Good Times for the Few

Chairman Bernanke and the Bailout of the Banks

By Mike Whitney

It's been a year and a half since Lehman Bros. collapsed, and the economy is just now beginning to show signs of life. At first, Federal Reserve chairman Ben Bernanke was caught flatfooted, when two Bear Stearns hedge funds blew up in July 2007. But, as the crisis deepened, Bernanke swung into action using all the tools at his disposal. He slashed interest rates to near-zero, set up emergency swap lines with banks in Canada, England, Japan, Switzerland and the EU, and transformed the Central Bank into a government-backed hedge fund to stem the downward slide.

Even before Lehman had failed, Bernanke started setting up lending facilities to provide liquidity to ailing financial institutions. The $700 billion Troubled Asset Relief Program fund gave the banks enough capital to roll over their debts and keep the lights on, while the new facilities provided the temporary hosing, needed to replace the ruptured plumbing of the shadow banking system.

Bernanke brushed aside the Fed's mandate to only accept Triple A bonds in exchange for loans and Treasuries. The Fed accepted all kinds of dodgy bonds and junk securities to maintain the vital flow of liquidity to the markets. As the toxic assets piled up on the Fed's balance sheet, the banks and other financial institutions resumed their speculation in high-risk instruments, which plumped up quarterly earnings and boosted their stock prices. With Bernanke's help, the banks emerged Lazarus-like from the crypt and raked in record profits in a matter of months. Tens of billions of dollars in bonuses were issued to banksters who – just weeks earlier – had been pulled from choppy waters by Uncle Sam.

Most people don't understand the roots of the crisis because they don't understand the workings of the modern banking system. This isn't the "take deposits and hold to maturity" model that most of us grew up with. This is a shadowy high-tech industry, where enormous sums of money appear briefly on a computer screen and then quickly vanish into the digital abyss.

Before the crisis, the shadow banking system accounted for more than 50 per cent of the credit flowing into the economy. Now, wholesale credit has slowed to a trickle. The market for mortgage-backed securities and asset-backed securities is a fraction of what it had been in the peak years. The securitization boycott is still in force. The Fed's loans and quantitative easing have made up for the losses in credit-production, but it won't last. As deflation begins to resurface, securitization will need to be revived, or the vicious contraction will surely resume.

The rescue operation has focused exclusively on the financial sector, while everyone else has been expected to fend for themselves. Main Street was savaged so Wall Street could be salvaged.

But there's a structural flaw in securitization that poses a serious danger to the system. The process creates incentives for fraud by placing intermediaries between borrower and the lender. The banks merely act as "loan originators" who quickly sell off the mortgages to other financial institutions. Naturally, the bank is less motivated to make sure the borrower is creditworthy if the risk is pushed onto someone else's balance sheet. It's just "garbage in, garbage out." And this gets to the heart of the matter, which is the reason why regulated banks no longer keep mortgages on their books, because it's not profitable for them to do so. And the only thing that makes it profitable for shadow banks is that they ignore the standard rules for adequate capitalization. In other words, they balance more and more debt on smaller and smaller slices of capital, which further exacerbates systemic risk. The main lesson of Lehman's crash is that, when highly leveraged, undercapitalized institutions can't meet their margin calls, the whole system caves in.

Presently, Bernanke is rebuilding this same crisis-prone system, brick by brick. If shadow banks are going to create credit, they need to be regulated like depository institutions and held to the same capital standards. Otherwise, one disaster will follow the other.

In truth, the financial meltdown had little to do with "subprime contagion" or even Lehman's default. It was mainly the result of deregulation, a process in which all of the traffic lights, road signs and guardrails were removed, so that a handful of Wall Street uberbanks could fatten the bottom line.

While Bernanke deserves some credit for slowing the cycle of debt deflation (by propping up asset prices), on balance, his efforts have hurt the country. Trillions in aid have gone to broken institutions, while 8.5 million workers have been shunted off to unemployment lines. The rescue operation has focused exclusively on the financial sector, while everyone else has been expected to fend for them-

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selves. Main Street was savaged so Wall Street could be salvaged.

Many believe that Bernanke helped to restore the banking system to solvency, but this is a myth. In April 2009, The Financial Accounting Standards Board suspended its "mark to market" rule, which required financial institutions to assign a true market value to the assets on their balance sheets. This gave the banks the green light to lie about how much red ink was really on their books. The truth is, accounting fraud helped the banks stay afloat more than anything Bernanke ever did.

However, the issue now is not Bernanke's past performance but what comes next. Will he do what's necessary to strengthen the recovery, or will he tighten the screws? He appears to have chosen the latter. Bernanke opposes a second round of stimulus and the administration's jobs bill. Instead, he's pushing for fiscal consolidation, which means he supports cuts to Social Security and Medicare.

Bernanke doesn't try to hide his anti-big-government bias or his enthusiasm for "fiscal austerity." But his comments are wildly out of sync with his lavish gifts to Wall Street, which exceed the amount of the new jobs bill ($15 billion) by more than a hundredfold. What he seems to be saying to Congress is that the costs of the meltdown should be seen as a justification for looting Social Security. In other words, the victims should pay for what the fraudsters stole. Such is the logic of Chairman Ben.

So, where will Bernanke steer the economy now that unemployment is stuck officially at 9.7 per cent (with unofficial estimates that one in five in America are either unemployed or doing part-time work), private consumption is below trend, the credit markets are in disarray, household balance sheets are in tatters, and housing stumbling toward the precipice?

Instead of fiscal stimulus, strong demand, and full employment, Bernanke has thrown his weight behind hybrid derivatives, securitization, and too-big-to-fail megabanks. His misguided focus on "fiscal consolidation" and "deficit reduction" is a liquidationist ploy to further unravel the social safety net, cut public services, crush the unions, and scoop up public assets for pennies on the dollar. What we really need is a strategic plan to lift us from the muck and point the way forward. Here's an excerpt from an interview with James Galbraith who sums it up perfectly:

"I've always taken exception to the reference to 'stimulus' as ... a relatively short-term spending spree, … that will somehow return the economy to … a path of what economists like to call 'self-sustaining growth.' ... In the present environment, there is no such thing as a return to self-sustaining growth. There will be no return to the supposedly normal conditions, which were, in fact, from a historical point of view, highly abnormal.

"What one needs is to set a strategic direction for renewal of economic activity. We need to create the institutions that will support that direction. Those institutions are public institutions, which create a framework for private activity. This is the way it is done. It is the way countries have always developed in the past and, to the extent that they are successful, they will always do so in the future or they won't succeed. "**CP**

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