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Can Congress Bail Out of the Bailout?

And what about the Fed's Even Larger Giveaway?

By Prof Michael Hudson
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We are now entering the financial End Time.

Bailout "Plan A" (buy the junk mortgages) has failed, "Plan B" (buy ersatz stocks in the banks to recapitalize them without wiping out current mismanagers) is fizzling, and the debts still can't be paid.

That is the reality Wall Street avoids confronting.

"First they ignore you, then they denounce you, and then they say that they knew what you were saying all the time," said Gandhi.

The same might be said of today's overhang of debts in excess of the economy's ability to pay. First the policy makers pretend that they can be paid, then they denounce the pessimists as spreading panic, and then they say that of course students have been taught for four thousand years now how the "magic of compound interest" keeps on doubling and redoubling debts faster than the economy can squeeze out an economic surplus to pay.

What has ended is the idea that "the magic of compound interest" can make economies rich without having to work and without industry. I hope we have seen the end of derivatives formulae seeking to make money by playing in a zero-sum game. A debt overhang always ends either in foreclosure of the debtor's property, or in a debt annulment to preserve the economy's overall freedom and equity.

This means that the postmodern economy as we know it must end – either in financial polarization and debt peonage to a new oligarchic elite, or in a debt cancellation, a Jubilee Year to rescue society.

But when the government says that it is reviewing "all" the options, this reality is not one of them. Treasury Secretary Henry Paulson's first option was to buy packages of junk mortgages (collateralized debt obligations, CDOs) to save the wealthiest institutional investors from having to take a loss on their bad bets. When this was not enough, he came up with "Plan B," to give money to banks.

But whereas Britain and European countries talked of nationalizing banks or at least taking a controlling interest, Mr. Paulson gave in to his Wall Street cronies and promised that the government's stock purchases would not be real. There would be no dilution of existing shareholders, and the government's investment would be non-voting. To cap the giveaway to his cronies, Mr. Paulson even agreed not to ask executives to give up their golden parachutes, exorbitant annual bonuses or salaries.

Plan A (the $700 billion to buy mortgage-backed junk that the private sector will not buy) failed partly because it let financial institutions avoid putting a fair value on the debt packages they were selling. Instead of telling the truth about their financial position by marking assets to market prices), they can "mark to model," Enron-style.

We have seen the result: A solid week of plunging stock market prices. The public media call this a panic, but there is nothing irrational about it. Who in their right mind would buy securities or buy into a bank without knowing what the securities were worth? Faith in junk mathematical models has ended.

So we still await a public response to the problem of how to write down debts. Whose economic interest will have to give: that of debtors, as increasingly has been the case over the past eight centuries; or that of creditors, which have fought back to create a neoliberal economy controlled by the FIRE sector?

It is not too late to decide which road to take, but Wall Street bankers and creditors have taken the lead in positioning themselves. Seeing which way the political winds were blowing, they moved to empty out the Treasury before the November 3 elections much like medieval citizens fleeing a horde of Mongolian raiders under Genghis Khan. "We're moving. Clean out the cupboards," much as Lehman Brothers emptied out their foreign bank accounts in Britain and elsewhere just before declaring bankruptcy, taking what they could and steering it to their best friends.

The pretense was that a bailout was needed to restore confidence. But the ensuing week showed that the claims were false. It didn't turn the stock market around as promised. The Dow Jones Industrial Average fell 2,200 points from Wednesday, October 1 through the following Friday October 10 – eight straight trading days, not even pausing for the usual zigzags. Friday's plunge was 100 points a minute for the first seven minutes – a 690 point drop to under 8000. Each 100 points was more than a 1 percent drop, which was reflected on the NASDAQ. Nothing could withstand the pressure of so many Americans cashing in their mutual funds overnight and so many foreigners in earlier time zones putting in sell-at-market orders.

Short sellers made one of the largest and quickest fortunes ever, and then covered their positions by buying back the stocks they had pre-sold. This pushed prices up even into positive territory just before 10:30 AM when George Bush began to speak.

Half the financial stocks showed gains – a sign that the Plunge Protection Team had jumped in. But Mr. Bush said nothing helpful and stocks went back into freefall, ending down another 128 points despite the upcoming weekend G7 meeting. There was no talk at all of reducing debt levels – only of giving more money to banks, insurance companies and other money managers, as if "pushing on a string" somehow would lead them to lend yet more to an already debt-ridden economy.

If Congress really wanted to restore confidence, here's what it might have done: First, mark to market, not to model. Investors no longer believe America's Enron-style accounting, debt rating agencies or monoline risk insurers. They don't trust U.S. banks to be honest about their financial positions. They worry about the fraud charges brought by attorneys general in eleven states against predatory lenders such as Countrywide and Wachovia that Citibank, JPMorgan Chase and Bank of America were so eager to buy.

So is it too late for Congress to change its mind and repeal the giveaway? If the $700 billion handout didn't stabilize the unsalvageable for small investors, pension funds and even the financial sector itself, what did it do?

What the Fed has been doing while the media have not been looking

Let's put the giveaway in perspective. While Senators and Congressmen subject to voters' choice were debating $700 billion for the major Wall Street contributors to both parties (admittedly only for starters, Mr. Paulson explained), the Federal Reserve already had given even more, without any public discussion and without the major media noticing.

Since Bear Stearns failed in March, the Federal Reserve has used the small print of its charter to go outside its normal customers (which are supposed to be commercial banks), to give investment banks, brokerage houses and now large corporations almost indiscriminately some $875 billion in "cash for trash" swaps. (The statistics are released each week in the Fed's H41 report.)

Like Aladdin offering new lamps for old, the Fed has exchanged Treasury securities for junk mortgages and other securities that brokerage houses and investment banks did not have time to pawn off onto OPEC, Asian sovereign wealth funds or other investors.

The press lauds Mr. Bernanke as "a student of the Great Depression." If he were, he should know that what led to the 1929 collapse were harsh U.S. Government creditor policies toward its World War I Allied governments. This created a situation where the Federal Reserve had to provide easy credit to hold interest rates artificially low so as to encourage U.S. investors to lend to Britain and Germany, which would use these dollar inflows to pay their Inter-Ally arms and reparations debts.

Mr. Bernanke's predecessor, Alan Greenspan, promoted easy credit simply for ideological reasons, to enrich Wall Street by enabling it to sell more debt.

A student of the Great Depression would understand the conflicts of interest between retail commercial banking and wholesale investment banking and money management that led Congress to pass the Glass-Steagall Act in 1933 – conflicts unleashed once again when Pres. Clinton backed then-Fed Chairman Alan Greenspan and Republican leader (and McCain hero) Senator Phil Gramm in leading the repeal of this act, opening up the floodgates to today's financial double-dealing that has cost the American economy so much.

If Mr. Bernanke does know this history, his behavior is simply that of an opportunistic student of the art of political self-advancement, toadying to Wall Street in campaigning for one last great rip-off before the Bush Administration goes out of business. The Fed has given Wall Street newly minted Treasury bonds, added to the national debt out of thin air. It has done this without feeling any need to rationalize it by drawing absurd public-relations pictures about how the government may "make a profit for taxpayers."

The Fed Chairman is not elected democratically. He traditionally is designated by the Wall Street financial sector that the Fed is supposed to regulate, acting as its lobbyist for creditor interests – the top 10 percent of the population – against that of the indebted "bottom 90 percent." This "independence of the central bank" is trumpeted as a hallmark of democracy. But it is undemocratic, precisely by being isolated from public control.

The Age of Oligarchy

Treasury Secretary Paulson has no such luxury. The Treasury is supposed to represent the national interest, not that of bankers – even though its head these days is drawn from Wall Street and acts as its lobbyist. Mr. Paulson presented his almost totalitarian giveaway gruffly to Congress on a take-it-or-leave it basis, announcing that if Congress did not save Wall Street from taking losses on its mountain of bad loans, the banks were willing to crash the economy out of spite. “Please don’t make us wreck the economy,” he said in effect. As Margaret Thatcher used to say while selling off the British government’s crown jewels in the 1980s, TINA: There is no alternative.

In making this bold threat Mr. Paulson behaved as arrogantly as Lehman’s CEO Richard Fuld did when he tried to bluff Korea and other prospective investors into paying the full, fictitiously high book value for his company. (His bluff failed and Lehman went bankrupt, wiping out its shareholders, including the employees and managers who held 30 percent of its stock.) There turned out to be an alternative after all. Responding to the loudest public condemnation in memory, Congress called Mr. Paulson’s bluff.

What made his $700 billion Troubled Asset Relief Program (TARP) so much more visible to the media than the Fed’s actions is that Congress is involved, and this is an election year. The level of deception and false argument is therefore enormous – along with a few tradeoffs and tax cuts to distract attention. Erstwhile Republican opponent Sen. Jeff Sessions of Alabama came right out and said that “This bill has been packaged with a lot of very popular things to give it even more momentum,” so that (as The New York Times explained), “instead of siding with a $700 billion bailout, lawmakers could now say they voted for increased protection for deposits at the neighborhood bank, income tax relief for middle-class taxpayers and aid for schools in rural areas where the federal government owns much of the land.”

Left behind while Wall Street’s believers in the rapture of free markets were swept up to heaven by “socialism for the rich” have been mortgage debtors, student-loan debtors, the Pension Benefit Guarantee Corporation (PBGC, some $25 billion short), the Federal Deposit Insurance Corporation (FDIC, about $40 billion short), as well as Social Security which, we are warned, may run up a trillion dollar deficit thirty or forty years down the line. Only the wealthiest have been beneficiaries, not voters, homeowners and other debtors.

Still, Congress was panicked into acting on Friday, October 3, because a week earlier, September 26, stocks fell 777 points after Congressmen responded to an unprecedented volume of voter protest against the bailout. “This sucker could go down,” Pres. Bush warned as Wall Street’s lobbyists blamed the market downturn to the failure of Congress to preserve the “monetary system,” and specifically the banks and insurance companies that already had lost their net worth and were plunging deeper into Negative Equity territory.

Democratic leaders Barney Frank and House Speaker Nancy Pelosi said, in effect, “Look what you’ve done! You irresponsible politicians are grandstanding on principle, and wiping out peoples’ stock market savings and threatening their pension funds. If you don’t give Wall Street firms enough money to cover their losses so that everyone wins, they’ll kill the economy until they get their way.” Well, they didn’t quite say this, but that was basically their message. It certainly was Wall Street’s message: “Wall Street to Economy: Your money or your life.”

So Congress gave in. Democrats ran like lemmings to "save the economy." Yet the stock market fell a few hundred points, and kept on plunging all week long, much worse and much faster than had occurred right after Congress had initially defeated the bill.

The "Reality Problem"

What did the "free market" theory underlying the giveaway leave out of account? For starters, "the monetary system" turns out to be a euphemism for the fortunes of financial gamblers using junk mathematics (the Merton-Scholes derivatives formula) based on junk economics (blessed with Nobel Prizes) to buy, speculate and even to insure junk mortgages, junk bonds and junk commercial paper and derivatives based on their relative prices. So what is left out first of all was full knowledge of the value of what is being bought and sold. Mark-to-market models leave the price up to the investment bankers. If trust existed and there really was honor among these thieves, a government bailout would not be necessary, because "the market" could clear.

"Free market" ideology assumes that each party will act in his or her self-interest. If this is so, why should foreign governments accumulate more dollar claims on the U.S. Treasury, which already owes their central banks $4 trillion? When there hardly were enough Treasury securities to go around even as the United States ran unprecedented federal budget deficits, U.S. officials urged these banks and sovereign wealth funds to buy packaged mortgages yielding a higher rate of return. And at least by buying these bonds, foreign governments would not be accused of funding America's war in Iraq that most of their voters opposed. But investors made a fatal mistake in believing U.S. representations of the value of their junk-mortgage packages. This trust has now been lost, all the more so since the bailout's permission to keep on "marking to market."

Congress thought that its $700 billion would distract attention at least until the November 4 election. But to no avail. Markets fell 157 points on Giveaway Friday, and kept on going down another 800 points on Monday, October 6 (to about 9500) before bouncing 500 points off the floor, only to fall even more through Friday. So the giveaway failed in its stated purpose to rescue stock market investors ("peoples' capitalism") or their pension funds. But that was not its real purpose. The time simply had come to clear out and take whatever one could.

Making banks and insurers in the zero-sum derivative game whole, so that winners can collect their bets while losers can sell their bad investments to the Treasury, is supposed to re-inflate the credit pyramid. The idea is to solve the debt problem with yet more debt to prop up housing prices once again to unaffordable levels! This is not a long-term solution, but it would give insiders enough time to arrange a do-over and get out of the game more quickly, to sell out their junk mortgages and junk bonds to the proverbial "greater fool" – in this case, the "greater fool of last resort," the U.S. Treasury, as long as it can be run by Mr. Paulson or, under Mr. Obama, perhaps the former Goldman-Sachs official Robert Rubin.

The banks are to "earn" their way out of their negative equity position by selling more of their product – credit – to increase the economy's debt levels and hence receive more interest payments. The problem is that most families are already "loaned up." They have no more discretionary income to pledge to carry more debt. Without writing down their debts, there will be no fresh lending, and hence no source of credit and purchasing power for new autos, appliances, goods and services in general. Debt deflation is being imposed on the "real" economy. Creditors and speculators alone are to be made whole.

If no revenue was available for future Social Security, public health care and repair the nation's depleted infrastructure before this giveaway, think of how bare the cupboard must be now that the government has run up the recent trillions of dollars in new debt rather than writing off a penny of the bad mortgage debts being blamed for causing the debacle.

We can see where this is leading. The wealthiest 1 percent of the population will come into possession of even more returns to wealth than the 57 percent that they are now taking. In contrast to the Statue of Liberty's inscription "give me your poor … yearning to breathe free," the Fed – and now the Treasury, with Congressional blessing – is taking from the public purse and giving to America's wealthiest investors and insiders. This "Robin Hood in Reverse" program is being done without strings, without asking banks to stop paying dividends, exorbitant executive salaries and golden parachutes, and without taking over banks with negative net worth of the kind that many homeowners are experiencing.

Nobody is talking about a debt write-down or moratorium. The subprime mortgage problem could have been solved by writing down just $1 or $2 trillion of the face value and interest rates of predatory loans. Instead, the $10+ trillion in financial-sector damage in recent weeks reflects Wall Street's fraudulent packaging and sale of junk mortgages at unrealistically high prices, using junk mathematics to calculate junk derivatives and sell them to gullible investors who believe that the pretenses these mathematics, credit ratings and projected income have a basis in reality.

The amazing feature of today's crash is how many Wall Street firms actually believed that the game of musical financial chairs could go on before they had to stop dancing and indeed, escape from the room. I remember one day back in the 1970s when I warned Frank Zarb of Lazard Freres about the likelihood of Third World debt defaults, and suggested that the firm should do an ability-to-pay analysis. "We don't have to do any such thing," he replied. "We have the schedule of what they owe right here in this IMF report." It was a thick printout of the scheduled debt service for an African country that soon became insolvent. But Wall Street's mentalité (in the French broad structuralist sense of the word) was that of Herbert Hoover on the eve of the Great Depression: A debt is a debt, and that is that. The response is to blame the victim, as if the irresponsibility lies with debtors rather than creditors.

No reversal of the Bush tax cuts is offered to re-inflate the economy, no move toward more progressive taxation of Wall Street speculators who pay only a 15 percent "capital gains" tax rate instead of the much higher income-tax and FICA withholding rates that wage-earners pay. (Wall Street has its own golden parachute program, so why should it pay for Social Security for the rest of society?) There is to be no reduction in the special tax benefits for real estate, whose tax favoritism led to the crisis by "freeing" more income from the tax collector to be pledged to mortgage bankers as interest.

The Bubble Economy is to be re-inflated by Fannie Mae, Freddie Mac and the FHA lending to help buyers bid up housing and commercial office prices once again to a rate that promises to impose debt peonage on homeowners.

The budget deficit will soar, without any prosecution of tax evasion scams by UBS or KPMG. Instead of a fiscal or regulatory comet driving these dinosaurs to extinction, the climate has turned more conducive to their proliferation. Our Age of Deception is to be locked in even more tightly. The Congressional bailout's suspension of mark-to-market rules to rely on Wall Street's "self-regulation" should win a prize for Oxymoron of 2008 as investors have no clue as to what financial assets are worth. No wonder lending has dried up, especially to banks themselves.

Just as financial victims fail to vote and support their self-interest, predators also turn out to pursue self-defeating "free market" strategies. The financial sector's short-termism is the greatest enemy to its survival. It has translated its wealth into a fatal political control of its legal climate, blocking Congressional efforts to rewrite the oppressive bankruptcy laws that credit-card banks lobbied so hard to pass. These hard bankruptcy terms prevent the courts from renegotiating homeowner debts to keep property occupied, accelerating the real estate price collapse. The result is today's negative equity, posing the question of just who is to bear the cost of bring debts back in line with the economy's ability to pay. Will it be the financial institutions that sponsored asset-price inflation and lobbied for deregulation of lenders? Or, will it be the debtors who thought they were riding the wave to get an inflationary free lunch?

Will voters see the asymmetry in Congress's failure to offer debt relief for homeowners as real estate prices plunge below the mortgages that are owed? Will its members be blamed for not rewriting the nation's bankruptcy laws to free families from debt peonage – and free housing markets from the price declines that result from today's proliferation of foreclosure sales? For that matter, will there be no relief for corporations having to cut back investment in order to service their junk bonds and other debts with which Wall Street's corporate raiders and "shareholder activists" have loaded then down?

Evidently not. Instead of requiring creditors to absorb losses on the excess of debts over what can be paid, the debts are being kept in place, not scaled back to what the economy can pay. The government is to make creditors and computerized derivatives speculators whole – and will act as collecting agent for the overhead of bad debts the economy has run up.

Today we can see the debt-fueled bubble of asset-price inflation that Alan Greenspan trumpeted as real wealth creation for what it really is – credit creation to bid up real estate, stock market and packaged-debt prices. Tangible capital formation has been left out of account, as if postindustrial economies no longer need it.