The Paulson-Bernanke Bank Bailout: Will the Cure be Worse than the Disease?

By Prof Michael Hudson
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Saturday's $700 billion junk mortgage bailout is the largest and worst giveaway since a corrupt Congress gave land grants to the railroad barons a century and a half ago. If it goes through, it will shape the coming century by giving finance unprecedented power over debtors – homebuyers, industry, state and local government, and the federal government as well.

But what threatens to be even worse is the government's move to let the financial sector make even higher, unprecedented gains by working its way out of negative equity to "make taxpayers whole" by repaying the government's bailout by bleeding the economy at large. Anticipating congressional capitulation in this license to engage in predatory credit, the latest Sunday evening surprise is that Treasury Secretary Henry Paulson's own firm, Goldman Sachs, is to become bank holding company picking up the financial wreckage now that the government is covering the bad loans and investment gambles Wall Street has made.

What did Mr. Paulson not say in his weekend TV interviews, organized as what he hoped would be a series of victory laps. Neither he nor Fed Chairman Ben Bernanke nor any other Wall Street spokesman has acknowledged that the government has helped promote today's $46 trillion debt bomb. This enormous overhead consists of the product that banks are selling – interest-bearing debt that is being added to real estate, corporate industry and personal income to price the U.S. economy out of world markets.

We have heard nothing about how Wall Street lobbyists have succeeded in killing the financial cops on Wall Street – and done the same with the consumer cops on Main Street. There is no public recognition of the fact that more money in tax cuts went to the top 1% than the bottom 80% combined.

So how much credence should we give the newest proposals for the United States to commit economic suicide by turning over the powers of government in effect to Wall Street? When they talk about "making taxpayers whole," what really is their game?

At first glance it may sound appealing to taxpayers for banks to be told to use their future earnings to pay back the $700 billion dollars in junk mortgages, bad hedge-fund bets and other gambles that the Treasury promised on September 20 to pick up at face value, no loss incurred. To provide a sense of proportion, this money could have funded the next forty or fifty years of Social Security. It could have funded health care for all Americans. It could have made a big step toward rebuilding the nation's crumbling infrastructure. But that is another story. For now the major question is just how the banks, insurance companies and financial conglomerates are to raise the money to pay off this bailout.

The last time the government let banks earn their way out of negative equity was in 1980. Interest rates to bank customers topped 20 percent, driving down prices for real estate, stocks and bonds so low that the leading U.S. banks saw their net worth wiped out. Their debts to depositors and bondholders exceeded the collateral they held in their reserves to back these deposit obligations. But as soon as Ronald Reagan led the Republicans back into office, the Federal Reserve began to flood the economy with free credit, driving down the interest rates that banks had to pay. They were allowed to act as a monopoly and keep credit-card interest rates high, at 20 percent, and above 30 percent with penalties, thanks to the fact that America’s high post-Vietnam interest rates led state after state to repeal anti-usury laws to keep credit flowing.

So the banks did “earn their way out of debt.” But if you were a taxpayer who needed to use a credit card, you paid through the nose. The banks earned their way out of debt at your expense. And by the way, if you really did pay an income tax, you probably did not own commercial real estate or significant financial assets. The Internal Revenue Service made commercial real estate and a large swath of finance (at least for the wealthiest investors) income-tax free by generating tax credits that could be applied against income across the board. The capital-gains tax was lowered to a fraction of the income tax, leading investors to pay out whatever income their investments generated as interest on loans to buy property they expected to sell at a markup. And with Alan Greenspan appointed the head the Federal Reserve Board in 1987, the age of asset-price inflation had arrived.

Cities and states vied with each other to slash property taxes, replacing them with income and sales taxes that fall mainly on labor and consumers. The upshot is that wealth has polarized to an unprecedented degree. According to statistics collected by the Congressional Budget Office, the wealthiest 1% now own 57% of the nation’s returns to wealth (interest, dividends and capital gains) and the richest 10% own no less than 77%.

With this background in mind, it looks like the Paulson-Bernanke plan for the Wall Street investment banks and other predatory lenders – and insurers such as A.I.G. – to “earn their way out of debt” will be at the economy’s expense. The bailout is to be achieved by letting Wall Street’s post-Glass-Steagall financial conglomerates charge their customers exorbitant financial charges. As Britain’s Conservative Party leader Margaret Thatcher put it in her favorite phrase, TINA: There is no alternative. And as Lady Macbeth said, if the deed is to be done, let it be done fast. After all, it is a once-in-a-lifetime chance for every financial institution in America to cash out with a fortune!

For Mr. Paulson this means not giving Congress a chance to represent the public interest in designing the terms of this giant bailout. Sec. 8 of the Treasury plan bans any Congressional review, giving him unprecedented power by: “Decisions by the Secretary pursuant to the authority of this Act are non-reviewable and committed to agency discretion, and may not be reviewed by any court of law or any administrative agency.” Under cover of emergency force majeur conditions, the plan is to take the money and run, preferably without permitting any Congressional debate.

It is bad enough for the government to buy $700 billion of bad bank investments at prices that no private-sector investor has been willing to approach. This itself is an undeserved giveaway to the financial institutions that caused the problem by living recklessly in the short run. But making them – and indeed, helping them – pay back this gift with the aid of favorable tax and deregulatory policies will simply shift the cost off their shoulders onto those of bank depositors, credit-card users, mortgage borrowers and hapless pension-fund contributors to the money managers who have taken most of the current income in the form of commissions, salaries and bonuses to themselves. This will sharply add to the price of doing business in the United States, and specifically to the economy's debt overhead by the banks making even more predatory loans.

It gets worse. In order for the existing junk mortgages to be "made good," real estate prices must be raised further above the ability to pay for this year's five million homeowners in arrears and facing default. Is this a good thing? Is it good to raise access prices for housing even more, forcing new homebuyers to go further into debt than ever before to gain access to housing? Mr. Paulson has directed the Federal Reserve, Fannie Mae, Freddie Mac and the FHA (Federal Housing Authority) to re-inflate the real estate market. They are to pump nearly a trillion dollars into the mortgage market.

Fiscal policy is also to be brought to bear to turn the real estate market around by pressuring cities and states to "help homeowners pay their mortgage debts" by cutting property taxes. The idea is to leave more revenue available for property owners to pay mortgage bankers. Unfortunately, this will oblige cities to make up these cuts by taxing labor and sales, running deeper into debt than they already are, or cutting back their spending on basic infrastructure, education and public services and continue shortchanging their pension funds. This is the price to be exacted to "protect the taxpayer's interest" by bailing out irresponsible banks. The solution is to let them make even more money by acting in a yet more predatory way.

This is not industrial capitalism; it is asset stripping. The closest analogy I can think of would be to give the Mafia free reign to start a new crime wave "in the taxpayers' interest" so as to raise enough money to pay its fines to the Justice Department. Imagine how our world would look like if the economy had been turned over to Al Capone as head political capo and to Mafia financial manager Meyer Lansky as Treasury Secretary in the 1930s, with the pyramid schemer Carlo Ponzi heading the Federal Reserve and bank robber Willie Sutton as Attorney General.

The last thing the economy needs is a new real estate bubble. To prevent it, local property taxes need to be raised, not lowered. But this is not the Treasury's plan. Instead of representing the national interest, it is representing the banking sector whose profits come from making more and bigger loans. This is just the opposite from what a well-run economy needs to recover its growth and competitive power. It needs debt write-downs to what homeowners can pay.

But Mr. Paulson has made it clear that aid for homeowners is not part of the Treasury's plan. On Sunday, September 21, he resisted suggestions that his program be amended to include further relief for homeowners facing mortgage foreclosures. Because financial markets remain under severe stress, he claimed, there is an urgent need for Congress to act quickly without adding other measures that could slow down passage. "We need this to be clean and to be quick," he said in an interview on ABC's "This Week." He expressed concern that debate over adding all of those proposals would slow the economy down, delaying the rescue effort that is so urgently needed to get financial markets moving again. "The biggest help we can give the American people right now is to stabilize the financial system," Mr. Paulson said.

If you doubt that this is the government's ideal plan, just look at what it is rejecting. You hear no talk from Mr. Paulson or Mr. Bernanke about bailing out homeowners by writing down their debts to match their ability to pay. This is what economies have done from time immemorial. Instead, the Republicans – along with their allied Wall Street Democrats – have chosen to bail out investors in junk mortgages presently far exceeding the debtor's ability to pay, and far in excess of the current (or reasonable) market price. The Treasury and Fed have opted to keep fictitious capital claims alive, forgetting the living debtors saddled with exploding adjustable-rate mortgages (ARMs) and toxic "negative amortization" mortgages that keep adding on the interest (and penalties) to the existing above-market balance.

The question to be asked is just how much will the economy's debt overhead grow, and what will it cost debtors (a.k.a. "taxpayers")? And how will the economy look when the dust settles?

Economically the act gives a new meaning to the classical concept of circular flow. The traditional textbook meaning has referred to the circulation between producers and consumers, from wage payments by industrial companies to their employees, who use their wages to buy what they produce. This is why Henry Ford famously paid his workers the then-towering $5 a day. This was Say's law: Income paid for production is finds its counterpart in consumption to maintain equilibrium in a way that enables the economy to keep on growing. The new circular flow runs from the Fed and Treasury to Wall Street in the form of bailouts, and then back to Republicans in Washington in the form of campaign contributions. The money circulates without having to go through the "real" economy of production and consumption at all.

The Treasury Department issued a fact sheet on the proposal on Saturday evening: "Removing troubled assets will begin to restore the strength of our financial system so it can again finance economic growth." In everyday language the euphemism "removing troubled assets" means buying junk mortgages at way above current market price, as if the banks didn't know all along that they were junk but hoped to pawn them off on their clients. The problem is that the banks have not been financing growth in the form of tangible capital investment, but have found their quickest profits to lie in a combination of asset stripping and asset-price inflation.

On Sunday a BBC World Service reporter asked me to list three things that the financial sector would like to see. Taking the open-ended question on the highest philosophical plane, I said, first of all, the banks would love to free themselves of all deposit liabilities – simply to keep the money for themselves. That is their objective when they see a client, after all: How much of the client's earnings and money can they shift into their own pockets. Second, they would like to see politicians elected directly by the amount of money they could raise, thereby doing away with the actual problem of elections. If politics is going to be privatized, this is the way to do it. Rome's voting system was organized along these lines. Third, the financial sector prefers not to have to report any data at all or pay any taxes. It has lobbied Congress to block collection of statistics, on the premise that what is not seen will not be taxed. And at present, banks and brokerage houses are still screaming to repeal Sarbanes-Oxley bill calling for full and honest accounting. For financial ideologues this is an equivalent watershed dragon to Rowe vs. Wade, now that they have repealed the Glass-Steagall Act that had separated banks from casinos.

Somewhat taken aback by the rawness of these principles, the reporter asked what outcome was most likely. If Congress does what it is supposed to do, there should be quite a showdown. But how unlikely to be achieved is the above scenario? A few hours earlier on Sunday my friend Eric Janszen of itulip.com sent me a note he had received from a fund manager attesting to the lack of care for clients of financial institutions, giving a flavor of the predatory spirit guiding the bailout's planners and its beneficiaries:

RAIDS OF INDIVIDUAL ACCOUNTS

This is so important a topic, that it deserves top billing!!! Hidden inside the AIG bailout funding package, surely hastily cobbled together, but carefully enough to include a totally corrupt clause, was a handy dandy clause that permits raids. The conglomerate financial firms are permitted at this point to use private individual brokerage account funds to relieve their own liquidity pressures. This represents unauthorized loans of your stock account assets. So next, if the conglomerate fails, your stock account is part of the bankruptcy process. …

The actual evidence for legalized stock account raids by the financial firms can be found in recent articles in Financial Times and Wall Street Journal. So this is not a wild claim. The September 14th article on the Wall Street Journal entitled "Wall Street Crisis Hits Stocks" was the first exposure.

The runs on US banks are in progress. See Washington Mutual, where private email messages have been shared by WaMu bank officers. WaMu alone could deplete the entire Federal Deposit Insurance Corp fund for bank deposit coverage. Eventually the FDIC will compete for USGovt federal money for bailouts and nationalizations, which would be funded by the US Govt because they will not let FDIC run dry.

My Kucinich-campaign colleague David Kelley and I agree on how Wall Street's action plan ideally would work. The Republicans will take the $800 billion of U.S. Treasury securities presently earmarked for the Social Security Administration accounts, and achieve the privatization that Pres. Bush and his backers have been pressing for so hard for the past eight years. Under emergency conditions – today's 9/21 as the modern analogue to 9/11 just seven years ago (the well-known natural lifespan of locusts) – will swap these Treasury bonds for junk mortgages, at face value of course. Then, a few months from now (after the new president takes office in February, or perhaps a few days before to achieve the usual political clean slate) the government will tell prospective retirees and workers who have been suffering FICA withholding all these years, "Oops, the government has just lost all your money. Well, that just shows how government planning is the road to serfdom. Next time save yourself by handling your own accounts – or at least choosing whether to consign your forced retirement savings to Lehman Brothers, Bear Stearns or kindred predatory money managers. If only we could have done this a few months ago, there would have been no meltdown and Wall Street would have been doing just fine."

If you are going to take such a step, you of course say you are doing it to "save" the economy. You even proclaim yourself to be a hero. This is how the nation's newspaper and TV media responded after news of the bailout of AIG and, more to the point, the Wall Street gamblers and derivatives traders whose gains and losses – that is, the ability of trillions of dollars worth of computer-driven trading gambles – to collect their winnings and avoid losses.

Today's financial markets are well personified in the classic Hollywood westerns. They typically are about towns taken over and run by a banker ("Wall Street" in miniature), for whom a retinue of outlaws and their gangs work (the boys in the back room). The banker runs the town, usually doing business from its biggest building, the local saloon or casino where most of the action occurs. It has a brothel upstairs (the usual Hollywood simile for Congress). The good-hearted prostitute (sometimes the madam) with a heart of gold usually is the movie's only honest secondary character (a stand-in for one of the bleeding-heart Congressmen on the finance or mortgage-credit committees lisping well-scripted lines promising that all new legislation will benefit homeowners, not predatory mortgage lenders).

There also is a good-hearted investigative newspaper publisher-journalist. He almost always gets killed and his printing press destroyed. (Today his paper is simply bought out by a conglomerate and merged into the pro-Wall Street mass media.) The banker's gang appoints the sheriff (on today's larger scale, the Federal Reserve and Justice Department), and also the mayor (who rarely is seen except to sign papers). The sheriff's job is the same as in today's world: to evict debtors from homes and properties on which the land-greedy banker is foreclosing. This is the common theme of westerns, after all: They are all about the great American land grab – situated out West so as to protect the identities of the guilty here in the East on Wall Street.

Attentive readers will notice that I have left out of this script the hero. His role is to fight the banker/land grabber and the gang he has brought into town. Wearing a white hat, he rides into town to clean it up, and in the final showdown shoots the head gunslinger (or perhaps the banker himself, who is done for in any event). This is the position that Mr. Paulson portrays himself. But what the audience doesn't see (at first) is that the bullets he is shooting are merely blanks. It is in fact only a movie after all! The showdown is staged! He works for the banker himself!

Goldman Sachs turns itself into a big-fish bank and gobbles up all the little fish in a great financial squeeze.

An alien class of financial mock-heroic poseurs has taken over – land grabbers and banksters of various stripes. Almost unnoticed, an invasion of government snatchers, bank snatchers, money snatchers pretending to be Main Street, pretending to be "the economy" and now claiming to need to be rescued – at the cost of saying goodbye to public finance as we have known it, goodbye to Social Security, to peoples' hope for upward economic mobility.

It looks like Wall Street will receive government support at Main Street's expense. This is hardly surprising when you look at who the major campaign contributors are – to both parties. Understandably, Mr. Paulson and Mr. Bernanke are trying to muddy the issue for their financial constituency. Hedge fund traders and kindred banksters have metamorphosized into "the financial system to be saved" and hence "the economy" itself. As if it is necessary to save peoples' savings deposits and bank accounts by rescuing the casino companies with which the banks have merged – the predatory mortgage brokers, the insurance companies with their fraudulent accounting, the crooked asset-management firms, all of which have merged into conglomerates "too large to fail." If they are too large, simply un-merge them. Restore Glass-Steagall, which worked for 65 years to prevent this kind of problem from erupting.

The most egregious pretense is that the problem is only temporary, not structural. We are merely "freeing up" the market for new loans. This is precisely the opposite of what the classical economists meant by "free markets." What America has is a bad debt problem, not a “liquidity” problem. There is no “illiquidity” when people refuse to buy a junk mortgage on a property worth only a fraction of the mortgage’s face value. Many of these bad mortgage loans are fraudulent. The Treasury bailout seeks to make $700 billion of fictitious financial claims “real” – that is, way overvalued as compared to their actual worth(lessness).

What is reducing real estate and corporate stocks and bonds to junk is the exponential growth in the economy’s debt overhead. Debts that cannot be paid have little market value at any price. The nation must make a choice: If the government bails out the large financial institutions for having made bad loans – or to be more precise, for not being able to pawn off these bad loans on foreigners or other financial prey in a timely fashion – then the only way in which the government (or other new creditors) can be paid back is by not forgiving the debts owed by strapped homeowners. This would tighten the debt terms on debtors at the bottom of the food chain – those against whom the bank-sponsored new bankruptcy has been aimed. This is why I deplore the government bailout of Fannie Mae and Freddie Mac for the junk mortgages it has been packaging from predatory lenders such as Countrywide Financial, Washington Mutual and other deceptive lenders. The wrong parties have been gifted.

I should add that the solution does not lie simply in creating a new regulatory system, much less a single regulatory agency. After all, it was at Wall Street’s command that the Bush Administration installed deregulators in all the key regulatory positions. This meant that regulations didn’t matter at the Environmental Protection Agency (EPA), at the Fed under Alan Greenspan, at the Securities and Exchange Commission (SEC) under Mr. Cox (after William H. Donaldson resigned when the White House would not let him regulate as much as he thought necessary) or at the Department of Justice under Bush yes-men such as Alberto Gonzales. Politics and people have turned out to be more important than the law. We have seen the Supreme Court scrap the Constitution in the 2000 election – with acquiescence from the Democrats, starting with Mr. Gore’s refusal to contest Florida.

To appoint a single regulator would prevent all other regulators – and law enforcement officers, attorneys general, the SEC and so forth – from enforcing honest financial policies in the event that an incoming president should appoint another Greenspan, Gonzales or other ideological extremist averse to the idea of applying existing regulations and honest laws. Under these conditions “consolidated regulation” would mean a free ride for crooks much like J. Edgar Hoover gave the Mafia under his tenure.

My alternative solutions are as simple as Mr. Paulson’s, but of course are quite different. The public interest does indeed call for maintaining the economy’s basic credit, money-transfer, credit card and depository checking and savings functions. But not under the current venal and predatory management practices. It is this management that has lobbied so hard for deregulation, and whose industry representatives have insisted so strongly to place extremist ideological deregulators into the economy’s major positions. Therefore, the Treasury only should buy junk mortgages at current market price. The losses should be taken in order to re-even out the wealth pyramid that has become so much steeper under the Greenspan-Bernanke ploys. The banks knew full well that these mortgages lacked underlying value. The price of making use of this borrowing facility is to forfeit all equity stock to the government. The Treasury should prohibit any financial institution that sells or swaps securities to the Fed from paying any dividends to shareholders or stock options and bonuses to managers. It also should give the government priority over other creditors. Otherwise, firms that have negative equity will benefit purely at public expense, using the money to pay dividends, bonuses and exorbitant salaries.

Second, we need to restore the Glass-Steagall separation of commercial banks from risk-taking investment banks, mortgage brokers and other financial-sector flotsam and jetsam. Break up the mergers between banks and casino sell-side financial and real estate institutions. Just the opposite is occurring: On Monday, Sept. 22, the financial universe was transformed by the announcement that Mr. Paulson's Wall Street firm, Goldman Sachs, was transforming itself into a bank holding company. The casinos are to take over the banking system as big fish eat little fish in the present financial emergency. It looks like new giants are emerging, already larger than the government in terms of the magnitude of the debts they have run up – and certainly in their earning power. Indeed, who is to say that extracting interest from the U.S. economy will not emerge as the new form of taxation?

Third, re-write the bankruptcy laws to favor debtors once again, not creditors. This means reversing the current bankruptcy code sponsored by lobbies from the credit-card companies. The interests of the five million mortgage debtors faced with foreclosure and expropriation this year should rightly be placed above the interest (literally) of predatory creditors.

Fourth, sharply increase property taxes, shifting them back off labor and sales. We need to return to the classical idea of taxing unearned and unproductive income instead of adding to the price of labor and industry. What has been freed from the tax collector by the shift of taxes off property has not lowered the cost of housing and other real estate, or corporate costs of doing business. The income "freed" has ended up being paid to the banks as interest. The government still has had to raise money – but in the form of taxes that fall on labor's wages and industry's profits. So labor and industry now pay twice for what they formerly paid only once. They still pay the same overall amount of taxes, but also pay an equivalent amount of interest. The financial system is crowding out the government.

In the fifth place, we need to start discussing whether we really need a banking system that behaves in the way the present one does. In recent decades banks have made loans mainly to inflate asset prices by loading real estate and industry with interest-bearing debt. What if all banks were to be organized along the lines of savings banks, with 100% reserves. This is the Chicago Plan from the 1930s (currently revived by the American Monetary Institute, which holds its annual meeting this week in Chicago, by the way). This at least would go back to basics to provide a foundation from which to re-begin to discuss just what kind of credit the economy needs and what would be the best terms on which to structure financial markets.

Any solution does indeed need to be radical. But it can be much less radical than Mr. Paulson's power grab for his Morgan Stanley firm and the rest of Wall Street in the closing days of the Bush administration just before the Republicans look like losing power. The indicated solution is to reverse predatory finance, not bail it out at permanent taxpayer expense. Government funds are not unlimited. Is it worth wiping out hopes for Social Security and public health care, for renewed national infrastructure spending and industrial restructuring in order to bail out a banking and financial system that has not contributed to economic growth but has weighed it down with reckless debt regardless of the economy's ability to pay?

Is it right to blame the five million homeowners now in arrears and facing foreclosure, but rewarding the irresponsible bankers and outright fraudulent institutions who have used Enron accounting to make a once-in-a-lifetime rip-off? That is what Mr. Paulson would do in insisting that Congress pass his legislation without taking time to discuss the issue and above all without “assigning blame.” But without such assignation, how do we know where to go from the current mess caused by financial deregulation, repeal of Glass-Steagall, the financial system’s Enron-style accounting and predatory mortgage lending?

Before leaving from his post as Federal Reserve Chairman, Alan Greenspan’s speeches sounded like “Apres moi, le deluge.” We are living in a world whose economic and political pressures are much like those in the interregnum between Louis XIV and the French Revolution. Where are the revolutionists today?

Articles by: Prof Michael Hudson