The U.S. Financial System in Serious Trouble

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> "… a bailout of GSE (Fannie and Freddie) bondholders would be perhaps the greatest taxpayer rip-off in American history. It is bad economics and you can be sure it is terrible politics."Matt Kibbe, President of Freedom Works
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> "The first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring a permanent ruin. But both are the refuge of political and economic opportunists." Ernest Hemingway (1899-1961), (September 1932)
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> [After the Bear Stearns bailout] "As more firms lost access to funding, the vicious circle of forced selling, increased volatility, … and margin calls that was already well advanced at the time would likely have intensified. The broader economy could hardly have remained immune from such severe financial disruptions." Ben Bernanke, Fed Chairman (March 2008)

In August 2007, at the very beginning of the subprime financial crisis in the U.S., and referring to the alchemy-like practice of creating artificial financial instruments, such as mortgage-backed securities (MBSs), here is what I wrote:

> "Like all 'Ponzi schemes', such pyramidings of debts with no liquid assets behind them are bound to implode sooner or later." I also wrote about the Fed's intervention in such cases, that "it alleviates the 'liquidity crisis', for sure, but this does nothing to cure the underlying 'solvency crisis' of institutions holding large chunks of non-performing mortgage-based assets. Sooner or later, such low-valued derivatives will have to be written off, and this will necessarily lead to an erosion of these institutions' capital base. Bankruptcies of the most leveraged and imprudent institutions are to be expected."

In fact, such bankruptcies of over-leveraged financial institutions become unavoidable. For a while, forced mergers between banks, initiated by the Fed or the Treasury, can soften the blow. But after a while, outright bankruptcies cannot be avoided and balance sheets have to be balanced.

What is the cause of this financial mess?

Last month, I provided a short answer:

> "At the center of current financial problems is the failure to adapt standard financial regulation to new financial institutions, such as broker-investment banks, off-shore based hedge funds and large derivatives markets that remain, for the most part, outside of the traditional authority of regulators. However, when things go wrong, as they did with Bear Stearns last March, their demise

> threatens to destabilize the entire financial system and handy government bailouts are quickly called in."

Today I say that this major crisis has to be placed at the very feet of the Washington establishment. This is a politico-financial establishment that has pushed to the limits its ideology of deregulation of financial markets and stretched the working of unregulated corporate market capitalism to the breaking point. Now, the system is imploding under our very eyes and financial institutions are falling like dominos. As I wrote last August, and repeated in April of this year, the U.S. financial problem is not one of liquidity, (there is plenty of liquidity provided by the Fed when banks and brokers can borrow at will newly printed dollars from the Fed's discount window) but one of solvency, weak balance sheets, risky assets and debt liquidation. That's a horse of a different color.

Over the last twenty-five years, beginning with the Reagan administration and culminating with the current Bush-Cheney administration, the Washington establishment dismantled piece by piece the system of protection that had been built since the 1930's economic depression and removed nearly all government regulations that could stand in the way of greed and gouging on the part of unscrupulous market operators.

And that's where the rubber hits the road. Short of bankruptcies is the nationalization of the over-leveraged banks by the government. And the Bush-Cheney administration took a big step in that direction when it came to the rescue of the two largest mortgage financing institutions, Fannie Mae (Federal National Mortgage Association: FNM) and Freddie Mac, (Federal Home Loan Mortgage Corporation: FRE) which were close to being insolvent. This step was initiated after foreign central banks (in China, Japan, Europe, the Middle East and Russia) threatened to stop buying U.S. bonds and debentures issued by the two shaky financial institutions.

But the Bush-Cheney administration, while providing public money to keep the two lenders in operation, stopped short of nationalizing them. Indeed, the U.S. government committed to invest as much as $200 billion in preferred stock and extend credit through 2009, to keep the two mortgage lenders solvent and operating.

But instead of taking them over by placing them into administrative receivership, in order to change their business model, as they should have done since the government is now guaranteeing their outstanding debts, (more than $5 trillion US) the U.S. government chose rather to keep the appearance that these were still two privately run banks and only appointed a legal conservator for Fannie Mae and Freddie Mac. Even when they bail out what can be called two Government sponsored enterprises (GSEs), their market ideology prevents them from doing the right thing.

After years of irresponsible public deregulation and private mismanagement and irresponsible, pyramiding risk taking, the American financial system is now in serious trouble, and it may draw the U.S. economy further down with it in the months and years to come.

In the coming weeks, however, as other American financial institutions teeter on the brink of bankruptcy, the U.S. government will have to consider creating a Bank Resolution Trust under the model of the 1989 Resolution Trust Corp. which took over the savings and loans banks that were then in financial difficulties. For example, as recently as February 16 of this year, the British government did not hesitate to nationalize the Northern Rock bank and rescued this large British bank with about £55 billion ($107 billion) in public loans and guarantees. Sooner or later, the American government will have to do the same, in order to stabilize the financial system, because the financial problems in the U.S. are systemic and much more serious than elsewhere.

By the same token, maybe the U.S. government should correct an anomaly of the 20th Century, that is the semi-private status of its central bank. Indeed, the American Federal Reserve, is a semi-public and semi-private central bank organization that is as much responsible to large private banks as it is to the U.S. government and the population. This creates an unhealthy conflict of interests that is not fair to the American public. Indeed, the American practice of privatizing profits and socializing losses would be considered unacceptable in most other democracies.

What we are witnessing these days in the U.S. is a massive wealth transfer from taxpayers, savers and retirees to banks, their creditors and their managers. On the one hand, the Fed has pushed real interest rates deep into negative territory to help troubled banks, and, on the other hand, the American taxpayers have foot the bill for bailing out very large financial institutions.

I wonder what the two presidential camps, the Obama and the McCain camps, have to say about that! They both want to increase the federal deficit and add significantly to the already high national debt.

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