

The Federal Reserve and the Global Fracture

An Interview with Finnish Journalist Antti J. Ronkainen

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Antti J. Ronkainen: The Federal Reserve is the most significant central bank in the world. How does it contribute to the domestic policy of the United States?

Michael Hudson: The Federal Reserve supports the status quo. It would not want to create a crisis before the election. Today it is part of the Democratic Party's re-election campaign, and its job is to serve Hillary Clinton's campaign contributors on Wall Street. It is trying to spur recovery by resuming its Bubble Economy subsidy for Wall Street, not by supporting the industrial economy. What the economy needs is a debt writedown, not more debt leveraging such as Quantitative Easing has aimed to promote. But the Fed is in a state of denial that the U.S. and European economies are plagued by debt deflation.



Michael Hudson

The Fed uses only one policy: influencing interest rates by creating bank reserves at low give-away charges. It enables banks too make easy gains simply by borrowing from it and leaving the money on deposit to earn interest (which has been paid since the 2008 crisis to help subsidize the banks, mainly the largest ones). The effect is to fund the asset markets – bonds, stocks and real estate – not the economy at large. Banks also are heavy arbitrage players in foreign exchange markets. But this doesn't help the economy recover, any more than the ZIRP (Zero Interest-Rate Policy) since 2001 has done for Japan. Financial markets are the liabilities side of the economy's balance sheet, not the asset side.

The last thing either U.S. party wants is for the election to focus on this policy failure. The Fed, Treasury and Justice Department will be just as pro-Wall Street under Hillary. There would be no prosecutions of bank fraud, there would be another bank-friendly Attorney General, and a willingness to subsidize banks now that the Dodd-Frank bank reform has been diluted from what it originally promised to be.

So let's go back to beginning. When the Great Financial Crisis escalated in 2008 the Fed's response was to lower its main interest rate to nearly zero. Why?

The aim of lowering interest rates was to provide banks with cheap credit. The pretense was that banks might lend to help the economy get going again. But the Fed's idea was simply to re-inflate the Bubble Economy. It aimed at restoring the value of the mortgages that banks had in their loan portfolios. The hope was that easy credit would spur new mortgage lending to bid housing prices back up – as if this would help the economy rather than simply raising the price of home ownership.

But banks weren't going to make mortgage loans to a housing market that already was over-lent. Instead, homeowners had to start paying down the mortgages they had taken out. Banks also reduced their credit-card exposure by a few hundred billion dollars. So instead of receiving new credit, the economy was saddled with having to repay debts.

Banks did make money, but not by lending into the “real” production and consumption economy. They mainly engaged in arbitrage and speculation, and lending to hedge funds and companies to buy their own stocks yielding higher dividend returns than the low interest rates that were available.

In addition to the near zero interest rates, the Fed bought US Treasury bonds and mortgage backed securities (MBS) with almost \$4 trillion during three rounds of Quantitative Easing stimulus. How have these measures affected the real economy and financial markets?

In 2008 the Federal Reserve had a choice: It could save the economy, or it could save the banks. It might have used a fraction of what became the vast QE credit – for example \$1 trillion – to pay off the bad mortgages and write them down. That would have helped save the economy from debt deflation. Instead, the Fed simply wanted to re-inflate the bubble, to save banks from having to suffer losses on their junk mortgages and other bad loans.

Keeping these debts on the books, in full, let banks foreclose on defaulting homeowners. This intensified the debt-deflation, pushing the economy into its present post-2008 depression. The debt overhead is keeping it depressed.

One therefore can speak of a financial war waged by Wall Street against the economy. The Fed is a major weapon in this war. Its constituency is Wall Street. Like the Justice and Treasury Departments, it has been captured and taken hostage.

Federal Reserve chairwoman Janet Yellen's husband, George Akerlof, has written a good article about looting and fraud as ways to make money. But instead of saying that looting and fraud are bad, the Fed has refused to regulate or move against such activities. It evidently recognizes that looting and fraud are what Wall Street is all about – or at least that the financial system would come crashing down if an attempt were made to clean it up!

So neither the Fed nor the Justice Department or other U.S. Government agencies has sanctioned or arrested a single banker for the trillions of dollars of financial fraud. Just the

opposite: The big banks where the fraud was concentrated have been made even larger and more dominant. The effect has been to drive out of business the smaller banks not so involved in derivative bets and other speculation.

The bottom line is that banks made much more by getting Alan Greenspan and the Clinton-Bush Treasury officials to deregulate fraud than they could have made by traditional safe lending. But their gains have increased the economy's overhead.

Do you believe Mike Whitney's argument that QE was about a tradeoff between the Fed and the government: the Fed pumped the new bubble and saved the banks that the government didn't need to bail out more banks. The government's role was to impose austerity so that inflation and employment didn't rise - which would have forced the Fed to raise interest rates, ending its QE program? source:

<http://www.counterpunch.org/2016/01/15/the-chart-that-explains-everything/>

That was a great chart that Mike put up from Richard Koo, and you should reproduce it here. It shows that the Fed's enormous credit creation had zero effect on raising commodity prices or wages. But stock market prices doubled in just six years, 2008-15, and bond prices rose to new peaks. Banks left much of the QE credit on deposit with the Fed, earning an interest giveaway premium.

(Richard Koo: "The struggle between markets and central banks has only just begun,"

<http://www.businessinsider.com/richard-koo-struggle-between-markets-and-central-banks-ha-only-just-begun-2015-9?r=UK&IR=T>

The important point is that the Fed (backed by the Obama Administration) refused to use this \$4 trillion to revive the production-and-consumption economy. It claimed that such a policy would be "inflationary," by which it meant raising employment and wage levels. The Fed thus accepted the neoliberal junk economics proposing austerity as the answer to any problem - austerity for the industrial economy, not the Fed's own Wall Street constituency.

According to a Fed staff report, QE would lower the exchange rate of dollar to the other currencies causing competitiveness boost for the U.S. firms. Former finance minister of Brazil Guido Mantega, as well as the chairman of Central Bank of India Raghuram Rajan, have described the Fed's QE as a "currency war." What's your take?

The Fed's aim was simply to provide banks with low-interest credit. Banks lent to hedge funds to buy securities or make financial bets that yielded more than 0.1 percent. They also lent to companies to buy their own stock, and to corporate raiders for debt-financed mergers and acquisitions. But banks didn't lend to the economy at large, because it already was "loaned up," and indeed, overburdened with debt.

Lower interest rates did spur the "carry trade," as they had done in Japan after 1990. Banks and hedge funds bought foreign bonds paying higher rates. The dollar drifted down as bank arbitrageurs could borrow from the Fed at 0.1 percent to lend to Brazil at 9 percent. Buying these foreign bonds pushed up foreign exchange rates against the dollar. That was a side effect of the Fed's attempt to help Wall Street make financial gains. It simply didn't give much consideration to how its QE flooding the global economy with surplus dollars would affect U.S. exports - or foreign countries.

Exchange rate shifts don't affect export trends as much as textbook models claim. U.S. arms exports to the Near East, and many technology exports are non-competitive. However, a looming problem for most countries is what may happen when ending QE increases the dollar's exchange rate. If U.S. interest rates go back up, the dollar will strengthen. That would increase the cost to foreign countries of paying dollar-denominated debts. Countries that borrowed all dollars at low interest will need to pay more in their own currencies to service these debts. Imagine what would happen if the Federal Reserve let interest rates rise back to a normal level of 4 or 5 percent. The soaring dollar would push debtor economies toward depression on capital account much more than it would help their exports on trade account.

You have said that QE is fracturing the global economy. What do you mean by that?

Part of the flood of dollar credit is used to buy shares of foreign companies yielding 15 to 20 percent, and foreign bonds. These dollars are turned over to foreign central banks for domestic currency. But central banks are only able to use these dollars to buy U.S. Treasury securities, yielding about 1 percent. When the People's Bank of China buys U.S. Treasury bonds, it's financing America's dual budget and balance-of-payment deficits, both of which stem largely from military encirclement of Eurasia – while letting U.S. investors and the U.S. economy get a free ride.

Instead of buying U.S. Treasury securities, China would prefer to buy American companies, just like U.S. investors are buying Chinese industry. But America's government won't permit China even to buy gas station companies. The result is a double standard. Americans feel insecure having Chinese ownership in their companies. It is the same attitude that was directed against Japan in the late 1980s.

I wrote about this financial warfare and America's free lunch via the dollar standard in *Super Imperialism* (2002) and *The Bubble and Beyond* (2012), and about how today's New Cold War is being waged financially in *Killing the Host* (2015).

The Democrats loudly criticized the Bush administration's \$700 billion TARP-program, but backed the Fed's QE purchases worth of almost \$4 trillion during the Obama administration. How does this relate to the fact that officially, QE purchases were intended to support economic recovery?

I think you've got the history wrong. My *Killing the Host* describes how the Democrats supported TARP, while the Republican Congress opposed it on populist grounds. Republican Treasury Secretary Hank Paulson offered to use some of the money to aid over-indebted homeowners, but President-elect Obama blocked that – and then appointed Tim Geithner as Treasury Secretary. FDIC head Sheila Bair and by SIGTARP head Neil Barofsky have written good books about Geithner's support for Wall Street (and especially for Citigroup and Goldman Sachs) against the interests of the economy at large.

If you are going to serve Wall Street – your major campaign contributors – you are going to need a cover story pretending that this will help the economy. Politicians start with "Column A": their agenda to reimburse their campaign contributors – Wall Street and other special interests. Their public relations team and speechwriters then draw up "Column B": what public voters want. To get votes, a rhetorical cover story is crafted. I describe this in my

forthcoming *J is for Junk Economics*, to be published in March. It's a dictionary of Orwellian doublethink, political and economic euphemisms to turn the vocabulary around and mean the opposite of what actually is meant.

How do TARP and QE relate to the Federal Reserve's mandate about price stability?

There are two sets of prices: asset prices and commodity prices and wages. By "price stability" the Fed means keeping wages and commodity prices down. Calling depressed wage levels "price stability" diverts attention from the phenomenon of debt deflation – and also from the asset-price inflation that has increased the advantages of the One Percent over the 99 Percent. From 1980 to the present, the Fed has inflated the largest bond rally in history as a result of driving down interest rates from 20 percent in 1980 to nearly zero today, as you have noted.

Chicago School monetarism ignores asset prices. It pretends that when you increase the money supply, this increases consumer prices, commodity prices and wages proportionally. But that's not what happens. When banks created credit (money), they don't lend much to people to buy goods and services or for companies to make capital investments to employ more workers. They lend money mainly to transfer ownership of assets already in place. About 80 percent of bank loans are mortgages, and the rest are largely for stocks and bond purchases, including corporate takeovers and stock buybacks or debt-leveraged purchases. The effect is to bid up asset prices, while loading down the economy with debt in the process. This pushes up the break-even cost of doing business, while imposing debt deflation on the economy at large.

Wall Street isn't so interested in exploiting wage labour by hiring it to produce goods for sale, as was the case under industrial capitalism in its heyday. It makes its gains by riding the wave of asset inflation. Banks also gain by making labour pay more interest, fees and penalties on mortgages, and for student loans, credit cards and auto loans. That's the postindustrial financial mode of exploiting labor and the overall economy. The Fed's QE program increases the price at which stocks, bonds and real estate exchange for labour, and also promotes debt leverage throughout the economy.

Why don't economists distinguish between asset-price and commodity price inflation?

The economics curriculum has been turned into an exercise for students to pretend that a hypothetical parallel universe exists in which the *rentier* classes are job creators, necessary to help economies recover. The reality is that financial modes of getting rich by debt leveraging creates a Bubble Economy – a Ponzi scheme leading to austerity and shrinking markets, which always ends in a convulsion of bankruptcy.

The explanation for why this is not central to today's economic theory is that the discipline has been captured by this neoliberal tunnel vision that overlooks the financial sector's maneuvering to make quick trading profits in stocks, bonds, mortgages and derivatives, not to take the time and effort to develop long-term markets. *Rentiers* seek to throw a cloak of invisibility around how they make money. They know that if economists don't measure their wealth and the public does not see it, voters will be less likely to bring pressure to regulate and tax it.

Today's central economic problem is that inflating asset prices by debt leveraging extracts more interest and financial charges. When the resulting debt deflation ends up hollowing out

the economy, creditors try to blame labour, or government spending (except for bailouts and QE to help Wall Street). It is as if debtors are exploiting their creditors.

If there is a new class war, what is the current growth model?

It's an austerity model, as you can see from the eurozone and from the neoliberal consensus that cites Latvia as a success story rather than a disaster leading to de-industrialization and emigration. In real democracies, if economies polarize like they are doing today, you would expect the 99 Percent to fight back by electing representatives to enact progressive taxation, regulate finance and monopolies, and make public investment to raise wages and living standards. In the 19th century this drive led parliaments to rewrite the tax rules to fall more on landlords and monopolists.

Industrial capitalism plowed profits back into new means of production to expand the economy. But today's *rentier* model is based on austerity and privatization. The main way the financial sector always has obtained wealth has been by privatizing it from the public domain by insider dealing and indebting governments.

The ultimate financial business plan also is to lend with an eye to end up with the debtor's property, from governments to companies and families. In Greece the European Central Bank, European Commission and IMF demanded that if the nation's elected representatives did not sell off the nation's ports, land, islands, roads, schools, sewer systems, water systems, television stations and even museums to reimburse the dreaded austerity troika for its bailout of bondholders and bankers, the country would be isolated from Europe and faced with a crash. That forced Greece to capitulate.

What seems at first glance to be democracy has been hijacked by politicians who accept the financial class war ideology that the way for an economy to get rich is by austerity. That means lowering wages, unemployment, and dismantling government by turning the public domain over to the financial sector.

By supporting the banking sector even in its predatory and outright fraudulent behavior, U.S. and European governments are reversing the trajectory along which 19th-century progressive industrial capitalism and socialism were moving. Today's *rentier* class is not concerned with long-term tangible investment to earn profits by hiring workers to produce goods. Under finance capitalism, an emerging financial over-class makes money by stripping income and assets from economies driven deeper into debt. Attacking "big government" when it is democratic, the wealthy are all in favor of government when it is oligarchic and serves their interests by rolling back the past two centuries of democratic reforms.

Does the Fed realize global turbulences what its unconventional policies have caused?

Sure. But the Fed has painted itself in a corner: If it raises interest rates, this will cause the stock and bond markets to go down. That would reverse the debt leveraging that has kept these markets up. Higher interest rates also would bankrupt Third World debtors, which will not be able to pay their dollar debts if dollars become more expensive in their currencies.

But if the Fed keeps interest rates low, pension funds and insurance companies will have difficulty making the paper gains that their plans imagined could continue exponentially *ad infinitum*. So whatever it does, it will destabilize the global economy.

China's stock market has crashed, western markets are very volatile, and George Soros has

said that the current financial environment reminds him of the 2008 crash. Should we be worried?

News reports make it sound as if debt-ridden capitalist economies will face collapse if the socialist countries don't rescue them from their shrinking domestic markets. I think Soros means that the current financial environment is fragile and highly debt-leveraged, with heavy losses on bad loans, junk bonds and derivatives about to be recognized. Regulators may permit banks to "extend and pretend" that bad loans will turn good someday. But it is clear that most government reports and central bankers are whistling in the dark. Changes in any direction may pull down derivatives. That will cause a break in the chain of payments when losers can't pay. The break may spread and this time public opinion is more organized against 2008-type bailouts.

The moral is that debts that can't be paid, won't be. The question is, *how* won't they be paid? By writing down debts, or by foreclosures and distress sell-offs turning the financial class into a ruling oligarchy? That is the political fight being waged today – and as Warren Buffet has said, his billionaire class is winning it.

That's all for now. Thank you Michael!

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