

# Table of Contents

A trillion dollar rescue for Wall Street gamblers . . . . . 1



# A trillion dollar rescue for Wall Street gamblers

By Michael Hudson

Detailed summary by Michael Hudson (author of the essential *Super Imperialism*, new edition: Pluto Press, 2003) of US government moves over the last few weeks to rescue Wall Street's fictitious wealth claims by turning upside-down the New Deal-era agencies designed to keep small *producer-debtors* from going under. Treasury Secretary Paulson will pay whatever it costs to fund "creditors to lend debtors enough money for them to pay the interest costs so as to keep current on their loans", even if it means bankrupting Medicare and Social Security. In this respect Paulson may be closer than the neo-Georgeist Hudson to the minority-marxist intuition that 'capital's executive committee' *has to* bail the gamblers out because financial looting is by now the only possible basis for accumulation. But Hudson's ongoing account of this kind of policy as the 'socialization of risk' is vindicated today more obviously than ever. The other side of this, of course, is that when, government withdraws from 'the market', leaving a policy vacuum for the FIRE sector to fill, as Hudson describes, state action to condition and coerce *labour* tends to go into overdrive. As Elizabeth Povinelli observes in the current issue of Mute (<http://www.metamute.org/en/Doing-it-for-the-Kids>), in practice this often means mortal risk-taking becomes *compulsory* for the asset-poor, at the same time as the biggest gambling debts are being 'forgiven'.

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Nothing for Families and Retirees

A Trillion Dollar Rescue for Wall Street Gamblers

By MICHAEL HUDSON

If the move to a Unitary Executive of unfettered presidential power frightens you, America's radical right turn to Unitary Finance should compound your fears--and your debts as well. The financial events of the last two weeks of March 2008 demonstrate that the "economic royalists" and "money changers" whom Franklin Delano Roosevelt (FDR) drove from the temple of finance have returned to mismanage our economy into dire straights of unprecedented risk--debt creation, euphemized as "leveraging" and "wealth creation."

The few checks and balances that remain in the way of the financial sector's increasingly centralized planning, especially at the state level, are being swept aside under the guise of "saving the system." Few Wall Street beneficiaries who use this phrase explain just what the system is. For starters, its political managers are industry lobbies appointed to high managerial and planning positions in the public agencies that are supposed to regulate these industries. Their idea of financial planning is to put a trillion dollars in government agency funds and credit guarantees at risk. This agency funding was supposed to be used to help average American families obtain housing and health care, and to protect their savings and provide for their retirement. Instead, it is being mobilized to support the economy's bankers and financial managers. Indeed, the past few weeks have seen seemingly trillions of dollars committed for war making and bank support.

The banking system's free creation of credit, doubling each five years or so for the economy at large, threatens to culminate in debt peonage for many American families and also for industry and for state and local governments. The economic surplus is being quickly absorbed by a combination of debt service and government bailouts for creditors whose Ponzi schemes are collapsing right and left, from residential to commercial real estate and corporate takeover loans to foreign bubble-economy credit.

This is the context in which to view the past few weeks' financial turmoil surrounding Bear Stearns, JPMorgan/Chase and the rapidly changing debt landscape. "The system" that the Treasury, Federal Reserve and the New Deal agencies captured by the Bush Administration is trying to save is an economy-wide Ponzi scheme. By that I mean that the business plan is for creditors to lend debtors enough money for them to pay the interest costs so as to keep current on their loans.

For the past few years this system has depended on asset prices for real estate, stocks and bonds to be inflated by enough to enable debtors to pledge these assets as collateral at a higher market price for more and more new loans. But now that the real estate bubble has burst (and indeed, as stock prices sink), the problem is how to bail out the tip of our economic iceberg that has sunk into negative equity--a condition in which the debts attached to property exceed its market value. Someone must take a loss--but whom?

Normally, it is the banker or investor who takes the loss. But they are now supposed to be "rescued." This is being presented as a return to stability. But it was a system that never was stable to begin with. In fact, for the rescue to work, most Americans will have to own less and owe more, while being told that all this is the path to wealth creation--as if it were their wealth, not that of their creditors. The Bear Stearns/JPMorgan Chase/monoline insurance giveaway to "save the financial system" provides a vivid illustration of how Unitary Finance has developed a parasitic relationship with American labor in its role as pension contributor, consumer and homeowner. The system being subsidized enables the FIRE sector to direct and live off the productive efforts of others--people who make real things and provide real services.

#### Saving Wall Street with a trillion-dollar bailout of bad mortgage debt

The bailout started on Sunday, March 16. The government and JPMorgan Chase had reason to be embarrassed about the negotiations, for the details trickled out on the Federal Reserve or Treasury websites and Mr. Paulson's speeches went far beyond just Chase and Bear Stearns. It turned out that on the same Sunday on which he had negotiated the \$30 billion Fed bailout, Mr. Paulson started a frenetic ten days orchestrating actions by the Treasury, Federal Reserve, and other government agencies to earmark a trillion dollars to re-inflate financial markets for mortgage holders and their associated creditors and speculators. Behind the scenes, as matters turned out, the Bush Administration was mounting a financial surge: It decided to throw everything its mortgage financing agencies could muster to prevent property markets from collapsing on its watch.

The surge of support for the mortgage and real estate markets was headed by the two largest U.S. mortgage holders and packagers: the government-sponsored National Mortgage Association (FNMA) and Freddie Mac. These two agencies were created to develop tradable markets for mortgages that banks traditionally had kept on their own books by buying home mortgages from the banks and mortgage brokers that originated them. This created a vast new demand for mortgages by making them marketable in large packages for institutional investors such as pension and mutual funds. Being implicitly government-guaranteed, Fannie Mae and Freddie Mac were able to borrow at fairly low interest rates, and sell mortgages at a premium. Demand for these packaged mortgage securities provided an enormous new source of lending. It also turned banks into mortgage originators rather than mortgage holders.

Together, Fannie Mae and Freddie Mac bought more than three-fourths of all U.S. mortgages issued in the fourth quarter of 2007, bringing their holdings to \$1.4 trillion. However, the fact that their capital base was under \$70 billion--for a 20 to 1 debt-leveraging ratio--led investors to sell their stock steadily over the past year. Rather than insisting that Fannie Mae and Freddie Mac rebuild their capital position, the Office of Federal Housing Enterprise and Oversight (OFHEO) did just the opposite. It

reduced their capital requirements from 30 percent to 20 percent, and encouraged them to use this increased leverage to pour an extra \$200 billion to the nation's mortgage market. Limits on the size of mortgage loans that these two agencies could make were raised sharply in order to help re-inflate the troubled high-cost California and New York property markets in particular.

Designed to bring temporary relief, this maneuver threatened to further destabilize matters by simply kicking the can down the road. The same applied to the Federal Housing Administration (FHA), set up in 1934 as part of the New Deal. Its insurance fund of about \$20 billion backs some 3.8 million mortgage loans totaling \$365 billion, for an 18:1 debt-leverage ratio. On Monday, March 24, it promised \$400 billion in new mortgage credit insurance. This means that government agencies can use their capital to lend much more money to prospective homebuyers. The FHA, Fannie Mae and Freddie Mac also will be on the line for any losses, "socializing the risk" to a higher degree than ever before.

What was so worrisome about this strategy was that the FHA already was in financial straits as a result of its subprime loans. For the first time in its history it was running a deficit. Over a third of the loans it insured were made by home sellers to new buyers to cover their down payment--enabling homes to be bought without any down payment at all. (Traditionally, 20 percent has been the norm.) This was a brand-new market, barely existing in 2000 on the eve of the Greenspan-Bush real estate bubble. The Secretary of the Housing and Urban Development Agency (HUD), Alphonso R. Jackson, told a Senate committee: "These types of loans have pushed F.H.A. to the brink of insolvency." And now it was to double its activities to prop up the real estate and mortgage market.

The Federal Housing Finance (FHF) board dutifully did its part to increase the system's debt leverage. It doubled the ability of the 12 regional Federal Home Loan Banks (FHLB) to leverage their purchase of mortgage securities, from three times their capital to six times, twice the existing debt/equity ratio. The aim was to help them serve their clients, the nation's eight thousand savings banks, S&Ls, credit unions and insurance companies, finance the purchase of \$160 to \$200 billion new mortgage-backed securities issued by Fannie Mae and Freddie Mac. The target was for these two agencies to buy up about half a trillion dollars worth of mortgage securities from the private sector this year.

The Federal Home Loan Banking system also announced plans to start offering its own "monoline" mortgage insurance against the looming economic downturn at prices way below what private-sector insurance writers were willing to match. The aim is to shore up the nation's crumbling mortgage-insurance coverage at taxpayer expense. Again, the concept of a "free market" is being subjugated in order to socialize the losses for the FIRE sector's big players. The situation is much like the government insurance of beachfront properties against flood damage, paying for a chronically losing proposition at public expense. Of course, a disproportionate number of the owners of those beachfront properties also come from the campaign-contributing class.

Gillian Tett of the Financial Times noted that this mortgage insurance subsidy is "likely to trigger further debate about how policymakers are turning to state, or quasi-state, entities to stabilise the financial sector" by addressing "an absence of the market." Instead of shaping the market along less risky, less debt-leveraged lines, it was now another case of the government socializing financial risk at below-market rates. John Price, chairman of the Federal Home Loan Bank board, claimed that this "is what Government State Enterprises are for." In view of the fact that private insurers would charge higher rates, But the government's present plan being coordinated by Treasury Secretary Paulson seeks to avoid letting markets work in a way that would raise costs to Wall Street and hence leave less revenue for homeowners to pledge for debt service. This policy is presented sanctimoniously as lowering the price at which the financial sector "serves" the economy, not as putting it at risk.

The most amazing moves were still to come. On March 11 the Federal Reserve created a new Term Securities Lending Facility to extend \$200 billion in loans to primary bond and securities dealers against their holdings of mortgages and other packaged securities as collateral. The aim was to rapidly re-inflate mortgages that the free market was pricing as junk, as low as 20 percent of face value.

Then came the double bombshell. In a true showing of the green on St. Patrick's Day, March 17, the Fed extended nearly unlimited credit to non-bankers for the first time since the Great Depression. It accepted their toxic mortgages as collateral--dubious assets that "the market" was refusing to touch. So much for "market-based" solutions when it comes to high finance! For the first time since the 1930s, non-banks could borrow from the Fed's loan window against their junk mortgages, apparently at full face value. It was too late for Bear Stearns, but other investment bankers and brokerage houses saw the green lifeline as the Fed opened its discount window to non-bankers, that is, to investment bankers such as Lehman Brothers, in contrast to commercial bankers that are regulated by the Fed.

The volume of credit seemed to be unlimited, collateralized by mortgage-backed securities that "the marketplace" was pricing around the levels Third World loans were selling at after Mexico's 1982 insolvency. Labor economist Tom Palley wrote in his March 26 blog: "These subsidies are a travesty. Goldman Sachs, Lehman Brothers and Morgan Stanley are extraordinarily profitable. They also have been the drivers of the worst trends in the American economy over the past generation, pushing excessive CEO pay that has spread like a cancer throughout corporate America, even reaching into universities and non-profits. Additionally, they have pedaled the shareholder value paradigm that has pushed companies to emphasize short-term gain over long-term investment, and contributed to ripping up America's social contract. Meanwhile, their business model has promoted speculation that is behind repeated asset and commodity price bubbles."

It is to support this business model that the Fed and Treasury officials seem to be making up new rules on a daily basis--rules that receive only a superficial or perfunctory review by Congress. Critics point out that investment bankers are not subject to Federal Reserve oversight or other regulation. Perhaps even this does not really matter in view of the Fed's extreme non-regulatory mode ever since Alan Greenspan's four-term Chairmanship. Even more important, of course, is the fact that the Fed's new clients, investment banks and brokerage houses, do not serve the middle-class depositors in need of special protection for their life savings. The financial investments being saved from adverse market conditions are ultimately speculative in character.

It seems a biting irony that the institutions now being mobilized to bail out Wall Street creditors--the Federal Home Loan Banks to pump credit into the mortgage market, the Federal Housing Administration to insure mortgage loans, Fannie Mae and Freddie Mac to buy and package mortgages for bulk resale to institutional investors--were created to help homebuyers, not their creditors and speculators. But bailing out speculators and high finance has now becoming their primary function. This shift has turned America's housing, mortgage and banking agencies upside down. Wall Street of course has welcomed the capture of these New Deal and post-1945 institutions. But their doctrinaire ideology has accused Glass-Steagall, Social Security, and most recently Sarbanes-Oxley regulations by the Securities and Exchange Commission (SEC) as leading down the road to serfdom.

Politically, such bailouts require an ostensibly humanitarian cover story. They need to be presented as a subsidy not to banks and other wealthy creditors, but to debtors. This means that the "ideal" (that is, most smoothly hypocritical) bailout takes the form of new credit to pay banks and other bondholders and mortgage holders enough to keep the debt bubble afloat. That means enough more credit to keep it growing, at least by the amount of interest that must be paid.

The result is a true road to debt peonage. It is much more destructive--and certainly more real--than the imaginary road to serfdom that Hayek and other anti-government ideologues envision. While these free-enterprise boys wring their hands and denounce government power, their sponsors realize full well that when government steps back, the financial sector moves in to fill the vacuum. The banks and money managers become society's planners and resource allocators--in their own short-term interest. This interest leads them to oppose laws protecting, labor, consumers and debtors. This means that the "freedom" at issue is a one-way favoritism for employers, monopolistic privilege and creditors. What these vested interests mean by the "road to serfdom" is an economy managed by hands other than their own, an economy protecting the workers, consumers and debtors whom they seek to victimize.

No money left for Social Security and health insurance after the real estate bailout?

The American public may justifiably be puzzled by how the government can seem to come up trillions of dollars for foreign wars and banker bailouts, but so little for them. The United States is spending an estimated \$3 trillion for an illegal war that has made us less safe, and \$1 trillion so far to rescue bankers in a way that is destabilizing the economy. But it can't seem to secure health care or retirement security for all Americans. On Tuesday, March 25, fresh from providing a trillion dollars to underwrite the financial and real estate sector, Mr. Paulson revived the Bush Administration's pretense that there is no money to pay Social Security. Yet "fixing" Social Security--if indeed there is a problem (which is no means certain)--would be relatively easy. Merely restoring the Bush tax cuts for the top 1% of Americans (those earning over \$414,000 a year) to the high 30-percent tax rates of the 1990s (nowhere near approaching the 94% top marginal rate of the 1940s, or even the 70-percent rates of the 1970s) would provide 46% more than the Congressional Budget Office's estimate of the Social Security shortfall. The Administration does not acknowledge such inconvenient truths, or do the reporters who simply pass on its handouts to the mass media.

The claim that there is no prospective funding to meet the government's Social Security and Medicare obligations was rendered blatantly incredible in the last week of March, which saw the five-year anniversary of the Bush Administration's war in Iraq. As its death toll to U.S. soldiers reached 4,000, newspaper accounts across the country reported the calculations by Nobel Prize winner Joseph Stiglitz that the war's cost has reached the \$3 trillion mentioned above, taking into account its legacy of interest charges and medical treatment for the more than 25,000 troops that had been wounded or had post-traumatic and other psychiatric stress disorders. (Mr. Stiglitz recently updated his analysis to say \$3 trillion is a conservative number.)

Five years, four thousand lives, and three trillion dollars for the war--but no money for Social Security and Medicare! Did Mr. Paulson not feel just a little bit discomfort in claiming with seeming urgency that Social Security funding would be exhausted in just over another thirty years, by 2041? Medicare is supposed to be in even worse shape, having accumulated enough wage set-asides to last only until 2019, due largely to rising health costs--which the Bush Administration refused to control by negotiating prices with the drug companies, among others.

The historical road to serfdom is that of debt peonage to a financial oligarchy concentrating wealth in its own hands. Contemporary anti-government "libertarianism" creates a vacuum that the financial sector moves to fill. The problem for society at large is that finance finds its major gains to lie not in raising living standards, but in promoting a free lunch for its customers--while turning corporate profits, monopoly rent-seeking and real estate price gains into a flow of interest to itself, by advancing the credit to finance the purchase of these assets and privileges.

There is only one way to reverse this evolution toward debt peonage. That is to scale back existing mortgages, especially for properties with negative equity, to reflect the plunge in property values today--admittedly under distress conditions, but nonetheless real constraints on the debtor's ability to pay. Once the principal was reduced to realistic levels, adjustable-rate mortgages would be replaced by fixed-rate mortgages.

The problem with this solution is that to the financial institutions, the housing crisis is not their problem. Their blame-the-victim attitude holds it to be the mortgage holders' problem--and now increasingly the taxpayers' problem. This perspective on how to resolve the housing crisis can only succeed by creating a populist rhetoric for public officials to use in promoting financial interests as if all this is in the best interest of homeowners and other debtors.

Michael Hudson is a former Wall Street economist specializing in the balance of payments and real estate at the Chase Manhattan Bank (now JPMorgan Chase & Co.), Arthur Anderson, and later at the Hudson Institute (no relation). In 1990 he helped established the world's first sovereign debt fund for Scudder Stevens & Clark. Dr. Hudson was Dennis Kucinich's Chief Economic Advisor in the recent Democratic primary presidential campaign, and has advised the U.S., Canadian, Mexican and Latvian governments, as well as the United Nations Institute for Training and Research (UNITAR). A Distinguished Research Professor at University of Missouri, Kansas City (UMKC), he is the author of many books, including *Super Imperialism: The Economic Strategy of American Empire* (new ed., Pluto Press, 2002). He can be reached via his website, [mh@michael-hudson.com](mailto:mh@michael-hudson.com)