

Financial Crisis: Paulson Panics as UK, Germany find own solution

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America's de facto Finance Czar, US Treasury Secretary Henry Paulson has reached for the panic button and made a dramatic 180-degree reversal of his financial bailout plan passed only days before. On September 23 in testimony before the US Congress, Paulson, former CEO of the politically influential Wall Street investment firm, Goldman Sachs, declared his adamant opposition to the idea of the US Government taking equity stakes in troubled major banks in order to provide them capital and stabilize the frozen interbank trading market. On October 13, that opposition to 'nationalization' collapsed. What happened to cause that sudden reverse is what interests us here. It shows the utter lack of coherency in the US financial elites over how to deal with their home-grown securitization of risk fiasco.

The Paulson plan was widely criticized among more sober US bankers and economists, including Paulson's predecessor as Treasury Secretary, Paul O'Neill who simply called the concept of using \$700 billion taxpayer bailout fund to buy 'toxic debt' from banks, as 'crazy.' All critics agreed the Paulson approach was far the most costly model and far from guaranteed to solve the underlying problem—inadequate bank capitalization following hundreds of billions of dollars in sub-prime and other security losses.

Yet the Secretary adamantly refused to alter his plan, even after Congress rejected it in the first vote. He allowed non-related Democratic items to be glued on to his original TARP plan, a plan that gave the Treasury Secretary virtual dictatorial powers over the US finance and de facto the economy. It was referred to widely as 'the financial equivalent of the US Patriots Act.'

Then, on October 8 the unexpected took place. Gordon Brown, former British finance minister and now Prime Minister, facing a literal meltdown of the British banking system, on advice of senior staff of the Bank of England, swallowed his own opposition to bank nationalization and adopted an emergency nationalization scheme. He announced that the UK Treasury had made € 64 billion available to buy bank preferred shares in eight UK banks designated by the Government as strategic. The nationalization was to be partial but effective and included a €260 billion 'special liquidity scheme' of Treasury cash to inject into the frozen inter-bank market, consisting of UK Treasury bills in exchange for bank less liquid assets as collateral.

The relevance of 1931

The move was a replay of the dramatic decision by the British Government in 1931. At that time, Britain and members of the British Commonwealth 'broke the rules of the game' and

unilaterally abandoned the international Gold Standard. In September 1931, after months of debate, the UK abandoned monetary orthodoxy and unilaterally left the Gold Standard it had rejoined in 1925.

Germany had preceded the UK, under far different circumstances, by some weeks in August 1931 by abandoning the Gold Standard.

Germany, under emergency rule without Parliament under Chancellor Brüning, faced a crisis in the wake of the French decision to punish the German-Austrian economic entente. France had precipitated a banking crisis in Austria's largest bank, the Vienna Credit-Anstalt.

The role of J.P. Morgan Bank in New York, the leading private creditor of the German banking system since the end of Hyperinflation in 1923, and the Morgan controlled New York Federal Reserve under Governor George L. Harrison, was instrumental in precipitating the German banking crisis of 1931.

As a condition for its stabilization loan to the Reichsbank, Harrison demanded the Reichsbank cease lending to German commercial banks. Under maximum duress, it did. The banks collapsed.

So long as it remained on the Gold Standard, a requirement of JP Morgan and the New York Federal Reserve, Germany had to prevent capital outflows and impose higher taxes and budget austerity to persuade international creditors of its credit worthiness. As German recession deepened, the government cut the social programs instituted after the war. It was the outbreak of the banking crisis in the summer of 1931 that made the German depression so severe. The collapse of the banks in central Europe had a major social, psychological and political impact. The rest became tragic history.

The United States, guided by Harrison and backed up by the monetary orthodoxy of President Herbert Hoover, held bitterly to the Gold Standard until March 1933 when newly inaugurated President Roosevelt left the Gold Standard. By then, the United States economy was deep in depression.

Paulson's Volte Face

This time around it was again England that led the break with the rules of a US financial game by swiftly nationalizing its top eight banks, starting with the Royal Bank of Scotland (RBS) on October 8, a Wednesday. By that Friday it was clear that Germany was also moving towards a national resolution of its banking problems, problems which originated in the US spread of Asset Backed Securities and Credit Default Swaps, an exotic new area of finance which had grown up in recent years in a totally unregulated area of bank-to-bank practice to a nominal size of some \$68 trillion. The French Sarkozy Plan, a €300 to 400 billion 'common bailout fund' modelled loosely on the original Paulson Plan, was dead. German taxpayers would not pay for the excesses of French or Italian banks. It was a sea change in attitude across the EU away from a US-led global financial unity. The American Century faced catastrophe.

That was the point of Paulson's radical shift to what in the parlance of US radical free marketers was a bolt towards the dreaded 'S' word, socialisation of the banking system.

According to my best European banking sources, had Paulson not taken radical new action at that point, as one City of London veteran banker expressed it, 'the US banks were in danger of extinction.'

On Monday October 13 in the US Treasury, Paulson convened an emergency meeting with the heads of the nine largest US banks. According to reports from participants, Paulson handed each person a one page document to sign that they would agree to sell their stock shares in part to the US Government in return for an emergency injection of \$250 billions. Paulson told them they must all sign before leaving the room. Three hours and reportedly many acrimonious arguments later, all nine had signed in the largest Government intervention into the US banking system since the Great Depression.

According to insider accounts from bankers here I spoke with and in New York, it was precisely the decision by the UK, backed by a similar if not yet so detailed plan from the German authorities which forced Paulson's Volte Face.

After the fact, in a confirmation of how weak the new Federal Reserve Chairman, Ben Bernanke is in face of the domineering personality of Paulson, Bernanke mumbled to the press that he had 'all along' been in favor if the Government buying equity shares to recapitalize the banks. Why he refused to state that publicly before the Paulson Plan won the day is unclear, but it suggests the man Bush chose to succeed Alan Greenspan was chosen for his liability not his ability or his backbone.

San Francisco Federal Reserve President, Janet Yellen remarked as well, long after it had become clear that the US Administration's decision to let Lehman Brothers go bankrupt without Government assistance, had been a horrible miscalculation.

That Lehman Bros. bankruptcy on September 15, was the 'shock heard round the world,' which precipitated a global crisis in banking confidence resulting in the present situation. Whether Paulson and friends calculated the collapse would provide the basis to demand a US-crafted solution to the crisis remains unclear. What is clear, one of the chosen 'winners' in the present US banking reorganization, JP Morgan Chase, played a nasty role in the final push of Lehman Bros. into insolvency the Friday prior to Lehman's Monday declaration of insolvency. JP Morgan Chase had 'mysteriously' withheld a \$19 billion transfer that Friday which would have averted the collapse of Lehman Bros. It was an eerie echo of the nasty role played in 1931 by the House of Morgan in relation, then, to the German and European banking crisis.

After 1931 the House of Morgan never again rose to the prominent role it had held. It is looking increasingly likely that the successor to the bank, JP Morgan, despite the pretensions of its head, Jamie Dimon, to invincibility, may be far more modest.

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