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Paulson the Bungler

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Global Research, November 13, 2008
Information Clearinghouse 13 November 2008

Region: USA
Theme: Global Economy

Henry Paulson's time at Treasury has been one pratfall after another. Even so, on Tuesday he managed to out-due himself. Paulson held a "surprise" press conference where he announced that the $700 billion Troubled Asset Relief Program (TARP) wouldn't be used to buy troubled assets after all.

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Instead, the money will used to bail out insurance giant AIG, provide extra capital for the banks to hoard, and now (this is new part) give money to "nonbank financial institutions, like insurers and specialty-finance companies" so they can lend to credit-worthy consumers. (Isn't that why we gave money to the banks?)

Paulson's announcement was like tossing a hand-grenade in a San-i-can; it blew the stock market to Kingdom come. Just minutes after the opening bell on the New York Stock Exchange (NYSE) stocks plummeted to new lows ending the session in a 400 point death-spiral. Wall Street doesn't like uncertainty and Paulson's sudden about-face sent jittery investors running for cover. The message to investors is clear, the government doesn't have the foggiest idea of what it's doing and is just grasping at straws.

But Paulson's no fool; he knew exactly what the reaction would be on Wall Street. He simply decided that blowing up the equities market was worth the price of reviving "securitization"–the transformation of loans into securities. You see, securitization is Wall Street's Golden Goose. It's the foundation block upon which structured finance and all its complex credit-enhancing derivatives rests. Keep in mind, that all these exotic, financially-engineered products–the CDOs, MBS, and CDS–were all created with one goal in mind; to maximize leverage with minimum capital so that profits can be skimmed off the top. That's how Paulson managed to walk away from Goldman Sachs with hundreds of millions of dollars in his pockets. It's a racket.

There's a myth that credit is contracting because the banks won't lend. But, in truth, total bank credit expanded by $575 billion over the past 10 weeks. The real problem is that the securitzation market remains frozen.

So now Paulson wants to breathe new life into securitization by providing liquidity for nonbank financial institutions who get their money from the wholesale market. Of course, no one really knows how this will work since these operations are completely unregulated by the federal government. No worries; the charade will persist behind the dodgy claim that “it’s needed to get credit to the consumer”. Baloney. What the consumer needs job security and a pay-raise, not more debt. This is just more Paulson flim-flam.

It was clear that the Treasury Secretary was concocting a new swindle a couple weeks ago when Fed chief Bernanke defended “securitzation in a speech where he said:

> “The ability of financial intermediaries to sell the mortgages they originate into the broader capital market by means of the securitization process serves two important purposes: First, it provides originators much wider sources of funding than they could obtain through conventional sources, such as retail deposits; second, it substantially reduces the originator’s exposure to interest rate, credit, prepayment, and other risks associated with holding mortgages to maturity, thereby reducing the overall costs of providing mortgage credit.”
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> Nonsense. What it really does is create the optimal environment for speculative leveraging, debt-pyramiding and massive profit-taking. But, that’s beside the point. The real issue is that securitization is dead already because Paulson and his ilk poisoned the well by adding subprime garbage and Alt As to the mix. Now investors are steering clear of any securities that bundle debt. It’s a confidence issue.

According to the Wall Street Journal:

“Banks and other finance companies making loans for autos, credit cards and college tuition are having virtually no success in selling those loans to other investors, a potent sign of just how tight credit markets remain.

The market for selling such loans — by packaging, or securitizing, them into bonds — had just one $500 million deal for all of October, according to Barclays Capital. That compares with $50.7 billion worth of deals made one year earlier, according to market-research firm Dealogic. The overall market for so-called asset-backed securitization is estimated at $2.5 trillion. (Bond Woes Choke off some Credit to Consumers, Wall Street Journal, Robin Sidel)

$500 million is just 1 percent of $50 billion! Securitization will be dead for a decade or so; it was destroyed by lax lending standards and easy credit. Paulson and his fellows will have to find a new way to fleece gulible investors.

The TARP is most expensive boondoggle in history. No one even knows what the banks are doing with the money. There’s neither accountability nor transparency. As a result, investor confidence has deteriorated and stocks have continued to fall. No one trusts Paulson to do the right thing anymore; it’s that simple.

The Treasury’s new Financial Stability Oversight Board has met four times, but they still can’t say how the banks are using the money. It’s a joke. Congress has been missing in action, too. They promised to create their own oversight board, but five weeks have passed and still nothing has happened. Apparently, the idea throwing $700 billion down rathole isn’t enough to prod Ms. Pelosi and her congressional cohorts into action. All that really matters to them is getting reelected and nuzzling ever-closer to the public trough.

The TARP fiasco is not taking place in a vacuum either; the country is at the beginning of the deepest consumer-led recession in the last half century. Retail spending and automobile sales have been following the same grim flightpath as housing, while unemployment is at a 7 year high soaring to nearly 4 million. Household debt is at record levels of $14 trillion. The job market is steadily weakening while the consumer is more vulnerable than ever. Meanwhile, Paulson has dragged his feet on rewriting mortgages to slow foreclosures, stalled on providing another stimulus package, and diverted all the money from the $700 billion bailout to his friends in the financial industry. Not one dime has gone to a working man or woman. Paulson continues to play games while Rome burns even though, according to his colleague, former G-Sax chairman John Whitehead, the current downturn will be worse than the Great Depression.

According to Reuters:

> "The economy faces a slump deeper than the Great Depression and a growing deficit threatens the credit of the United States itself, former Goldman Sachs chairman John Whitehead …
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> "I think it would be worse than the depression," Whitehead said. "We're talking about reducing the credit of the United States of America, which is the backbone of the economic system. … I see nothing but large increases in the deficit, all of which are serving to decrease the credit standing of America. … I just want to get people thinking about this, and to realize this is a road to disaster. I've always been a positive person and optimistic, but I don't see a solution here."

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There is no solution. The first thing to realize is that it is not a matter of "fixing" the economy. The economy is fixing itself by purging the unsustainable debt from the system. That's how markets work. Greenspan's low interest rates created a subsidy for debt which–along with the alphabet soup of leveraged derivatives–buoyed the economy along on the biggest wave of speculative financing the world has ever seen. The distortions that were caused by the unprecedented credit expansion stimulated artificial demand that created the appearance of growth and prosperity but, in truth, was nothing more than an equity bubble. Now the bubble has popped and the financial system is returning to the mean. That means that credit will probably contract by 30 to 40 percent putting us on the path to another Great Depression. Unless the government takes preventative action to get money into the hands of consumers and restore confidence, the nation will face (what David Brooks called) "grueling scarcity" and widespread panic. That's probably why all the voting machines and exit polls finally matched up with the election results in the 2008 presidential balloting for the first time in 8 years; because the ruling elites know that they need a popular executive to put in front of the cameras when they try to calm the crowds and keep the country from disintegrating into anarchy. It also explains the nervous smiles on the faces of the money-lenders and graybeards assembled on the stage behind Obama at his first press conference.

The American establishment is placing all its hopes for economic survival on the narrow shoulders of their newest posterboy, Barak Hussein Obama.

There's more pain to come, but the suffering can be mitigated by sound decision-making and Keynesian policies. That means public work programs, bankruptcy reform, and extensions on unemployment. Nobel prize winner Paul Krugman recommends a stimulus package of $600 billion. That's a good start, but it will take much more than that. And foreign investors will have to be confident in our choices or the sale of Treasurys will slip and the US will face a funding crisis. The Fed's lending facilities have already loaned $2 trillion while the Treasury's bailout is $700 billion. By the end of 2010, fiscal deficits will be nearly $2 tillion and the total cost to the US taxpayer will be at least $5 trillion. That means rising interest rates, flagging growth and hard times ahead.

The present financial crisis is a self-inflicted wound. It started at the Federal Reserve with their cynical neoliberal monetary policies. Any solution, that does not involve the dismantling of the Fed, is unacceptable.

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