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IN SEARCH OF A HEALTHY SOCIETY: THE ILLNESS OF INTERCONNECTED GLOBAL CREDIT AND DEBT

Throughout most of history commerce has depended on the use of credit, particularly when large quantities of goods are involved. Barter had benefits and its limitations, limitations that today have not been significantly overcome by our electronically-connected markets. What has changed with the introduction of digital money is the potential for immediacy of payment, as cash balances are transferred in seconds from the bank account of one party to another. This does not yet always occur, of course, as payment by one party may depend on payment being received from a third party. Terms of payment often take *the time value of money* into consideration. Pay immediately and one might obtain a sizeable discount. Pay within thirty days at the contracted amount. Pay after thirty days and a penalty is imposed for every day beyond what is termed *the grace period*.

Monarchs, Feudal Lords, and most modern governments have borrowed for all sorts of reasons -- to engage in wars of territorial conquest, to defend territories already held, to modernize infrastructure, and (in societies with policies that redistribute income and establish some level of a safety net against life's risks) for so-called *social welfare entitlement obligations*. What is undeniably the case is that the stability of our interdependent economies today is tied to the uninterrupted access to affordable credit by business, government and individuals. The question I raise here is whether we might be approaching *death by debt strangulation?*

Readers might recall the 1978 documentary-series *Connections*, written and narrated by James Burke. In this series he provided what he described as an alternative view of change and our almost total dependency on the network of technologies functioning as a system. When this network breaks down, the result is a breakdown of societal norms as well.

The interdependency described by James Burke in 1978 has exponentially increased, and so has the risk of collapse. Those of us who live in cities cannot survive for long without access to food and other necessities. Even those who farm the land are almost as dependent on the network. And, a central part of the network is the system of financial services that provide us with access to credit.

James Burke identified the first major piece of technological advancement as the simple plough some 12,000 years ago, which he tells us triggered the beginnings of civilization. An increasing food supply stimulated population growth, led to the establishment of permanent settlements, which created the need of rules for the allocation of land, of access to natural resources, and of the things people produced. Written language facilitated codification of the rules but also stimulated the recording of the purchase and sale of goods. With every significant technological and organizational advance – every trigger of change – came new innovations in money, credit and finance.

Fast forward to the thirteenth century and we see a world where people are once again on the move, whether in search of commerce and profits, in search of new knowledge, or engaged in a quest to expand control over territory, over resources and over the wealth others produced. What triggered these changes was the Crusades, which turned the Mediterranean Sea into the main artery of inter-cultural exchange. And, in this new environment, the means of settling debt was the not very practical transfer of gold and silver coinage.

Throughout much of Europe, the need to acquire coinage in order to acquire goods not locally produced brought about the end of Feudalism and its self-contained economies. As peasant farmers were charged money rents and taxes instead of a large portion of crops harvested, land also became a commodity to be bought, sold and mortgaged. Credit and debt became constant features of expanding commercial and civic relationships. For centuries, the banking families of the Mediterranean city-states provided the credit to fuel economic expansion as well as wars over territory, natural resources and control of domestic political power.

The situation changed dramatically with the arrival of the Age of Discovery beginning in the middle of the fifteenth century. For a complex set of reasons causing *locational advantage*, the Dutch first emerged as the people who took the most advantage of the commercial opportunities of that era. Readers interested in the history would benefit by a reading of Immanuel Wallerstein's volume from the series *The Modern World System* covering the rise of Dutch hegemony among European powers. However, the part of the story that is of interest here is explained by Adam Smith in his masterly work *The Wealth of Nations*. The next great leap forward in the world's global economic structure was the establishment of the Bank of Amsterdam as a deposit bank, its "receipt money" circulating throughout Europe and beyond. The Bank held the coinage of its depositors as full reserves for the paper receipts issued. For over a century, this model of full reserve deposit banking stimulated a remarkable expansion of commerce between merchants in different countries.

The Bank of Amsterdam's architects had come up with an effective solution to a seemingly unsolvable problem: the escalation of the price of goods and services in terms of gold and silver caused by the large quantity of these precious metals brought to the European continent principally by the Spanish. As more and more of these precious metals were brought to the Bank of Amsterdam, the coinage minted contained a uniform content of gold and silver. The global economy now had money that could be relied upon. The influx of additional quantities of gold and silver slowed during the sixteenth century, and prices stabilized. The Dutch became the global economy's middlemen, providing the credit required for the triangle of production and consumption fostered by *mercantilism*.

With the establishment of colonial outposts around the globe by the major European powers, the level of commercial activity expanded dramatically, as did the need for money and credit. The directors of the Bank of Amsterdam (and others bankers as well) gambled that they could meet this increased demand by the issuance of bank notes well beyond the quantity of receipt money supported by coinage the banks held as their own assets. How unlikely would be the circumstance that depositors would all of a sudden come to close their accounts and withdraw their gold and silver coinage. The bankers persuaded themselves that confidence in their bank could be maintained even with only *fractional reserves* held by banks. The era of full reserve banking was abandoned. Time was to prove the bankers quite wrong in their optimism. Huge debts incurred by European governments during the Seven Years War caused the banking crisis of 1763, which began in Amsterdam and spread to Germany, Scandinavia and beyond. Cycle of boom and bust, accompanied by financial crises have plagued the world's economies ever since.

Yet another period of financial disruption was anticipated as the Second World War was still being fought in 1944. In an effort to change the course of financial history, delegates from forty-four countries were brought together in the United States, at Bretton Woods, New Hampshire, to develop a plan for post-war reconstruction and financial stability. Out of this conference came the establishment of the World Bank, the International Trade Organization, and the International Monetary Fund. Britain's John Maynard Keynes provided the theoretical arguments for the new system, but the United States held all of the cards, emerging from the war with its infrastructure greatly upgraded, its factors and its cities undamaged. As a result, the United States dollar became the world's reserve currency, the value of each dollar set at 1/35th of an ounce of gold. Confidence in the U.S. dollar was strengthened by the fact that in 1944 the United States held some 20,000 tons of gold in its vaults at Fort Knox in the state of Kentucky.

By the 1960s the dominant position of the United States in global commerce was disappearing, as other countries rebuilt their infrastructure and industrial capabilities. The need to hold U.S. dollars fell, and counties with growing exports began to exercise their right to exchange U.S. dollars for gold. By 1971 the United States had run out of measures to stem the outflow of gold, the market price of which had risen far above the price established under the Bretton Woods agreement. In August, President Nixon announced that foreign government could no longer exchange their dollars for gold. Economists and proponents of a return to some form of *gold standard* have ever since debated the consequences of this decision.

Today's global economy functions mainly on the use of digital monetary transfers. Central bank notes are issued independent of any reserves of gold or silver coins or other tangible form of wealth. The paper currency we hold or the balances we own in banks have a constantly changing purchasing power. The central bank notes are, in essence, *promises to pay nothing in particular*. By declaring central bank notes and their digital equivalent as legal tender, government is able to raise needed revenue by demanding payments of taxes and all other obligations in the stated form of legal tender. Moreover, this currency must be accepted in payment for any goods and services exchanged within a nation's domestic borders.

Physical currency is not yet obsolete; however, all around the globe – even in many less developed countries -- we rely on digital credit and digital currency transfers to meet most of our financial obligations. The introduction of debit cards for the purchase of necessary goods and services acts in the same way as a cash transaction, immediately adding to the cash assets of one party and the reduction of cash assets of another party. For the banking institution as a financial intermediary, the risk of someone over-drafting an account or falling behind on the payment of credit card balances is eliminated, as is *the time value of money* benefit during the time required for a check to be deposited and the cash transferred.

Access to and use of credit varies greatly around the globe. As is widely known, some countries have experienced rapid and steep declines in real household income over the last three or four decades.

A World Economic Forum report released in 2018 provided the country-by-country details. Only a small portion of the people in any country possesses sufficient financial assets to do without credit to make major purchases, although the use of credit cards in lieu of cash is a common practice even for those who pay off the balance each month. For some people use of the credit card is a convenient way to keep track of their spending. More than half of credit card holders in the United States use credit cards in this way.

WHO IS CREDIT-WORTHY?

Whether for business-to-business exchanges or business-to-consumer commerce, risk must be properly assessed and priced, or things do go quite wrong. Those who extend credit or directly lend money (paper or digital) rely on historical data to establish the criteria for determining the creditworthiness of others.

One of the most relied upon measures is one's *credit score*. How individual credit scores are determined is a closely-held secret by the firms who perform this analysis. Credit scores are extremely important for the issuers of credit cards because in most countries credit card debt is not secured by a lien on the cardholder's tangible assets.

The maximum credit limit permitted to any particular individual is determined by past history of repayment not only on a credit card but on all other debt. The significant level of pre-determined risk of loss determines what rate of interest is legally charged on outstanding balances. And yet, as the use of credit cards has expanded, more and more people experience higher levels of debt that must be serviced. In the United States, credit card debt is thought to be the number one reason individuals cannot put money aside as savings. At the same time, as household incomes fall or as the costs of living increase, more and more people rely on credit cards for essential purchases. In the United States, one of the main reasons for rising credit card debt is the cost of medical care, including prescription drugs.

For most households around the world, the highest level of debt incurred is mortgage loan debt taken on as a result of the purchase of a residential property. Only a small portion of households have savings sufficient to pay cash for a residential property. Those who do have sufficient cash or other financial assets tend to be longer-term property owners who have benefited by loan amortization and by appreciation of the value of land under a home. Others are often the beneficiaries of inherited financial assets.

It is useful here to remind readers that the monetary value of a housing unit is its replacement cost, less depreciation. If one is to believe the average economist or economics journalist, a house is the only asset we produce that does not depreciate over time. The amount of equity may be sufficient upon sale to permit a cash purchase of another property, particularly for *empty nesters* downsizing to a smaller dwelling or to a less-costly location in anticipation of retirement. However, at the other side of the property transfer is a buyer who is asked to pay much more for the land parcel on which the dwelling is located and therefore take on a higher level of mortgage debt that must be serviced year after year after year.

A major difference between making purchases with a credit card and purchasing a residential property is the placement of a mortgage lien on the subject property. The buyer becomes a *mortgagor* in this process; the bank (or, more commonly these days, an investor in a mortgage-backed security) becomes a *mortgagee*. In what is described as the conventional institutional lending environment, the investor's risk of loss is mitigated by obtaining information from the buyer detailing household income, savings and debt. The subject property is appraised by an independent property appraiser, and the maximum loan is determined as some percentage of the lower of the purchase price of the property or the appraised value.

One can be exempted from the above scrutiny by making a large cash down payment of at least 25 percent, or by going to a non-conventional lender that charges a higher rate of interest to compensate for the risk of not obtaining the borrower's financials.

From the late 1940s until the mid-1960s in the United States, the buyer was required to make a cash down payment of 20 percent of the purchase price of the property. In most markets this meant, in practical terms, that the buyer was paying cash for the land parcel involved and financing the purchase of the dwelling with a loan that amortized at roughly the rate of depreciation a house experiences before needing to be substantially renovated.

A buyer qualified for this mortgage financing if the monthly payment (plus a monthly escrow toward payment of property taxes and fire insurance premiums) did not exceed 28 percent of total monthly income. A secondary calculation looked at any other debts and the extent to which servicing those debts reduced the buyers' disposable income. Anything over around 33 percent of total monthly income would be viewed as a problem.

As land prices have continued to increase, fewer property buyers have the cash savings to pay cash for the land being purchased. In many of the world's great cities, the land cost often comprises over 50 percent of the total property value. And, in certain centrally-located neighborhoods, the land cost may comprise far more than 50 percent. This sometimes results in the demolition of the existing dwelling, replaced by a new structure that is a higher, better use of the location.

The high cost of rental housing combines with stagnant or declining wages to make it almost impossible for many young adults to save toward a down payment or qualify for the necessary mortgage financing. Some young adults are able to obtain gifts from parents or grants from foundations and other organizations in order to become property owners.

Governments in high cost markets struggle to find the financial resources to subsidize the cost of acquiring land for the construction of housing units, whether offered under a lease or for sale. One way this revenue is raised is the issuance of tax-exempt bonds, the exemption from taxation provided as an inducement to investors. Permanent affordability of these publicly-subsidized units is sometimes guaranteed by restrictions on the household income of renters or buyers.

We should not be surprised to learn that the crisis of an undersupply of decent, affordable housing is most severe in regions with high and increasing land values. Even where the employment market is strong, wages are likely to be too low for many working persons to afford even a small apartment - not to mention - a small house. In the United States today, somewhere around one-half of all college graduates under the age of 30 live in their parents' home.

EXTERNALITIES

An unacknowledged outcome of the historically low mortgage interest rates available in many countries since the 2008 financial crisis has been the resurgence of property prices. At such low rates of interest, buyers who have sufficient household income and good credit are able to qualify for higher levels of borrowing, and this has been capitalized by market forces into higher asking prices for property.

For now, little concern has been given to the potential for yet another cyclical property-driven recession and how rising unemployment would result in another period of widespread defaults, foreclosures and the pressure for a public bail-out of insolvent financial institutions. Of course, none of the financial models relied upon by government or the financial sector factored in a worse-case scenario of a global pandemic.

A related shock to the financial system is the damage done to both public infrastructure and private property by what I will generously refer to as *natural disasters*. Roughly one-third of the world's population lives within 100 vertical meters of sea level. Hundreds of millions more live in regions subjected to increasingly frequent and increasingly destructive storms, hurricanes, volcanic eruptions, severe droughts, tornadoes, forest fires and flooding. Private insurance companies must price for these risks or simply decline to provide coverage, in which case government is faced with the decision of whether and how to intervene. Absent general insurance protection or government-provided disaster relief grants, the destruction of one's house and other assets represents a setback recovery from which is unlikely. At the same time, providing insurance protection covering properties located in high risk areas props up the value of land. One can argue the case that for property owners who pay risk-based premiums to an insurance carrier, intervention by government is unwarranted. There is certainly reason to object when government revenue is provided to permit individuals to rebuild again and again after their property is destroyed because the location is prone to repeated events as described above.

The human condition has always been characterized by a high degree of uncertainty. There have been periods of economic expansion that lifted the financial condition of millions of people, and this expansion has reached people in many countries where not long ago the majority of the population experienced deep poverty.

Students of the writings of Henry George will understand that the reason why prosperity is neither universal nor sustainable is that the systems of law, of regulation and taxation secure and protect entrenched privilege for some at the expense of the common good. While George emphasized how the private appropriation of the rent of land divided societies into the *haves* and *the have nots*, he did not ignore the destructive character of the manner in which money is created and how banks are regulated.

Frequent readers of *Land&Liberty* will likely concur with the observation that every society one can name is in need of a real program of comprehensive tax reform, finally collecting rents generated from the many natural assets privately exploited. Henry George argued that the monetary value of a nation's aggregate rents would be more than sufficient to pay for all necessary (or even desired) public goods and services, with the potential for distribution of some amount as a form of citizen's dividend.

Moreover, by preventing land prices from rising above modest levels (and theoretically, pulling them down to near zero), the need by government, by business or the private individual to borrow funds in order to produce goods or provide services would be greatly reduced.

THE BOTTOM LINE

We continue to struggle to convince our governments to move in the direction Henry George's analysis proved was both equitable and economically efficient.

However, as country-after-country established a central bank authorized to issue central bank notes as currency, the story of *receipt money* as issued by the Bank of Amsterdam was ignored.

Eventually, even fractional reserves in gold or silver were abandoned so that countries would not be required to purchase with these precious metals excess quantities of their paper currency held by foreign banks, governments and others. In one important sense, the bankers won by preventing the direct issuance and spending of currency by government into their nation's economy. Instead, any deficit between revenue received and the amount spent was acquired by the issuance of bonds sold to investors at interest in order to acquire the necessary central bank notes. Today, not a single government in the world is backing its own official currency with anything specific or tangible.

Despite the fact that since the bottom of the last recession property (meaning land) prices have climbed and climbed even as wages have stagnated or fallen, the tools of statistical analysis relied upon by economists and government officials report that the massive increase in the money supplies of nations has not caused serious inflation or exposed their societies to untenable levels of economic stress.

We are today in unchartered waters. The massive increase in the money supply now underway may put off the day of reckoning for a time, but the bill will soon come due. The question becomes: How will that bill eventually be paid?

In the classroom, after delivering a lecture covering much of the above material, my adult students often ask what they should do to in some way protect themselves and their families from the worst that is likely to occur.

My advice is simple but not easy to follow. First, live within your means. For housing, purchase a property that requires you to spend no more than 25 percent of your monthly income on the mortgage payment plus property taxes and fire insurance. If you need an automobile, consider a low mileage previously-owned vehicle over a new one. Set reasonable goals for saving so that at any time you have no less than six months of cash savings in a fully-insured bank account sufficient to cover your expenses for that period of time.