Financial Bailout: America's Own Kleptocracy

The largest transformation of America's Financial System since the Great Depression

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Nobody expected industrial capitalism to end up like this. Nobody even saw it evolving in this direction. I'm afraid this failing is not unusual among futurists: The natural tendency is to think about how economies can best grow and evolve, not how it can be untracked. But an unforeseen road always seems to appear, and there goes society goes off on a tangent.

What a two weeks!

On Sunday, September 7, the Treasury took on the $5.3 trillion mortgage exposure of Fannie Mae and Freddie Mac, whose heads already had been removed for accounting fraud.

On Monday, September 15, Lehman Brothers went bankrupt, when prospective Wall Street buyers couldn't gain any sense of reality from its financial books. On Wednesday the Federal Reserve agreed to make good for at least $85 billion in the just-pretend "insured" winnings owed to financial gamblers who bet on computer-driven trades in junk mortgages and bought counter-party coverage from the A.I.G. (the American International Group, whose head Maurice Greenberg already had been removed a few years back for accounting fraud).

But it is Friday, September 19, that will go down as a turning point in American history. The White House committed at least half a trillion dollars more to re-inflate real estate prices in an attempt to support the market value junk mortgages – mortgages issued far beyond the ability of debtors to pay and far above the going market price of the collateral being pledged.

These billions of dollars were devoted to keeping a dream alive – the accounting fictions written down by companies that had entered an unreal world based on false accounting that nearly everyone in the financial sector knew to be fake. But they played along with buying and selling packaged mortgage junk because that was where the money was. As Charles Prince of Citibank put it, "As long as they're playing music, you have to get up and dance." Even after markets collapsed, fund managers who steered clear were blamed for not playing the game while it was going. I have friends on Wall Street who were fired for not matching the returns that their compatriots were making. And the biggest returns were to be made in trading in the economy's largest financial asset – mortgage debt. The mortgages packaged, owned or guaranteed by Fannie and Freddie alone exceeded the entire U.S. national debt – the cumulative deficits run up by the American Government since the nation won the Revolutionary War!

This gives an idea of just how large the bailout has been – and where the government's (or at least the Republicans') priorities lie! Instead of waking up the economy to reality, the government has thrown all its resources to promote the unreal dream that debts can be paid – if not by the debtors themselves, then by the government – "taxpayers," as the euphemism goes.

Overnight, the U.S. Treasury and Federal Reserve have radically changed the character of American capitalism. It is nothing less than a coup d'Etat for the class that FDR called "banksters." What has happened in the past two weeks threatens to change the coming century – irreversibly, if they can get away with it. This is the largest and most inequitable transfer of wealth since the land giveaways to the railroad barons during the Civil War era.

Even so, there seems little sign that it even may end the free-market patter talk by financial insiders who have managed to avert public oversight by appointing non-regulators to the major regulatory agencies – and thus created the mess that Treasury Secretary Henry Paulson now says threatens the bank deposits and jobs of all Americans. What he really means, of course, are simply the largest Republican campaign contributors (and to be fair, also the largest contributors to Democratic candidates on key financial committees).

A kleptocratic class has taken over the economy to replace industrial capitalism. Franklin Roosevelt's term "banksters" says it all in a nutshell. The economy has been captured – by an alien power, but not the usual suspects. Not socialism, workers or "big government," nor by industrial monopolists or even by the great banking families. Certainly not by Freemasons and Illuminati. (It would be wonderful if there were indeed some group operating with centuries of wisdom behind them, so at least someone at least had a plan.) Rather, the banksters have made a compact with an alien power -not Communists, Russians, Asians or Arabs. Not humans at all. The group's cadre is a new breed of machine. It may sound like the Terminator movies, but computerized Machines have indeed taken over the world – at least, the White House's world.

Here is how they did it. A.I.G. wrote insurance policies of all sorts of that people and businesses need: home and property insurance, livestock insurance, even aircraft leasing. These highly profitable businesses were not the problem. (They therefore will probably be sold off to pay the company's bad gambles.) A.I.G.'s downfall came from the $450 billion – almost half a trillion – dollars it was on the hook for as a result of guaranteeing hedge-fund counterparty insurance. In other words, if two parties played the zero-sum game of betting against each other as to whether the dollar would rise or fall against sterling or the euro, or if they insured a mortgage portfolio of junk mortgages to make sure that they would get paid, they would pay a teeny tiny commission to A.I.G. for a policy promising to pay if, say, the $11 trillion U.S. mortgage market should "stumble" or if losers placing trillions of dollars in bets on foreign exchange derivatives, stock or bond derivatives should somehow find themselves in a position that so many Las Vegas patrons are in, and be unable to come up with the cash to cover their losses.

A.I.G. collected billions of dollars on such policies. And thanks to the fact that insurance companies are a Milton Friedman paradise – not regulated by the Federal Reserve or any other nation-wide agency, and hence able to get the proverbial free lunch without government oversight – writing such policies was done by computer printouts, and the company collected massive fees and commissions without putting in much capital of its own. This is what is called "self-regulation." It is how the Invisible Hand is supposed to work.

It turned out, inevitably, that some of the financial institutions that made billion-dollar gambles – usually in the form of a thousand million-dollar gambles in the course of a few minutes or so, to be precise – couldn't pay up. These gambles all occur in microseconds, at strokes of a keyboard almost without human interference. In that sense it is not unlike alien pod people taking over. But in this case they are robot-like machines, hence the analogy I drew above with the Terminators.

Their sudden rise to dominance is as unforeseen as an invasion from Mars. The nearest analogy is the invasion of the Harvard Boys, World Bank and U.S.A.I.D. to Russia and other post-Soviet economies after the Soviet Union was dissolved, pressing free-market giveaways to create national kleptocracies. It should be a worrying sign to Americans that these kleptocrats have become the Founding Fortunes of their respective countries. We should bear in mind Aristotle's observation that democracy is the political stage immediately preceding oligarchy.

The financial machines that placed the trades that bankrupted A.I.G. were programmed by financial managers to act with the speed of light in conducting electronic trades often lasting only a few seconds each, millions of times a day. Only a machine could calculate mathematical probabilities factored in regarding the squiggles up and down of interest rates, exchange rates and stock and bonds prices – and prices for packaged mortgages. And the latter packages increasingly took the form of junk mortgages, pretending to be payable debts but in reality empty flak.

The machines employed by hedge funds in particular have given a new meaning to Casino Capitalism. That was long applied to speculators playing the stock market. It meant making cross bets, lose some and win some – and getting the government to bail out the non-payers. The twist in the past two weeks' turmoil is that the winners cannot collect on their bets unless the government pays the debts that the losers are unable to cover with their own money.

One would have thought that this requires some degree of control over the government. The activity probably never should have been licensed. In fact, it never was licensed, and hence nor regulated. But there seemed to be a good reason: Investors in hedge funds had to sign a paper saying that they were rich enough to afford to lose their money on this financial gambling. Your average mom and pop investors were not permitted to participate. Despite the high rewards that millions of tiny trades generated, they were deemed too risky for the uninitiated lacking trust funds to play with.

A hedge fund does not make money by producing goods and services. It does not advance funds to buy real assets or even lend money. It borrows huge sums to leverage its bet with nearly free credit. Its managers are not industrial engineers but mathematicians who program computers to make cross-bets or "straddles" on which way interest rates, currency exchange rates, stock or bond prices may move – or the prices for packaged bank mortgages. The packaged loans may be sound or they may be junk. It doesn't matter. All that matters is making money in a marketplace where most trades last only a few seconds. What creates the gains is the price fibrillation – volatility.

This kind of transaction may make fortunes, but it is not "wealth creation" in the form that most people recognize. Before the Black-Scholes mathematical formula for calculating the value of hedge bets, this kind of put and call option was too costly to provide much profit to anyone except the brokerage houses. But the combination of powerful computers and the "innovation" of almost free credit and free access to the financial gambling tables has made possible a frenetic back-and-forth maneuvering.

So why has the Treasury found it necessary to enter this picture at all? Why should these gamblers be bailed out, if they had enough to lose without having to become public wards by going on welfare? Hedge fund trading was limited to the very rich, for investment banks and other institutional investors. But it became one of the easiest ways to make money, loaning funds at interest for people to pay out of their computer-driven cross-trades. And almost as fast as it was made, this revenue was paid out in commissions, salaries and annual bonuses reminiscent of America's Gilded Age in the years prior to World War I – years before the income tax was introduced in 1913. The remarkable thing about all this money was that its recipients didn't even have to pay normal income tax on it. The government let them call it "capital gains," which meant that the money was taxed at only a fraction of the rate that incomes were taxed.

The pretense, of course, is that all this frenetic trading creates real "capital." It certainly does not do so in the classical 19th-century concept of capital. The term has been decoupled from producing goods and services, hiring wage labor or from financing innovation. It is as much "capital" as the right to conduct a lottery and collect the winnings from the hopes of the losers. But then, casinos from Las Vegas to riverboats have become a major "growth industry," muddying the language of capital, growth and wealth itself.

For the gaming tables to be closed and the money paid out, the losers must be bailed out – Fannie Mae, Freddie Mac, A.I.G. and who knows what to come? This is the only way to solve the problem of how companies that already have paid out their revenue to their managers and stockholders instead of putting it in reserves are to collect their winnings from insolvent debtors and insurance companies. These losers also have paid out their income to their financial managers and insiders (along with the usual patriotic contributions to the political candidates on the key committees in charge of deciding the nation's financial structuring).

This has to be orchestrated well in advance. It is necessary to buy politicians and give them a plausible cover story (or at least a well-crafted set of poll-tested euphemisms) to explain to voters just why it was in the public interest to bail out gamblers. Good rhetoric is needed to explain why the government should let them go into a casino and let them keep all their winnings while using public funds to make good on the losses of their counterparties.

What happened on September 18-19 took years of preparation, capped by a faux ideology crafted by public-relations think tanks to be broadcast under emergency conditions to panic Congress – and voters – right before the presidential election. This seems to be our September election surprise. Under staged crisis conditions, Pres. Bush and Treasury Secretary Paulson are now calling for the country to come together in a War on Defaulting Homeowners. This is said to be the only hope to "save the system." (What system is this? Not industrial capitalism, or even banking as we know it.) The largest transformation of America's financial system since the Great Depression has been compressed into just two weeks, starting with the doubling of America's national debt on September 7 with the nationalization of Fannie Mae and Freddie Mac. (My computer's spellchecker will not permit me to use the euphemism "conservatorship" that Mr. Paulson applied to bailing out the Fannie Mae and Freddie Mac fraudsters.)

Economic theory used to explain that profits and interest were a return for calculated risk. But today, the name of the game is capital gains and computerized gambling on the direction of interest rates, foreign currencies and stock prices – and when bad bets are made, bailouts are the calculated economic return for campaign contributions. But this is not supposed to be the time to talk of such things. “We must act now to protect our nation’s economic health from serious risk,” intoned Pres. Bush on September 19. What he meant was that the White House must make the Republican Party’s largest group of campaign contributors whole – Wall Street, that is – by bailing out their bad gambles. “There will be ample opportunity to debate the origins of this problem. Now is the time to solve it.” In other words, don’t make this an election issue. “In our nation’s history there have been moments that require us to come together across party lines to address major challenges. This is such a moment.” Right before the presidential election! The same guff was heard earlier on Friday morning from Sec. Paulson: “Our economic health requires that we work together for prompt, bipartisan action.” The broadcasters said that half a trillion dollars was discussed for this day’s maneuverings.

Much of the blame should go to the Clinton Administration for leading the call to repeal Glass-Steagall in 1999, letting the banks merge with casinos. Or rather, the casinos have absorbed the banks. That is what has put the savings of Americans at risk.

But does this really mean that the only solution is to re-inflate the real estate market? The Paulson-Bernanke plan is to enable the banks to sell off the homes of five million home mortgage debtors faced with default or foreclosure this year! Homeowners with “exploding adjustable-rate mortgages” will lose their homes, but the Fed will pump enough credit into the mortgage-lending agencies to enable new buyers to go deeply enough into debt to take the junk mortgages off the hands of the gamblers who presently own them. Time for another financial and real estate bubble to bail out the junk mortgage lenders and packagers.

America has entered into a new war – a War to Save Computerized Derivative Traders. Like the Iraq war, it is based largely on fictions and entered into under seeming emergency conditions – to which the solution has little relation to the underlying cause of the problems. On financial security grounds the government is to make good on the collateralized debt obligations packaged (CDOs) that Warren Buffett has called “weapons of mass financial destruction.”

Hardly by surprise, this giveaway of public money is being handled by the same group that warned the country so piously about weapons of mass destruction in Iraq. Pres. Bush and Treasury Secretary Paulson have piously announced that this is no time for partisan disagreements over this shift of public policy to favor creditors rather than debtors. There is no time to make the biggest bailout in election history an election issue. Not an appropriate time to debate whether it is a good thing to re-inflate housing prices to a level that will continue to oblige new home buyers to go so deeply into debt that they must pay some 40 percent of their take-home pay on housing.

Remember when President Bush and Alan Greenspan informed the American people that there was no money left to pay Social Security (not to mention Medicare) because at some future date (a decade from now? 20 years? 40 years?) the system might run a deficit of what now seems to be merely a trivial trillion dollars spread over many, many years. The moral was that if we can’t figure out how to pay, let’s plow the program under right now.

Mr. Bush and Greenspan did have a helpful solution, of course. The Treasury could turn Social Security and medical insurance money over to Bear Stearns, Lehman Brothers and their brethren to invest at the “magic of compound interest.”

What would have happened to U.S. Social Security had this been done? Perhaps we should view the past two weeks' events as having assigned to Wall Street gamblers all the money that has been set aside since the Greenspan Commission in 1983 shifted the tax burden onto FICA wage withholding. It is not retirees who are being rescued, but the Wall Street investors who signed papers saying that they could afford to lose their money. The Republican slogan this November should be "Gambling insurance, not health insurance."

This is not how the much-vaunted Road to Serfdom was mapped out to be. Frederick Hayek and his Chicago Boys insisted that serfdom would come from government planning and regulation. This view turned upside down the classical and Progressive Era reformers who depicted government as acting as society's brain, its steering mechanism to shape markets – and free them from income without playing a necessary role in production.

The theory of democracy rested on the assumption that voters would act in their self-interest. Market reformers made a kindred happy assumption that consumers, savers and investors would promote economic growth by acting with full knowledge and understanding of the dynamics at work. But the Invisible Hand turned out to be accounting fraud, junk mortgage lending, insider dealing and a failure to relate the soaring debt overhead to the ability of debtors to pay – all of this mess seemingly legitimized by computerized trading models, and now blessed by the Treasury.

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