The Coming Savings Meltdown

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> Debts that can't be paid, won't be. That point inevitably arrives on the liabilities side of the economy's balance sheet

But what of the asset side? One person's debt is a creditor's claim for payment. This is defined as "savings," even though banks simply create credit endogenously on their own computers without needing any prior savings. When debts can't be paid and debtors default, what happens to these creditors?

As President Obama showed, banks and bondholders can be bailed out by new Federal Reserve money creation. That is what the $4.6 trillion in Quantitative Easing since 2008 was all about. The Fed has spent the last few years supporting stock market prices (and holding down gold prices) by manipulating the forward option markets.

But this artificial life support to keep the debt overhead afloat is nearing the reality of the debt wall. The European Central Bank has almost run out of available euro-bonds to buy. The new fallback position to keep the increasingly zombified U.S. and Eurozone financial markets afloat is to experiment with negative interest rates.

Writing down savings by a few percentage points helps bring the glut of creditor claims marginally back towards balancing bank deposits with the ability of debtors to pay. But such marginal moves are rarely sufficient. A quantum leap is needed.

Governments have long followed a basic guideline when faced with a need to devalue their currencies (for instance, as the dollar was devalued against gold in 1933). Nothing is worse for a politician or central banker than to be overly shy when it comes to devaluation. The motto is, "Always depreciate to access." That means at lest 25 percent, often a third when a basic structural adjustment is needed.

The recent experiment in negative interest rates writing down savings as a necessary compliment to the inevitable debt writedowns means that financial policy makes are beginning to fact the hitherto unthinkable fact that many zombie companies and debtors have no foreseeable means of paying the amounts that they owe on paper.

The tendency of debts to grow exponentially at rates in excess of the economy's ability to create an economic surplus to pay creditors has been known for nearly 5,000 years. My book "… and forgive them their debts" describes how ancient Near Eastern rulers recognized the inherent tendency of financial dynamics to cause instability, leading to debt bondage and forfeiture of land to creditors.

To prevent this rising indebtedness from tearing their realms apart, rulers started their first full year on the throne by clearing away the overhang of arrears that had been accruing on personal and agrarian debts. The aim was to restore an idealized "mother condition" in which bondservants were liberated, able to start with a Clean Slate with their self-support land returned to them, in balance with regard to their income and outgo.

An analogy would be the idyllic condition that the U.S. economy would achieve if we could restore the financial situation that existed in 1945. The end of World War II left an economy in which most families were almost debt-free. Families and businesses and were rife with cash, as there had not been much opportunity to spend during the wartime years, and the Great Depression had wiped out substantial debts. Returning soldiers were able to start families and buy homes by committing to pay only 25 percent of their income for 30 years. This era was as close as the United States came to a Clean Slate. Today it seems an unrecoverable golden age – as the ancient Near East seemed to be to debt-wracked imperial Rome.

Germany's Economic Miracle consisted of its Allied Monetary Reform of 1948 – a Clean Slate erasing most personal and business. That debt cancellation was fairly easy because most debts were owed to Nazis, and the Allies were glad to see their savings claims for payment wiped out.

Fast forward to today: Indebted students graduate with an obligation to pay so much education debt that they cannot qualify for mortgages to buy homes of their own. Marriage rates are down, U.S. home ownership is plunging, and rents are rising.

Automobile debt also has soared, leading to rising default rates second only to student debt defaults. The overhang of junk-mortgage debts that crashed the economy in 2008 remains on the books of families who managed to survive the ten million foreclosures under the Obama bailout of Wall Street. (His constituency turned out to be his Donor Class, not the junk-mortgage victims among his voters. He characterized them as "the mob with pitchforks" to the banksters he invited to the White House to celebrate his bailout.)

By driving down interest rates, the Fed's policy of Quantitative Easing has subsidized an enormous debt buildup without increasing the interest burden proportionally. This has enabled corporations to carry much higher debt and even indulge in leveraged buyouts and stock buyback programs.

This QE policy has made financial engineering much more enriching than industrial engineering. But it has painted the U.S. and European economies into a corner. At some points interest rates will inevitably begin to rise back up. Some countries will have to increase rates in order to borrow to stabilize their exchange rates when their balance of trade and payments falls into deficit. Other countries will simply see that the game is over and will give up the pretense that the personal, corporate and public-sector debt overhead can be paid.

It is to prepare for this inevitable eventuality that Europe is experimenting with its trial run of negative interest rates. Once the technique is established, it will prepare the way for the inevitable step of writing down national savings in line with the economy's ability to pay.

That ability is shrinking much more than at any time since the 1920's, which gave way to the Great Depression despite the many debt writedowns of 1931-32. The exponential mathematics of compound interest have created more and more claims on personal income and corporate cash flow, leaving less and less to be spent on goods and services.

Until a debt writedown occurs, storefronts will continue to close, arrears will mount, students will continue to postpone marriage and family formation, high-risk bonds will begin to give way and default.

That should be what economic theory is all about. But for the past generation, economic models have pretended that banks and creditors act responsibly enough not to make bad loans. Pension fund managers pretend that they can provide for future retirement by corporate or public employees by earning 8 percent annually ad infinitum, doubling every 7 years, as if this is really possible in an economy not really growing outside of the Finance, Insurance and Real Estate (FIRE) sector (and even so, growing at only 1 or 2 percent). How then can the economy pay its debts without imposing financial austerity much like Third World countries subjected to IMF austerity programs?

Today’s economic orthodoxy denies that this debt problem can exist. Debt dynamics and the exponential growth curve of compound interest does not exist in the parallel academic universe that somehow has been situated in the social science department instead of the literature department as science fiction.

Perhaps someday a revamped economics curriculum will include the study of history to see how earlier societies have coped with the inherent tendency of debts to increase faster than the ability to be paid. It is a long history with many examples. Western civilization has failed to solve the financial problem that Near Eastern societies were able to cope with by intervening from “outside” the economy.

But these formative debt experiences are as repressed today as sexual drives repressed academically before the work of Freud. Academic economists are financial prudes. Debt cancellation is historically the solution. Quantitative Easing and bailouts of the One Percent can only be a temporary substitute. We should think of them as “abstinence” from recognizing the need to write down bad loans (“savings”) along with the bad debts.

http://www.informationclearinghouse.info/52011.htm

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