so, but as Lord Acton put it so memorably, “The issue which has swept down the centuries and which will have to be fought sooner or later is the people versus the banks.”