A Time to Re-Think:

How Economics has Failed America

By Brett Sheckler

As we stand in the midst of our lingering economic crisis, many of us carry a pervasive sense that something has gone wrong.

Yes, we all know the standard answers:

We know that the financial system is a rigged game—rewards accrue to a handful of financiers while the costs and risks they create are born by the rest.

We know that politics is a rigged game as well. Those with means have inordinate influence over the process; and when all is said and done, their means expand.

We know that much of our nation's capacity to produce has been systematically dismantled.

We know these standard answers, but what we don't know, and what we wish to know, is more fundamental: *How did we get here?*

The answer to this question is startling. To a large degree, we are where we are because economics has failed us. As a field of endeavor, economics has failed to develop an accurate understanding of how the world works. And because of the immense influence economics has on policy over the long term, our nation has spent decades worrying about the wrong things and pursuing the wrong actions.

When you step back and consider, our situation is remarkable:

We have this vast field of endeavor called economics. Countless practitioners invest millions of hours observing how our system works; they engage in scholarly debate as they refine theories about the dynamics at play; they develop complex mathematical models; and based on their theories and models, they seek to explain what is happening today and what can be expected to happen tomorrow.

And yet, whenever a major event occurs (a depression that rocks the world, the bursting of a multi-trillion-dollar housing bubble, a resulting crisis among institutions that extend credit), inevitably, it turns out that the mainstream of economics failed to see the event coming.

It is tempting to be philosophical about economics' failures. Everybody makes mistakes. But in the end there is no way around a fundamental truth—a failure to predict is indicative of a failure to understand. If mainstream economics is not able to identify a multi-trillion-dollar housing bubble, how can we possibly have confidence in the role economics plays in directing policies—in determining how our nation functions?

The truth is: every person in America has a stake in this game. Economists' understanding of how the world works has far-reaching implications for the policies our nation pursues, and ultimately, for the way we live our lives.

The world would be a better place if each of us could stand up for our interests—if every American could articulate how economics has failed and then demand better. And fortunately, this is possible.

Much of economics is like rocket science. But the ways in which economics has failed are not. Mainstream economics has failed in ways that are clear, and that are describable in terms that any lay-person can understand.

A Place to Start: Pulling on a Thread

To understand how we got where we are, a good place to start is by going back to a little-known study published in 1990.

In 1990, economists Finn Kydland and Edward Prescott published a study that should have rattled economics to its foundation. In their paper entitled ***Business Cycles: Real Facts and a Monetary Myth***, the two economists used real-world observations to demonstrate that some of the fundamental theories that economics is founded on do not hold water. They demonstrated that these theories are directly contradicted by observed facts.

For anyone who reads their study, Kydland and Prescott's work offers a treasure-trove of insights about how our economy really works. Their headline finding, however, was that economists' standard theory of money creation (their understanding of how money creation happens) is, in fact, a myth.

The Myth of Money Creation

For a long time, economists have believed that the supply of money in the system is controlled by central banks. They believe that money creation begins with the injection of dollars into the so-called "monetary base."

In practical terms, it is supposed to work like this:

The Federal Reserve purchases an asset like a Treasury Bill on the open market. Through the transaction, two things happen: (1) the bank that previously owned the Treasury Bill transfers its ownership to the Fed and (2) the Fed credits the bank's central reserves with an amount equal to the purchase price.

With increased reserves on its balance sheet, the bank now has the capacity to extend more loans to borrowers. The bank takes advantage of its new reserves and loans me money to buy a car. I take the check they give me and hand it to the seller. The seller then turns around and deposits the check in her bank, creating more reserves in that institution, which in turn allows her bank to extend more loans.

As the process unfolds from party to party and from bank to bank, a million dollars injected by the Fed into the monetary base translates into many millions of dollars circulating in the broader system.

This is a clean and elegant theory, and it is an understanding of money creation that economists have taught one another for decades. The only problem is, as Kydland and Prescott demonstrated, this theory is pure myth. It is directly contradicted by the facts.

Through observations of real-world events, Kydland and Prescott showed that the process of creating money (of creating purchasing power) is not driven by injections of dollars into the monetary base. Rather, the creation of purchasing power is driven by the independent actions of you, me, and our banks.

In the real world, banks do not sit around waiting for reserves before they originate loans. Banks extend loans first, and to the extent that they need reserves, they go looking for those later. And when they go looking, the reserves they need are out there because the dollars in the system were created when they created the afore-mentioned loans.

What Kydland and Prescott's findings highlighted was that, in the real world, the action that initiates the creation of money is when you or I make the choice to incur debt—when you or I nod our heads and say, "Yes, I pledge more of my future resources to create purchasing power today."

A Revolution that Did Not Happen

To understand how economics has failed, it is important to note what happened in the weeks and months after Kydland and Prescott shared their findings. In short…nothing.

One would think that findings like Kydland and Prescott's would explode like a bomb. If someone demonstrates that a foundational theory of economics is a myth, one would expect those findings to set off a firestorm of debate, a process of testing and re-testing the analysis in question, and if the findings stood, a fundamental re-visiting of what economists thought they knew.

Instead, mainstream economics took a less ambitious path: it simply ignored Kydland and Prescott's findings. In 1998, when I studied macroeconomics at university, my professor taught me the same mythical theory of money creation that has been taught for decades, without even a whisper about Kydland and Prescott. And with our money-creation myth as a foundation, we went on to build an entire mythical understanding of how the world works.

Do you recall in 2009 how many economists were warning that inflation was imminent? They warned that, because the Federal Reserve was buying so many assets—"printing so much money"—it was inevitable that money would become cheap. It was inevitable that we were headed to a world of increasing prices.

The reason economists issued that warning, and the reason they were dead wrong, was because they still believe in their myth of money creation. They are still working from a mythical understanding of how the world works.

In 1990, Kydland and Prescott concluded their paper with characteristic understatement:

> *".... Introducing money and credit into growth theory… is an important open problem in economics."*

Unfortunately for us, twenty years later, its status as an "open problem" remains unchanged.

Continuing to Pull on the Thread

What Kydland and Prescott's study exposed was the Achilles Heel of economics: its failure to appropriately account for the role of debt in our system. We are not talking about governmental debt, here. We are talking about total debt, the most important component of which exists in the private sector (households and businesses).

From an economist's perspective, Kydland and Prescott's study presents both bad and good news. The bad news is that if you start to think through their findings you are forced to re-think big chunks of macroeconomic theory. The good news is, once you do that, things start making a lot more sense. Things like the Great Depression, housing bubbles, the recent financial crisis, and now our Great Recession become entirely understandable and predictable.

For proof, all one has to do is look at Australian economist Steve Keen. Steve describes himself as an anti-economist—by which he means he did not ignore Kydland and Prescott's findings and he seeks to fully account for the role of debt in our system. Because he does these things, Steve warned of our current crisis years in advance—explaining why and how it would unfold.

Cutting to the Chase

For the lay person, the crux of the issue can be summarized in less than three minutes.

First, one minute on fundamentals:

Our economy is sputtering. Millions of people are working less than they would like, and the nation's largest businesses are sitting on big reserves of cash that they would like to put to productive uses. If these resources were fully employed, our entire economy would be producing more goods and services—generating a better quality of life for Americans as a whole.

With resources sitting idle, all but the most dogmatic economists acknowledge that we are suffering from insufficient demand. We have the supply—we have the capacity to produce more—but the demand (the animated purchasing power of Americans) is not there to spur the full use of our resources.

So, given this understanding of the fundamentals, here is what you need to know.

Stop, take a deep breath, and clear your mind of all of the stuff we were just talking about. All of that was just background. The core of how things work is summarized in the next four points:

1. An increase in private debt drives growth in demand. *(We pledge more resources from our future to purchase things today.)*
2. A decrease in private debt diminishes demand.

3. When private debt is growing, things feel good. Demand is strong. People are pledging future resources, creating purchasing power, and the economy has the fuel it needs to drive growth.
4. But when debt stops growing and begins to fall, that is when things fall apart. The so-called "paradox of thrift" kicks in. *Reducing debt means reducing demand. Decreased demand translates into decreased employment and earnings for many Americans. And the burden of the debt we are attempting to pay down becomes even heavier, putting even more downward pressure on demand.*

A look at history tells us that a country can expand its debt for a long time (more than 60 years in our last stint). But logic and history tell us we cannot pledge more and more of our future resources forever. And when a nation finally gets to a place where overall debt switches from growing to shrinking, bad things happen.

As individuals, we all know this. We all know that if we add to our piles of debt year after year, sooner or later our debts are going to crush us.

A Few Specifics

Over the past 90 years, there were only three turning points where America's nominal private debt switched from growing to shrinking. Those turning points were 1929, 1937, and 2008. To risk a serious understatement, from an economic perspective, these were not good years.

And if you look to Japan for one last data point, you can see another year when nominal private debt started to shrink. That year was 1997, kicking off Japan's deflationary struggles that continue today.

America in 1929, Japan in 1997, and America in 2008 all have one thing in common—those were all points where really big economies began to try to climb down off of a mountain of debt.

Back in 1929, when America's private debt reached the peak and switched from growing to shrinking, the amassed private debt equaled an unprecedented 156% of our national GDP (the value of everything our country produced in that same year). In 1929, standing on a mountain of debt meant that, when we started onto the slippery slope of trying to pay it down, there was a long, long, *long* way to slide.

Unfortunately for us, the mountain of debt we stand on today is far bigger. In 2008, when we switched from growing to shrinking debt, our stockpile of non-governmental debt was $43 Trillion—more than 290% of the nation's GDP. In other words, in real terms (in terms of our ability to generate income), our mountain of debt is nearly twice as big as the mountain that existed in 1929.

Where Economics Falls Short

For a lay-person, it is tempting to think that economists must understand all this. Don't we hear economists talking on a daily basis about household debt?

If only it were so.

Recent events have compelled economists to recognize that debt is a force to be reckoned with. But in truth, mainstream economics has always thought of debt as a side issue—as something they don't really need to worry about.

The revolution that was required in the wake of Kydland and Prescott's study never happened. Economists are still working from a mythical understanding of money creation. And as a result, economic theory has yet to come to terms with the reality that debt is not a side issue in how our economy operates, it is the central issue.

Actually, it is easy to demonstrate the depths to which economics has failed to account for debt. Consider two illustrations:

Illustration #1

Economists like to say that money doesn't matter—that it is a veil over a system of barter. Money is simply a mechanism that makes it easier to trade what I produce for the things produced by others. What really matters, they say, is the *relative* values of the things we produce. To support their point, they argue that if we suddenly doubled the amount of money in the world we wouldn't be any better off; it would just mean the price of everything would double.

Of course, in reality, this last statement isn't true. Faced with an offer to double my salary and the costs of everything I buy, I would take the deal in a second. Once the bargain was locked in, I would laugh as I strolled by the bank that holds my mortgage. Life is good because my mortgage payment no longer feels like a burden; the $4,000 outstanding debt on my credit card looks much less menacing; and my house just doubled in value, leaving me with a big pile of equity.

Economists will argue that this illustration isn't fair; because of course they know that inflation benefits borrowers. So let's look at the second illustration.

Illustration #2

An even better example of economists' failure to account for debt can be seen when they offer explanations of why deflation (a world of falling prices and wages) is undesirable.

A standard explanation of deflation (the kind you see in the newspaper all the time) goes like this:

> *When consumers begin to expect prices to be lower tomorrow, they postpone spending. As sales lag, businesses cut salaries and/or they lay off workers, which leads to even weaker demand, lower wages, rising unemployment, and even lower prices. What you end up with is a downward spiral.*

While the above description does contain some kernels of truth, in reality, this is a truly terrible explanation.

The real reason why deflation is bad is because, when prices and incomes start to fall, we all get crushed by our outstanding debts. Some of us struggle to cover our debt payments with the fewer dollars that come in the door (which means that we all have to curtail spending on other things—driving demand through the floor), and some of us default on our debts (which means that our bank just took a hit *and* we are no longer a good credit risk so we can no longer drive the economy by pledging our future resources). To make matters worse, for the folks who don't default, the value of our houses just dropped, erasing huge chunks of equity we thought we had—equity we were counting on for retirement.

The first ones to get crushed are those with the highest debt burdens and/or the least secure jobs. But as each victim falls, and as the ability to generate new purchasing power through debt remains scarce, times get tougher. Folks who felt secure in the first year of deflation may be victims in the second, third, or fourth. In other words, until our debts are sufficiently destroyed so they can no longer squeeze us, our economy will continue to struggle.

This is the ride America took in the Great Depression. This is the ride Japan is in the midst of today. And unless we get on the ball and do something drastic, this is the ride America began in 2008.

And as shocking as it sounds, the vast majority of economists do not understand this.

Within economic circles one of the great, long-standing mysteries revolves around the question: *Why do depressions last so long?* Why don't wages and prices simply adjust to a lower level so markets can clear and we can get back to a fully-functioning economy?

The answer is: *Depressions last so long because they are all about debt.* Until enough of our debt is destroyed, falling wages and prices only make our situation worse. (Imagine how crushing your debts would feel if your wages were cut in half.)

A depression is not over until demand recovers. Demand does not recover until our debts are sufficiently destroyed. And absent a stimulative event like a world war, when you start out on top of a mountain of accumulated debt, meaningful debt destruction takes a very long time.

A Window into Economic Thinking

One of the first to recognize the toxic combination of debt and deflation was Irving Fisher, an academic who articulated what he saw during the Great Depression. Fisher's ideas influenced President Roosevelt and helped shape the President's actions. His ideas, however, gained much less traction with economists.

Federal Reserve Chairman Ben Bernanke summed up economists response to Fisher in his book **Essays on the Great Depression**. Bernanke writes:

> *Fisher's idea was less influential in academic circles… because of the counterargument that debt-deflation represented no more than a redistribution from one group (debtors) to another (creditors)…. " (Bernanke 2000, p. 24)*

What Bernanke is alluding to here is the fundamental line of thinking that has allowed economists to believe that they don't need to worry about debt—that debt is, in effect, a side issue.

Economists reason that, from the perspective of the economy as a whole, debt is something we owe to ourselves. Because each debt has two sides (a borrower and a creditor) the *net* impact of the debt on the system is zero. Hence, in most instances, we don't need to worry about it.

In layman's terms, what Bernanke was saying was that, even if borrowers get crushed by debt, it shouldn't matter because there was another party (creditors) whose benefits offset the borrowers' pain.

Economists' logic in this area fails on at least two levels:

First, it fails with respect to Fisher's specific observations. The reality is that when deflation combines with debt and begins to crush us, it crushes us all—borrowers and creditors alike.

Some borrowers struggle to continue to pay off their debts with the fewer dollars that come in the door (so that group has fewer dollars available to purchase goods and services to drive the economy). Other borrowers default. This means that they no longer bear the burden of the debt, but they are now a bad credit risk so they are in a poor position to drive demand by pledging future resources. This also means bankers (and other creditors) are fighting for their financial lives because they are getting pounded by all those defaults. Lastly, creditors are getting hammered on another front because they are having a hard time finding enough people who (1) are a good credit risk and (2) are willing to take on debt. And, of course, creating debt is how banks make money.

The second front where economists' logic fails runs even more deeply.

At the most fundamental level, debt is a mechanism that allows us to move purchasing power through time. As Kydland and Prescott showed, I can expand purchasing power in the system today simply by raising my hand and agreeing to pledge more of my future resources.

This is a double-edged sword. It is good for growth as long as the dynamic is bringing more purchasing power to bear in the present (as long as increasing debt is fueling current demand), but it kills the economy when the dynamic switches—when the bill finally comes due.

When the household sector as a whole scales back, even a little, in our willingness to create purchasing power, the economy finds itself with insufficient demand. And when the household sector finds itself overextended—when we find ourselves needing to work our way down off of a mountain of debt—the economy is headed into a long, long slide.

To see where we stand today, it helps if you can look at the patterns of household debt creation over time. Anyone who does that—anyone who looks at the two charts below—cannot help but be concerned about where we find ourselves.

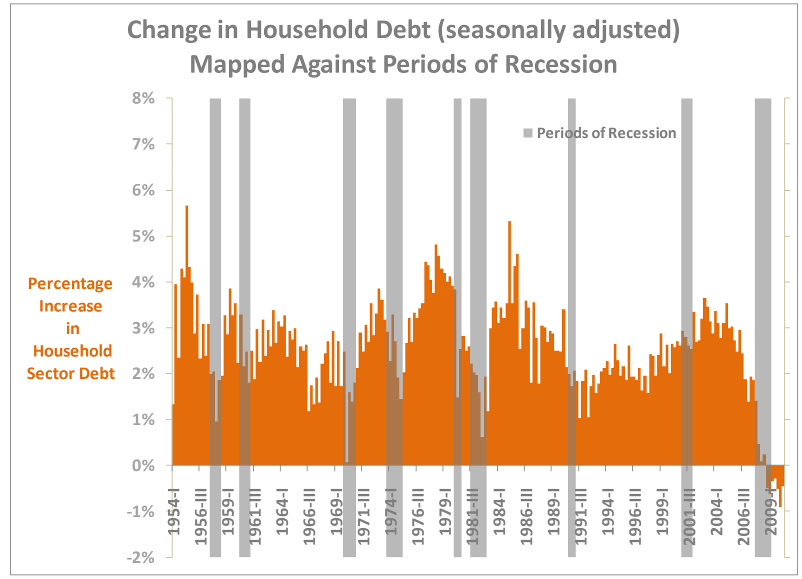
The first chart highlights the extent to which household debt (households creating purchasing power by pledging future resources) drives our economy. Eight of our last nine recessions were preceded by a trend of decelerating household debt creation. (The exception was the recession that followed the events of September 11, 2001.)

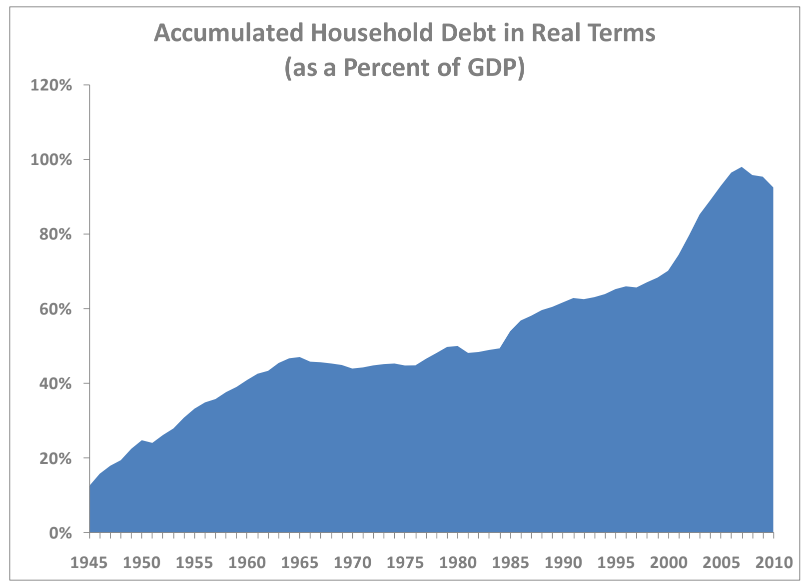
In late 2006, anyone who mapped these data would have no choice but to be concerned about where we were headed. By standard measures the economy still looked fine, but household debt creation was decelerating rapidly.

On top of this, an observer would become even more concerned if he or she took into account the second chart, a chart that shows levels of real, accumulated household debt in the nation.

By late 2006, American households had accumulated astonishing levels of debt. Debt had been extended to all sorts of people who would never normally qualify, credit terms were easy, and yet, household debt creation had begun to decelerate. Our economy had been running on fumes, and by 2006 even the fumes were running out.

These are the facts that Steve Keen was looking at when he raised his warning. These are the facts that mainstream economists were disregarding. And these are the facts that suggest our troubles are not yet behind us.





Source: Federal Reserve.

What If

What would have happened if mainstream economists had not ignored Kydland and Prescott's findings and, instead, had begun to re-visit what they thought they knew?

If they had done that, then economists would have acquired a whole new perspective on how our economy operates, and they would have recognized that debt is a double-edged sword.

They would have looked back at the early 1980s, when household debt began to grow at a rapid pace, and they would have been troubled. And by 2003, when real household debt levels reached 80% of GDP, just like Steve Keen, they would have been shouting warnings from the rooftops.

Instead, in 2003 and beyond, folks like Alan Greenspan and Ben Bernanke cheered and abetted as Wall Street innovated new ways to ensure our debt levels reached new heights—to ensure debt would permeate every crack and crevice of our economy. And they cheered as Wall Street innovated new ways to package and sell that debt, allowing financiers to make huge profits by exposing investors around the globe to the effects of the inevitable reversal.

In the wake of the events of 2008 and 2009, many people began to notice a suspicious correlation—a correlation between skewed income distributions and massive economic crises. They noted that, in 2008, the top one percent of Americans reaped a greater share of the nation's income than in any year since 1929.

Economists like Paul Krugman noted this correlation, and they noted that there might be a *causal* relationship—a reason *why* skewed income distributions lead to economic crises. The problem was: existing economic models did not provide any such reason.

However, when one recognizes the role that debt plays in driving our system, the dynamic becomes clear.

In a world where increasing shares of income flow to the few, the only way to maintain demand is for most households to pile up more debt. As this process unfolds, the time with the most heavily-skewed income will be the time before the crash.

In a world with mountains of debt, large portions of income must flow to creditors. This means that, in the final years before the system crashes, those who are well-to-do will enjoy extraordinary times, while households who are in debt find themselves feeling more and more squeezed.

Even when borrowers are squeezed, however—even when logic suggests that these households cannot afford to take on any more debt—the system requires that they do. In order to maintain demand, in order to keep the economy growing, the financial system must generate debt.

When you play this tape forward, it becomes clear that the years just before the crash will be the years when the craziest things happen.

When borrower households become most squeezed, keeping debt growing requires more and more drastic steps. Interest rates may need to be held at very low levels for extended periods, to entice borrowers. The financial sector may need to innovate all sorts of ways to extend debt to new pools of borrowers—borrowers who would not normally qualify. And as a result, one might expect to see asset bubbles—asset bubbles that are fed by the low interest rates and the new pool of consumers with debt-driven spending power—asset bubbles that make potential borrowers feel wealthier than they really are, which in turn makes them comfortable spending and borrowing at levels they typically wouldn't.

These are the kinds of things you would expect to see before the crash.

If economists had understood all this, just imagine how policies in recent decades might have been different.

Our Current Position

Put yourself in President Obama's shoes. You take office and your economic advisors tell you we are in a terrible recession brought on by a bursting housing bubble and a banking system in crisis. What we need to do, they say, is repair the balance sheets of the banks—to put them in a position where they can start lending again—and then we need to jump-start demand. If we do that, employment will begin to rebound, the banks will begin to lend again, and our economy will recover.

If that is the advice you are receiving, then the smart thing to do is to (1) do whatever it takes to make the banks healthy; (2) pass a politically-acceptable government stimulus; and (3) promise everyone that if they just show some patience, the economy will recover.

Clearly, this is the advice the President has received, and this is the path the President has pursued.

If, on the other hand, President Obama had a clearer understanding of where we are, then the smart path forward looks very different.

The reality is this:

1. For 60-plus years, demand in our economy has been driven by ever-expanding private debt. Every year, we pledged more of our future resources to buy things today. *(In 1945, non-governmental debt in the US was 39% of what we produced in a given year [39% of GDP]. In 2008, after 63 years of almost non-stop growth, it stood at 292%.)*

2. *Maybe* we can arrest the slide, for now, and convince households and businesses to start expanding their debt again. Ultimately, though, no private sector can continue indefinitely to pledge more and more of its future resources. At some point, what goes up must come down (or at the very least, it must stop going up).

3. The last time we started down off a mountain of debt was 1929—and that was a much smaller mountain.

4. More recently, Japan saw its own mountain of debt peak at the end of the 1980s. Japan's private debt began to level off in 1989—kicking off a period of stagnation—and it began to actually decline in 1997—kicking off the country's continuing deflationary struggles.

In April of 2009, President Obama delivered a speech at Georgetown University in which he explained the economic strategy employed in his first months of office. In explaining the rationale for bailing out the nation's banks, the President stated the following:

… And although there are a lot of Americans who understandably think that government money would be better spent going directly to families and businesses instead of banks - "where's our bailout?," they ask - the truth is that a dollar of capital in a bank can actually result in eight or ten dollars of loans to families and businesses, a multiplier effect that can ultimately lead to a faster pace of economic growth.

I do not know who wrote these lines, but it is hard to imagine a statement more firmly rooted in the myth of money creation—in a myth-based understanding of how the world works.

The problem America faces is one of insufficient demand. With earnings for many families stagnating or falling, and with a mountain of accumulated debt, we are now in the long, slow process of being crushed by debt. Households can no longer drive demand by pledging more of their future resources.

Fine… do what you need to do to ensure credit markets do not freeze up. But we need to be clear. The answer to the question, “Where do we go from here?” does not begin with, “We need to get banks lending again.”

If you were to spend a day walking the streets of Phoenix (or a long list of other American cities), you would rub elbows with many who are financially shattered. Some households have lost their homes through foreclosure; some have entered bankruptcy; and perhaps even worse, many others face the prospect of sinking large portions of their income into mortgages that are irretrievably under water. These households will pay a big chunk of their income into their mortgage, year after year, and they will still have zero equity that they can count on for retirement.

Until we address the reality of financially-shattered households and a mountain of household debt, we are in for a long hard time. Debt destruction will happen. The key questions are: How will it happen? How painful will it be? And who will share in that pain?

Were the shattered households of Phoenix financially imprudent? Perhaps. But it is safe to say that they were nowhere near as imprudent as the economists, the financiers, and the policy makers who designed the structure of our economic collapse. It is also safe to say they have paid a much dearer price.

Those of us with financial histories above reproach can rail against households who were financially unsophisticated, who were imprudent, and who wanted to live beyond their means. And we can rail against financiers who were greedy; financially sophisticated; and who were imprudent, or more likely, who were prudent in ways that were good for them but bad for the rest of us.

In reality, though, people are people. Some are smarter than others; some invest time and effort to become financially sophisticated while their counterparts pursue other endeavors; and given the opportunity, almost all of us will pursue our self-interest as we perceive it.

It seems both silly and a waste of effort to rail against the players of the game when it is the *design* of the game itself that really matters.

The truth is: for decades, America has built a system where much of our nation’s talent has been funneled to Wall Street. Rather than being used to enhance our nation's competitiveness, rather than enhancing the quality of people's lives, these talents have been almost exclusively focused on devising ways to move money out of your pocket and into theirs.

The system we have built has been enormously successful in achieving what it was designed to do; it has made many on Wall Street fabulously wealthy. Unfortunately and obviously, though, it has been bad for our Country.

If we had an effective financial system, we would know it. Demand would be strong. Capital would flow easily (and at low cost) to any enterprise that is well positioned to meet that demand. The financial sector would absorb only a small portion of the nation's income. And our economy would be resilient in the face of unforeseen events.

Clearly, this is not the system we have built.

For decades, mainstream economics has been lost—failing to develop an accurate understanding of how the world works, and disregarding facts that are inconvenient to them.

When things seemed to be going okay, perhaps we thought we could afford to humor economics' failings. Yes, you could find economists to argue both sides of any question, but what was the harm?

Now, through painful events, we have come to understand the harm. The responsibility has fallen to you and me, as consumers of economic thought, to demand better.

We need an understanding of our economic world that actually makes sense. And based on that understanding, we need to think about where we go from here.

Again, we may be in for a long hard time. Debt destruction needs to happen. The key questions for the coming years will be: *How will it happen? How long and painful will it be? And who will share in that pain?*

When one looks around the world, Iceland stands out as the one nation that stood up and insisted that creditors who made imprudent loans must bear a share of the cost. One could argue that for Iceland the choice was easier. Iceland maintains its own currency, and most of the creditors in question lived elsewhere in the world.

For many other first-world nations, the choice is much harder. If you do not control your own currency (as is the case in Europe), or if the creditors in question have inordinate influence in the political process (as is the case in the US), the job becomes much tougher.

Still, the question is before us:

Is it right, or wise, to insist that the process of debt destruction must be geared to hold creditors unharmed? Is it right, or wise, to insist that debt destruction must, through a long and grinding process, be achieved on the backs of households, non-financial businesses, and ultimately, on the back of the economy as a whole?

To quote Michael Hudson's famous aphorism: *Debts that can't be repaid, won't be repaid*. We can try to ignore that reality, but by choosing such a path we will be dooming ourselves to learning its truth the hard way—depressed year after depressed year—one day, and one financially crushed household, at a time. By trying to honor debts that were created under a system that never should have existed—with many of these debts ultimately unpayable—we are dooming everyone to a long, depressed future.

Perhaps we need to face up to our folly. Perhaps we need to acknowledge that the way we have managed our economy in recent decades is, in fact, no way to manage an economy. And rather than trying to repay the foolhardy and unrepayable, perhaps we should instead be working out how to dishonor those debts in a way that will cause the least damage to the economy and, in particular, to the financially innocent.

Let us face the truth: the financially innocent have been ill-served by our decades of folly.

A homeowner in Phoenix who has owned his home for 20 years, and who has never taken out a home equity line of credit, has seen his earning stagnate for decades. In recent years, he watched his already-too-small 401k dwindle in the face of a mammoth market crash. By 2009, while he watched much of his home equity disappear in the housing market collapse, the DOW dropped to 7,500. Knowing that he and his wife absolutely could not afford to see it go to 5,000, he sold. It had become clear to him that the role he was playing in this game was that of the sucker, he had been twice burned, and he was done.

He watched as younger families on his block lost their homes to foreclosure and moved away. He misses the sound of the kids playing on the street on Saturday afternoons, and now those homes sit vacant.

If we don't change course, people like the homeowner in Phoenix face the prospect of paying for our continued folly for years to come. Depressions and lost decades claim victims of all kinds.

And looking out beyond our current crisis, the core challenge remains: *How do we re-structure our nation's economy to strengthen and maintain the purchasing power (the non-debt-related purchasing power) of American households?*

The implications of this question are massive. Because economics has spent so many years wandering in a land of myth, we have not had the conversations we need to have. But one thing is clear: the things we need to do are likely to involve the polar opposite of what economists for decades have been recommending as sound policy.

Debt and money are fundamental to our economic system. And when you get something as fundamental as that wrong, the odds are that much of what you describe as wisdom is likely to be folly.

If an economist tells you it is sustainable to have a financial system that absorbs huge chunks of the nations' income, tell him to go back and sharpen his pencil. And if an economist tells you it is sustainable for a CEO to go from earning 42 times as much as a factory worker in 1960 to more than 300 times as much in 2008, ask him where demand in the economy will come from.

In the end, the one thing economists cannot afford to lose is their constituency. If you and I and a million of our friends understand how economics has failed, if many in the media understand, and if people in Washington DC who are genuinely interested in good policy understand as well, then mainstream economics will have lost its constituency and it will have no choice but to begin the long process of trying to earn it back. It will have no choice but to face up to its failure and begin pursuing a true understanding of how the world works.

We can no longer afford to have economists wandering in a land of myth. We need to begin to sweep up the mess from our decades of folly. We need to begin the conversation about how economies really work. And we need to begin the conversation about what we, as a country, can do to build a better future with the raw materials we have been given.

Technical Notes:
Figures for US debt levels for 1945 through 2010 are based on Federal Reserve Board Flow of Funds data (Table L.1 - September 17, 2010 release). Figures for US debt levels for 1920 through 1944 are based on data presented by Paul Krugman (through his blog) and by Steve Keen (through his blog and publications). I believe both economists used the same source for their pre-1945 data (Historical Statistics for the United States).

Seasonal-adjustments for quarterly-changes in debt were applied to first-quarter debt creation for the period spanning 1954 through 2005.

Statements about Japanese debt levels are based on data presented by McKinsey Global Institute in their January 2010 study entitled Debt and Deleveraging: The Global Credit Bubble and Its Economic Consequences.