Sovereign Debt Crisis. No Wonder the Economy Is not Improving

Transferring risk from private banks to governments

By Washington's Blog
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I've read countless news headlines recently about how economists are "surprised" over an "unexpectedly bad" economic indicator.

But it's not surprising at all. It's no mystery.

The government hasn't taken the necessary actions, and has instead been doing all of the wrong things.

Let's recap.

The leading monetary economist told the Wall Street Journal that this was not a liquidity crisis, but an insolvency crisis. She said that Bernanke is fighting the last war, and is taking the wrong approach. Nobel economist Paul Krugman and leading economist James Galbraith agree. They say that the government's attempts to prop up the price of toxic assets no one wants is not helpful.

The Bank for International Settlements – often described as a central bank for central banks (BIS) – slammed the easy credit policy of the Fed and other central banks, the failure to regulate the shadow banking system, "the use of gimmicks and palliatives", and said that anything other than (1) letting asset prices fall to their true market value, (2) increasing savings rates, and (3) forcing companies to write off bad debts "will only make things worse".

BIS also cautioned that bailouts could harm the economy (as did the former head of the Fed's open market operations).

And BIS warned that the Fed and other central banks were simply transferring risk from private banks to governments, which could lead to a sovereign debt crisis.

Virtually all leading independent economists have said that the too big to fails must be broken up, or the economy won't be able to recover (and see this). Instead, they have been allowed to get even bigger (and see this and this).

While modern economic theory shows that debts do matter (and see this), the U.S. is spending on guns and butter like debts are a good thing.

Nobel prize winning economist George Akerlof predicted in 1993 that credit default swaps would lead to a major crash, and that future crashes were guaranteed unless the government stopped letting big financial players loot by placing bets they could never pay off when things started to go wrong, and by continuing to bail out the gamblers. (Not only has the government rewarded the gamblers, bailed them out and let them engage in a new round of risky betting, but it hasn't even reined in credit default swaps.)

And instead of trying to restore trust in our financial system – which is a prerequisite for any sustainable economic recovery – Summers, Geithner, Bernanke and the boys have tried to sweep the problems under the rug and con the public into believing that everything is okay and that no real reform is needed.

As I wrote in October:

> William K. Black – professor of economics and law, and the senior regulator during the S & L crisis – says that that the government's entire strategy now – as during the S&L crisis – is to cover up how bad things are ("the entire strategy is to keep people from getting the facts").
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> Indeed, as I have previously documented, 7 out of the 8 giant, money center banks went bankrupt in the 1980's during the "Latin American Crisis", and the government's response was to cover up their insolvency.
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> Black also says:
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>> There has been no honest examination of the crisis because it would embarrass C.E.O.s and politicians . . .
>>
>> Instead, the Treasury and the Fed are urging us not to examine the crisis and to believe that all will soon be well.
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> PhD economist Dean Baker made a similar point, lambasting the Federal Reserve for blowing the bubble, and pointing out that those who caused the disaster are trying to shift the focus as fast as they can:
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>> The current craze in DC policy circles is to create a "systematic risk regulator" to make sure that the country never experiences another economic crisis like the current one. This push is part of a cover-up of what really went wrong and does absolutely nothing to address the underlying problem that led to this financial and economic collapse.
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> Baker also says:
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>> "Instead of striving to uncover the truth, [Congress] may seek to conceal it" and tell banksters they're free to steal again.
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> Time Magazine called Tim Geithner a "con man" and the stress tests a "confidence game" because those tests were so inaccurate.
>
> William Black said:

> How do you think we did the stress tests? Like doing a stress test on an airplane wing, but you don't actually have airplane wing. And don't know what airplane wing is made out of. It's a farce.

And see this.

And while stopping the rising tide of unemployment is key to reversing the financial crisis, the government hasn't done much at all to staunch the loss of jobs.

For example, as I wrote last August:

> The government has committed to give trillions to the financial industry. President Obama's stimulus bill was $787 billion, which is less than a tenth of the money pledged to the banks and the financial system. [106]
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> Of the $787 billion, little more than perhaps 10% has been spent as of this writing. [107]
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> The Government Accountability Office says that the $787 billion stimulus package is not being used for stimulus. [108] Instead, the states are in such dire financial straights that the stimulus money is instead being used to "cushion" state budgets, prevent teacher layoffs, make more Medicaid payments and head off other fiscal problems. So even the money which is actually earmarked to help the states stimulate their economies is not being used for that purpose.
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> Indeed, much of the $787 billion was earmarked pork [109], not for anything which could actually stimulate the economy. [110]
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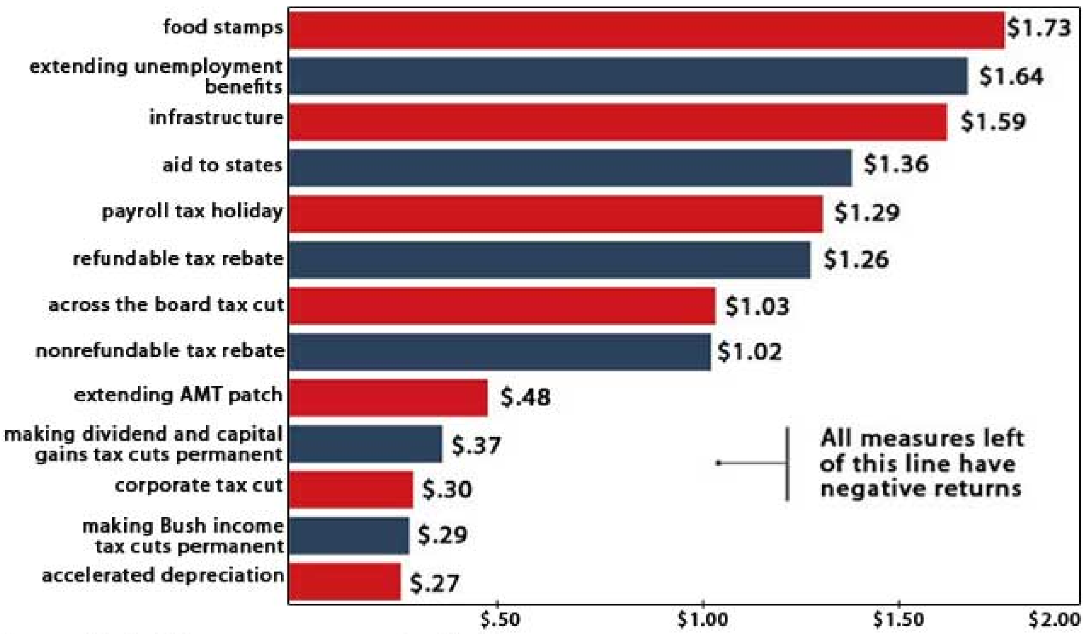
> Mark Zandi – chief economist for Moody's – has calculated which stimulus programs give the most bang for the buck in terms of the economy:



Source: Moody's Economy.com; congressional testimony

> [111]
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> But very little of the stimulus funds are actually going to high-value stimulus projects.

Indeed, as the Los Angeles Times points out:

> Critics say the [stimulus money reaching California] is being used for projects that would have been built anyway, instead of on ways to change how Californians live. Case in point: Army latrines, not high-speed rail.
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> Critics say those aren't the types of projects with lasting effects on the economy.
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> "Whether it's talking about building a new [military] hospital or bachelor's quarters, there isn't that return on investment that you'd find on something that increases efficiency like a road or transit project," said Ellis of Taxpayers for Common Sense.
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> Job creation is another question. A recent survey by the Associated General Contractors of America found that slightly more than one-third of the companies awarded stimulus projects planned to hire new employees. But about one-third of the companies that weren't awarded stimulus projects also planned to hire new employees.
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> "While the construction portion of the stimulus is having an impact, it is far from delivering its full promise and potential," said Stephen E. Sandherr, chief executive of the contractors group.
>
> It's unclear how many jobs will be created through the Defense Department projects. Most of the construction jobs are awarded through multiple award contracts, in which the department guarantees a minimum amount of business to certain contractors, and lets only those contractors bid on projects.
>
> That means many of the contractors working on stimulus projects already have been busy at work on government projects.even the stimulus money which is being spent [112]

David Rosenberg writes:

> Our advice to the Obama team would be to create and nurture a fiscal backdrop that tackles this jobs crisis with some permanent solutions rather than recurring populist short-term fiscal goodies that are only inducing households to add to their burdensome debt loads with no long-term multiplier impacts. The problem is not that we have an insufficient number of vehicles on the road or homes on the market; the problem is that we have insufficient labour demand.[113]

Donald W. Riegle Jr. – former chair of the Senate Banking Committee from 1989 to 1994 – wrote (along with the former CEO of AT&T Broadband and the international president of the United Steelworkers union):

> It's almost as if the administration is opting for a rose-colored-glasses PR strategy rather than taking a hard-nose look at actual consumer and employment figures and their trends, and

modifying its economic policies accordingly.[114]

As yesterday's front-page story on ABC notes:

> Even as many Americans still struggle to recover from the country's worst economic downturn since the Great Depression, another crisis – one that will be even worse than the current one – is looming, according to a new report from a group of leading economists, financiers, and former federal regulators.
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> In the report, the panel, that includes Rob Johnson of the United Nations Commission of Experts on Finance and bailout watchdog Elizabeth Warren, warns that financial regulatory reform measures proposed by the Obama administration and Congress must be beefed up to prevent banks from continuing to engage in high risk investing that precipitated the near collapse of the U.S. economy in 2008.
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> The report warns that the country is now immersed in a "doomsday cycle" wherein banks use borrowed money to take massive risks in an attempt to pay big dividends to shareholders and big bonuses to management – and when the risks go wrong, the banks receive taxpayer bailouts from the government.
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> "Risk-taking at banks," the report cautions, "will soon be larger than ever."
>
> Without more stringent reforms, "another crisis – a bigger crisis that weakens both our financial sector and our larger economy – is more than predictable, it is inevitable," Johnson says in the report, commissioned by the nonpartisan Roosevelt Institute.
>
> The institute's chief economist, Nobel Prize-winner Joseph Stiglitz, calls the report "an important point of departure for a debate on where we are on the road to regulatory reform."
>
> The report blasts some of Washington's key players. Johnson writes, "Our government leaders have shown little capacity to fix the flaws in our market system." Two other panelists, Simon Johnson, a professor at MIT, and Peter Boone of the Centre for Economic Performance, voiced similar criticisms.
>
> Federal Reserve Chairman Ben Bernanke and Treasury Secretary Tim Geithner "oversaw policy as the bubble was inflating," write Johnson and Boone, and "these same men are now designing our 'rescue.'"
>
> The study says that "In 2008-09, we came remarkably close to another Great Depression. Next time we may not be so 'lucky.' The threat of the doomsday cycle remains strong and growing," they say. "What will happen when the next shock hits? We may be nearing the stage where the answer will be – just as it was in the Great Depression – a calamitous global collapse."
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> Frank Partnoy, a panelist from the University of San Diego, claims that "the balance sheets of most Wall Street banks are fiction."

Another panelist, Raj Date of the Cambridge Winter Center for Financial Institutions Policy, argues that government-backed mortgage giants Fannie Mae and Freddie Mac have become "needlessly complex and irretrievably flawed" and should be eliminated. The report also calls for greater competition among credit rating agencies and increased regulation of the derivatives market, including requiring that credit-default swaps be traded on regulated exchanges.

With the Senate Banking Committee, led by Chris Dodd, D-Conn., poised to unveil its financial regulatory reform proposal sometime in the next week, the report calls on Congress to enact reforms strong enough to prevent another meltdown.

"Sen. Dick Durbin once said the banks 'owned' the Senate," says Johnson. "The next few weeks will determine whether or not that statement is true."

(Here is the Roosevelt Institute report.)

Heck of a job, guys.

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