5000 Years of Debt

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June 2012

Debt seems to be one of the major factors shaping the lives of people around the world today. Until recently, debt was seen as something that could leverage economic growth and enable us to have the good things in life sooner rather than later. However, we are coming to see that debt can also leverage economic decline and prevent whole countries from enjoying the lifestyles they had become used to and felt entitled to expect in the future.

Debt – the New Money

Over the course of the last 40 years the influence on Western, capitalist markets and societies of government-issued currency has been overwhelmed by the creation of a new form of money – viz., debt (and the wide variety of financially engineered products related to debt such as credit default swaps). The supply of this new "currency" has grown to be many times that of the traditional government-backed version and is controlled by a wide variety of non-government players; e.g., banks, building societies, finance companies. The obligation to pay the "tax" or interest charged by debt issuers is usually backed by legal sanctions almost as severe as the sanctions governments impose for default on their taxes.

In 2007-2008, a Global Financial Crisis was triggered when holders of US sub-prime mortgages found themselves unable to service the debt load they had taken on. Real incomes for the median American male had not grown since the 1970s and median household incomes had remained static since the mid 1990s. Government policies designed to keep the American dream alive by making credit more widely available had resulted in much of middle America being seduced by low interest rates and "no doc" loans. However, when low "honeymoon" interest rates began to be reset and people were unable to re-finance their homes because the economy had slowed the banks and other investors that held these sub-prime mortgages or the financially engineered investment products based on them found themselves facing large losses and, in some cases, insolvency (think Lehman Brothers).

In the years leading up to 2007, many companies were also investing as though the good times of easy, cheap credit were going to continue indefinitely. Many had levels of gearing (debt) that became unsustainable as the global economy slowed dramatically in 2008.

At the individual level, the ratio of household debt to income in Australia went from being one of the lowest in the advanced economies in the late 1980s to one of the highest in December 2007 (according to Michael Davies of the Reserve Bank in a paper given to a conference held by the Bank for International Settlements in March 2008). According to Davies: "During the 1980s, the ratio of debt to disposable income for Australian households was fairly stable at around 45%... But since 1990, this ratio has risen rapidly, reaching 157% in December 2007." It is now (June 2012) almost 10% higher still according to Citibank. This rise is mostly a result of the ratio of housing debt to disposable income rising from 31% to 134% over the period. Increasing debts are also being incurred by many young Australians as a result of the Higher Education Contribution Scheme that was introduced in 1989. The average individual HECS debt in 2012 is estimated to exceed $20,000 and the total HECS debt owed by students to the federal government is now over $22 billion.

Even people who did not have high debt levels had their wealth and retirement dreams savaged when stock markets crashed in early 2008. The Australian All Ordinaries index fell from a high of over 6800 in November 2007 to a low of around 3200 in March 2009. It has since made a nervous recovery to over 5000 before falling again to around 4100 (as at mid June 2012).

To bail out banks and insurance companies that were deemed "too big to fail" governments around the world injected vast amounts of taxpayers' money into many over-indebted organisations saving them from bankruptcy while undermining their own sovereign balance sheets. In many cases, governments borrowed in order to fund these bailouts thus mortgaging the future welfare of their citizens including the welfare of future generations. The government bailouts and stimulus packages basically meant that debt was transferred from private hands to sovereign governments. This process is still going on in Europe and in other countries that are struggling to kick-start a new period of economic growth while at the same time paying down hugely increased levels of government debt.

A New, Unfolding Chapter in the Debt Story

A new phase of the debt story recently began when citizens in highly indebted nations were asked (or, more accurately, forced) to accept significantly lower standards of living and much diminished future expectations. People in Greece, Spain, America, France and elsewhere began marching in the streets protesting at the social promises that governments were breaking in their seemingly futile attempts to rein in their ballooning sovereign debt levels. As a result, it has become clear that debt is not just a neutral financial construct but something that can foster social unrest, political upheaval, rising trade barriers, high unemployment, disappointed retirement expectations – and also increasing levels of fear, anger, violence, depression and suicide.

How Did We Get Here?

Yet, in spite of its profound impact on the world we live in, what do we really know about debt and the role that it has played in human history? And, what role might debt play in the future?

Anthropologist David Graeber, in his monumental book "Debt: the first 5000 years", has tried to answer these questions. He states: "If one looks at the history of debt, then, what one discovers first of all is profound moral confusion. Its most obvious manifestation is that most everywhere, one finds that the majority of human beings hold simultaneously that (1) paying back money one has borrowed is a simple matter of morality, and (2) anyone in the habit of lending money is evil". He acknowledges that opinion on the latter point shifts back and forth over time: e.g. in the twelfth century the Pope issued instructions that all known usurers (people who lend money at interest) were to be excommunicated; while in the early years of the twenty-first century the masters of the debt universe were deemed worthy of multi-million dollar bonuses.

Graeber shows how over the millennia since civilisation began moral obligations around sharing skills and resources between members of a community who each knew each other and had a stake in maintaining the quality of the relationship between them has morphed into today's capitalist world where money and debt has turned important moral arenas into "a matter of impersonal arithmetic" between strangers backed up by the threat of force (legal or otherwise) being applied in the event of default.

Even in the course of the last 80 years, we have moved from the mindset of my grandparents that one should "save up" for what one wants to a mindset of buying what we want now (on credit) and paying for it later. Voluntary saving in order to consume what we want has been replaced by morally and socially obligatory work and saving to pay off legally enforceable debts entered into so that we can consume now. This latter strategy only works if one can safely assume that one's future income streams and the market value of the assets one has acquired with debt will be greater in the future than they are now. The economic downturn and global uncertainty prevailing since 2007 has thrown considerable doubt on this assumption.

GFC as Wake-up Call

In the longer term, the strategy of debt-funded economic growth was almost certainly bound to fail as a result of global demographic trends that are leading to: (1) a rapidly ageing population in the developed world over the next couple of decades; and (2) a peak in the total global population around the middle of this century due to rising affluence and more widespread female education (both trends that have traditionally had negative impacts on birth rates). From around 2050 onwards, the people will simply not be there to bid up the price of our debt-funded houses or to buy the products and support the levels of remuneration of our debt-fuelled businesses. Even if the world's governments succeed in negotiating a renewed period of global economic growth, the GFC should be seen as a timely crystal ball view of where debt is inexorably taking us in the longer term.

If we take this forecast seriously, then we are obliged to start thinking about new ways of organising vibrant, peaceful societies and their financial affairs. In recent years, the most popular blueprint for a prosperous society is a growing, capitalist (or market based) economy embedded within democratic governance structures. However, Graeber questions the universal value of this model and shows that markets did not evolve naturally as a Darwinian social success story. Rather, they were, historically, frequently created by rulers as a means of provisioning standing armies. The story as told by Graeber goes like this: Rulers wishing to maintain large standing armies could avoid the huge logistical burden of feeding, clothing and housing them by issuing coins to the soldiers and then levying taxes on every family in their realm that could only be paid with the currency minted by the ruler. Farmers, artisans and landlords were therefore obliged to sell goods and services to the ruler's soldiers in order to earn the currency required to pay their taxes. In this way, rulers or the State forced markets into being. Some would argue that a similar strategy is still used today by governments to fund armies, bureaucracies, and a variety of other State-funded agencies that are supposedly acting in ways that serve "the people".

Western Capitalism is Not the Only Way

Joe Bageant, in his book "Rainbow Pie: A memoir of redneck America", reminds us that the mindset of American capitalism was shaped by America's experience of World War II and its legacy. Unlike most of war-ravaged Europe (its traditional competitor), the war had caused rapid growth in the size and profitability of American corporations. It had also raised the living standards of those who worked in them. "In any case, the trick at hand for post-World War II corporations was to keep American workers mobilised to produce goods at the same pious levels that had whipped Hitler and Hirohito, and then increase upon that". Growth had been the key to prosperity then and growth could be further leveraged by debt.

However, the way we deal with money and debt in the capitalist West is not the only way to do things. Dating from the Middle Ages (around 1000AD), Islamic societies have organised finance very differently to their Christian cousins. As Graeber tells us: "…instead of interest-bearing investments, the preferred approach was partnerships, where (often) one party would supply the capital, the other carry out the enterprise. Instead of a fixed return, the investor would receive a share of the profits [in return for accepting a share of the risks]. Even labour arrangements were often organized on a profit-sharing basis. In all such matters, reputation was crucial – in fact, one lively debate in early commercial law was over the question of whether reputation could (like land, labor, money or other resources) itself be considered a form of capital…it was said that [Malacca's] merchants shunned enforceable contracts, preferring to seal transactions 'with a handshake and a glance at heaven'". Mohammed was believed to have argued that markets were designed by God to regulate themselves and should not be subject to government interference.

Hernando de Soto in his book "The Mystery of Capital: why capitalism triumphs in the West and fails everywhere else" argues that most people in developing countries "cannot participate in an expanded market because they do not have access to a legal property rights system that represents their assets in a manner that makes them widely transferable and [interchangeable]" and that therefore allows them to be used as collateral for loans that can fund entrepreneurial ventures. In developing countries that do not have a legally protected property rights system people "hold and use their assets on the basis of myriad disconnected informal agreements where accountability is managed locally". This form of local management depends fundamentally on trust, relationships, reputation, and community enforcement of fair play. In this regard, it bears some similarities to the Islamic basis for managing financial affairs. It also differs greatly from our Western system for dealing with debt based on legal contracts between people who often have no ongoing relationship of trust between them, interest obligations that are independent of future circumstances, and State backed sanctions for default.

Yet another view of how things might be organised in the future is given by Matt Ridley in his book "The Rational Optimist: How prosperity evolves". He argues that if we take a long enough view then the level of prosperity of the human species has been increasing for thousands of years (with some significant periods of decline from time to time). His extensive review of human history identifies the key drivers of this long upward trajectory as being specialization, trade and the exchange of ideas that flow with trade. These drivers have historically not needed social governance mechanisms that look like our Western version of corporate capitalism in order to flourish.

Ridley forecasts that new technology (e.g. the Internet, genetic engineering, social networks) will help to create a world where: "People will more and more freely find ways to exchange their specialised production for diversified consumption". He adds: "Intelligence will become more and more collective; innovation and order will become more and more bottom-up; work will become more and more specialised, leisure more and more diversified. Large corporations, political parties and government bureaucracies will crumble and fragment as central planning agencies did before them". Increased specialisation and exchange will drive a new wave of social and economic innovation and lead to higher levels of aggregate prosperity.

The continuing proliferation of small businesses requiring relatively small amounts of debt together with the power of internet-driven social networks to leverage or dismantle reputations (e.g. for reliability and trustworthiness) may lead to entrepreneurial funding being directly available online in ways that extend the models already operated by Kickstarter, eBay, Kiva, Grameen Bank and others. Debt in developed Western countries could increasingly be made available in ways that are based on shared risks and returns, trust, reputations and relationships (with reciprocal moral obligations regarding repayment and fair treatment) rather than impersonal, legally enforceable financial contracts and penalties that have the potential to destroy lives and communities.

However, Ridley sees several risks to the continued operation of the historical drivers of human prosperity: "Governments will bail out big corporations and big bureaucracies, hand them special favours such as subsidies or carbon rations and regulate them in such a way as to create barriers to entry, slowing down creative destruction." "Chiefs, priests, thieves, financiers, consultants and others will appear on all sides, feeding off the surplus created by exchange and specialisation…". He also identifies a potentially even greater risk to prosperity in the twenty-first century: "…the integrated nature of the world means that it may soon be possible to capture the entire world on behalf of a foolish idea, where before you could only capture a country, or perhaps if you were lucky an empire". Political or religious ideas or even corporate business models that inhibit the free exchange of trade and ideas now have global potential to inhibit the drivers of human progress.

The Present Has Happened Before

The future of the world's diverse economies and societies is unfolding in the midst of the current economic and social turmoil that dominates the world's media headlines every day. The efforts being made by the world's leaders to manage their countries' unsustainable levels of debt, unbalanced trading relationships and transformative demographic shifts may be part of the creative process but may, in retrospect, prove to have only slowed the evolution of human progress. So far, it seems that they are struggling to revitalise the economic models and mindsets that created our problems in the first place.

Graeber, Ridley and other writers with a diversity of backgrounds (e.g. Jared Diamond, George Soros, Robert Prechter) have shown us the many historical parallels to our present global challenges and uncertainties. It has all happened before. However, they have also shown us that, in other cultures and at other times, societies have found a variety of different ways to finance dreams, aspirations and innovative ventures that may have less potential for creating nationwide or even global crises when things do not work out as planned.

The story of debt summarised here reveals that there is much we might learn from the past rather than continuing to act as if we have already discovered the one best way and simply have to figure out how to breathe new life into it.