

The Great Switch: Banks Rob People

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The US government is on the verge of making an unprecedented financial commitment, likely to cost \$700 billion, to buy the bad securities held by large US and foreign financial institutions. Having driven our economy to the edge of financial destruction, the Lords of Finance now want the public to put up the money needed to save them and their firms from collapse. Maybe men don't bite dogs, but banks do rob people.

How did we get here?

In response to the collapse of unregulated financial markets in the early 1930s, the American people decided to tightly regulate the financial system so that it could never again threaten the US economy. The Depression-era regulations worked effectively until the late 1970s, helping to create the best economic performance in US history. When our financial system was buffeted by high inflation in the late 1970s, it became necessary to reform the regulatory process so it would be effective in the new economic era. But instead of reform, the rise to power of anti-government, right wing forces- reflected in the election of President Reagan in 1980s – led to a radical deregulation process. By the end of the Clinton presidency, radical deregulation was completed. A similar process of financial deregulation occurred in other industrialized countries as well.

Deregulation, in concert with rapid financial innovation that made complex financial products such as derivatives and mortgage backed securities possible, created a volatile pattern of financial booms and crises. Each crash led to bailouts by affected governments, which only increased incentives to financial firms to expand further and take greater risks, since there were massive profits to be made in the upturn while the public paid to limit their losses in the downturn. The new era thus saw an explosion in the size and profits of financial firms. Financial assets were less than five times larger than US GDP in 1980, but over ten times as large in 2007. In the US, the share of total corporate profits generated in the financial sector grew from 10% in the early 1980s to 40% in 2006. As financial markets grew

larger and thus more dangerous, the pressure on governments to bail them out increased proportionately.

The Housing Bubble

The recent boom was driven by the rapid rise in home prices in the decade ending in 2006. Home buyers and mortgage lenders assumed that housing prices would never decline. This sustained the boom, but the fact that banks and mortgage brokers were paid large fees to originate and service mortgages added fuel to the fire. Since most of these mortgages were not held by their originators, but rather sold to others, it made sense for banks and brokers to maximize the flow of mortgages, even if that meant selling mortgages that were likely to default if home prices stopped rising or interest rates rose substantially. Investment banks received similar fees to package the mortgages into mortgage-backed securities that were then sold to banks, hedge funds, pension funds and insurance companies around the world. These securities were essentially highly leveraged risky bets that housing prices would keep rising. They were so complicated that no one knew what their price should be. Thus, they could only be sold because credit ratings agencies such as Fitch and Moody's gave them AAA ratings. The agencies provided overly optimistic ratings only because they were paid by investment banks to do so.

Why did so many large financial institutions borrow so much money to invest in such risky securities? The answer lies in the way their top people are paid. Financial firm 'rainmakers' get most of their compensation in the form of bonuses tied to the profits of their enterprise. When markets are booming, profits and bonuses are maximized by borrowing lots of money – investment banks borrowed \$32 for every \$33 of assets they owned in 2007 - and taking high risks with it. For example, in 2006 Goldman Sachs had a banner profit year and the average bonus for its 25,000 employees was \$650,000. But most of this money was paid to those at the top, with key traders taking home \$50 million. Everyone knew that such risk-taking would eventually lead to disaster when markets turned down, but they would not have to give back the big boom-time bonuses.

The Bubble Pops

When housing prices began to fall in 2006, the game was up, though it took another year before the crisis broke out. Once it did, the gravitational pull of “reverse leverage” accelerated the downfall. Firms that borrowed heavily to buy assets used the value of the assets as collateral for their loan. When asset prices started to fall, so did their collateral value. Their creditors demanded that they put up additional cash, which forced them to sell assets. Of course, this made asset prices fall faster. Soon financial firms across the globe found the value of their assets and the value of their capital plunging along with the price of their stock. As usual, they rushed to government agencies to save them.

Bailouts and More Bailouts

In the US, the Federal Reserve Bank (referred to simply as the Fed) responded to the crisis by extending massive loans to commercial banks, and, for the first time since the Great Depression, to investment banks as well. In addition, the Federal Home Loan Bank increased its loans to banks by almost \$300 billion between June 2007 and June 2008, a rise of 43%. In the Bear Stearns rescue, the Fed in effect bought \$29 billion worth of devalued securities from the failing investment bank. The collapse of Fannie Mae and Freddie Mac, two firms that own or insure almost \$5 trillion in mortgages (and made their top executives fabulously rich by investing in shaky mortgage-backed securities in the boom) led to their nationalization; the taxpayer is now liable for their losses, which could hit \$100 billion. The US government, which the Lords of Finance told us should stay out of financial markets, now owns the largest financial companies in the world. The Fed then effectively nationalized AIG, one of the largest insurance companies and biggest financial speculators in the world, at a cost of \$85 billion, even though it does not regulate and has no responsibility for insurance companies. The rout was on.

Finally, in mid September, when even these unprecedented interventions proved unable to calm financial markets, Fed Chair Ben Bernanke and Secretary of the Treasury Henry Paulson, former CEO of the top investment bank Goldman Sachs, proposed that the government put up an additional \$700 billion of taxpayer money to buy most of the bad assets held by financial corporations. This would be the largest bailout in history. At the same time, the government announced a blanket guarantee of the \$3.5 trillion money market

mutual fund industry. By this time, Paulson (or Goldman?) seemed to be in control of the bailout process. His initial proposal stated that all decision making power over the dispersal of this enormous amount of money was to be in his own hands. Neither the courts nor other government bodies would be able to exercise oversight of Paulson's handling of the money. Since the proposal said nothing about which securities would be purchased, or which firms would receive payouts, or how the prices of securities would be valued, Paulson (or Goldman?) was actually proposing that the President and Congress simply give him up to \$700 billion to distribute to his cronies as he saw fit. As economist and New York Times columnist Paul Krugman put it: "Mr. Paulson is demanding dictatorial authority, plus immunity from review 'by any court of law or any administrative agency'."

Scare tactics

Adding insult to injury, Paulson planned to privatize the bailout process. Wall Street firms hired by Paulson would decide how much to value the bad securities the public had to buy from Wall Street firms. These firms would, of course, be paid hundreds of millions of dollars of public money to provide this service. Moreover, Paulson and Bernanke tried to panic the Congress into accepting their Trojan Horse by arguing that if Paulson's proposal was not accepted without revision within a few days, global financial markets would collapse. Congress was to be stampeded by fear into rubber stamping legislation that would complete the process of a virtual government takeover of a huge share of the country's financial system by one man. This was reminiscent of President Bush's successful effort to get Congress to quickly authorize his war in Iraq. And there were no penalties for financial firms or their rainmakers in the proposal, and no new regulation to prevent this fiasco from recurring a few years down the road.

This is, literally, unbelievable. As recently as spring 2007, Paulson argued that excessive regulation was crippling American finance in its battle for global financial supremacy: the government should stay out of financial markets. And Goldman Sachs along with other large investment banks played a key role in packaging and selling the mortgage backed securities that led to the crisis – the same securities they now want to pawn off on the taxpayer. Paulson is a representative and charter member of the Lords of Finance who foisted this corrupt and absurd system of deregulated financial markets on the American public, a

system that created financial instability and rising inequality, pressured the public time and again for money to clean up the messes they made, and used their ill-gotten money and power to corrupt the political process. Having done this, the Lords of Finance now want total control of \$700 billion public dollars to allocate to themselves. New York Times liberal columnist Bob Herbert put it nicely. “Does anyone think it’s just a little weird to be stampeded into a \$700 billion solution to the worst financial crisis since the Great Depression by the very same people who brought us the worst financial crisis since the Great Depression?” No doubt the outrage over this destructive proposal that has been building since its announcement will eventually lead to amendments that change its form, though perhaps not in substance. The American people should inundate Congress with a demand to stop this insanity. There should be no bailout unless there is a concurrent and dramatic increase in the regulatory restraints on financial firms that will prevent a rerun of this catastrophe.