The Worsening Debt Crisis

An Interview with Economist Michael Hudson

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Mike Whitney: On Friday afternoon the government announced plans to place the two mortgage giants, Fannie Mae and Freddie Mac, under "conservatorship." Shareholders will be virtually wiped out (their stock already had plunged by over 90 per cent) but the US Treasury will step in to protect the companies' debt. To some extent it also will protect their preferred shares, which Morgan-Chase have marked down only by half. This seems to be the most sweeping government intervention into the financial markets in American history. If these two companies are nationalized, it will add $5.3 trillion dollars to the nation's balance sheet. So my first question is, why is the Treasury bailing out bondholders and other investors in their mortgage IOUs? What is the public interest in all this?

Michael Hudson: The Treasury emphasized that it was under a Sunday afternoon deadline to finalize the takeover details before the Asian markets opened for trading. This concern reflects the balance-of-payments and hence military dimension to the bailout. The central banks of China, Japan and Korea are major holders of these securities, precisely because of the large size of Fannie Mae and Freddie Mac – their $5.3 trillion in mortgage-backed debt that you mention, and the $11 trillion overall U.S. mortgage market.

When you look at the balance sheet of U.S. assets available for foreign central banks to buy with the $2.5 to $3.5 trillion of surplus dollars they hold, real estate is the only asset category large enough to absorb the balance-of-payments outflows that U.S. military spending, foreign trade and investment-capital flight are throwing off. When the U.S. military spends money abroad to fight the New Cold War, these dollars are recycled increasingly into U.S. mortgage-backed securities, because there is no other market large enough to absorb the sums involved. Remember, we do not permit foreigners – especially Asians – to buy high-tech, "national security" or key infrastructure. The government would prefer to see them buy harmless real estate trophies such as Rockefeller Center, or minority shares in banks with negative equity such as Citibank shares sold to the Saudis and Bahrainis.

But there is a limit on how nakedly the U.S. Government can exploit foreign central banks. It does need to keep dollar recycling going, in order to prevent a sharp dollar depreciation. The Treasury therefore has given informal assurances to foreign governments that they will guarantee at least the dollar value of the money their central banks are recycling. (These governments still will lose as the dollar plunges against hard currencies – just about every currency except the dollar these days.) A failure to provide investment guarantees to foreigners would thwart the continuation of U.S. overseas military spending! And once foreigners are bailed out, the Treasury has to bail out domestic American investors as well, simply for political reasons.

MW: Fannie and Freddie have been loading up on risky mortgages for ages, under-stating the risks largely to increase their stock price so that their CEOs can pay themselves tens of millions of dollars in salary and stock options. Now they are essentially insolvent, as the principal itself is in question. There was widespread criticism of this year after year after year. Why was nothing done?

Hudson: Fannie and Freddie were notorious for their heavy Washington lobbying. They bought the support of Congressmen and Senators who managed to get onto the financial oversight committees so that they would be in a position to collect campaign financing from Wall Street that wanted to make sure that no real regulation would take place.

On the broadest level, Treasury Secretary Paulson has said that these companies are being taken over in order to reflate the real estate market. Fannie and Freddie were almost single-handedly supporting the junk mortgage market that was making Wall Street rich.

The CEOs claimed to pay themselves for "innovation." In today's Orwellian vocabulary financial "innovation" means the creation of special rent-extracting privilege. The privilege was being able to get the proverbial "free ride" (that is, economic rent) by borrowing at low-interest government rates to buy and repackage mortgages to sell at a high-interest markup. Their "innovation" lies in the ambiguity that enabled them to pose as public-sector borrowers when they wanted to borrow at low rates, and private-sector arbitrageurs when they wanted to get a rake-off from higher margins.

The government's auditors are now finding out that their other innovation was to cook the accounting books, Enron-style. As mortgage arrears and defaults mounted up, Fannie and Freddie did not mark down their mortgage holdings to realistic prices. They said they would do this in a year or so – by 2009, after the Bush Administration's deregulators have left office. The idea was to blame it all on Obama when they finally failed.

But at the deepest level of all, the "innovation" that created a rent-extracting loophole was the deception that making more and more bad-mortgage loans could continue for a prolonged period of time. The reality is that no exponential rise in debt ever has been able to be paid for more than a few years, because no economy ever has been able to produce a surplus fast enough to keep pace with the "magic of compound interest." That phrase is itself a synonym for the exponential growth of debt.

The Road to Debt Peonage

MW: In an earlier interview you said: "The economy has reached its debt limit and is entering its insolvency phase. We are not in a cycle but the end of an era. The old world of debt pyramiding to a fraudulent degree cannot be restored." Would you expand on this in view of today's developments?

M Hudson: How long more and more money can be pumped into the real estate market, while disposable personal income is not growing by enough to pay these debts? How can people pay mortgages in excess of the rental value of their property? Where is the "market demand" to come from? Speculators already withdrew from the real estate market by late 2006 – and in that year they represented about a sixth of all purchases.

The best that this weekend's bailout can do is to postpone the losses on bad mortgage debts. But this is a far cry from actually restoring the ability of debtors to pay. Mr. Paulson talks about more lending to support real estate prices. But this will prevent housing from falling to levels that people can afford without running deeper and deeper into mortgage debt. Housing prices are still way, way above the traditional definition of equilibrium – prices whose carrying charges are just about equal to what it would cost to rent over time.

The Treasury's aim is to revive Fannie and Freddie as lenders – and hence as vehicles for the U.S. economy to borrow from the foreign central banks and large institutional investors that I mentioned above. More lending is supposed to support real estate prices from falling quite so far as they otherwise would – and in fact, the aim is to keep the debt pyramid growing. The only way to do this is to lend mortgage debtors enough to pay the interest and amortization charges on the existing volume of debt they have been loaded down with. And since most people aren't really earning any more – and in fact are finding their budgets squeezed – the only basis for borrowing more is to inflate the price of real estate that is being pledged as collateral for mortgage refinancing.

It is pure hypocrisy for Wall Street's Hank Paulson to claim that all this is being done to "help home owners." They are vehicles off whom to make money, not the beneficiaries. They are at the bottom of an increasingly carnivorous and extractive financial food chain.

Nearly all real estate experts are in agreement that for the next year or two, many of today's homeowners will find themselves locked into where they are now living. Their situation is much like medieval serfs were tied to their land. They can't sell, because the market price won't cover the mortgage they owe, and they don't have the savings to pay the difference.

Matters are aggravated by the fact that interest rates are scheduled to reset at higher non-teaser rates for the rest of this next year and 2010, increasing the financial burden. You may remember that Alan Greenspan recommended that homebuyers take out adjustable-rate mortgages (ARMs) because the average American moves every three years. By the time the mortgage interest rate jumped, he explained, they could sell to a new buyer in this game of musical chairs – presumably with more and more chairs being added all the times, and plusher ones to boot.

But homeowners can't move today, so they find themselves stuck with rising interest charges on top of their rising fuel and heating and electricity charges, transportation charges, food costs, health insurance and even property taxes as these begin to catch up with the rise in Bubble Prices. The government has carefully avoided nationalizing the companies and thereby taking them onto its own balance sheet. It has created a "conservatorship" (a word that my spellchecker does not recognize). So the bailout of Fannie and Freddie looks like the Republicans are trying to play the financial just-pretend game simply until they leave office in February, after which time they can blame the failure of the "miracle of compound debt interest" on the incoming Democratic Congress.

So it's politics as usual: play for the short run. In the long run – even next year – the real estate market will continue to drift down.

MW: The economic news keeps getting grimmer and grimmer, but you'd never know it by listening to the politicians at the Republican Convention. The only time the economy was brought up at all was in the context of praise for free markets and globalization. The housing crash and credit market meltdown were not mentioned. Could you tell us what you think the rising unemployment numbers, falling consumer demand, skyrocketing foreclosures and ongoing troubles in the credit markets mean for America’s future? Is this just a blip on the radar or are we in the middle of a major retrenchment that will result in falling living standards and a deep, protracted recession?

M Hudson: The Republicans prefer to distract attention from how the Bush regime has failed over the past eight years. If attention can be focused on Iraq and terrorism, on personalities and style, serious discussion of such matters may be crowded out. That’s what the news media are for. When politicians do talk about the economy, the basic strategy is to fight the November election over who has the nicest dream for what people would like to believe. Amazing as it seems, a large number of Americans actually expect to have a good chance of becoming millionaires. They’re simply not looking at the debt side of the balance sheet.

The most striking economic dynamic today is polarization between those who live off the returns to wealth (finance and property extracting interest and rent, plus capital gains as asset prices are inflated) and those who live off what they can earn, struggling to pay the taxes and debts they are taking on. The national income and product accounts – GNP and national income – don’t say anything about the polarization of property, and doesn’t include capital gains, which are how most wealth is being achieved these days, not by actual direct investment to increase the means of production as lobbyists for trickle-down economic theory claim.

Here’s how things look today: The richest 1 per cent of the population receive 57.5 per cent of all the income generated by wealth – that is, payment for privilege, most of it inherited. These returns – interest, rent and capital gains – are not primarily a return for enterprise. They are pure inertia, weighing down markets. They do not “free” markets, except by providing a free lunch to the wealthiest families. The richest 20 per cent of the population receives some 86 per cent of all this income – that is, what actually is increasing household balance sheets.

What people still view as an economic democracy is turning into a financial oligarchy. Politicians are looking for campaign support mainly from this oligarchy because that is where the money is. So they talk about a happy-face economy to appeal to American optimism, while being quite pragmatic in knowing who to serve if they want to get ahead and not be blackballed.

During the 1990s the bottom 90 per cent of the population tried to catch up by going into debt to buy homes and other property. What they didn’t see was that an insatiable growth in debt is needed to keep a real estate and finance bubble expanding. All this credit imposes financial charges, which have been largely responsible for polarizing wealth ownership so sharply in recent decades.

These debt charges have grown so heavy that debtors are able to pay only by borrowing the interest that is falling due. They have been able to borrow for the past few years by pledging real estate or other collateral whose prices are being inflated by Federal Reserve policy. The Treasury also contributes by giving tax favoritism, un-taxing property and finance. This forces labor and tangible industrial capital to pick up the fiscal slack, even as they are being forced to carry a heavier debt burden.

Homeowners do not gain by this higher market “equilibrium” price for housing. Higher prices simply mean more debt overhead. Rising price/rent and price/earnings ratios for debtfinanced properties, stocks and bonds oblige wage earners to go deeper and deeper into debt, devoting more and more years of their working life to pay for housing and to buy income-yielding stocks and bonds for their retirement.

Debt expansion to buy property seems self-justifying as long as asset prices are rising. This asset-price inflation is euphemized as "wealth creation" by focusing on real estate, stock and bond prices – even as disposable personal income and living and working conditions are eroded.

So to come back to your broad question, I don't see consumer demand rising much, except by foreign tourists coming over and spending their money as the dollar falls. Here in New York, foreign buyers are supporting the real estate market. The Wall Street downturn already has forced the city to postpone its promised property tax cuts and its subway expansion. My wife and I just got our condo tax bill this week. There was an explanatory note telling us that the only tax cuts will be for commercial property owners. Residential property tax rates rise.

It gets worse. Without better transportation, wage earners will be squeezed across the country. Higher gas prices, electricity, health care and food are crowding out spending on output and forcing people into even more debt. That's why arrears and defaults are rising. Even rents are rising, despite falling real estate prices. This is because houses under foreclosure can't be rented out, so millions of houses may be taken off the market.

MW: What exactly do you mean by "modern debt peonage"?

M Hudson: This is what happens when wage earners are obliged to turn over all their income above basic subsistence needs to the FIRE sector – mainly for debt service but also to pay for compulsory insurance and, most recently, the tax burden that finance and property have shifted off themselves. The distinguishing feature about peonage is its lack of choice. It is the antithesis of free markets. As I mentioned above, many families today find themselves locked into homes that have negative equity. Their mortgage debt exceeds the market price. These homes can't be sold – unless the family can pay the difference to the banker who has made the bad mortgage loan. The gap may exceed all the income the family earns in an entire year – just as it was making on paper a price gain larger than its annual take-home pay.

But what did all this matter, in retrospect, if the house was for living, not for buying and selling? This dimension of use value was left out of account by focusing on paper wealth.

In a nutshell, debt peonage is the other side of the coin in a rentier economy. The negative equity we are seeing today is a key component of debt peonage. It forces debt peons to spend their lives trying to work their way out of debt. The more desperate they get, the more risks they take, and the deeper they end up. In Kansas City, one of my students wrote his class paper on how the immediate cause of many mortgage defaults is gambling debt. Missouri has a lot of fundamentalist Christians who think of God as watching carefully over them. Being good people, they want to give God a chance to reward them for living an honest life. So they go to the gambling boats that are moored along the river. But the odds are against them, and it looks like Einstein was wrong when he said that God doesn't play dice. Gambling – and much financial speculation – is all about probability, and the odds are as much against gamblers as they are against debtors. Being laws of nature, the laws of probability are like the privilege of land ownership: a gambling license provides the house with an opportunity to rake economic rent off the top.

Debt defaltion and the tax shift off finance and property onto labor

MW: In the short run it looks like slow growth and deflation will be bigger problems than inflation. Commodities, including gold and oil, are tumbling almost daily, while bank assets are being steadily downgraded, foreclosures are soaring and the stock market is reeling. The financial crisis that began in the real estate market has triggered a boycott of structured products and is now rippling through the broader economy.

The Federal Reserve has already dropped interest rates by 3.5 per cent and has used up half its balance sheet ($450 billion) to shore up the faltering banking system. But the situation keeps getting worse. The banks have curtailed their lending, and consumer spending is off in nearly every area. It looks like the Fed is out of ammo. Is it time to consider fiscal alternatives to the present downturn, such as cutting payroll taxes to give families more money to increase demand, or initiating massive infrastructure projects?

M Hudson: By "deflation" I assume you mean debt deflation – draining purchasing power as a result of rising debt service and compulsory insurance, plus the wage squeeze that the government praises for "raising productivity" to "create wealth" for the CEOs who pay themselves what they have cut back from labor's paycheck. There will be less consumer spending – but even so, consumer prices may not come down if the dollar resumes its fall, especially if monopoly pricing continues to be permitted. Your solution is indeed what is needed, and Mr. Obama has promised to raise the wage and salary limit subject to FICA withholding. I think that an even better idea would be to go back to the original 1913 income tax and exempt wages that merely cover subsistence. I would restore a cut-off point at $102,000 in today's dollars, matching the terms of America's 1913 income tax. People earning less would not have to file an income-tax return at all.

This truly conservative idea would free income to be spent on improving living standards. Instead, high income brackets and property are being un-taxed today, and their tax savings are being spent mainly in making loans that are used to bid up the price of wealth and luxury goods. This is what the classical economists warned against, yet the tax shift off property onto labor is being done hypocritically in their name. To get the kind of free markets they advocated, taxes should fall on the FIRE sector (finance, insurance and real estate) and monopolies, not wages or bona fide industrial profits stemming from tangible capital investment and employment.

MW: This June you wrote a groundbreaking paper for a recent Post-Keynesian conference at the University of Missouri in Kansas City, where you're an economics professor. Its title was "How the Real Estate Bubble drives Home buyers into Debt Peonage." You earlier wrote a now famous May 2006 Harpers cover story on debt peonage. Your Kansas City paper produces charts showing how tax favoritism for real estate and other clients for the banking and financial sector stimulates asset-inflation, leading to massive equity bubbles like the one we are currently experiencing in the housing market. Would you give us a brief summary of your thesis?

M Hudson: My paper explained how the money the tax collector gives up is "freed" to be paid to banks as interest. This is the motto of real estate investors: "Rent is for paying interest." The FIRE sector has adopted a populist rhetoric to persuade homeowners to believe that lowering the property tax will end up giving them more money. It seems at first blush that this would happen. But in practice, new buyers – and speculators – come into the market and pledge the tax cuts to bid up housing prices all the more. The winner in this new anti-tax marketplace is the buyer who pledges to pay the tax cut to the banks as interest on a mortgage loan to buy the property.

As my paper describes:

"Tax favoritism for real estate, corporate raiders and ultimately for bankers has freed income to be pledged to carry more and more debt, which has been used to fuel asset-price inflation that raises the price of home ownership, corporate stocks and bonds – but not to increase production and output. … Shaping the marketplace to favor finance and property over industry and labor does not create a 'free market.' It favors the debt-leveraged buying and selling of real estate, stocks and bonds, distorting markets in ways that de-industrialize the economy. [And] shifting taxes off property and finance is more a distortion than a virtue, unless debt leveraging is deemed virtuous.

"This is the tragedy of our economy today. Credit creation, saving and investment are not being mobilized to increase new direct investment or raise living standards, but to bid up prices for real estate and other assets already in place and for financial securities (stocks and bonds) already issued. This loads down the economy with debt without putting in place the means to pay it off, except by further and even more rapid asset-price inflation. This is largely the result of relinquishing planning and the structuring of markets to large banks and other financial institutions, political lobbyists have rewritten most of today's tax laws and sponsored general public deregulation of the checks and balances that were being put in place by the late 19th century. At that time, just over a hundred years ago, it seemed that wealth – and banking – were being industrialized, while landed wealth and monopolies would become more socialized and their rents fully taxed. Instead of real estate prices rising, the rental 'free lunch' would provide the basic source of public finance. Technology and productivity would increase industrial capital formation and raise labor's living standards. These policies would free markets from rent extraction and also from taxes as the fiscal burden was shifted back onto property.

But this is not what has occurred. The financial system has used its power to extract fiscal favors for real estate and to press for deregulation of monopolies as the major source of its interest and collateral for its loans."

MW: What do you think the positive effects would be of taxing property rather than income and industrial profit?

M Hudson: It would have two major positive effects. First, it would free labor and industry from the tax burden. And by the same token, it would require the economic rent currently used to pay interest and depreciation to be paid instead as a property rent tax. This would free an equivalent sum from having to be raised in the form of income and sales tax. That was the classical idea of free markets. As matters stand today, the tax subsidy for real estate and finance leaves more net rental income to be capitalized into bank loans. This is a travesty of the "free markets" that lobbyists for the banks and the wealthy in general claim to advocate.

Replacing income and sales taxes by a land-rent "free lunch" tax would make real estate prices more affordable, because the interest now "free" to be paid to banks to support a high debt overhead would instead be collected and used to lower the tax burden on labor and industry. This would reduce the cost of production and living, I estimate by about 16 percent of national income.

Homeowners and renters would pay the same amount as they now do, but the public sector would recapture the expense of building transportation and other basic infrastructure out of the higher rental value this spending creates. The tax system would be based on user fees for property, falling on owners in a way that collects the rising value of their property resulting from the rent of location, enhanced by public transportation and other infrastructure, and from the general level of prosperity, for which landlords are not responsible but merely are the passive beneficiaries under current practice.

A Neo-Progressive fiscal policy would aim at recapturing the land's site value created by public infrastructure spending, schooling and the general level of prosperity. The debt pyramid would be much smaller, and savings could take the form of equity investment once again. Slower growth of debt, housing and office prices, and lower taxes on income and sales would make the economy more competitive internationally.

MW: I'd like to expand on what you have said in your article and you can correct me if I've got it wrong. You say that today's tax code poses an obstacle to progressive political change, and puts more and more power in the hands of bankers and speculators who profit from "boom and bust" cycles. In other words, reworking the tax system has to be the cornerstone of any progressive platform? Is this the bigger point you are trying to make?

M Hudson: It's certainly the tax point I want to make. But I think that my most important point is the analysis of how the mathematics of compound interest intrudes increasingly into the economy. The fiscal link is that as finance strips more and more wealth, Wall Street converts its economic power into political power. Its main aim is to free itself from taxation – by shifting the burden onto labor.

One way to achieve this tax shift has been to re-define taxes as a "user fee." This is what the Greenspan Commission did in 1983 when it imposed heavy regressive taxation on labor via FICA wage withholding for Social Security and Medicare instead of funding these programs out of the general budget, to be paid for largely by the higher brackets. The Social Security Trust Fund generated a heavy tax surplus, which was used to cut tax rates on the upper wealth brackets.

The tax code's "small print" made commercial real estate free of having to pay income tax by pretending that landlords were losing money on their property as buildings depreciated – as if the land's rising site value did not more than compensate. Most important, interest was treated as a tax-deductible expense. This encouraged debt leveraging rather than equity investment, creating an enormous market for bankers creating credit and collecting interest on it.

MW: You say in your article that there's "a symbiosis between finance, insurance and real estate" which is at the core of the Bubble Economy. And that this creates a "a feedback between bank credit and asset prices. The quickest and easiest path to wealth is not to earn profits by investing in industry, but to go into debt to ride the wave of asset-price inflation. The result is a shift of wealth seeking away from industry to financial maneuvering on credit to ride the wave of asset-price inflation."

Is this financialization trend irreversible, or is there a way we can revitalize America's industrial base? Should we consider nationalizing the failing auto industry and putting people to work while we build vehicles for the future?

M Hudson: Nationalization may not be the answer as long as financial interests have replaced the government as society's new central planners. I fear that nationalization under today's political conditions would mean "socializing the losses," having the government bear them and then sell off the companies at the usual give-away price to new buyers on credit, all to the benefit of Wall Street.

If there is any sector to be nationalized, it should be the FIRE sector – finance, insurance and industry – along with taking basic infrastructure back into the public domain by de-privatizing it. The Progressive Era's plan that made America so rich and dominant a nation was for the government to supply basic services such as railroads, phone systems, the post office and roads or canals at cost or at a subsidy. This lowered the price structure across the economic spectrum, enabling the United States to undersell and out-produce other economies.

MW: We are now in Year 2 of the so-called credit crisis, what Bloomberg News calls "the worst financial crisis since the Depression." More and more pundits are pointing at the Fed's monetary policies as the source of the troubles. Surprisingly, even the New York Times has joined in the finger pointing by admitting that Greenspan played a central role in the housing bubble.

Here's what The New York Times recently said: "Who's to blame? In the estimation of many economists, it starts with the Federal Reserve. The central bank lowered interest rates following the calamitous end of the technology bubble in 2000, lowered them more after the terrorist attacks of Sept. 11, 2001, and then kept them low, even as speculators began to trade homes like dot-com stocks. Meanwhile, the Fed sat back and watched as Wall Street's financial wizards engineered diabolically complicated investments linked to mortgages, generating huge amounts of speculative capital that turned real estate into a conflagration."

MW: How would you characterize Greenspan's part in the present crisis?

M Hudson: He was its cheerleader, with backup from the University of Chicago and a slew of right-wing think tanks. Mr. Greenspan gave all this trickle-down economics a patina of rationale and also a rhetoric pretending that the financial bubble was helping homeowners rather than mortgage lenders and Wall Street. His role was to translate Ayn Rand propaganda into populist euphemism.

The role of a financial cheerleader is to confuse the economic issues, above all by depicting running into debt as "debt leverage" to accelerate "wealth creation." Looking backward, we now can see that this was really debt creation. When Mr. Greenspan spoke about wealth, he didn't mean the kind that Adam Smith referred to in The Wealth of Nations – tangible means of production. Mr. Greenspan meant balance-sheet financial claims on this wealth in the form of stocks, bonds and property claims. Adam Smith said that to count these monetary forms of wealth alongside the actual land and capital of Britain would be double counting. For Greenspan, the liabilities side of the economy's balance sheet – what its producers owed to financial and property owners – became the only kind of wealth he really cared about.

This inside-out perspective was largely responsible for de-industrializing, downsizing and outsourcing the U.S. economy. Mr. Greenspan's idea of "free markets" was simply to deregulate them – covertly, to be sure, by appointing non-regulators to the government's key regulatory positions. This resulted in asset stripping, which created some conspicuous billionaires (corporate raiders, re-christened as "shareholder activists" these days) and hence won the praise of Mr. Greenspan for ostensibly playing a positive role in "wealth creation."

The bottom line is that the economic vocabulary was turned into double-think.

The Political Dimension

MW: I have no background in economics, and never had any particular interest in the topic. My frustration with the direction of the country – particularly the Iraq war and the dismantling of civil liberties – led me to search for answers in places that I never otherwise would have looked. Now I am convinced that the war in Iraq and the rapid shift towards a police state here in America are logical corollaries of the economic polarization that has its root in policies that are fundamentally flawed and serve the narrow interests of corporatists, bankers and other vested interests.

M Hudson: With regard to your abhorrence of economics, some of my best students at the New School withdrew from the discipline as they found that it wasn't addressing the problems they were most concerned about. The field has been sterilized by more than a generation of Chicago School intolerance.

The economics profession does not seem to be amenable to reform along the lines that would get you interested in it. It has become mainly a rhetorical gloss to depict financial oligarchy as if it were populist economic democracy. Many people have tried to expand its scope, and have failed. Thorstein Veblen made an attempt a century ago, his analysis – basically, classical political economy – was exiled to the academic sub-basement of sociology. Economists preferred to put on blinders when it came to looking at wealth distribution and the classical distinction between "earned" and unearned" (that is, parasitic) income. Just while sex was becoming un-repressed, wealth distribution became the new politically incorrect topic to discuss.

In the old movies about invaders from outer space such as The Thing, there usually was a near-sighted scientist who said, "Let's try to reason with it. It's smarter than we are, because it's come in a flying saucer with all that great technology." The monster from outer space then would simply whack the man aside, killing him brutally.

It's much like the Terminator from the future. "It doesn't feel compassion. It doesn't feel pain. You can't reason with it," says the movie's hero. "All it does is kill."

This is the task the Chicago Boys have taken on in their defense of financialized markets as being "free." You can't reason with them. Reason is not their job. They are not there to be fair.

But to achieve its censorial role, today's economic orthodoxy pretends that markets work in a fair way to provide everyone with opportunity – something like a sperm with a chance to inherit a billion dollars from a Russian kleptocrat or American real estate magnate or Wall Street operator. To promote this worldview, one needs to craft a rhetoric pretending that markets are "free," not leading to serfdom. One has to pretend that is government regulation of the kleptocrats that is leading to serfdom rather than protecting the population from predatory finance.

Regarding your concern with the police state and, ultimately military aggression that is required to promote "free markets" at gunpoint, Pinochet-style, empire building always has gone hand in hand with impoverishing the population of the imperial center as well as its periphery. For starters, empires and wars don't pay, at least not in modern times. At best, it is like the war in Iraq – a vehicle for the Bush administration to channel billions of "missing" dollars to its campaign supporters, to recycle back into new Republican campaign funding. The economy at large is taxed as imperialism turns into asset stripping.

A second and more purely political dimension of imperial warfare is to distract the attention of voters away from economic issues, by appealing to their nationalism and chauvinism.

Hobson's theory of imperialism was that the domestic population lacked the income to consume what it produced, so that producers had to seek out foreign markets. This led to war. But today, the "postindustrial" mode of imperialism is more about recycling wealth to produce capital gains, mainly by globalizing and privatizing the Bubble Economy. The most important markets for "wealth creation" are not for goods and services, but for real estate and financial assets. So we are brought back to your initial questions today, about how Fannie Mae and Freddie Mac will sponsor more sales of mortgage-backed securities.

MW: I think your article offers a straightforward way to avoid disaster and to transform society by changing the tax code so that it strengthens the middle class and levels the playing field between "the haves and the have-nots." But how can this be achieved without breaking your ideas into snappy sound-bytes and building a broad-based grassroots movement devoted to working class issues and economic justice? Is there a way to make these transformative social changes without starting a third political party; an American Labor Party perhaps?

M Hudson: If the incoming Democratic administration proves to be more of the same, pressure will indeed arise to create a new party. More often economic reform has come from the top, but I don't see it from the Republicans, given their corruption. Within the Democratic Party the question is whether the Wall Street Democratic Leadership Committee (who gave us Gore and Lieberman after the Clintons) will continue to impose its stranglehold.

Any real improvement will need an educational campaign to prepare the ground for making economic reform the centerpiece of major elections. This educational role often has been filled by third parties. In the 1890s, for instance, the main Progressive Era campaigning occurred outside of the Democrats and largely outside of the Republicans as well.

Michael Hudson is a former Wall Street economist specializing in the balance of payments and real estate at the Chase Manhattan Bank (now JP Morgan Chase & Co.), Arthur Anderson, and later at the Hudson Institute (no relation). In 1990 he helped established the world's first sovereign debt fund for Scudder Stevens & Clark. Dr. Hudson was Dennis Kucinich's Chief Economic Advisor in the recent Democratic primary presidential campaign, and has advised the U.S., Canadian, Mexican and Latvian governments, as well as the United Nations Institute for Training and Research (UNITAR). A Distinguished Research Professor at University of Missouri, Kansas City (UMKC), he is the author of many books, including Super Imperialism: The Economic Strategy of American Empire (new ed., Pluto Press, 2002. He can be reached via his website, mh@michael-hudson.com

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