

# The Weaponization of Economic Theory

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Europe's Three Needs: A Debt Write-down, A Real Central Bank, and a More Efficient Tax System

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*What can Europe learn from the United States?*

First, the United States – like Canada, England and China – have central banks that do what central banks outside of Europe were created to do: finance the budget deficit directly.

I have found that it is hard to explain to continental Europe just how different the English-speaking countries are in this respect. There is a prejudice here that central bank financing of a domestic spending deficit by government is inflationary. This is nonsense, as demonstrated by recent U.S. experience: the largest money creation in American history has gone hand in hand with debt deflation.

It is the commercial banks that have created the Bubble Economy's inflation, from North America to Europe. They have recklessly lent mortgage credit and other credit far beyond the ability of domestic economies to pay. A real central bank can create credit on its electronic keyboards just as easily as commercial banks can do. But central banks do not create credit for speculative purposes. They do not make junk mortgages based on "liars' loans" (the liars are the banks, not the borrowers), based on fictitious evaluations by crooked appraisers, and sold fraudulently to investment banks to package and sell to gullible Europeans, pension funds and other customers.

In short, there is no need for the present austerity. If Europe acted like the United States, it could bail out the banks.

But would this be a good thing? My second point is that there are good reasons not to fund a dysfunctional debt overhead, financial and tax system. It is preferable to change these systems.

In the United States, Paul Krugman has urged the Federal Reserve to simply lend banks an amount equal to their bad loans and negative equity (debts in excess of the market price of assets). He urges a "Keynesian" program of spending to re-inflate the economy back to bubble levels. This is the liberal answer: to throw money at the problem, without seeking structural reform.

The Bank for International Settlements (BIS) disagreed last week in its annual report. It said – and I believe that it is right – that monetary policy alone cannot solve an insolvency problem. And that is what Europe has now: not merely illiquidity for government bonds and corporate debt, but insolvency when it comes to the ability to pay.

In such circumstances, the BIS explains, it is necessary to write down the debt to the amount that can be paid – and to undertake structural reforms to prevent the Bubble Economy from recurring.

The Canadian postal workers union has an informal slogan: “A job that’s not worth doing is not worth doing well.” I might apply this to Europe by saying that a badly structured economy is not worth subsidizing or saving. It should be made well.

This entails, for starters, writing down the debt overhead. That is what created the German Economic Miracle of 1948: the Allied Monetary Reform that wiped out debts over and above minimum working balances, and wages debts owed by employers to employees. It was easy to write down debts that were owed to Nazis. It is much harder to do so when the debts are owed to powerful and entrenched institutions – especially to banks.

Take the case of a Greek debt writedown. This would hurt the Greek banks first and foremost, and also more innocent German insurance companies and banks. I have a modest suggestion as to how to handle this. First, let the Greek banks go under. They helped stymie the Greek government’s attempt to stop tax evasion and money laundering. They have been described as co-conspirators and corrupt. Of course their depositors should be made whole by a standardized, public bank insurance scheme. But bank bondholders and stockholders, and even non-insured depositors, are another matter.

As for the German institutions, if a Greek Clean Slate pushes them into insolvency, the German Government should do what the U.S. Federal Deposit Insurance Corp. (FDIC) is empowered to do: take them over, make all the depositors and policy holders whole, and operate these institutions as a public option – either temporarily or permanently.

The alternative is austerity and debt deflation that will leave European markets shrinking, living standards falling, and turn Europe into what U.S. Defense Secretary Rumsfeld has said so often: “Old Europe,” as if it is too late to be saved. Any discussion of the U.S. economy necessarily involves the global context. So it is necessary to discuss not only domestic U.S. developments, but also relations with Europe and the BRICS countries.

The most important dynamic is financial. A continued decline in real estate prices, coupled with local government debts, has led to debt deflation. As personal and corporate income are diverted to pay debt service, spending on new consumption and investment goods is cut back. Sales and employment opportunities are falling off, especially for new entrants into the labor force. Major categories of debt cannot be repaid in Europe and the United States, except by foreclosures transferring property to creditors. Short-term financial aims overshadow the long-term adjustments that ultimately will be needed: debt writedowns in the public and private sectors. The alternative to this “business as usual” scenario is for the U.S. and European economies to look increasingly like the Baltics – austerity aggravating economic shrinkage.

The U.S. Government as well as European governments have taken bad bank debts onto the public balance sheet. This is not a problem for the United States, whose Federal Reserve can

simply create the credit to roll over its debt. But for Europe, public debts simply cannot be paid under current central bank constraints. Instead of changing the central bank rules, the European Union is willing to plunge the continent into depression and economic shrinkage.

### U.S. Austerity and deeper Negative Equity

The U.S. economy is free of the monetary constraint that Europeans impose on themselves. The Federal Reserve does what central banks are supposed to do: monetize government deficit spending by buying public debt. However, the increase in new government debt creation has not been mainly to finance deficit spending to increase economic activity and employment, to invest in rebuilding the nation's infrastructure or providing states and cities with the revenue sharing that in the past enabled them to balance their local budgets. Instead, the government has created debt in an attempt to re-inflate real estate markets back toward Bubble Economy levels. The idea was for the economy to "borrow its way out of debt."

In practice, there was not much hope of success. The banks sent the \$800 billion of Federal Reserve's Quantitative Easing (QE2) in 2012 abroad, mainly to the BRICS economies in the form of interest rate and currency arbitrage. The banks' idea was to earn their way out of their own negative equity, but not by lending to a real estate market whose prices continue to decline. This is forcing more properties into negative equity - and that leaves the banks themselves in a negative equity position. So there is little new lending for real estate, to consumers, or to business. Markets are being shrunk by debt deflation.

States and cities also face a shrinking tax base, and many are subject to constitutional requirements for balanced budgets. The path of least resistance has been to underfund their pension plans - which have fallen far behind, especially inasmuch as most plans assume an 8% annual rate of return. This rate - assuming a savings doubling time of just nine years - has become even more fictitious today than it was a decade ago. So some localities have taken risks and lost - with their loss being the counterpart to earnings by the largest banks on derivatives.

The bottom line here is that the U.S. economy is not in a position to "borrow its way out of debt." The outlook thus is for a similar austerity to that of Europe.

Financial fraud has been effectively decriminalized in the United States. In a nutshell, people have lost trust in the banks - and the financial sector itself mistrusts its fellow institutions. So the non-bank money market funding has dried up for business, and individuals are afraid to invest in the stock market.

President Obama retains his progressive rhetoric, but actually is neoliberal. (His Senate mentor was Joe Lieberman who helped him go for the money and choose Rubinomics advisors.) Mitt Romney pretends to be a right-wing extremist, but seems reasonable on economic policy. However, he may feel under pressure to support right-wing Republican lobbyists in the Congressional leadership. Even if he does, there will not be much difference from the Obama administration. The U.S. situation thus is much like that of Britain under Labour party leadership in recent years: centrist or even left-wing rhetoric on social policies, but neoliberal financial policy favoring the banks.

**BOTTOM LINE:** Neither the U.S. nor European economies can "grow their way out of debt." Their debt deflation will worsen, and their budget deficits will widen.

## The U.S. Political Outlook

As in Europe, there is little alternative from the ostensible left – from the Democratic Party, the labor unions and allied interests. President Obama seems likely to win this November’s presidential elections, and he is a neoliberal – probably more so than the Republican candidate Mitt Romney.

The common backers of the Republican and Democratic Parties – mainly, Wall Street and real estate interests – realize that a Democratic President is in a better position than a Republican to neutralize Congressional or Senate opposition to scaling back and privatizing Social Security and Medicare. Democratic politicians are more likely to counter Republican proposals along these lines than proposals put forth by their party’s own president. The situation is much like Tony Blair out-Thatcherizing Britain’s Conservatives in trying to privatize British rail and tube infrastructure and promoting the Public-Private Partnership plan. This is essentially the Rubinomics position supported by the Democratic leadership.

Many voters simply will stay home, so Mr. Romney may have a chance to win, based on support in the South and the West – and even perhaps some Midwestern swing states. In either case, the 2013-16 administration looks like it will be a bipartisan neoliberal austerity.

From the U.S. vantage point, Europe is a dead zone. It looks to me like financial and fiscal self-destruction.

There would be some hope for progress if the financial crisis was used to clean up bureaucracy and shift the tax system off the cost of living and doing business to a land tax on economic rent. This would prevent a new real estate bubble from developing, by holding down the “free” site value that could be capitalized into bank loans. This would lower the cost of housing, and also free employment from taxation. And it could go hand in hand with reducing the size of the Greek bureaucracy, for instance.

But I don’t see this happening in Europe. So financial austerity is likely to aggravate the budget deficits rather than help them. European economies are likely to grow “surprisingly” less than forecasts suggest, and news media will report this as “unanticipated slowdown” “to everyone’s surprise” and so forth.

The likely political reaction in Europe is likely to be a nationalistic opposition to relinquishing government power. But this opposition is likely to come more from the right than from the left of the political spectrum. This is what is so striking about today’s political situation both in Europe and the United States: the failure of the left to provide an economic alternative, and of the right to reform the tax system and corruption.

**BOTTOM LINE:** The U.S. trade balance may improve as consumer budgets are squeezed, limiting imports, and as domestic shale gas cuts import demand. But capital inflows are unlikely to increase. And until interest rates begin to rise, capital outflows will continue (much as was the case in Japan after 1990). The U.S. is thus suffering a “Japan syndrome.”

### **Increasing global fracture into regional blocks**

Instead of international “cooperation,” I see a regional rivalry among blocs polarizing between the U.S.-centered NATO bloc and the BRICS, expanding their influence. Europe looks pretty much left out, as its markets are not growing and it is not a prime investment

area. The BRICS countries are likely to start erecting capital controls against easy-credit policies in the United States funding a takeover of their assets.

Financial flows and capital flight are putting upward currency pressure on the BRICS at the expense of the euro and the dollar. If the euro does not decline against the dollar, it is largely because both currencies are equally weak together and share similar problems. Both economies will shrink, leading to more insolvency for real estate and also for government budgets. This Euro-American shrinkage is likely to spur moves in China and other BRICS to rely more on growth of their internal market. China's wage levels are likely to rise, prompting production to aim more to satisfy domestic consumer demand than foreign export demand.

The main problem for China is that one of the first expenditures of families with rising revenue is to buy autos. The government's response is to invest more in public transportation, and is likely to impose an environmental tax. More dispersion of urban centers is likely in order to minimize transportation costs – and more infrastructure spending in general.

Capital controls are likely, and also a denomination of foreign trade and investment in BRICS currencies rather than the U.S. dollar or euro. This tendency will accelerate if U.S. and European military policy continues to expand into Asia and other regions. As matters look at present, U.S. military diplomacy will focus more on trying to recover influence in Latin America, including privatization of key infrastructure to buyers (on credit) who will engage in rent extraction, adding to the price level. The result of debt deflation is thus to raise the cost of living and doing business for much of the economy, squeezing labor and commerce alike.

These policies are likely to be characterized as “muddling through.” This means postponing what looks like the inevitable end game: a large write-down of government debt, a shift away from the dollar as global currency (quite possibly with a re-introduction of gold to settle balance-of-payments deficits). Diplomatically, these changes will constrain U.S. military spending, while pressuring Europe to re-orient its geographic focus if it is to resume economic growth and pull itself out of a feedback of debt deflation, unemployment and even emigration.

### **The neoliberal challenge**

The term “neoliberalism” misrepresents and even inverts the classical liberal idea of free markets. It is a weaponization of economic theory, kidnapping the original liberal ethic that sought to defend against special privilege and unearned income. To classical economists, a free market meant one free of unearned income, defined as land rent, natural resource rent, monopoly rent and rent-extracting privilege. But to neoliberals a free market is one free from taxes or regulation of such rentier income, and indeed gives it tax favoritism over wages and profits.

Neoliberalism and neo-conservatism are complementary doctrines of power and autocracy combined with deregulation and dismantling of democratic law. The aim is to replace government power as used to protect the people with an oligarchic power to oppress the people.

Today, the neoliberal aim is to cripple government power, enabling a free-for-all for the financial sector. Protecting civil freedoms are also heavily signposted, but the high price of

legal representation is a barrier for most. A doctrine primarily of the financial sector, the aim is to un-tax banks and financial institutions and their major customers: real estate and monopolies.

Neoliberalism is a doctrine of central planning, which is to be shifted from governments to the more highly centralized financial centers. This requires disabling public power to regulate and tax banking and finance. As a transition, ideological deregulators such as Alan Greenspan and Tim Geithner have been appointed to the key regulatory positions in the United States.

The result is a doctrine of financial war not only against labor but also against industry and government. Gaining the financial power to indebt economies at increasing speed, the banking and financial sector is siphoning resources away from the real economy. Its business plan is not based on employing labor to expand output, but simply to transfer as much of the existing flow of revenue as possible into its own hands, by capitalizing all such revenue into interest payments, on loans collateralized and pledged to creditors.

The effect is no more democratic than the Roman democracy, which arranged voting by "centuries" headed by the largest landowners - essentially an acre-per-vote, to make an analogy. In the U.S. case, votes are bought not by land as such, but by dollars - mainly from the financial sector. In the end, to be sure, most dollars come from rent extraction.

The result must be economic polarization, above all between creditors and debtors as in Rome. So the end stage of neoliberalism threatens a Dark Age of poverty/immiseration - most characteristically, one of debt peonage. And just as Rome's creditor class and its predatory imperial expansion brought down the Roman Empire and reduced it to mere subsistence, so the combination of neoliberalism and neo-conservatism today seeks to globalize itself, spreading austerity even as it brings technological progress to sovereign debtors.

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