Black Monday. Global Investors Vote “No” on Paulson Bailout

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The wrangling continued on the floor of the House of Representatives all weekend, but when the final tally was taken, Treasury Secretary Paulson’s $700 billion Emergency Economic Stabilization Act of 2008 failed to win enough votes to pass. Republicans swam against the current and voted down the legislation at a margin of two to one. Wall Street was stunned and the stock market went into an immediate 770 point freefall. To their credit, conservative die-hards held their ground and defended the “trickle down” supply side, free market ideology to the bitter end; and the end may be closer than they think. The credit markets have frozen-over, the housing market is crashing, and the banking system is on its last legs. If Paulson’s got another trick up his sleeve, he’d better pull it out fast. This thing is about to blow.

In the last few weeks, the number of casualties among the financial giants–Bear Stearns, Indymac, AIG, Lehman, Washington Mutual–has continued to grow. Three more struggling European banks were added to the list of financial institutions that needed emergency government assistance just last weekend. It’s no wonder Speaker Pelosi felt like something had to be done to stop the bleeding. The dollar is slipping, consumer spending is down, and foreign creditors are beginning to slow their purchases of US debt. It’s all bad. Even so, no one really knows whether buying up the illiquid mortgage-backed assets from the nation’s banks would have helped to avert a major catastrophe or not. According to professor Nouriel Roubini, chairman of Roubini Global Economics, “You’re not resolving the two fundamental issues: You still have to recapitalize the banking system, and household debt is going to stay high”. A large number of economists believe Roubini is right. The bill will not solve the underlying problems.

Before the stock market opened on Monday, the futures markets had slumped heavily into negative territory, while the TED spread, an indicator of stress in interbank lending, had widened to 3.19, a level that suggests another rocky week of trading ahead. Could this be another Black Monday?

Paulson’s bill is designed to avoid a system-wide crash by clearing the banks’ balance sheets so they can resume extending credit to consumers and businesses. The hope is that massive infusion of capital will “turn back the clock” to the happy days of low interest speculation and bubble economics. Paulson is a “one trick pony” who firmly adheres to the belief that wealth creation depends on maximum leverage and an ever-weakening currency. But that world view is no longer applicable after reaching Peak Credit, where consumers are no longer able to make the interest payments on their loans and businesses and financial institutions are forced to curb their spending and dump their toxic assets at firesale prices. The system is deleveraging and nothing can stop it. Paulson has yet to accept the new reality.

Besides, there’s no guarantee that the banks will use the money in the way that Paulson imagines. As one Wall Street veteran explained to me, “I don’t see one penny of that $700 billion ending up helping the broader economy. I see it being used to prop up share prices so the insiders can salvage as much as possible when dumping their shares”.

Indeed, the $700 billion is just part of a massive “pump and dump” scheme engineered with the tacit approval of the US Treasury and the Federal Reserve. Once the banksters have offloaded their fraudulent securities and crappy paper on Uncle Sam, they will do whatever they need to do pad the bottom line and drive their stocks up. That means they will shovel capital into hard assets, foreign currencies, gold, interest rate swaps, carry trade swindles, and Swiss bank accounts. The notion that they will recapitalize so they can provide loans to US consumers and businesses in a slumping economy is a pipedream. The US is headed into its worst recession in 60 years. The housing market is crashing, securitzation is kaput, and the broader economy is drifting towards the reef. The banks are not going to waste their time trying to revive a moribund US market where consumers and businesses are already tapped out. No way; it’s on to greener pastures. They’ll move their capital wherever they think they can maximize their profits. In fact, a sizable portion of the $700 billion will likely be invested in commodities, which means that we’ll see another round of hyperbolic speculation in food and energy futures pushing food and fuel prices back into the stratosphere. Ironically, the taxpayers largess will be used against him, making a bad situation even worse.

Then again, if the bill isn’t passed, no one can predict with certainty what will happen. Here’s how Tim Shipman summed it up in “Bailout Failure Will Cause US Crash”, in the UK Telegraph:

“Officials close to Paulson are privately painting a far bleaker portrait of the fragility of the global economy than that advanced by President George W Bush in his televised address last week.

One Republican said that the message from government officials is that ‘the economy is dropping into the john.’ He added: ‘We could see falls of 3,000 or 4,000 points on the Dow [the New York market that currently trades at around 11,000]. That could happen in just a couple of days.

‘What’s being put around behind the scenes is that we’re looking at 1930s stuff. We’re looking at catastrophe, huge, amazing catastrophe. Everybody is extraordinarily scared. It’s going to be really, really nasty.’”

The fear on Capital Hill is palpable, especially among the Democrats who have led the effort to pass Paulson’s boondoggle ASAP. Speaker of the House, Madame Botox, and fellow Democratic Party leaders, Chris Dodd, Harry Reid and the blabbering blowhard from Massachusettes, Barney Frank, have done everything in their power to sandbag dissenters, quash resistance, and rush the bill to a vote without the usual deliberation and debate. Rep. Marcy Kaptur (D-ohio) was one of many angry congressman who lashed out at Pelosi’s highhandedness. It’s all caught on a one minute video on you tube:

Rep. Marcy Kaptur: “The normal legislative process that should accompany a monumental proposal to bail out Wall Street has been shelved. Yes, shelved! Only a few insiders are doing the dealing. These criminals have so much power they can shut down the normal legislative process of the highest lawmaking body in this land. All the committees that should be scanning every word that is being negotiated have been benched. And that means the American people have been benched. We are constitutionally sworn to protect this country against all enemies foreign and domestic, and yes, my friends, there are enemies….The people who are pushing this bill are the very same one's who are responsible for the implosion on Wall Street. They were fraudulent then; and they are fraudulent now.We should say No to this deal". (http://www.youtube.com/watch?v=oAADyc6t4nY)

Republicans were equally furious at the way the Pelosi Politburo kept the rank and file out of loop as much as possible. Rep. Michael Burgess (R-Texas) summarized the feelings of a great many congressmen who felt they were being railroaded by Pelosi and Co: "We have seen no bill. We have been here debating talking points …House Republicans have been cut out of the process and derided by the leaders of the House Democrats as "unpatriotic" for not participating in supporting the bill. Mr. Speaker, I have been thrown out of more meetings in the last 24 hours than I ever thought possible as an elected official of 800,000 citizens of N. Texas….Since we didn't have hearings, since we didn't have markup, let's at least put this legislation up on the Internet for 24 hours and let the American people see what we have done in the dark of night. After all, I have never gotton more mail on a single issue than on this bill that is before us tonight." (http://www.youtube.com/watch?v=l7B4laX1E70)

Predictably, Rep Dennis Kucinich (D-Ohio) gave the best speech of the day railing against the financial industry and defending the interests of working class Americans.

Rep. Dennis Kucinich: "The $700 bailout bill is being driven by fear not fact. This is too much money, in too short of time, going to too few people,while too many questions remain unanswered. Why aren't we having hearings…Why aren't we considering any other alternatives other than giving $700 billion to Wall Street? Why aren't we passing new laws to stop the speculation which triggered this? Why aren't we putting up new regulatory structures to protect the investors? Why aren't we directly helping homeowners with their debt burdens? Why aren't we helping American families faced with bankruptcy? Isn't time for fundamental change to our debt-based monetary system so we can free ourselves from the manipulation of the Federal Reserve and the banks? Is this the US Congress or the Board of Directors of Goldman Sachs? (Watch the whole speech: http://www.youtube.com/watch?v=CAuQzS5LJgc&NR=1)

There is greater opposition to the Paulson bill than any legislation in the last half century. The groundswell of public outrage is unprecedented, and yet, Congress–completely insulated from the demands of their constituents–continues to blunder ahead following the same pro-industry script as their ideological twins in the White House. There's not a dime's worth of difference between the two parties. Not surprisingly, neither Pelosi nor any of the Democratic leadership has even met with any of the more than 200 leading economists who have stated unequivocally that the bailout will not address the central problems that are wreaking havoc on the financial system. Instead, they have caved in to Bush's demagoguery and the spurious claims of G-Sax bagman Henry Paulson, a man who has misled the public on every issue related to the subprime/financial fiasco so far.
There are parts of Paulson's Emergency Economic Stabilization Act of 2008 that every US taxpayer should understand, even though the media is attempting to keep the details

obscured. In sections 128 and 132; the proposed bill will suspend “mark to market” accounting. This means that the banks will no longer be required to assess the worth of their assets according to what similar assets fetched on the open market. For example, Merrill Lynch just sold $31 billion of mortgage-backed securities for $6 billion, which means that similar bonds should be similarly priced. Simple; right? The banks need to adjust the value of those assets on their balance sheet accordingly. This gives investors and depositors the ability to know whether their bank is in bad shape or not. But Paulson’s bill lifts this requirement and allows the banks to assign their own arbitrary value to these assets, which is the same old Enron-style accounting bullsh**.

Paulson bill also proposes the “Elimination of FASB 157 and 0% reserves”. This is just as sketchy as it sounds. FASB or Financial Services Regulatory Relief Act reads:

“Federal Reserve Banks are authorized to pay banks interest on reserves under Section 201 of the Act. In addition, Section 202 permits the FRB to change the ratio of reserves a bank must maintain relative to its transaction accounts, allowing a zero reserve ratio if appropriate. Due to federal budgetary requirements, Section 203 provides that these legislative changes will not take effect until October 1, 2011.”

Blah, blah, blah. It’s all legal mumbo jumbo to conceal the fact that the banks can continue to operate with insufficient capital, which is why the system is currently blowing up. It all get’s down to this: The reason the system is exploding is because the various financial institutions have been allowed–via deregulation–to act as banks and create as much credit as they choose without a sufficient capital base. When one reads about massive deleveraging; this relates directly to the fact that under-capitalized businesses were operating with too much debt in relationship to their capital. That’s it in a nutshell; forget about the CDOs, the MBSs, the CDS and the whole alphabet soup of derivatives garbage. They were all inserted into the system so greedy Wall Street landsharks could expand credit without supervision and balance trillions of dollars of debt on the back of a one dollar bill. This is why Paulson wants to suspend the rules which would bring credibility and trust back to the system. After all, that might impinge on Wall Street’s ability to enrich itself at the public’s expense.

Finally, Nouriel Roubini sites a study by Barry Eichengreen, “And Now the Great Depression”, which points out why Paulson’s $700 billion plan is likely to fail:

“Whenever there is a systemic banking crisis there is a need to recapitalize the banking/financial system to avoid an excessive and destructive credit contraction. But purchasing toxic/illiquid assets of the financial system is NOT the most effective and efficient way to recapitalize the banking system….

A recent IMF study of 42 systemic banking crises across the world provides evidence of how different crises were resolved.
First of all only in 32 of the 42 cases there was government financial intervention of any sort; in 10 cases systemic banking crises were resolved without any government financial intervention. Of the 32 cases where the government recapitalized the banking system only seven included a program of purchase of bad assets/loans (like the one proposed by the US Treasury). In 25 other cases there was no government purchase of such toxic assets. In 6 cases the government purchased preferred shares; in 4 cases the government purchased common shares; in 11 cases the government purchased subordinated debt; in 12 cases the

government injected cash in the banks; in 2 cases credit was extended to the banks; and in 3 cases the government assumed bank liabilities. Even in cases where bad assets were purchased – as in Chile – dividends were suspended and all profits and recoveries had to be used to repurchase the bad assets. Of course in most cases multiple forms of government recapitalization of banks were used." (Nouriel Roubini's Globl EonoMonitor http://www.rgemonitor.com/blog/roubini)

In short, it won't work. Nor is it designed to work. The bill is just Paulson's way of carving a silver canoe for himself and his brandy-drooling investor buddies so they can paddle away to some offshore haven while the rest of us drown in a bottomless ocean of red ink.