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Parsing Mr. Paulson's Bailout Speech: The Unprecedented Giveaway of Financial Wealth

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Mr. Paulson¹s bailout speech on Monday, October 13 poses some fundamental economic questions: What is the impact on the economy at large of this autumn¹s unprecedented creation and giveaway of financial wealth to the wealthiest layer of the population? How long can the Treasury¹s bailout of Wall Street (but not the rest of the economy!) sustain a debt overhead that is growing exponentially? Is there any limit to the amount of U.S. Treasury debt that the government can create and turn over to its major political campaign contributors?

In times past, national debt typically was run up by borrowing money from private lenders and spent on goods and services. The tendency was to absorb loanable funds and bid up interest rates on the one hand, while spending led to inflationary price increases for goods and services. But the present giveaway is different. Instead of money being borrowed or spent, interest-yielding bonds are simply being printed and turned over to the banks and other financial institutions. The hope is that they will lend out more credit (which will become more debt on the part of their customers), lowering interest rates while the money is used to bid up asset prices real estate, stocks and bonds. Little commodity price inflation is expected from this behavior.

The main impact will be to reinforce the concentration of wealth in the hands of creditors (the wealthiest 10 percent of the population) rather than wiping out financial assets (and debts) through the bankruptcies that were occurring as a result of "market forces". Is it too much to say that we are seeing the end of economic democracy and the emergence of a financial oligarchy a self-serving class whose actions threaten to polarize society and, in the process, stifle economic growth and lead to the very bankruptcy that the bailout was supposed to prevent?

Everything that I have read in economic history leads me to believe that we are entering a nightmare transition era. The business cycle is essentially a financial cycle. Upswings tend to become economy-wide Ponzi schemes as banks and other creditors, savers and investors receive interest and plow it back into new loans, accruing yet more interest as debt levels rise. This is the "magic of compound interest" in a nutshell. No "real" economy in history has grown at a rate able to keep up with this financial dynamic. Indeed, payment of this interest by households and businesses leaves less to spend on goods and services, causing markets to shrink and investment and employment to be cut back.

Wearing blinders to avoid confronting any reality that would suggest that banks cannot make money *ad infinitum* by selling more and more credit – that is, indebting the non-financial economy more and more – government officials such as Treasury Secretary

Paulson or Federal Reserve Chairman Bernanke are professionally unable to acknowledge this problem, and it does not appear in most neoclassical or monetarist textbooks. But the underlying mathematics of compound interest are rediscovered in each generation, often prompted by the *force majeur* of financial crisis.

A generation ago, for instance, Hyman Minsky gained a following by describing what he aptly called the Ponzi stage of the business cycle. It was the phase in which debtors no longer were able to pay off their loans out of current income (as in Stage #1, where they earned enough to cover their interest and amortization charges), and indeed did not even earn enough to pay the interest charges (as in Stage #2), but had to borrow the money to pay the interest owed to their bankers and other creditors. In this Stage #3 the interest was simply added onto the debt, growing at a compound rate. It ends in a crash.

This was the flip side of the magic of compound interest – the belief that people can get rich by "putting money to work." Money doesn't really work, of course. When lent out, it *extracts* interest from the "real" production and consumption economy, that is, from the labor and industry that actually do the work. It is much like a tax, a monopoly rent levied by the financial sector. Yet this quasi-tax, this extractive financial rent (as Alfred Marshall explained over a century ago) is the dynamic that is supposed to enable corporate, state and local pension funds to pay for retirement simply out of stock market gains and bond investments – purely financially and hence at the expense of the economy at large whose employees are supposed to be gainers. This is the essence of "pension-fund capitalism," a Ponzi-scheme variant of finance capitalism. Unfortunately, it is grounded in purely mathematical relationships that have little grounding in the "real" economy in which families and companies produce and consume.

Mr. Paulson's bailout plan reflects a state of denial with regard to this dynamic. The debt overhead is self-aggravating, becoming less and less "solvable" and hence more of a quandary, that is, a problem with no visible solution. At least, no solution acceptable to Wall Street, and hence to Mr. Paulson and the Democratic and Republican congressional leaders. The banks and large swaths of the financial sector are broke from having made bad gambles in the belief that money could be made to "work" under conditions that shrink the underlying industrial economy and stifle wage gains, eroding the market for consumer goods. Debt deflation reduces sales and business activity in general, and hence corporate earnings. This depresses stock market and real estate prices, and hence the value of collateral pledged to back the economy's debt overhead. Negative equity leads to bankruptcy and foreclosures.

By increasing America's national debt from $5 trillion earlier this year to $13 trillion in almost a single swoop by taking on junk loans and other bad investments rather than letting them to under as traditionally has occurred in the "cleansing" culmination of business crashes ("cleansing" in the sense of clean slates for debts that cannot reasonably be paid), Mr. Paulson's bailout actions increase the interest payments that the government must pay out of taxes or by borrowing (ore printing) yet more money. Someone must pay for bad debts and junk loans that are not wiped off the books. The government is now to take on the roll of debt collector to "make a profit for taxpayers" by going around and kneecapping the economy – which of course is comprised primarily of the "taxpayers" ostensibly being helped.

It is a con game. Financial gains have soared since 1980, but banks and institutional investors have not used them to finance tangible capital formation. They simply have recycled their receipt of interest (and credit-card fees and penalties that often amount to as much as interest) into yet new loans, extracting yet more interest and so on. This financial extraction leaves less personal and business income to spend on consumer goods, capital goods and services. Sales shrink, causing defaults as the economy is less able to pay its stipulated interest charges.

This phenomenon of debt deflation has occurred throughout history, not only over the modern business cycle but for centuries at a time. The most self-destructive example of financial short-termism is the decline and fall of the Roman Empire into debt bondage and ultimately into a Dark Age. The political turning point was the violent takeover of the Senate by oligarchic creditors who murdered the debtor-oriented reformers led by the Gracchi brothers in 133 BC, picking up benches and using them as rams to push the reformers over the cliff on which the political assembly was located. A similar violent overthrow occurred in Sparta a century earlier when its kings Agis and Cleomenes sought to annul debts so as to reverse the city-state's economic polarization. The creditor oligarchy exiled and killed the kings, as Plutarch described in his *Parallel Lives of the Illustrious Greeks and Romans.* This used to be basic reading among educated people, but today these events have all but disappeared from most people's historical memory. A knowledge of the evolution of economic structures has been replaced by a mere series political personalities and military conquests.

The moral of ancient and modern history alike is that a critical point inevitably arrives at which economies either adopt hard creditor-oriented laws that impoverish the population and plunge downward socially and militarily, or save themselves by alleviating the debt burden. What is remarkable today is the almost total failure of political leaders to provide an alternative to Mr. Paulson's bailout of Wall Street from the Bear Stearns bankruptcy down through the government takeover of Fannie Mae and Freddie Mac to last week's giveaway to the banks. Nobody is even warning where this destructive decision is leading. Governments ostensibly representing "free market" philosophy are acting as the lender of last resort – not to households and business non-financial debtors, and not to wipe out the debt overhang in a Clean Slate, but to subsidize the excess of financial claims over and above the economy's ability to pay and the market value of assets pledged as collateral.

This attempt is necessarily in vain. No amount of money can sustain the exponential growth of debt, not to mention the freely created credit and mutual gambles on derivatives and other financial claims whose volume has exploded in recent years. The government is committed to "bailing out" banks and other creditors whose loans and swaps have gone bad. It remains in denial with regard to the debt deflation that must be imposed on the rest of the economy to "make good" on these financial trends.

Here's why the plan for the government to recover the money is whistling in the dark: It calls for banks to "earn their way out of debt" by selling more of their product – credit, that is, debt. Homeowners and other consumers, students and car buyers, credit card users and their employers – the "taxpayers" supposed to be helped – are to pay the repayment money to the banks, instead of using it to purchase goods and services. If they charge only 6% per year, they will extract $93 billion in interest charges – $42 billion to pay the Treasury for its $700 billion, and another $51 billion for the Federal Reserve's $850 billion in "cash for trash" loans.

If you are going to rob the government, I suppose the best strategy is simply to brazen it out. To listen to the mass media, there seemed no alternative but for Congress to ram the plan through just as Wall Street lobbyists had written i, to "save the market from imminent meltdown," refusing to hold hearings or take testimony from critics or listen to the hundreds of economists who have denounced the giveaway.

Hubris has reached a level of deception hardly seen since the 19th century's giveaways to the railroad barons. "We didn't want to be punitive," Mr. Paulson explained in a *Financial Times* interview, as if the only alternative was an enormous gift. Europe did not engage in any such giveaway, yet he claimed that England and other European countries forced his hand by bailing out their banks, and that the Treasury simply wanted to keep U.S. banks competitive. Wringing his hands melodramatically, he assured the public on Monday that "We regret having to take these actions." Banks went along with the pretense that the bailout was a worrisome socialist intrusion into the "free market," not a giveaway to Wall Street in the plan drawn up by their own industry lobbyists. "Today's actions are not what we ever wanted to do," Mr. Paulson went on, "but today's actions are what we must do to restore confidence to our financial system." The confidence in question was a classic exercise in disinformation – a well-crafted con game.

Mr. Paulson depicted the government's purchase of special non-voting stock as a European-style nationalization. But government's appointed public representatives to the boards of European banks being bailed out. This has not happened in America. Bank lobbyists are reported to have approached Treasury to express their worry that their shareholdings might be diluted. But the Treasury-Democratic Party plan invests $250 billion in government credit in *non-voting* shares. If a recipient of this credit goes broke, the government is left the end of the line behind other creditors. Its "shares" are not real loans, but "preferred stock." As Mr. Paulson explained on Monday: "Government owning a stake in any private U.S. company is objectionable to most Americans – me included." So the government's shares are not even real stock, but a special "non-voting" issue. The public stock investment will not even have voting power! So the government gets the worst of both worlds: Its "preferred stock" issue lacks the voting power that common stock has, while also lacking the standing for repayment in case of bankruptcy that bondholders enjoy. Instead of leading to more public oversight and regulation, the crisis thus has the opposite effect here: a capitulation to Wall Street, along lines that pave the ground for a much deeper debt crisis to come as the banks "earn their way out of debt" at the expense of the rest of the economy, which is receiving no debt relief!

Mr. Paulson shed the appropriate crocodile tears on behalf of homeowners and the middle class, whose interest he depicted as lying in ever-rising housing and stock market prices. "In recent weeks, the American people have felt the effects of a frozen financial system," he explained. "They have seen reduced values in their retirement and investment accounts. They have worried about meeting payrolls and they have worried about losing their jobs." He almost seemed about to use the timeworn widows and orphans cover story and beg Americans please not to unplug Granny from her life support system in the nursing home. We need to preserve the value of her stocks, and help everyone retire happily by restoring normal Wall Street financial engineering to make voters rich again.

European executives who steered their banks into the debt iceberg have been fired. England wiped out shareholders in Northern Rock last summer, and more recently Bradford and Bingley. But in America the culprits get to stay on. No bank stockholders are being wiped out here, despite the negative equity into which the worst risk-taking banks have fallen or the prosecutions brought against them for predatory lending, consumer fraud and related wrongdoing.

Government aid will be used to pay exorbitant salaries to the executives who drove these banks into insolvency. "Institutions that sell shares to the government will accept restrictions on executive compensation, including a clawback provision and a ban on golden parachutes," Mr. Paulson pretended – only to qualify it by saying that the rule would apply only "during the period that Treasury holds equity issued through this program." The executives can stay on and give themselves the usual retirement gifts after all, prompting Democratic Congressman Barney Frank complained about how weak the Treasury restrictions are. "Compensation experts say that the provisions, though politically prudent to appease public anger, will probably have little real impact on how financial executives are paid in coming years. They predict banks will simply pay higher taxes and will find other creative ways of paying their executives as they see fit. Some say there could even be a sudden surge in compensation as soon as the government program ends, in a few years, leading to eye-popping numbers down the road. … When Congress limited the tax deductibility of cash salaries to $1 million, for example, it simply led to an explosion in stock options used as compensation and even higher total payouts."

And speaking of stock options, the government shortchanged itself here too, despite its promises to ensure that it will shares in the gains when banks recover. Senator Schumer went so far as to assure voters that "under any capital injection plan that Treasury pursues, dividends must be eliminated, executive compensation must be constrained, and normal banking activities must be emphasized." This was mostly hot air. England and other countries have insisted that banks not pay dividends until the government is reimbursed. The idea is to avoid using public money to pay dividends to existing shareholders and continued exorbitant salaries to their mismanagers! But the terms of the U.S. bailout is made simply call for banks not *increase* their dividend payouts – a policy they most likely would follow in any case in view of their earnings crunch.

Mr. Schumer verged on the ridiculous when he proclaimed: "We must operate in the same way any significant investor operates in these situations – when Warren Buffett invested in Goldman Sachs and General Electric in recent weeks, he demanded strict, but not onerous terms. The government must be similarly protective of taxpayer interests." But Mr. Buffett obtained a much better deal for his $5 billion investment in Goldman Sachs, including warrants to buy its stock at a price below the going price when he helped rescue the company. Likewise in England, the government took stock ownership at low prices *before* the bailout, not at higher prices *after* it! But instead of exercising its warrants at the depressed prices where bank stocks stood at the time Mr. Paulson detailed the bailout terms, the U.S. Treasury would be able to exercise its warrants (equal to 15 percent of its investment) only at prices that were to be set *after* the banks had time to recover with the Treasury's aid. Existing stockholders thus will benefit more than the government – which is why bank stocks soared on news of the bailout's terms. So the government does not appear to be a good bargainer in the public interest. In fact, Mr. Paulson may be guilty of deliberate scuttling of the public interest that, as Treasury Secretary, he is supposed to defend.

Given his financial experience, Mr. Paulson had to know how deceptive his promise was in placing such emphasis on the government's stock options, the sweetener that has made so many executives fabulously wealthy: "taxpayers will not only own shares that should be paid back with a reasonable return, but also will receive warrants for common shares in participating institutions," he explained. But the "reasonable return" is only 5% annually, just above what the government typically has to pay, not a rate reflecting anything like what the "free market" now charges Wall Street firms with negative equity. The government's $250 billion in preferred stock will carry a dividend that rises to 9% after five years, with no limit on how long the loan may be outstanding.

All I can say is, Wow! If only homeowners could get a similar break: a reduction in *their* interest rate to just 5%, rising to a penalty rate of just 9% – without the heavy penalties and late fees that Countrywide/Bank of America charges! By contrast, German banks that receive a public rescue will pay "a fee of at least 2% annually of the amount guaranteed. The U.K. will charge 0.50% plus the cost of default insurance on a bank's debt." A British banker wrote to me that "the government offers 12% preference shares, and ordinary shares at an absolutely huge discount to asset value to provide the cash." But the U.S. Government agreed to exercise its stock options at the *post*-bailout price, not the price prior to rescue. It even gives up most of these options if the banks *do* repay the Treasury's loan. On the excuse of encouraging private Wall Street investors to replace government "ownership" and "intrusion" into the marketplace, banks can "cut in half the number of common shares the government will eventually be able to purchase. That can be done if a bank sells stock by the end of 2009, and raises at least as much cash as the government is investing."

These bailout terms suggest that what Wall Street wants is pretty much what colonialist Britain achieved for so many years in India and Africa: puppet leaders with an imperial political advisor, in America's case a Secretary of the Treasury and a vice-regent as head of the Federal Reserve System. But what the rest of the economy needs is a genuinely free leader able to impose better and more equitable laws to write down debt, not build it up and bail out more bad loans. Within the present administration itself, Sheila Bair, head of the Federal Deposit Insurance Corporation, complained in a *Wall Street Journal* interview that she didn't understand "Why there's been such a political focus on making sure we're not unduly helping borrowers but then we're providing all this massive assistance at the institutional level." She "described painstaking efforts made by lawmakers in crafting the federal Hope for Homeowners program to make sure it limited resale profits for borrowers who received affordable home loans," by giving the government a share of the rising sales price.

The imbalance between creditor demands and debtors' ability to pay is indeed the problem! Mr. Paulson claimed in his Monday address that he needed to get to the root of the economic problem. But in his view it is simply that the banks "are not positioned to lend as widely as is necessary to support our economy. Our goal is to see … that they can make more loans to businesses and consumers across the nation." As he explained in his *Financial Times* interview (cited above), "for the first time you have seen an action that is systematic, that is getting at the root causes" of the financial crisis. But his perspective is remarkably narrow-minded. It denies that the problem is debt above and beyond the ability of the economy at large to pay, and higher than the market price of property and assets pledged as collateral.

Creating a system for the banks to "earn their way out of debt" means creating yet more interest-bearing debt for the economy at large. Mortgage loans are what is supposed to restore high housing prices and office costs – precisely what caused the debt meltdown in the first place! Despite Mr. Paulson's and Ms. Bair's characterization of the present crisis as merely a liquidity problem, it is really a debt problem. The volume of real estate debt, auto debt, student loans, bank debt, pension debts by municipalities and states as well as private companies exceed their ability to pay.

Shortly after Mr. Paulson's Monday speech a Dutch economics professor, Dirk Bezemer, wrote me that: "In my thinking I liken it to a Ponzi game where in the final stages the only way to keep things going a bit longer is to pump in more liquidity. That is a solution in the sense that it restores calm, but only in the short run. This is what we now see happening and – despite the 10% stock market rally today – I am still bracing myself for the inevitable end of the Ponzi game – suddenly or as a long drawn out debt deflation." He went on to explain what he and other associates of mine have been saying for many years now: "The actual solution is to separate the Ponzi from the non-Ponzi economy and let the pain be suffered in the first part so as to salvage what we can from the second. This means bailing out homeowners but not investment banks, etc. The qualification to this general approach is that those Ponzi game players whose demise is a real 'system threat' need support, but only with punitive conditionalities attached. And just like Third World countries, they won't have a choice."

The situation has some similarities to global warming. Current U.S. presidential debates propose solving the ³oil problem² not so much by conservation as by extracting more oil from Alaska and along the U.S. seacoast to sustain rising domestic demand. The effect of this policy is to increase air pollution and hence global warming. In a similar fashion, the problem of ³debt pollution² is being ³solved² by creating yet more debt, not by reducing its volume.

Neither the Treasury nor Congress is helping to resolve this problem. The working assumption is that giving newly created government debt to the banks and Wall Street will lead to more lending to re-inflate the real estate and stock markets. But who will lend more to the one-sixth of U.S. homes already said to have fallen into negative equity territory? As debt deflation eats into the domestic market for goods and services, corporate sales and earnings will shrink, dragging down stock prices. Wall Street is in control, but its policies are so shortsighted that they are eroding the underlying economy which is passing from democracy to oligarchy, and indeed it seems to a bipartisan financial kleptocracy.
