Quantitative Easing: Blaming China For the Failures of US Monetary Policy

Krugman's China-bashing defense of the Fed's QE2 policy

By Prof Michael Hudson
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Here's the quandary that the U.S. economy is in: The Fed's quantitative easing policy– creating more liquidity so that banks can lend more – aims at helping the economy "borrow its way out of debt." But banks are not lending more, for the simple reason that a third of U.S. real estate already is in negative equity, while small and medium-sized businesses (which have created most of the new jobs in America for the past few decades) have seen their preferred collateral (real estate and sales orders) shrink. How can banks be expected to lend more to re-inflate the economy's asset prices while wages and consumer prices continue to drift down? The "real" economy as a whole therefore must shrink.

What has made the argument over Fed policy so important in recent weeks is a series of exchanges between Republicans and Democrats. The deteriorating situation prompted a group of Republican economists and political strategists to publish an open letter to Federal Reserve Chairman Ben Bernanke criticizing the Fed's policy of Quantitative Easing (QE2), flooding the economy with liquidity spilling over into foreign exchange markets to push the dollar's exchange rate down.[1] True enough, as far as this criticism goes. But it only scratches the surface.

Enter Paul Krugman, one of the most progressive defenders of Democratic Party policy. His *New York Times* op-eds usually rebut Republican advocacy for Wall Street and corporate interests. But he also indulges in China bashing. To "blame the foreigner" rather than the system is normally a right-wing response, yet he blames China simply for trying to save itself from being victimized by the Wall Street policies he normally criticizes when labor is the prey. By blaming China, he not only lets the Federal Reserve Board and its Wall Street constituency off the hook, he blames virtually the entire world that confronted Mr. Obama's financial nationalism with a united front in Seoul two weeks ago when he and his entourage received an almost unanimous slap in the face at the Group of 20 meetings.

Sadly, Prof. Krugman's "Axis of Depression" column on Friday, November 19, showed the extent to which his preferred solutions do not to beyond merely marginalist tinkering. His op-ed endorsed the Fed's attempt at quantitative easing (QE2) to re-inflate the real estate bubble by flooding the markets with enough credit to lower interest rates. He credits the Fed with seeking to "create jobs," not mainly to bail out banks that hold mortgages on properties in negative equity.

The reality is that re-inflating real estate prices will not make it easier for wage earners and homebuyers to make ends meet. Lowering interest rates will re-inflate real estate prices ("wealth creation" Alan-Greenspan style), raising the degree to which new homebuyers must go into debt to obtain housing. We. And the more debt service that is paid, the less is available to spend on goods and services (the "real" economy). Employment will shrink in a financial spiral of economic austerity.

Unfortunately, most economists are brainwashed with the trivializing formula MV=PT. The idea is that more money (M) increases "prices" (P) – presumably consumer prices and wages. (One can ignore velocity, "V," which is merely a tautological residual.) "T" is "transactions," for GDP, sometimes called "O" for Output.

Some 99.9% of money and credit is not spent on consumer goods (the "T" in MV = PT). Every day more than an entire year's GDP passes through the New York Clearing House and the Chicago Mercantile Exchange for bank loans, stocks and bonds, packaged mortgages, derivatives and other financial assets and bets. So the effect of the Fed's Quantitative Easing (monetary inflation) is to inflate asset prices, not consumer prices and other commodity prices.

This is the key dynamic of today's finance capitalism. It loads down economies with debt – and when debt service exceeds the surplus out of which to pay it, the central bank tries to "inflate its way out of debt" by creating enough new credit ("money") to make real estate, stocks and bonds worth more –enough more for debtors to borrow the interest due. This is the *deus ex machina*, the external influx of credit enabling financialized economies to operate as Ponzi schemes. The dynamic is encouraged by taxing speculative ("capital") gains at a lower rate than wages and profits. So why should investors finance tangible capital investment when they can ride the wave of asset-price inflation. The Bubble Economy turns into speculative "wealth creation."

Can it work? How long will gullible investors bet on a pyramid scheme growing at an impossibly exponential rate, enjoying fictitious "wealth creation" as bankers load the economy down with debt? How long will people think that the economy is really growing when banks lend to an economy overseen by regulatory agencies staffed by ideological deregulators?
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The bankers' ideal is for the entire surplus over and above bare subsistence to be paid in the form of interest and fees – all disposable personal income, corporate cash flow and real estate rent. So when the Fed's QE lowers mortgage interest rates, will this enable homeowners to pay less – or will it simply increase the capitalization rate of existing rental value?

The Fed's cover story is that QE benefits homebuyers by reducing the debt they must take on. But if this were true, their gain would be the banks' loss – and the bankers are the Fed's main constituency. To the Federal Reserve, the economic "problem" is that falling (that is, more affordable) housing prices are killing the balance sheets of banks. So the Fed's real goal is to re-inflate the real estate bubble (while spurring a stock market bubble as well, if it can).

A *Wall Street Journal* op-ed by Andy Kessler (also published on Friday, Nov. 19, the date of Prof. Krugman's op-ed in *The New York Times*) pointed this out – but also recognized that the Fed would create a public relations disaster if it came right out and explained that its motivation in QE2 was to reverse the fall in property prices. "Mr. Bernanke would create a panic if he stated publicly that, if not for his magic dollar dust, real estate would fall off a cliff," and admitted that bank balance sheets still suffer from "toxic real estate loans and derivatives." But the degree to which reported bank solvency is largely fictitious is reflected in the fact that the stock market value for the Bank of America (which brought Countrywide Finance) is only half its reported book value, while that of Citibank is off by 20%.[2]

Foreclosure is of course bad for homeowners, but it is even worse for banks, because of the financial pyramid of credit erected on the past decade's worth of junk mortgages. The problem with Prof. Krugman's analysis is his assumption that QE – intended to re-inflate the real estate bubble – is good for employment and indeed even for a renewal of U.S. competitiveness, not its antithesis. By focusing on trade and labor, he implies that the dollar is weakening only because of the trade deficit, not because of military spending and capital flight. And he assumes that re-inflating the real estate bubble – the Fed's explicit aim – will make U.S. exports more competitive rather than less so! Most seriously, he asserts, "the core reason for the attack on the Fed is self-interest, pure and simple. China and German want America to stay uncompetitive."[3]

This is not what I have been told in China and Germany. They simply want to avoid having instability disrupt their trade and domestic production, and to avoid having to take a loss on their international reserves held (mainly from inertia stemming from World Wars I and II when the United States increased its share of the world's gold to 80% by 1950). The U.S. Treasury would like U.S. banks and speculators to make an easy $500 billion at the expense of China's central bank on slick speculative currency trading. The Fed would like to see the U.S. economy revive by looting other economies.

It's not going to happen. The plunging-dollar standard of international finance is being wound down as fast as other countries are able to replace the dollar with currency swaps among themselves, led by the BRIC countries (Brazil, Russia, India and China). South Africa has just joined these countries as a fifth member, and oil exporters from Nigeria to Venezuela and Iran are associating themselves in the attempt to make the international monetary system less unfair and less exploitative. Prof. Krugman's fellow Nobel Prize winner, Joseph Stiglitz has provided (seemingly ironically, also in a *Wall Street Journal* op-ed): "That money is supposed to reignite the American economy but instead goes around the world looking for economies that actually seem to be functioning well and wreaking havoc there."[4]

The Fed and Congress have told China to revalue its currency, the renminbi, upward by 20%. This would oblige the Chinese government and its central bank to absorb a loss of half a trillion dollars – over $500 billion – on the $2.6 trillion of foreign reserves it has built up. These reserves are not merely from exports, much less exports to the United States. They are capital flight by U.S. money managers, Wall Street arbitragers, international speculators and others seeking to buy up Chinese assets. And they are the result of U.S. military spending in its bases in Asia and elsewhere – dollars that recipient countries turn around and spend in China.

Chinese authorities have tried to make it clear that what they object to is the U.S. policy of creating "electronic keyboard credit" at one quarter of a percent (0.25%) to buy up higher yielding assets abroad (and nearly every foreign asset is higher yielding). The Group of 20 in Seoul Korea last week accused the United States of competitive currency depreciation and financial aggression, and countries stepped up attempts to shun the dollar and indeed, to avoid running trade and payments surpluses as such.

The bottom line is that there is no way that the United States can defend depreciation of the dollar on terms that oblige other countries to take a loss on their holdings. Investors throughout the world have lost faith in the dollar and other paper currencies, and are moving into gold or simply closing off their economies. Over the past year – ever since the BRIC meetings in Yekaterinburg, Russia, in summer 2009 – their response has been to avoid using the dollar, to protect themselves from aggressive U.S. capital flight seeking to raid their central banks, buy out their companies, raw materials and assets with “paper credit” and indeed to step up military spending.

Instead of supporting this attempt – a drive that has the positive consequence for world peace that it will limit U.S. military adventurism (much as the Vietnam War finally forced the dollar off gold in 1971), Mr. Krugman is using the crisis to attack China – as if its success is what is harming U.S. labor, not U.S. post-industrial pro-financial policies that have inflated the real estate bubble, privatized health care without a public option – and without even a bulk discount for U.S. Government drug purchases – and the failure to write down mortgages and other bank debts to the ability to pay.

Today’s China-bashing is much like the earlier attacks on Japan and other Asian countries in the late 1980s, demonizing successful economies for avoiding the predatory practices that have corroded American industry, “financializing” and post-industrializing the economy. The U.S. debt pyramiding that has occurred since 1980 has turned into a class war that has little economic justification. So blaming foreigners – for getting rich in the very same way that the United States has done ever since the North won the Civil War in 1865 – simply offers political cover for a status quo that is not working.

The two U.S. parties and their spokesmen find it easier to demonize policies that go beyond the merely marginal than to set about solving structural problems. So political discussion ends up by highlighting fairly insignificant policy differences. One would hardly realize that the problem facing U.S. industrial employment is that wage earners must earn enough to pay for the most expensive housing in the world (the FDIC is trying to limit mortgages to absorb just 32% of the borrower’s budget), the most expensive medical care and Social Security in the world (12.4% FICA withholding), high personal debt levels owed to banks and rapacious credit-card companies (about 15%) and a tax shift off property and the higher wealth brackets onto labor income and consumer goods (another 15% or so). The aim of bankers is to calculate just how much their customers can pay, defined as everything they make over and above basic subsistence costs and “non-discretionary” spending to the FIRE sector.

This is post-industrial suicide – and it is the road to debt peonage for American wage earners and consumers. China has created an economy that has managed – so far – to avoid financializing its firms. The government owns over half the equity in its commercial banks. According to its Ministry of Finance, assets of all state enterprises in 2008 totaled about $6 trillion (equal to 133% of annual economic output.) The effect is that when loans are made to domestic enterprises – especially to partially or wholly owned by the government – the interest and financial returns accrues to the public sector, making it unnecessary to tax labor.

China understandably is trying to defend this system. Yet the Obama administration (echoed by Republican free marketers) has criticized it, especially for its public subsidy of solar energy investment to slow domestic pollution and global warming. Wednesday's *Wall Street Journal* provided an almost comically hypocritical attack earlier last week, decrying China's accelerated investment in solar power to free its economy (and its air quality) from oil imports and carbon emissions. "It leverages state control of the financial system to channel low-cost capital to domestic industries—and to resource-rich foreign nations whose oil and minerals China needs to maintain rapid growth."[5] This policy prompted Charlene Barshefsky, U.S. trade representative under President Bill Clinton (who helped negotiate China's 2001 entry into the World Trade Organization) to complain that "powerful state-led economies like China and Russia … decide that 'entire new industries should be created by the government,' … it tilts the playing field against the private sector." This is just what Japan did to promote its industrialization – by providing government credit intended to promote tangible capital investment, not extract financial rake-offs. "Vast swaths of industry still controlled by state companies and tightly restricted for foreigners," complain the *Wall Street Journal* authors. "The government owns almost all major banks in China, its three major oil companies, its three telecom carriers and its major media firms."

We are dealing with two quite different ideas of what the proper role of a financial system should be. Commercial banks in the West have created most credit for speculation and asset-price inflation over the last thirty years, not to fund capital formation and industry. The guiding idea of a public-sector bank is to promote long-term investment to raise productivity, output and employment. This is what has enabled China to succeed so rapidly while Western economies have let themselves be financialized. The Baltics, Iceland and now Ireland are examples of the disaster that financial neoliberals cause when given a free hand.

The moral is that China's bank success – and its attempt to avert U.S. currency raiding and arbitrage speculation seeking to loot its foreign reserves – should be emulated, not accused of being economic warfare. This emulation is what the BRIC+ countries have announced as their goal. The Obama administration and European politicians certainly are making an obvious point in urging China to focus more on its own domestic market and accelerate the rise in its living standards. It is clear that markets in the United States and Europe are shrinking as debt deflation sets in.

China is not as economically self-sufficient in natural resources and water as the United States. This means that a sustained rise in its living standards will require spending much of the international savings it has built up. But at least it is on the right path. Can the same be said of America? Does it help to denounce China, or should we rather ask why its productivity, capital investment and living standards are rising while ours are declining?

Asking this question suggests the answer: China's financial system is designed to promote a growing surplus, not siphon it off. A byproduct is to increase real estate and stock market prices – but this is a reflection of capital investment and progress, not a diversion of investment to fuel financial asset stripping as has occurred in the United States with increasingly arrogant greed over the past 30 years.

What Prof. Krugman and other economists advocating for wage earners and the economy at large should be concerned with is the danger of the Fed undertaking yet another back-door bailout for its Wall Street constituency. Mr. Kessler suggests that the Fed should do just this – to "move the toxic debt onto the balance sheets of the FDIC and the Fed, and re-float the banks with fresh capital to open on Monday morning."

You can't blame China for this!

Notes

[1] Peter Wallsten and Sudeep Reddy, "Fresh Attack on Fed Move," *Wall Street Journal*, November 15, 2010. For the full text see http://blogs.wsj.com/economics/2010/11/15/open-letter-to-ben-bernanke/

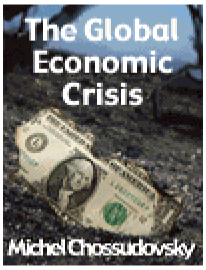
[2] Andy Kessler, "What's Really Behind Bernanke's Easing?" *Wall Street Journal*, November 19, 2010.

[3] Paul Krugman, "Axis of Depression," *The New York Times*, November 19, 2010.

[4] Joseph Stiglitz, "Why Easier Money Won't Work," *Wall Street Journal*, October 23, 2010.

[5] Jason Dean, Andrew Browne and Shai Oster, "China's 'State Capitalism' Sparks a Global Backlash," *Wall Street Journal*, November 16, 2010.

Read Michael Hudson's chapter in *The Global Economic Crisis, The Great Depression of the XXI Century*, Michel Chossudovsky and Andrew Gavin Marshall, Editors.



Michel Chossudovsky
Andrew G. Marshall (editors)

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