Real Estate Bubbles, Trade and Exchange Rates: The Balance-of-Payments Dimension of Today's Bubble Economies

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Summary

I. *The impact of real estate bubbles on international costs*

Whereas food prices provided a proxy for wages as in Ricardo's day, family budgets now are dominated by housing, debt service and other FIRE-sector transactions. The rising degree to which real estate, corporate and other asset ownership have been debt-leveraged makes costs and prices – and hence, an economy's competitive advantage – increasingly dependent on the terms on which credit is created and extended. In classical terminology, we are seeing prices with less and less cost-value and labor content as economies are becoming more financialized. That is the essence of Bubble Economies – until they burst.

A major consequence of this financialization of economies is that adjustment of balance-of-payments deficits or surpluses no longer occurs on trade account alone by shifts in prices and incomes. Sustained trade imbalance is now financed on capital account, by a combination of borrowing (increasingly by private mortgage borrowers and private corporations) and asset sell-offs, especially from the public domain. International real estate speculation and mortgage lending have financed trade deficits for the post-Soviet economies, while the buildup of Asian and European central bank reserves in the form of loans to the U.S. Treasury has supported America's trade and payments deficit, which is the source of today's global asset-price inflation.

II. *The dollar's free lunch, and the future of the global payments system*

The United States enjoys an international free ride by virtue of the dollar's status as key currency, able to run up debts without international constraint. U.S. officials threaten that if foreign central banks do not relend their inflow of surplus dollars to the U.S. Treasury, their currencies will rise, reducing their competitive position vis-à-vis dollar-area exporters. Foreign economies therefore have held down their exchange rates by keeping their own interest rates low, spurring financial and real estate bubbles of their own. As a "carrot," U.S. officials claim that U.S. consumer demand is the "engine" that drives world economic growth, while U.S. investor demand – and their own low interest rates – powers their financial and property markets. For the global economy, dollar hegemony has become a form of international economic overhead.

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I. **The impact of real estate bubbles on international costs**

The past decade's global real estate boom has seen capital inflows and mortgage lending sharply inflate the price of home ownership and office space. Denominated in euros, sterling and other foreign currencies, this lending has financed trade deficits especially for the Baltic States and other post-Soviet economies that have experienced the fastest growing bubbles. But now that these real estate bubbles are slowing, such lending and speculative inflows no longer are covering their trade deficits. This has left these countries with a balance-of-payments gap, and a foreign-currency debt burden that will increase in proportion to the rate at which their currencies depreciate.

In the United States, collapse of the subprime mortgage market has led investors to dump dollar-denominated debts across the board, causing the dollar to plunge against the euro and sterling. The fact that U.S. Treasury debt to foreign central banks now exceeds $2.5 trillion and does not show signs of abating has led foreign governments and private investors to treat dollar-denominated securities as "hot potatoes." Raising interest rates to stabilize the currency would reduce property prices and lead recent property buyers suffer to negative equity, while leaving the cost of living and doing business high as a result of debts already run up. A downward economic spiral therefore threatens the U.S. and foreign post-bubble economies alike.

How rent, mortgage levels and interest rates determine cost disparities

Theories of trade and payments focus on direct production costs, which are assumed to reflect what it costs to cover labor's basic living expenses. Trade models may include labor productivity to explain how high-wage nations can undersell low-wage economies. But productivity gains usually require capital investment, which may be financed in a wide variety of ways with regard to debt-equity ratios, interest rates, debt maturities and tax rates. These financial and fiscal considerations play no role in Ricardian trade theory or in the Heckscher-Ohlin theory of relative incomes reflecting the proportions of labor and physical capital.

A further financial consideration is the degree to which capital movements overshadow trade in today's world. The "purchasing power parity" theory of exchange rates views export prices as reflecting consumer prices (*e.g.*, for MacDonald hamburgers), but John Stuart Mill's *Essays on Some Unsettled Questions of Political Economy* (1844) explained how foreign military spending and other capital transfers lead exchange rates to diverge from export prices.[1] What remains to be elaborated is the degree to which credit creation and debt overhead, land rent and today's global financial and real estate bubble affect export pricing and the balance of payments.

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[1] Mill composed his analysis in 1829. He further elaborated it in Book III, ch. xvii ("Of international values") in his *Principles of Political Economy* (1848). I review this and other theories relevant to the present article in *Trade, Development and Foreign Debt* (London 1992, new ed. 2008).

Food was the major component of most family budgets in Ricardo's day. England needed to import low-priced grain from abroad in order to become the low-cost workshop of the world. Its industrialists therefore campaigned to repeal its protectionist Corn Laws. They were backed by the financial sector, as bankers anticipated that the ensuing global specialization of labor would open up a vast expansion of trade financing.

By inflating the real estate bubble, financialization has made housing expenditure an increasingly dominant factor in international wage comparisons, and hence commodity prices. Housing now plays the role that food did in Ricardo's day, accounting for as much as 40 percent of many U.S. and British family budgets, and at least a third has become the norm.[2] In fact, housing, debt service, medical care and taxes (including wage withholding for Social Security and health insurance) now dominate the budgets of most wage earners. A regressive shift of income taxes, health insurance and Social Security onto labor via wage withholding is raising the wage level that must be paid simply to cover basic living expenses. This means that international cost variations reflect the degree to which economies are financialized, not merely the direct, material or "real" costs of production on which most trade theories have focused.

Land prices are the major factor determining home ownership and commercial real estate costs. Even as economies have shifted from an agricultural to an industrial and even post-industrial character, land has remained the largest asset category.[3] Throughout history one's home and neighborhood have been the most important status symbol. Today's families pledge most of their disposable income to cover the mortgage charges entailed in buying their primary residence. While the supply of land remains fixed, site valuations tend to rise in keeping with the growth of bank lending to enable new buyers to bid up prices. In a bubble economy, banks capitalize the rent-of-location into mortgage loans up to the point where interest charges absorb the net rental income. Buyers pledge this revenue in the hope of "cashing out" for a "capital" gain, or more accurately a land-price gain.

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[2] See *e.g.* John Leland, "Housing Costs Consumed More of Paychecks in 2006," *The New York Times*: September 12, 2007: "Nationally, half of renters and more than one third of mortgage holders – 37 percent, up from 35 percent in 2005, or a rise of more than 1.5 million households — spent at least 30 percent of their gross income on housing costs, the level many government agencies consider the limit of affordability. … Fourteen percent of mortgage-holders spent at least half their income on housing in 2006 … [and] 25 percent of renters spent half their income on housing."

[3] Political lobbying by the financial and real estate sectors has blocked governments from collecting realistic statistics on the market valuation of land. Britain has not conducted a property census since the 1870s, and the U.S. Federal Reserve Board's flow-of-funds statistics produces numbers so nonsensical that in 1994 the value of all the land owned by U.S. corporations was reported to be a negative $4 billion. I have sought to make more realistic estimates in "Where did all the land value go," available on my website, michael-hudson.com.

After housing, the major item in family budgets is debt service. Forced saving in the form of wage withholding for Social Security and health insurance is part of today's global tax shift off property and finance onto labor. The upshot of these developments is that *export and import prices reflect a rising proportion of non-labor costs of production as cost structures depend on the finance, insurance and real estate – the FIRE-sector overhead.* Trade theory therefore must explain comparative labor costs more in terms of land prices and debt charges than food prices.

By raising the price of home ownership, office space and industrial sites, a real estate bubble transfers the economic surplus from labor and industry to the economy's *rentier* layer. This cost squeeze tends to impair the trade balance. And because such bubbles are financial in character and rely largely on declining interest rates (which enable bank lenders to capitalize property income at a higher price) and on the monetary authorities' willingness to allow credit creation on easier terms, credit tends to flow to higher-interest economies, creating a capital outflow on top of the negative trade balance.

How the post-Soviet property bubbles have financed structural trade deficits

The Soviet Union's breakup in 1991 disrupted the specialized production patterns that existed, leaving each new country on its own. Russia and a few central Asian countries were able to finance their trade deficits by exporting oil and minerals, but the Baltics and Central European countries had no such option and fell into chronic import dependency. Political insiders privatized government enterprises in their own name and sold at least some of their shares to foreigners, although a large portion of the proceeds were moved out of their countries as capital flight.

What stabilized the post-Soviet currencies was mainly private real estate borrowing from foreign banks (mainly by the wealthiest layer of the population), and foreign purchases of prime sites. Not having commercial banking systems of their own, these countries depended on foreign banks, especially those of Scandinavia and Germany for the Baltic States. Substantial room for lending existed, because real estate and public enterprises were debt-free at the time of political independence in 1991. A speculative boom and new construction occurred in tourist areas such as the old city centers and in hotels, but most of the population was frozen into where they lived.

Mortgages as percentage of GDP, 2001-2005

	2001	2002	2003	2004	2005
Bulgaria	-	-	1.1	2.7	4.8
Croatia	5.9	6.9	8.8	10.3	-
Czech Republic	1.4	2.1	3.1	4.4	6.2
Estonia	**5.8**	**7.9**	**11.7**	**16.6**	**28.8**
Latvia	**-**	**4.2**	**7.7**	**12.1**	**19.6**
Lithuania	-	-	3.4	5.6	7.7

Poland	1.8	2.6	3.6	4.0	5.4
Romania	-	-	1.1	1.4	1.8
Slovakia	-	-	5.1	6.6	8.2

Having little to export in exchange for their imports of consumer and capital goods, the "Baltic miracle" countries privatized their land and real estate, and let "free market" forces prompt owners to take out mortgage loans. The longer countries delayed privatizing their real estate, the higher their home ownership prices rose as their property bubbles gained momentum. And to make matters worse, most mortgage loans were in euros, sterling or Swiss francs, not domestic currency. (Some 75 percent of Latvia's mortgages are denominated in foreign currencies.) This foreign mortgage lending has fueled the world's fastest-growing property bubbles, exacerbating already uncompetitive export positions by raising the cost of living without putting in place new means of production to export and pay off the debts, except by gentrification, renovation and hotel construction for the tourist trade – the usual malls of more consumer goods and fast food such as now mark the Old Town districts of most post-Soviet economies.

Percentage of household borrowing in foreign currency by loan type, 2004

	Total	Housing	Mortgage
Bulgaria	10.3	24	24
Croatia	0.5	-	-
Czech Republic	0.2	0.1	0.2
Estonia	**65.1**		-
Latvia	**68.9**	**74.5**	-
Poland	**29.6**	**56.6**	**-**
Romania	**-**	**89.2**	-
Slovakia	0.5	0.0	

Source: Robert C. Shelburne and Jose Palacin, "Is There an East European Housing Bubble," *Global Economy Journal* **6** (2006). (Both authors are members of UN Economic Commission for Europe.) The figures come from the UNECE common database.

What is ironic is that the ending of the global real estate bubble threatens the exchange rates of the Baltics and other post-Soviet economies. Having financed their structural trade deficits by selling off their infrastructure or, more often, mortgaging their privately owned real estate with foreign-currency debt, how will they finance their trade deficits without further credit inflows? Since 1991 most former members of the Soviet Union have dismantled their infrastructure spending and imposed a flat tax (with hardly any property tax), in contrast to Western progressive income and property taxes. Countries without oil and mineral resources have financed their trade deficits by borrowing against real estate and selling off their public domain in a modern equivalent of England's 16th-18th-century enclosures of the Commons. Lacking export capacity already in place, currency depreciation will not help stabilize their balance of payments. How then will they

carry the debts that the past decade of mortgage lending has run up? They have added foreign debt dependency to trade dependency, threatening political as well as exchange-rate instability.

The moral is that instead of restoring balance by causing shifts in production costs, wages and prices, today's trade deficits are financed on capital account, mainly by mortgage borrowing, and sell-offs of public enterprises and real estate. Demographic byproducts of financialization include emigration skilled workers and the young (*e.g.*, from the Baltics to Ireland), falling birth rates and shortening life expectancy, especially throughout the post-Soviet economies.

The rising importance of FIRE-sector costs

Most countries find their balance of payments dominated today not by the commodity trade balance as in classical theory, but by transactions in bonds, stocks and real estate, and their associated flows of interest and dividends. What used to be viewed as an exchange of goods has become an exchange of goods for assets and debt claims on capital account. Exchange rates accordingly are coming to reflect relative *asset* prices, not commodity prices as economies shift their focus from earning income (wages and profits) to rent-seeking and asset-price gains.

Within domestic economies too, non-production costs are overshadowing labor and other direct production costs. Debt service accounts for a rising share of capital costs and labor budgets, with mortgage charges being the major cost of owning residential property. Rising mortgage indebtedness increases the access price and carrying charges for homes, office space and other property, raising the overall cost of doing business.

Under these conditions credit creation becomes extractive. Yet asset-price inflation is widely welcomed as "wealth creation," as if it were not simultaneously debt creation putting future downward pressure on exchange rates (and hence, upward pressure on import prices) by entailing balance-of-payments obligations to pay off the loans that bid up asset prices.

In addition to home mortgages, education loans, medical debts and health insurance, as well quasi-taxes in the form of forced saving for retirement pensions, have come to overshadow "real" wages and labor productivity in determining prices, and hence international competitive advantage. The property bubble has spurred emigration by Indian-born computer engineers from California back to India, where they can rent a large estate with servants for what it costs merely to have a bungalow in Silicon Valley. In England, job offers now often include in addition to salary a "season ticket" for the train connection to London, where residential property prices have risen beyond the ability of most wage earners to afford. A large number of properties in central London are reportedly owned without mortgage, reflecting England's role as a haven for capital flight.

The key to wealth accumulation is not profits on tangible capital formation employing labor to produce goods and services, but financial engineering to inflate asset-price ("capital") gains. The FIRE sector (finance, insurance and real estate) has emerged dominant over manufacturing, and industrial engineering has given way to financial engineering. This has turned today's economies more into *rentier* societies than ever before – just the opposite of what classical political economists and liberal reformers hoped to see.

The insurance sector includes health management organizations (HMOs) in the United States, where the cost of medical care falls on individuals and their employers rather than government. Property insurance is being supplemented by risk insurance against bond defaults for pension funds and mutual funds. The tendency is for the FIRE sector to recover its ancient role as tax farmer. Wall Street has begun to privatize natural monopolies in the public domain, from roads, water and power to state lotteries. This follows from the global dynamic shifting the tax burden off finance and property onto labor. Whatever revenue is freed from the tax collector leaves more rental value to be capitalized by the financial sector – which recycles its gains to further inflate asset prices.

In sum, as property and financial transactions come to overshadow commodity trade in determining exchange rates, the concept of "cost of production" has become more complex than it was in the formative centuries of classical trade theory. Instead of trade deficits being adjusted by shifts in wages and other costs, economies rely on bank credit. This creates a rising degree of indebtedness without corresponding growth in the ability to export their way out of debt.

Instead of representing prior savings, today's great growth in credit is freely created or represents the automatic accrual of interest recorded on existing loans. Banks create "junk credit" by issuing junk mortgages, that is, high-interest securities packaged into junk CDOs (collateralized debt obligations). Never before has economic theory had to deal with a situation in which trade and financial transactions have been so lacking in any incentive to be balanced. Removal of gold transfers as the asset of choice to settle balance-of-payments deficits has left no constraint on domestic credit creation. Removal of the gold cover has opened the door to unprecedented asset-price inflation, raising property prices and also the price of financial securities, and hence the cost of buying a fixed retirement income relative to current wages.

Banks direct most of their credit creation into the property and financial markets. The effect is to inflate asset prices. High prices for real estate increase the cost of doing business, by requiring buyers to take on a rising debt overhead. By diverting future spending away from goods and services, asset-price inflation is *de*flationary as far as the "real" economy is concerned. It also diverts savings and credit away from capital investment in tangible "real" wealth.

But what *is* most real these days, now that the financial sector has come to dominate the material technology that 19th-century economists expected to shape the future? Instead of funding capital investment to earn profits by employing more labor, finance capital is used to buy property already in place, using credit leveraging to ride the wave of asset-price inflation in the hope that real estate and stock prices will rise at a rate higher than the rate of interest. Interest charges are paid out of capital gains. The proceeds are recycled to finance the purchase of more assets, as if no "real" capital investment needs to be made to sustain the rising debt dynamic. Employment is downsized and outsourced to squeeze out more revenue, while research, development and other long-term projects are cut back in order to maximize the debt payout.

How the global financial bubble gains momentum

It seems ironic at first glance – but logical enough when one stops to think about it – that the largest and hence presumably most "credit-worthy" borrowers are the first to keep adding the interest onto their existing debts, year after year. Wealthy borrowers seem to be the most secure, headed by governments because they always can print money. Real estate seems the most solid collateral for loans, rising steadily in price over time, as do stocks.

Yet the largest and most prestigious borrowers tend to become insolvent faster than anyone else. They enjoy the highest degree of public confidence, enabling them to expand their debt ratios the most. This gives them enough financial rope to hang themselves.

The world's largest debtor is the U.S. Government. Foreign central banks not finance most of its budget deficit, freeing it from having to tax the wealthy at home, as formerly. In fact, its budget deficit stems largely from cutting taxes on the higher wealth brackets, real estate and finance since 1980, and from military spending.[4] U.S. Treasury bonds and notes held by foreign governments amounted to $1.5 trillion in May 2007, and other foreign central bank holdings of U.S. securities raise the figure to $2.7 trillion. Most of the run-up has been to Asia: $2 trillion, followed by Europe at $0.4 trillion. These sums represent the excess of U.S. foreign spending over what foreign importers and investors buy in the United States. Foreign sellers of goods and assets cash in their dollar receipts for domestic or other non-dollar currencies, leaving central banks holding the bag – that is, holding dollars that they now are coming to treat as hot potatoes.

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[4] As economies polarize between *rentiers* and the rest of the population, the power elite turn their wealth into political patronage and shift the tax burden off themselves. The financial and property income freed from the tax collector is available to be pledged to bankers on larger loans that are used to bid up property prices for real estate, stocks and bonds. Debt services thus replaces taxes. Of course, someone has to pay taxes. Wage earners and consumers are designated to pick up the slack, diverting the normal circular flow between employee earnings and their spending on the goods and services they produce (Say's Law). Shifting the fiscal burden onto labor and industry increases the cost of living and doing business, making tax cuts on real estate and other *rentier* wealth self-defeating as far as an economy's competitive position is concerned.

Foreign central banks find themselves flooded with dollars thrown off by U.S. overseas military spending, widening trade deficit, and spending by U.S. investors to buy up foreign assets. The U.S. Treasury is running up about $50 billion in interest charges each year to countries such as China – and simply adds this amount to the bill it owes, even though its foreign debt has soared far beyond its ability to pay in any foreseeable future, even if its politicians were willing to do so.

This is how Brazil and other Latin American governments operated before Mexico threatened to default in 1982, setting off the Third World "debt bomb." Each year these countries would ask their international bankers to lend enough to cover the interest falling due – in effect, to add the interest onto the loan balance. Their debts grew at compound interest, doubling exponentially every ten to twelve years at the then-normal annual interest rates of 6 to 7 percent. In effect, banks were paying interest to themselves, using Third World debtors as vehicles in what was becoming an increasingly fictitious global economy. It was fictitious because there was no way that the debts feasibly could be paid out of current earnings.

After governments, the leading borrowers are property investors. When rental income fails to cover the interest charge, most bankers are willing to let the debt service mount up, hoping to be paid out of capital gains. By 2006, many bankers went so far as to make "negative mortgages" – loans that are not paid off, but add the accrual of interest automatically to the debt balance. The result is an exponentially rising debt curve.

Speculators can keep ahead of the game as long as prices rise at a faster pace than the rate of interest charged by the banker. Borrowers and lenders both hope that homes and office buildings can keep on being sold at a high enough price to cover the mortgage and still leave a capital gain (mainly the land's site value beneath these properties). Prestigious academics and journalists explain that all this adds to "wealth creation" and should be taxed at only half the rate paid on earned income – wages and profits. This tax favoritism for debt-financed real estate and stock market speculation shifts the fiscal burden onto labor.

Property prices plunge when the debt overhead grows too large, leaving owners with negative equity. Many walk away from their property, leaving the banks holding a portfolio of bad debts. When Citibank, Chase Manhattan and other major banks found themselves left with negative equity in the credit crunch of 1980, they saved themselves by explaining to financial officials (most of whom were their own former officers) that their failure would bring down the economy around them. Deeming the leading banks too big to fail, regulators allowed them to rebuild their asset base and capital reserves by keeping interest rates high for their consumer loans throughout the 1980s and into the 1990s – around 20 percent, well above the old usury limits – even as normal interest rates and loans to prime borrowers plunged to 5 percent.

Borrowers are dependent on the banking system's compliance in turning the economy into a Ponzi scheme. Such schemes need to attract new members to put in enough money to pay investors who want to "cash out" for the returns they have been promised. But as the size of such schemes grows, it becomes more difficult to achieve the exponential growth of assets needed to cover the interest that is mounting up. Defaults occur if assets fail to appreciate or begin to lose value, leaving investors in such schemes – and ultimately, banks themselves – holding the bag. That is what occurred in Japan after 1990, and in the United States in 2007. It is to avoid triggering such losses that banks agree to lend borrowers the credit to pay their interest charges. Bank officers hope at least to buy enough time before the crash comes to retire safely with their golden pension parachutes in place.

The increasingly reckless debt buildup depends ultimately on the willingness of central banks to keep interest rates low enough and credit abundant enough to enable borrowers to keep paying debt service by borrowing against collateral whose price is being steadily inflated.

The U.S. role in today's global financial bubble

Where does all this credit come from that is inflating property and stock markets throughout the world? Most of it comes from the United States, thanks to America's unique ability to monetize credit without constraint. This unique lack of international or domestic constraint is the distinguishing feature of today's global credit bubble. It reflects how radically money and credit have been transformed over the past generation.

By the 20th century the world had come to agree on gold as the backing for monetary reserves and, as such, the common denominator used to settle debts arising from payments imbalance. Gold or silver coinage was related to material production by valuing bullion as any other commodity, in terms of the expenditure of labor needed to mine and refine it.[5] Although colonialism obtained most gold and silver by slave labor and military seizure, the basic principle remained: Money had a cost of production.

Balance-of-payments constraints were largely responsible for bringing business expansions to an end in decades past. Booms create a demand for imports, while exports become less competitive as wages and prices rise. Central banks usually respond by raising their interest rate to stabilize the exchange rate, applying a "stop-go" policy that slows economic upswings. At least, this was the pattern before economies began to be swamped with dollars.

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[5] The classic statement is that of William Petty in his *Treatise of Taxes and Contributions* (London, 1662, p. 32): "If a man can bring to London an once of Silver out of the Earth in Peru, in the same time that he can produce a bushel of Corn, then one is the natural price of the other."

Matters changed in 1971, when U.S. overseas military spending forced the dollar off gold.[6] Instead of payments imbalances being settled by a pure asset (gold) they were settled by pure debts, in the form of a single government's IOUs – those of the U.S. Treasury. The dollar crisis of 2007 reflects the inevitable new bubble phenomenon resulting from this free financial lunch. Internationally and domestically, paper credit has been etherealized as electronic blips created on keyboards *ex nihilo*, involving almost no cost of production. It therefore has no "value" in the sense that classical economists defined it in terms of cost of production.

Being based on debt in the form of government bonds or, increasingly, those of private-sector debtors, today's international reserves support a credit pyramid that has two characteristics unique to the modern era. First, paper currency and bank money are forms of debt that do not involve any classical *quid pro quo* of labor content. Bank credit takes the form of blips on a computer screen. Second, the debts that central banks now hold in their reserves is that they are almost uniquely those of the U.S. Government – bonds that finance the domestic federal deficit. And third, the debts in international reserves are not expected to be paid off but are to be rolled over indefinitely, like England's old "consols" (government bonds with no maturity date). As Adam Smith observed over two centuries ago, no government ever has repaid its public debt, although many have pretended to do so. American officials already proposed a way not to pay. The IMF will turn Treasury bonds into Special Drawing Rights ("paper gold") that central banks can exchange among themselves, but which no longer will be official U.S. obligations.

One dynamic making this system unstable is that the international financial system is set up in a way that obliges foreign governments to keeping their reserves in the form of loans to the U.S. Government. This means that nations holding dollars in their central bank reserves finance U.S. spending abroad, headed by military actions that most foreign voters oppose.

Most seriously, foreigners are obliged to provide exports to U.S. consumers and investors without receiving any *quid pro quo*. This creates a double standard in how economies respond to balance-of-payments deficits. For most governments, the price of getting the International Monetary Fund and banks to roll over their loans has been to privatize their public domain, selling off government enterprises to the creditor nations. Debtor countries also have been obliged to adopt the deflationary monetary policies laid down by the IMF and the trade-dependency policies dictated by the World Bank. These programs tend to prevent them from paying off their debts, making international crises chronic, forcing yet further asset sell-offs.

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[6] I provide the statistics and describe the political context in *Super Imperialism* (1972, new ed. 2002). The U.S. private sector was in balance throughout the 1960s, while U.S. Government non-military transactions ran a surplus thanks to the money made by U.S. foreign aid. The entire U.S. balance-of-payments deficit was attributable to U.S. military spending abroad.

II. **The dollar's free lunch, and the future of the global payments system**

Thanks to its status as a key-currency nation since it stopped converting dollars into gold in 1971, the United States has been uniquely free of balance-of-payments constraints. Not only has U.S. domestic demand expanded in the face of unparalleled trade deficits, but capital outflows from the U.S. economy have been a major force inflating financial bubbles abroad as its investors buy up foreign assets.

These deficits return to the United States in a circular flow. U.S. diplomats claim that foreign savers have so much faith in the U.S. economy that they send their savings there to finance America's trade and payments deficit. The reality is that foreign capital inflows to the United States are not so voluntary. Now that central banks no longer have the alternative of the gold or gold-exchange standard, they are left with little choice but to accept dollars *ad infinitum*. The United States exports IOUs, while other countries export products and sell their assets to U.S. buyers.

U.S. officials have argued that American consumers are the "engine of world growth." Yet real wages for most people have not increased since 1979. What have risen are asset prices for real estate, stocks and bonds. Consumers have maintained their living standards largely by going into debt. With cheerleader Alan Greenspan heading the parade, bankers and public officials have encouraged homeowners to "cash out" on the rising market price of their homes by refinancing their mortgages or taking out "equity" loans to reflect this asset-price inflation (API). The idea is that homes are like "piggy banks," from which owners can "extract equity" much like drawing down a savings account. But running into a debt involves paying interest. Repaying debts will divert income away from future spending on goods and services, deflating markets.

The idea that consumer demand can be an engine of growth has a long pedigree. Thomas Malthus expressed it in arguing that landlords played a productive role by spending their rental income on coaches, fine clothes and other luxuries. Without such spending, he argued, economic activity would slow. This argument endeared Malthus to John Maynard Keynes in the 1930s, when insufficient consumer spending and business investment to meet it were major factors aggravating the Great Depression. In the 19th century, however, critics of land-rent depicted *rentiers* as idle consumers whose revenue – and consumption – was an overhead charge. John Stuart Mill described landlords not as earning their rent by productive effort but making money "in their sleep." The analogy with today's U.S. consumer spending abroad seems clear enough.

When officials depict the U.S. trade deficit as the engine of world growth, they mean that U.S. import demand, overseas military spending and capital outflows are pumping dollars abroad. Surplus dollars end up in central banks, which have little alternative but to recycle them

to the United States by purchasing U.S. Treasury securities. Since central banks agreed in 1971 to stop settling balance-of-payments deficits in gold, they have kept their currencies from rising against the dollar by recycling their dollar inflows back into U.S. Treasury bonds.

Central banks have little option but to turn around and send the dollars back to the United States by buying its Treasury bills. *In effect, America's finances its federal budget deficit by running a balance-of-payments deficit that obliges foreign countries to use their export proceeds to buy U.S. Treasury IOUs*. This is the basic dynamic fueling today's global financial bubble.

Financing its domestic federal budget deficit in this way frees Americans from having to pay taxes or use their own savings. As foreign central banks finance this twin deficit, the U.S. Treasury has been able to cut taxes on property and finance – and what the tax collector relinquishes is available to be paid to bankers for loans – whose effect is to bid up property prices. The combination of tax cuts and low interest rates frees income to be pledged to banks as debt service, which the banks re-lend to keep on inflating the bubble economy. The U.S. bubble thus becomes self-financing in the form of a "Ponzi scheme."

Foreigners provide the dollar reflux that the U.S. economy uses to finance growth in its rising public and private debt, domestic and foreign. But nobody has explained how America ever can repay this debt, or even pay its interest charges except by the artifice of adding them onto the principal each year. This creates a soaring compound-interest curve that strips the words "security" and "bond" of their former literal meaning.

In sum, now that payments-surplus economies no longer receive gold or other "money of the world" on which domestic money and credit creation is based, the key to geopolitical and financial control has become the power to create free credit that other countries and their central banks accept without constraint. This power belongs uniquely to the United States by virtue of the dollar's role as key currency. It is the source of today's financial and real estate bubbles. Asia and Europe are suffering the opposite of affluence. They are supplying exports and ownership of their assets to U.S. buyers for mere paper.

U.S. buyouts of foreign companies, stocks and real estate via hedge funds and other debt-leveraging is pouring dollars into continental European, Asian, post-Soviet and Third World stock, bond and real estate markets in search of speculative gains. The resulting financial and property bubble has created a flood of dollars into the world's central banks as local recipients exchange these payments for domestic currency. To sellers, these speculative inflows are an engine of capital gains. As in all bubbles, everyone seems to gain in the short run. But by accepting dollar IOUs as international reserves, central banks in Europe and Asia exchange tangible exports and enterprises for mere paper – virtually forced loans to the U.S. and European treasuries.

And that is the problem. Finance capital has become decoupled from tangible capital formation, just as today's debt- money has been decoupled from having the kind of cost of production that characterized gold. This decoupling makes it almost infinitely cheap to create interest-bearing debt without limit. Dollar hegemony enables America to pay for imports, foreign military adventures and the purchase of foreign assets with government IOUs in unlimited quantity.

Some policy conclusions: "A trend that can't go on forever, won't."

The international economy is made extractive by a combination of asset stripping by creditor-nation investors and bankers, and the right of the United States as key-currency issuer to import goods and buy out foreign companies with paper IOUs of questionable quality as to the prospect of repayment. Now that money and credit no longer require gold or silver backing, the United States runs up payments deficits and foreign debt at will, without having to transfer asset ownership or raise its interest rates. It exports paper dollars for other countries' goods and services and ownership of their real estate, stocks and bonds. If they do *not* recycle their dollar inflows in this way, their currency will soar, hurting their exporters in dollarized markets. One recent writer notes that as the dollar has depreciated during 2006-07, foreign exporters "have resisted increasing prices here, accepting lower profit margins in order to maintain their market share. The American market is too big and too important for them to run the risk of losing customers … a Federal Reserve study published after the dollar's crash in 1985-87 suggested that 'foreign competitors relinquished profits for market share' by holding down price increases. … a recent Federal Reserve study found that changes in the value of the dollar today have half the impact on American prices that they did during the eighties. It's hardly surprising, then, that over the past three years the prices of imported goods have risen, on average, just a little more than two per cent annually."[7] So much for attempts to link export prices and exchange rates to domestic production costs and product prices.

The United States is turning other nations into financial satellites, and even fiscal satellites despite the fact that its economy is being hollowed out by debt and no longer is able to run a balance-of-payment surplus. The key to geopolitical and financial control has become the power to create free credit that other countries and their central banks accept without constraint. This power belongs uniquely to the United States by virtue of the dollar's role as key currency. It is the source of today's financial and real estate bubbles. But economic textbooks barely have dared approach this dimension of international trade and finance.

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[7] James Surowiecki, "Greenback Blues," *The New Yorker*, October 8, 2007. This situation "creates bizarre disjunctions; for example, foreign-made luxury cars are often cheaper to buy in the U.S. than in their home countries. Foreign consumers pay more for games and software than their U.S. counterparts."

The cost to Asia and Europe of American financial affluence is to suffer the opposite of affluence. They are supplying exports and ownership of their assets to U.S. buyers simply for paper. Payments-surplus economies no longer receive gold or "hard" currencies on which domestic money and credit creation was based in times past.

Why should foreign economies want to earn dollars under these conditions? Under the gold standard, export surpluses provided the monetary backing needed to expand domestic credit to finance economic growth. The larger a nation's gold and hard-currency reserves, the longer its central bank could avoid having to raise interest rates to protect its international financial reserves when incomes rose, leading to higher imports in business upturns. Creditor economies also could buy natural resources and other assets from payments-deficit countries.

Today's U.S. Treasury-bill standard renders the leading axiom of political science inoperative: the assumption that countries and their governments will act in their overall long-term self-interest. European and Asian appear powerless to react in the face of the global dollar glut. U.S. officials have said boldly that this is a dilemma for Europe and Asia, not their own country.

Oil and minerals exporters face a different problem: how to preserve the value of their trade surpluses, now that U.S. officials have made it clear that their economy has neither the means nor the political will to let other countries cash in their dollars by buying U.S. assets – in contrast to U.S. demands that other countries sell off *their* assets to pay their foreign debts. The new U.S. attitude has prompted foreign governments to start creating their own sovereign capital investment funds inn an attempt to avoid absorbing more buildup of dollar reserves.

This is causing the dollar to plunge. But instead of pursuing policies to protect their industry and build up their own domestic markets by isolating the U.S. economy, foreign governments continue to rely on the U.S. consumer market and U.S. buyouts of their industry. An alternative scenario would have to start by greater reliance on domestic markets. This must go hand in hand with a policy to isolate the dollar, and perhaps to enact special tariffs against depreciating currencies. With the proceeds provided as a subsidy to exporters to such markets. These would be steps back toward the currency blocs of the 1930s with their associated barter deals. The result would be a breakdown of the monetary system into global barter arrangements to obtain the kind of fair market postulated by classical free-trade theory.

6,629 words – 406 summary = 6,223