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Saving, Asset-Price Inflation and Debt Deflation

The National Income and Product Accounts (NIPA) measure the circular flow between production, consumption and new investment. Employers earn profits which they invest in capital goods, and they pay their employees who spend their income to buy the goods they produce (Fig. 1).

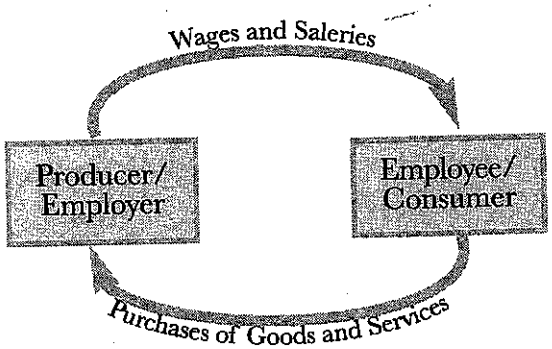


Fig. 1: Economy no. 1, Production/ Consumption (the "Real Economy" without FIRE and government)

Production and consumption represent only part of the economy. Governments levy taxes and user fees, which they spend and sometimes run budget surpluses (the government's way of saving) that drain income from the economy's flow of spending. But more often, governments inject spending power by running deficits (financed by running into debt). The NIPA measure these fiscal removals or injections of revenue by taxing and spending (Fig. 2).

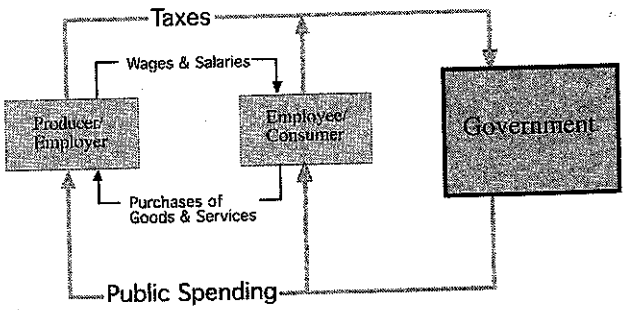


Fig. 2: Economy no. 1, with government

Economy #1 - Peduction/Consumption
Government Spending &Rxes

* The "Real Economy" with Govement and without FIRE

A half century ago economists anticipated that rising incomes and living standards would lead to higher savings. The most influential view of the economic future was that of John Maynard Keynes. Addressing the problems of the Great Depression in 1936, his General Theory of Employment, Interest, and Money warned that people would save relatively more as their incomes rose. Spending on consumer goods would tail off, slowing the growth of markets, new investment and employment.

This view of the saving function—the propensity to save out of wages and profits—saw saving break the chain of payments simply by not being spent. The modern dynamics of saving—and the debts in which savings are invested—are more complex. Most savings are lent out. Nearly all new investment in capital goods and buildings comes from retained business earnings, not from savings that pass through financial intermediaries. Under these conditions, higher personal saving rates are reflected in higher indebtedness.

Since World War II, in fact, each new business upswing has started with a higher set of debt ratios. A rising proportion of savings find their counterpart more in other peoples' debts rather than being used to finance new direct investment. The net savings rate has fallen, even though debt ratios and gross savings have increased.

To understand these dynamics it is necessary to view economies as composed of two distinct systems. The largest system is that of land, monopoly rights and financial claims that yield *rentier* returns in the form of interest, other financial fees, rents and monopoly gains (which can be viewed either as economic rents or super-profits). These returns far overshadow the profits earned on investing in capital goods and employing labor to produce goods and provide actual services. This reflects the fact that the value of rentier property and financial securities far exceeds that of physical capital in the form of factories and machinery, buildings, or research and development.

Keynes was not careful to analyze how the savings functions associated with financial securities and *rentier* claims—and the property rights backing them as collateral—differed from personal savings functions. Some help, however, is provided by the NIPA, which break out the distinct flow of property and financial income that accrues to the FIRE sector, an acronym for Finance, Insurance and Real Estate.

To fill out the picture from the investor's vantage point, especially that of FIRE, it is necessary to recognize the increasingly important role played by capital gains rather than current earnings. The economy's wealthiest layers take their "total returns" primarily in the form of capital gains, not profit, interest or rental income.

No regular measures of capital gains are published, but they can be estimated on the basis of the Federal Reserve Board's balance-sheet data published in Table Z of its annual Flow-of-Funds statistics on financial assets (stocks, bonds and bank deposits and loans) and tangible assets (land, buildings and capital goods). These statistics show that capital gains and the returns to property and finance—rent, interest and capital gains—far overshadow profits.

This distinction between the property and financial sectors and the rest of the economy is not immediately apparent, however. NIPA statistics follow modern "value-free" economics in conflating all forms of current income (excluding capital gains) into the single category of "earnings." Interest, rent, insurance and financial fees are treated as payments for current services, not claims by property, credit or monopoly power that find no counterpart in direct outlays.

These forms of revenue are not inherently necessary expenses of production, but are best viewed as being institutional in character. Returns to finance and property may be viewed as transfer payments rather than as actual costs entailed by producing goods and services. This contrast makes the savings and debt functions of these rentier sectors differ from those associated with the wages and profits paid to labor and tangible capital investment (Fig. 3).

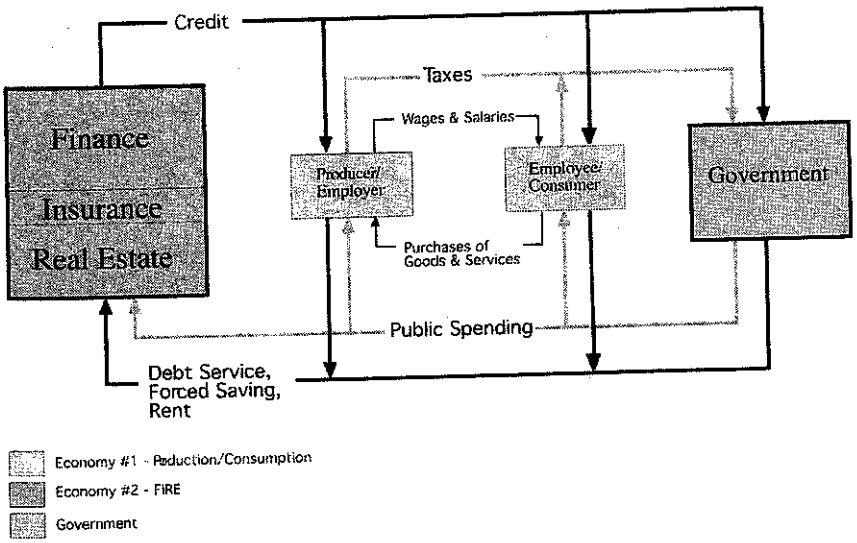


Fig. 3: Interaction of Economy no. 1, Economy no. 2 & Government

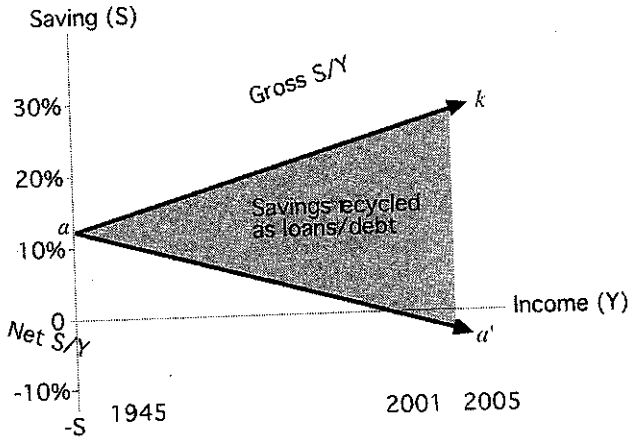
Monetary Considerations

Industry and agriculture, transport and power, and similar production and consumption expenditures account for less than 0.1 percent of the economy's flow of payments. The vast majority of transactions passing through the New York Clearing House and Fedwire are for stocks, bonds, packaged bank loans, options, derivatives and foreign-currency transactions. The entire stock-market value of many high-flying companies now changes hands in a single day, and the average holding time for currency trades has shrunk to just a few minutes.

The value of these financial transactions each day exceeds that of the entire annual U.S. national income. It therefore seems absurd to relate the money supply only to consumer and wholesale prices, excluding asset prices.

Today's Anomalies That Need to Be Explained

Today's world requires more variables to be analyzed. The (net) savings rate has moved in the opposite direction from what Keynes had anticipated. The NIPA report a zero-savings rate for the economy at large. If the recycled dollar holdings of foreign central banks are excluded, the domestic U.S. savings rate is a negative 2 percent. A time series of the *U.S. propensity to save* since 1945 shows a steady decline in (net) S/Y.



S/Y = Saving (S) as % of Income (Y)
ak = Keynes' expected rise in saving
aa' = Actual net domestic U.S. Savings (fr NIPA)
-S = Net Debt (Dis-saving)

* As reported in the National Income and Product Accounts (NIPA).

Fig. 4: Actual Saving* vs. Keynes' Expected Saving

Despite a falling savings rate, however, the economy never has been flusher with savings and credit. The growth of savings, wealth and net worth is less and less the result of new direct investment in tangible capital formation, but rather the product of rising asset prices for real estate, stocks and bonds. In balance-sheet terms, gross savings are soaring while net savings are zero or negative.

This growth in net worth occurs despite the fact that most new saving is offset on the liabilities side of the balance sheet by growth in debt. The rise of net worth is the result of savings being lent to borrowers who bid up asset prices by using new loans and credit to buy property and securities, that is, wealth and financial claims on wealth.

In balance-sheet terms, gross savings are soaring while net savings are zero or negative.

These features of today's economy appear to be an anomaly as compared to the formulae that Keynes traced out in 1936. Today's economy is best seen as a financial bubble, just the opposite of the deflationary Great Depression described by Keynes. Credit—and hence, debt—is being created to inflate the bubble rather than to finance direct capital formation. In this respect the banking and financial systems have become dysfunctional.

Monetary expansion and prices in the commodity and asset markets move asymmetrically. Today's asset-price inflation goes hand in hand with commodity-price stagnation and a deflation of labor's spending power. Upon closer examination this inverse relationship is not an anomaly. But the phenomenon shows that the savings problem has become more serious than Keynes feared, for reasons that he had little reason to discuss seventy years ago.

For one thing, the volume of savings compounds by being recycled into the creation of new interest-bearing debt as savers or financial institutions use their accrual of income, dividends and capital gains to buy more securities, make more loans or buy property rather than to spend this revenue on current output. The growing debt overhead—and the savings that form the balance-sheet counterpart to this debt—bears interest charges that divert income to debt service rather than being available for spending on consumption and direct investment.

The FIRE Sector in Relation to the Rest of the Economy

The institutions that distinguish one national economy from another are the property and financial institutions that steer saving and investment, and the public tax policies that shape markets. These policies determine the character of the FIRE sector. The largest and defining features of any economy are those of the property and financial sector, whose rent, interest, monopoly revenue and "capital" gains (most of which are real-estate gains) rise relative to overall national income.

Instead of examining these contrasting financial and fiscal policies, most economics texts concentrate on abstract technological production and consumption dimension of economic life. It is as if the property and financial dimension—tangible wealth and financial claims on property and income—lie somewhere on the far side of the moon, invisible to earth or at least wrapped in a cloak of invisibility.

When Keynes viewed individuals as saving a portion of the income they earned, he defined (S) as a function of income (Y) multiplied by the marginal propensity to save (*mps*, or simply *s*), so that $S = sY$. Keynes thus derived the savings function $s = S/Y$ for economies as a whole.

This formula does not acknowledge that financial institutions tend to save all their income. Furthermore, over time a rising proportion of this inflow of interest, dividends and rent is plowed back into new loans rather than invested in tangible capital formation.

Keynes recognized that wealthy individuals save a higher portion of their income as they earn more. He feared that as economies grew richer over time, the propensity to save would rise. But he did not describe corporate financial institutions as having a distinct propensity of their own to save all their interest and dividend receipts.

Today we can see that the problem with saving is not simply that it is "non-spending." A rising proportion of savings are lent out or invested in loans and securities, dividend-yielding stocks and rent-yielding properties, to become interest-bearing debts owed by the economy at large. These savings expand of their own accord as their interest receipts are recycled into new loans and other income-yielding assets, growing in an exponentially rising curve. This exponentially rising curve is that of compound interest, so that $S_t = S_{t-1}^{(1+i)}$, where i represents the rate of interest. Meanwhile, the growth of debt grows *pari passu*, as Keynes would have put it.

It thus is helpful to distinguish between the propensity to save (1) by labor and industrial firms out of income earned by producing goods and services, and (2) by the FIRE sector out of debt service and rental charges. Drawing

his distinction requires that the economy itself be viewed as a combination of wo separate parts, by separating the FIRE sector from the rest of the economy. I refer to these two sectors as (1) the production and consumption economy comprising fixed capital and labor, and (2) the economically larger property and financial sector receiving *rentier* income (defined to include finan- cial "service" fees).

Although net saving does not increase in such cases, the volume of loanable funds expands. These funds are built up as interest, dividends and rents accrue to owners of securities and property. To the extent that these revenues accrue to large financial institutions—insurance companies, pension and mutual funds—the propensity to save such returns is nearly 100 percent. To be sure, bankers pay interest to their depositors while insurance and pension funds pay their policy holders. However, most of these interest and dividend accruals are left in accounts to accumulate. The result is an exponentially rising curve of savings at compound interest.

The idea of a propensity to consume is appropriate only for consumer income, not that of the financial, insurance and real estate (FIRE) sectors. Con- sumers, especially retirees, do indeed consume some part of their *rentier* in- come, but this is not true of institutional investors. Keynes recognized that the wealthiest income brackets have a high propensity to save, while less affluent brackets have a lower propensity. Today, the wealthiest 10 percent of the pop- ulation holds most of the savings in every economy. The bottom 90 percent tend to be net debtors rather than net savers in today's highly financialized economies of North America and Europe.

Additional saving is created when banks create credit. Most finds its coun- terpart in the new debts that borrowers owe, so that the net saving rate is not affected. Keynes concerned himself almost entirely with net saving, not gross savings and their counterpart debt.

When Keynes defined saving as equal to investment, he did not emphasize the distinction between direct investment in tangible capital goods and loans that became the debts of the economy's non-financial sectors. Failure to draw this distinction led to an ambiguity between gross or net saving. National income accounts define saving net of the growth in debt, so that no increase in net saving occurs when savings are lent out.

This condition has become more and more the case for the U.S. economy in recent decades. Today's propensity to save is less than zero as the economy is running into debt faster than it is building up new savings. Keynes did not address this possibility, and indeed it was not a pressing concern back in 1936 when he wrote his *General Theory*.

Modern national income accounts also combine the wages and profits that labor and industry earn with the interest and rent that finance and property receive. The basic idea is that providing land, the radio spectrum, subsoil minerals and even monopoly goods supplies a "service" alongside the goods and services produced by labor and capital goods. But it is equally possible to view finance and property not as "factors of production" producing services that earn interest, financial fees and rent, but as receiving transfer payments or what Henry George called "value from obligation." This distinction enables the classical distinction between "earned" and "unearned" income to be preserved in a way that I believe Keynes would have appreciated in view of his call for "euthanasia of the *rentier*."

Most lending and credit creation are directed into the capital markets via borrowers who buy property or financial securities

Nearly all new fixed capital formation is financed out of retained business earnings, not out of bank borrowing. Banks finance sales, foreign trade, consumer debt and the purchase of property already in place, but hardly ever have they taken the risk of financing new direct investment. Their time horizon is short-term, not long-term.

This chapter proposes a model to integrate the analysis of asset-price inflation with debt deflation and Say's Law. Viewing savings and debt in their institutional context, it relates the behavior of banks and institutional investors to the dynamics of asset-price inflation and debt deflation. A central theme is that most lending and credit creation are directed into the capital markets via borrowers who buy property or financial securities. As the economy's assets are loaded down with debt and its interest charges, this credit growth extracts interest payments that divert revenue away from current demand for goods and services. That is why asset-price inflation usually involves debt deflation. The deflationary effect may be mitigated by lowering interest rates, as occurred in the United States during 1994–2004. The debt/savings overhead can rise without extracting a higher flow of interest payments as interest rates approach their nadir (about 1 percent today).

Keynes viewed saving as causing insufficient market demand to provide full employment. The long-term threat seemed to be that as economies grew richer, people would save more, disrupting the circular flow of spending between producers and their employees as consumers. What was not emphasized was that as savings were recycled into loans, economies would polarize between creditors and debtors.

Today the net savings rate has fallen to zero, and the major factor impairing effective demand is the diversion of revenue to service the economy's debt overhead. Paying interest and principal reduces the disposable income that debtors have available to spend on goods and services, while the financial institutions that receive this revenue do not spend it on goods and services. They lend out their receipts to enable the buyers to purchase assets that already exist.[1]

Today's problem of inadequate consumer demand and capital investment lies on the liabilities (debt) side of the balance sheet, not on the asset (saving) side.

The National Income and Product Accounts (NIPA) define the amortization of debt principal as saving. Most of these repayments are lent out to new borrowers, including corporate business whose balance sheets have reached what Hyman Minsky called the Ponzi stage of fragility—the point at which the debt overhead is carried by debtors borrowing the interest charges that are growing exponentially. In this respect "debts cause saving."

Today's problem of inadequate consumer demand and capital investment lies on the liabilities (debt) side of the balance sheet, not on the asset (saving) side. Keynes anticipated that as economies grew and incomes rose, a rising proportion of S/Y would reduce consumption, leading to overproduction if employers did not cut back their own direct investment. This line of thought reflected the psychological theorizing of British marginal utility analysis rather than a financial view of the dynamics that determined the buildup of savings.

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[1] Keynes noted that Malthus pointed out that landlords helped contribute to aggregate demand by spending their rental income on hiring servants. But banks lend to service producers and other labor, increasing the volume of debt.

Keynes's discussion of savings led him to re-examine Say's Law, which described circular flow of spending between producers and consumers. Under normal conditions producers would hire workers, who would spend their wages on buying what they produced. This was the basic meaning of the phrase "supply creates its own demand." But savings threatened to interrupt this circular flow by diverting the purchasing power of consumers away from the demand for goods and services, and that of employers away from the purchase of capital goods.

Keynes found saving to be the main culprit for the economic slow-down of the Great Depression on the ground that it led to reduced market demand, deterring new direct investment and hence slowing the growth of employment. But in today's U.S.-centered bubble economy the problem has become more complicated. To the extent that savings are lent out (rather than invested out of retained earnings to purchase capital goods, erect buildings and create other tangible means of production), they divert future income away from consumption and investment to pay debt service. In this respect the growth of savings in financial form (that is, in ways other than new direct capital formation) adds to the debt overhead and hence contributes to debt deflation. This is what occurs with nearly all the savings intermediated and lent out or reinvested by the banks, insurance companies and other financial institutions.

Keynes did not devote much attention to the accrual of interest on past savings. His *General Theory* was ambiguous with regard to the specific forms that savings might take. They were identified simply as investment, so that on the macroeconomic plane, S=I. The implication by many Keynesians today is that savings actually cause investment. The reality is that savings not invested directly in new means of production were invested indirectly in stocks, bonds and real estate. Investment in securities and property already in existence had no positive employment effects. But there was not much growth in either borrowing or this kind of indirect investment back when the *General Theory* was published. The tendency was for savings to sit idle, as did much of the labor force.

The Self-Expanding Growth of Savings through Their Accrual of Interest

The financial system exists in a symbiosis with the "real" economy. Each system has its own set of growth dynamics. Financial systems tend to grow exponentially at compound interest. The cumulative value of savings grows through a dynamic that Keynes had little reason to analyze in the 1930s—what Richard Price described as the "geometric" growth of a penny invested at 5 percent at the time of Jesus's birth, growing to a solid sphere of gold extending from the Sun out beyond the orbit of Jupiter by his day (1776). He con-

ed this "geometric" growth of savings invested at compound interest to merely "arithmetic" growth of a similar sum invested at simple interest. This was the metaphor that Malthus adopted to describe the growth of human populations in contrast to the means of subsistence.[2]

Many people saved money back in the time of Jesus. But nobody has obtained savings amounting to anywhere near a solid sphere of gold. The reason is that savings that are invested in debt tend to stifle economies, causing downturns that wipe out the debts and savings together in a convulsion of bankruptcy. This was what happened to the Roman Empire, and on a smaller scale has characterized business cycles for the past two centuries. Yet this dynamic rarely has been related to the bankruptcy phenomenon although it is a key factor countering the growth of savings.

Economies do grow faster than "arithmetically," but not "geometrically." Their typical growth pattern is that of an S-curve, tapering off over the course of the business cycle. The exponential growth of savings and debts thus tends chronically to exceed that of the "real" economy. Unless interest rates decline, the debt burden will divert income away from spending on goods and services, turning the economy downward (Fig. 5 & Fig. 6).

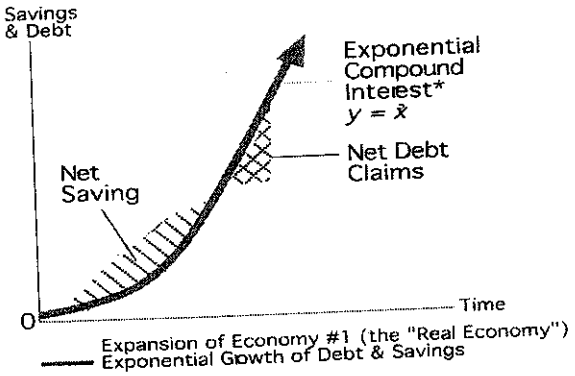

Fig. 5. How the Rise in Debt Overhead Slows Down the Business Cycle.

The *General Theory* recognized saving as arising out of current income, not as growing through the compounding of interest, doubling and redoubling at compound interest by their own inertia. They accrue interest independently of the course of incomes when invested in bonds or left in savings accounts, as

[2] I review how economists have treated this phenomenon in "The Mathematical Economics of Compound Interest: A Four-Thousand Year Overview," *Journal of Economic Studies* 27 (2000): 344–363.

well as accruing dividends if invested in stocks, or rental income if invested in property. This is especially true of "forced savings" in the form of paycheck withholding for Social Security, pension and retirement accounts, along with insurance policies segregated in a way that makes them unavailable for current spending.

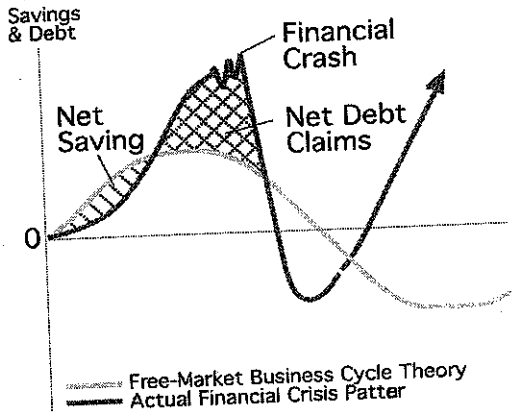

Fig. 6: Financial Crisis Pattern versus Business Cycle

Not being limited by the course of income or the ability to pay, the exponential growth of savings tends to exceed growth of the real economy. This is what occurs when economies are loaded down with debts, which could equally well be thought of as the savings overhead that is lent out. Rising savings on the asset side of the balance sheet connote a rising debt overhead on the liabilities side. In this case saving does not necessarily reflect an increase of productive powers and the means of production, nor does it tend to employ labor. Rather, the debt service that results from lending out savings tends to shrink markets and employment.

It should be noted that while the financial sector represents itself as providing credit to consumers and producers, it also absorbs income by charging interest, in amounts that are as large as the entire loan principal every doubling period—seven years at 10 percent interest, 13 years at 5 percent. Ultimately the financial sector extracts revenue from the economy. That is why it is in business, after all: to "make money from money."

Money cannot be made from money, of course. It is itself sterile, as Aristotle noted long ago. But it can charge interest from the rest of the economy that does perform the work. Levying interest, rent and other property and financial charges is not to be confused with making money through labor or capital investment. The perception of classical economics that the property and financial system is different has been lost in today's economic thought

The Growth of Net Worth through Capital Gains

The cumulative volume of savings also grows through a dynamic that Keynes had little reason to analyze in the 1930s: capital gains. Property and financial securities tend to appreciate in price over time. The main cause of this price appreciation is that the physical volume of assets grows slowly, while the financial volume of loanable funds grows exponentially.

Let us return for a moment to Richard Price's example of a penny saved at the time of Jesus being worth a sphere of gold extending from the sun out to Jupiter. Few investors buy gold, as it does not yield an income. The largest investment—and the most heavily debt-financed asset these days—is land. More credit does not expand the volume of land, which is fixed, but it does raise its market price. A rising volume of savings is channeled to buy a fixed supply of land. The financial system thus creates capital gains as the finite volume of property and supply of buildings and financial securities expands more slowly than the potentially infinite volume of loanable funds.

Keynes did not anticipate that savings would be channeled in a way that bid up asset prices for securities and property without funding tangible capital formation. In the 1930s net worth was built up mainly by saving, not by asset-price inflation such as is occurring today. In traditional Keynesian terms, revenue or credit spent on buying property in place represented hoarding, not investment.

Homeowners and investors imagine themselves growing richer as prices rise for their assets. Their net worth rises without their having to save. However, this rise tends to require more income set aside to pay debt service on the loans taken out to buy their property. Credit lent out in this way does not increase consumption and direct investment. It creates debts whose carrying charges shrink markets. Savings and debts rise together, so that there is no increase in net saving.

New saving does occur as financial institutions recycle the receipts of debt service into new loans, whose carrying charges absorb yet more future income. The result is that *gross* savings (and hence, indebtedness) rise relative to national income. Stated another way, saving for many homeowners takes the form of paying off their mortgages. This is not the same thing as hoarding (in Keynes's sense), but it plays much the same function, as it is not available for spending on current output.

As savings rise and are lent out, debt service absorbs more income. But the net economic surplus available to service these savings—by paying interest and dividends on the debts and securities in which they are invested—tends not to keep pace with their stipulated debt service. This debt problem therefore plays the deflationary economic role that Keynes attributed to savings.

How Asset-Price Inflation Aggravates Economic Polarization

Keynes favored inflation as eroding the burden of debt. He saw inflation as the line of least political resistance to wiping out the economy's debt burden. His idea was that inflation would leave more income available for consumption and for new direct investment. But asset-price inflation works in a different way. Instead of eroding the purchasing power of wealth relative to commodities and labor, it increases property prices without increasing consumer prices or wages. At least this has been the pattern since 1980. Wealth disparities have increased even more than have disparities among income brackets. The net worth for the wealthiest 10 or 20 percent of the population has soared, while the rest of the economy has fallen more deeply into debt and many of its gains have turned out to be short-term.

Keynes recognized that rich and poor income and wealth brackets had differing marginal propensities to save. But today's financial polarization has gone beyond anything he anticipated, or what anyone else anticipated back in the 1930s, or for that matter even in the 1950s.

Long before the *General Theory*, economists recognized that wealthy people did not expand their consumption in keeping with their income growth. The image of widows and orphans living off their interest was relevant only for a small part of the economy. Rentiers always have tended to save their income and reinvest it in the financial and property markets. This occurs also with savings deposits, which banks lend out or invest directly in financial securities. Most of the interest and dividends credited to savers thus is left to grow by being lent out or plowed back into indirect securities and property investment, increasing asset prices.

The ability to get an easy ride from the resulting asset-price inflation—coupled with an easy access to credit and favorable tax treatment—prompts investors to take their returns in the form of capital gains rather than current income. In real estate, the economy's largest sector, property owners use their rental income to pay interest on the credit borrowed to buy properties, leaving no taxable earnings at all. The same phenomenon characterizes the corporate sector, where equity has been retired for bonds and bank loans since 1980. Ambitious CEOs, managers of privatized public enterprises and corporate raiders have bought entire companies with debt-financed leveraged buyouts. Interest charges have absorbed corporate earnings, leaving little remaining for new capital investment. The name of the game has become capital gains, which have been spurred more by downsizing and outsourcing than by new corporate hiring.

Prices for property, stock, and bonds have soared relative to wages, forcing home buyers to spend a rising multiple of their annual incomes to buy housing. Also rising has been the cost of acquiring companies relative to corporate profits as price/earnings ratios increase.

Capital gains make the inequality of wealth and property more extreme than income inequality. The wealthiest layer of the population derives its power from capital gains, while using its income to pay interest—as long as interest rates are less than the rate of asset-price inflation. The ratio of wealth and property has risen relative to the value of goods and services, wages and profits, while the debt overhead has grown proportionally.

Does Asset-Price Inflation "Crowd Out" New Direct Investment?

The FIRE sector has been expanding at the expense of the "real" economy. It drains revenue in the form of interest, rental income and monopoly profits, which are paid out increasingly as interest and financial fees. This triggers a fresh cycle of saving and re-lending by the FIRE sector itself, not so much by the rest of the economy. The more interest accrues in the hands of creditors, the faster their supply of loanable funds increases, thanks to the "magic of compound interest." This revenue is lent out and accrues new interest ("interest on interest"), which is recycled into yet new loans.

This growth of savings and loanable funds in the hands of financial institutions is lent out mainly to buy property in place and financial securities, not to fund tangible capital formation. This financial dynamic spurs asset-price inflation, which in turn reduces the incentive to invest directly in capital goods, because it is easier to make capital gains than to earn profits.

These developments have prompted investors to seek "total returns"—capital gains plus profits or earnings—rather than earnings alone. Under Federal Reserve Board Chairman Alan Greenspan as "Bubble Maestro" in the 1990s, stock prices for dot.com and internet companies soared without a foundation in earnings or dividend-paying ability. Balance-sheet maneuvering was decoupled from tangible investment in the "real" economy. Companies such as Enron prided themselves in not having any tangible assets at all, just a balance sheet of speculative contracts. People began to ask whether wealth could go on increasing in this way *ad infinitum*.

Keynes's analysis implied that the income "multiplier" (Y/S, or 1/mps) would increase as prosperity increased and people consumed a smaller portion of their income. What was being multiplied, however, was not national income—wages, profits and other earned income—but the volume of credit and hence the pace of capital gains in the asset markets.

Tax Policy and Financial Bubbles

Unlike the industrial sector, real estate does not report a profit—and hence, pays no income taxes. Property owners do pay state and local real estate taxes, to be sure, but they have been joined by the financial and insurance lobbies to shift local government budgets away from the land and onto the shoulders of labor, through income taxes, sales taxes and various user fees for municipal services hitherto provided as part of the basic economic needs and infrastructure.

Although land does not depreciate—that is, wear out and become obsolete—by far the bulk of depreciation tax credits are taken by the real estate sector. This is because the economic theory underlying tax obligations has become essentially fictitious. Each time a property is sold, the building is assumed to increase in value, rather than the land's site value generating the gain.

Nothing like this could happen in industry. Machinery wears out and becomes obsolete—think of computers and word processors bought a decade ago, or even three years ago. Technological progress reduces the value of physical capital in place. But the prosperity that progress brings increases the market price of land.

Keynes pointed to the desirability of preventing the diversion of income into the purchase of securities and property already in place. He hoped to restructure the stock market and financial system so as to direct savings and credit into tangible capital formation rather than speculation. He deplored the waste of human intelligence devoted merely to transferring property ownership rather than creating new means of production.

Today's financial markets have evolved in just the opposite direction from that advocated by Keynes. New savings and credit are channeled into loans to satisfy the rush to buy real estate, stocks and bonds for speculative purposes rather than into the funding of new direct investment and employment. Matters are aggravated by the fact that financial gains are taxed at a lower rate, thanks to the growing power of the financial sector's political lobbies. This prompts companies to use their revenue and go into debt to buy other companies (mergers and acquisitions) or real estate rather than to expand their means of production.

Going into debt to buy assets with borrowed funds experienced a quantum leap in the 1980s with the practice of financing leveraged buyouts with high-interest "junk" bonds. The process got underway when interest rates were still hovering near their all-time high of 20 percent in late 1980 and early 1981. Corporate raiding was led by the investment banking house of Drexel Burnham and its law firm, Skadden Arps. Their predatory activities required a loosening

America's racketeering (RICO) laws to make it legal to borrow funds to take over companies and repay creditors by emptying out their corporate treasuries and "overfunded" pension plans. New York's laws of fraudulent conveyance also had to be modified.

Tax laws promoted this debt leveraging. Interest was allowed to be counted as a tax-deductible expense, encouraging leveraged buyouts rather than equity financing or funding out of retained earnings. Depreciation of buildings and other assets was permitted to occur repeatedly, whenever a property was sold. This favored the real estate sector by making absentee-owned buildings and other commercial properties virtually exempt from the income tax. To top matters off, capital gains tax rates were reduced below taxes on the profits earned by direct investment. This diverted savings to fuel asset-price inflation. By the 1990s the process had become a self-feeding dynamic. The more prices rose for stocks and real estate, the more mortgage borrowing rose for homes and other property, while corporate borrowing soared for mergers and acquisition.

Meanwhile, the more gains being made off the bubble, the more powerful its beneficiaries grew. They turned their economic power into political power to lower taxes and deregulate speculative finance—along with fraud, corrupt accounting practices and the use of offshore tax-avoidance enclaves—even further. This caused federal, state and local budget deficits while shifting the tax burden onto labor and industrial income. Markets shrank as a result of the fiscal drain as well as the financial debt overhead.

Abuses of arrogance and outright fraud occurred in what became a golden age for Enron, WorldCom and other "high flyers" akin to the S&L scandals of the mid-1980s. But free-market monetarism draws no distinction between tangible direct investment and purely financial gain-seeking. Opposing government regulation to favor any given way of recycling savings as compared to any other way, the value-free ethic of our times holds that making money is inherently productive regardless of how it is made. "Free-market fundamentalism" came to shape neoliberal tax policy in a way that favored finance, not industry or labor.

Can Economies Iinflate Their Way out of Debt?

Only a limited repertory of opportunities for profitable new direct investment exists at any given point in time. The exponential growth in savings tends to outstrip these opportunities, and hence is lent out. This lending—and its mirror image, borrowing—may become self-justifying at least for a time to the extent that it bids up asset prices. Homebuyers and investors feel that it pays them to go into debt to buy property, and this is viewed as "prosperity," although it is primarily financial rather than industrial in character.

About 70 percent of bank loans in the United States and Britain take the form of real estate mortgages. Most new savings and credit creation thus enables borrowers to bid up the price of homes and office buildings. The effect is to increase the price that consumers must pay to obtain housing, as new construction loans account for only a small proportion of mortgage lending. Over-extended families become "house-poor" as rising financial charges for housing diverts income away from being spent on new goods and services, "crowding out" consumer spending and business investment.

Balance sheets improve as the pace of capital gains outstrips the rate of interest. Debt service can be paid out of rising asset values, either by selling off assets or by borrowing against the higher asset prices as collateral.

Governments may try to mitigate the inflation of housing prices by raising interest rates. But this will increase the carrying charges for borrowers with floating-rate mortgages, as well as debtors throughout the economy. (Also, as Britain discovered in spring 2004, the increase in interest rates also raises the currency exchange rate, making its exporters less competitive in world markets.) For fixed-rate mortgages, higher interest rates may squeeze the banks, leading to losses in their portfolio values and prompting calls for the government to bail out losers (at least depositors, if not to rescue S&Ls and commercial banks).

Perception of this problem leads central bankers not to raise interest rates and take the blame for destroying financial prosperity by pricking the bubble. Instead, they try to keep it from bursting. This can be done only by inflating it all the more. So the process escalates.

Balance sheets improve as the pace of capital gains outstrips the rate of interest. Debt service can be paid out of rising asset values, either by selling off assets or by borrowing against the higher asset prices as collateral. The problem occurs when current income no longer can carry the interest charges. The financial sector absorbs more income as debt service than it supplies in the form of new credit. Asset prices turn down—but the debts remain on the books. This has been Japan's condition since its bubble peaked

in 1990. It may result in "negative equity" for the most highly leveraged mortgage borrowers in the real estate sector, followed by debt-ridden companies. When interest charges exceed rental income, commercial borrowers hesitate to use their own money or other income to keep current on their debts. The limited liability laws let them walk away from their losses if markets are deflated, leaving banks, insurance companies, pension funds and other financial institutions to absorb the loss. Sell-offs of these properties to raise cash would accelerate the plunge in asset prices, leaving balance sheets "hollowed out."

Savings do not appear as the villain in such periods. The zero net savings rate has concealed the fact that gross savings have been relent to create a corresponding growth in debt.

Savings do not appear as the villain in such periods. The zero net savings rate has concealed the fact that gross savings have been relent to create a corresponding growth in debt. America's national debt quadrupled during the 12-year Reagan-Bush administration (1981–93). This increase in debt was facilitated by reducing interest rates by enough so that the unprecedented increase in credit rose without extracting more interest from many properties.

The natural limit to this process was reached in 2004 when the Federal Reserve reduced its discount rate to only 1 percent. Once rates hit this nadir, further growth in debt threatened to be reflected directly in draining amortization and interest payments away from spending on goods and services, slowing the economy accordingly. Further debt growth would require a rising proportion of disposable personal income to be spent on debt service.

How Long Can Bubbles Keep Expanding?

The potential credit supply is limited only by the market price of all existing property and securities. The process is open-ended, as each new credit creation inflates the market value of assets that can be pledged as collateral for new loans.

Until bubbles burst, they benefit investors who borrow money to buy assets that are rising in price. Running into debt becomes the preferred way to make money, rather than the traditional first step toward losing the homestead. The

motto of modern real estate investors is that "rent is for paying interest," and this also applies to corporate raiders who use the earnings of companies bought on credit to repay their bankers and bondholders. What real estate investors and corporate financial officers are after is capital gains.

There is no inherent link with making new direct investment. Indeed, the after-tax return from asset-price inflation exceeds that which can be made by investing to create profits. Retirees, widows and orphans do best by living off capital gains, selling part of their growing portfolios rather than seeking a flow of interest, dividends and rental income. The idea begins to spread that people can live off capital gains in an economy whose incomes are not growing.

Asset-price inflation reaches its limit when interest charges absorb the entire flow of earnings.

Asset-price inflation would be a rational long-term policy if economies could inflate their way out of debt via capital gains. The solution to debt would be to create yet more debt to finance yet more asset-price inflation. This dynamic is more likely to create debt deflation than commodity-price inflation, however. It is true that a consumer "wealth effect" occurs when homeowners refinance their mortgages by taking new "home equity" loans to spend on living, or at least to pay down their credit-card debt so as to lower the monthly diversion of income for debt service. If this were to lead to a general inflation, interest rates would rise, prompting investors to shift out of stocks into bonds. Foreign investors and speculators bail out, accelerating the price decline. This threatens retirement funds, insurance companies and banks with capital losses that erode their ability to meet their commitments.

The more likely constraint comes from asset-price inflation itself as price/earnings ratios rise. Interest rates and other returns slow, making it difficult for pension plans and insurance companies to earn the projected returns needed to pay retirees. In any event, asset sales exceed purchases as the proportion of retirees to employees grows, causing stock and bond prices to decline. Pension funds must sell more stocks and bonds—or employers must set aside more of their revenue for this purpose, in which case their ability to pay dividends is reduced.

Asset-price inflation reaches its limit when interest charges absorb the entire flow of earnings. Debt-financed bubbles remove more purchasing power from the "bottom 90%" of the population than they supply. Debt spurs rising housing prices but reduces consumer demand as a result of the need to service mortgages. Likewise, financing for leveraged buyouts, mergers and acquisitions may increase stock prices, but the interest charges absorb corporate earnings and "crowd out" new direct investment and employment.

The drive for capital gains thus complicates the traditional macroeconomic Keynesian categories. Although these gains are not included in the national income statistics, they have become the key to analyzing how asset-price inflation leads to debt deflation of the "real" economy. One thus may ask what sphere of the economy is more "real" and powerful: that of tangible production and consumption, or the financial sector which is wrapped around it.

Can the Debt and Savings Overhead Be Supported Indefinitely?

Richard Price's illustration of the seemingly magical powers of compound interest is a reminder that many people saved pennies (and much more) at the time of Jesus, and long before that, but nobody yet has obtained an expanding globe of gold. The reason is that savings have been wiped out repeatedly in waves of bankruptcy.

The reason is clear enough. When savings, lending and "indirect" financial investment grow by compound interest in the absence of new tangible investment, something must give. The superstructure of debt must be brought back into a relationship with the ability to pay.

Financial crashes occur much more quickly than the long buildup. This is what produces a ratchet pattern for business cycles—a gradual upsweep and sudden collapse of financial and property prices, leaving economies debt-ridden. Many debts are wiped out, to be sure, along with the savings that have been invested in bad loans—unless the government bails out savers at taxpayer expense.

Financial crises are not resolved simply by price adjustments. Almost all crises involve government intervention, solving matters politically. As the financial and property sectors gain political power relative to the increasingly indebted production and consumption sectors, their lobbies succeed in lowering tax rates on *rentier* income relative to taxes on wages and profits. Tax rates on capital gains have been slashed below those on "earned" wages and profits, whereas the two rates were equal when America's income-tax laws first were introduced.

Financial lobbies also have gotten law-makers to adopt the "moral hazard" policy of guaranteeing savings. Debtors still may go bankrupt, but savings are

to be kept intact by making taxpayers liable to the economy's savers. Ever since the collapse of the Federal Savings and Loan Insurance Corporation (FSLIC) in the late 1980s a political fight has loomed over just whose savings are to be rescued. Unfortunately, the principle at work is that of "Big fish eat little fish." Small savers are sacrificed to the wealthiest savers and institutional investors.

The mathematics of compound interest dictates that such public guarantees to preserve savings cannot succeed in the long run. Financial savings and debts tend to grow at exponential rates while economies grow only by S curves, causing strains that cannot be supported as credit is used to buy assets rather than to invest in capital goods or buildings.

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Financial strains become further politicized as large institutions and the "upper 10 percent" of the population account for nearly all the net saving, which is lent out to the "bottom 90%" and to industry. The balance-sheet position of the wealthiest layer increases as long as capital gains exceed the buildup of debt. The bottom 90% also benefit for a while during the early and middle stages of the financial bubble. Workers are invited to think of themselves as finance-capitalists-in-miniature rather than as employees being downsized and outsourced. But much of what they may gain in the rising market value of their homes (for the two-thirds of the U.S. and British populations that are homeowners) is offset by the debt deflation that bleeds the production-and-consumption economy.

Throughout history societies that have polarized between creditors and debtors have not survived well. Rome ended in a convulsion of debt foreclosure, monopolization of the land and tax shifts that reduced most of the population to clientage. Third-world countries today are being stripped of their public domain and public enterprises by the international debt buildup, while industry and real estate in the creditor nations themselves are becoming debt-ridden.

Today's bubble economy is seeing interest charges expand to absorb profits and rental income, leading to slower domestic direct investment and employment. Much as classical economists believed that rent would expand to absorb the entire economic surplus, it now appears that interest-bearing debt will play this role.

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America's Monetary Imperialism

It's not hard to find examples of coercive exploitation in today's global economy. The International Monetary Fund (IMF) imposes austerity on debtor economies, shrinking their investment and production. This causes unemployment and a domestic fiscal crisis, while making them more dependent on foreign suppliers. A widening trade deficit ensues, financed by further borrowing whose interest charges aggravate the overall payments deficit in a deteriorating spiral.

The World Bank demands that debtor countries raise money by privatizing their public domain, despite the notorious underpricing of assets, exorbitant underwriting fees, insider dealings, and falling post-privatization service standards. The World Trade Organization (WTO) blocks governments from taxing the profits and rents generated by these privatized assets. Its neoliberal agenda aims at turning control over markets to the multinational corporations, while promoting tax codes that enable companies to deduct from taxable profits all interest and insurance charges, management fees, and the fatal slack variable of intra-company transfer pricing through offshore tax havens. This starves governments fiscally, forcing them to borrow more even as they slash public services.

Debtor countries thus suffer from a proliferating debt pollution—the build-up of debts beyond their ability to pay, as well as suffering from ecological standards being cut back by economic distress conditions. Austerity blocks governments from making the social investment needed to avert long-term educational cleanup costs to repair a broken social system, debt cleanup costs to cope with the creditor leverage held over their heads, and the physical cleanup costs that result from hosting some of the world's most environmentally destructive industries.

The thrust of the Washington Consensus enforced by the IMF, World Bank and WTO is to dismantle the regulatory and fiscal power of governments throughout the world. Not only are debtor-country governments blocked from running the budget deficits that the United States runs freely in response to its own unemployment, but even the European Central Bank (ECB) blocks member-country governments from running sustained budget deficits of more than 3 percent of GDP, despite the continent's unemployment and balance-of-payments surplus.

These payments-surplus nations find themselves unable to cope with the influx of dollars stemming from America's trade deficit, now overlayered by a military deficit that threatens to escalate as the United States expands its adventurism in the Near East. In exchange for these excess dollars, Europe and Asia supply exports and sell off their companies and other assets. But what do they get in return?

A double standard has been implicit in the world's economic rules since the dollar was decoupled from gold in 1971, when the U.S. trade deficit of $10 billion deficit was the equivalent of more than half the U.S. gold stock. But today there is no gold convertibility and hence no major constraint on U.S. spending abroad or at home. The United States has not subjected itself to any of the distressing fiscal conditions that all other countries feel obliged to follow. What makes this asymmetry so ironic is that it was made possible by what seemed to be a financial defeat for the United States. Once America stopped paying gold, there was not much that other central banks could ask for as they found themselves flooded with dollars obtained by private-sector exporters and asset sellers in excess of their needs.

America was not about to yield control of its strategic sectors to foreign holders of these dollars, even as foreign countries have privatized their major public-sector utilities and infrastructure. In 1973, U.S. diplomats made it clear that if OPEC countries tried to use their dollars to buy out major companies, this would be treated as a belligerent act. The Islamic countries were told that they could earn interest by leaving their money in American banks, or they could buy U.S. Treasury bonds or—considering their religious strictures against usury—they could buy minority shares of U.S. stocks, an activity that would bid up the stock market and thus help create a boom in the United States, but they could not buy enough shares to dominate these companies. They could buy real estate, Japan-style, helping to inflate the U.S. property market. But one way or another, OPEC and other dollar holders would have to keep their dollar inflows in the form of dollars. There was no alternative, politically and indeed militarily speaking.

So much for the patina of free-market rhetorical glove in which this iron fist was wrapped! Now that gold has been demonetized, all that foreign central banks can do with their excess dollars is to send them back to the U.S. Government by buying Treasury bonds. If they do not do this, their currencies will surge against the dollar, threatening to price their manufacturers and food exporters out of foreign markets.

What may cause a break between the United States and foreign dollar holders is a non-economic strain: America's war in Iraq and its threat of p

ggressive (that is, unprovoked) attacks on Iran, North Korea, Syria and North frica. In the 1960s military spending in Vietnam pushed America's balance f payments into deficit, drained the gold stock that had been the source of nternational power since World War I. Back then at least the private sector was n balance. But today it is deep in deficit, while military spending is frightening he world not merely by financially undercutting the dollar's already deterio- ating value, but by the political adventurism that is sparking popular protests round the entire world. Other countries now fear America's military aggres- iveness as well as its unchecked financial unilateralism. Although the Iraq War s only the most recent cap to the unconstrained growth of America's trade and payments deficit, the anti-war protests around the world have given the problem a highly political coloration.

The world still remembers how it was the Vietnam War that forced America off gold, as the U.S. balance-of-payments deficit during the 1960s stemmed entirely from overseas military spending. By 1971 the United States stopped redeeming foreign-held dollars in gold, and the dollar ceased to be a gold proxy. As the U.S. payments deficit shifted to the private sector, it expressed itself in the form of a demand for foreign products. This was welcomed by foreign countries on the grounds that at least it helped spur their domestic employment. But America's new military adventurism has no visible side benefits for Europe, Asia or other countries. It has given the U.S. Treasury-bill standard the coloration of a political and military threat as well as being merely an economic form of exploitation.

Having taken over three decades for the crisis to reach today's critical mass, the multilateral character of international finance is now beginning to crumble because other countries are now coming to see that the Dollar Standard has enabled the United States to obtain the largest free lunch in history. Whereas the world's financial system formerly rested on gold, central bank reserves now are held in the form of U.S. Treasury IOUs that are being run up without limit. America has been buying the exports and even the companies of Europe, Asia and other regions with paper credit whose volume now exceeds America's ability to pay, and which the United States has made it clear that it has little intention of paying off. That is the essence of today's "paper gold."

The widening U.S. payments deficit and the dollar's consequent plunge pose the question of whether any practical balance-of-payments constraint exists—or can be imposed—to the United States spending as much as it wants. The problem is that it is paying for non-U.S. goods and services in exchange for Treasury IOUs that are rapidly losing the fiction that they ever will be paid.

This is where the unfair double standard comes into play. If Latin American and African countries—and now, Iraq—cannot be expected to pay their exponentially growing debts and ask for debt write-offs, can the United States be far behind? And if the U.S. debt is written off, what will Europe and East Asia have got in exchange for having provided a rising torrent of automobiles and other manufactures, and even the sale of their companies for dollars? The United States for its part will have got a free ride, even as its economists promise the world that there is no such thing as a free lunch.

What Makes Super Imperialism Different from Past "Private Enterprise" Imperialism

A new mode of international exploitation has been created. As Henry C. K. Liu has noted recently in the *Asia Times*, "Dollar hegemony is a structural condition in world finance and trade in which the United States produces dollars and the rest of the world produces things dollars can buy." Primarily financial in character, this new kind of imperialism is turning the more classical forms of imperialism upside down. Unlike former modes of imperialism, it is a strategy that only one power, the United States, has been able to employ. Also novel is the fact that the U.S. Treasury-bond standard does not rely on the corporate profits or the drives of private companies investing in other countries to extract profits and interest. Monetary imperialism operates primarily through the balance of payments and central bank agreements, which ultimately are government functions. It occurs between the U.S. Government and the central banks of nations running balance-of-payments surpluses. The larger their surpluses grow, the more U.S. Treasury securities they are obliged to buy.

I recently have updated and republished a book that I wrote when this process was just getting underway, in 1972: *Super Imperialism: The Origins and Fundamentals of U.S. World Dominance*. It gives a fuller explanation than I can afford here of how America went off gold in 1971, obliging the world's central banks to finance the U.S. balance-of-payments deficit by using their surplus dollars to buy U.S. Treasury bonds. It explains why there is little Europe or Asia can do about the situation except reject the dollar. The problem is that to do that would lead their currencies to appreciate, hurting their own exporters in world markets.

Gold was the source of America's financial power since World War I, when arms sales and related material exports to the Allies turned the United States from a debtor into a creditor nation. From 1917 through 1950 the United States used its creditor position to domineer international diplomacy. The British Loan of 1944 was granted on the condition that the British Empire and

Sterling Area would be wound down after World War II ended and made virtually into an extension of the U.S. economy. Similar creditor power has been used against third world debtors since the 1950s, once they exhausted the foreign-exchange reserves built up during World War II as a result of providing raw materials to the Allies and not finding many consumer or investment goods to import.

When the United States was forced off gold it appeared that this era had ended. Most observers assumed that creditor nations would call the tune. An era had ended, in the sense that the United States was becoming the world's largest debtor. But what replaced its creditor power was a new debtor power, based on America's power to wreck the world financial system if other countries asserted their own creditor interests at the expense of U.S. demands that it be permitted to become a reckless debtor.

Old Classical Imperialism	**Dollar Hegemony under the Treasury-Bond Standard**
Globally symmetrical opportunities	Geopolitically asymmetrical, and hence unstable
Based on commercial trade and investment, supplemented by international loans.	Based on U.S. dollars supplying central bank reserves via the U.S. Treasury-bill standard
Based on cosmopolitan creditor power	Based on America's unique debtor power
An imperial-nation trade surplus provides the resources to sustain a capital investment abroad.	The U.S. economy runs a deepening trade deficit in addition to a capital and military deficit
The major competition is for export markets	The object is to import as much as possible without having to give a quid pro quo
All countries can become imperialistic following a common pattern	Only the United States can play the new dollar game
The effect is to underdevelop dependent countries	The effect is to make foreign central banks arms of the monetarist Washington Consensus
Exploits low-wage labor in less developed countries	Extracts forced credit and rent from Europe and Asia
Exploitation is measured by the wage differential	The aim is to get the entire product for nothing
Imperial power enforced by gunboats	Imperial power enforced by air and missile power

The Seignorage Benefits of Dollar Hegemony

The free ride that America receives from its ability to run a balance-of-payments deficit has been likened to the seignorage a government gets when it prints paper currency and spends it on goods and services. More U.S. paper currency is held abroad than that of any other country, more even than is held in the United States itself. Most consists of $100 bills. Russia accounts for a large proportion, and the world's drug traders, tax dodgers and other criminals have absorbed most of the balance. Foreign countries get paper, while Americans get their goods and services.

But most of the benefits of U.S. dollar credit have come from foreign central banks receiving bank drafts denominated in dollars. Over and above what their private sector spends to buy U.S. exports, pay interest and dividends to U.S. investors or remit profits to U.S.-owned firms, nearly a trillion dollars have mounted up in the world's central banks for which the private sector has no use, and hence has turned them over in exchange for their own domestic currency.

Central banks find themselves with the equivalent of the $100 bills collected by the Russians. At least the central banks are able to get interest credited to these holdings, for they return these dollars to the United States to buy its Treasury bonds. These form the growth in their international reserves.

Europe, China and Japan have been the major regions building up such reserves. They finally are beginning to ask themselves just what practical use these reserves are, and how much value these dollar claims will retain as they become increasingly fictitious. When it comes down to the essence of matters, what will today's U.S. Government let foreign governments spend their monetary reserves on? The U.S. economy has been hollowing itself out by treating its industry as a financial vehicle to turn profits into interest payments. Its labor is rendered high-cost not only by its current living expenses paid for goods and services, but for its sharp rise in debt service, headed by mortgage-debt service on the increasingly expensive cost of buying homes.

Although the U.S. real estate and financial bubble has been welcomed as post-industrial "wealth creation," it is rendering the American economy uncompetitive in world markets and hence unable to pay off its foreign debt by running a trade surplus. U.S. labor is obliged to pay for high-cost housing and pay debt service on the loans needed to stay afloat in today's economy. Agriculture remains the mainstay of U.S. exports, but the nation's farm protectionism finally is coming under criticism by food-deficit countries. It has been a sticking point in new global trade negotiations ever since the Common Agricultural Policy triggered U.S.-European rivalry 45 years ago.

The Irony of Dollar Hegemony: Power and Unlimited Credit through the Threat of Bankruptcy

The United States achieves hegemony not by its creditor status as it did prior to the Korean War, but by its payments-deficit status. This seeming weakness enables it to run a trade deficit that is now approaching half a trillion dollars annually and shows no sign of abating. The world finds itself confronted by America running this deficit without constraint, importing as much as it wants from abroad and permitting its investors to buy as many foreign companies, stocks and bonds as they want, without limit.

By "without limit" I mean without having to provide a *quid pro quo* beyond Treasury IOUs whose prospects for repayment are diminishing as their volume grows. As fewer and fewer economic analysts are able to see a way for these official obligations to be paid, the question becomes which nations will succeed in dropping the dollar first, and what political upheavals may result as they draw the line against accepting more dollars in their reserves.

The larger the balance-of-payments deficit grows, the more money central banks have to recycle to finance America's budget deficit.

As far as domestic U.S. fiscal and monetary relations are concerned, the government can finance its budget deficit by foreign central-bank demand for U.S. Treasury securities rather than borrowing from or taxing U.S. citizens. The larger the balance-of-payments deficit grows, the more money central banks have to recycle to finance America's budget deficit. Both deficits thus can increase together, financing each other.

The Treasury-bond standard is thus a more specific term than dollar hegemony. It explains how this hegemony is achieved. Other countries running budget deficits are obliged to raise interest rates. But America has lowered its interest rates, pursuing a tax policy and related fiscal and monetary policy of "benign neglect" in the face of its trade and payments deficit. The United States alone is able to lower its interest rates to spur domestic economic activity, even to the point of spurring a stock market and real estate bubble. This freedom is not available to European, Asian or other countries. No country ever before has been able to do this.

When other countries run sustained trade deficits, they must finance these by selling off domestic assets or running into debt — debt which they actually are obliged to pay. It seems that only the Americans are so bold as to say "Screw the world. We're going to do whatever we want." Other countries simply cannot afford the chaos from which the U.S. economy is positioned to withstand as a result of the fact that foreign trade plays a smaller role in its economy than in those of nearly all other nations in today's interdependent world.

Using debtor leverage to set the terms on which it will refrain from causing monetary chaos, America has turned seeming financial weakness into strength. U.S. Government debt has reached so large a magnitude that any attempt to replace it will entail an interregnum of financial chaos and political instability. American diplomats have learned that they are well positioned to come out on top in such grab-bags.

No other country is able to play the game of international finance in this way. Other countries running balance-of-payments deficits are obliged to sell off the assets in their public domain and run up debts that indeed must be paid. Free of such constraint, America keeps on supplying paper or electronic dollars to the world at will.

The upshot is that although at first appearing as a sign of weakness, the U.S. trade and payments deficit supplies its consumers and companies with foreign goods, while spending abroad militarily and lowering its interest rates to inflate a bubble economy without international constraint. This asymmetrical ability to exploit is a double standard that is implicit in the dollar standard. It enables America to play both sides of the creditor-debtor street.

As a debtor country the United States exploits Europe and Asia by running a balance-of-payments deficit now approaching half a trillion dollars annually. It pays for its net imports and buyouts of foreign industry by with Treasury bonds that its diplomats have long hinted they have little intention of paying off. Central banks end up with paper or electronic IOUs bearing 4 or 5 percent interest, which the U.S. Treasury simply adds to the balance of what it owes, while U.S. investors buy foreign companies, resources and hitherto public enterprises expected to yield in the neighborhood of 20 percent in earnings and capital gains.

Meanwhile, the United States uses traditional "hard-money" creditor leverage toward third world debtor countries. Through the IMF and World Bank it forces these countries to pay foreign debts by privatizing their natural resources and public enterprises which, for thousands of years, have been considered to be the national patrimony and guarantee of self-determination in economic and fiscal policy.

the fact that much of the foreign debt being used as leverage over third countries can be traced to capital flight and interest accruals building up bad loans to kleptocracies and client oligarchies backed by the United States a further note of asymmetry to illustrate America's remarkable ability to the best of both worlds in applying this dual international strategy. It buys over imports and foreign companies it wants, with a line of credit that to have no end, and whose modest interest charges are simply added the balance hypothetically due, while using its ability to create bank credit dollars) at will as leverage over the governments of indebted countries. alternative is to suffer the fate that Cuba, Iraq and other exiles from the shington Consensus have suffered.

Engine of Global Economic Growth, or Financial Exploitation?

American diplomats represent U.S. foreign spending as an "engine of growth" pumping dollars into the world economy to provide a source of market demand that saves other nations from unemployment and recession. The logic is that foreign labor would not be employed without U.S. consumer demand, as if Europe and Asia could not replace U.S. imports with growth in their own markets.

If this were true, it would be an indictment of Europe's central banking system, reflecting the extent to which the ECB and central banks throughout the world have become part of the monetarist Washington Consensus—a monetary stranglehold outside of the United States while the U.S. banking system creates credit freely and cut taxes as foreign central banks finance the resulting budget deficit.

A related euphemism is that the U.S. economy is doing so well that it "attracts" money, which provides it with the resources to buy more abroad than it sells. The implied line of causation turns what is happening inside-out. Under today's geopolitical conditions these dollars have nowhere to go except back to the U.S. economy, which pushes dollars on the world in the knowledge that like a boomerang foreign central banks must return them.

No active steps are needed to attract these dollars back. All that is needed is to prevent the euro and sterling, the yen and yuan from being used to expand domestic market demand and finance social democratic programs, creating securities that other countries could hold as alternatives to U.S. Treasury debt. Not to see that depicting the dollar as the world's "engine of growth" is a euphemism for dollar hegemony and the American free ride is to lose touch with financial reality by reversing the actual arrow of causality at work.

The question that needs to be asked is how the rest of the world came to be dependent on the U.S. trade and payments deficit to obtain enough money to spend domestically. Money historically has been a government creation. It also is an instrument of debt—today, mainly debt owed by the U.S. Government. How did the creation of international monetary reserves pass out of the hands of all governments except that of the United States?

Part of the answer is IMF and World Bank imposition of the Washington Consensus. When American advisors were given a free hand in Russia in the mid-1990s, the insisted that the central bank hold U.S. dollars as counterparts to their creation of rubles to pay domestic labor. The central bank notoriously paid 100 percent interest for these dollars—dollars that had nothing whatsoever to do with the ruble credit being created to pay labor, but everything to do with creating huge profits for well-connected U.S. investors and speculators. The problem is ideological, not economically necessary.

In all such questions the surest answer is supplied by following the money. As Willy Sutton is said to have remarked, he robbed banks because that's where the money was. Empires follow the same strategy. A century ago John Hobson pointed out that the imperial nations invested mainly in each other. It is they that have the money and markets, after all, and whose real estate, stock and bond markets offer the best opportunities for asset-price gains. The problem is not rich exploiting the poor as much as the rich exploiting other rich nations. That has been the key to empire-building throughout history.

It was not labor that America wanted when it sent its advisors to Russia. Its investors wanted the country's raw materials, its oil and gas, minerals, and especially its urban land, as land and subsoil resources are still the major assets of every economy. This is why they are the main objectives of imperialism—yielding rent and capital gains whose magnitude exceeds the profits gained on employing wage labor.

Was the Oil War in Iraq about the Dollar Standard?

The 2003 Iraq War has inspired speculation that it is was fought to keep OPEC oil priced in dollar rather than in euros. The problem with this theory is that when OPEC-held dollars or U.S. Treasury bonds are sold for securities denominated in euros, yen or yuan, these dollar securities are passed on to the central banks of Europe, Japan and China respectively. These central banks then find themselves obliged to do just what they have been doing all along to prevent their currencies from rising against the dollar: They recycle the dollar inflows into U.S. Treasury bonds. If they receive balance-of-payments inflows as a result of OPEC purchases, overall global central bank hold-

of Treasury securities will not decline, but will merely shift out of OPEC banks to those of Europe and East Asia. OPEC will have divested itself dollar problem by passing the problem on like the proverbial hot potato. This means that concerns about the euro threatening the dollar have been drawn. If the oil-exporting countries shift their international reserves from dollars to euros, they will do so by selling U.S. Treasury bonds and buying the government bonds or other securities of European countries. This would force up the euro's exchange rate against the dollar, confronting Europe with the same dilemma it has faced since the dollar was cut off from gold in 1971. If it stops recycling its surplus dollars—that is, its trade and payments surpluses—as loans back to the U.S. Treasury, its currencies will rise, hurting its exporters. This is the dilemma spelled out in the final two chapters of *Super Imperialism*.

The effect of a shift out of dollars into euros by OPEC would be much like Europe exporting more goods directly to the United States or other dollar-using countries, or selling more companies, stocks and bonds to U.S. investors. As the euro rises against the dollar, European exporters already are complaining that products denominated in their own currency were being priced out of world markets. To prevent this from occurring, European countries are receiving central bank inflows from the Organization of Petroleum-Exporting Countries (OPEC) already are coming under pressure to hold down the euro's exchange rate by using these dollar inflows to buy yet more U.S. Treasury bills.

The 2003 Oil War therefore is not part of a currency rivalry between the dollar and euro, for Europe and East Asia remain the residual absorbers of the world's surplus dollars. No opposition has arisen as yet to U.S. dollar hegemony because, as Mrs. Thatcher might put it, there is as yet no alternative.

But this does not mean that one is not in the gestation stage. As the United States works both sides of the creditor/debtor street, Europe, Asia, Latin America and Africa (and even Canada) find themselves obliged out of self-protection to create a fairer system of world debt and payments.

Steps toward a Counter-Strategy

One tempting response would be to revert to the old system of two exchange rates, one for trade and another for financial movements. This would have to be done in a way that did not let speculators arbitrage between the two rates by selling proxies and matching buy and sell orders. Such a task would involve a complex regulatory management that would run the risk of futility.

A simpler option is to do what the United States did in 1922 when it was threatened by low-priced imports from Germany as the mark's exchange rate collapsed under the burden of paying reparations. Congress restored the 1909

American Selling Price (ASP) tariff against countries with depreciating currencies. A floating tariff was imposed equal to the price advantage of foreign imports below U.S. domestic prices. This denied Germany and other countries a price advantage resulting either from depreciation or even from superior efficiency. Europe and Asia could impose such a retaliatory tariff, and use the proceeds or other dollar inflows to subsidize its exports in markets competing with U.S. exports to offset the price benefit from the depreciating dollar.

Most important, foreign countries must realize that they do not need dollars in order to re-inflate their home markets. Their Treasuries can create their own money based on their own economic needs rather than letting their central bank reserves be a derivative of the U.S. payments deficit.

To date, U.S. diplomats have used the clash of political cultures to their own advantage. It is as if only the United States acts in its own national interest, while Europe, Asia and the third world acquiesce in the Washington Consensus as if they were client oligarchies. Only by pushing back can they create a more equitable arrangement between the dollar, the euro and the yen and yuan. And only by running a balance-of-payments deficit can Europe and East Asia follow the U.S. path in providing a vehicle for other countries to hold their international monetary reserves. This requires an abandonment of the world's dependence on the Washington Consensus and its imposition of monetarist austerity outside of the United States.

18

INCORPORATING THE *RENTIER* SECTORS INTO A FINANCIAL MODEL

Now that the Bubble Economy has given way to debt deflation, the world is discovering the shortcoming of models that fail to explain how most credit creation today (1) inflates asset prices without raising commodity prices or wage levels, and (2) creates a reciprocal flow of debt service. This debt service tends to rise as a proportion of personal and business income, outstripping the ability of debtors to pay—leading to (3) debt deflation. The only way to prevent this phenomenon from plunging economies into depression and keeping them there is (4) to write down the debts so as to free revenue for spending once again on goods and services.

By promoting a misleading view of how the economy works, the above omissions lead to a policy that fails to prevent debt bubbles or deal effectively with the ensuing depression. To avoid a replay of the recent financial crisis—and indeed, to extricate economies from their present debt strait-jacket that subordinates recovery to the overhang of creditor claims (that is, saving the banks from taking a loss on their bad loans and gambles)—it is necessary to explain how credit creation inflates housing and other asset prices, while interest and other financial charges deflate the "real" economy, holding down commodity prices, shrinking markets and employment, and holding down wages in a downward economic spiral. We are dealing with two price trends that go in opposite directions: asset prices and commodity prices. It therefore is necessary to explain how credit expansion pushes asset prices up while simultaneously causing debt deflation.

The typical MV = PT monetary and price model focuses on commodity prices and wages, not on the asset prices inflated by debt leveraging. In the real world most credit today is spent to buy assets already in place. Some 80 percent of bank loans in the English-speaking world are real estate mortgages, and much of the balance is lent against stocks and bonds already issued. Banks lend to buyers of real estate, corporate raiders, ambitious financial empire-builders, and to management for debt-leveraged buyouts.

Extending credit to purchase assets already in place bids up their price. Prospective homebuyers need to take on larger mortgages to obtain a home.

The effect is to turn property rents into a flow of mortgage interest. These payments divert the revenue of consumers and businesses from being spent on consumption or new capital investment. The effect is ***de***flationary for the economy's product markets, and hence consumer prices and employment, and therefore wages.

Debt-leveraged buyouts and commercial real estate purchases turn business cash flow (ebitda: earnings before interest, taxes, depreciation and amortization) into interest payments. Likewise, bank or bondholder financing of public debt (especially in the Eurozone, which lacks a central bank to monetize such debt) has turned a rising share of tax revenue into interest payments. It was to extricate themselves from this situation that nations created central banks, starting with the Bank of England in 1694. The aim was to avoid reliance on commercial banks for credit, by creating money by the state itself.

As creditors recycle their receipts of interest and amortization (and capital gains) into new lending to buyers of real estate, stocks and bonds, a rising share of employee income, real estate rent, business revenue and even government tax revenue diverted to pay debt service. By leaving less to spend on goods and services, the effect is to reduce new investment and employment. So wages do not increase, even as prices for property and financial securities rise. This price divergence has become the major characteristic of the post-2001 Bubble Economy, and indeed of the post-1980 period throughout the Western economies.

It is especially the case since 1991 in the post-Soviet economies, where neoliberal (that is, pro-financial) policy makers have had a free hand to shape tax and financial policy in favor of banks (mainly foreign bank branches). Latvia is cited as a neoliberal success story, but it would be hard to find an example where *rentier* income and prices have diverged more sharply from wages and the "real" production economy.

The more that credit creation takes the form of inflating asset prices—rather than financing purchases of goods or direct investment employing labor—the more ***de***flationary its effects are on the "real" economy of production and consumption. Housing and other asset prices crash, causing negative equity. Yet homeowners and businesses still have to pay off their debts. The national income accounts classify this pay-down as "saving," although the revenue is not available to the debtors doing the "saving."

The moral is that using homes as what Alan Greenspan referred to as "piggy banks" to take out home-equity loans was not really like drawing down a bank account at all. When a bank account is drawn down there is less money available, but no residual obligation to pay. New income can be spent at the discretion of its recipient. But borrowing against a home implies an obligation to set aside future income to pay the banker—and hence a loss of future discretionary spending.

Creating a more realistic model of today's financialized economies to trace this phenomenon requires a breakdown of the national income and product accounts (NIPA) to see the economy as a set of distinct sectors interacting with each other. These accounts juxtapose the private and public sectors as far as current spending, saving and taxation is concerned. But the implication is that government budget deficits inflate the private-sector economy as a whole. However, a budget deficit that takes the form of transfer payments to banks, as in the case of the post-September 2008 bank bailout, the Federal Reserve's $3 trillion in cash-for-trash financial swaps and the $700 billion QE II credit creation by the Federal Reserve to lend to banks at 0.25 percent interest in 2011, has a different effect from deficits that reflect social spending programs, like Social Security and Medicare, public infrastructure investment or the purchase of other goods and services. The effect of transfer payments to the financial sector—as well as the $5.3 trillion increase in U.S. Treasury debt from taking Fannie Mae and Freddie Mac onto the public balance sheet—is to support asset prices (above all those of the banking system), not inflate commodity prices and wages.

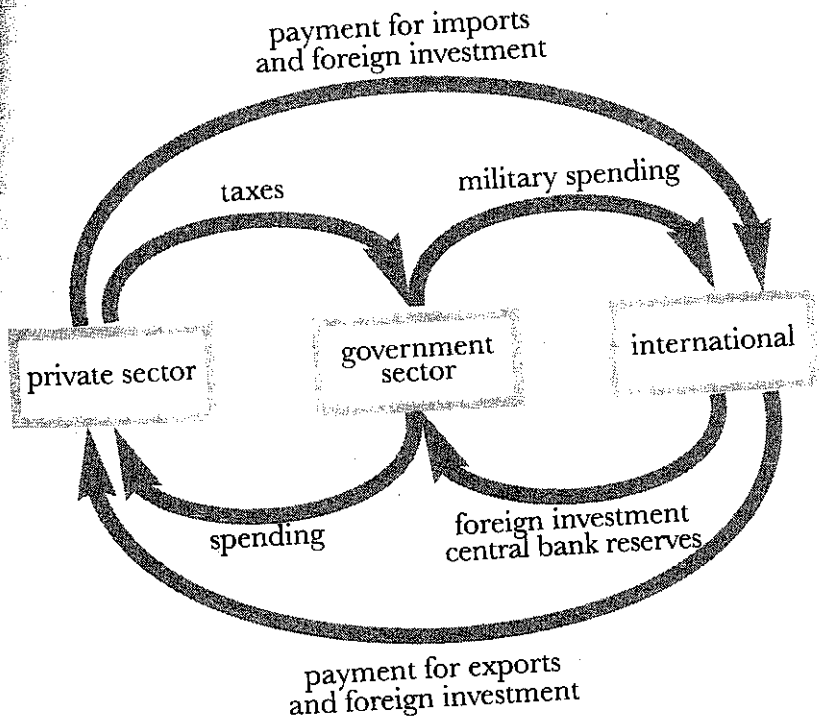

Fig. 1: Private sector, government sector and international sector

Most models treat the international sector either as a "leakage" (as Keynes termed foreign trade and capital flows) or as a balancing item in the private/public sector surplus or shortfall (as in the Levy Institute model). But the international sector involves not only export and import trade and other current account items (emigrants' remittances, and above all, military spending) but also foreign investment and income—and foreign central bank reserves held in U.S. Treasury and other securities, that is, in loans to the U.S. Government.

So the international sphere may either provide inflows or record an outflow to the U.S. economy and its financial markets. For instance, U.S. consumers and businesses ran a trade deficit, and banks used the entire $700 billion QEII supply of Fed credit for foreign currency arbitrage and other international speculation, not for lending to the domestic U.S. economy. But the U.S. Treasury received an inflow from foreign central banks building up their dollar reserves by buying Treasury securities and other U.S. financial securities.

This model can be used to trace U.S. transactions with China. The economy runs a trade deficit with China, and also a private-sector investment outflow to China. There is some return of earnings from these investments to U.S. companies. But on balance, there is a dollar outflow to China—which also

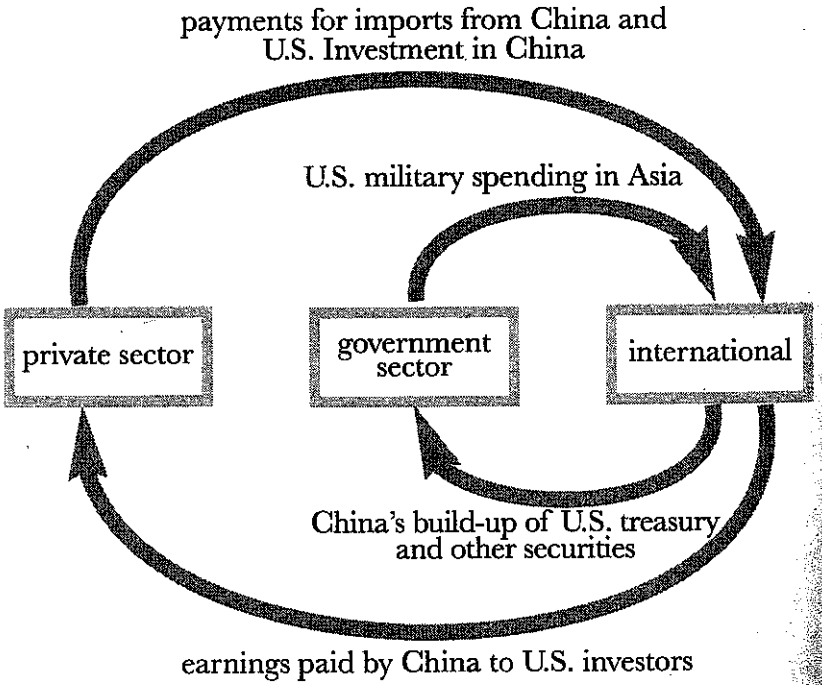

Fig. 2: U.S. transactions with China, broken down between private and government sectors

ves dollars from its exports to third countries. China's central bank has ded most of these dollar receipts to the U.S. Treasury (and earlier, into nie Mae bonds and kindred investments), but was not permitted to buy companies such as Unocal's refinery operations.

This public/private/international model may be made more realistic by ing the financial, insurance and real estate (FIRE) sector as distinct from underlying production and consumption economy. The FIRE sector deals the economy's balance sheet of assets and debts, real estate, stocks and nds, mortgages and other bank loans—and the payment of interest, money nagement commissions and other fees to the financial sector, as well as surance payments and also rental payments for housing.

In principle, monopolies should be included in this *rentier* sector, as they present a special privilege (control over markets, especially for necessities) hose return in the form of prices and income in excess of necessary costs of production is a form of economic rent, that is, a transfer payment rather than earned" income.

Classical political economists from the Physiocrats through Adam Smith, John Stuart Mill and their Progressive Era followers were reformers in the sense that they treated the *rentier* sectors as extracting transfer payments rather than earning a return for producing actual output ("services"). Their labor theory of value found its counterpart in the "economic rent theory of prices" to distinguish the necessary costs of production and doing business (reduced ultimately to the value of labor) from "unearned income" consisting mainly of land rent, monopoly rent, and financial interest and fees. The various categories of *rentier* income were depicted as the "hollow" element of prices. Land rent, natural resource rent, monopoly rent and returns to privilege (including financial interest and fees) had no counterpart in necessary costs of production. They were historical and institutional products of privileges handed down largely from the medieval conquests that created Europe's landed aristocracy and banking practice that developed largely by insider dealing. What legitimized interest was, pragmatically, lending to kings to finance war debts, in an epoch when money and credit were the sinews of war. So banking as well as military rivalries for land essentially involved the foreign sector.

The political aim of classical analysis was to minimize the economy's cost structure by freeing industrial capitalism from these carry-overs from feudalism. The reformers' guiding idea was to minimize the role of *rentier* income (economic rent) by (1) direct public investment in basic infrastructure, including education, transportation systems, communication systems and other enterprises that were long kept in the public domain or publicly regulated from the late 19th century onward, (2) tax policy (taxing land and natural resources), and

(3) regulatory policy to keep the prices charged by natural monopolies such as railroads, power and gas companies in line with actual production costs plus normal profit.

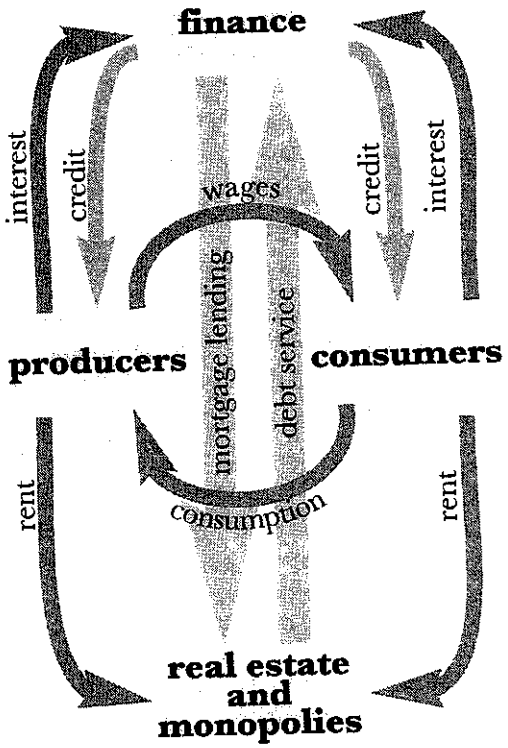

Fig. 3: The FIRE sector's role in the domestic economy

The financial sector has become the leading *rentier* sector. Its "product" is debt claims ***on*** the "real" economy, underwriting, and money management on a fee basis. For this it receives interest and dividends from real estate and business borrowers, and from consumers. Over time, real estate buyers typically pay more in interest to their mortgage lenders than the original purchase price paid to the property seller.

In its interactions with the government, the financial sector buys bonds (and also makes campaign contributions). The Federal Reserve pumps money into the banking system by purchasing bonds and, when the system breaks down, makes enormous bailout payments to cover the bad debts run up by banks and other institutions to mortgage borrowers, businesses and consumers.

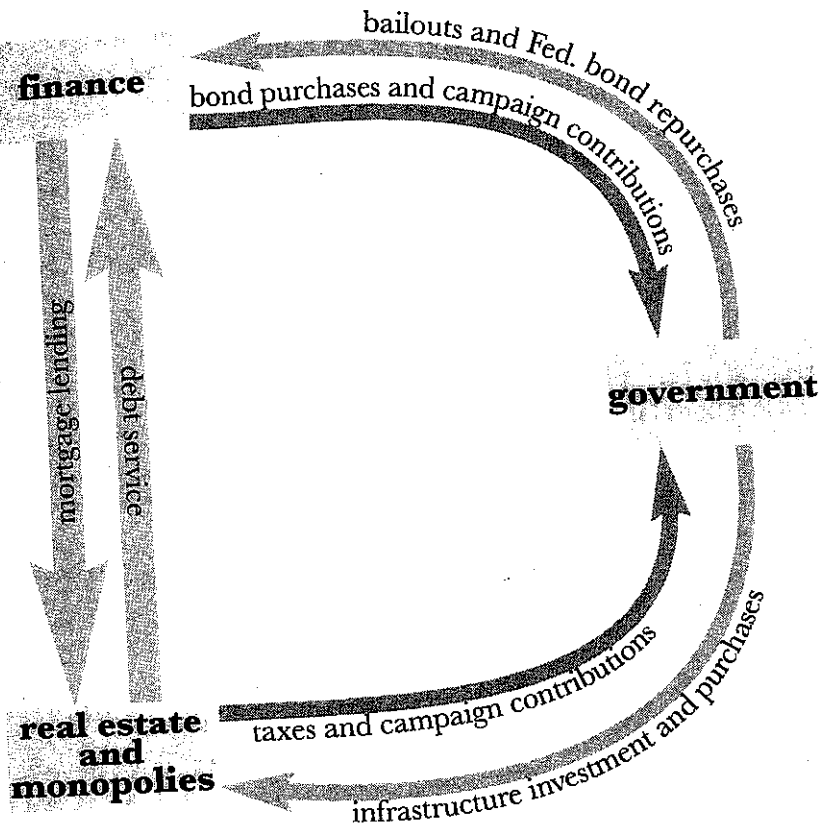

Fig. 4: Interaction between the FIRE and government sectors

The government also enhances the real estate sector by providing transportation and other basic infrastructure that enhances the site value of property along the routes. Finally, the government acts as direct purchaser of monopoly services from health insurance providers, pharmaceutical companies and other monopolies. In the other direction, the U.S. Government receives a modicum of taxes from real estate (mainly at the local level for property taxes), not much income tax but some capital gains tax in good years.

Hardly by surprise, the financial sector prefers to make itself invisible—not only to the tax collector and government regulators, but to voters. What the classical reformers called economic rent is now called "earnings." So the failure to break out the *rentier* sector from the rest of the economy—and hence, balance sheet and debt transactions from the purchase of goods and services—has helped soften criticism of shifting the tax burden off land and monopoly rent, and off finance. Yet the NIPA report that some 40 percent of U.S. corporate profits in 2010 were registered by the financial sector.

This reflects the fact that interest and other financial charges have risen steadily as a proportion of GDP. Credit card companies report higher returns from late fees and penalties than they receive in interest. And other payments to the FIRE sector also are increasing as a rising proportion of employee budgets is spent on housing (largely for mortgage interest), other debt service, and payments to the government in the form of FICA withholding, taxes and user fees that have been shifted off FIRE onto employers and employees in the "real" production sector.

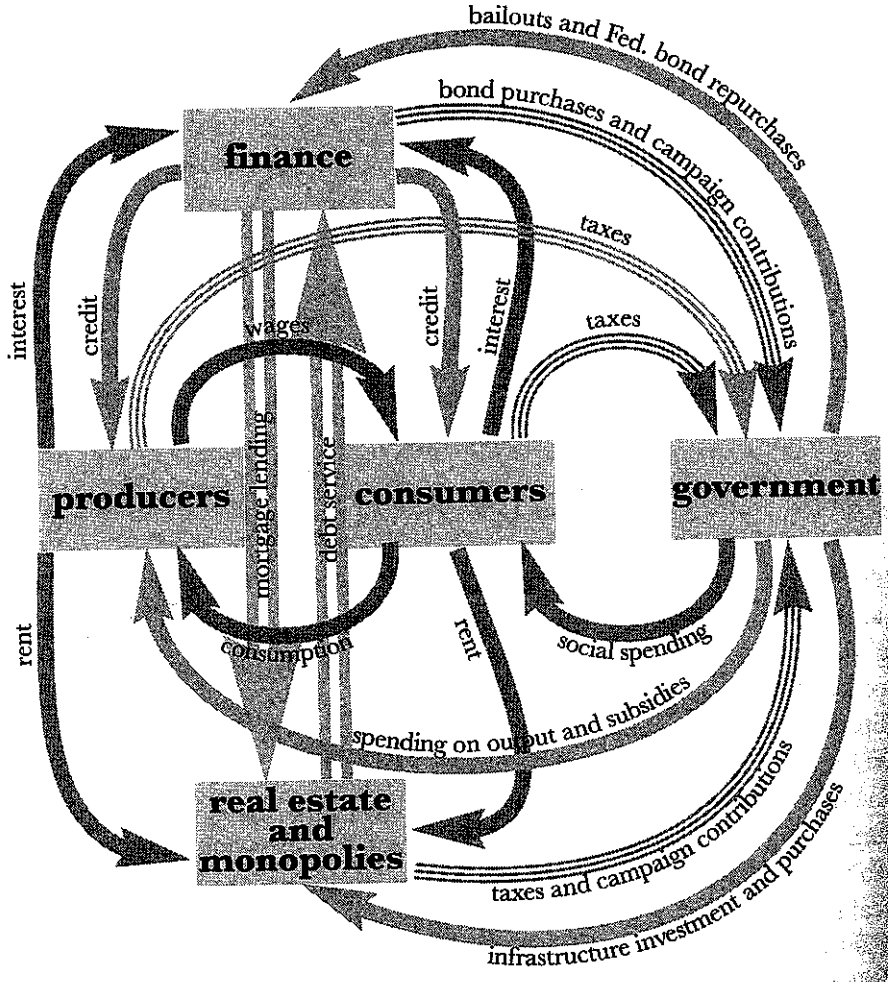

Fig. 5: Overall model of the FIRE sector, producers and consumers and government

The distinction between *rentier* and "earned" income was not incorporated into the NIPA. This is largely the result of a long political and ideological fight waged by the real estate and financial sectors against the Progressive Era's economic reforms. Financial and real estate interests preferred descriptions of an economy in which all income was earned by playing a productive role, and in which money (and hence, credit and debt) was "neutral," only a "veil," that does not affect the distribution of income and wealth. Credit was spent only on goods and services, not on assets. And the financial sector's loans always took the form of productive credit, enabling businesses to pay back the loans out of future earnings while consumers paid out of rising future incomes. There thus was no explanation of how a credit bubble could inflate real estate prices and then collapse into a negative equity disaster. Finance seemed only to create wealth, not impoverish the underlying economy.

Nor was there any way for mainstream models to distinguish government transfer payments to the financial sector (*e.g.*, the $13 trillion in post-2008 financial bailouts in the United States) from Keynesian-style deficit spending. Such transfer payments did not "jumpstart" the economy. They turned a politically well-connected financial elite into new vested interests.

One can understand why the financial sector has had so little interest in tracing the effect of rising money and credit on diverting income from the circular flow between producers and consumers, diverting business revenue from new capital formation, and stripping industrial assets and natural resources. Most model builders isolate these long-term structural, environmental and demographic feedbacks as "externalities." But they are part and parcel of reality. So one is tempted to say that the financial element of economic models is too important to be left to the self-interested tunnel vision of bankers.

Environmental Asset Stripping as an Analogue for Debt Deflation

Just as debt deflation diverts income to pay interest and other financial charges—often at the cost of paying so much corporate cash flow that assets must be sold off to pay creditors—so the phenomenon leads to stripping the natural environment. This is what occurs, for instance, when the IMF and World Bank act on behalf of global banks to demand that Brazil pay its foreign debt by privatizing its Amazon forest so that loggers can earn enough foreign exchange to pay foreign bankers. The analogy is absentee landlords who pay their mortgages by not repairing their property but letting it deteriorate. In all these cases debt deflation caused by extracting interest affects not only spending—and hence current prices—but also the economy's long-term ability to produce. It eats into natural resources and the environment as well as society's manmade capital stock.

Demographically, the effect of debt deflation is emigration and other negative effects. For example, after Latvian property prices soared as Swedish bank branches fueled the real estate bubble, living standards plunged. Families had to take on a lifetime of debt in order to gain the housing that was bequeathed to the country debt-free when the Soviet Union broke up in 1991. When Latvia's government imposed neoliberal austerity policies in 2009–10, wage levels plunged by 30 percent in the public sector, and private-sector wages followed the decline. Emigration and capital flight accelerated. In debt-strapped Iceland, the census reported in 2011 that 8 percent of the population had emigrated (mainly to Norway).

The Effect of Credit-Financed Asset Prices on the "Real" Economy

Inasmuch as investors today have come to aim more at "total returns" (net income + capital gains) rather than simply income by itself, a realistic model should integrate capital gains and investment into the current production-consumption model. Producers not only pay wages and buy capital goods as in "current economy" models; they also use their cash flow (and even borrow) to buy other companies, as well as their own stock. When they make acquisitions on credit, the resulting debt leveraging finds its counterpart in interest payments that absorb a rising share of corporate cash flow.

This has an effect on the government's fiscal position, because interest is a tax-deductible expense. By displacing taxable profits, creditors receive the business revenue hitherto paid out as income taxes. The result in the early 1980s, when debt-leveraged buyouts really gained momentum, was that financial investors were able to obtain twice as high a return (at a 50 percent corporate income tax rate) by debt financing than they could get by equity financing. This tax incentive for debt leveraging rather than equity investment is the reverse of what Saint-Simon and his followers urged in the 19th century to become the wave of the future.

Only a portion of FIRE sector cash flow is spent on goods and services. The great bulk is recycled into the purchase of financial securities and other assets, or lent out as yet more interest-bearing debt—on easier and easier credit terms as the repertory of bankable direct investments is exhausted. So the pressing task today is to trace how directing most credit into the asset markets affects asset prices much more than commodity prices. Loan standards deteriorate as debt/equity ratios increase and creditors "race to the bottom" to find borrowers in markets further distanced from the "real" economy. This increasingly unproductive character of credit explains why wealth is being concentrated in the hands of the population's wealthiest 10%. It is the dysfunctional result of economic parasitism.

Keynes recognized a "leakage" in the form of saving (specifically, hoarding). At the time he wrote in the midst of the Great Depression there was little motivation to focus on debt service, or on the distinction between direct capital investment (tangible capital formation) and financial securities speculation or real-estate speculation (which had all but dried up as asset markets were shrinking to reflect the economy's shrinking). Saving took the form of non-spending, not of paying down debt. There was little lending under depression conditions.

Today's post-bubble attempts to incorporate balance-sheet analysis into NIPA statistics on current activity are too crude. Stock averages do not give an adequate quantitative measure distinguishing the flow of funds into land and capital improvements or industrial capital formation in contrast to speculation in financial securities. So monetary analysis needs to be reformulated along with a better structural breakdown of NIPA to distinguish between money and credit spent on goods and services from that spent on financial assets and debt service.