

THE U.S. FINANCIAL QUANDARY: ZIRP'S ONLY EXIT PATH IS A CRASH

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ABSTRACT

Interest-bearing debt grows exponentially, in an upsweep. The non-financial economy of production and consumption grows more slowly as income is diverted to carry the debt overhead. A crash occurs when a large part of the economy cannot pay its scheduled debt service. That point arrived for the U.S. economy in 2008, but was minimized by a bank bailout, followed by a 14-year boom as the Federal Reserve increased bank liquidity by its Zero Interest-Rate Policy (ZIRP). Flooding the capital markets with easy credit quintupled stock prices and engendered the largest bond market boom in U.S. history, but did not revive tangible capital investment, real wages or prosperity for the non-financial economy at large.

Reversing the ZIRP in 2022 caused bond prices to fall and ended the runup of stock market and real estate prices. The great 14-year debt increase faced sharply rising interest charges, and by spring 2023 a number of banks failed, but all their depositors were bailed out by the Federal Deposit Insurance Corporation (FDIC) and Federal Reserve. The open question is now whether the U.S. economy will face the financial crash that was postponed from 2009 onwards by

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the vast expansion of debt under ZIRP that has added to the economy's debt burden.

Keywords: Central Banks and their policies, financial crisis, financial economics, financial markets.

JEL classification: E58, G10, G12, G18.

EL DILEMA FINANCIERO DE ESTADOS UNIDOS: LA ÚNICA SALIDA A LA POLÍTICA DE TASA DE INTERÉS CERO ES UNA BANCARROTA

RESUMEN

La deuda con intereses crece de forma exponencial como una curva ascendente. La economía no financiera de la producción y el consumo crece más lentamente conforme el ingreso se desvía para solventar los gastos de la deuda. El crac financiero ocurre cuando una gran parte de la economía no puede pagar el servicio de su deuda programada. Ese momento llegó para la economía de Estados Unidos en 2008, pero fue minimizado por un rescate bancario, seguido de un auge de 14 años porque la Reserva Federal incrementó la liquidez mediante su política de tasa de interés cero (ZIRP, *Zero Interest-Rate Policy*). La inundación de los mercados de capital con crédito fácil quintuplicó los precios de las acciones y generó el auge del mercado de bonos más grande en la historia de Estados Unidos, pero no reanimó la inversión de capital tangible, los salarios reales ni la prosperidad de la economía no financiera en general. El abandono de la ZIRP en 2022 causó un descenso de los precios de los bonos y puso punto final al auge del mercado de valores y de los precios de los bienes raíces. El gran aumento de la deuda de esos 14 años confrontó drásticos cargos de tasas de interés crecientes y en la primavera de 2023 un número importante de bancos quebró, pero los depósitos de sus clientes fueron rescatados por la FDIC y la Reserva Federal. La pregunta abierta es si ahora la economía de Estados Unidos experimentará el crac financiero que fue pospuesto desde 2009 en adelante por la vasta expansión de deuda de la ZIRP que ha acrecentado el peso de la deuda de la economía.

Palabras clave: bancos centrales y sus políticas, crisis financiera, economía financiera, mercados financieros.

Clasificación JEL: E58, G10, G12, G18.

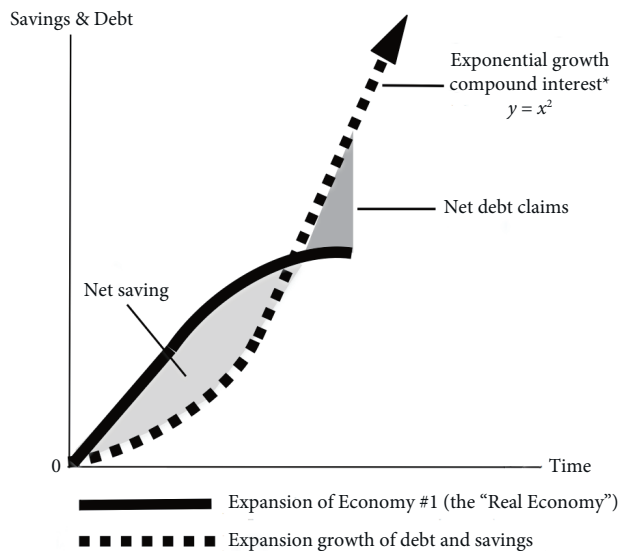


1. INTRODUCTION

Throughout history the buildup of debt has tended to outstrip the ability of debtors to pay. Any rate of interest will double what is owed over time (*e.g.*, at 3% the doubling time is almost 25 years, but 14 years at 5%). Paying carrying charges on the rising debt overhead slows the economy and hence its ability to pay. That is the dynamic of debt deflation: Rising debt service as a proportion of income. Carrying charges may rise to reflect the growing risk of non-payment as arrears and defaults rise. The non-financial economy of production and consumption grows more slowly, tapering off in an S-curve as income is diverted away from new tangible investment to carry the debt (see Graph 1). The crash usually occurs quickly.

Governments may try to inflate their societies out of debt by creating yet more credit to postpone the inevitable crash, by bailing out lenders or debtors —mainly lenders, who have captured control of government policy. But the debt crisis ultimately must be resolved either by transferring property from debtors to creditors or by writing down debts.

Graph 1. How the rise in debt overhead slows down the business cycle



* All compound interest accrual is exponential.



The National Income and Product Accounts (NIPA) count the financial sector as producing a product, and adds its interest income and other financial charges to the economy as “earnings,” not subtracting them as *rentier* overhead. The rise in financial wealth, “capital gains,” interest and related creditor claims on the economy are held to reflect a productive contribution, not an extractive charge leaving the economy with less to spend on new consumption and investment.


The problem gets worse as this financial extraction grows larger. As credit and debt expanded in the decade leading up to the 2008 junk mortgage crisis, banks found fewer credit-worthy projects available, and turned to less viable loan markets. Banks wrote mortgage loans with rising debt/income and debt/asset ratios. Racial and ethnic minorities were the most overstretched borrowers, falling into payment arrears and defaulting. Real estate prices crashed, causing the market value of bad mortgage loans to fall below what many banks owed their depositors.

There is nothing “natural” or inevitable about how such bank insolvency and negative equity will be resolved. The solution always is political. At issue is who will absorb the loss: Depositors, indebted borrowers, bank bondholders and stockholders, or the government via the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve bailouts?

Less often asked is who will be the winners. Since 2009 it has been America’s biggest banks and the wealthiest One Percent —the very parties whose greed and short-sighted policies caused the crash. Having been deemed “systemically important,” meaning Too Big To Jail (TBTJ, sometimes cleaned up to read Too Big To Fail, TBTFF), they were rescued. And today (2023), that special status is making them the beneficiaries of a flight to safety in the wake of the FDIC’s decision following the collapse of Silicon Valley Bank that even large depositors should not lose a penny, no matter how poorly their banks have coped with the Fed’s policy of rising interest rates that have reduced the market value of their banks’ assets, aggravated by falling post-COVID demand for office space lowering commercial rents and leading to mortgage defaults. Once again, this time by protecting depositors, the Federal Reserve and Treasury are trying to save the economy’s debt overhead from crashing and wiping out the nominal bank loans and other financial assets that cannot be paid.

The usual result of a crash is a wave of foreclosures transferring property from debtors to creditors, but leading banks also may become





insolvent as their debtors default. That means that their bondholders lose and counterparties cannot be paid.

The 2008 crash saw an estimated eight to ten million over-mortgaged home buyers lose their homes, but the banks were bailed out by the Federal Reserve and Treasury. Instead of the economy's long buildup of debt being written down, the Federal Reserve increased bank liquidity by its Zero Interest-Rate Policy (ZIRP). This provided banks with enough liquidity to help the economy “borrow its way out of debt” by using low-interest credit to buy real estate, stocks and bonds yielding higher rates of return.

The 14-year boom resulting from this debt leveraging featured an innovation in the economy's ability to sustain growth in its debt overhead: Debt service was paid not only out of current income but largely out of asset-price gains — “capital” gains, meaning finance-capital gains engineered by fintech, financial technology. Lowering interest rates created opportunities to borrow to buy real estate, stocks and bonds yielding a higher return. This arbitrage quintupled stock prices and created the largest bond market boom in U.S. history, as well as fueling a real-estate boom marked especially by private capital firms as absentee owners of rental properties. But tangible capital investment did not recover, nor did real wages and prosperity for the non-financial economy at large.

Ending the ZIRP in 2022 reversed this arbitrage dynamic. Rising interest rates caused bond prices to fall and ended the runup of stock market and real estate prices —in an economy whose debt overhead had risen sharply instead of being wiped out in the aftermath of 2008. In that sense, today's debt deflation and its associated financial fragility that has already seen a number of banks fail are still part of the aftermath of trying to solve the debt crisis by creating a flood of debt to lend the economy enough credit to inflate asset prices and enable debts to be paid.

That poses a basic question: Can a debt crisis really be resolved by creating yet more debt? That is how Ponzi schemes are kept going. But when does the “long run” arrive in which, as Keynes once remarked, “we are all dead”? The remainder of the article is structured as follows. Section 2 discusses President Obama's choice to bail out Wall Street, section 3 examines the inflation of asset prices brought about by the Fed's ZIRP and section 4 analyzes the negative impact of the Fed ending its ZIRP. Section 5 delves into the future of the financialized U.S. economy.

2. THE OBAMA ADMINISTRATION'S DECISION TO BAIL OUT WALL STREET, NOT THE ECONOMY

The 2008-2009 crash was caused by U.S. banks writing fraudulent loans, packaging them and selling them to gullible pension funds, German state banks and other institutional buyers. The mainstream press popularized the term “junk mortgage,” meaning a loan far in excess of the reasonable ability to be paid by NINJA borrowers —those with No Income, No Jobs and no Assets. Stories spread of crooked mortgage brokers hiring appraisers to report fictitiously high property assessments to justify loans to buyers whom they coached to report fictitiously high income to make it appear that these junk mortgages could be carried.

There was widespread awareness that an unsustainable debt overhead was building up. Even at the Federal Reserve Board, Ed Gramlich (1997-2005) warned about these fictitious valuations. But Chairman Alan Greenspan (1987-2006) announced his faith that banks would not find it good business to mislead people, so that was unthinkable. Embracing the libertarian anti-regulatory philosophy that led to his being appointed Fed Chairman in the first place, he refused to see that bank managers live in the short run, not caring about long-term relationships or how their financial operations may adversely affect the economy at large.

This blind spot seems to be a requirement to rise in academia and the government's regulatory club. The idea that a debt pyramid may be unsustainable makes no appearance in the models taught in today's neoliberal economics departments and followed in government circles staffed by their graduates. So nothing was done to deter the financial pyramid of speculative packaged mortgage loans.

Running up to the November 2008 election, President Obama promised voters to write down mortgage debts to realistic market price levels so that bank victims could keep their homes. But honoring that promise would have resulted in heavy bank losses, and the Democratic Party's major campaign contributors were Wall Street giants. The largest banks where mortgage fraud was largely concentrated were the most insolvent, headed by Citigroup and Wells Fargo, followed by JP Morgan Chase. Yet these largest banks were classified as being “systemically important,” along with brokerage houses such as Goldman Sachs and other major financial institutions that the Obama Administration redefined as “banks”

so that they could receive Federal Reserve largesse, in contrast to the hapless victims of predatory junk mortgages.

FDIC Chair Sheila Bair wanted to take Citibank, the most reported offender, into government hands. But bank lobbyists claimed that the economy's health and even survival required protecting the financial sector and keeping its most notorious failures from being taken over. Parroting the usual junk-economic logic given credentials by Nobel Prize awards and TV media appearances, bankers pointed out that making them bear the cost of writing down their fictitiously high mortgages to realistic market levels and the ability of debtors to pay would leave much of the financial sector insolvent, going on to claim that they needed to be rescued to save the economy. This remains the same logic used today in saving banks from the negative equity resulting from ending the Federal Reserve's ZIRP.

Not acknowledged in 2009 was that failure to write down bad loans would lead millions of families to lose their homes. Today's economic model-builders call such considerations "externalities." The social and environmental dimensions, the widening of income and wealth inequality and the rising debt overhead, are dismissed as "external" to the financial sector's tunnel vision and the NIPA and Gross Domestic Product (GDP) accounting concepts that it sponsors¹.

That willful blindness by economists, regulators and financial institutions, selfishly concerned with avoiding their own loss without caring for the rest of the economy, enabled the TBTJ/F excuse for not prosecuting bankers and writing down their fraudulent mortgage loans. Instead, the Fed provided banks with enough money to prevent their bondholders from absorbing the loss, and the FDIC's deposit-insurance limit of \$100,000 was raised to \$250,000 in July 2010.

Banks had great political leverage in the threat to cause widespread economic collapse if they did not get their way and were required to take responsibility for their financial mismanagement. So instead of being obliged to write down bad mortgage loans, these debts were kept on the books and an estimated eight to ten million U.S. families were evicted. The "real" economy was left to absorb the bad-loan loss².

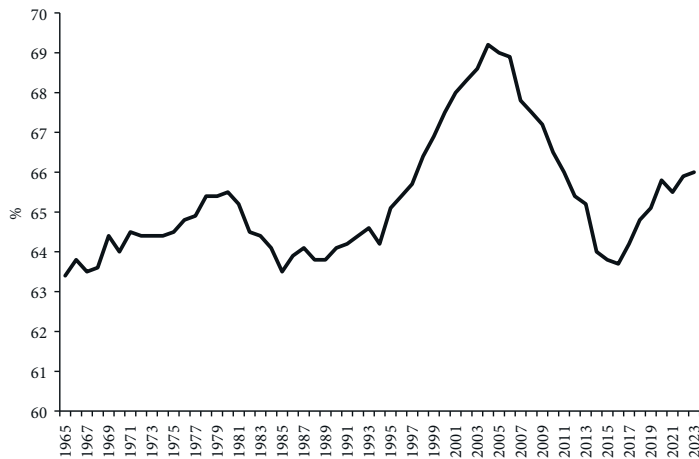
¹ I have outlined my analysis in Hudson (2021) and in Bezemer and Hudson (2016).

² I summarize these developments in Hudson (2015).

Homes under foreclosure were bought largely by private capital firms and turned into rental properties. The U.S. homeownership rate —the badge of membership in the middle class, enabling it to think of itself as property owners with a harmony of interest with *rentiers* instead of as wage-earners— fell from 69% in 2005 to 63.7% by 2015 (see Graph 2). Home debt/equity rates soared from just 37% in 2000 to 55% in 2014 (see Graph 3). In other words, the equity of homeowners peaked at 63 percent in 2000 but then fell steadily to just 45% in 2014 —meaning that banks held most of the value of U.S. owner-occupied homes³.

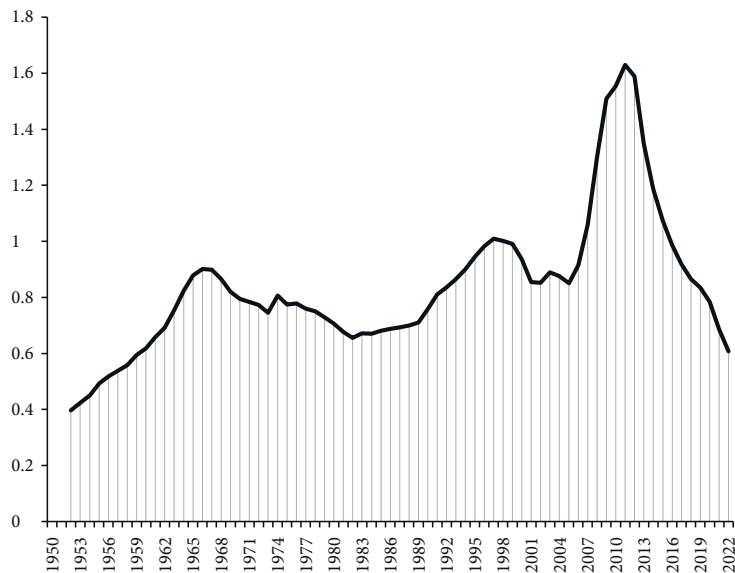
On the broadest level we can see that the 19th century’s long fight by classical economists to free industrial capitalism from the landlord class and economic rent has given way to a resurgent *rentier* economy. The financial sector is the new *rentier* class, and it is turning economies back into *rentier* capitalism —with rent being paid as interest while absentee real estate companies seek their major returns in the form of “capital” gains, that is, financialized asset-price inflation.

Graph 2. How ownership, United States, 1965-2023



³ More recent statistics are questionable as the debt ratio plunged to just 28% in 2022 as a result of private equity entering the housing market as rental income far exceeded borrowing costs for large investors. It seems that many small landlords lost their over-mortgaged homes to large investors, while the decline in mortgage rates did enable some recovery in home ownership rates to 65.8% today.

Graph 3. Debt/Equity



3. INFLATING ASSET PRICES BY FLOODING THE FINANCIAL MARKETS WITH CREDIT

From the Federal Reserve's vantage point, the economic problem after the 2008 crash was how to restore and even enhance the solvency of its member banks, not how to protect the "real" economy or its home ownership rate. The Fed orchestrated a vast "easing of credit" to raise prices for real estate, stocks and bonds. That not only revived the valuation of assets pledged as collateral against mortgages and other bank loans but has fueled a 15-year asset-price inflation. The Fed did this by raising its backing for bank reserves from \$2 trillion in 2008 to \$9 trillion today. This \$7 trillion easy-credit policy lowered interest rates to 0.2 percent for short-term Treasury bills and what banks paid their savings depositors.

The basic principle behind ZIRP was simple. The price of any asset is theoretically determined by dividing its income by the discount rate: $Price = Income/Interest$ ($P = Y/i$). As interest rates plunged to near-zero, the capitalized value of real estate, corporations, stocks and bonds rose inversely. Fed Chairman Ben Bernanke (2006-2014) was celebrated as the



savior of Wall Street, which the popular media depicted as synonymous with the economy at large.

The result was the largest bond-market boom in history. Real estate prices recovered, enabling banks to avoid losses on mortgages as they auctioned off foreclosed homes in a “recovering” market, whose character was changing from owner-occupied housing to rental housing. Stock prices, which had fallen to 6,594 in March 2009, far surpassed their pre-crash high of 14,165 in October 2007 to more than quintuple to over 35,000 by 2020. The lion’s share of gains accrued to the economy’s wealthiest ten percent, mostly to the One Percent who own most bonds and stocks.

Artificially low interest rates enabled private finance capital and corporations to borrow low-cost bank credit to bid up prices for real estate, stocks and bonds whose rents, profits and fixed interest yields exceeded the lowered borrowing costs. The ZIRP’s higher debt ratios inflated real estate and stock prices to bail out the banks and other creditors by creating a bonanza of financial gains. But only asset prices were inflated, not wages or disposable personal income after paying debt service. Housing prices soared, but so did the economy’s debt overhead. The ZIRP thus planted a financial depth charge: What to do if and when interest rates were allowed to return to more normal levels.

A recent report by McKinsey (2023) calculates that asset price inflation over the two decades from 2000 to 2021 “created about \$160 trillion in ‘paper wealth,’” despite the fact that “economic growth was sluggish and inequality rose,” so that “Valuations of assets like equity and real estate grew faster than real economic output. ... In aggregate, the global balance sheet grew 1.3 times faster than GDP. It quadrupled to reach \$1.6 quintillion in assets, consisting of \$610 trillion in real assets, \$520 trillion in financial assets outside the financial sector, and \$500 trillion within the financial sector”.

This enormous “capital gain” or “paper wealth” was debt-financed. “Globally, for every \$1.00 of net investment, \$1.90 of additional debt was created. Much of this debt financed new purchases of existing assets. Rising real estate values and low interest rates meant that households could borrow more against existing homes. Rising equity values meant that corporates could use leverage to reduce their cost of capital, finance mergers and acquisitions, conduct share buybacks, or increase cash



buffers. Governments also added debt, particularly in response to the global financial crisis and the pandemic”⁴.

4. THE FED REVERSES ZIRP TO CAUSE A RECESSION AND PREVENT WAGES FROM RISING

In March 2022 the Fed announced that it intended to cope with rising wage levels (“inflation”) by raising interest rates. Fed Chairman Jerome Powell (2018-present) explained that it was necessary to slow the economy to create enough unemployment to hold down wages. His right-wing illusion was that the inflation was caused by rising wages (or by government spending too much money into the economy, increasing the demand for labor and thereby raising wage and price levels).

In reality, of course, the inflation was caused largely by U.S.-NATO sanctions against Russian exports in 2022, causing a spike in world energy and food prices, while corporate “greedflation” raised prices where there was enough monopoly power to do so. Rents also increased sharply, following the rise in housing prices encouraged by the flood of mortgage credit to absentee owners.

4.1. Ending ZIRP reversed the Fed’s asset-price inflation policy

The Fed’s announcement of its intention to raise interest rates warned investors that this would reverse the asset-price inflation that ZIRP had fueled. Rising interest rates lower the capitalization rate for bonds, stocks and real estate. To avoid taking a price loss for these assets, “smart money” (meaning wealthy investors) sold long-term bonds and other securities and replaced them with short-term Treasury bills and high-liquidity money-market funds. Their aim was simply to conserve the remarkable runup in financial wealth subsidized during the 2009-2022 ZIRP.

⁴ McKinsey, *The future of wealth and growth is in the balance*, May 24, 2023. [online] Available at: <<https://www.mckinsey.com/mgi/overview/the-future-of-wealth-and-growth-hangs-in-the-balance#all-scenarios>>. The report adds: “For the United States, debt climbed from 2.5 to 2.8 times GDP, in the United Kingdom from 2.5 to 2.8, in Japan from 3.4 to 4.3, and in China from 1.6 to 2.7. In Germany, debt remained stable at about 2.0 times GDP” (p. 13).



The Fed's aim in rising interest rates was to hurt labor by bringing on a recession, not to hurt its bank clients. But ending ZIRP caused a systemic problem for banks: Collectively they were too large to have the maneuverability that private investors enjoyed. If banks tried *en masse* to move out of long-term bonds and mortgages by selling their portfolios of 30-year mortgages and government bonds, prices for these securities would plunge —to a level reflecting the Fed's targeted 4 percent interest rate.


There was little by way of an escape route for banks to buy hedge contracts to protect themselves against the prospective price decline of the assets backing their loans and deposits. Any reasonable hedge seller would have calculated how much to charge for guaranteeing securities in the face of rising interest rates causing securities with a face value of, say, \$1,000 to fall to, say, \$700. A hedge contract promising to pay the bank \$1,000 would have had to be priced at least at \$300 to cover the expected price decline.

So the banking system as a whole was locked into holding loans and securities whose market price would fall as the Federal Reserve tightened credit. Rising interest rates threatened to push many banks into negative equity —the problem that banks had faced in 2008-2009.

Federal and state regulators ignored this interest-rate threat to bank solvency. They focused narrowly on whether the banking system's debtors and bond issuers could pay what they owed. It was obvious that the Treasury could keep paying interest on government bonds, because it can always simply print the money to do so. And housing mortgages were secure, given the housing-price boom. Outright fraud thus was no longer a major worry. The new problem, seemingly unanticipated by regulators, was that capitalization rates would fall as interest rates rose, causing asset prices to decline, leaving banks with insufficient reserves to cover their deposit liabilities.

Bank reporting rules do not require them to report the actual market value of their assets. They are allowed to keep them on their books at their original acquisition price, even when that initial "book value" no longer is realistic. If banks were obliged to report the evolving market reality, it would have been obvious that the financial system had been turned into an unsustainable Ponzi scheme, kept afloat only by the Fed flooding the market with liquidity.





Such bubble economies have been blamed on “popular delusions” ever since the Mississippi and South Sea bubbles of the 1710s in France and England. But all financial bubbles have been sponsored by governments. To escape from their public debt burden, France and England engineered debt-for-equity swaps of shares in companies with a monopoly in the slave trade and plantation agriculture —the growth sectors of the early 18th century— with payment made in government bonds. But the 2009-2023 stock market bubble has been engineered to rescue the private sector, largely at government expense instead of it being the beneficiary. That is a major characteristic of today’s finance capitalism.

The essence of “wealth creation” under finance capitalism is to create asset-price “capital” gains. But the economic reality that such financialized gains cannot be sustained led to the term “fictitious capital” being used already in the 19th century. The idea that inflating asset prices can enable economies to pay their debts out of finance-capital gains for more than just a short period has been promoted by an unrealistic economic theory that depicts any asset price as reflecting intrinsic value, not puffery or financial manipulation of stock, bond and real estate prices.

Today’s bank assets are estimated to be \$2 trillion less than their nominal book value. But banks were able to ignore this reality as long as they did not have to start selling off their real-estate mortgages and government bonds. All that they had to fear was that depositors would start withdrawing their money when they saw the widening disparity between the typical 0.2 percent interest that banks were paying on savings deposits and what the government was paying on safe U.S. Treasury securities.

That interest-rate disparity is what led to the eruption of bank failures in spring 2023. At first that seemed to be an isolated problem unique to each local bank failure. When Sam Bankman-Fried’s FTX fraud showed the problems of cryptocurrency as an investment, holders began to sell. What was said to be “peer to peer” lending turned out to be mutual funds in which cryptocurrency buyers withdrew money from banks and turned them over to the cryptofund managers, with no regulation. The “peers” at the other end turned out to be the managers behind an opaque balance sheet. That realization led customers to withdraw, and crypto sites met these withdrawals by drawing down their own bank deposits. Many bankruptcies ensued from what turned out to be Ponzi



schemes. Two banks failed as a result of heavy loans to the cryptocurrency sector and reliance on deposits from it: Silvergate Bank on March 8 and Signature Bank in New York on March 12.

The other set of failed banks were those with a high proportion of large depositors: Silicon Valley Bank (SVB) on March 10 and neighboring First Republic Bank in San Francisco on May 1. Their major customers were private capital backers of local information-technology startups. These large financially savvy depositors were substantially above the \$250,000 FDIC-insured limit and also were the most willing to move their money into government bonds and notes that paid higher interest than the 0.2 percent that SVB and other banks were paying.


Another set of high-risk banks are community banks with a high proportion of long-term mortgage loans against commercial real estate. Office prices are plunging as occupancy rates decline now that employers have found that they need much less space for their on-site work force since COVID has led many workers to work from home. As a recent *Wall Street Journal* report explains: “Around one-third of all commercial real-estate lending in the U.S. is floating rate ... Most lenders of variable-rate debt require borrowers to buy an interest-rate cap that limits their exposure to rising rates. ... Replacing these hedges once they expire is now very expensive. A three-year cap at 3% for a \$100 million loan cost \$23,000 in 2020. A one-year extension now costs \$2.3 million”⁵.

It is cheaper to default on heavily debt-leveraged properties. Large real estate companies, such as Brookfield Asset Management (with assets of \$825 billion) which saw its mortgage payments rise by 47 percent in the past year, are walking away as commercial rents fall short of the carrying charges on their floating-rate mortgages. Blackstone and other firms are also bailing out. Stock-market prices for real-estate investment trusts (REITs) have fallen by more than half since the COVID pandemic began in 2020, reflecting office-building price declines by about a third so far, and still plunging.

Many banks are now offering depositors interest in the 5 percent range to deter a deposit drain, especially as a “flight to safety” is concentrating deposits in the large “systemically critical banks” blessed with FDIC

⁵ “Even top property owners can default”, *Wall Street Journal, Heard on the Street*, May 23, 2023.





guarantees that customers will not lose their money even when their deposits exceed the nominal FDIC limit. These are precisely the banks whose behavior has been the most outright reckless. As Pam Martens has documented on her e-site “Wall Street on Parade,” JP Morgan Chase, Citigroup and Wells Fargo are serial offenders, the most responsible for the reckless lending that contributed to the financial system’s negative equity in the first place. Yet they have been made the winners, the new havens in today’s debt-ridden economy.


It turns out that being “systematically important” means that one belongs to the group of banks that control government policy of the financial sector in their own favor. It means being important enough to oppose the appointment of any Federal Reserve officials, bank regulators and Treasury officers who would not protect these banks from regulation, from prosecution for fraud, and from being taken over by the FDIC and government when their asset-price losses exceed their equity and leave them as zombie banks.

5. WHERE WILL THE FINANCIALIZED U.S. ECONOMY GO FROM HERE?

Rising interest rates are winding the clock back to the same negative-equity condition that the banking system faced in 2008-2009. When Silicon Valley Bank’s “unrealized loss” of \$163 billion on falling prices for its government bondholdings and mortgages exceeded its equity base, that was merely a scale model of the condition of many big U.S. banks in late 2008.

The problem this time is not bank-mortgage fraud but falling asset-prices resulting from the Fed raising interest rates. And behind that is the most basic underlying problem: The banking system’s product is debt, which is extracting a rising share of national income. The economics profession, the Federal Reserve, bank regulators and the Treasury share a blind spot when it comes to confronting the degree to which debt is a burden draining income from the “real” economy of production and consumption.

The trillions of dollars in nominal financial wealth registered by the bond, stock and real estate markets since ZIRP was initiated has been plowed back with yet more credit into more asset purchases to keep the price-rise going with rising debt leverage, bidding up financial claims on



property rights, especially rent-yielding claims. All this financialization was given tax advantages over ‘real’ capital investment.

The \$7 trillion of Fed support for the banking system to lend out and bid up prices for real estate, stocks and bonds could have been used to reduce carrying charges on homes and other real estate. That could have helped the economy lower its housing, living and employment costs and become more competitive. Instead, the role of the Federal Reserve and privatized banking system has been to create yet more credit to keep bidding up asset prices.

The beneficiaries have been mainly the wealthiest One Percent, not the economy at large. Inflation-adjusted wages have remained in the doldrums, enabling corporate profits and cash flow to increase—but over 90 percent of this corporate revenue has been paid out as dividends or spent on corporate stock buyback programs, not invested in tangible new means of production or employment. Many corporate managers have even borrowed to raise their stock prices by buying back their own shares.

Today’s financial system has not managed its credit creation and wealth to help the economy grow. Debt-inflated housing prices have increased the economy’s cost structure, and debt deflation is blocking recovery. The household sector, corporate sector, and state and local budgets are fully loaned up, and default rates are rising for auto loans, student loans, credit-card loans, and mortgage loans, especially for commercial office buildings as noted above.

Looking back over recent decades, the Federal Reserve and Treasury have created a banking crisis of immense proportions by protecting commercial banks and now even brokerage houses and the shadow banking system as clients to be served instead of shaping financial markets to promote overall economic growth. Behind this financial crisis is a crisis in economic theory that is largely a product of academic and media lobbying by the Finance, Insurance and Real Estate (FIRE) sector to depict *rentier* income and property claims as being part of the production-and-consumption economy, not external to it as an extractive layer.

And behind this neoliberal theory that has replaced classical political economy is the *rentier* dynamic of finance capitalism. Its essence has been to financialize industry, not to industrialize finance. The monetary and credit system has been increasingly privatized and financial regula-



tory agencies have been captured by the sectors that they are supposed to regulate in the economy's long-term interest. The financial sector notoriously has lived in the short run, and tried to free itself from any constraint on its extractive and outright predatory behavior that burdens the non-financial economy.

The exponentially rising debt overhead is the financial equivalent of environmental pollution causing global warming, disabling the economy's health much as long COVID incapacitates humans⁶. The result today is an economic quandary —something more serious than just a “problem.” A problem can be solved, but a quandary has no solution. Any move will make the situation even worse. Mathematicians express this as being in an “optimum position”: One from which any move will make matters worse.

That is the kind of optimum position in which the U.S. economy finds itself today. If the Fed and other central banks keep interest rates high to bring about a recession to lower wages, the economy will shrink and its ability to carry its debt overhead —and to make further stock-market and real-estate price gains— will be eroded. The debt arrears that already are mounting up will lead to defaults, which already are occurring in the commercial real estate sector.

Trying to return to a ZIRP to sustain asset prices is much harder in the face of today's legacy of post-2009 debt —not to mention the pre-2009 debt that crashed. Bank reserves have shrunk, and in any case the economy is largely “loaned up” and can hardly take on any more debt. So one path or another, the end-result of ZIRP —and the Obama Administration's failure to write down the economy's bad-debt overhead— must be a crash.

But a crash would not mean that the economy's debt problem will be “solved.” As long as the guiding policy principle remains “Big fish eats little fish,” the economy will polarize and the concentration of financial wealth will accelerate as debt-burdened assets pass into the hands of creditors whose wealth has been so vastly increased since 2009. ◀

⁶ I have outlined my analysis further in Hudson (2020) and Hudson (2013).



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