From the bubble economy to debt deflation and privatization
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The Federal Reserve’s QE3 has flooded the stock and bond markets with low-interest liquidity. This makes it profitable for speculators to borrow cheap and make arbitrage gains buying stocks and bonds yielding higher dividends or interest. In principle, one could borrow at 0.15 percent (one sixth of one percent) and buy up stocks, bonds and real estate throughout the world, collecting the yield differential as arbitrage. Nearly all the $800 billion of QE2 went abroad, mainly to the BRICS for high-yielding bonds (headed by Brazil’s 11% and Australia’s 5+%), with the currency inflow for this carry trade providing a foreign-exchange bonus as well.

This financial engineering is not your typical bubble. The key to the post-2000 bubble was real estate. It is true that the past year and a half has seen some recovery in property prices for residential and commercial property. But something remarkable has occurred. So in this new debt-strapped low-interest environment, hedge funds and buyout funds are doing something that has not been seen in nearly a century: They are buying up property for all cash, starting with the inventory of foreclosed properties that banks are selling off at distress prices.

Ever since World War II, the operating principle of real estate investors is never to use their own money – or at least, to use as little of their own as possible. Debt leveraging leaves the rental income paid to the banks as interest. The absentee owner is after the capital gain at the end of the bubble’s rainbow. That is what a bubble economy is all about. But the only way that investors can obtain current returns above today’s miniscule rates is to buy assets directly for cash.

In a bubble economy, falling interest rates (e.g., from 1980 to today) almost guarantee capital gains. But today’s near-zero interest rates cannot fall any further. They can only rise, threatening capital losses. That is what is panicking today’s bond and stock markets as the Fed talks about ending QE3’s near-zero interest rate regime. So there is little incentive for bond buying. Once interest rates rise, we are in an “anti-bubble” economy. Instead of capital gains driving “wealth creation” Alan Greenspan style, we have asset-price deflation.

In the Bubble Economy, families became convinced that the way to build up their wealth was to borrow as much as they could to buy the most expensive home they could, and ride the wave of asset-price inflation. But since 2008, consumers have paid down about $5 trillion of personal debt. This has meant using their wages and other income to pay down mortgages, student debt, auto debt, credit-card debt and other bank loans. This leaves only about a quarter of the typical family’s paychecks to spend on goods and services after paying the Finance, Insurance and Real Estate (FIRE) sector and the taxes shifted onto wage earners and consumers. The outlook looks dim for corporate sales and hence earnings. So instead of debt-leveraged inflation of asset prices, we have debt deflation of the overall economy.

To put this in perspective, from 1945 until interest rates rose to their peak in 1980, there was an almost steady 35-year downturn in bond prices. The Bubble Economy was fueled by interest rates being rolled back down to their 1945 levels and even lower. Credit flowed into
the financial markets to buy stocks, peaking in the dot.com bubble in 2000, and then to inflate
the 2001-2008 real estate bubble.

So we are now in is the Bubble Economy’s legacy. We can think of this as Phase 2: 
repayment time, along with foreclosure time. That is what happens in debt deflation. The
Obama Administration has broken its 2008 campaign promises to Congress and to voters to
write down mortgage debt to the ability to pay or to market prices reflecting realistic rental
values. The debt legacy has been kept in place, not written down.

Carrying this debt overhead has caused a fiscal crisis. The financial and real estate bubble
helped keep state and local finances solvent by providing capital gains taxes. These are now
gone – and properties in default or foreclosure are not paying taxes. And whereas public
pension funds assumed an 8+% rate of return, they now are making less than 1%. This has
left pensions underfunded, and prompted some municipalities to engage in desperate
gambles on derivatives. But the Wall Street casino always wins, and most cities have lost
heavily to the investment banking sharpies advising them.

In place of a new bubble, financial elites are demanding privatization sell-offs from debt-
strapped governments. Pressure is being brought to bear on Detroit to sell off its most
valuable paintings and statues from its art museums. The idea is to sell their artworks for
tycoons to buy as trophies, with the money being used to pay bondholders.

The same dynamic is occurring in Europe. The European Union and European Central Bank
are demanding that Greece sell off its prime tourist land, ports, transport systems and other
assets in the public domain – perhaps even the Parthenon. So we are seeing a neo-rentier
grab for basic infrastructure as part of the overall asset stripping.

This is a different kind of inflation than one finds from strictly financial bubbles. It is creating a
new neo-feudal rentier class eager to buy roads to turn into toll roads, to buy parking-meter
rights (as in Chicago’s notorious deal), to buy prisons, schools and other basic infrastructure.
The aim is to build financial charges and tollbooth rents into the prices charged for access to
these essential, hitherto public services. Prices are rising not because costs and wages are
rising, but because of monopoly rents and other rent-extraction activities.

This post-bubble environment of debt-strapped austerity is empowering the financial sector to
become an oligarchy much like landlords in the 19th century. It is making its gains not by
lending money – as the economy is now “loaned up” – but by direct ownership and charging
economic rent. So we are in the “economic collapse” stage of the financialized bubble
economy. Coping with this legacy and financial power grab will be the great political fight for
the remainder of the 21st century.

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