Obama, like Bush, is Throwing Public Money into a Black Hole

By Prof Rodrigue Tremblay
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> "The [financial] crisis was not a failure of the free market system and the answer is not to try to reinvent that system. …Government intervention is not a cure-all." President George W. Bush, Thursday November 13, 2008
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> "There is no cause to worry. The high tide of prosperity will continue." Andrew W. Mellon, Hoover's Secretary of the Treasury. September 1929
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> "While the crash only took place six months ago, I am convinced we have now passed the worst and with continued unity of effort we shall rapidly recover. There is one certainty of the future of a people of the resources, intelligence and character of the people of the United States – that is, prosperity." President Herbert Hoover, May 1, 1930

Tuesday, February 10, may be the date when the U.S. economy officially entered into an economic depression. This was when President Obama's Treasury Secretary, Timothy Geithner, announced that the Obama administration was about to expand Bush's Secretary Paulson's $700-billion plan to rescue large U.S. banks from insolvency, euphemistically called the **Troubled Assets Relief Program (TARP).** The purpose now, as it was previously, is to use public capital, loans and guarantees to remove toxic financial assets from private banks' balance sheets and to transfer them to the Government and/or to willing private investors (hedge funds, private equity firms and other investors). One must keep in mind that Mr. Paulson and Mr. Geithner were the principal architects of last October's original plan. This was then, and it is now, a plan designed primarily to use hundreds of billions of taxpayer dollars to prevent banks from declaring bankruptcy, while in fact doing little to accomplish its presumed primary objective of getting banks to resume normal lending. Such a cure has failed in the past and is likely to fail now. Saving insolvent banks is not the same as fixing them and making them viable.

Indeed, when Mr. Geithner announced on Tuesday, February 10, that he was expanding the Paulson plan to make it a $1.5 trillion bailout plan, financial markets saw it as simply rearranging the chairs on the deck of the Titanic, and they sold off. I believe the markets are right and the Obama-Geithner plan only makes the Bush-Paulsen plan worse. Both are misguided and do little to address the root cause of the financial crisis, which is a mountain of unsustainable bad debts that was allowed to expand recklessly over the last ten years, and which is now crumbling down, dragging the entire economy down with it.

With more public money thrown at the problem with little strings attached, large U.S. banks will only use the new cash to de-leverage themselves and pay off their debts, buyout smaller banks and find a way to reward their incompetent executives with large bonuses, but little will trickle down to the real economy. We are back to the discredited Reagan era's **economic trickle-down theory**, the rich helping themselves first and the poor getting the crumbs.

Let's look coldly at the situation. The ratio of total debt to the U.S. Gross Domestic Product (GDP) is now higher than it was in 1933, when it reached the lofty and unsustainable level of 299.8 percent. It took nearly twenty years to bring down the debt/GDP ratio to below 140 in 1952. In the second quarter of 2008, all debt records were broken when the total debt ratio in the U.S. registered at 356,7 percent of GDP. If the same process of unwinding of excessive debt level plays itself out this time, this could translate into a debt deflation process lasting possibly until 2027!

It all depends on the problem being recognized for what it is, that is to say a mountain of unsustainable and insolvable debts and bets that have to be cancelled and erased from the books. Transferring such bad debts from the banks and other entities to the government will not solve the problem. It will only displace the it from one place to another and potentially create new and even more serious problems, such as horrendous future tax increases or an onset of **hyperinflation** down the road.

There exists a state of denial in Washington D.C. regarding the excessive debt problem, essentially because the same people who are responsible for creating the mess are in power. It doesn't matter whether a Republican or a Democratic administration is in place, they remain in charge and they rely on the same failed economic policies. The Geithner plan is the son of the Paulson plan. Both are destined to fail because they are based on a flawed diagnosis.

To deflate the mountain of bad debts and unclog the credit system in an orderly fashion, and to prevent a deflationary spiral from taking hold, the Obama administration should take the advice of **L. William Seidman**, chairman of the **S&L Resolution Trust Corp. (RTC),** the agency created in the 1990s to manage hundreds of insolvent thrifts. At that time, the RTC seized the assets of troubled savings and loans and resold them to bargain-seeking investors. The Obama administration should bite the bullet and create a similar Banking Restructuring Trust to temporarily take over the large insolvent American banks, streamline their operations, liquidate their bad debts and bets, and reorganize them on a firmer financial basis. I myself proposed such a restructuring trust **last September**. This would be more efficient and less costly than throwing trillions of dollars down a black hole without even solving the structural problem at hand.

The creation of such a Trust to unify government intervention has also been proposed by former Federal Reserve Chairman Paul A. Volcker and by former Treasury Secretary Nicholas F. Brady. This would entail, of course, that many of the banks' illiquid assets in CDOs ("Collateralized Debt Obligations") and in CDS ("Credit Default Swaps") and other shaky assets, would have to be written off or cancelled in a chapter 11-like process. Such a process would cleanse the banks from the excesses accumulated in previous years and prepare them to meet credit demand as the economy recovers. But, above all, it would mark an end to incremental, complicated and improvised 'ad hoc' government interventions to solve the banking crisis. I would bet that there would be a powerful rally of financial markets if such a take-charge and decisive approach were to be adopted.

The Geithner bank bailout plan must not be confused with the $800 billion-plus **fiscal**

stimulus plan for the entire economy that **Congress** is about to adopt. The latter, contrary to the former, is designed to cushion the fall of real spending in the economy and is likely to have a net positive impact. Indeed, as households increase their savings rate and curtail their **discretionary spending** to compensate for the loss of housing and financial wealth, government spending has to take up the slack.

However, it should be realized that the multiplier effect on aggregate spending of each dollar of fresh public spending is not very high because national economies nowadays are globalized. Indeed, as domestic spending is being sustained, imports increase but exports may decline as world demand contracts. It is only if all governments adopt expansionary fiscal policies that all economic boats can be lifted. With European and Chinese economies weakening, this may take some time before world demand stops contracting.

All this is to say that while the Geithner bank rescue plan is misguided and should be reengineered, Obama's fiscal stimulus package is most likely too timid and should be enlarged, considering the scope of the problem at hand. All in all, let us hope that a prolonged economic depression can be avoided

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/

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