How the Chicago Boys Wrecked the Economy

An Interview with Michael Hudson

By Mike Whitney

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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

Mike Whitney: The United States current account deficit is roughly $700 billion. That is enough "borrowed" capital to pay the yearly $120 billion cost of the war in Iraq, the entire $450 billion Pentagon budget, and Bush's tax cuts for the rich. Why does the rest of the world keep financing America's militarism via the current account deficit or is it just the unavoidable consequence of currency deregulation, "dollar hegemony" and globalization?

Michael Hudson: As I explained in Super Imperialism, central banks in other countries buy dollars not because they think dollar assets are a "good buy," but because if they did NOT recycle their trade surpluses and U.S. buyout spending and military spending by buying U.S. Treasury, Fannie Mae and other bonds, their currencies would rise against the dollar. This would price their exporters out of dollarized world markets. So the United States can spend money and get a free ride.

The solution is (1) capital controls to block further dollar receipts, (2) floating tariffs against imports from dollarized economies, (3) buyouts of U.S. investments in dollar-recipient countries (so that Europe and Asia would use their central bank dollars to buy out U.S. private investments at book value), (4) subsidized exports to dollarized economies with depreciating currency, and similar responses that the United States would adopt if it were in the position of a payments-surplus country. In other words, Europe and Asia would treat the United States as its Washington Consensus boys treat Third World debtors: buy out their raw materials and other industries, their export plantations, and their governments.

MW: Economist Henry Liu said in his article "Dollar hegemony enables the US to own indirectly but essentially the entire global economy by requiring its wealth to be denominated in fiat dollars that the US can print at will with little in the way of monetary penalties.....World trade is now a game in which the US produces fiat dollars of uncertain exchange value and zero intrinsic value, and the rest of the world produces goods and services that fiat dollars can buy at "market prices" quoted in dollars." Is Liu overstating the case or have the Federal Reserve and western banking elites really figured out how to maintain imperial control over the global economy simply by ensuring that most energy, commodities, and manufactured goods are denominated in dollars? If that's the case, then it would seem that the actual "face-value" of the dollar does not matter as much as long as it continues to be used in the purchase of commodities. Is this right?

Michael Hudson: Henry Liu and I have been discussing this for many years now. We are in full agreement. The paragraph you quote is quite right. His Asia Times articles provide a running analysis of dollar hegemony.

MW:What is the relationship between stagnant wages for workers and the current credit crisis? If workers wages had kept up with the rate of production, isn't it less likely that we would be in the jam we are today? And, if that is true, than shouldn't we be more focused on re-unionizing the labor force instead looking for solutions from the pathetic Democratic Party?

Michael Hudson: The credit crisis derives from "the magic of compound interest," that is, the tendency of debts to keep on doubling and redoubling. Every rate of interest is a doubling time. No "real" economy's production and economic surplus can keep up with this tendency of debt to grow faster. So the financial crisis would have occurred regardless of wage levels.

Quite simply, the price of home ownership tends to absorb all the disposable personal income of the homebuyer. So if wages would have risen more rapidly, the price of housing would simply have risen faster as employees pledged more take-home pay to carry larger mortgages. Stagnant wages merely helped keep down the price of houses to merely stratospheric levels, not ionospheric ones.

As for labor unions, they haven't been any help at all in solving the housing crisis. In Germany where I am right now, unions have sponsored co-ops, as they used to do in New York City, at low membership costs. So housing costs only absorb about 20% of German family budgets, compared to twice that for the United States. Imagine what could be done if pension funds had put their money into housing for their contributors, instead of into the stock market to buy and bid up prices for the stocks that CEOs and other insiders were selling.

MW:When politicians or members of the foreign policy establishment talk about "integrating" Russia or China into the "international system"; what exactly do they mean? Do they mean the dollar-dominated system which is governed by the Fed, the World Bank, the IMF, and the WTO? Do countries compromise their national sovereignty when they participate in the US-led economic system?

Michael Hudson: By "integrating" they mean absorbing, something like a parasite integrating a host into its own control system. They mean that other countries will be prohibited under WTO and IMF rules from getting rich in the way that the United States got wealthy in the 19th and early 20th centuries. Only the United States will be permitted to subsidize its agriculture, thanks to its unique right to grandfather in its price supports. Only the United States will be free from having to raise interest rates to stabilize its balance of payments, and only it can devote its monetary policy to promoting easy credit and asset-price inflation. And only the United States can run a military deficit, obliging foreign central banks in dollar-recipient countries to give it a free ride. In other words, there is no free lunch for other countries, only for the United States.

Other countries do indeed give up their national sovereignty. The United States never has adjusted its economy to create equilibrium with other countries. But to be fair, in this respect only the United States is acting fully in its own self-interest. The problem is largely that other countries are not “playing the game.” They are not acting as real governments. It takes two to tango when one party gets a free ride. Their governments have become “enablers” of U.S. economic aggression.

MW:What do you think the Bush administration’s reaction would be if a smaller country, like Switzerland, had sold hundreds of billions of dollars of worthless mortgage-backed securities to investment banks, insurance companies and investors in the United States? Wouldn’t there be litigation and a demand that the responsible parties be held accountable? So, how do you explain the fact that China and the EU nations, that were the victims of this gigantic swindle, haven’t boycotted US financial products or called for reparations?

Michael Hudson: International law is not clear on financial fraud. Caveat emptor is the rule. Foreign investors took a risk. They trusted a deregulated U.S. financial market that made it easiest to make money via financial fraud. Ultimately, they put their faith in neoliberal deregulation – at home as well as in the United States. England is now in the same mess. The “accountability” was supposed to lie with U.S. accounting firms and credit rating agencies. Foreign investors were so ideologically blinded by free market rhetoric that they actually believed the fantasies about “self-regulation” and self-regulating markets tending toward equilibrium rather than the real-world tendency toward financial and economic polarization.

In other words, most foreign investors lack a realistic body of economic theory. The United States could simply argue that they should take responsibility for their bad investments, just as U.S. pension funds and other investors are told to do.

MW:The Congress recently passed a bill that gives Treasury Secretary Henry Paulson the unprecedented authority to use as much money as he needs to keep Fannie Mae and Freddie Mac solvent. Paulson assured the Congress that he wouldn’t need more than $25 billion but, the 400 page bill allows him to increase the national debt by $800 billion. How will the Fannie/Freddie bailout affect the dollar and the budget deficit? Are interest rates likely to skyrocket because of this action?

Michael Hudson: The Fed can flood the economy with money, Alan Greenspan-style, to prevent interest rates from skyrocketing. Nobody really knows what will happen to FNMA and Freddie Mac, but it looks like the mortgage and financial crisis will get much, much worse over the coming year. We are just heading into the storm where adjustable-rate mortgages (ARMs) are scheduled to reset at higher rates, and where U.S. banks have to roll over their existing debts in a market where foreign investors fear that these banks already have no net worth left.

So the principle here is “Big fish eat little fish.” Wall Street will be bailed out, and banks will be allowed to “earn their way out of debt” as they did after 1980, by exploiting retail customers, above all credit-card customers and individual borrowers. There will be a lot of bankruptcies, and people will suffer more than ever before because of the harsh pro-creditor bankruptcy law that Congress passed at the behest of the bank lobbyists.

MW: A few months ago, the Wall Street Journal ran an editorial which said that they could imagine two nightmare scenarios if the current credit crisis was not handled properly; either there would be a run on the dollar causing a sudden plunge in its value, or the unexpected failure of a major financial institution could send the stock market crashing. Last week, the former head of the IMF Kenneth Rogoff triggered a sell-off on Wall Street when he said, "We're not just going to see mid-sized banks go under in the next few months, we're going to see a whopper; we're going to see a big one — one of the big investment banks or big banks." What happens if Rogoff is right and Merrill, Citi or Lehman go belly up? Is that enough to send the stock market freefalling?

Michael Hudson: Not necessarily. Citibank would be nationalized, then sold off. The principle should be that if a bank is "too big to fail," it should be broken up.

This should start with a repeal of the Clinton Administration's repeal of Glass-Steagall.

As for Lehman, that would be given the Bear Stearns treatment, and also sold off – probably to a hedge fund. Merrill is much larger, but it also could be parceled out, I suppose. The stock market's financial index would plunge, but not necessarily industrial stock prices.

MW:According to MarketWatch: "In the three months from April to June, banks posted their second worst earnings performance since 1991…. Earnings for the quarter totaled just $5 billion, compared with $36.8 billion a year ago, a decline of 86.5%." Also, according to a front page article in the Wall Street Journal: "financial institutions will have to pay off at least $787 billion in floating rate notes and other medium term obligations before the end of 2009." How are the banks going to pay off nearly $800 billion ($200 billion by December!) when they only earned a measly $5 billion in the quarter!?! And how in the world is the Federal Reserve going to keep the banking system functioning when earnings can't even cover current liabilities? Do the banks have some secret source of revenue we don't know about or is the system headed for disaster?

Michael Hudson: The traditional way to pay debt is with yet MORE debt. The interest due is simply added on to the principal, so that the debt grows exponentially. This is the real meaning of "the magic of compound interest." It means not only that savings left to accumulate interest keep on doubling and redoubling, debts do to, because the savings that are lent out on the "asset" side of the creditor's balance sheet (today, that of America's wealthiest 10%) become debts on the "liabilities" side of the balance sheet (the "bottom 90%").

The banks don't have a secret source of revenue. It's right out in the open. They will take their junk mortgages to the Federal Reserve and borrow the money at full face value. The government will be left with the junk.

It then can either take over the bank, as the Bank of England did with Northern Rock when it went bankrupt early this year, or it can let the bank "earn" money by stiffing its customers some more.

MW: From 2000 to 2006, the total retail value of housing in the United States doubled, going from roughly $11 trillion to $22 trillion in just 6 years. For the last 200 years, housing has barely kept pace with the rate of inflation, usually increasing 2 to 3% per year. The Federal Reserve's low interest rates were the main cause of this unprecedented housing bubble and, yet, ex-Fed chief Alan Greenspan still denies any responsibility for what "The Economist" calls “the largest bubble in history”. Did Greenspan understand the problems he was creating with his “loose” monetary policies or was there some ulterior motive to his actions?

Michael Hudson: He simply didn’t care about the problem. He saw his job as a cheerleader for people who were able to get rich fast. These always had been his major clients in his years on Wall Street, and he saw himself as their servant – sort of like a pilot fish for sharks.

Mr. Greenspan’s idea of “wealth creation” was to take the line of least resistance and inflate asset prices. He thought that the way to enable the economy to carry its debt overhead was to inflate asset prices so that debtors could borrow the interest falling due by pledging collateral (real estate, stocks and bonds) that were rising in market price. To his Ayn-Rand view of the world, one way of making money was as economically and socially productive as any other way of doing so. Buying a property and waiting for its price to inflate was deemed as productive as investing in new means of production.

Ever since his days as co-founder of NABE (the National Association of Business Economists), Greenspan has long looked only at GNP and the national balance sheet as an economic indicator, being “value-free.” This is his intellectual and conceptual limitation. He wanted to provide a way for savvy investors to get rich, and the easiest way to get rich is to be passive and get a free lunch. His ideology led him to believe the “free market” ideology that the financial sector would be self-regulating and hence would act honestly. But he opened the floodgates to financial crooks. His set of measures did not distinguish between Countrywide Financial getting rich, Enron getting rich, or General Motors or industrial companies expanding their means of production. So the economy was being hollowed out, but this didn’t appear in any of the measures he looked at from his perch at the Federal Reserve.

So just as journalists and the mass media proclaim every market downturn as “surprising” and “unexpected,” he was as clueless as a lemming running headlong over the cliff. It’s an inherent instinct for free-market boys.

MW: The housing market is freefalling, setting new records every day for foreclosures, inventory, and declining prices. The banking system is in even worse shape; undercapitalized and buried under a mountain of downgraded assets. There seems to be growing consensus that these problems are not just part of a normal economic downturn, but the direct result of the Fed’s monetary policies. Are we seeing the collapse of the Central banking model as a way of regulating the markets? Do you think the present crisis will strengthen the existing system or make it easier for the American people to assert greater control over monetary policy?

Michael Hudson: What do you mean “failure”? Your perspective is from the bottom looking up. But the financial model has been a great success from the vantage point of the top of the economic pyramid looking down? The economy has polarized to the point where the wealthiest 10% now own 85% of the nation’s wealth. Never before have the bottom 90% been so highly indebted, so dependent on the wealthy. From their point of view, their power has exceeded that of any time in which economic statistics have been kept.

You have to realize that what they’re trying to do is to roll back the Enlightenment, roll back the moral philosophy and social values of classical political economy and its culmination in Progressive Era legislation, as well as the New Deal institutions. They’re not trying to make the economy more equal, and they’re not trying to share power. Their greed is (as Aristotle noted) infinite. So what you find to be a violation of traditional values is a re-assertion of pre-industrial, feudal values. The economy is being set back on the road to debt peonage. The Road to Serfdom is not government sponsorship of economic progress and rising living standards; it's the dismantling of government, the dissolution of regulatory agencies, to create a new feudal-type elite.

The former Soviet Union provides a model of what the neoliberals would like to create. Not only in Russia but also in the Baltic States and other former Soviet republics, they created local kleptocracies, Pinochet-style. In Russia, the kleptocrats founded an explicitly Pinochetista party, the Party of Right Forces ("Right" as in right-wing).

In order for the American people or any other people to assert greater control over monetary policy, they need to have a doctrine of just what a good monetary policy would be. Early in the 19th century the followers of St. Simon in France began to develop such a policy. By the end of that century, Central Europe implemented this policy, mobilizing the banking and financial system to promote industrialization, in consultation with the government (and catalyzed by military and naval spending, to be sure). But all this has disappeared from the history of economic thought, which no longer is even taught to economics students. The Chicago Boys have succeeded in censoring any alternative to their free-market rationalization of asset stripping and economic polarization.

My own model would be to make central banks part of the Treasury, not simply the board of directors of the rapacious commercial banking system. You mentioned Henry Liu's writings earlier, and I think he has come to the same conclusion in his Asia Times articles.

MW: Do you see the Federal Reserve as an economic organization designed primarily to maintain order in the markets via interest rates and regulation or a political institution whose objectives are to impose an American-dominated model of capitalism on the rest of the world?

Michael Hudson: Surely, you jest! The Fed has turned "maintaining order" into a euphemism for consolidating power by the financial sector and the FIRE sector generally (Finance, Insurance and Real Estate) over the "real" economy of production and consumption. Its leaders see their job as being to act on behalf of the commercial banking system to enable it to make money off the rest of the economy. It acts as the Board of Directors to fight regulation, to support Wall Street, to block any revival of anti-usury laws, to promote "free markets" almost indistinguishable from outright financial fraud, to decriminalize bad behavior – and most of all to inflate the price of property relative to the wages of labor and even relative to the profits of industry.

The Fed's job is not really to impose the Washington Consensus on the rest of the world. That's the job of the World Bank and IMF, coordinated via the Treasury (viz. Robert Rubin under Clinton most notoriously) and AID, along with the covert actions of the CIA and the National Endowment for Democracy. You don't need monetary policy to do this – only massive bribery. Only call it "lobbying" and the promotion of democratic values – values to fight government power to regulate or control finance across the world. Financial power is inherently cosmopolitan and, as such, antagonistic to the power of national governments.

The Fed and other government agencies, Wall Street and the rest of the economy form part of an overall system. Each agency must be viewed in the context of this system and its dynamics – and these dynamics are polarizing, above all from financial causes. So we are back to the "magic of compound interest," now expanded to include "free" credit creation and arbitraging.

The problem is that none of this appears in the academic curriculum. And the silence of the major media to address it or even to acknowledge it means that it is invisible except to the beneficiaries who are running the system.

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