# Debt Deflation in Europe and America

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*"Without consumption, markets are going to shrink.Companies won't invest, stores will close, "for rent" signs will spread on the main streets and local tax revenues will fall. Companies will lay off their employees and the economy will shrink more. Why aren't economists talking about theseeffects of debt deflation, which are becoming the distinguishing phenomenon of our time?Theyadvocategiving more money to the banks, hoping that somehoweverything will be okay, as if the banks would lend out the money to fund new production and employment.Mainstream economics and political leaders in both parties are failing to askwhy the banks are using these giveaways to speculate abroad, pay their managers bonuses and high salaries or to pay dividends rather than to lend to small businesses or do other things to actually get the economy moving again. This phenomenon cannot be explained without seeing that debt service is siphoning off revenue into the financial sector, which is not recycling it back into the production-and-consumption economy."*

*Michael Hudson, let's start by talking about Germany. Angela Merkel is to attend an importantEuropean Unionmeeting onSeptember 7. What is going to be discussed?*

The Bundestag is meeting to discuss how the German courts will ruleon whether the European Central Bank (ECB) and the German government can bail out Greece and Portugal by buying the bonds of theirgovernments directly,or whether the German Constitution prevents this. The European Union is having a similar discussion over what has become a constitutional crisis over whether the ECB should buy these government bonds.

The problem is that Germany and the EU are constitutionally blocked from doing this. Their banks have perpetuated the "road to serfdom" myth that a central bank runs the danger of fueling inflation if it creates money– in contrast to commercial banks, which supposedly run no such danger if they create money on their own computer keyboards.It is not considered inflationary for them to charge interest to the government, which then needs to pay by taxing the economy at large.

When you find this kind of distortion being popularized and even written into law, there always is a special interest at work. The supposed contrast between "bad" central banks and “good” commercial banks is a lobbying effort seeking to monopolize credit creation in the hands of commercial banks, by promoting a travesty of how central banks are supposed to act.

The reality is that commercial banks have fueled an enormous asset-price inflation in recent years. The debt they have created imposes an interest burden that deflates the economy – even while adding to the cost of living and doing business. Meanwhile, central banks monetize government deficits that are supposed to spur recovery, not simply be giveaways to financial institutions and other vested interests.

Unlike the United States and England whose central banks were founded to monetize the government debt so that they wouldn’t have to pay interest, the EU’s Maastricht and Lisbon Treaties rule that the EuropeanCentral Bank must be independent from the government – which means in practice, acting on behalf of the commercial banking monopoly.They must avoid creating “inflationary” credit (any money at all that takes business away from the commercial banks) by not buying government debt. The ECB is to serve the commercial banks only. It can create money to bail them out, for them to give away, to lend out, to pay dividends or to pay their own salaries and bonuses. But it cannot fund government operations. It must starve the governments to make them entirely dependent on commercial banks.

The effect, of course, has been to create a captive market for the banks. It enriches them at taxpayer expense – needlessly! Whether a bank is private or public, money and credit are created electronically on computer keyboards. So it is a myth that government money is more inflationary. But this myth has a political function reflecting private self-interest: it blocks the “public option” of creating money without paying interest to banks which have obtained the privilege of creating credit freely. They are not lending out peoples’ savings deposits, but are creating deposits much like they used to print bank notes. They then look for customers willing to pay interest.

Governments are the largest borrowers, and under normal circumstances are the safest clients because they always can print the money. That is one of the three basic criteria of statehood: being able to create money, levy taxes (whose payment gives value to the money being created), and declare war. But as written by bank lobbyists, Europe’s constitution deprives the continent of the money-creating function. That is why its economy is shrinking, and why its own commercial banks are now suffering. Their business plan has created a continent-wide financial short-circuit.

Angela Merkel wants the German government and the ECB to buy the debts of Greece and Portugal and other countries in trouble, because otherwise they’re going to default. This would mean losses for the French and German banks have bought these governments’ bonds. As governments are unable to roll over their loans – that is, to re-borrowing the funds as past borrowings fall due – banks and other investors insist on much higher yields to compensate them for the risk of default. They also buy default insurance, paying a premium over the interest rate that governments pay. But the investors and guarantors then turn around and demand that the government take all the risk and promise to bail out the governments – leaving the banks with large interest premiums while taking insurance speculators off the hook. So there is an underlying hypocrisy at work.

If governments default on these bonds, the banks will lose money. So the banks are now saying that they're sorry they insisted that the ECB not create money. Creating it to pay the banks turns out to be a good thing, they say. It's only bad if it benefits labor and employers instead of the financial sector.

Mrs. Merkel insists that she has no qualms at all about pushing Greece and other debtors into poverty and demanding that debtor economies act as defeated countries and forfeit their land, their water and sewer systems and even the Parthenon to the creditors as if they were conquered militarily. So the question is whether Germany and Europe can do this without an army, as used to be the case.

Greek labor unions and citizens are protesting and holding general strikes to protest the fact that the EU is turning out not to be the peaceful and basically socialist project anticipated half a century ago, when the European Economic Community was formed in 1957. It is a financially bellicose, extractive attempt to create a financial oligarchy and impoverish Europe, stripping the assets of debtors to pay creditors. This partly explains why Mrs. Merkel is finding such opposition even in her own right-wing party. Many Germans do not want to see themselves taxed to bail out their banks for the reckless lending these banks have made – and the even more reckless "road to serfdom" ideology that prevents EU governments from financing their own budget deficits. The euro is threatening with being pulled apart by the greed, short-sightedness and ideological extremism of the anti-debtor, anti-labor neoliberals who have gained control of the legal system and much of the political system.

European banks have the same fallback position that U.S. banks had here in 2008 after Lehman Brothers failed. They are threatening to wreck the economy if the government doesn't savethem from taking a loss on loans gone bad as a result of the over-indebted economy. They have the power to disrupt the payment system and hold the economy hostage if the government doesn't take their losses onto the public balance sheet.

This is what Ireland's government did, bailing out the banks for blatantly crooked loans (that turn out to be worth only about 22 cents on the dollar) and making taxpayers pay. The reality, of course, is that the banks have enough assets to pay their retail depositors. But they can't pay the wealthiest layer of depositors at the top of the economic pyramid. The financial core institutions say that they*are* the economy.In practice, that means financial wealth-holders.So what you're seeing today as a purely technical financial crisis is actually a stage in the class war. The financial sector's tactic is to threaten to wreck the economy if politicians don't surrender and strip the economy bare to pay the creditors.This is its weapon of mass financial destruction.

The bankers who wrote the ECB constitution followed up their mess with mass fiscal destruction. The EU treaties limit governments to running budget deficits of only 3% of GDP.

This blocks them from counter-cyclical “Keynesian” spending to pull their economies out of depression. So these economies are now able to “grow their way out of debt,” any more than they can borrow their way out of bad debts. Their hands are tied, fiscally as well as financially.

No wonder there is talk of the Eurozone breaking apart, polarizing between creditor and debtor economies – which in turn are polarizing domestically as creditors seek to cap their victory by reducing their labor and industry to debt peonage. The fact that all this is being done with the trappings of political democracy and an “informed electorate” no doubt will strike future historians as remarkable.

Needless to say, a political split has developed in Angela Merkel’s own party over whether Germany should go along and help buy the debts of countries running fiscal deficits so as to support the banks. At issue is whether governments and the EU should put the interests of the banks and wealthy investors first, or the economy at large.Should governments be permitted to do what governments are supposed to do, and create their own money to spend? That is what the Bank of England was created to do in 1694, and the U.S. Federal Reserve in 1913. Or should Europe resist this “public option” and let only private-sector banks create credit? That would put the narrow layer of wealthy individuals first, sacrificing the economy. But so far, that has been the policy choice.

If your listeners are trying to follow the news in Europe they should realize that the morality of European finance and economics is different from that of the United States.Here, states can go under – like California, or Alabama with the problems it’s having in Birmingham – but the federal government will say that this is a local problem that does not concern Washington.There is no federal liability for state and local insolvency.

For example, I understand that yesterday, September 1, Republicans in Congress blocked the spending of federal money to help the victims of the hurricane on the East Coast. Republican leadersinsistthat the federal government not spend any money to help unless it cutsspending somewhere else – preferably in Social Security.This is unthinkable in Europe.Germans have explained to me that their government always supports or bails out the city of Berlin, which runs a chronic deficit.There’s a feeling that national governments have to support their states and the cities as part of a basic mutual aid ethic.

The question now before Europe is whether this principle of a government supporting a poorer region – such as Italyhas supported the southernMezzogiornofor 50 years –should be applied on a continent-wide level. Should Europe’srich nations take responsibility for supporting other countries, or should they be treated as completely separate?So the political and social character of Europe is now being determined. Unfortunately, what really is at stake is bailing out the rich, not the poor – saving the financial markets that have profiteered from government deficits and now want to avoid taking a loss on the unworkable plan their short-term self-interest has created.

This is what really underlies the debate about whether theEuropean Union overall or its individual governments can issue debt:What is going to happen to the banks that hold these bonds?Will populations be taxed to save them?

If the government is going to bail out banks, then why shouldn't banks be public in the first place? What is the point of having banks private – if wealthy creditors are to be given absolute priority over everyone else, over governments and over the economy to the extent of shrinking it deeper and deeper into depression until all Europe looks like Latvia?

European banking is different from that in the United States.The Federal Reserve can create as much money as it wants to fund the U.S.Government spending.But no continental European central bank monetizes public deficits.Instead, Europe relies on banks and insurance companies to do this. They are required under the law to hold a specific portion of their reserves in the form of government bonds.So now they're stuck with the prize they've obtained.

Their right-wing ideology has blocked governments from being able to create the money to pay them. And they've already lost huge amounts on their bad real estate loans, so many banks are so close to insolvency that U.S. banks and others are closing down the credit lines that have been keeping these banks afloat.

*So the EU meeting willdiscusswhether the European central bank should buy government debt, should buy bonds of Greece, Portugal, Spain, Italy and other governments that have big fiscal deficits.Who exactly is to buy these bonds?*

The European Central Bank, possibly backed up by the governments of Germany and perhaps France. They will create Europe-wide debt to replace the bonds of countries that have difficulty paying and are unwilling to tax property or the rich to balance their budgets.Technically, this is to be done by expanding the European Financial Stability Facility (EFSF) to go far beyond its supposed ceiling of €440 billion. It would issue the equivalent of a eurozone bond – which Mrs. Merkel and others are opposing, and which the German courts apparently are blocking in principle.

*Is the EuropeanCentral Bank part of the government, or is it privately owned?*

It's government-owned, but Europe's governments themselves are being privatized by a financial oligarchy. The Europeans can't imagine a private central bank – at least, not yet.So it is a government body, but it's independent of the government.It's run by bank officials, not by elected officials or by parliament, although its heads are appointed by parliament.So the situation there is very much like the Federal Reserve here. Bankers in effect have a veto power over any bank officer that does not act as a lobbyist to defend their interests vis-à-vis the rest of the economy.

The kind of administrators that are going to get appointed either to the U.S. Federal Reserve or to theEuropeanCentral Bank are those with financial experience that can be got only by working for the big banks.Heads of the Federal Reserve, for example, are basically appointed from Goldman Sachs to act as their lobbyist, asTim Geithner did when he ran the Federal Reserve Bank of New York. His first concern was to bail out the big banks and Wall Street,shifting the loss onto taxpayers.

The kind of people who are appointed to any central bank are former bankers who have the worldview of the financial sector – or brainwashed professors such as Ben Bernanke at the Fed.Their worldview is that no matter what happens, the banks haveto stay solvent for the economy to operate. But this view shrinks the economy keeping the debts in place, so that is the basic internal contradiction at work.

Well, the banks now, if they're buying a bond of Greece or somewhere else, all of a sudden they haveto pay huge risk insurance premiums in order to protect themselves against the fact that Greece may simply say, "Look.We don't haveenough money to pay the bonds."

And this brings up the other moral issue that's being talked about here.To what extent should a country impose austerity and even depression on itself – more than a great recession, an entire lost decade on itself – simply to pay interest to bondholders who've been financing a fiscal system that hasn't really taxed the rich in Greece?

The countries that are in trouble were fascist at one point – Spain under Franco, Portugal, Greece under the Colonels.Right-wing military dictatorships put in place tax systems that favored the rich and avoided taxing real estate or financial wealth.You could think of these tax systems as the Republican Party's dream, or for that matter that of the Obama Administration's Wall Street backers.Shifting the tax burden onto labor and industry seems to be the direction in which the world is heading these days.That is what is causing such trouble for countries going neoliberal, that is, favoring a financial oligarchy.

*What does the Lisbon Treaty prescribe?*

It says a number of bad things.For starters, Eurozone members – that is, countries using the euro – should keep their budget deficits within three percent of GDP.This blocks them from running a countercyclical Keynesian policy.What governments should be doing to pull economies out of depression in Europe and America is to run deficits to restore employment and markets.But the deficits that Greece, Portugal, Spain and Ireland have run up in past years have obliged more and more of their budgets to be paid in interest. These payments, along with rising the subsidies to the wealthy and to the financial sector, are crowding out social spending. So their economies are shrinking – and polarizing at the same time.

*Are there laws to restrict the European Central Bank from how much debt it buys?*

Yes.It's not allowed to buy government debt.It exists to help private banks, not governments or the economy as a whole. The economy exists to provide a surplus to the financial sector, not the other way around.

*Then why are they discussing the purchase of government debt right now?*

Because Angela Merkel recognizes that if the ECB or the EFSF donot somehow change their rules to buy government debt and lend money to the PIIGS – Portugal, Ireland, Italy, Greece and Spain – then they're going to default on their bonds or simply write down their debts. That's what the Greeks are rioting about as a class war of the population against the financial sector breaks out in full force.And governments pay less on their bonds or simply say that they cannot and will not pay,thenit will be obvious that leading French, German and other banks lack the reserves to back their deposits and financial gambles. Other banks will not lend to them, and they will go under.And to avoid this, they will do everything they can to cause a crisis to wreck their economies, and then blame the wreckage on the failure of governments to "act responsibly" and sell off whatever is in their public domain, Thatcher-style, to save the "poor rich" – epitomized by widows and orphans living off trust funds.

*What you're saying, then, is that Angela Merkel is proposing a constitutional change in Europe.*

That's what's involved. But it's as hard to change constitutions in Europe as it would be in the United States. So in effect, they're proposing that the European Central Bank and European Financial Stability Facility simply ignore the constitution.

*Has the European Central Bank ever done this in the past?*

No.

*So this would be a break with the past.*

Yes, a break with the past.For instance, Christian Wulff is Germany's president. He was elected on a platform of "fiscal restraint." Last week he warned that the European Central Bank is going beyond its mandate by purchasing Spanish and Italian government bonds.He said that this rush towards a fiscal union is striking at the very core of democracy. If Europe is going to act against its constitution, decisions haveto be made in parliament in order to be politically legitimate.

So the basic question concerns just who is to make European financial and fiscalpolicy.Is it the Constitution?Governments?Who is decide whose debt to buy, and how much?

On September 7 the Constitutional Court in Germany will rule on the legality of the European Union's bailout policy.Investors are wondering how it will rule.That's why the stock market is plunging, andwhy the euro is under such pressure and falling.

[As matters turned out, the Court permitted the purchases made so far, but blocked further bailout spending.]

If the Constitutional Court rules that the 440 billion euro –about $600 billion –rescue fund breaches treaty law or undermines German fiscal sovereignty, this will post the question over whether the country wantsto expand the half-baked monetary union into a fiscal union.If not, what does that mean for the EU as currently mal-structured?

The problem is that the EU has been turned into the opposite of what it was in the beginning.Back in the 1950s it was created by Social Democrats and Socialists who wanted to save Europe from ever going to war again within its own borders.The left took leadership.But as financial and monetary union has risen to the foresince the 1980s, the continent has become more right-wing.Planning has been shifting out of the hands of government andelected officialsinto those of bankers, especially through their proxy in the European Central Bank.What now is at issue is whether Europe will be run for the bankers and financial sector or for the population at large.So far, Angela Merkel has worked with Nicolas Sarkozy to try to represent the bankers' position, not that of political democracy.

*Is there public opposition to bailing out the banks in Germanyand the rest of the EU?*

Sure.Many voters believe that economic recovery should come first, and that banks and the financial sector should serve the economy.Government budgets should be spent on social programs, not mainly on bailing out banks. If there's a crisis because of bad fiscal policy stemming from the rich blocking taxation of their own wealth and property Greece and other post-dictatorship countries, the solution isn't simply to lend them enough to subsidy this regressive tax policy. It's not to tell Greeceto sell off the Parthenon and other tourist sites for privatizers to buy on credit and pay the rental value to the banks. It would be a reversal of the past few centuries of European reform to carve up the public domain and sell it to the interests that organizefinancial backing.This would turn bad fiscal policy into a victory for the privatizers. Europe would go Thatcherite and Blairite. The Greek colonels would have "won the peace."

The moral hazard problemis that banks, investors and speculators rely on governments to bail out their bad bets that in turn reflect a self-defeating business plan to load economies down with debt and extract the entire economic surplus as debt service – and then foreclose and get one's capital back via privatization sell-offs.

It's the same in the United States.Most Americanvoterssaid they were against the bailout.Even Republican Michelle Bachmann has made a big point of having voted against it in September of 2008.So politicians have said that they are against further bailouts. ButTreasury Secretary Tim Geithner and the Federal Reserve are saying thatWashington may indeed have to bail out the banks again.It's as if they can keep squeezing enough out of the economy to pay the financial sector to make up for the losses that its debt-deflation business plan is causing.

*Earlier you said that Europe'sbanking crisis wasn't as severe as it is in the United States.I had thought it was worse.*

There are a number of differences.There hasn't been the wholesale financial mortgage fraud in Europe that flourished in the United States – except in Ireland, where they found the average mortgage to be worth only about 20 or 22 cents on the dollar, especially with Anglo-Irish Bank and the Royal Bank of Scotland there was a huge fraud.But in Continental Europe there was less fraud – merely over-lending against property, in the context of a fiscal policy that taxes labor and industryrather than land or natural resources and gives tax subsidy to debt financing.

Only now are Europeans having the discussion that they should have had 10 or 20 years ago.Nobody wants the Greeks and Portugal to starve.The question is, what's the best way to help them?Is it simply to give money to their governments? They would simply pay their bankers.Supporting bond prices by buying bonds in the market would reward speculators.If the aim is to support Greece, why include the financial sector or gamblers?

Treasury Secretary Geithner is reported to be pressuring the Europeans to bail out the banks because Goldman Sachs and othersAmerican bankshave gambled that Greece and other countries can pay, and written default insurance. It seems that if these U.S. banks lose the bets that they've made, they'll go under and Washington will have to bail them out.So Mr. Geithner is telling Europeans to sacrifice their economies so that U.S. financial casino gamblers won't take a loss.This did not go over very well in Europe.

*Are you referring to the credit default swaps that U.S. banks hold, and theinsurance policies they have written against European bond defaults?*

That'sa big part of the problem,along with lines of credit.Throughout Europe and the United States most banks have lines of credit with other banks.Just as individuals have overdrafts with their bank, most banks have credit lines with numerous other banks.Right now, banks are canceling their lines of credit with many European banks, because nobody knows really what bank balance sheets are worth.Europe has been as lax as U.S. authorities in conducting "stress tests" to get honest reporting. Banks are allowed to fiddle with their accounting practice so much that most analysts view them as being pretty fictitious.

So if a bank finds out that you've lost your job or that you've been misrepresenting your income they're going to say, "I'm sorry.We've got to lower your credit card amount from $10,000 to $2,000," or "We're canceling your credit card."Well, that's what the American banks are doing to the European banks.So all of these lines of credit that are all created on a computer keyboard are being canceled and that's creating a balance sheet problem.So that's why people call this the balance sheet recession, not really a worker spending recession.

*Has the financial system reached its limit?*

It's reached its debt limit.The financial system is much more a debt system than one based on equity financing, that is, a share of the gains made from the loan.The bank's product is debt – and neither businesses, real estate orpeople (or governments, for that matter) can afford to pay more than they're paying now.Much of the economy already is in negative equity.

*Is any financial investment safe?*

Nobody knows of any.That’s why people are buying gold.They’re trying to protect what they have at this point more than to make further gains. It’s not that they lovegold as such, because there isn’t all that much use for it, after all. Its price is rising because investors have lost faith in governments – except for the U.S. Treasury, whoseshort-term debt now is yielding almost nothing.People are moving into Treasury IOUsbecause it can simply print the money to pay. It doesn’t need to borrow – as we’ve seen with the $13 trillion in financial bailout debt created just since 2008.

Everything else is insecure.If you look at markets going up 400 points one day, down 400 points another, this wild zigzaggingis a market for professionals.If you don’t have a billion dollars in computer-driven trades, you don’t have much chance,because there’s no rational explanation grounded in the real economy is to why the stock market should careen so wildly up and down.

*Do you think that lack of confidence in governments is driving the precious metals markets, specifically gold?*

It’s also copper, and even food.People are trying to move out of financial securitiesinto thing that are tangible – farmland, wheat and trophies.

*Do you feel that that the move into tangibles is rational?*

It’s a self-protective response by people who worry that theymay lose if they buy stocks orbonds. Not since the 1920s has the stock market been so limited to professionals, especially as the Bush and Obama administrations have decriminalized financial fraud by not prosecuting it and by understaffing the government’s major regulatory and justice agencies.If people buy stocks today, they may lose money – and evenif they put their money in a bank, it may go bust.So investors want to get out of the financial superstructure back into the real economy.

The problem is that what people call “the economy” has been financialized.In the United Stateslast year, 40 percent of corporate profits were made by the banking sector.The rest of the economy is shrinking under the weight of debt deflation – interest and fees paid to this financial sector.

Germany is the strongest economy because it’s better structured in many ways,and more industrial.It has a higher proportion of the real economy to GDP, andalso is much lower-cost, because it hasn’t built financial overhead into real estate and family budgets to anywhere near the extent that has occurred in the United States.

Countries that have let themselves become post-industrial service economies are finding out that if you don’t make things, you can’t live forever by going to Las Vegas.The casino always wins – and today's casino is Wall Street. It's a zero-sum game for the economy – with the economy's losses plus Wall Street's gains netting out to zero. So in economic jargon, the financial sector has become a transfer payment, not playing a productive role.

*As long as we're speaking of Germany, what is good about its economy?Can you describe its social safety net and what you began to sayabout housing there?*

The typical American family spends about 40 percent of its budget on housing.In Germany it's only about 20 percent.There are a number of reasons for that.For starters, real estate prices are whatever a bank will lend. Easier credit means higher debt leveraging – and hence, higher property prices.

German homebuyers must pay 20 or usually 30 percent of the purchase price down, so they don't have 100 percent mortgages like there are in the United States.And mortgages are self-amortizing. For renters, there are co-op arrangements for a much larger market supplied at cost, in contrast to the United States, where the rental market is owned by landlords who squeeze out as much as possibleover and above the actual cost of maintaining the property.

A German moving to Hamburg or Frankfurt mayjoin a co-op organization and pay perhaps $1,000 or $2,000.Anyone can join.So there's not much motivation to buy houses as a speculative means, because it's usually cheaper to rent than to buy – and less effort for upkeep. As a result, there has not been a Germanfinancial bubble to bid up prices as has occurred in the English speaking or neoliberalized countries where people have been panicked to buy before prices rise even further beyond their reach.

In the time of Ricardotwo hundred years ago, the most important element in labor's budget was food. He judged wage competitiveness largely by the price of bread.But today, labor costs are set by what it costs workers to buy or live in a home, whose price is set by highly debt-leveraged credit terms.So Germany's low unit labor costs are not simply the result of high technological productivity.They reflect low housing costs and relatively low social security costs.It hasn't financialized its economy to anywhere near the extent that the United States has done.

*You have said that Social Security in Germany is pay-as-you-go.Who is paying: the government or citizens?*

Basically, individual citizens.Pay-as-you-go is an American way of putting it, butthe Germans call it a "generation treaty."The young generation agrees to support retirees, on the understanding that when it gets old, new employees will support it in turn.

By "pay as you go"I mean that there are no financial intermediaries as in the United States – no saving in advance to lend to the government to provide funding to cut taxes on the higher income and wealth brackets.Alan Greenspan and his right-wingers claimed that government budgets were just like private budgets, so that workers need to pay for their own Social Security by saving in advance – and then drawing down these wage set-asides.So FICA withholds over 13 percent of employment costs to pay much more into a government fundthan actually is paid out.

This extra money is used to buy Treasury bonds.The Treasury uses this revenue to cut taxes on the rich, and on real estateand to give subsidies to the financial sector. So the effect is to move away from progressive taxation into regressive taxation.

What makes the U.S. system a con game is that **when it comes time for the Social Security Administration to start paying out more than it is taking in – by selling off the Treasury securities that it's been buying for all these decades –these sales have the same financial effect as when the government issues and sells fresh Treasury bills to finance a new budget deficit**.So all this pre-saving is unnecessary from the financial standpoint. The gimmick has been to shift the year-to-year tax burden off wealth onto employees.

The idea of pre-saving for Social Security is as absurd as trying to pre-save for a war.What if the government said, "Maybe there's going to be another war that may cost, say, $3 trillion.Let's prepare by saving that in advance, bytaking it out of employee paychecks to buy Treasury bills." Soon enough, politicians would get the idea of usingthis money to cut taxes ontheir major campaign contributors, the wealthy.

**The trick has been to convince voters that paying excess Social Security contributions is a user fee, not a social program to be paid out of the general budget by progressively taxing the wealthiest brackets**.By contrast, Germany'spolicy of paying out of current tax revenue iswhat Adam Smith recommended that governments do.Just as he said that wars should be financed on a pay-as-you-go basis, so that people would understand their cost.

*So employees and employers pay much more into the system than ispaidout*.

That's the idea: to save enough in advance, beyond what you currently have to pay,to lend the revenue to the government to cut taxes on the rich.It's pay-in-advance rather than pay as you go.Pay much more than the government needs at present, so that the Treasury has enough money to slash the income tax that wealthy people have to pay.You can follow the *Treasury Bulletin* or the *Federal Reserve Bulletin*to see how the savings of the Social Security Administration go up every year – and are lent to government. (George W. Bush wanted to put this money into the stock market to create a stock-price boom that would enrich Wall Street – and would collapse once the flow of funds was reversed and more stocks were sold to pay retirees than new employees paid in. Thank heavens that potential bubble was averted.)

The result that we have today is not really a Social Security system.It's a system of taxing employees instead of the rich.This tax shift increases the cost of employing people in the United States.That is one of the reasons, in addition to the housing costs, that prices

America out of world markets.

The system that financial lobbyists have put inis designed to tax labor and siphon off so much that American labor cannot compete in any market in the world except in arms markets and special markets, and food.So what they call free-market efficiency is crippling the efficiency of the United States by adding to housing costs and adding needlessly to the Social Security and Medicare costs.

There’s no need for these pre-savings to have taken place.Workers could have kept much more of their wages and the government would have had to maintain higher taxes on the rich. But the Republican policy was to tax labor and un-tax wealth –class war with afinancial fist.

*Since we’ve talked about Social Security, what about the new Super Congress – the Committee of 13, with Obama being the 13th member?What is the composition of this committee, and what automatic budget cuts will go into effect in November if Republicans reject the Obama budget?*

The Super Congress is made up of people that President Obama has selected largely because they want to cut Social Security.They pretend that it must be paid as user fees, in advance, to stem the budget deficit that has resulted from untaxing the estates of billionaires – the super-rich – and continuing the regressive tax shift that has been underway since the 1980s.

The basic rule of high finance is that big fish eat little fish.Millions of Americans have put their paychecks into Social Security.Just as corporate raiders set their eyes on emptying out pension funds to pay themselves (and their stockholders and bondholders), so financial lobbyists are seeking to raid the Social Security fund. Their motto is, “Let’s take the employees’ moneyand give it to ourselves.”

President Obama’s“Main Street” is Wall Street.His talent as a politician is to get votes from Main Street and deliver policies to Wall Street. He actually seems to believe that Social Security should be cut back to give money to his major campaign contributors.The richare his constituency today,just as they were for George W. Bush. So Obama may cast the deciding tie-breaking vote, but as we’ve spoken on your program before,he’s already appointed people to the Budget Commission and the Social Security Commission when he was first elected, people who want to cut back Social Security by pretending that there’s a crisis. Their working assumption is that if the government needs money the poor should lose, not the rich.

It’s hard for congressmen or senators to vote against Social Security and Medicare, because most voters are in favor of these programs.So President Obama’s strategy is to take the Social Security issue out of Congress – and give himself an opportunity to posture during late September and October to propose pro-labor policies that he knows a Republican Congress will reject, thereby triggering the “automatic” budget cutbacks he negotiated in

August with the Republicans.

If you look at who the campaign contributors of the Super Committee, they're mainly in the financial sector. Even if they committee members are unpopular, they're going to be able to retire with such high paying jobs in the financial sector.This is what the Japanese call Descent from Heaven.They'll get their payoff for taking the heat on stiffing the Social Security recipients for their Wall Street constituency.

I'm amazed that there's not more of a political reaction against this.People have worked hard to save for Social Security out of their paychecks.These are real savings.For Republicans to characterize these payments as an "entitlement" is totreat the elderly as if they're mere welfare recipients freeloading off the rich – while it's actually the banks and big fortunes that have been given the handout.

If the Bush and Obama Administrationcan give $13 trillion to the banks to save them from taking losses on their bad investments, then why can't they give another trillion to Social Security?The reason is,**there's a class war on.If you don't realize this, then you're not going to understand what politics is all about these days.**

**However, it's not the kind of class war that people talked about a century ago.It's fought in the financial arena.The idea is for the big sharks to take the savings of the little savers. They exploit labor not by employing it – as in Marx's description in Vol. I of *Capital* – but financially, by loading it down with debt and making labor spend a working lifetime to pay it off. So instead of the wage slavery socialists used to talk about, you have debt peonage today**.

*Food is becoming very expensive in the United States.Do you see this trend continuing, and is the rise in food prices a consequence of the weak dollar?*

It's not a consequence of the weak dollar.One factor is global warming, which is creating water shortages all over the world.Urbanization also is doing this.But also there's been a huge diversion of cropland to grow gasohol – to make gasoline out of corn or rapeseed or other crops. This has diverted land and water away from food for cars and other energy.

We are now seeing incipient water wars in the West. Who will get the scarce water? Will it be urban areas, or agricultural farmland?What will the price of water be?Will it be diverted to make gasohol and coal liquids?

The Canadian tar sands are one of the worst projects, because they use about ten gallons of water for every gallon of coal gas.I was the economist working for ERDA, the Energy Research Development Administration, around 1975 and did the study of this.The Carter Administration came in they said, "Look.How are we going to pay for all this high-pricedOPEC oil now that the OPEC countries are raising the price?"Carter's solution was for coal gasification and liquefaction to lower oil costs while raising the price of wheat,by diverting water away from agriculture.

Speculators all over the world are buying land as they move out of credit and finance.Land is real, andeverybody needsto eat, after all.So food is becoming as speculative an investment vehicle as gold, copper or stocks – and water monopolies.

*So you would say that speculation is one of the big reasons why food is going up – land speculation, food speculation and water.*

Not only speculation,but the fact that water levels are falling.Food is made as much out of water as out of soil.The weather is another problem.Global warming is causing weather changes that reduce crop yields, asflooding and droughts go together.

*Putting land into gasohol production was a political decision, right?*

Yes.The mainstay of America’s trade balance has been food exports.Aconstant in U.S. foreign policy since 1945 has been to promote food export markets to cover the cost of American imports and military spending abroad.

*Why is the cost of gasoline rising?*

This would be a job for anti-monopoly regulators to look at if they were still regulating.President Obama has appointed a justice department that refrains from prosecutingeconomic crime, andan environmental department much like the Reagan version. It gives the oil companies whatever they want, such as new offshore drilling rights.Obama has put deregulators everywhere in a way that George Bush, as a Republican, was not able to do, because the Democrats would have opposed a Republican president from disabling the regulatory agencies to the extent that Obama has done. But they can’t stop their own party leader doing this.

*Are there similarities between the economic crisis of September 2008 and the present situation?*

Yes,we’re still in the aftermath of 2008.Economists are talking about a double-dip recession, butwe’ve never gotten out of the first crash.The economy has not recovered.The stock market has gone up, because the Federal Reserve has been flooding it and the bond market with liquidity.But employment, living standards and sales are not going up.Housing is still down.So we’re in more than a Great Recession.We’re going into a lost decade.

We’re entering a period where wages will drift downward in a slow crash, because the government is not renegotiating mortgages downwardor canceling bad debts.It is not bailing out the cities that are in trouble and there’s a downward financial spiral basically coming from the debt situation.

The question shouldn’t be whether we’re in a double-dip recession, but why a recovery fromthe crash has not taken place.Why haven't the bank bailouts created jobs? How could the government create $13 trillion of Treasury and Federal Reserve cash, loans and guarantees to Wall Street for the wealthiest one percent of our population without this trickling down and created jobs?

How do we jumpstart an economy when 70 percent is consumer spending, but consumers aren't spending because they're spending their money to pay off debts taken on in the past, or worried that they may be unemployed?In other words, what has Washington not been doing that it should have been doing? What has it left out of account?

Before President Obama he was elected he said he was going to renegotiate mortgages downward. Butthe banks have not done this.So did he just give up and say, "Well, just forget it"?The Federal Reserve flooded the banks with liquidity, but they sent it abroad. They argue – with good reason – thatthe economy is shrinking too much to qualify for enough loans to borrow its way out of debt.

It should be obvious by now that giving money to the banksdoesn't create jobs for the people. It is mere propaganda tocall the rich "job creators." They have put in place an extractive financial system that has destroyed jobs. They're the ones that are closing down the factories andoutsourcing American labor.

*Are the banks creating a permanent depression?*

That's the outcome of their business plan, which is to take the entire economic surplus in the form of debt service. Banks want to create as much debt as they can.Debt is their "product." The economy is merely "collateral damage" to a financial dynamic that is impersonal, not deliberate.

Every economy for hundreds of years has seen debts grow more rapidly thancan be paid.At a point there's a crash, whichnormally wipes out debts.It also wipes out savings on the other side of the balance sheet, of course. But this time the governmenthas tried to keep the debt overhead on the books – and to tax the population to give banks enough to make sure that the rich don't lose money.Only industry and labor will lose.

The effect will be to de-industrialize the economy even more, because markets shrinkwithout consumer spending. Companies won't invest, stores will close, "for rent" signs will go up, tax payments to the cities will fall, and municipal employees will be laid off while social services are cut back. The economy will shrink and life will get harder.

Why aren't economists talking more about this obvious phenomenon of debt deflation? It is the distinguishing phenomenon of our time.But opinion-makers are insisting that the solution is simply to give more money to the banks.Not many people are askingwhy this isn't working. And when they do ask, they don't get much media coverage.

*Could you explain debt deflation?It's a confusing term.*

Economics textbooks depictpeople earning income and spending it on the goods and services they produce.This is why Henry Ford said he paid his workers $5.00 a day – so that they could buy the Fords they made. Economists call this circular flow Say's Law.

But people spend a rising proportion of their income to pay debt service. That is their first charge.Before they decide how much is available to spendon goods and services,they have to pay their credit card debt, student loans, other bank debt, and of course the mortgage.The more they pay the banks, the less they have to spend on goods and services.Business salesshrink, because the banks recycle their interest receipts into even more loans – on even "easier" terms, meaning more debt leveraging.So the "real" economy of production and consumption shrinks while the payments to the financial sector go up.

Financial investors don't buy many goods and services.They leave their revenue in the financial system, mainly to be lent out on new loans,sent abroad or used for speculation.Debt deflation is what happens when spending is diverted away from buying goods and services to paying debts. The financial sector grows, relative to the "real" production-and-consumption economy.So debt deflation of the underlying economy goes hand in hand with asset-price inflation fueled by increasingly loose credit and steeper debt leveraging.

*I see.And then that deflates the economy.*

Yes.Less national income is available to be spent on goods and services, and more is given to the financial sector.

*The Federal Housing Authority is suing the major banks – Bank of America, Chase, Citibank, Deutsche Bank and other big banks.What is the lawsuit about?*

These banks misrepresented the junk mortgages that they were making and selling to outside investors.They packaged mortgages and sold them to pension funds, insurance companies and foreign banks.Ratings agencies bid for clients by agreeing to give junk mortgages AAA ratings – as good as the U.S. Government.But the mortgage lenders and the ratings agencies they hired assured clients that these mortgages were good and could be paid – or at least that the market would continue to rise, so that if there was a default, new buyers would play the role of the proverbial "greater fool" and buy properties being foreclosed.

It turned out that the appraisals were based on unrealistic appraisals and either fake or absent reports on the borrower's income and hence ability to pay. They were no-documentation loans, and the biggest banks have turned out to be running a fraud.Bill Black has written more on this than anyone else,at the University of Missouri in Kansas City.

By the way – if we're talking about debt deflation and other financial issues, there's a UMKC economic blog, called New Economic Perspectives. Prof. Black and I (and others) write about how the financial sector has become what he calls criminogenic.In other words, it's been criminalized, and bankers have run what he calls "control fraud."The economy's largest financial market, real estate mortgage lending, turns out to be based on crooked real estate brokers, appraisers, underwriters, ratings agencies and so9 forth.Right down the line almost everybody's been engaged in a gigantic fraud that's helped inflate the real estate bubble.Whereas when similar fraud happened in the 1980s with the savings and loan associations thousands of people went to jail, nobody's gone to jail yet.Hardly anybody's been arrested.And yet they're on a much larger scale than Bernie Madoff.

The Justice Department is reluctant to prosecute fraud, because the largest perpetrators are the banks that already are dependent on the U.S.Government for bailouts. So from the Justice Department's vantage point, the governmentsimply would be fining itself, because it would turn around and lend the crooked banks enough to keep them in business. So they're not sending anybody to jail, not even Angelo Mozilo of Countrywide, the toxic bank at the core of junk mortgage lending. It's now part of Bank of America.

So in effect the United States has decriminalized financial fraud.The Federal Housing Authority that brought the suit you cite had three years from the time it took over Fannie Mae and Freddie Mac, the housing guaranty agencies, to bring up fraud.So it's making the point that government-guaranteed agencies bought "toxic waste" from crooks. The inference is that Citibank, Chase Manhattan, Wells Fargo andBank of America are a financial gang. It's now being asked tomake restitution.Or at least the FHA has to pretend to go after them.

The banks tried to stop this by having the Iowa attorney general head a group of attorneys general to make an overall agreement with the banks, basically to forgive them.In effect, their position is that "They've stolen $13 trillion.Let's fine them $100."The Obama Administration is backing this little slap on the wrist.

But now the New York attorney general and I think his Nevada counterpart have said, "Wait a minute.These guys have falsified loan documents andwritten in false figures.These guys are crooks.Bank of America is like a mafia.These are absolute crooks and we're going to go after them and fine them and get restitution."And that's why Bank of America stock is down six percent today, because now they think, "Oh, my God.What if they actually enforce the law?"

Obama's attorney general EricHolder,seems reluctant to enforce the law.He seems like the crooked sheriff who works for the gangsters who run a small town, as their protector.So this should be what the election is all about – to make Holder and Obama prosecute the frauds rather thanmaking sure that the crooked banksdon't lose anything.

But despite all this, the important thing is that the real estate bubble would have developed in any event, simply because of the exponential financial dynamics at work and the increasing tax favoritism for real estate – taxing labor and industry rather than land rent.

*Talk about the University of Missouri-Kansas City economics blog, the New Economic Perspectives on MMT that you mentioned.What is modern monetary theory?*

Basically, it's the realization that we're not on a gold standard anymore.When banks make a loan, they create a credit on their computer keyboard and their customer signs an IOU. So the loan creates the deposit, not the other way around.

Governments can do this too. They don't need to borrow from banks.They can create the money on their own keyboards to pull the economy out of recession.Some people call this post-Keynesian, others call it heterodox. We're the opposite of the Chicago School, which claims to befree market but actually is pro-banker. Its idea of a free market is to let gangsters be part of the economy, as ifcrime is all part of individualistic gainseeking.

What is "modern" about today's money is that it is created by banks electronically at will – "freely." If the government runs a deficit, it pumps spending power into the economy – either the goods-producing sector, or Wall Street balance sheets.But if the government runs a surplus, it sucks revenue out of the economy.

If we're going to spur recovery today, we need employment.The way to get this when there's a lack of private sector demand is for the government to become the source of demand, by running a deficit. This is the opposite of what the Republicans and the Democrats are saying.But even Herbert Hoover as well as Roosevelt said back in the 1930s.The Republicans and the Democrats back then realized that the government had to spend more money to get the economy out of recession.Today both parties are pushing austerity plans.

*If people want to read about Modern Monetary Theory, where would they go on the Internet?*

To the UMKC (University of Missouri-Kansas City) economics blog:New Economic Perspectives.Most of my articles are posted there. Another good source is Yves Smith's Naked Capitalism, and also the Levy Institute.

*What about currencies – the dollar and euro as well as the renminbi and yuan?*

Currency markets are in turmoil because nobody knows how Europe will resolve its debt crisis.People are moving out of the euro into the dollar, and then out of the dollar into gold.They're moving out of everything financial.Meanwhile,currency markets are being swamped by huge computer programs.There's no underlying way to relate exchange rates to domestic consumer prices, labor's wage rates anything that the textbooks talk about.It's now all about the flow of funds – on credit, dominated by speculators.

*If debts are canceled, how would this be done?*

The original plan for bad mortgage debt was to reset mortgages to match the current propertyprices.That's one method.Or, you can bring mortgages in line with rental valuation, by asking what ahome would rent for – and then capitalize the net rental revenue at, say, 5 percent interest.That would be a reasonable price for the property, so banks would be told to reset the mortgage at that level.

*So the banks would write off a lot of the debt.*

Yes.And somebody would haveto lose and it would have to be the big bank depositors because the Federal Deposit and Insurance Corporation insures depositors up to $100,000 or $200,000, I think pretty positively.So the big rollers would lose.

And they've increased.The wealthiest one percent of Americans in 1979 had 39 percent of the interest, dividends, rent and capital gains.Now they have about two-thirds.They'd haveto go back to their historical proportions and the economy would become much less polarized between rich people and the rest of the economy.So you'd have a much more normal economy by writing down this financial fat or parasitism.You'd get rid of it

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