



## Working Paper No. 639

---

# US “Quantitative Easing” Is Fracturing the Global Economy \*

by

**Michael Hudson**

Levy Economics Institute of Bard College

**November 2010**

---

\* Paper presented at the 14th Conference of the Research Network Macroeconomics and Macroeconomic Policies, “Stabilising an Unequal Economy? Public Debt, Financial Regulation, and Income Distribution,” Hans Böckler Stiftung, Berlin, Germany, October 29–30.

---

The Levy Economics Institute Working Paper Collection presents research in progress by Levy Institute scholars and conference participants. The purpose of the series is to disseminate ideas to and elicit comments from academics and professionals.

Levy Economics Institute of Bard College, founded in 1986, is a nonprofit, nonpartisan, independently funded research organization devoted to public service. Through scholarship and economic research it generates viable, effective public policy responses to important economic problems that profoundly affect the quality of life in the United States and abroad.

Levy Economics Institute  
P.O. Box 5000  
Annandale-on-Hudson, NY 12504-5000  
<http://www.levyinstitute.org>

Copyright © Levy Economics Institute 2010 All rights reserved

## **ABSTRACT**

The Federal Reserve's quantitative easing is presented as injecting \$600 billion into "the economy." But instead of getting banks lending to Americans again—households and firms—the money is going abroad, through arbitrage interest-rate speculation, currency speculation, and capital flight. No wonder foreign economies are protesting, as their currencies are being pushed up.

**Keywords:** Exchange Rates; Asset-price Inflation; Monetary Policy

**JEL Classifications:** E50, E58, F34, F42, G12

Moreover, it may well be asked whether we can take it for granted that a return to freedom of exchanges is really a question of time. Even if the reply were in the affirmative, it is safe to assume that after a period of freedom the regime of control will be restored as a result of the next economic crisis.

—Paul Einzig, *Exchange Control* (1934)<sup>1</sup>

Great structural changes in world trade and finance occur quickly—by quantum leaps, not by slow marginal accretions. The 1945–2010 era of relatively open trade, capital movements, and foreign exchange markets is being destroyed by a predatory financial opportunism that is breaking the world economy into two spheres: a dollar sphere in which central banks in Europe, Japan, and many OPEC and third world countries hold their reserves the form of US Treasury debt of declining foreign-exchange value; and a BRIC-centered sphere, led by China, India, Brazil, and Russia, reaching out to include Turkey and Iran, most of Asia, and major raw materials exporters that are running trade surpluses.

What is reversing trends that seemed irreversible for the past 65 years is the manner in which the United States has dealt with its bad-debt crisis. The Federal Reserve and Treasury are seeking to inflate the economy out of debt with an explosion of bank liquidity and credit—which means yet more debt. This is occurring largely at other countries' expense, in a way that is flooding the global economy with electronic “keyboard” bank credit while the US balance-of-payments deficit widens and US official debt soars beyond any foreseeable means to pay. The dollar's exchange rate is plunging, and US money managers themselves are leading a capital flight out of the domestic economy to buy up foreign currencies and bonds, gold, and other raw materials, stocks, and entire companies with cheap dollar credit.

This outflow from the dollar is not the kind of capital that takes the form of tangible investment in plant and equipment, buildings, research, and development. It is not a creation of assets as much as the creation of debt, and its multiplication by mirroring, credit insurance, default swaps, and an array of computerized forward

---

<sup>1</sup> Paper presented at the Boeckler Foundation meetings in Berlin, October 30, 2010. I am indebted to Eric Janszen of i-tulip for bringing the Einzig quote to my attention.

trades. The global financial system has decoupled from trade and investment, taking on a life of its own.

In fact, financial conquest is seeking today what military conquest did in times past: control of land and basic infrastructure, industry and mining, banking systems and even government finances to extract the economic surplus as interest and tollbooth-type economic rent charges. US officials euphemize this policy as “quantitative easing.” The Federal Reserve is flooding the banking system with so much liquidity that Treasury bills now yield less than 1% and banks can draw freely on Fed credit. Japanese banks have seen yen borrowing rates fall to 0.25%.

This policy is based on the wrong-headed idea that if the Fed provides liquidity, banks will take the opportunity to lend out credit at a markup, “earning their way out of debt”—inflating the economy in the process. And when the Fed talks about “the economy,” it means asset markets—above all for real estate, as some 80% of bank loans in the United States are mortgage loans.

One-third of US real estate is now reported to be in negative equity, as market prices have fallen behind mortgage debts. This is bad news not only for homeowners but also for their bankers, as the collateral for their mortgage loans does not cover the principal. Homeowners are walking away from their homes, and the real estate market is so thoroughly plagued with a decade of deception and outright criminal fraud that property titles themselves are losing security. And despite FBI findings that financial fraud is found in over three-quarters of the packaged mortgages they have examined, the Obama Justice Department has not sent a single banker to jail.

Instead, the financial crooks have been placed in charge—and they are using their power over government to promote their own predatory gains, having disabled US public regulatory agencies and the criminal justice system to create a new kind of centrally planned economy in the hands of banks. As Joseph Stiglitz recently observed:

In the years prior to the breaking of the bubble, the financial industry was engaged in predatory lending practices, deceptive practices. They were optimizing not in producing mortgages that were good for the American families but in maximizing fees and exploiting and predatory lending. Going and targeting the least educated, the Americans that were most easy to prey on.

We've had this well documented. And there was the tip of the iceberg that even in those years the FBI was identifying fraud. When they see fraud, it's really fraud. But beneath that surface, there were practices that really should have been outlawed if they weren't illegal.

... the banks used their political power to make sure they could get away with this [and] ... that they could continue engaging in these kinds of predatory behaviors. ... there's no principle. It's money. It's campaign contributions, lobbying, revolving door, all of those kinds of things.

... it's like theft ... A good example of that might be [former Countrywide CEO] Angelo Mozillo, who recently paid tens of millions of dollars in fines, a small fraction of what he actually earned, because he earned hundreds of millions.

The system is designed to actually encourage that kind of thing, even with the fines. ... we fine them, and what is the big lesson? Behave badly, and the government might take 5% or 10% of what you got in your ill-gotten gains, but you're still sitting home pretty with your several hundred million dollars that you have left over after paying fines that look very large by ordinary standards but look small compared to the amount that you've been able to cash in.

The fine is just a cost of doing business. It's like a parking fine. Sometimes you make a decision to park knowing that you might get a fine because going around the corner to the parking lot takes you too much time.

I think we ought to go do what we did in the S&L [crisis] and actually put many of these guys in prison. Absolutely. These are not just white-collar crimes or little accidents. There were victims. That's the point. There were victims all over the world. ... the financial sector really brought down the global economy and if you include all of that collateral damage, it's really already in the trillions of dollars.<sup>2</sup>

This victimization of the international financial system is a consequence of the US Government's attempt to bail out the banks by reinflating US real estate, stock, and bond markets at least to their former Bubble Economy levels. This is what US economic policy and even its foreign policy is now all about, including decriminalizing financial fraud. As Treasury Secretary Tim Geithner tried to defend this policy:

---

<sup>2</sup> "Stiglitz Calls for Jail Time for Corporate Crooks," DailyFinance: <http://srph.it/aRwI4I>, October 21, 2010.

Americans were rightfully angry that the same firms that helped create the economic crisis got taxpayer support to keep their doors open. But the program was essential to averting a second Great Depression, stabilizing a collapsing financial system, protecting the savings of Americans [or more to the point, he means, their indebtedness] and restoring the flow of credit that is the oxygen of the economy.<sup>3</sup>

Other economists might find a more fitting analogy to be carbon dioxide and debt pollution. “Restoring the flow of credit” is simply a euphemism for keeping the existing, historically high debt levels in place rather than writing them down—and indeed, adding yet more debt (“credit”) to enable homebuyers, stock market investors, and others to use yet more debt leverage to bid asset prices back up to rescue the banking system from the negative equity into which it has fallen. That is what Mr. Geithner means by “stabilizing a collapsing financial system”—bailing banks out of their bad loans and making all the counterparties of AIG’s fatal financial gambles whole at 100 cents on the dollar.

The Fed theorizes that if it provides nearly free liquidity in unlimited amounts, banks will lend it out at a markup to “reflate” the economy. The “recovery” that is envisioned is one of new debt creation. This would rescue the biggest and most risk-taking banks from their negative equity, by pulling homeowners out of *theirs*. Housing prices could begin to soar again.

But the hoped-for new borrowing is not occurring. Instead of lending more—at least, lending at home—banks have been tightening their loan standards rather than lending more to US homeowners, consumers, and businesses since 2007. This has obliged debtors to start paying off the debts they earlier ran up. The US saving rate has risen from zero three years ago to 3% today—mainly in the form of amortization to pay down credit-card debt, mortgage debt, and other bank loans.

Instead of lending domestically, banks are sending the Fed’s tsunami of credit abroad, flooding world currency markets with cheap US “keyboard credit.” The Fed’s plan is like that of the Bank of Japan after its bubble burst in 1990: the hope is that lending to speculators will enable banks to earn their way out of debt. So US banks are engaging in interest-rate arbitrage (the carry trade), currency speculation, commodity

---

<sup>3</sup> Tim Geithner, “Five Myths about TARP,” *Washington Post*, October 10, 2010.

speculation (driving up food and mineral prices sharply this year), and buying into companies in Asia and raw materials exporters.

By forcing up targeted currencies against the dollar, this US outflow into foreign exchange speculation and asset buy-outs is financial aggression. And to add insult to injury, Mr. Geithner is accusing China of “competitive non-appreciation.” This is a euphemistic term of invective for economies seeking to maintain currency stability. It makes about as much sense as to say “aggressive self-defense.” China’s interest, of course, is to avoid taking a loss on its dollar holdings and export contracts denominated in dollars (as valued in its own domestic renminbi).

Countries on the receiving end of this US financial conquest (“restoring stability” is how US officials characterize it) understandably are seeking to protect themselves. Ultimately, the only serious way to do this is to erect a wall of capital controls to block foreign speculators from deranging currency and financial markets.

Changing the international financial system is by no means easy. How much of alternative do countries have, Martin Wolf recently asked. “To put it crudely,” he wrote:

[T]he US wants to inflate the rest of the world, while the latter is trying to deflate the US. The US must win, since it has infinite ammunition: there is no limit to the dollars the Federal Reserve can create. What needs to be discussed is the terms of the world’s surrender: the needed changes in nominal exchange rates and domestic policies around the world.<sup>4</sup>

Mr. Wolf cites New York Federal Reserve chairman William C. Dudley to the effect that quantitative easing is primarily an attempt to deal with the mortgage crisis that capped a decade of bad loans and financial gambles. Economic recovery, the banker explained on October 1, 2010, “has been delayed because households have been paying down their debt—a process known as deleveraging.” In his view, the US economy cannot recover without a renewed debt leveraging to reinflate the housing market.

By the “US economy” and “recovery,” to be sure, Mr. Dudley means his own constituency—the banking system—and specifically the largest banks that gambled the

---

<sup>4</sup> Martin Wolf, “Why America is going to win the global currency battle,” *Financial Times*, October 13, 2010.

most on the real estate bubble of 2003–08. He acknowledges that the bubble “was fueled by products and practices in the financial sector that led to a rapid and unsustainable buildup of leverage and an underpricing of risk during this period,” and that household debt has risen “faster than income growth ... since the 1950s.” But this debt explosion was justified by the “surge in home prices [that] pushed up the ratio of household net worth to disposable personal income to nearly 640%.” Instead of saving, most Americans borrowed as much as they could to buy property they expected to rise in price. For really the first time in history an entire population sought to get rich by running to debt (to buy real estate, stocks, and bonds), not by staying out of it.

But now that asset prices have plunged, people are left in debt. The problem is what to do about it. Disagreeing with critics who “argue that the decline in the household debt-to-income ratio must go much further before the deleveraging process can be complete,” or who even urge “that household debt-to-income ratios must fall back to the level of the 1980s,” Mr. Dudley retorts that the economy must inflate its way out of the debt corner into which it has painted itself. “First, low and declining inflation makes it harder to accomplish needed balance sheet adjustments.” In other words, credit (debt) is needed to bid real estate prices back up. A lower rather than higher inflation rate would mean “slower nominal income growth. Slower nominal income growth, in turn, means that less of the needed adjustment in household debt-to-income ratios will come from rising incomes. This puts more of the adjustment burden on paying down debt.” And it is debt deflation that is plaguing the economy, so the problem is how to reflate (asset) prices.

(1) How much would the Fed have to purchase to have a given impact on the level of long-term interest rates and economic activity, and, (2) what constraints exist in terms of limits to balance-sheet expansion, and what are the costs involved that could impede efforts to meet the dual mandate now or in the future?<sup>5</sup>

---

<sup>5</sup> William C. Dudley, “The Outlook, Policy Choices and Our Mandate,” Remarks at the Society of American Business Editors and Writers Fall Conference, City University of New York, Graduate School of Journalism, New York City, October 1, 2010. <http://www.zerohedge.com/article/why-imf-meetings-failed-and-coming-capital-controls>.



On October 15, 2010, Fed Chairman Ben Bernanke explained that he wanted the Fed to encourage inflation—his of program of quantitative easing (QE)—and acknowledged that this would drive down the dollar against foreign currencies. Flooding the US banking system with liquidity will lower interest rates, increasing the capitalization rate of real estate rents and corporate income. This will reflate asset prices—by creating yet more debt in the process of rescuing banks from negative equity by pulling homeowners out of *their* negative equity. But internationally, this policy means that foreign central banks receive less than 1% on the international reserves they hold in Treasury securities—while US investors are making much higher returns by borrowing “cheap dollars” to buy Australian, Asian, and European government bonds, corporate securities, and speculating in foreign exchange and commodity markets.

Mr. Bernanke proposes to solve this problem by injecting another \$1 trillion of liquidity over the coming year, on top of the \$2 trillion in new Federal Reserve credit already created during 2009–10. The pretense is that bailing Wall Street banks out of their losses is a precondition for reviving employment and consumer spending—as if the giveaway to the financial sector will get the economy moving again.

The working assumption is that if the Fed provides liquidity, banks will lend it out at a markup. At least this is the dream of bank loan officers. The Fed will help them keep the debt overhead in place, not write it down. But as noted above, the US market is “loaned up.” Borrowing by homeowners, businesses, and individuals is shrinking. Unemployment is rising, stores are closing, and the economy is succumbing to debt deflation. But most serious of all, the QE II program has a number of consequences that Federal Reserve policymakers have not acknowledged. For one thing, the banks have used the Federal Reserve and Treasury bailouts and liquidity to increase their profits and to continue paying high salaries and bonuses. What their lending is inflating are asset prices, not commodity prices (or output and employment). And asset-price inflation is increasing the power of property over living labor and production, elevating the FIRE sector further over the “real” economy.

These problems are topped by the international repercussions that Mr. Dudley referred to as the “limits to balance-of-payments expansion.” Cheap electronic US “keyboard credit” is going abroad as banks try to earn their way out of debt by

financing arbitrage gambles, glutting currency markets while depreciating the US dollar. So the upshot of the Fed trying save the banks from negative equity is to flood the global economy with a glut of US dollar credit, destabilizing the global financial system.

## **CAN FOREIGN ECONOMIES RESCUE THE US BANKING SYSTEM?**

The international economy's role is envisioned as a *deus ex machina* to rescue the economy. Foreign countries are to serve as markets for a resurgence of US industrial exports (and at least arms sales are taking off to India and Saudi Arabia), and most of all as financial markets for US banks and speculators to make money at the expense of foreign central banks trying to stabilize their currencies.

The Fed believes that debt levels can rise and become more solvent if US employment increases by producing more exports. The way to achieve this is presumably to depreciate the dollar—the kind of “beggar-my-neighbor” policy that marked the 1930s. Devaluation will be achieved by flooding currency markets with dollars, providing the kind of zigzagging opportunities that are heaven-sent for computerized currency trading, short selling, and kindred financial options.

Such speculation is a zero-sum game. Someone must lose. If quantitative easing is to help US banks earn their way out of negative equity, by definition their gains must be at the expense of foreigners. This is what makes QE II a form of financial aggression.

This is destructive of the global currency stability that is a precondition for stable long-term trade relationships. Its underlying assumptions also happen to be based on junk economics. For starters, it assumes that international prices are based on relative price levels for goods and services. But only about a third of US wages are spent on commodities. Most is spent on payments to the finance, insurance, and real estate (FIRE) sector and on taxes. Housing and debt service typically absorb 40% and 15% of wage income respectively. FICA wage withholding for Social Security and Medicare taxes absorb 11%, and income and sales taxes another 15 to 20%. So before take-home pay is available for consumer spending on goods and services, these FIRE-sector

charges make the cost of living so high as to render American industrial labor uncompetitive in world markets. No wonder the US economy faces a chronic trade deficit!

The FIRE sector overhead has become structural, not merely a marginal problem. To restore its competitive industrial position, the United States would have to devalue by much more than the 40% that it did back in 1933. Trying to “inflate its way out of debt” may help bank balance sheets recover, but as long as the economy remains locked in debt deflation it will be unable to produce the traditional form of economic surplus needed for genuine recovery. A debt write-down would be preferable to the policy of keeping the debts on the books and distorting the US economy with inflation—and engaging in financial aggression against foreign economies. The political problem, of course, is that the financial sector has taken control of US economic planning—in its own self-interest, not that of the economy at large. A debt write-down would threaten the financial sector’s creditor power over the economy.

So it is up to foreign economies to enable US banks to earn their way out of negative equity. For starters, there is the carry trade based on interest-rate arbitrage—to borrow at 1%, lend at a higher interest rate, and pocket the margin (after hedging the currency shift). Most of this financial outflow is going to China and other Asian countries, and to raw materials exporters. Australia, for example, has been raising its interest rates in order to slow its own real estate bubble. Rather than slowing speculation in its large cities by fiscal policy—a land tax—its central bank is operating on the principle that a property is worth whatever a bank will lend against it. Raising interest rates to the present 4.5% reduces the capitalization rate for property rents—and hence shrinks the supply of mortgage credit that has been bidding up Australian property prices.

This interest-rate policy has two unfortunate side effects for Australia—but a free lunch for foreign speculators. First of all, high interest rates raise the cost of borrowing across the board for doing business and for consumer finances. Second—even more important for the present discussion—high rates attract foreign “hot money” as speculators borrow at low interest in the United States (or Japan, for that matter) and buy high-yielding Australian government bonds.

The effect is to increase the Australian dollar's exchange rate, which recently has achieved parity with the US dollar. This upward valuation makes its industrial sector less competitive, and also squeezes profits in its mining sector. So on top of Australia's rising raw-materials exports, its policy to counter its real estate bubble is attracting foreign financial inflows, providing a free ride for international arbitrageurs. Over and above their interest-rate arbitrage gains is the foreign-currency play—rising exchange rates in Australia and many Asian countries as the US dollar glut swamps the ability of central banks to keep their exchange rates stable.

This foreign-currency play is where most of the speculative action is today, as speculators watching these purchases have turned the currencies and bonds of other raw-materials exporters into speculative vehicles. This currency speculation is the most aggressive, predatory, and destructive aspect of US financial behavior. Its focus is now shifting to the major nation that has resisted US attempts to force its currency up: China. The potentially largest prize for US and foreign speculators would be an upward revaluation of its renminbi.

The House Ways and Means Committee recently insisted that China raise its exchange rate by the 20% that the Treasury and Federal Reserve have suggested. Suppose that China would obey this demand. This would mean a bonanza for US speculators. A revaluation of this magnitude would enable them to put down 1% equity—say, \$1 million to borrow \$99 million—and buy Chinese renminbi forward. The revaluation being demanded would produce a 2000% profit of \$20 million by turning the \$100 million bet (and just \$1 million “serious money”) into \$120 million. Banks can trade on much larger, nearly infinitely leveraged margins.

### **CAN US BANKS CREATE ENOUGH ELECTRONIC “KEYBOARD CREDIT” TO BUY UP THE WHOLE WORLD?**

The Fed's QE II policy poses a logical question: Why can't US credit buy out the entire world economy—all the real estate, companies, and mineral rights yielding over 1%, with banks and their major customers pocketing the difference?

Under current arrangements, the dollars being pumped into the global economy are recycled back into US Treasury IOUs. When foreign sellers turn over their dollar receipts to their banks for domestic currency, these banks turn the payment over to the central bank—which then faces a Hobson’s Choice: either to sell the dollars on the foreign exchange market (pushing up their currency against the dollar), or avoid doing this by buying more US Treasury securities and thus keeping the dollar payment within the US economy. Why can’t this go on *ad infinitum*?

What makes these speculative capital inflows so unwelcome abroad is that they do not contribute to tangible capital formation or employment. Their effect is simply to push up foreign currencies against the dollar, threatening to price exporters out of global markets, disrupting domestic employment as well as trade patterns. These financial gambles are setting today’s exchange rates, not basic production costs.

In terms of relative rates of return, foreign central banks earn 1% on their US Treasury bonds, while US investors buy up the world’s assets. In effect, US diplomats are demanding that other nations relinquish their trade surpluses, private savings, and general economic surplus to US investors, creditors, bankers, speculators, arbitrageurs, and vulture funds in exchange for this 1% return on US dollar reserves of depreciating value—and indeed, in amounts already far beyond the foreseeable ability of the US economy to generate a balance-of-payments surplus to pay this debt to foreign governments.

The global economy is being turned into a tributary system, achieving what military conquest sought in times past. This turns out to be implicit in QE II. Arbitrageurs and speculators are swamping Asian and Third World currency markets with low-priced US dollar credit to make predatory trading profits at the expense of foreign central banks trying to stabilize their exchange rates by selling their currency for dollar-denominated securities—under conditions where the United States and Canada are blocking reciprocal direct investment (e.g., Potash Corp. of Saskatchewan in Canada and Unocal in the United States).

## THE ROAD TO CAPITAL CONTROLS

Hardly by surprise, other countries are taking defensive measures against this speculation, and against “free credit” takeovers using inexpensive US electronic “keyboard bank credit.” For the past few decades they have stabilized their exchange rates by recycling dollar inflows and other foreign currency buildups into US Treasury securities. The Bank of Japan, for instance, recently lowered its interest rate to just 0.1% in an attempt to induce its banks to lend back abroad the foreign exchange that is now coming in as its banks are being repaid on their own carry-trade loans. It also offset the repayment of past carry-trade loans extended by its own banks in yen by selling \$60 billion of yen and buying US Treasury securities, of which it now owns over \$1 trillion.

Foreign economies are now taking more active steps to shape “the market” in which international speculation occurs. The most modest move is to impose a withholding tax on interest payments to foreign investors. Just before the IMF meetings on October 9–10, 2010, Brazil doubled the tax on foreign investment in its government bond to 4%. Thailand acted along similar lines a week later. It stopped exempting foreign investors from having to pay the 15% interest-withholding tax on their purchases of its government bonds. Finance Minister Korn Chatikavinij warned that more serious measures are likely if “excessive” speculative inflows keep pushing up the baht. “We need to consider the rationality of capital inflows, whether they are for speculative purposes and how much they generate volatility in the baht,” he explained, but the currency continues to rise.

Such tax withholding discourages interest-rate arbitrage via the bond market, but leaves the foreign-currency play intact—and that is where the serious action is today. In the 1997 Asian Crisis, Malaysia blocked foreign purchases of its currency to prevent short-sellers from covering their bets by buying the ringgit at a lower price later, after having emptied out its central bank reserves. The blocks worked, and other countries are now reviewing how to impose such controls.

Longer-term institutional changes to more radically restructure the global financial system may include dual exchange rates such as were prevalent from the 1930 through the early 1960s, one (low and stable) for trade and at least one other (usually

higher and more fluctuating) for capital movements. But the most decisive counter-strategy to US QE II policy is to create a full-fledged BRIC-centered currency bloc that would minimize use of the dollar.

China has negotiated currency-swap agreements with Russia, India, Turkey, and Nigeria. These swap agreements may require exchange-rate guarantees to make central-bank holders “whole” if a counterpart currency depreciates. But at least initially, these agreements are being used for bilateral trade. This saves exporters from having to hedge their payments through forward purchases on global exchange markets.

A BRIC-centered system would reverse the policy of open and unprotected capital markets put in place after World War II. This trend has been in the making since the BRIC countries met last year in Yekaterinburg, Russia, to discuss such an international payments system based on their own currencies rather than the dollar, sterling, or euro. In September, China supported a Russian proposal to start direct trading using the yuan and the ruble rather than pricing their trade or taking payment in US dollars or other foreign currencies. China then negotiated a similar deal with Brazil. And on the eve of the IMF meetings in Washington on Friday, October 29, 2010, Premier Wen stopped off in Istanbul to reach agreement with Turkish Prime Minister Erdogan to use their own currencies in a planned tripling of Turkish-Chinese trade to \$50 billion over the next five years, effectively excluding the dollar.

China cannot make its currency a world reserve currency, because it is not running a deficit and therefore cannot supply large sums of renminbi to other countries via trade. So it is negotiating currency-swap agreements with other countries, while using its enormous dollar reserves to buy up natural resources in Australia, Africa, and South America.

This has reversed the dynamics that led speculators to gang up and cause the 1997 Asia crisis. At that time the great speculative play was against the “Asian Tigers.” Speculators swamped their markets with sell orders, emptying out the central bank reserves of countries that tried (in vain) to keep their exchange rates stable in the face of enormous US bank credit extended to George Soros and other hedge fund managers and the vulture funds that followed in their wake. The IMF and US banks then stepped

in and offered to “rescue” these economies if they agreed to sell off their best companies and resources to US and European buyers.

This was a major reason why so many countries have tried to free themselves from the IMF and its neoliberal austerity programs, euphemized as “stabilization” plans rather than the economic poison of chronic dependency and instability programs. Left with only Turkey as a customer by 2008, the IMF was a seemingly anachronistic institution whose only hope for survival lay in future crises. So that of 2009–10 proved to be a godsend. At least the IMF found neoliberal Latvia and Greece willing to subject themselves to its precepts. Today its destructive financial austerity doctrine is applied mainly by Europe’s “failed economies.”

This has changed the equation between industrial-nation creditors and third world debtors. Many dollar-strapped countries have been subject to repeated raids on their central banks—followed by IMF austerity programs that have shrunk their domestic markets and made them yet more dependent on imports and foreign investments, reduced to selling off their public infrastructure to raise the money to pay their debts. This has raised their cost of living and doing business, shrinking the economy all the more and creating new budget squeezes driving them even further into debt. But China’s long-term trade and investment deals—to be paid in raw materials, denominated in renminbi rather than dollars—are alleviating their debt pressures to the point where currency traders are jumping on the bandwagon, pushing up their exchange rates. The major international economic question today is how such national economies can achieve greater stability by insulating themselves from these predatory financial movements.

## **SUMMARY**

The 1945–2010 world economic dynamic has ended and a new international system is emerging—one that was not anticipated as recently as just five years ago.

From the 1960s through 1980s, the international economy was polarizing between indebted raw-materials producers in Africa, Latin America, and large parts of Asia—“the South”—and the industrialized North, led by North America, Europe, and Japan.

Economists analyzing this polarization focused on: (1) the terms of trade for raw materials



as compared to industrial goods; (2) the failure of World Bank programs to help “the South” cure its food dependency and other import dependency; and (3) the failure of IMF austerity programs to stabilize the balance of payments. The IMF-World Bank model promoted austerity, low wage standards, trade dependency, and deepening foreign debt. It was applauded as a success story in the creditor-investor nations

Today’s world is dividing along quite different lines. The main actor is still “the North,” composed of the United States and Europe. But the counterpart economic bloc that is emerging is growing less dependent and indebted. It is led by a rapidly growing China, India, Brazil, and even Russia (the BRIC countries), joined by the strongest Middle Eastern economies (Turkey and potentially Iran) and Asian economies such as Korea, Taiwan, Malaysia, and Singapore. This “BRIC bloc” and its allies are in payment surplus, not deficit. It is now the US and European governments that find themselves debt-ridden beyond their ability to pay, especially when it comes to paying foreign governments, central banks and bondholders.

Yet the world is now seeing a race to convert electronic (“paper”) credit creation from these already debt-ridden economies into asset ownership before governments in the payments-surplus economies can erect protective walls. Easy credit in the United States and Japan is fueling speculation in economies that are not so heavily loaded down with debt. This flight out of the US dollar into Asian and third world currencies is changing the global economy’s orientation—in such a way as to restore financial dominance to nations running balance-of-payments surpluses, whose currencies promise to rise (or at least remain stable) rather than to fall along with the dollar.

As the US and European domestic markets shrink in response to debt deflation, Asian countries and raw-materials exporters from Australia to Africa have recovered mainly because of China’s growth. As in 1997, the problem they face is how to keep predatory US and allied financial speculation at bay. This makes these countries the most likely to find capital controls attractive, but this time around, they are trying to keep speculators from buying into their assets and currencies, not selling them. Targeted economies are ones that are strong, not ones that are weak.

Since the mid-19th century, central banks raised interest rates to hold their currencies stable when trade moved into deficit. The universal aim was to gain financial

reserves. In the 1930s, money and credit systems were still based on gold. Protective tariffs and trade subsidies aimed at running trade and balance-of-payments surpluses in order to gain financial reserves, but today's problem is too *much* liquidity, in the form of keyboard bank credit that can be created without limit.

This has turned the world of half a century ago upside-down. National economies in the United States, Japan, and other leading nations are lowering their rates to 1% or less, encouraging capital outflows rather than payments surpluses, while their banks and investors are seeking to gain more by financial speculation than by trade.

## **CONCLUSION**

The American economy may be viewed as a tragic drama. Its tragic flaw was planted and flowered in the 1980s: a combination of deregulation leading to financial fraud so deep as to turn the banking system into a predatory gang, while shifting the tax burden off real estate and the higher tax brackets onto wage earners and sales taxes. This increased the economy's cost of doing business in two ways. First, taxes on employees (including FICA withholding for Social Security and Medicare) and on business profits increase the cost of doing business for American industry.

Second, untaxing the site value of land (and most "capital gains" are actually land-value gains) has "freed" rental income to be pledged to banks for yet higher mortgage loans. This obliged new homebuyers to take on more and more debt as taxes were shifted off property. So homeowners working for a living did not really gain from low property taxes. What the tax collector relinquished ended up being paid to banks as interest on the loans that were bidding up housing prices, creating a real estate bubble. Meanwhile, governments had to make up the property-tax cuts by taxing employees and employers all the more. So the United States became a high-cost economy.

It didn't have to be this way—and that is the tragedy of the US economy over the past thirty years. It was a fiscal and financial tragedy, with the tragic flaw being the propensity for the financial sector to engage in wholesale fraud and "junk economics." A flawed tax policy was endorsed by a failure of economic thought to explain the costs entailed in trying to get rich by running into debt. What Alan Greenspan famously called

“wealth creation” during his tenure as Federal Reserve Chairman, sponsoring asset-price inflation turned out simply to be debt leveraging—that is, debt creation when the dust settled and prices fell back into negative equity territory.

To rescue the increasingly irresponsible financial sector from its mortgage-debt gambles, the United States is taking a path that is losing its international position, ending the long epoch of what was actually a free lunch—the US Treasury-bill standard of international finance. All that US diplomats can do at this point is play for time, hoping to prolong the existing double standard favorable to the United States and its Treasury debt a bit further, to permit US bankers to get just one more year of enormous bonuses in keeping with the American motto, “You only need to make a fortune once.”

What no doubt will amaze to future historians is why the rest of the US economy has let the banking sector get away with this! Apart from the Soviet Union’s self-destruction in 1990–91, it is hard to find a similar blunder in economic diplomacy. It reflects the banking system’s success in shifting economic planning out of the hands of government into those of finance-sector lobbyists.

United States officials always have waged American foreign trade and financial policy in reference to their own domestic economic interests without much regard for foreigners. The history of US protective tariffs, dollar policy, and interest-rate policy has been to look only at home. Other countries have had to raise interest rates when their balance of trade and payments move into deficit, above all, for military adventures. The United States alone is immune—thanks to the legacy of the dollar being “as good as gold” during the decades when it was running a surplus.

To quote Joseph Stiglitz once again:

[T]he irony is that money that was intended to rekindle the American economy is causing havoc all over the world. Those elsewhere in the world say, what the United States is trying to do is the twenty-first century version of ‘beggar thy neighbor’ policies that were part of the Great Depression: you strengthen yourself by hurting the others.<sup>6</sup>

---

<sup>6</sup> Nobel Laureate Joseph Stiglitz: Foreclosure Moratorium, Government Stimulus Needed to Revive US Economy, *Democracy Now*, Oct. 21, 2010.

It is natural enough for the United States to shape its international policy with regard to its own interests, to be sure. The self-interest principle is a foundation assumption of political theory as it is economic logic. What is less understandable is why other countries have not acted more effectively in their own interests—and why US diplomats and economic officials should be so upset today when other nations in fact begin to do so.