A Comment On The ’08 Bailouts

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<u>(ON THE NEED TO ATTACH STRINGS)</u>

<u>BACKGROUND:</u>

Since the fall of ’08, there has been a well-meaning yet very mis-led indictment of the “bailouts” (e.g. the Troubled Asset Relief Program). In part, the grievance has been championed by anarcho-capitalists, right-wing libertarians, and other manner of free-market fundamentalists who, ironically, implicitly support the very corporatist policies on which the terms of the program were based. The standard grievance is based on a mis-understanding of what actually happened.

In brief, in order to re-establish solvency for large private financial institutions that found themselves “underwater” in 2008 (most notably, AIG), a publicly-subsidized capital infusion was necessary. That is to say, the “re-capitalization” of those institutions *via the State* was required in order to avert a macro-economic disaster. The “troubled asset relief” injection was the only way to prevent a nation-wide crisis that would have ensued from the (impending) implosion of those institutions.

The question, then, is not “should have” vs. “shouldn’t have” bailed them out. The question is: What *conditions* should have been (unilaterally) *imposed* when the capital infusion was provided? After all, the infusion was given by American tax-payers. Moreover, it was done to clean up a mess they didn’t create, but which was endangering everyone.

We’d be wise to remember that in the 80’s (with the S&L scandal), in the late 90’s (with Long Term Capital Management’s implosion), in 2000 (with the notorious corporate corruption cases), and in 2008 (with the hyper-securitization of AIG / Goldman Sachs, et. al.), the story was similar: abuse of highly-concentrated private power.

In each case, the problems had similar causes. All of it was the result of right-wing economic policy—policy that:

- Fostered the formation of systems of un-accountable, highly-concentrated private power
- Encouraged opaque, unchecked schemes of hyper-speculation

How? By preventing ROTA (regulation, oversight, transparency, and accountability) while enabling flagrant conflicts of interest to become institutionalized. Naturally, this fostered an egregiously flawed incentive structure.

In each of the above cases, the problems arose from the same kind of structural defects: insiders rigging the system for their own benefit at the risk / expense of everyone else…and then engaging in unfettered hyper-speculation—with little or no oversight or accountability. Insiders were able to do this with impunity, because—per Neoliberal ideology—ROTA had been all-but-eliminated in the name of unbridled “free enterprise”.

The elimination of ROTA and the dismantling of the Glass-Stegal Act (following the fraudulent formation of Citi-Group in order to retro-actively legitimize an otherwise illegal merger) set the stage for the economic disaster of 2008. A neutered CFTC (Commodity Futures Trading Commision) and emasculated transaction standards (via the Commodities Futures Modernization Act) cleared the way for the malfeasance of “notorious” A.I.G., Bear Sterns, Lehman Brothers, Goldman Sachs, et. al.

In the fall 2008, the story was the same as in the previous cases. A confluence of events precipitated the meltdown. The dissolving of lending standards and systemically dysfunctional incentives created an incubator for hyper-speculation (facilitated by, among other things, hyper-leveraging). Predictably, this led to hyper-securitization in the financial sector. As manufacturing was shipped overseas to venues of cheap labor, a hyper-financialization of the economy inevitably ensued…a scenario with devestating effects soon thereafter demonstrated in Iceland.

This was a matter of gaming “risk-adjusted” capital within opaque derivative markets. Due to the incentive structure in place, financial institutions pursued maximization of short-term profits via promiscuous use of exotic financial vehicles (complex instruments concocted by highly-paid “quants” who operated myopically in an environment of cupidity). All of this avarice transpired with lack of accountability and little oversight: It was an orgy of unchecked power, conflicts of interest, and dubious motives…undertaken in the name of free markets.

In other words: it was a train-wreck waiting to happen.

A house—nay, skyscraper—of cards had been erected on a shaky foundation of sub-prime mortgages—credit that was based on prospective equity on housing values that were being determined by inflated bubble pricing. We can blame irresponsible lending for the shaky foundation, but that begs the question: The banks built the sky-scraper on that foundation. Those well-positioned within the machine were making fortunes for themselves on “swaps” based on credit default prognostications (CDSs) and on “debt obligations” that had been “collateralized” (CDOs)…instead of actually creating genuine Value. Institutions were raking in obscene profits by creating and trading derivatives of derivatives of derivatives (making bets placed on bets placed on bets)…as opposed to ***actually producing*** anything. When this becomes a significant part of a nation’s economy, something extremely unhealthy is afoot.

The case could be made that if Fannie-Mae and Freddie-Mac had remained 100% socialized, and hadn’t been mostly privatized, the dubious (for-profit) motives to lend indiscriminately (for the sake of maximizing sales of real estate mortgages) may not have existed. As has been demonstrated over and over again, the moment the profit-motive becomes the prevailing factor in an operation, self-regulation is rendered anathema. And when risk / cost remains socialized whilst gains are privatized, flagrant conflicts of interest can’t help but ensue. Predictably, there ended up being mortgage-backed-security-mania.

A speculative bubble, after all, is just a house of cards based on the high leveraging of chimerical equity—causing prices to become artificially high based on the hope that they will become ever-higher. In this scheme, the players try to milk that equity as if it were liquid capital—betting money they don't (yet) have (but plan to have later, if things go according to plan). The problem is the extensive fall-out when the house of cards (inevitably) collapses.

But what, exacly, is a "bubble", anyway? It is a scenario in which "price" is no longer defined by the supply and demand of ACTUAL GOODS. Instead, the pricing is driven by sheer speculation—a process to which supply and demand become subordinate. The result is that pricing is utterly disconnected from actual productivity / material value. Such pricing can only last so long before the house of cards collapses.

In a healthy market, market forces are dictated primarily by supply and demand (of actual goods) in the wider marketplace. Here, artificially-inflated pricing is mitigated. Ideally, "price" is a function of ***productivity*** (if it concerns an enterprise) or ***real utility*** (if it concerns a good or service)—things that are determined ***by the wider marketplace***, not by a "shadow market" of inside players gaming the system for their own benefit. The moral: Speculatory activity should be subordinate to supply and demand, not vice versa. Otherwise the floodgates are opened to speculative excess.

(Comically, hidebound Neoliberal ideologues pretend not to know what a speculative bubble IS. Unsuprisingly, they don't even want to acknowledge the concept, because doing so would reveal the untenability of their sanctified doctrine–like the infamous "Efficient Market Hypothosis". Eugene Fama said that he cancelled his subscription to the Economist because he didn't like that it kept using the word, "bubble".)

When the rest of the economy is integrated with the success/failure of these shenanigans, the entire economic system becomes subject to the collateral damage whenever things fail…as they always eventually do…and EVERYONE gets screwed. In 2008, such fall-out had to be mitigated by the only meta-market mechanism available to society: the State. Ergo TARP.

There was a near-universal consensus amongst the world's leading economists that embattled institutions HAD to be re-capitalized, lest EVERYONE would have incurred dire consequences. We should remind ourselves that while BENEFITS almost never "trickle down", damage often DOES trickle down. Contrary to the myths of supply-side economic dogma (a.k.a. Neoliberal ideology), trickle-down effects only apply to destruction, not prosperity.

To fuss over TARP per se, therefore, is to miss the larger point. The lesson to be learned is that the State must have a larger role in the economy…or bad things happen. When an economy is beholden to highly-concentrated private power, it's a recipe for disaster. This simple truth has been corroborated time and time and time again.

With this understanding, we see that the problem with the 2008 capital infusion was that there were *not* the strings attached when there *needed* to be strings attached.
In each of the so-called "bailout" scenarios mentioned above, there was an NSA arrangement—thus failing to address the very problems that created the mess in the first place.

Moreover, in each case, the NSA rescue created a moral hazard.

So the "catch" is that "strings" must be *attached to* a publicly-subsidized bailout–conditions for necessary corrections. This means fixes that address:

- The SYSTEMIC dysfunctions (e.g. a perverse incentive structures)
- The STRUCTURAL defects (e.g. legalized corruption / exploitation, State-corporate collusion, and a lack of ROTA)

Therefore, the debate that says "bailout" or "no bailout" is a false choice. The real question is: What conditions needed to stipulated when such a capital infusion was executed?

THESIS:

Publicly-funded recapitalization confers on the lender (the public) the power to set the terms of the deal. In other words, it is the State's right ***and obligation*** to establish certain conditions for the capital infusion (to be imposed on the guilty institutions)—namely: that changes will be instituted that *correct* the problems at hand. That this is a problem that wasn't the public's fault (but the fault of corporatists and plutocrats) makes it all the more obvious that the promotion of the public interest was the condition by which a publicly-subsidized capital infusion should take place.

ANALYSIS:

"If we help you avoid implosion by re-establishing solvency," the State must say to the complicit banks, on behalf of the citizenry, "Here are the four basic conditions you're now compelled to meet." Among other things, it should have been made loud and clear:

1. Hereafter, unlike before, you will have to pay your fair share in taxes. (The year after the bailout, Citigroup and Bank of America—like Boeing, Exxon-Mobil, Wells Fargo, and GE—paid ZERO corporate taxes.)
2. Certain internal contracts (notably, promises of exorbitant bonuses) are now null and void—for obvious reasons." (No bonuses? Who's fault is that? Look no further than the upper management of each company.) Common sense dictates that tax-payer money isn't to be used to honor such contracts. (More on this point later.)
3. Submit to robust ROTA (regulation, oversight, transparency, and accountability measures).
4. Once re-capitalized, you must lend (i.e. extend credit to worthy enterprises)—and do so at reasonable rates.

Preposterously, such common-sense conditions were almost entirely overlooked during the 2008 bailout. So, unsurprisingly, the dysfunctions leading to the problems persist to this day. Thus:

- The so-called "financial services" sector continues to operate without having to pay anything close to common-sense taxes. There is still ZERO financial transaction tax or speculation tax, and minimal dividends and capital gains taxes…with gigantic loopholes in the pseudo-rates that exist only on paper. (Again, reference the ACTUAL taxes paid—the very next year—by hugely profitable mega-corporations…or lack thereof.)
- The complicit banks used tax-payer money to doll out exorbitant pay-packages to employees—based on contracts that should have been rendered null and void the moment their employer became autonomously insolvent. (Executives forfeited the right to bonuses as soon as their institution could only survive by a publicly-subsidized

rescue. Obviously, the terms of a State rescue supercede contracts ***that were predicated on a solvent institution***.)

- Hyper-speculation continues apace. In other words, the complicit banks continue to operate without any significant oversight, without the much-needed transparency, and STILL without much accountability—with only some of the most egregious abuses marginally curbed with half-assed regulations.
- For years after the crisis, even after having been saved by the public, the complicit banks refused to loosen credit / lending (which was half the point of the rescue).

There is a name for what happened: corporate welfare. (The over-all phenomenon of socializing cost / risk while privatizing profits is called “corporate socialism”—a phenomenon we see with the military-industrial complex, the agri-industrial complex, the pharma-industrial complex, the petro-industrial complex, the prison-industrial complex, etc.)

So why the consistent NSA nature of bailouts, time after time? The explanation is simple: the collusion of corporate power and State officials entails quid pro quos. Predictably, then, in 2008 (with Hank Paulson and George Jr. at the helm), few strings were attached to the rescue plan. Consequently, the STRUCTURAL defects (i.e. the defects responsible for the crisis in the first place) were left in place.

In other words, the State defaulted on its *duty to* the public *to use* the public’s money *in the best interests of* the public. This point couldn’t be more straight-forward. NSA assistance is tantamount to corporate socialism. It’s not the assistance itself that was the problem; it was the NSA.

A metaphor may help illustrate the point. Let’s suppose that your cousin, Vern, has willfully and wantonly engaged in horribly irresponsible activity (in order to accrue undeserved spoils for himself)…and has thereby rendered himself insolvent.

Note that Vern has only ever used whatever finances he could get his hands on (often, not his own) to indulge in (destructive) self-aggrandizing schemes, at the expense of everyone around him. So the temptation is to allow him to be hoist by his own petard—to let him sink. Why? Well, *he brought it upon himself*—so he doesn’t deserve to be “bailed out” by those who had no fault in bringing about his present state. “You have nobody to blame but yourself, so you should get what’s coming to you.” Sounds fair.

However, it is then brought to your attention that IF Vern is allowed to go under, his entire family will suffer from the fall-out (due to whatever logistics you care to imagine). Therefore, in order to ensure the innocent bystanders to Vern’s malfeasance don’t incur the negative consequences of his demise, you’re hand is forced: You must rescue Vern to protect his family.

When you opt to give Vern the required amount of funds to re-establish his solvency, what ELSE do you do? Do you just sign a check (without putting key conditions on the “capital infusion”)? OR…should there be strings attached to your loan?

If the former, then you are essentially acting as an “enabler” of Vern’s irresponsible behavior—establishing a precedent that serves as a *moral hazard* for Vern’s future decisions. On the other hand, by attaching some basic strings, you are invoking what is often referred to as “common sense”.

The key, then, is to attach conditions to Vern's bailout.

The point needs to be emphasized: Vern doesn't have a leg to stand on, so he has forfeited any leverage in "negotiating" the terms of the "rescue package" you're offering him. It's one thing that he's screwing himself over, but now he's threatening to drag others down. So he no longer has the right to call the shots. Certainly, any level-headed person dealing with Vern would recognize this elementary point.

Naturally, you stipulate that, if you give him the money, not only does Vern have to change his ways (desist from the dysfunctional activity that got him into this mess in the first place), but you demand that, from here on out, *the framework of arrangements* (within which the problematic behavior was allowed to transpire) be changed as well. For example, no more drinking (using his new spending cash for alcohol is now unacceptable), no more gambling, and he has to submit to a new system of oversight / transparency…so that he will hereafter be held personally accountable for all of his deeds.

This isn't "punishment". This is simply a matter of taking prudent measures to address the glaring dysfunctions. After all, Vern is no longer dealing with his own money, he's now using YOUR money. So YOU get to specify the conditions for the loan. Put another way: Vern is no longer the only person involved with Vern's activity; his conduct now involves many other people. The line has been drawn. You have the right to tell Vern how he can and can't spend the money that YOU are giving him.

For example (regarding "bonuses"), any proceeds Vern may have had coming to him from his gambling escapades, if he'd remained afloat on his own, are—in spite of any original agreements he may have had—no longer his to collect. That money must now be used to pay off the damage he's done. (Employees of complicit institutions are in an analogous boat: their contracts were predicated on a solvent employer. After all, they signed up for the ride.)

Now for the thought-experiment:

Imagine, for a moment, Vern saying to you, as you hand him the money: "Forbidding me to use this to get drunk and spend as I see fit at casinos is depriving me of my economic freedom!" Imagine how you would respond.

For good reason, you stipulate that Vern can NOT use the bailout funds for certain things; and that he MUST use the bailout funds for other certain things (i.e. for getting his shit together). That takes care of the use of the capital infusion.

You ALSO stipulate that—from here on out—the very terms on which he lives his life need to be changed—changed, that is, in a STRUCTURAL way. That takes care of ROTA.

Vern MUST accept these conditions, because YOU hold all the cards. Due to the mess that he's caused, he has forfeited his right to set the terms of the arrangement, and is obligated to acquiesce to an imposed set of (reasonable) conditions. The well-being of his family is now at stake, and so the time for him making demands is over.

Most reasonable people would agree that not only are such conditions eminently fair; it is *common sense*.

END METAPHOR.

Such strings were never attached in any of the “bailout” scenarios listed above… *strings that desperately needed to be attached*. Consequently, unsurprisingly, the same problems keep recurring, again and again. In other words, the STRUCTURAL problems remain in place—unaddressed, and even unacknowledged. (Essentially, Vern refused to change his ways, and simply used the money you gave him to keep gambling, to keep getting drunk, to keep indulging his own gluttony.)

Let’s review the real-life cases:

Coolidge’s vice president, Charles Dawes, helped out in Hoover’s bailout operation, later changing hats and grabbing a big slice of the bailout pie for his own bank. Hoover distributed NSA bank bailouts in the early years of the Great Depression—trying to stimulate the economy from the supply side (based on a fetishization of the free market).

The Reagan administration rescued Continental Illinois from what was then the largest bank failure in U.S. history. (Citibank’s market-worshiping CEO, Walter Wriston, begged for—and, of course, received—the assistance he requested from his corporatist buddies in the administration.) Once more, the thinking was to stimulate the economy from the supply side. And then, with Long Term Capital Management’s house of cards collapsing, the Clinton administration refused to put in place ROTA that would have solved the problems that lead to the incident. Again, the approach was based on supply-side economics.

What was the problem with those scenarios? No strings attached; no strings attached; and no strings attached. Notice a pattern? In each case, the hyper-speculation that caused the problems continued—with impunity—precipitating more bubbles and the ensuing crises. The crash of 1929, then, was followed by the S&L scandal (late 80’s), LTCM’s implosion (late 90’s), AIG / Goldman Sachs, Lehman Bros., et. al. (late 00’s) As for the 40’s, 50’s, 60’s, and 70’s? Well, coincidentally, that’s when Keynesian economic policy was in place. Go figure.

Question: In each of the aforesaid crises, *why weren’t* obviously-needed strings attached? The answer is quite straight-forward: ***corporatism***. Stipulated conditions for each “rescue” were omitted (due to deeply-embedded conflicts of interest—the inevitable conflicts of interest that result from the collusion between corporate power and the government insiders who serve that power).

The “bailout” for Goldman Sachs (via A.I.G. and otherwise) was tremendously costly. Goldman, which was the beneficiary of at least $13 billion in public assistance through the AIG bailout, also receive $10 billion more via TARP, and almost $29 billion on top of that in cheap money coming via FDIC-backing for new debt (via Geithner’s “Temporary Liquidity Guarantee Program”).

Of course, the best “program” for “guaranteeing liquidity” is to preemptively make rules REQUIRING LIQUIDITY. (Duh.) This would mean:

- Tightened margin requirements: say, a maximum allowable leverage of 4 or 5 to 1

- Reserve capital must be instantly liquidate-able “cash”. (This means that the “equity” in the “debt to equity” ratio must be real, solid money.)
- No circumventing margin requirements with financial chicanery like CDSs.
- No more “proprietary trading” (i.e. opacity).

Also, no more betting on defaults. No more betting on the success or failure of others’ bets. (As has been demonstrated over and over, “shorts” and “puts” are a recipe for conflicts of interest.) Attaching such “strings” is eminently reasonable. Instead, we got a “no more leveraging 30:1” rule…and a castrated CFPA (Consumer Financial Protection Agency), replete with the rebuffing of the most qualified steward, Elizabeth Warren.

It’s estimated that we ultimately will have spent over $13 trillion (that’s TRILLION, with a “T”) of tax-payer money on the bailouts. To what end? How much of this tax-payer money will the public get back? Well, that’s all contingent on the nature of the “strings attached”. Alas, because there were so few conditions, we’ll never really know the answer to that question.

CONCLUSION:

In the 2008 “bailout”, there were no stipulations as to how the money would be allocated, few arrangements for crucial ROTA, and no obligation for the banks to offer credit at reasonable rates (credit for pro-social, productive enterprise investment) once the financial institutions’ solvency was re-established. (Couple this with a woefully inadequate stimulus, and is it any wonder the recovery has taken as long as it has?)

Indeed, there were SOME conditions stipulated, such as new restrictions on leveraging proportions (no more 30:1 leverage), but few other (desperately needed) strings were attached. Even an obviously needed Consumer Financial Protection Agency was neutered (and Elizabeth Warren denied a role in orchestrating those protections).

Predictably, without the “after you get bailed out, you must lend” string attached, for the next 4 years, the (further-consolidated) banks were making record profits…***while sitting on massive cash reserves***. In other words, for the next four years (and counting), the banks refused to free cash up for investment in pro-social enterprises (ventures that were looking for capital). So projects that would have helped the commonweal were (unnecessarily) kept on hold, thereby rendering the economic recovery far more sluggish than it needed to be. Meanwhile, over 90% of the recovery (usurprisingly) went to the richest 1% of the country. The system remained rigged to benefit the privileged few…even as desperately-needed “stimulus” (investment in public works) was woefully inadequate.

Responsible citizens must learn the obvious lesson from these tragic ordeals. We should pray that the E.U. learns this lesson. It’s not the bailout ***per se*** that is at issue; it’s the conditions that go along with the bailout. Those conditions must be designed for the general welfare (to promote the public interest), not for the aggrandizement of a few well-positioned insiders (i.e. to abet corporate interests).

REFERENCES:

There are five books that are indispensable for understanding what happened in 2007-8. All five books are profoundly insightful—and quite jaw-dropping.

By far, the two best are Joseph Stiglitz's ***Freefall*** and Matt Taibbi's ***Griftopia***. Stiglitz (arguably, the most esteemed economist in the world) gives the theoretical background for what happened. Taibbi provides a (snarky, well-researched) blow-by-blow account of who did what, when, where, why, and how. Also used were myriad articles by Robert Reich and Paul Krugman.

There are three excellent books that address the back-story—explaining the events leading up to the debacle:

- ***It Takes A Pillage*** by Nomi Prins
- ***The Great American Stick-up*** by Robert Scheer
- ***Winner-Take-All Society*** by Pierson and Hacker

The conclusion is quite clear: right-wing economic policy—enacted by both Democrats and Republicans.

RESPONSE TO A COMMON CRITICISM OF THE THESIS:

Criticism: "In your metaphor, cousin Vern wasn't integral to the maintenance of the national economy; the financial sector is. So it is a false analogy. For-profit financial institutions (investment banks, hedge funds, private equity firms, and other speculation-based operations) are necessary to optimise the allocation of capital. They do this by connecting liquid assets with the "best" enterprises. Vern, meanwhile, plays no necessary role in society. In other words, we can do without Vern, but we NEED for-profit financial institutions. So we should cut them a little slack."

Response: Arguing that for-profit financial institutions are required for the common good is a brazen proposition. That the general welfare is predicated on the existence of Goldman Sachs and Citi-Group is a peculiar notion, indeed, as their summum bonum is anything but the general welfare. Indeed, their activity has often proven to be profoundly deleterious to the general welfare. It has been clearly demonstrated for three decades: The better off that Goldman Sachs does, the better of the rank and file does NOT do.

The fact of the matter is that society doesn't need a Goldman Sachs. In fact, the case could easily be made, society may well be better of without Goldman Sachs, et. al. The evidence that for-profit financial institutions are necessary for optimizing the allocation of society's resources is dubious at best. There are other mechanisms that accomplish that vital task, and do so in a more pro-social way: the NIH, federal grants, and philanthropic foundations, for example. (There are also NORMAL BANKS, prepared to lend money to worthy ventures, in ways that don't involve speculation.)

If I have mountains of money, surely I can marshal the wherewithall to find worthy ventures into which to channel it without an AIG, a Blackstone Group, a Bear Stearns, or a Long-term Capital Management. (Frankly, after all that has happened, that institutions like A.I.G. and Goldman Sachs still exist is an embarrassment to our country.)

I'd go so far as to contend that, in a typical week, the average public school teacher does more for society than Lloyd Blankfein, Dick Fuld, or many other corporate execs will do their entire lives. This is sad, but true. In fact, many of the highest paid businessmen in the country have done society more harm than good. So the analogy with cousin Vern seems quite apt. After all, Vern has the potential to do some good if he changes his ways. As with individuals, institutions are influenced p;p;by incentive structures.

POSTSCRIPT: NSA in Other Contexts:

Attaching "strings" isn't always a good thing. Indeed, it depends on what the strings are. For example, the IMF and World Bank (the so-called "lenders of last resort" for embattled nations) are notorious far attaching BAD strings.

Often, when these institutions offer struggling economies capital infusions, insiders make draconian demands—most notably: special "favors" for corporate interests in return for the "rescue". Specifically, they demand that much of the economy be privatized (i.e. sold off to the highest bidder). Such "bailouts" are often more harmful than helpful in the long-run BECAUSE OF those strings–conditions designed for corporate interests rather than the public interest. (For more on this important point, see Naomi Klein's landmark work, ***The Shock Doctrine***, and Ha-Joon Chang's ***Bad Samaritans***.)

Such interventions are an example of ulterior motives on steroids. This colossal abuse of leverage enables a few well-positioned agents to take advantage of an already unfortunate situation–and do so under the pretense of "coming to the rescue". The lesson here is simple: There are iniquitous strings as well as prudent ones. It is important to tell the difference.