The Dance of the Trillions to Shore up Banks, Bankers, and Gamblers

By Prof Rodrigue Tremblay
Global Research, March 26, 2009
thenewamericanempire.com/blog 26 March 2009

Region: USA
Theme: Global Economy

> "Deficits in the, let's say, 5 percent of GDP range would lead to rising debt-to-GDP ratios that would ultimately not be sustainable." Peter Orszag, Obama White House budget chief

> "The [US] financial system is facing possible total losses of $7 trillion. …With the banks 'effectively insolvent', we've concluded that the only viable solution is nationalization." Matthew Richardson and Nouriel Roubini, American economists

> "China is worried that the U.S. may solve its problems by printing money, which will stoke inflation." Zhao Qingming, Chinese financial analyst

> "Whoever controls the volume of money in any country is absolute master of all industry and commerce." James A. Garfield, (1831-1881) 20th President of the United States

After ten years of wholesale financial deregulation, bad policies and unsound banking practices, and facing a worsening recession, over the last year and a half the U.S. government has been pumping trillions of dollars in order to deleverage and recapitalize banks that were on the brink of insolvency. But the banking crisis is of such a magnitude, and the damage done to the financial system so widespread, that each pumping of money into the system has never seemed to be enough. This is because numerous American financial institutions, and among the largest, have suffered multibillion-dollar losses, not only with subprime mortgages, but especially with large amounts of derivative products that have turned sour. Not the least of these are the famous gambling products called credit default swaps, (CDS), [which the Bank of International Settlements is reporting to be worth some $57 trillion.

For its part, ever since the collapse of the investment bank Bear Stearns on March 15, 2008, the Fed has pumped trillions of dollars, under various forms, into sick financial institutions in order to keep them afloat, or in order to merge them with other entities.

In the case of Bear Stearns, for example, the Fed guaranteed $29 billion so that the new owner of Bear Stearns (JP Morgan Chase) would not suffer losses on the most risky assets on the books of the acquired bank. The Fed has also been buying loads of financial assets from troubled institutions, thus issuing new "high-powered" money against such assets. On November 25, 2008, for example, the Federal Reserve Board launched its up-to-one-$ trillion

Term Asset-Backed Securities Loan Facility (TALF) to support the issuance of asset-backed securities (ABS) collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration (SBA).

As recently as March 17, 2009, the Fed has also announced that its purchases of Fannie Mae and Freddie Mac Mortgage Backed Securities (MBS) would be expanded from $500 billion to $1.25 trillion, and that it intends to double its purchases of Fannie Mae, Freddie Mac, and Federal Home Loan Bank bonds to $200 billion from the $100 billion intended initially.

Because the Fed stands ready to buy large amounts of the newly issued Treasury bonds to cover the large U.S. government’s fiscal deficit, it can be said that the Fed is actively and effectively busy monetizing both the public debt and private financial debts. As a consequence, the Fed’s balance sheet has ballooned to over $2 trillion now from less than $900 billion only one year ago. And it is likely to continue to expand in the coming months. Some of these loans will be repaid in the future and some of the new money will be retrieved, but if the Fed were to sell its portfolio of Treasury bonds to prevent an onset of inflation or to prevent the U.S. dollar from depreciating too fast, bond prices would drop significantly and interest rates would also rise quickly.

Similarly, the U.S. Treasury has been “investing”, guaranteeing and loaning hundreds of billions of dollars of public money to large American banks. It began on earnest last September, after the large investment bank Lehman Brothers($691 billion of assets at the end of 2007) failed and the large world insurance company American International Group (AIG) followed thereafter and became insolvent. Then, the U.S. Congress passed in a hurry the $700 billion Troubled Assets Relief Program (TARP), under the threat of a financial Armageddon.

It has been evaluated that all these public bailouts of the financial system amount together to a staggering $12.9 trillion, nearly as large as the U.S. economy (GDP) at some $14 trillion, and larger than the current U.S. national debt of $11 trillion. This includes, of course, the close to $800 billion Obama Economic Stimulus package that the new administration sent to Congress in February and that Congress passed with a minimum of Republican support (none in the House and three in the Senate).

That is where we stand.

On Monday, March 23, Treasury Secretary Timothy Geithner announced that the Obama administration had decided to create a Public-Private Investment Program, and to pour $75 to $100 billion into it, the money coming from remnants of the old TARP program. The purpose, this time, is to rid American banks of the bad financial assets that are destroying their balance sheets, to the point of insolvency. What the new “Program” calls for is the purchase of as much as a half-trillion dollars of the American banks’ so-called toxic assets, with the government providing 85 percent of the funds to willing private investors at low interest rates, and guaranteeing (through FDIC) any loss on the financial assets that banks will unload through public auctions. The political attractiveness of this measure is that it provides a public subsidy to the banks and other financial institutions without Congress having to debate and vote new funds. It can be done administratively.

What can be said is that finally the Obama administration is doing, through the back door, what I myself recommended last April 12, 2008. The Obama administration, in effect, has decided to create the equivalent of the old Resolution Trust Corp. to liquidate bad mortgage-backed assets and other bad financial bets made by the banks and large insurance companies, such as AIG. The way that it is being done, however, is questionable, because this may turn out to be very costly to the U.S. taxpayers and is less than transparent.

Indeed, the new entity to be created would be tailored somewhat along the lines of the 1980s' Resolution Trust Corp., which was established to dispose of the bad real estate assets of savings and loan institutions. However, and this may be a sign of the times, the new public-private program would be a mixed venture and would be far from having the same powers that the RTC had in managing the current troubled banks. Nevertheless, the new PPIP will fill essentially the same basic function as the RTC, i.e. selling bonds and borrowing in order to finance the purchase of bad "toxic" assets from insolvent or near insolvent institutions, in partnership with private investors and managers.

Financially, this is an operation that could be very profitable to the private firms that join the government in the operation, because the profit potential for them is high and the risks of losses are at a minimum, since such losses will be underwritten by the government. Therefore, most everybody in the private financial industry stands to win with the new policy: 1- the banks will rid themselves of bad assets at enhanced market prices (compared to what they are worth today); 2- banks' shareholders will see an appreciation in the value of their common shares; and, 3- private investment firms and hedged funds will buy some of these assets at prices lower than par, using low cost non-recourse government loans, and all the while being fully protected by government guarantees of no loss to themselves. The only losers in the operation could be the American taxpayers who are guaranteeing that there would be no loss to private investors. That is the reason Wall Street rallied 500 points after the announcement of the new banks' bailout. Cynics could say that this is American-styled capitalism at its best: no loser except possibly the government and the taxpayers who support it. How it is going to play politically is anybody's guess. It may be a good thing for the Obama administration that such a plan is not going to be debated in Congress.

When all is said and done, the Obama administration is essentially pursuing a policy similar to the one followed by the Bush administration, i.e. supplying public money to private banks and to private investors with a minimum of strings attached. Remember that last September, the Bush administration committed $400 billion to obtain a near 80 percent control in the world's two largest mortgage companies, Fannie Mae (Federal National Mortgage Association: FNM) and Freddie Mac, (Federal Home Loan Mortgage Corporation: FRE) which were close to insolvency. Instead of taking them over and placing them into administrative receivership, in order to change their business model and their lending practices, since the government was guaranteeing these two institutions' outstanding debts, (more than $ 5 trillion US), the Bush administration chose instead to keep up the appearance that these were still two privately run banks and only appointed a legal conservator for Fannie Mae and Freddie Mac. The rest was business as usual, including the payments of huge bonuses to the entrenched management.

Similarly, with the new Public-Private Investment Program, the Obama administration would have the authority to place a failed bank deemed 'too big to fail' in the equivalent of a conservatorship, while keeping its management more or less intact. One thing is different this time, however. Indeed, contrary to what happened after the U.S. government poured $185 billion into the large insurance company AIG, this time around the Treasury Secretary would have the power to limit payments to creditors and to break contracts governing executive compensation. The fact remains that there is still no intention of placing the most insolvent firms into administrative receivership and to change their business model or practices.

In conclusion, let us say that there will be consequences following from all this bailout money. In particular, what foreign lenders, especially the Chinese, do with their holdings of U.S. dollar-denominated debt, considering the risk of future interest rates hikes and future dollar depreciation. Already, China's Premier Wen Jiabao has publicly raised his government's concern about the safe value of the U.S. Treasury bonds and other dollar-denominated assets that they hold in huge quantities. —But, I guess, this is something for another day.

Rodrigue Tremblay is professor emeritus of economics at the University of Montreal and can be reached at rodrigue.tremblay@yahoo.com .

He is the author of the book The New American Empire.

Visit his blog site at www.thenewamericanempire.com/blog.

Author's Website: www.thenewamericanempire.com/

Check out Dr. Tremblay's coming book

The Code for Global Ethics at:

www.TheCodeForGlobalEthics.com/

*****The French version of the book is now available.

See: www.LeCodePourUneEthiqueGlobale.com/

or: Le code pour une éthique globale

The original source of this article is thenewamericanempire.com/blog
Copyright © Prof Rodrigue Tremblay, thenewamericanempire.com/blog, 2009

Comment on Global Research Articles on our Facebook page

Become a Member of Global Research

Articles by: **Prof Rodrigue Tremblay**

Disclaimer: The contents of this article are of sole responsibility of the author(s). The Centre for Research on Globalization will not be responsible for any inaccurate or incorrect statement in this article. The Centre of Research on Globalization grants permission to cross-post Global Research articles on community internet sites as long the source and copyright are acknowledged together with a hyperlink to the original Global Research article. For publication of Global Research articles in print or other forms including commercial internet sites, contact: publications@globalresearch.ca

www.globalresearch.ca contains copyrighted material the use of which has not always been specifically authorized by the copyright owner. We are making such material available to our readers under the provisions of "fair use" in an effort to advance a better understanding of political, economic and social issues. The material on this site is distributed without profit to those who have expressed a prior interest in receiving it for research and educational purposes. If you wish to use copyrighted material for purposes other than "fair use" you must request permission from the copyright owner.

For media inquiries: publications@globalresearch.ca