10 days That Changed Capitalism

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> The world has changed. The market fundamentalism that has dominated our economics over last three decades has been unmasked as a sham, deemed useless by the guardian of the integrity of finance itself, the Federal Reserve.

Without a vote of the Congress or a public debate, the Bush administration and the Federal Reserve have made government the guarantor of the shadow banking system – the unregulated, unhinged hedge funds and investment houses whose compulsive excesses now threaten the global economy. They say necessity is the mother of invention, but we seen only a part of the new machine, not surprisingly, the part that buttresses Wall Street. They have scrambled to put this together in an emergency, behind closed doors, without a hint of the necessary regulatory changes that must rationally accompany such guarantees. That is what the fight in the coming months will surely be about.

As the article below by David Wessel of the Wall Street Journal summarizes, the intervention puts at risk hundreds of billions of taxpayer dollars.

It also transforms the economic debate. It is inconceivable that taxpayers should be asked to bail out private buccaneer speculators without enforcing limits on their speculation – capital reserves, limits on what gambles they can take, oversight, transparency, new restrictions on their pay packages to remove the current multi-million dollar personal incentives to invent new Penza schemes and scams.

The shadow banking system now must be brought out of the shadows. After all we are constantly told that finance serves the economy, and the market system is the best means to solve our social goals. It feels very uncomfortable when our servant's servant becomes our master's master as Wall Street has been permitted to become in America in recent years by contribution- hungry elected officials.

As Barack Obama noted in his speech yesterday, the deregulation that fostered this folly was supported by both parties. It began under Jimmy Carter, accelerated under Ronald Reagan, went into hyper speed under Bill Clinton, and spiraled into catastrophe under George Bush. The freedom to gamble with other peoples' money has been protected by lavish campaign contributions and powerful lobbies. These financial buccaneers have treated the laws and rules that govern our financial markets like just one more asset to be bought and sold. They have been unabashed in their arrogant abuse of power, rigging the rules and daring the world to stop them. A particularly audacious example occurred only last year when a concerted lobby campaign convinced the Democratic majority in the Senate to sustain the tax dodge that enables billionaire hedge fund operators to pay a lower tax rate than their secretaries.

This cannot continue. They ask to pocket their profits and have taxpayers protect them from their losses. That offends the principles of both democracy and the market. If they are too big to fail – if their failure will bring down the entire economy – then they are also too big to gamble on their own. They must be regulated – or perhaps nationalized, as the British have just done with one of their leading banks. After all they are asking to nationalize their losses. Why not some of their profits too?

This debate must be accessible to, and reflect the concerns of, citizens. It cannot be the exclusive province of so-called experts, Wall Street operators, economists and legislators. Too often, Wall Street manages to profit having the party and then make a bundle from the government in cleaning up the mess as they socialize the losses that they created.

It is important to understand how reckless Wall Street has been. They have not only victimized the American people through recession and bailouts. Their recklessness threatens to blow up their own cherished role as well. They have damaged the international reputation of the U.S. dollar, turning the world's reserve currency into the equivalent of a junk bond. The excesses of their hubris-driven repackaging of assets has muddied the U.S. credit allocation process and accelerated the US decline as the financial center of world commerce. Their sacred cow of "free trade" is unlikely to withstand the pressure of a prolonged slump. Wall Street is compulsively consuming itself.

We are going to follow this debate closely at CAF. It will be a constant feature of this blog. We'll call on the best progressive economists and analysts to break it down. We'll collect the best documents so you can follow the debate. And we'll be driving campaigns to make certain that the public doesn't once more get stuck with the bill for the bankers' party, with no assurances that the reckless structure of finance has been repaired.

David Wessel provides good summary of where we are below.

http://online.wsj.com/article/SB120657397294066915.html

Ten Days That Changed Capitalism
Officials Improvised
To Rescue Markets;
Will It Be Enough?
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David Wessel

The past 10 days will be remembered as the time the U.S. government discarded a half-century of rules to save American financial capitalism from collapse.

On the Richter scale of government activism, the government's recent actions don't (yet) register at FDR levels. They are shrouded in technicalities and buried in a pile of new acronyms.

But something big just happened. It happened without an explicit vote by Congress. And, though the Treasury hasn't cut any checks for housing or Wall Street rescues, billions of dollars of taxpayer money were put at risk. A Republican administration, not eager to be viewed as the second coming of the Hoover administration, showed it no longer believes the market can sort out the mess.

"The Government of Last Resort is working with the Lender of Last Resort to shore up the housing and credit markets to avoid Great Depression II," economist Ed Yardeni wrote to clients.

First, over St. Patrick's Day weekend, the Fed (aka the Lender of Last Resort) and the Treasury forced the sale of Bear Stearns, the fifth-largest U.S. investment bank, to J.P. Morgan Chase at a price so low that a shareholder rebellion prompted J.P. Morgan to raise the price. To induce J.P. Morgan to do the deal, the Fed agreed to take losses or gains, if any, on up to $29 billion of securities in Bear Stearns's portfolio. The outcome will influence the sum the Fed turns over to the Treasury, so this is taxpayer money; that's why the Fed sought Treasury Secretary Henry Paulson's

OK.

Then the Fed lent directly to Wall Street securities firms for the first time. Until now, the Fed has lent directly only to Main Street banks, those that take deposits from ordinary folks. That's because banks were viewed as playing a unique economic role and, supposedly, were more closely regulated than other types of lenders. In the first three days of this new era, securities firms borrowed an average of $31.3 billion a day from the Fed. That's not small change, and it's why Mr. Paulson, after the fact, is endorsing changes to give the Fed more access to these firms' books.

Increased Leverage

In the days that followed, the Republican Treasury secretary leaned on two shareholder-owned, though government-chartered, companies -- Fannie Mae and Freddie Mac -- to raise capital that their boards didn't want to raise. In exchange, their government regulator allowed them to increase their leverage so they can buy about $200 billion more in mortgage-backed securities.

So Fannie and Freddie will get bigger, a welcome development when mortgage markets are in trouble. Already, they have regained lost market share. They accounted for 76% of new mortgages in the fourth quarter of last year, up from 46% in the second quarter, Mr. Paulson said Wednesday. But everyone knows that if Fannie or Freddie stumble, taxpayers will get stuck with the tab.

And then, the federal regulator of the low-profile Federal Home Loan Banks, which are even less well capitalized than Fannie and Freddie, said they could buy twice as many Fannie and Freddie-blessed mortgage-backed securities as previously permitted -- more than $100 billion worth.

Was this necessary? It's messy, uncomfortable and undoubtedly flawed in many details. Like firefighters rushing to a five-alarm fire, policy makers are making mistakes that will be apparent only in retrospect.

Too Great to Ignore

But, regardless of how we got here, the clear and present danger that the virus in the housing, mortgage and credit markets is infecting the overall economy is too great to ignore. The Great Depression was worsened because the initial government reaction was wrong-headed. Federal Reserve Chairman Ben Bernanke spent an academic career learning how to avoid repeating those mistakes.

Is it working? It is helping. One key measure is the gap between interest rates on mortgages and safe Treasury securities. A wide gap means high mortgage rates, which hurt an already sickly housing market. A lot of recent activity, including Wednesday's previously planned auction in which the Fed is trading Treasurys for mortgage-backed securities, is aimed at increasing demand for those securities to drive down mortgage rates.

The gap remains enormous by historical standards, but has narrowed. On March 6, according to FTN Financial, 30-year fixed-rate mortgages were trading at 2.92 percentage points above the relevant Treasury rates; Wednesday the gap was down to 2.22. Normal is about 1.5 percentage points. Money markets are still under stress, as banks and others hoard cash and super-safe short-term Treasurys.

Is it enough? Probably not. Although it's hard to know, the downward tug on the overall economy from falling house prices persists. The next step, if one proves necessary, is almost sure to require the explicit use of taxpayer money.

Cushion the Blow

The case for doing more is twofold. One is to cushion the blow to families and communities, even if some are culpable. The other is to disrupt a dangerous downward spiral in which falling prices of houses and mortgage-backed securities lead lenders to pull back, hurting the economy and dragging asset prices down further, and so on.

In ordinary times, a capitalist economy lets prices -- such as those of homes, mortgage-backed securities and stocks -- fall to the point where the big-bucks crowd rushes in, hoping to make a killing. But if the big money remains on the sidelines, unpersuaded that a bottom is near, the wait for bargain hunters to take the plunge could be very long and very painful.

So the next step, no matter how it is dressed up, is likely to involve the government's moving in ways that put a floor under prices, hoping that will limit the downside risks enough so more Americans are willing to buy homes and deeper-pocketed investors are willing, in effect, to lend them the money to do so.

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