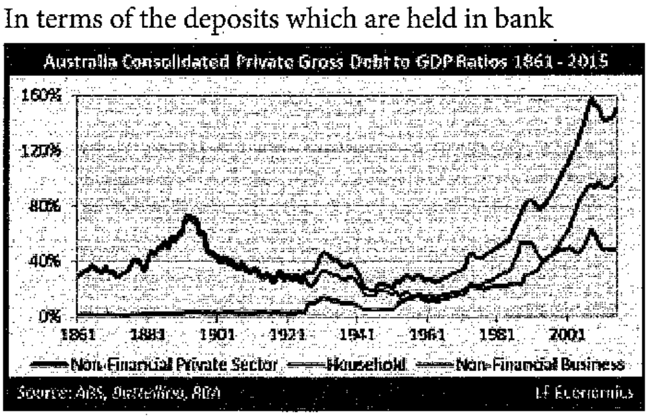
The Modern Debt Jubilee, a taboo medicine we desperately need

by Jesse Hermans

Economies all over the world, primarily the Western ones, are entering what appears to be an era of stagnation. Japan's experience over the last 25 years offers us insights into what the future holds. Unsurprisingly, economists dispute the cause of what they refer to as "secular stagnation", but a growing number are coming to the same conclusion – that the source of this stagnation is declining private sector aggregate demand due to excess private debt. In many countries, this grew at an exponential rate and has now reached saturation, where borrowers owe more than they can credibly repay.

In the mainstream orthodoxy's haste to curtail public debt, private debt has largely been ignored. In spite of the efforts of heavyweights, such as the Bank of England, to correct a faulty understanding of the mechanisms behind lending and money creation, many economists still do not appreciate the significance of the money which is created by the private sector and how private debt affects the economy.

In terms of the deposits which are held in bank



accounts, a currency user can obtain new money (credit from the bank which has been monetised) in one of two ways. They can receive it:

a) As payment for the provision of goods or services to a government that has the authority to issue money.

b) As a credit from the banking system when a loan is made, which appears as a bank deposit.

The former comes from an overall increase in the overall financial assets (high-powered/base money) for the non-Government sector. The base money appears in the accounts that banks hold at the central bank, and they in turn create deposits for the person who supplied goods or services to the Government. This allows the private sector to net save and there is no increase in private debt.

On the other hand, the latter creates new private sector financial assets (deposits), but simultaneously increases liabilities (private debt) for the banks. The result is no new net financial assets have been created. This has significant implications for sustainable growth.

For the last 20 years, private debt in Australia has been growing at an exponential rate, which has mostly fuelled speculative asset bubbles in real estate and financial markets. Consumption related debt (consumer loans, credit cards, etc.) has also grown because real wages have not been increasing in line with productivity growth for over 40 years. Corporate debt has also increased, a lot of which did not add to production capacity but merely inflated stock prices. Australia, like many other nations, has now reached a point where the ratio of private debt to incomes is at unsustainable levels. The country now has the most indebted household sector in the world, at over 123% of GDP.

While notions of a currency issuer "maxing out the credit card" might seem like a humorous logical fallacy, "maxing out the credit card" is no joke for Australia's currency-using private sector. With consumers awash with debt, repayments detract a significant portion of disposable income. This forces a reduction in consumption, which means that there is lower demand for the goods and services that are already being produced. When stock markets or the market for real estate, eventually run out of incoming debt-financed buyers and the capital growth ends, the party is over! Real income is needed to support these debts, and right now most are sustained in a Ponzi-like fashion, relying on capital growth to generate profit and repay the loans.

What happens once asset prices fall and people are left with a mountain of debt? It depends on the government's policy response...

The worst case is that governments continue to attempt contractionary fiscal policy, which creates an overall deficit for the private sector that prevents individuals and businesses from ever paying down their debts collectively. This can only result in permanent stagnation as consumers are compelled to allocate most of their income to either taxes or debt service, which leaves little disposable income for consumption. In other words, consumers have less money to spend on things that businesses are selling and employing staff to produce. This scenario is most evident in the Eurozone which, by circumstance, enforces such a policy. Since no state is permitted to issue the Euro (only the ECB can), member states are required to attempt contractionary fiscal policy to meet the Stability and Growth Pact.

The next possible scenario is beginning to happen around the rest of the developed world, albeit slowly and painfully. As private sector consumption shrinks, unemployment increases. For currency issuing governments, political constraints tend to prevent contractionary fiscal policy as the public cannot take any more pain. This allows the "automatic stabilisers" to kick in and continue working – tax revenues fall and unemployment benefits rise. This allows the government deficit to rise (i.e. the government spends more than it takes from the private sector). The resulting net increase in private sector wealth allows the repayments of debt and deleveraging to occur. This has been happening in Japan for decades and is still going. It is a long, slow, tedious and painful process. This scenario could be significantly improved if the deficit were deliberately increased and used to expand public investment and consumption, and/or reduce taxation to allow more private sector investment and consumption. Such a policy could quickly achieve full employment and price stability, while vastly increasing economic activity.

However it still leaves the mountain of private debt in place, which would still take a long time to demolish to historically sound levels unless a more direct approach were taken. Professor Steve Keen of Kingston University advocates for a modern debt jubilee; a mechanism for the instantaneous repayment of private sector debts. The broader concept of a debt jubilee has been used throughout history in many ancient societies and is even mentioned in the Bible. Today, its implementation is as simple as the currency issuer "writing a cheque" (or digital equivalent) to every citizen (or permanent resident) in the country, on the condition that it must be used to repay any outstanding debts first.

Now the first thought that should come to mind is the question of inflation. It is important to understand that the repayments of debt with newly created money is non-inflationary, due to the mechanics of credit creation. This deserves a full explanation, but let's try to sum it up briefly by saying that the private sector creates bank deposits whenever loans are made and, conversely, repaying debts destroys bank deposits. Repayments of debt in this manner does not result in an increase of the broad money supply, it merely changes the composition of the bank's portfolio from being owed money by their customers to having money in their account at the central bank. Since the money that exists within the closed loop system inside the central bank can never be withdrawn, it never makes its way out into the economy to cause inflation.

But what of the debt-free people? Would giving them money lead to price inflation in the economy? Demographically, the young (under 18s), the elderly, the richest and the poorest are the most likely to have no debt. A sudden and significant increase in their spending power occurs, and if they were to spend the money rather than save it, then price inflation would be a possibility. One way to get around this would be to use a mechanism that stores the money and gradually releases it over a long period of time. For example, if all money that is left over after outstanding debts have been paid down were directed into superannuation accounts, there would be no sudden shock of increased consumption spending, but rather a slow release over decades.

If we are to end "The Great Malaise", we must recognise that the overwhelming majority of private sector debts came about because the 'common wisdom' of a malfunctioning system unfairly incentivised them to borrow beyond their means. We must be willing to consider solutions which are today considered unorthodox to address systemically-induced debt in order to re-establish fairness. There is little to lose and much to gain from a modern debt jubilee, with the capacity to achieve in a year what would otherwise take decades.

Jesse Hermans is studying engineering at University of Melbourne. He spent summer as an intern at Prosper.