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Obama's Junk Economics: Democrats Relinquish the Populist Option to the Republicans

By Prof Michael Hudson
Global Research, February 01, 2010
1 February 2010

Region: USA
Theme: Global Economy

In a dress rehearsal for this November's mid-term election, Democrats and Republicans vied last week for who could denounce the banks and blame the other party the most for the giveaways to Wall Street that have swollen the public debt since September 2008, pushing the federal budget into deficit and the economy into a slump.

The Republicans are winning the populist war. On the weekend before his State of the Union address on Wednesday, Mr. Obama strong-armed Democratic senators to re-appoint Ben Bernanke as Federal Reserve Chairman. His Wednesday speech did not mention this act (happily applauded by Wall Street). The President sought to defuse voter opposition by acknowledging that nobody likes the banks. But he claimed that unemployment would be much higher if they hadn't been bailed out. So the giveaway of public funds was all for the workers. The $13 trillion that has created a new power elite was just an incidental byproduct. Unpleasant, perhaps, as American democracy slips into oligarchy. But all for the people. The least bad option. It had to be done. People might not like it, but Main Street simply cannot prosper without creating hundreds of Wall Street billionaires – without enabling them to increase their bonuses and capital gains as bank stock prices quadruple. It's all to get credit flowing again (at 30% for credit card users, to be sure).

So the rest of us must wait for wealth to trickle down. The cover story is that this is how the world works, like it or not. At least this is the argument of the lobbyists who are drafting and censoring laws and signing off on just who is acceptable to run the Federal Reserve, Treasury and other public-subsidy agencies. The working assumption is that the economy cannot recover without enriching Wall Street.

This is the Administration's tragic flaw. What the economy needs is to recover from the Bush-Obama supposed cure, i.e., from the mushrooming debt overhead. It needs to recover from the enrichment of Wall Street. It doesn't need more credit, but a write-down for the unpayably high debts that the banks have imposed on American families, businesses, states and localities, real estate, and the federal government itself.

Instead of helping debtors, Mr. Obama has moved to heal the creditors, making them whole at public expense. If debtors cannot pay, the Treasury and Fed will take their IOUs and bad casino gambles onto the public sector's balance sheet. The financial winners must come first – and it seems second and third, too. The rationale is that unless the government gives the large financial institutions what they want and saves them from taking a loss, their "incentive" to protect the economy from devastation will be gone.

Knuckling under to this protection racket is not the change that most people voted for in

November 2008. So on Thursday afternoon, most Republican senators opposed a second four-year term for Bernanke. By leading the effort to re-confirm him, the Corporate Democrats (but not most of their colleagues who had to face voters this autumn) removed this albatross from the Republican neck and put it around their own.

For starters, Chairman Bernanke has convinced the President that the Fed should be the single regulator of Wall Street – ideologically kindred, and drawn from its ranks, or with its assent. Mr. Obama's address made no reference to the Consumer Financial Products Agency he promised a year ago to be the centerpiece of financial reform. Its main sponsor, Elizabeth Warren, has been warning that hopes for reform are being overwhelmed by financial lobbyists arguing that truth-in-lending laws and anti-usury regulations threaten to reduce bank profits, forcing lenders to raise costs to consumers. In Mr. Bernanke's world, regulations to protect consumers simply will oblige the banks to pass on the cost increase caused by this "government interference." The more regulation there is, the more consumers will have to pay.

This is the inside-out picture drawn by bank lobbyists and purveyed by Mr. Obama's economic team. Could George Bush have gotten away with it? Democrats have a friendlier and more compassionate face, but the substance remains the same.

Most economists believe that Mr. Obama is whistling in the dark when he says the economy will recover this year under Chairman Bernanke's guidance. The financial screws are being tightened, yet the Fed refuses to abide by its charter and regulate credit card rates going through the roof. Instead of countercyclical federal spending to rescue the economy from debt deflation, Mr. Obama says that since we have given so much to Wall Street in the past year and a half, little is left to spend on the "real" economy. Sounding like a Republican in Democratic clothing not unlike his Senate mentor Joe Lieberman, his State of the Union speech urged creation of a bipartisan (that is, Republican-friendly) working group to agree on how to lower the deficit. The President proposes that starting next year Congress should freeze spending not already committed under entitlement programs.

Testifying Wednesday morning as a run-up to Pres. Obama's evening speech, Messrs. Geithner and Paulson at least avoided the Washington ploy of emulating Alzheimer's patients and saying that they couldn't recall anything about their giveaways. Sophisticated enough to outplay their questioners in verbal tennis, the past and present Treasury Secretaries brazened it out. Using the Plausible Deniability defense, they claimed that they weren't even in the loop when it came to paying AIG enough to turn around and pay Goldman Sachs and other arbitrageurs 100 cents on the dollar for securities worth about a fifth as much. It was all done by their subordinates. Their underlings did it. "This was a Federal Reserve loan," Mr. Paulson explained. "They had the authority. They had the technical expertise … and I was working on many other things which were in my bailiwick."[1] And in any case an AIG bankruptcy "would have buckled our financial system and wrought economic havoc." Unemployment, he warned, "could have risen to 25%." The Fed had to protect people.

When there was no way to dodge, they frankly admitted what had happened, providing helpful pieties to the effect that it is the job of Congress to change the law to make sure nothing like this happens again. Yes, there was a big giveaway, but we saved the economy. Wall Street's loss would have been the peoples' loss. Certainly we need new rules to protect the taxpayer, blah, blah, blah. We're all in the same boat. If the banks took a loss, they would have to raise the price of financial services and we would all have had to pay more.

Thank heavens that everything is getting back to normal now.

“A lot of people think the president of the New York Fed works for the government,” Democrat Marcy Kaptur of Ohio concluded, “but in fact he works for the banks on the board that elected you.”[2] Not so, testified New York Federal Reserve general counsel Thomas Baxter. “A.I.G. wanted to keep the information confidential, for fear that it would lose business if customers were named.” And if it lost business, “This would have had the effect of harming the taxpayers’ investment in A.I.G.” So it was all to save the taxpayers money that the Fed spent $185 billion of their money.

But was it really necessary not to let A.I.G. go bankrupt in September of 2008? The Wall Street Journal’s editorial page blew the whistle on how the government’s wheeler-dealer insiders have been changing their story again and again – not usually a sign of truthfulness. “Secretary of the Treasury Timothy Geithner and predecessor Hank Paulson said they didn’t bail out AIG to save its derivatives counterparties” from bad credit default swap contracts because if it would have asked these counterparties to “take a haircut,” credit-ratings agencies would have downgraded AIG. A lower rating would have obliged it to post even more collateral on its other swap contracts, presumably because of the higher risk.

There are a number of problems with this story, the editorial explained. First of all, Goldman Sachs and other counterparties unilaterally said the prices had declined for securities that had no market price at all, only subjective valuations. A.I.G. would have been reasonable in disputing this. In any event, as the firm’s new 80% stockholder, the U.S. Government said it would stand behind AIG. This should have removed fears of non-payment. But most important of all was the claim by Messrs. Paulson and Geithner that failure to “honor” AIG’s swaps would have threatened its far-flung insurance businesses on which so many American consumers depended. New York Insurance Superintendent Eric Dinallo, who was AIG’s principal insurance regulator at the time, testified before the Senate last year that these operations were not threatened at all! “‘The main reason why the federal government decided to rescue AIG was not because of its insurance companies.’ He was so confident in the health of the AIG subsidiaries that, before the federal bailout, he was working on a plan to transfer $20 billion of their excess reserves to the parent company.”[3]

This directly contradicts Mr. Geithner’s claim “that the ‘people responsible’ for overseeing the insurance subsidiaries ‘had no idea’ about the risks facing AIG policyholders. He’s talking about Mr. Dinallo here. Instead of being safely segregated, Mr. Geithner said the insurance businesses were ‘tightly connected’ to the parent company. Mr. Paulson added that the healthy parts of AIG had been ‘infected’ by the ‘toxic assets.’ He added, ‘One part of the company would have contaminated the other.’” Does this mean that New York’s “heavy state insurance regulation was a sham,” the newspaper asked? It would seem that “When push came to shove, policyholders were not protected from a default by the parent company.” It urges that Mr. Dinallo be brought back to straighten the matter out.

Mr. Geithner closed his own comments by saying, “if you are outraged by what happened with A.I.G., then you should be deeply committed to financial reform.”[4] This is rhetorical judo. The financial system in question is not the economy at large. It was A.I.G.’s carefully segregated bookies’ account for wealthy hedge fund gambles and Wall Street speculations that should have had little to do with the “real” economy at all.

Wall Street – and most business schools – promote the myth that the “real” economy of production and consumption cannot function without making Wall Street's insiders immensely rich. Emulating Louis XIV, Wall Street's spokesmen explain, "L'economie, c'est nous." There seems nothing to be done about banks impoverishing people by extortionate credit card rates, junk securities and a debt burden so heavy that it will require one bailout after another over the next few years. Present policy is based on the assumption that the U.S. economy will crash if we don't keep the debt overhead growing at past exponential rates. It is credit – that is, debt – that is supposed to pull real estate out of its present negative equity. Credit – that is, debt leveraging – that is supposed to raise stock market prices to enable pension funds to meet their scheduled payments. And it is credit – that is, debt –is supposed to be the key to employment growth.

Credit means giving Wall Street what it wants. Regulating it is supposed to interfere with prosperity. Truth-in-lending, for example, will increase the "cost of production" by "making" banks charge consumers even more for creating credit on their computer keyboards.

This Stockholm syndrome when it comes to Wall Street's power-grab is junk economics. Wall Street is not "the economy." It is a superstructure of credit and money management privileges positioned to extract as much as it can, while threatening to close down the economy if it does not get its way. High finance holds the economy hostage not only economically but also intellectually at least to the extent of having captured Mr. Obama's brain – and also the federal budget, as money paid to Wall Street has crowded out spending on economic recovery. It has re-defined "reform" to mean putting Wall Street even more in power by making the Fed the sole regulator of Wall Street. Under these conditions, saving "the system" means saving a mess. It means saving a debt dynamic that must grow exponentially at the economy's expense, absorbing more and more federal bailout funds and hence crowding out the spending needed to revive the economy.

Mr. Paulson's testimony echoed the idea that the rescue of A.I.G. was necessary to keep the economy from collapsing. "We would have seen a complete collapse of our financial system," Mr. Paulson said, "and unemployment easily could have risen to the 25 percent level reached in the Great Depression." So it was all for the working class, for employees and consumers. It was done to save the government – a.k.a. "taxpayers" – from losing money on its investment. It was to save the economy from breaking down – or perhaps to pay off protection-racket money to Wall Street not to wreck the economy. And as we all know, taxpayers today are mainly the lower-income individuals unable to take their revenue in the form of low-taxed "capital gains" like Wall Street traders, in today's fiscal war between finance and labor.

It seems to be merely an incidental by-product of saving taxpayers and labor that Wall Street ended up with the hundreds of billions of dollars of gains (and losses avoided) – at a $13 trillion expense of government and of about four million jobs in the overall economy whose employment is shrinking, and about four million home foreclosures in 2009-10. The cover story is that matters would have been worse otherwise. This was the price for "saving the system." But "the system" turns out to be the Bubble Economy, in which the Obama administration has put as much faith as Bush did. This is why the same managers have been kept in place. This policy has enabled Republicans to strike a posture of denouncing the banks in preparation for this November's mid-term election.

"Saving the economy" has become a euphemism for the policy of keeping bad debts on the books and saving high finance from writing them down to reflect the realistic ability to pay. Wall Street has used its bailout money to lobby Washington, back its political nominees to hold Congress hostage, and blame the downturn on any regulator or president who does not yield to its demands.

The resulting program is not saving the economy; it is sacrificing it. What has been saved is the debt overhead – the wrong side of the balance sheet.

The reactionary political outlook

A bipartisan compact between Corporate Democrats and Republicans is not the change voters expected in November 2008. Confronted with the “Obama surprise” – an absence of change – the only option that many voters believe they have is to change the existing party. Republicans are setting their eyes on Pres. Obama’s former Senate seat in Illinois, Vice Pres. Biden’s seat in Baltimore, and Majority Leader Reid’s seat in Nevada. Losing these and other seats would create a political standoff giving Mr. Obama further excuse for not changing course.

This kind of standoff normally would enable a popular president to ask voters to elect a majority large enough to legislate the program he outlines. But instead of a program, Mr. Obama has simply appointed the leading Bush-era administrators and brought back the Clinton “Rubinomics” team from Wall Street. His spending freeze in a shrinking economy is a Republican program, his modest “stimulus package” is over, and he has dropped the Consumer Financial Products Agency under Wall Street pressure. So if we are to look at what the administration actually is doing, its program is simply a blank check to the Fed and Treasury (under Bush-era management) to revive Wall Street fortunes – in a nutshell, more Rubinomics.

Convergence between the two parties reflects the privatization of politics by political lobbying and campaign contributions. Getting paid back with fiscal favors, sell-offs and bailouts promises to increase in the wake of the recent Supreme Court “Frankenstein” decision that corporations are virtual people when it comes to freedom of speech and the purchase of media time.

The only countervailing power is that within the Republican Party a fringe of tea partiers threatens to run against more established candidates safely sold to special interests. The Democratic Party always has been a looser coalition, which may not hold together if the Rubinomics team continues to lock out non-Corporate Democrats. So a political realignment may be in the making. Financial and fiscal restructuring issues span left and right, progressive Democrats and populist Republicans. So far, their sentiments are reactive rather than being spelled out in a policy program. But there is a widening realization that the economy has painted itself into a financial corner.

What is needed is to explain to voters how financial and tax policies are symbiotic. The tax shift off finance, insurance and real estate (FIRE) onto labor and industry since 1980 has polarized the economy between a creditor class at the top of and an indebted “real” economy below. Unless this tax favoritism is reversed, more and more revenue will be diverted away from spending on consumption and investment to pay debt service and “financialize” the economy even more.

It is natural that the world’s most debt-ridden economies – Latvia and its Baltic and post-

Soviet neighbors, and Iceland – are the first to perceive the problem. They may be viewed as an object lesson for a dystopian future of debt peonage. New Europe's debt strains are threatening to break up the core euro-currency area (aggravated from within by the Greek, Spanish and Irish public debt problems). The British economy is likewise financialized, weakening sterling. And Europe lacks the U.S. financial safeguard that enables mortgage debtors here to walk away from properties that have fallen into negative equity. Insolvent homeowners in Europe face a lifetime of literal debt peonage to make the banks (even foreign banks, which dominate Central Europe's post-Soviet economies) whole on their bad debts as the continent's real estate prices are plunging even more steeply than those in the United States – some 70 percent in Iceland and Latvia.

The only silver lining I can see is that perception will spread that the financial sector is an intrusive dynamic subjecting the economy to debt deflation. But at present, lawmakers are acting as if the economy is an albatross around Wall Street's neck. ("How are we wealthy people to bear the cost of healing the sick and employing the masses?" the financial sector complains. "The cost is eating into our ability to create wealth.") Libertarians have warned that our economy is going down the Road to Serfdom. What they do not realize is that by fighting against government power to check financial hubris, they are paving the road for centralized financial planning by Wall Street. They have been tricked into leading the parade on behalf of the financial, insurance and real estate sector – down the road to debt peonage in a monopolized and polarized economy.

Notes

[1] Serena Ng and Michael R. Crittenden, "Geithner Defends Big AIG Payouts," *Wall Street Journal*, January 28, 2010.

http://online.wsj.com/article/SB10001424052748704094304575029050775285726.html

[2] Mary Williams Walsh, "Drawing Fire, Geithner Backs Rescue of A.I.G." *The New York Times*, January 28, 2010. http://www.nytimes.com/2010/01/28/business/28aig.html?scp=2&sq=Walsh,%20Geithner&st=cse

[3] "The Latest AIG Story," *Wall Street Journal* editorial, January 28, 2010.

[4] Mary Williams Walsh and Sewell Chan, "Under Fire, Geithner Says A.I.G. Rescue Was Essential," *The New York Times*, January 27, 2010. (http://www.nytimes.com/2010/01/28/business/28aig.html?pagewanted=2&hp)

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