phirang 04-07-08 03:02 PM

Re: Interview: Dr. Michael Hudson - Part I: Neo-Feudalism in Crisis

hence i will not short 10yr until the next major leg down, if ever.

the fear in a bear market will overwhelm the greed. inflation is academic so long as you live to fight another day.

jk 04-07-08 02:55 PM

Re: Interview: Dr. Michael Hudson - Part I: Neo-Feudalism in Crisis

reading this, i had a thought about the long bond. we think people are buying treasuries for safety, to get away from private debt. but that leaves open the question of duration. why would someone want to buy a long duration treasury at current rates? there are prisoners of duration - pension funds which feel forced to match duration for their assets and liabilities. if they want to flee private debt, what would they buy? tbonds.

WDCRob 04-07-08 12:45 PM

Re: Interview: Dr. Michael Hudson - Part I: Neo-Feudalism in Crisis

Quote:

> H: That's what I said Europe could do with its claims on the US Treasury. It could say, "Okay we're taking over a part of the US direct investment in Europe." They don't have to come over here. Europe doesn't have to put its customs collectors at US ports and it doesn't have to come to America and say, "Okay, we're now taking over General Motors." It can say "Look, we don't want the assets that you have in your country but since you've used these paper dollars to buy assets in Europe and now you're not giving us any quid pro quo, we're reversing it. We're giving you back the dollars and we're taking these companies here in Europe."
>
> J: This is something of an "a-hah" moment for me because I've always wondered what China was going to do. Their behavior doesn't strike me as being anything like the Japanese who are going to roll over and just kind of take it. The Chinese are highly capable diplomats, and are not going to do anything rash.

> H: Quite right.
>
> J: Basically you'd think they'd like to encourage US investment in China so they have US assets to confiscate later in the manner that you are suggesting the Europeans may do in the future.
>
> H: They don't need that as long as Third World raw materials exporters are willing to play the US game and need dollars to pay their debt to the US. China can say, "We don't have to risk a political confrontation with the United States by taking over investments there. There are still countries that do want dollars, such as Africa, and in fact these countries are willing to accept our dollars by giving us their mineral resources and their oil. So thank heavens we can avoid political confrontation with the US and just use the dollars to buy assets we want from third parties. We end up owning Africa and Latin America instead of the US, and we get rid of our dollars. There's no confrontation with America. We can all be friends."

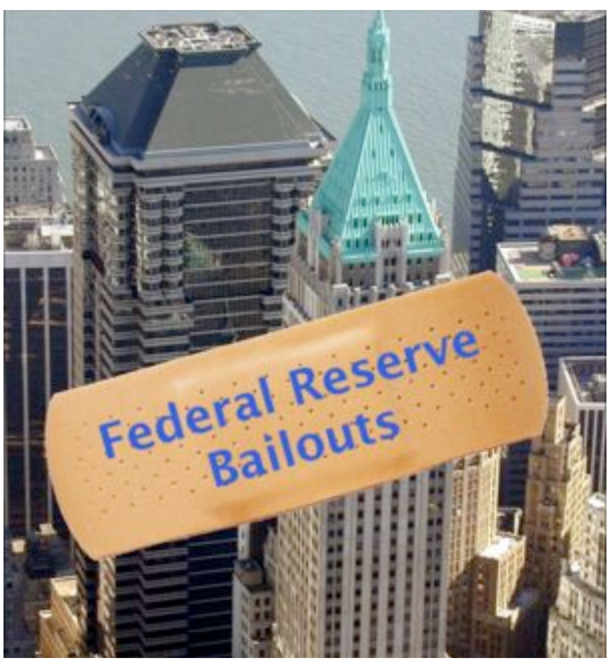
This is fascinating.

What would be the consequences for raw materials exporters if this is how it played out? Seems like they'd left with nothing of value, and the cost of necessities would skyrocket. Wouldn't they be forced to repudiate their dollar debt at some point?

Also, what would the US response to a forced sale of US investment in Europe? Would the US allow it?

FRED 04-07-08 11:54 AM

Interview: Dr. Michael Hudson - Part I: FIRE Economy in Crisis



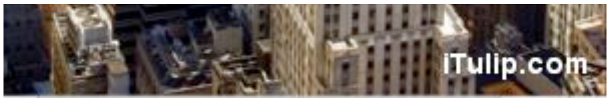
Interview: Dr. Michael Hudson - Part I: FIRE Economy in Crisis

April 7, 2008

Eric Janszen interviews Dr. Michael Hudson on:

- **Interest rates have decoupled from the real economy**
- **Marginal repairs cannot cure structural failures**
- **"Poom" inflation spiral has arrived**

Janszen: Welcome back. A lot has happened since our last conversation. It's no surprise to our readers that the housing bubble is continuing to collapse and create huge liquidity and solvency problems for mortgage debt issuers and holders, debt that depended on collateral values



remaining at asset bubble prices.

I sent you a few questions to guide our conversation that will focus on the bond crisis, which we have labeled the American Bond Crisis. We might wind up going someplace else in the discussion but I wanted to give us a place to start.

So the first question is about the chart. What's your interpretation of this chart?

Hudson (H): The chart is amazing.

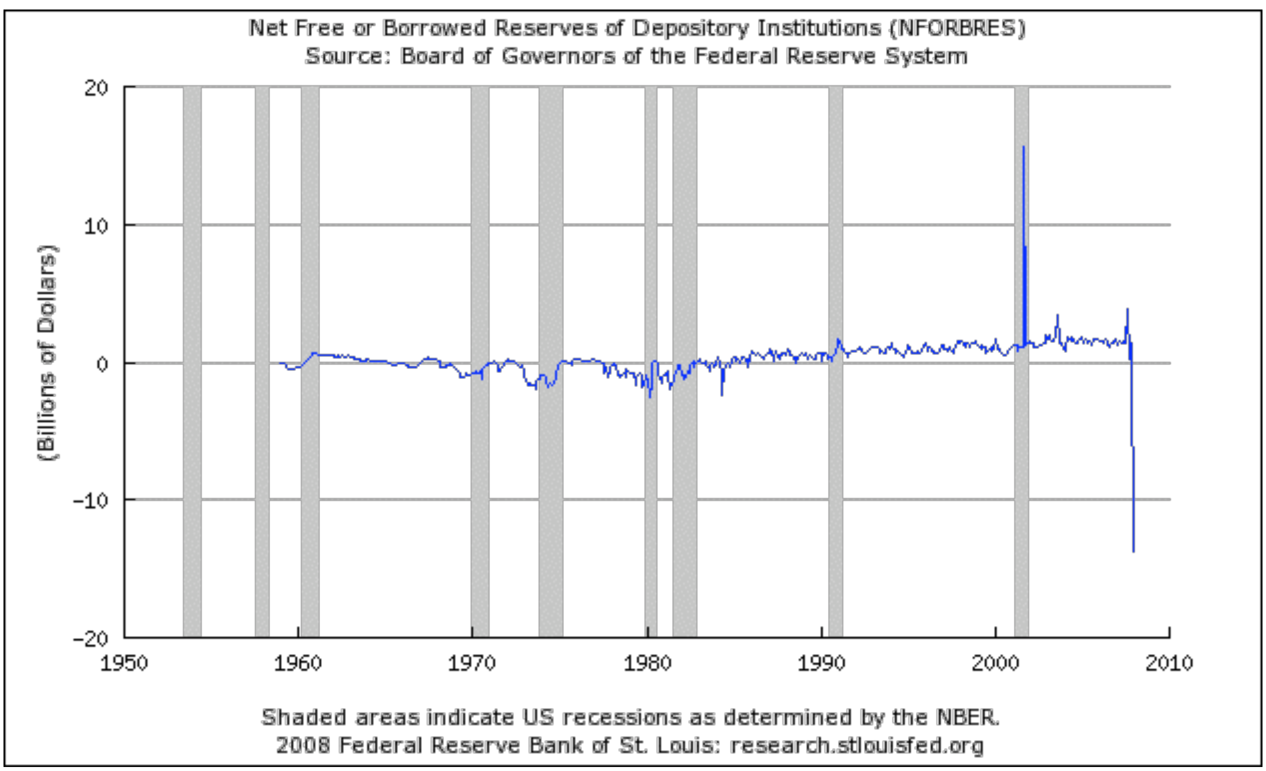
J: It appears to show a quite dramatic event.

H: You may think it's to compensate for losses but that's not my interpretation.

J: What's your interpretation?

H: I think what it reflects is the Banks don't trust each other and they're closing their lines of credit. Nobody's willing to take risks. The Banks had all these open lines of credit, to CDOs and to finance each other's off-balance sheet liabilities. Now all of the sudden nobody knows what's in these things. So what they're doing is saying "We don't know if there's a loss or not, but we're not going to take a chance. We can't believe the rating agencies and we certainly can't believe the banks and we can't believe the Wall Street firms that have packaged these things. So we're just going to protect ourselves and not renew the lines of credit." This has forced these banks, all of the sudden, to go and borrow from the Fed.

J: Right.



H: So I assume probably not all of the credit lines that have closed reflect actual losses, although for all we know they do. I think they just reflect people's unwillingness to take a risk. There is no bond rating system that anyone trusts. The bond rating companies are behaving much like Arthur Anderson and other accounting firms did after the Enron fiasco. There's an inherent conflict of interest between their objective reports and their marketing department that states, "Hey, give us your business and we'll give you a good rating."

J: So this is the American version of what's been going on in Europe for a while, when inter-bank lending essentially disappeared over the period of about a month.

H: That's right. And somebody has to make up for it. Either the banks dump all of these assets on the market or the central banks monetize them. In Europe it was more of a bailout. There's a myth they're promoting that all of this is just to provide liquidity. This is supposed to be the role of central banks. But that's not what's happening. Governments are bailing out the losses. In Europe, this occurred with the Dusseldorf and Saxony banks that went under after naively buying US "AAA"sub-prime mortgage paper.

J: Getting back to the chart for a moment, there are two anomalies in it over a long period of time here. One is just around the time of the end of our last recession in 2001. There's this big spike. So that would be the opposite? That would be the banks taking on each other's line of credit or some other factor?

H: After 9/11 the Federal Reserve flooded the market with liquidity, as there was a general panic, not from financial dynamics but because of the attacks. The key is to look at the date and you'd have to look at the headlines. I notice that around 1984, one spike was the Volcker credit crunch, when interest rates topped 20%. There's another spike that looks like 1984 – I bet that's the Continental Bank failure. In 1991 there's the dot.com bust. There must have been some big operation for the big spike in 2001... (Note: We did that after the interview and correlated the spike to 9/11.)

J: Yes. That's my interpretation of what happened in the more recent instance in January 2008. That makes sense. And what's happening now, your interpretation is that the Banks stopped lending to each other?

H: Yes.

J: Okay. It'll be interesting to see what the response is from the politicians that you shared it with.

H: I've never yet met a politician who understood how money and credit worked.

J: Ron Paul thinks he does.

H: No, he doesn't. On the other hand, I've been talking to Dennis Kucinich now for a number of years and he does.

J: Ron Paul, like a lot of libertarians – and I consider myself one – is enamored of 19th century economists. They're kind of stuck in the 1800s. It was an era when the nature of rainfall wasn't especially well understood so I don't know why anyone expects that the state of the art of economics, money, and credit was better then than today.

H: No one who thinks we can go back to a gold standard and have liquidity flexibility understands how the credit system works. They somehow don't believe that there is a credit system that is not fully 100% bullion-based, and that it's all done with mirrors and somehow it's all going to fall. It is sort of like walking down the street and thinking "I don't understand how gravity works. Maybe I'm just going to soar up in the air any minute" and being afraid to take the next step.

J: Yes. We've struggled with this quite a bit with our readers. Our arguments are complicated by the fact that we offered the opinion in 2001 that gold was cheap and a good buy. There are an awful lot of guys on the Internet who are very taken with the ideas of Friedrich August von Hayek, Ludwig von Mises and others of the Mises school. A number of yeas ago I went through what I'd call an Austrian "phase" but I grew out of it. They don't really understand how modern credit markets work. Martin Mayer describes it as a big accordion – it's never going to blow a big hole and disappear. It's going to constantly change and morph and flex. You know, if you talk Keynes in front of these guys it's like waving a cross in front of vampires. They don't want to hear that we actually figured out how credit works a long time ago. Of course, there is a tendency to take it to excess, and this creates crises.

H: I think money and credit are a psychodrama for them but also the idea of double-entry bookkeeping is so unnatural to many people you almost need to work in the field and have done accounting yourself or worked in a bank to understand how it works. I think Galbraith who said: "The process by which banks create money is so simple that the mind is repelled." They are astonished to find out that banks can create credit as long as they have customers willing to sign IOUs.

J: Yes. And the other thing we have trouble getting readers to understand, and this is one of Keynes' great insights that I think very few people have absorbed – is money is not this 'thing' that is created and destroyed. Actually once it is created money never disappears again. It just changes its form and moves around the economy. It moves, flows around the system.

H: The problem is that when banks create credit, it bears an interest charge. The interest charge absorbs more and more money from the economy at large and deflates it. At a point, this prevents debtors from repaying, and there is a break in the chain of payments. And that's what cancels out money, in the way that Irving Fischer described.

J: Are you familiar with Professor John Atley over at Harvard?

H: No.

J: He's been there for a long while, but has never been particularly well known. I stumbled across his analysis a while back. He was writing about this topic since the 1950s and he's probably no spring chicken and he's got some interesting notions about how money flows through the economy. He has some criticisms of the way the Fed's Flow of Funds report describes how money actually flows in the economy. He believes the Fed confuses credit with money in the execution of monetary policy. He's pretty critical of the banking policy moves they made in the mid '90s, when sweep accounts and other policy moves were engineered to unfreeze the banking system.

H: You mentioned sweep accounts in your Harper's article, but you didn't explain them.

Reserve Requirements

Type of liability	Requirement	
	Percentage of liabilities	Effective date

J: The quick story is that the banking system seized up right after

Net transaction accounts [1]		
$0 to $9.3 million[2]	0	12-20-07
More than $9.3 million to $43.9 million[3]	3	12-20-07
More than $43.9 million	10	12-20-07

about a thousand banks went out of business over a period of three or four years in the early 90s. What the Fed did to restart the system was to change the rules to allow banks to create several types of accounts with different levels of reserve requirements, from 10% for large accounts of more than $43.9 million and all the way down to zero for smaller accounts of $9.3 million or less. The reason they call these sweep accounts is that the new rules made in 1995 allowed banks to every six months move money from one classification of account to another, from accounts with a high reserve requirement to accounts with lower or no reserve requirement, and to split up big accounts with a high reserve requirement into smaller accounts with a lower reserve requirement.

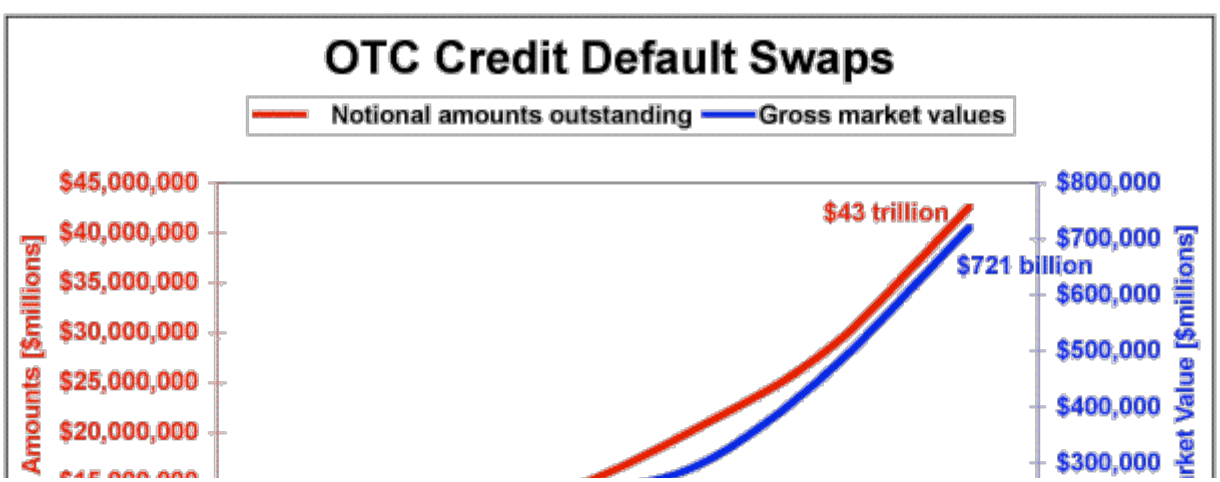
And if you follow all the trails of all the money that's moved around from one account type to another over the years and add up all the reserves in aggregate across the entire banking system you come up with an astoundingly low 1.6%.

H: Yes.

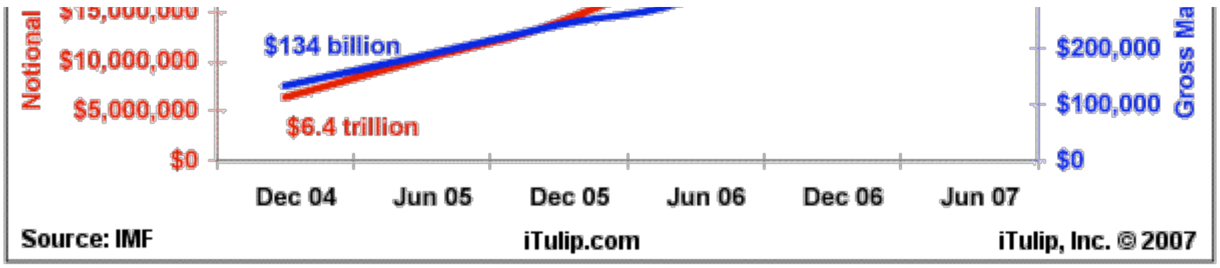
J: Which to his thinking, being an old timer, is that managing the money supply in the commercial banking system with a 1.6% Federal Reserve system capital reserve is like trying to put peas in a bottle with a twenty-foot spoon. You know, you can't really do it.

H: That's what's called an accident waiting to happen.

J: So the Fed cannot control bank credit via reserves, but rather depends now on targeting interest rates. The trouble with using interest rates to manage the credit system is that the credit markets have gotten very complex. Banks have used credit derivatives and default swaps, primarily to expand their balance sheets instead of using them to reduce the risk of existing loans on their balance sheets. At least this is what the St. Louis Fed said recently. So what appears to be happening now is that when the Fed attempts to meet an interest rate target, the derivatives market works against the effort. It appears that the Fed cannot effect interest rate changes through open market operations to the extent that it once could. Do you agree?



H: I



agree with that. And that leads to the next point. Bernanke has lowered the rate by 75 basis points to support the financial markets and real estate prices. The first effect, as you can see, was to force the dollar's exchange rate way down. If you lower the exchange rate, that's going to weaken the dollar against the European and Asian currencies. The weaker the dollar, the more import prices and consumer prices will rise. Central banks are supposed to be maneuvering interest rates in order to hold down commodity prices and consumer prices. But they are now changing their minds, and using interest rates to inflate asset prices. By doing this, they're inflating the overall consumer price level.

J: It's becoming so obvious that it's even showing up in the CPI numbers, which are formulated to minimize the impact of rising import prices.

H: Indeed. There are a number of websites of people that actually do make their calculations of what the CPI would be without the Hedonic and other methods.

J: There's John Williams of Shadowstats and one of our members, our ShadowFed Chairman who goes by the name Finster, has his own synthetic M3 and CPI and his own way of calculating the numbers that are quite credible as they better conform to what anyone can see around them in terms of prices, the result of inflation. I believe he uses the 1983 CPI rule, that is, how the BLS used to calculate the CPI before the Reagan administration.

H: Well, Dennis Kucinich plans to submit the Monetary Transparency Act that is going to call for calculating the CPI in this old way without the hedonic prices to actually get an estimate of what people actually have to pay.

J: That would be a good start.

H. Yes.

J: You're the expert on this: how do other countries measure inflation? We just happened to be poking around, for example, on a website for Spain's Central Bank to see how it measures inflation. It seems quaint because it appears that their objective for measuring inflation is old-fashioned, that the government measures inflation as a tool for measuring future inflation expectations and predicting future behavior. Because if you have high inflation and don't do anything about it, and inflation expectations start getting built into the economy, then well, you want to know that. The only way you're going to know that is if you're honest about what inflation rates really are. Otherwise you're not measuring inflation accurately. People's behavior is going to anticipate more inflation than is reported, and you're not going to know why.

H: Here, the inflation measure is about how little the government can pay money to Social Security recipients and holders of inflation protected bonds like TIPS. You have the statistics used in a very anti-consumer fashion.

J: Here's the conundrum. The question I always have with this issue of the CPI not reflecting *the true level of inflation: the bond markets seem to believe the numbers. Why? I mean interest rates are falling. Yields on both short-term and long-term bonds are declining as if the inflation numbers reflect true inflation risk, that is, potential future loss of purchasing power.*

H: It's the supply and demand of funds to buy bonds that is determining yields now. Inflation risk does not figure into it. There are always people sitting near the ticker, traders who see a high inflation number and ask, "What does this mean?" and they go by the old textbook assumptions. But that's usually a blip. And then the blips are overwhelmed by the supply and flow of funds.

J: The recent rise in demand for Treasury bonds, and the rise in price and fall in yields started with this credit crunch back in the summer of 2007. Do you think that's primarily what's driving yields, not inflation expectations?

H: That seems to be. Absolutely. It's the reverse of a credit crunch. The Fed is trying to keep the bubble inflating, or at least not bursting. It's like trying to keep a Ponzi scheme going.

J: So could we have a situation where we're banging against the zero-boundary on the short end the way the Japanese did a few years into their debt deflation...

H: That's exactly the situation.

J: ...yet we have high inflation rates?

H: That's also the situation. That's exactly it. So America will try to inflate its way out of debt, mainly by inflating its asset markets. There will be a spillover into consumer prices. This is not so much because high asset prices are letting people borrow against their home equity any longer, but because the dollar is going down against other currencies, raising import prices.

J: If you go to ask what I will call, for lack of a better term, "establishment economists" if they are not worried about the inflationary impact of a weak dollar, their answer is that of all the things they can do that can stimulate the economy, the impact of a weak currency is the least inflationary, because imports account for only something like 12% of the US economy.

H: That's true with respect to the percentage of the economy affected by imports, but not with respect to the impact. Consider the price of oil. Domestic oil is not imported, but its price is set by the price of oil imports. The economists you cite must know that their argument is dishonest. They're simply trying to distract your attention from what's really happening. Import prices determine domestic prices. It doesn't matter that they are a small portion of the economy. This also is true for every economy throughout history, by the way, and is the basis of most economic theory. Whoever claims otherwise has no shame.

J: Do you expect some day the BLS will give up on the idea of core inflation? It's Statistics 101 to smooth data using a rolling average not by eliminating the more volatile or fast rising components of a data set, right?

H: I think we're going to make a kind of glossary of euphemisms and core inflation means the inflation that we 'want' to talk about as opposed to what we 'don't want' to talk about.

J: A lot of people seem to have figured that out. But again, because of the demand that's been created for bonds, the credit crisis inflation has not hit the bond market yet. But at some point it will. Do you agree? That at some point the long end of the yield curve is going *to have to rise?*

H: You'd think so, but a lot of us have thought that for quite awhile. When you see this chart that we used to start this conversation, obviously the purpose is to inflate the prices for securities, real estate, absolutely everything. It's essentially giving people a free lunch at the Fed's expense by giving them easy credit that they can arbitrage.

J: Most of the lending that we see being done through the Fed's discount window consists of very short term loans. Thus, there's some validity to the use of the term "liquidity," in the sense that these are essentially providing a cash market for otherwise illiquid assets.

H: It provides liquidity but the purpose is to compensate for what are going to be actual losses. What happens if a company's borrowed and then it goes bankrupt? What if a bank borrows and goes bankrupt? What if Citibank is not able to get more loans from foreign sovereign governments? What if its borrowed a lot and then all of the sudden says, "Whoops, we've gone under"?

J: Well. Yes. There certainly is a theory that Citibank is too big to fail and the Fed can't let them. You're leading us nicely into our next question that has to do with the "dollar hot potato" which we talked about last time.

US trade partners have been funding the current US account deficit and they're kind of caught in a trap, as you described, of needing to buy more US financial assets to protect the purchasing power of the assets they already hold. But also they have their own motives for doing this which are political, or mostly political, but also economic. One of the recent developments is that some of our strongest political allies who have been supporting the dollar and our economy are making noises that are slightly ominous--particularly on the trip by Bush to Saudi Arabia in January 2008 when they flatly turned him down on his request for them to produce more oil to bring down prices and help our inflation problem. In other words, we'd like OPEC to pump more oil so we don't have to print so much money to pay for their oil. Also, some fairly high level people at the European Central Bank (ECB) are coming out and saying "uncle" on our using dollar depreciation to inflate our way out of our debt.

H: The question is, What are they going to do about it? They're not going to be serious unless they actually do what America did in 1921 when the German currency was succumbing to hyperinflation. Europe would have a floating tariff against dollar area imports so that the tariff would equal the degree of currency depreciation of the dollar against the euro or sterling. And it would use these tariff proceeds to give an export subsidy to promote exports to dollar area countries. That's one thing they could do.

Another thing that has been discussed is that Europe will say "Okay we have about a trillion dollars worth of claims on the United States. The US owes $3.5 trillion to foreign central banks. Not only can it not pay but it has no desire to pay because the United States is not letting central banks invest here by buying up key US industries. So we're going to use this money to buy out American firms in Europe at their book value. Instead of having claims on the US Treasury, we will now be minority or majority stock holders in US direct investment in Europe."

That's what they'd have to do to be serious. If they're not willing to do either one of these two things it's just saying "Oh we're being tortured by the dollar standard. Isn't that too bad. We're in pain."

J: If the whining evolved into actual meaningful action, real action, those are the most likely actions we should expect. What's the leading edge? Legislation coming up through the political *process?*

H: It wouldn't even require legislation necessarily.

J: They'd just start doing it.

H: If the tariff route is taken that will require legislation. But they're not doing it. There's no sign at all that Europe is taking any concrete act to defend itself nor is there any sign that Saudi Arabia or the OPEC countries are. They say they aren't going to lower oil prices but you saw the terms on which they bought their stake in Citibank last autumn -- for non-voting stock! It's just a giveaway, and they've already lost an enormous amount on this.

J: Yes. And everybody knows that the first guys in on the first of a series of bailouts get heavily diluted by subsequent bailouts. They're going to get that diluted to nothing by the time the third or fourth set of investors comes in to refinance Citigroup.

H: That's right. So what they're doing is throwing their money away in any event. So how would America react? America would never put foreign economies before its own interests. But other countries are willing to put America's interests before their own. And that goes against every assumption of political theory and trade theory, by the way. Countries and individuals are supposed to act and vote in their own economic interests. But that is not happening.

J: So what do you think the reason is? What is the US providing for their money?

H: Central bankers are brainwashed to a degree that they don't think about how to change the legal or institutional environment in which credit and economic activity occurs. They just assume that somehow all changes are marginal. It is part Europe's marginalist mindset. The American diplomats are always thinking, "What do we have to change in the structure of the world system so that it benefits our economy?" Europeans think, "What are we going to do that is marginal so it avoids shaking things up?" There's an asymmetry of psychological attitudes and mental processes at work.

J: I'll remind readers that you know this from more than 30 years of consulting to these governments. So we're more innovative than they are, it's true?

H: Yes. It's like a hundred to one when it comes to political and strategic innovation. We're innovative. They're not. I can't think of any innovation in the financial sphere that the Europeans have done. And if you look at the Basel II rules, they tend to create unanticipated crises like Northern Rock.

J: The Chinese also are not innovators in banking and finance. The last time we chatted about them it was your impression that they were going to keep improving their banking system, but that there are still a lot of risks in the stock market and we might be in for some surprises later on.

H: As long as it continues to go up they think its all working. They do have a lot of people like Henry Liu who understand the system very well but obviously there is not policy agreement within the Chinese leadership. There are the Thatcherites who say, "It's working now, lets keep it this way until there's a collapse." But I think in China, Japan and most Asian countries they always have two scenarios in mind. They say, "Here's our set of actions if the current situation continues. But we also have an alternative plan, a Plan B in case we shift around." I expect the Chinese have a pretty sophisticated Plan B for how they may change things. This certainly is how America usually operates, after all.

J: Any guesses what Plan B might look like?

H: Well they'll create their own credit, and extend the Shanghai Cooperation Organization into an economic trading and currency block.

J: So they'll accelerate a process already in motion to create an Asian-zone currency.

H: Yes, so that they won't have to be dependent on the US or Europe. They want to be able to create free credit like the US does. They understand that America is creating free credit. They want to do just what America does. If that happens you'll find Asia acting symmetrically with the United States, while poor Europe and Third World countries are just left out, being squeezed. This is their "choice," given their current policies.

J: And so, paradoxically, a US-centric crisis might be a forcing function for some kind of significant change in the political and economic arrangements among Asian nations. It already has been to a certain degree. Have U.S. diplomats been anticipating it? (Note: Hudson's collected books have been translated into Chinese by the State Publishing Company.)

H: I think so. US strategists have been talking now for about thirty years regarding how to counter if and when foreign countries push back against our free ride. The answer is there is no way we can forecast when they will do so, until it actually happens. So we're just going to keep on doing what we're doing until there is counter-pressure. So far, there isn't any counter pressure. The Americans have all sorts of contingency plans, but other countries have shown no apparent plans of their own. They merely respond, not initiate.

J: So what do you think US contingency plans are?

H: Essentially it will be the old paper-gold proposed via the IMF. It will tell foreign central banks, "Okay you have $3.5 trillion of dollar claims on the US Treasury. All we can do is pay you with new notes. But we have a way to solve your problem. (Note that we frame the issue as their problem, not ours.) You'll turn over these US Treasury bonds to the IMF, and they will give you paper-gold certificates worth $3.5 trillion. These no longer will be liabilities of the US Treasury but they'll be your assets with the IMF. So we can continue with a 'clean slate.' We won't owe anything, but you'll still have your $3.5 trillion in assets." That's the plan that the US is going to propose as a rescue for itself. A debt repudiation masked as IMF credit creation. Tey will call this "progress," "innovation," "reform" – all the usual euphemisms that are trotted out for such bailouts.

J: But what value will those assets then have?

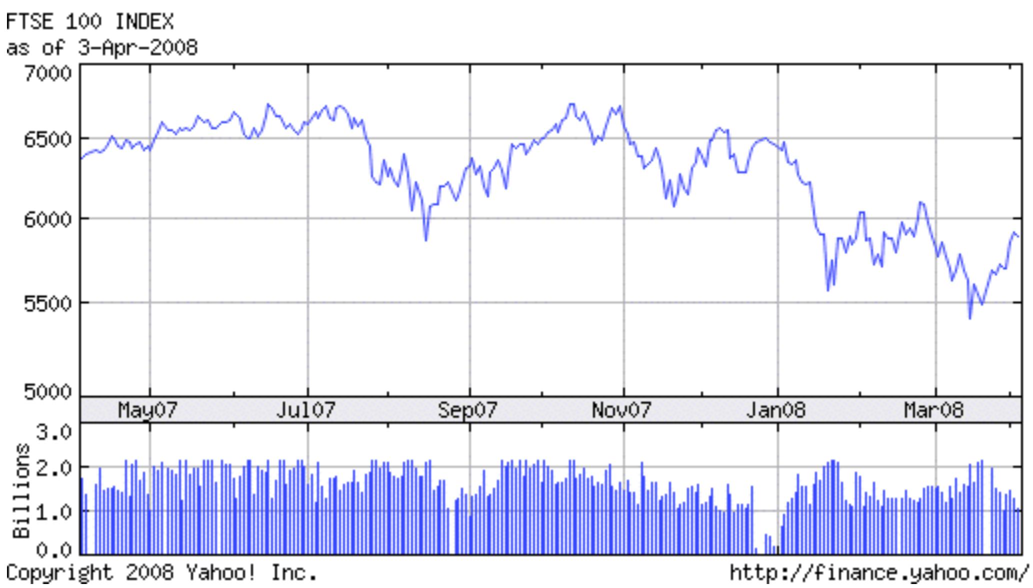
H: It's what anybody believes they have. In other words, if you believe it, it has value. The key is not "value," but price. If I give you an IOU for a $100 and you think some day you'll get something worth $100, then you're happy. You'll think, "I have a $100 in savings. I have Michael Hudson's IOU." But if you think Michael Hudson isn't going to pay you, and is just going to laugh, then you're not going to put up with it. It's all in the mind. For governments, these magnitudes are units of $100 million each.

J: It's all in the mind but these are governments and it also depends on what kind of political backlash there is at home. Right now we're creating inflation all over the world. Russian inflation is like 12%. According to The Peninsula, Inflation rates in Bahrain, Kuwait, Oman and Saudi Arabia December 2007 were 8.4%, 6.6%, 5.3% and 6.5% respectively, and a staggering 12.8 percent and 11.3 percent in Qatar and the UAE. The Saudi British bank estimates a 35% share of imported inflation in overall inflation, meaning dollar inflation. This *article explains the phenomena.*

> "...the most controversial cause of the inflation is domestic currencies pegged to the sliding dollar, thereby sapping the purchasing value of local currencies. Also the movements between the US dollar and the euro/yen have been devaluing local currencies that are pegged to the dollar and, therefore, also contributing to the acceleration of inflation by increasing the cost of goods imported from Europe and Japan." - Inflation in the Gulf states: Are subsidies the antidote? (By Dr. Samir Ranjan Pradhan)

So by devaluing the dollar we're exporting inflation to countries that peg their currencies to the dollar, either in effect of in fact, such as oil producers and China. It's becoming a real domestic political problem for them.

H: Meanwhile, the US debt crisis is deflating capital markets all over the world. When the US stock market goes down people aren't moving into other stocks. Largely because of the debt leveraging at work, there's a drain of liquidity in Europe and Asia. All the stock markets in the world have been going down as a result of this liquidity drain.




GERMANY DAX INDEX
as of 3-Apr-2008
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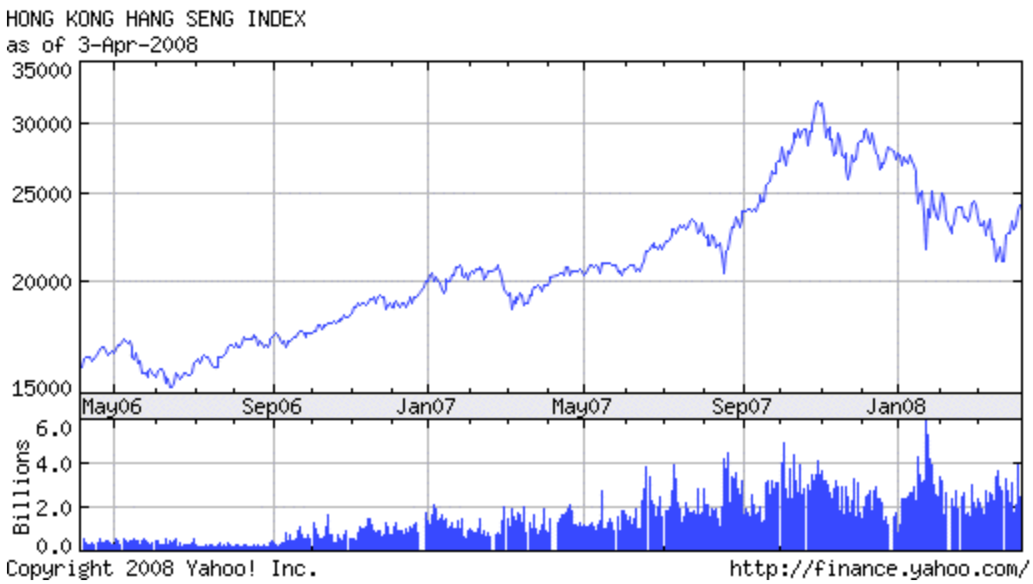
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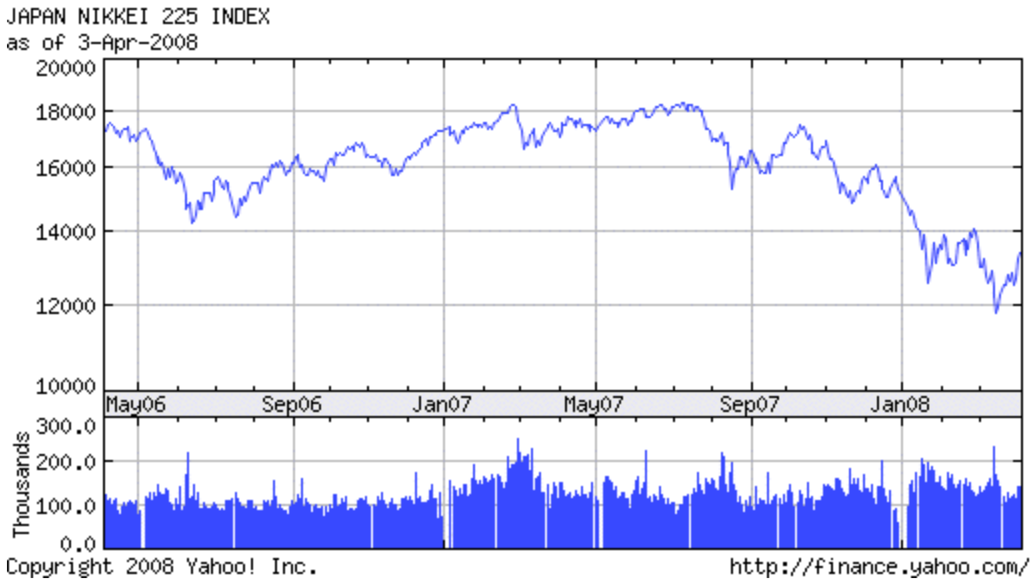

J: They're anticipating that the primary policy tool that all governments will use to manage debt deflation – unilaterally by the US in any case in the short term but probably all governments eventually in the long term – is currency depreciation?

H: Right. That's why the Chinese government and others are treating the dollar like a hot potato. They want to buy real assets – minerals, oil wells, agricultural land and technologically important industries. The Chinese want to get assets that can supply their economy with the raw materials, food and primary materials it needs -- and maybe some manufacturing, and certainly technology. They want to get rid of claims of a financial character, as these are now depreciating in price.

J: Well if the Chinese were operating the way governments used to say in the 19th century, if another country owed you money and they weren't paying you back then it was generally a rule of international law that it was okay to treat those debts as claims against real assets. You could just go get them.

H: That's what I said Europe could do with its claims on the US Treasury. It could say, "Okay we're taking over a part of the US direct investment in Europe." They don't have to come over here. Europe doesn't have to put its customs collectors at US ports and it doesn't have to come to America and say, "Okay, we're now taking over General Motors." It can say "Look, we don't want the assets that you have in your country but since you've used these paper dollars to buy assets in Europe and now you're not giving us any quid pro quo, we're reversing it. We're giving you back the dollars and we're taking these companies here in Europe."

J: This is something of an "a-hah" moment for me because I've always wondered what China was going to do. Their behavior doesn't strike me as being anything like the Japanese who are going to roll over and just kind of take it. The Chinese are highly capable diplomats, and are not going to do anything rash.

H: Quite right.

J: Basically you'd think they'd like to encourage US investment in China so they have US assets to confiscate later in the manner that you are suggesting the Europeans may do in the future.

H: They don't need that as long as Third World raw materials exporters are willing to play the US game and need dollars to pay their debt to the US. China can say, "We don't have to risk a political confrontation with the United States by taking over investments there. There are still countries that do want dollars, such as Africa, and in fact these countries are willing to accept our dollars by giving us their mineral resources and their oil. So thank heavens we can avoid political confrontation with the US and just use the dollars to buy assets we want from third parties. We end up owning Africa and Latin America instead of the US, and we get rid of our dollars. There's no confrontation with America. We can all be friends."

J: Makes sense. Africa, South America, Central America. Pretty much everywhere. Canada?

H: Yes. Canada always has welcomed companies coming in to get rich by making holes in the ground. But Asians don't like to be confrontational, so these countries are the path of least resistance.

J: It's not their culture, that's right. You probably know my wife is Chinese, from Taiwan, and she's taught me a lot about the culture. You know how Americans like to take a small thing and blow it up into something big? The Chinese do the opposite. They take something big and try to minimize it. Make it small and go away.

H: Well my wife is Korean and she's a psychotherapist and I get the same description of their behavior. She tries to cure them and make them more assertive, especially vis-à-vis their own families of origin.

J: That's the mindset. The average Chinese is not political. They don't like politics. It doesn't interest them. They want to increase living standards. That's their priority.

H: It's a Confucian quality to rely much more on authority. The American personality is much freer of this psychological constraint. When negotiating with the Japanese, for instance, American diplomats know that if they raise their voice at a meeting, their Japanese counterparts will fold.

J: Any authority is acceptable as long as things are going okay and living standards are rising. Whoever is in charge is whatever as long as things aren't really, really bad and getting worse. And even then they put up with bad conditions for an awfully long time.

H: Yes.

The interview continues for **iTulip Select** subscribers at the link below.

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