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Michael Hudson: America's Deceptive 2012 Fiscal Cliff: Part I

By Michael Hudson, a research professor of Economics at University of Missouri, Kansas City, and a research associate at the Levy Economics Institute of Bard College. His latest book is "The Bubble and Beyond."

How today's fiscal austerity is reminiscent of World War I's economic misunderstandings

When World War I broke out in August 1914, economists on both sides forecast that hostilities could not last more than about six months. Wars had grown so expensive that governments quickly would run out of money. It seemed that if Germany could not defeat France by springtime, the Allied and Central Powers would run out of savings and reach what today is called a fiscal cliff and be forced to negotiate a peace agreement.

But the Great War dragged on for four destructive years. European governments did what the United States had done after the Civil War broke out in 1861 when the Treasury printed greenbacks. They paid for more fighting simply by printing their own money. Their economies did not buckle and there was no major inflation. That would happen only after the war ended, as a result of Germany trying to pay reparations in foreign currency. This is what caused its exchange rate to plunge, raising import prices and hence domestic prices. The culprit was not government spending on the war itself (much less on social programs).

But history is written by the victors, and the past generation has seen the banks and financial sector emerge victorious. Holding the bottom 99% in debt, the top 1% are now in the process of subsidizing a deceptive economic theory to persuade voters to pursue policies that benefit the financial sector at the expense of labor, industry, and democratic government as we know it.

Wall Street lobbyists blame unemployment and the loss of industrial competitiveness on government spending and budget deficits – especially on social programs – and labor's demand to share in the economy's rising productivity. The myth (perhaps we should call it junk economics) is that (1) governments should not run deficits (at least, not by printing their own money), because (2) public money creation and high taxes (at lest on the wealthy) cause prices to rise. The cure for economic malaise (which they themselves have caused), is said to be less public spending, along with more tax cuts for the wealthy, who euphemize themselves as "job creators." Demanding budget surpluses, bank lobbyists insist that austerity can enable private-sector debts to be paid.

The reality is that when banks load the economy down with debt, this leaves less to spend on domestic goods and services while driving up housing prices (and hence the cost of living) with reckless credit creation on looser lending terms. Yet on top of this debt deflation, bank lobbyists urge fiscal deflation: budget surpluses rather than pump-priming deficits. The effect is to further reduce private-sector market demand, shrinking markets and employment. Governments fall deeper into distress, and are told to sell off land and natural resources, public enterprises, and other assets. This creates a lucrative market for bank loans to finance privatization on credit. This explains why financial lobbyists back the new buyers' right to raise the prices they charge for basic needs, creating a united front to endorse rent extraction. The effect is to enrich the financial sector owned by the 1% in ways that indebt and privatize the economy at large – individuals, business and the government itself.

This policy was exposed as destructive in the late 1920s and early 1930s when John Maynard Keynes, Harold Moulton and a few others countered the claims of Jacques Rueff and Bertil Ohlin that debts of any magnitude could be paid if governments would impose deep enough austerity and suffering. This is the doctrine adopted by the International Monetary Fund to impose on Third World debtors since the 1960s, and by European neoliberals defending creditors imposing austerity on Ireland, Greece, Spain and Portugal.

This pro-austerity mythology aims to distract the public from asking why peacetime governments can't simply print the money they need. Given the option of printing money instead of levying taxes, why do politicians only create new spending power for the purpose of waging war and destroying property, not to build or repair bridges, roads and other public infrastructure? Why should the government tax employees for future retirement payouts, but not Wall Street for similar user fees and financial insurance to build up a fund to pay for future bank over-lending crises? For that matter, why doesn't the U.S. Government print the money to pay for Social Security and medical care, just as it created new debt for the $13 trillion post-2008 bank bailout? (I will return to this question below.)

The answer to these questions has little to do with markets, or with monetary and tax theory. Bankers claim that if they have to pay more user fees to pre-fund future bad-loan claims and deposit insurance to save the Treasury or taxpayers from being stuck with the bill, they will have to charge customers more – despite their current record profits, which seem to grab everything they can get. But they support a double standard when it comes to taxing labor.

Shifting the tax burden onto labor and industry is achieved most easily by cutting back public spending on the 99%. That is the root of the December 2012 showdown over whether to impose the anti-deficit policies proposed by the Bowles-Simpson commission of budget cutters whom President Obama appointed in 2010. Shedding crocodile tears over the government's failure to balance the budget, banks insist that today's 15.3% FICA wage withholding be raised – as if this will not raise the break-even cost of living and drain the consumer economy of purchasing power. Employers and their work force are told to save in advance for Social Security or other public programs. This is a disguised income tax on the bottom 99%, whose proceeds are used to reduce the budget deficit so that taxes can be cut on finance and the 1%. To paraphrase Leona Helmsley's quip that "Only the little people pay taxes," the post-2008 motto is that only the 99% have to suffer losses, not the 1% as debt deflation plunges real estate and stock market prices to inaugurate a Negative Equity economy while unemployment rates soar.

There is no more need to save in advance for Social Security than there is to save in advance to pay for war. Selling Treasury bonds to pay for retirees has the identical monetary and fiscal effect of selling newly printed securities. It is a charade – to shift the tax burden onto labor and industry. Governments need to provide the economy with money and credit to expand markets and employment. They do this by running budget deficits, and this can be done by creating their own money. That is what banks oppose, accusing it of leading to hyperinflation rather than help economies grow.

Their motivation for this wrong accusation is self-serving and their logic is deceptive. Bankers always have fought to block government from creating its own money – at least under normal peacetime conditions. For many centuries, government bonds were the largest and most secure investment for the financial elites that hold most savings. Investment bankers and brokers monopolized public finance, at substantial underwriting commissions. The market for stocks and corporate bonds was rife with fraud, dominated by insiders for the railroads and great trusts being organized by Wall Street, and the canal ventures organized by French and British stockbrokers.

However, there was little alternative to governments creating their own money when the costs of waging an international war far exceeded the volume of national savings or tax revenue available. This obvious need quieted the usual opposition mounted by bankers to limit the public monetary option. It shows that governments can do more under force majeur emergencies than under normal conditions. And the September 2008 financial crisis provided an opportunity for the U.S. and European governments to create new debt for bank bailouts. This turned out to be as expensive as waging a war. It was indeed a financial war. Banks already had captured the regulatory agencies to engage in reckless lending and a wave of fraud and corruption not seen since the 1920s. And now they were holding economies hostage to a break in the chain of payments if they were not bailed out for their speculative gambles, junk mortgages and fraudulent loan packaging.

Their first victory was to disable the ability – or at least the willingness – of the Treasury, Federal Reserve and Comptroller of the Currency to regulate the financial sector. Goldman Sachs, Citicorp and their fellow Wall Street giants hold veto power the appointment of key administrators at these agencies. They used this beachhead to weed out nominees who might not favor their interests, preferring ideological deregulators in the stripe of Alan Greenspan and Tim Geithner. As John Kenneth Galbraith quipped, a precondition for obtaining a central bank post is tunnel vision when it comes to understanding that governments can create their credit as readily as banks can. What is necessary is for one's political loyalties to lie with the banks.

In the post-2008 financial wreckage it took only a series of computer keystrokes for the U.S. Government to create $13 trillion in debt to save banks from suffering losses on their reckless real estate loans (which computer models pretended would make banks so rich that they could pay their managers enormous salaries, bonuses and stock options), insurance bets gone bad (underpricing risk to win business to pay their managers enormous salaries and bonuses), arbitrage gambles and outright fraud (to give the illusion of earnings justifying enormous salaries, bonuses and stock options). The $800 billion Troubled Asset Relief Program (TARP) and $2 trillion of

Federal Reserve "cash for trash" swaps enabled the banks to continue their remuneration of executives and bondholders with hardly a hiccup – while incomes and wealth plunged for the remaining 99% of Americans.

A new term, Casino Capitalism, was coined to describe the transformation that finance capitalism was undergoing in the post-1980 era of deregulation that opened the gates for banks to do what governments hitherto did in time of war: create money and new public debt simply by "printing it" – in this case, electronically on their computer keyboards.

Taking the insolvent Fannie Mae and Freddie Mac mortgage financing agencies onto the public balance sheet for $5.2 trillion accounted for over a third of the $13 trillion bailout. This saved their bondholders from having to suffer losses from the fraudulent appraisals on the junk mortgages with which Countrywide, Bank of America, Citibank and other "too big to fail" banks had stuck them. This enormous debt increase was done without raising taxes. In fact, the Bush administration cut taxes, giving the largest cuts to the highest income and wealth brackets who were its major campaign contributors. Special tax privileges were given to banks so that they could "earn their way out of debt" (and indeed, out of negative equity).[1] The Federal Reserve gave a free line of credit (Quantitative Easing) to the banking system at only 0.25% annual interest by 2011 – that is, one quarter of a percentage point, with no questions asked about the quality of the junk mortgages and other securities pledged as collateral at their full face value, which was far above market price.

This $13 trillion debt creation to save banks from having to suffer a loss was not accused of threatening economic stability. It enabled them to resume paying exorbitant salaries and bonuses, dividends to bondholders and also to pay counterparties on casino-capitalist arbitrage bets. These payments helped the 1% receive a reported 93% of the gains in income since 2008. The bailout thus polarized the economy, giving the financial sector more power over labor and consumers, industry and the government than has been the case since the late 19th-century Gilded Age. All this makes today's financial war much like the aftermath of World War I and countless earlier wars. The effect is to impoverish the losers, appropriate hitherto public assets for the victors, and impose debt service and taxes much like levying tribute. "The financial crisis has been as economically devastating as a world war and may still be a burden on 'our grandchildren,'" Bank of England official Andrew Haldane recently observed. "'In terms of the loss of incomes and outputs, this is as bad as a world war.' he said. The rise in government debt has prompted calls for austerity – on the part of those who did not receive the giveaway. 'It would be astonishing if people weren't asking big questions about where finance has gone wrong.'"[2]

But as long as the financial sector is winning its war against the economy at large, it prefers that people believe that There Is No Alternative. Having captured mainstream economics as well as government policy, finance seeks to deter students, voters and the media from questioning whether the financial system really needs to be organized in the way it is. Once such a line of questioning is pursued, people may realize that banking, pension and Social Security systems and public deficit financing do not have to be organized in the way they are. There are much better alternatives to today's road to austerity and debt peonage.

NOTES

[1] No such benefits were given to homeowners whose real estate fell into negative equity. For the few who received debt write-downs to current market value, the credit was treated as normal income and taxed!

[2] Philip Aldrick, "Loss of income caused by banks as bad as a 'world war', says BoE's Andrew Haldane," The Telegraph, December 3, 2012. Mr. Haldane is the Bank's executive director for financial stability.

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