



the new road to serfdom

An illustrated guide to the coming real estate collapse

By Michael Hudson

Even men who were engaged in organizing debt-serf cultivation and debt-serf industrialism in the American cotton districts, in the old rubber plantations, and in the factories of India, China, and South Italy, appeared as generous supporters of and subscribers to the sacred cause of individual liberty.

—H. G. Wells, *The Shape of Things to Come*

Never before have so many Americans gone so deeply into debt so willingly. Housing prices have swollen to the point that we've taken to calling a mortgage—by far the largest debt most of us will ever incur—an “investment.” Sure, the thinking goes, \$100,000 borrowed today will cost more than \$200,000 to pay back over the next thirty years, but land, which they are not making any more of, will appreciate even faster. In the odd logic of the real estate bubble, debt has come to equal wealth.

And not only wealth but *freedom*—an even stranger paradox. After all, debt throughout most of history has been little more than a slight variation on slavery. Debtors were medieval peons or Indians bonded to Spanish plantations or the sharecropping children of slaves in the postbellum South. Few Americans today would volunteer for such an arrangement, and therefore would-be lords and barons have been forced to develop more sophisticated enticements.

The solution they found is brilliant, and although it is complex, it can be reduced to a single word—*rent*. Not the rent that apartment dwellers

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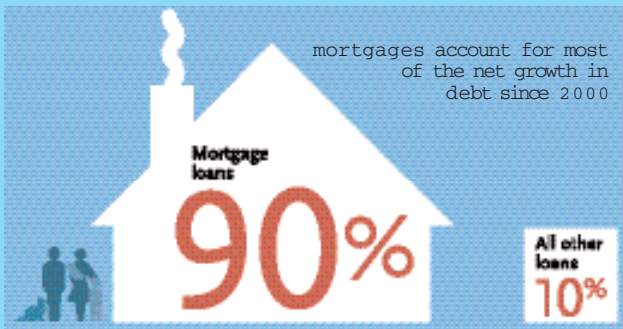
Nigel Holmes was the graphics director of Time magazine for sixteen years and is the author of Wordless Diagrams.

pay the landlord but economic rent, which is the profit one earns simply by owning something. Economic rent can take the form of licensing fees for the radio spectrum, interest on a savings account, dividends from a stock, or the capital gain from selling a home or vacant lot. The distinguishing characteristic of economic rent is that earning it requires no effort whatsoever. Indeed, the regular rent tenants pay landlords becomes economic rent only after subtracting whatever amount the landlord actually spent to keep the place standing.

Most members of the rentier class are very rich. One might like to join that class. And so our paradox (seemingly) is resolved. With the real estate boom, the great mass of Americans can take on colossal debt today and realize colossal capital gains—and the concomitant rentier life of leisure—tomorrow. If you have the wherewithal to fill out a mortgage application, then you need never work again. What could be more inviting—or, for that matter, more egalitarian?

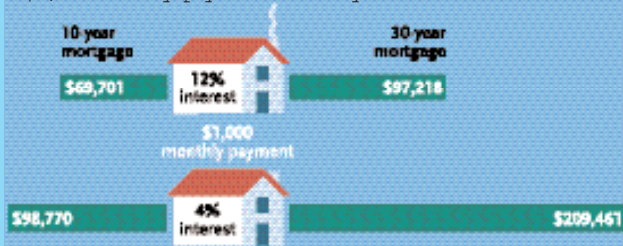
That's the pitch, anyway. The reality is that, although home ownership may be a wise choice for many people, this particular real estate bubble has been carefully engineered to lure home buyers into circumstances detrimental to their own best interests. The bait is easy money. The trap is a modern equivalent to peonage, a lifetime spent working to pay off debt on an asset of rapidly dwindling value.

Most everyone involved in the real estate bubble thus far has made at least a few dollars. But that is about to change. The bubble will burst, and when it does, the people who thought they would be living the easy life of a landlord will soon find that what they really signed up for was the hard servitude of debt serfdom.



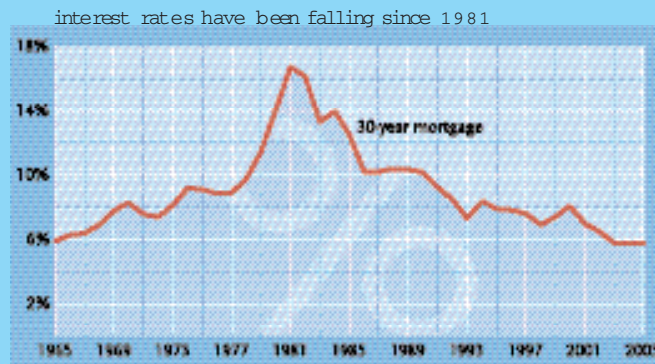
1 The new road to serfdom begins with a loan. Since 2003, mortgages have made up more than half of the total bank loans in America—more than \$300 billion in 2005 alone. Without that growing demand, banks would have seen almost no net loan growth in recent years.

a \$1,000 monthly payment can carry different levels of debt

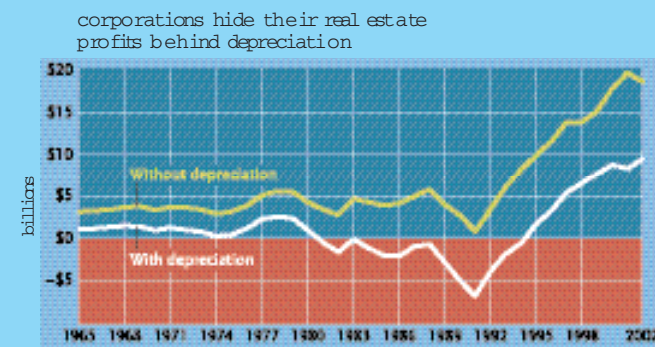


2 Why is the demand for mortgage debt so high? There are several reasons, but all of them have to do with the fact that banks encourage people to think of mortgage debt in terms of how much they can afford to pay in a given month—how far they can stretch their paychecks—rather than in terms of the total amount of the loan. A given monthly payment can carry radically different amounts of debt, depending on the rate of interest and how long those payments last. The purchasing power of a \$1,000 monthly payment, for instance, nearly triples as the debt lingers and the interest rate declines.

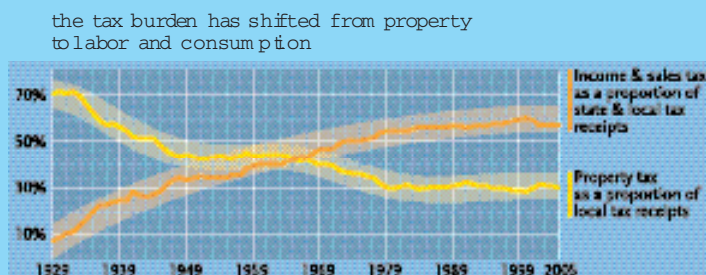
3 As it happens, banks are increasingly un- hurried about repayment. Nearly half the people buying their first homes last year were allowed to do so with no money down, and many of them took out so-called interest-only loans, for which payment of the actual debt—amortization—was delayed by several years. A few even took on “negative amortization” loans, which dis- pense entirely with payments on the principal and require only partial payment of the interest it- self. (The extra interest owed is simply added to the total debt, which can grow indefinitely.) The Federal Reserve, meanwhile, has been pushing interest rates down for more than two decades.



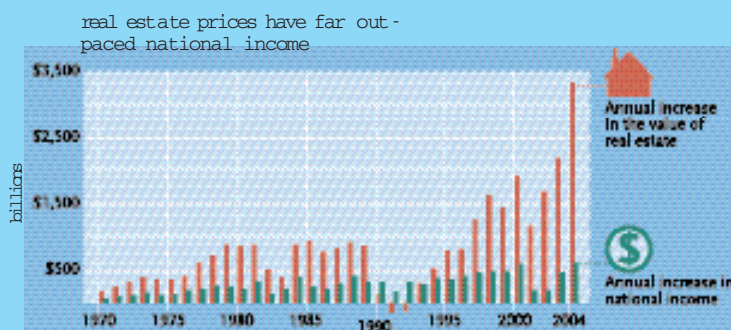
4 The IRS has helped create demand for debt as well by allowing tax breaks—the well-known home-mortgage deduction, for instance—that can transform a loan into an attractive tax shelter. Indeed, commercial real estate investors hide most of their economic rent in “depreciation” write-offs for their build- ings, even as those buildings *gain* market value. The pretense is that buildings wear out or be- come obsolete just like any other industrial invest- ment. The reality is that buildings can be depreciated again and again, even as the prop- erty’s market value increases.



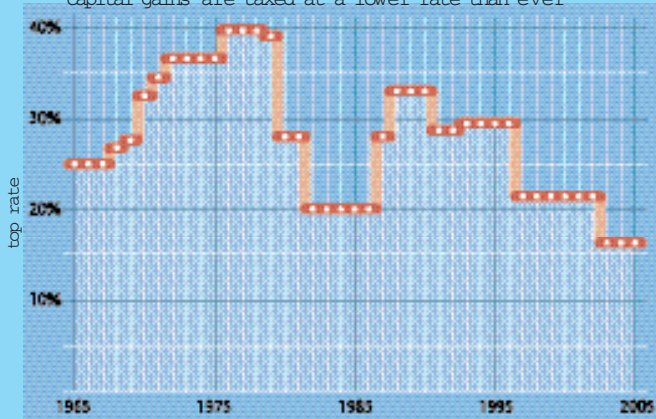
5 Local and state governments have done their share too, by shifting the tax bur- den from property to labor and consumption, in the form of income and sales taxes. Since 1929, the proportion of tax burden has almost completely reversed itself.



6 In recent years, though, the biggest in- centive to home ownership has not been owning a home per se, or even avoiding taxes, but rather the eternal hope of getting ahead. If the price of a \$200,000 house shoots up 15 percent in a given year, the owner will realize a \$30,000 capital gain. Many such owners are spending tomorrow’s capital gain today by tak- ing out home-equity loans. For families whose real wages are stagnant or falling, borrowing against higher property prices seems almost like taking money from a bank account that has earned dividends. In a study last year, Alan Greenspan and James Kennedy found that new home-equity loans added \$200 billion to the U.S. economy in 2004 alone.

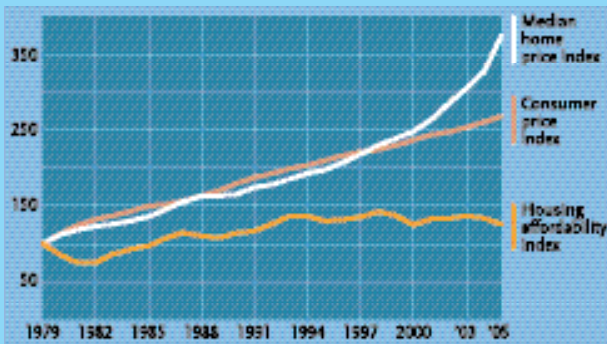


capital gains are taxed at a lower rate than ever



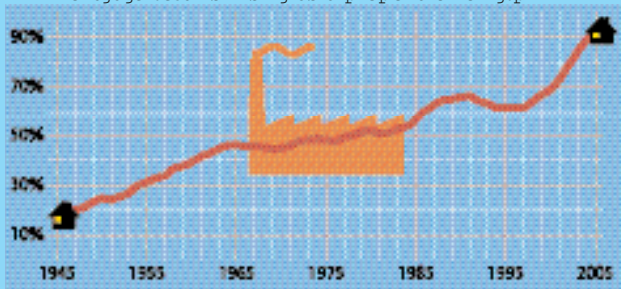
It is also worth noting that capital gains—economic rent “earned” without any actual labor or industrial investment—are increasingly untaxed.

housing prices have far outpaced consumer prices, even as monthly payments remain affordable



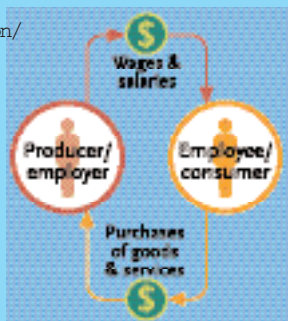
All of these factors have combined to lure record numbers of buyers into the real estate market, and home prices are climbing accordingly. The median price of a home has more than doubled in the last decade, from \$109,000 in 1995 to a peak of more than \$206,000 in 2005. That growth far outpaces the consumer price index, and yet housing affordability—the measure of those month-to-month housing costs—has remained about the same.

mortgage debt is rising as a proportion of gdp



That sounds like good news. But those rising prices also mean that more people owe more money to banks than at any other time in history. And that’s not just in terms of dollars—\$11.8 trillion in outstanding mortgages—but also as a proportion of the national economy. This debt is now on track to surpass the size of America’s entire gross domestic product by the end of the decade.

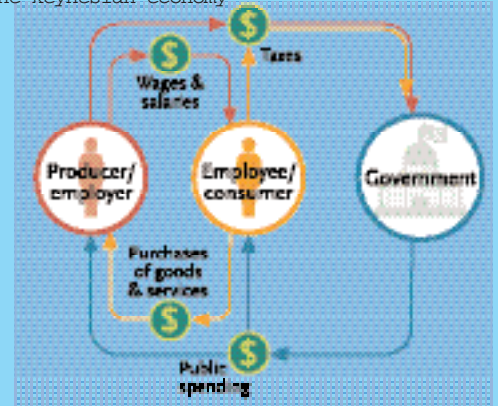
the production/consumption economy



Even that huge debt might not seem so bad, what with those huge capital gains beckoning from out there in the future. But the boom, alas, cannot last forever. And when the growth ceases, the market will collapse. Understanding why, though, requires a quick detour into economic theory. We often think of “the economy” as no more than a closed loop between producers and consumers. Employers hire workers, the workers create goods and services, the employers pay them, and the workers use that money to buy the goods and services they created.

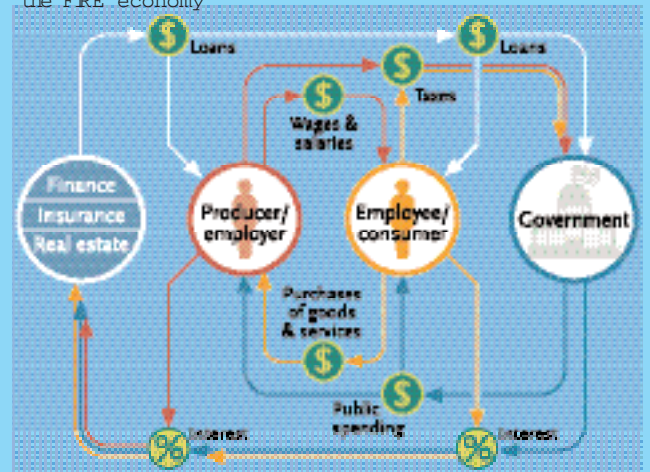
1 As we have seen, though, the government also plays a significant role in the economy. Tax hikes drain cash from the circular flow of payments between producers and consumers, slowing down overheated economies. Deficit spending pumps more income into that flow, helping pull stalled economies out of recession. This is the classical policy model associated with John Maynard Keynes.

the keynesian economy



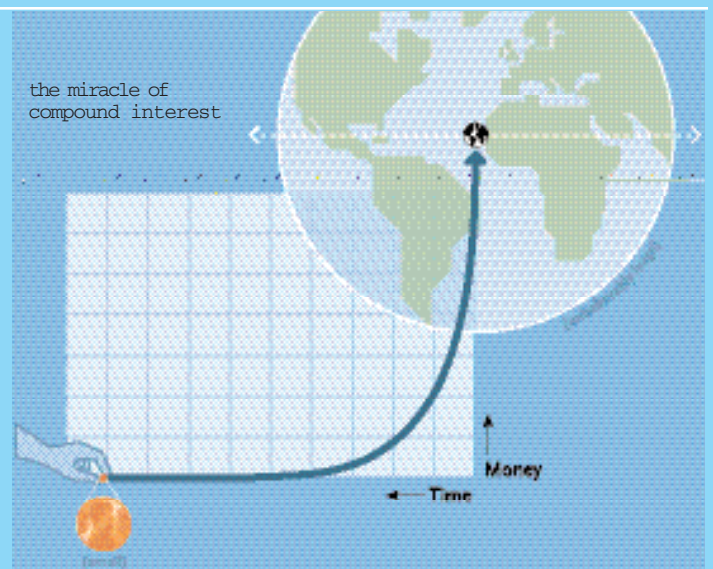
1 A third actor also influences the nation's fortune. Economists call it the FIRE sector, short for finance, insurance, and real estate. These industries are so symbiotic that the Commerce Department reports their earnings as a composite. (Banks require mortgage holders to insure their properties even as the banks reach out to absorb insurance companies. Meanwhile, real estate companies are organizing themselves as stock companies in the form of real estate investment trusts, or REITs—which in turn are underwritten by investment bankers.) The main product of these industries is credit. The FIRE sector pumps credit into the economy even as it withdraws interest and other charges.

the FIRE economy

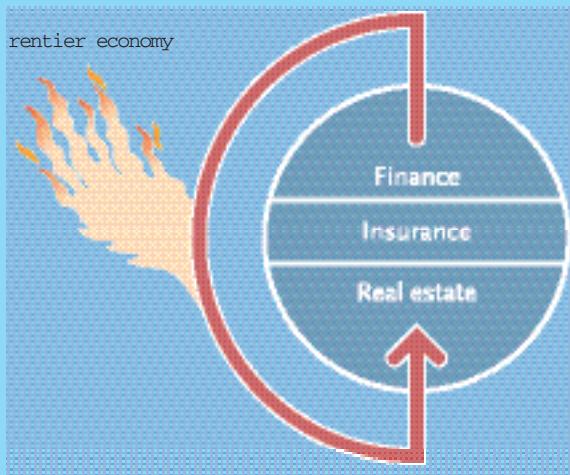


1 The FIRE sector has two significant advantages over the production/consumption and government sectors. The first is that interest wealth grows exponentially. That means that as interest compounds over time, the debt doubles and then doubles again. The eighteenth-century philosopher Richard Price identified this miracle of compound interest and observed, somewhat ruefully, that had he been able to go back to the day Jesus was born and save a single penny—at 5 percent interest, compounded annually—he would have earned himself a solid gold sphere 150 million times bigger than Earth.

the miracle of compound interest

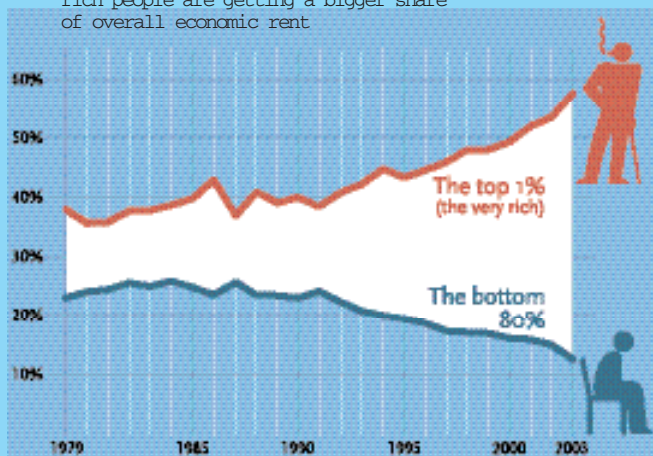


the rentier economy



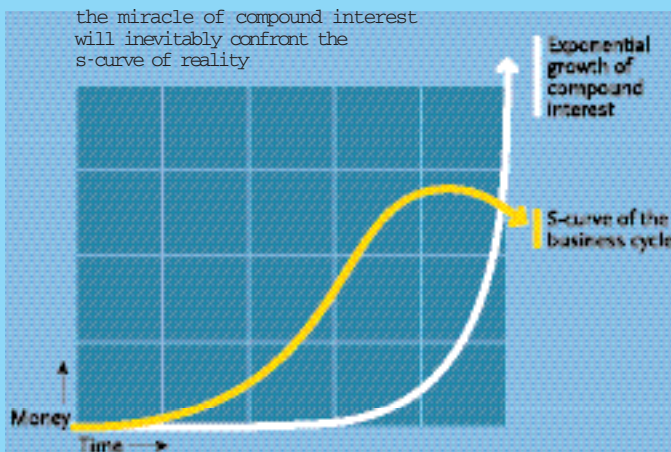
1 The FIRE sector's other advantage is that interest payments can quickly be recycled into more debt. The more interest paid, the more banks lend. And those new loans in turn can further drive up demand for real estate—thereby allowing homeowners to take out even *more* loans in anticipation of future capital gains. Some call this perpetual-motion machine a “post-industrial economy,” but it might more accurately be called a rentier economy. The dream is that the FIRE sector will expand to embrace the fortune of every American—that we need not work or produce anything, or, for that matter, invest in new technology or infrastructure for the nation. We certainly need not pay taxes. We need only participate in the boom itself. The miracle of compound interest will allow every one of us to be a rentier, feasting on interest, dividends, and capital gains.

rich people are getting a bigger share of overall economic rent



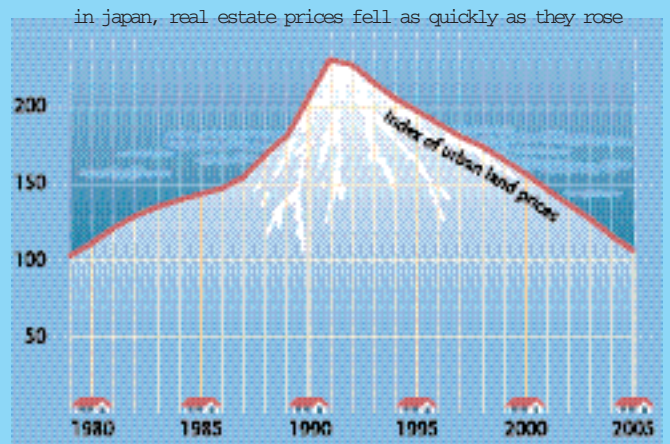
1 In reality, alas, we can't all be rentiers. Just as, in Voltaire's phrase, the rich require an abundant supply of the poor, so too does the rentier class require an abundant supply of debtors. There is no other way. In fact, the vast majority of Americans have seen their share of the rental pie *decrease* over the last two decades, even as the real estate pie as a whole has expanded. Everyone got a little richer, but rich people got much, much richer.

the miracle of compound interest will inevitably confront the s-curve of reality

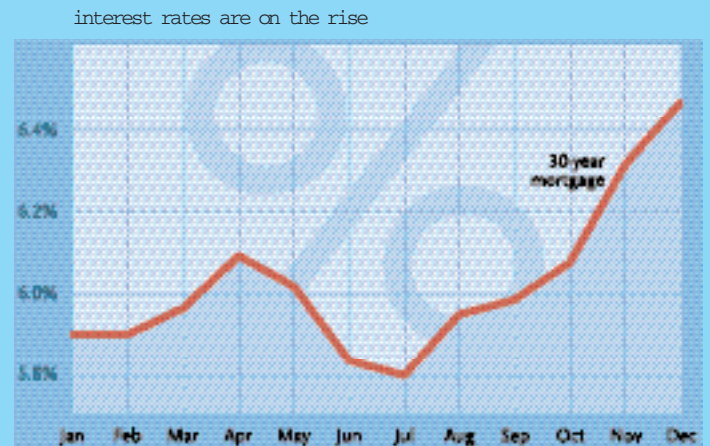


1 We will be hard-pressed to maintain even this semi-blissful state. Like any living organism, real economies don't grow exponentially, or even in a straight line. They taper off into an S-curve, the victim of their own successes. When business is good, the demand for labor, raw materials, and credit increases, which leads to large jumps in wages, prices, and interest rates, which in turn act to depress the economy. That is where the miracle of compound interest founders. Although many people did save money at interest two thousand years ago, nobody has yet obtained even a single Earth-volume of gold. The reason is that when a business cycle turns down, debtors cannot pay, and so their debts are wiped out in a wave of bankruptcy along with all the savings invested in these bad loans.

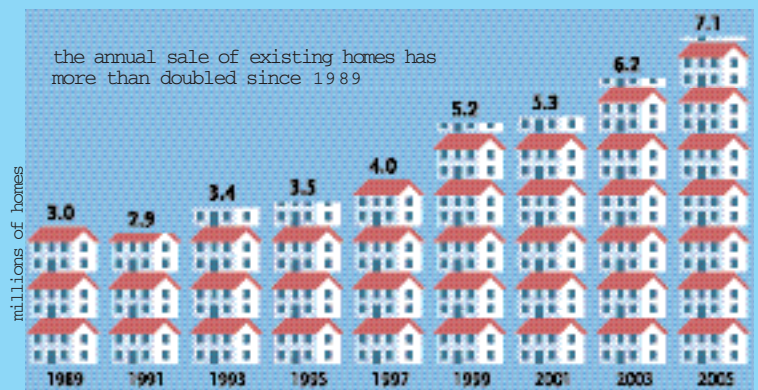
1 Japan learned this lesson in the Nineties. As the price of land went up, banks lent more money than people could afford to pay interest on. Eventually, no one could afford to buy any more land, demand fell off, and prices dropped accordingly. But the debt remained in place. People owed billions of yen on homes worth half that—homes they could not sell. Many commercial owners simply went into foreclosure, leaving the banks not only with “non-performing loans” that were in fact dead losses but also with houses no one wanted—or could afford—to buy. And that lack of incoming interest also meant that banks had no more reserves to lend, which furthered the downward spiral. Britain’s similarly debt-burdened economy inspired a dry witticism: “Sorry you lost your job. I hope you made a killing on your house.”

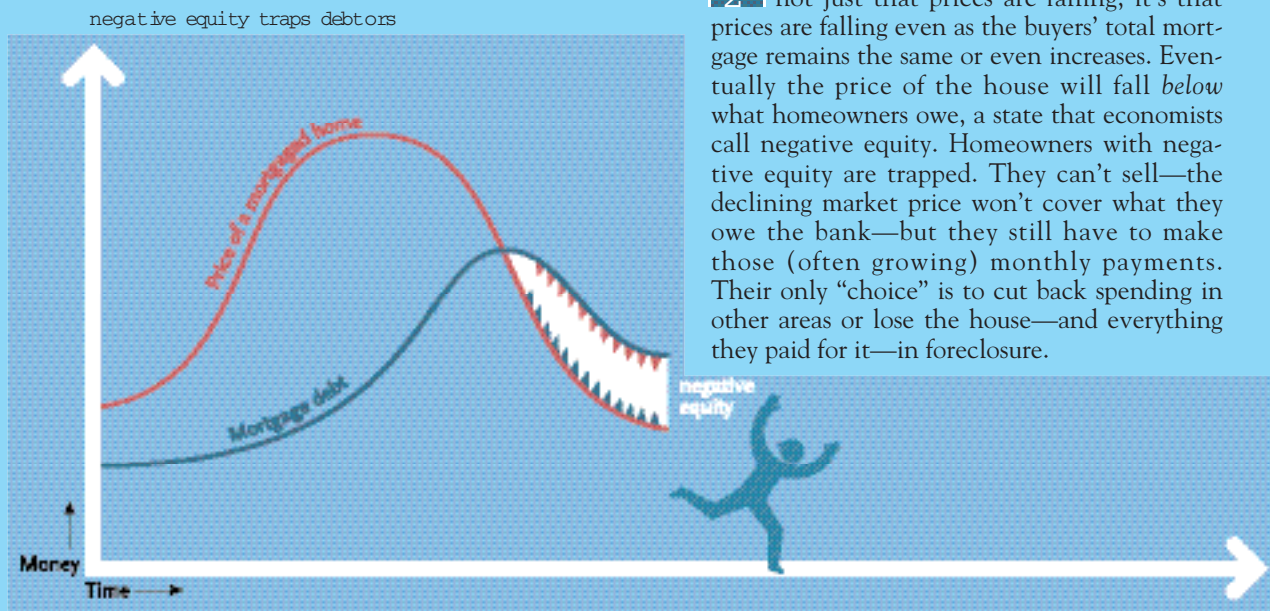


1 We have already reached our own peak. As of last fall, even Alan Greenspan had detected “signs of froth” in the housing market. Home prices had “risen to unsustainable levels” in some places, he said, and would have exceeded the reach of many Americans long ago if not for “the dramatic increase in the prevalence of interest-only loans” and “other, more exotic forms of adjustable-rate mortgages” that “enable marginally qualified, highly leveraged borrowers to purchase homes at inflated prices.” If the trend continues, homeowners and banks alike “could be exposed to significant losses.” Interest rates, meanwhile, have begun to creep up.



1 So: America holds record mortgage debt in a declining housing market. Even *that* at first might seem okay—we can just weather the storm in our nice new houses. And in fact things *will* be okay for homeowners who bought long ago and have seen the price of their homes double and then double again. But for more recent homebuyers, who bought at the top and who now face decades of payments on houses that soon will be worth less than they paid for them, serious trouble is brewing. And they are not an insignificant bunch.





2 The problem for recent homebuyers is not just that prices are falling; it's that prices are falling even as the buyers' total mortgage remains the same or even increases. Eventually the price of the house will fall *below* what homeowners owe, a state that economists call negative equity. Homeowners with negative equity are trapped. They can't sell—the declining market price won't cover what they owe the bank—but they still have to make those (often growing) monthly payments. Their only “choice” is to cut back spending in other areas or lose the house—and everything they paid for it—in foreclosure.

Free markets are based on choice. But more and more homeowners are discovering that what they got for their money is fewer and fewer choices. A real estate boom that began with the promise of “economic freedom” almost certainly will end with a growing number of workers locked in to a lifetime of debt service that absorbs every spare penny. Indeed, a study by The Conference Board found that the proportion of households with any discretionary income whatsoever had already declined between 1997 and 2002, from 53 percent to 52 percent. Rising interest rates, rising fuel costs, and declining wages will only tighten the squeeze on debtors.

But homeowners are not the only ones who will pay. The overall economy likely will shrink as well. That \$200 billion that flowed into the “real” economy in 2004 is already spent, with no future capital gains in the works to fuel more such easy money. Rising debt-service payments will further divert income from new consumer spending. Taken together, these factors will further shrink the “real” economy, drive down those already declining real wages, and push our debt-ridden economy into Japan-style stagnation or worse.

Then only the debt itself will remain, a bitter monument to our love of easy freedom.

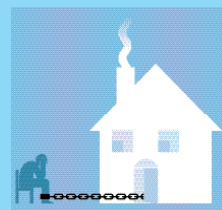


Chart Sources

1 Federal Reserve; 2 Lendingtree.com mortgage calculator; 3 Freddie Mac; 4,5 Bureau of Economic Analysis; 6 Federal Reserve and Bureau of Economic Analysis; 7 U.S. Treasury Department; 8 Moody's Economy.com and Bureau of Labor Statistics; 9 Federal Reserve and Bureau of Economic Analysis; 15 Center on Budget and Policy Priorities; 17 Japan Real Estate Institute; 18 Federal Housing Finance Board; 19 National Association of Realtors.