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EIR Economics

Put Up the Firewall, Bring In the Shrinks!

by John Hoefle

As their speculative financial system crumbles around them, the bankers and their regulators are in obvious denial about the nature of the problems they face, and the nature of the solutions. Rather than being guided by reason, they are being guided by their compulsions, trying to save what cannot be saved, by methods which have failed repeatedly. Like crack addicts or compulsive gamblers, they find themselves unable to stop their destructive behavior, even when they know, deep in their hearts, that their actions are leading them to their doom.

All the signs are there. Fed chairman Ben Bernanke has rather openly stated that the Fed's escalating series of emergency bank loan operations will continue, thereby confirming that the U.S. banking system is insolvent. Treasury Secretary Henry Paulson, while talking openly about the possibility of the failure of a major U.S. investment bank, is pushing for further deregulation of the financial system. Regulators are discussing the possibility of using the big private equity funds to inject badly needed capital into the banks, in exchange for further deregulation; and some of the bankers, like J.P. Morgan Chase CEO Jamie Dimon, are calling for the banks to be allowed to operate like private equity funds. Congress, under the guise of protecting homeowners, is pushing legislation designed to protect the banks and other holders of mortgage-related debt. More bailouts, more deregulation, more of the same poison that is killing us all.

Meanwhile, the disintegration continues. The FDIC is gearing up to handle a rash of commercial bank failures, as rumors of problems circulate amid suggestions that quiet runs on suspect banks have already begun. The FDIC is, at least nominally, focussing its attention on small and medium-sized banks with large exposures to their local/regional commercial real estate markets, in the hope that the Plunge Protection Team can head off the open failure of the giant banks. The situation is far worse than they will publicly admit, and they have no solution other than buying time, in the hope that the financial markets can somehow be brought back to life.

What they are doing is the equivalent of rearranging the deck chairs on the *Titanic*, trying to keep themselves and their passengers calm as their ship sinks beneath the waves. They are in denial, paralyzed with fear, and making the same mistakes over and over again. They obviously cannot stop themselves so we must intervene, get them some professional psychiatric help, and let more reasonable minds take over.

It's the System

The tendency of most people, regulators and citizens alike, is to approach this banking crisis through the prism of individual institutions. As institution after institution flames out, from mortgage lenders to giants like Bear Stearns, we are treated to a series of soap operas, a new cast of villains to be blamed for our trouble. The Justice Department has indicted over 400 individuals in the mortgage-loan business as part of Operation Malicious Mortgage, including two former officers of Bear Stearns. While we leave it to the courts to decide the innocence or guilt of individuals, there is certainly no shortage of criminal culpability in the mortgage sector, and people who committed fraud should be held to account for their actions. However, this approach falls far short of what is needed.

Take the cases of Fannie Mae and Freddie Mac, the big government-sponsored enterprises that buy mortgages and issue mortgage-backed securities. Both institutions, due to their huge exposure to the collapsing residential mortgage system, are effectively insolvent, and both have had their share of investigations and accounting problems. Nevertheless, the Plunge Protection Team and the Congress are using both Fannie and Freddie, along with the Federal Housing Administration, as integral parts of their bailout machine. The name of the game is to convert as much of the private mortgage paper as possible into government-guaranteed paper, even though that will ultimately mean huge taxpayer bailouts.

Former St. Louis Fed president William Poole made the point about Fannie and Freddie explicitly, in a interview with Bloomberg News July 9. "Congress ought to recognize that these firms are insolvent, that it is allowing these firms to exist as bastions of privilege, financed by the taxpayer," Poole said. Poole later told the *New York Times*, "We are potentially looking a crisis in the face, and we must not allow this to happen. The government must intervene."

Poole's comments helped accelerate the slide in the stock prices of both institutions. Fannie Mae's stock is off 76% from a year ago, Freddie Mac is down 83%, and they are now at their lowest levels in 17 years.

Poole's blunt comments and the stock slide had both Paulson and Bernanke in damage-control mode during Congressional hearings July 10. Paulson claimed that both companies were "adequately capitalized" and "working through this challenging period," while Bernanke claimed that they "are well capitalized in a regulatory sense." Given the dismal track record of this pair and the weakness of their statements, they were less than reassuring.

Sooner, rather than later, Fannie Mae and Freddie Mac will blow up and require huge bailouts. Inevitably, investigations will be launched to find out what went wrong, and those investigations will likely focus on events and personalities inside the companies, whereas the real culprits will be people like Paulson and Bernanke, whose policies put the companies in an untenable situation.

To understand what has gone wrong, one must focus on the system itself, the overall process, rather than merely one or two components of the system. It is the policy of attempting to bail out the bankrupt system, which will be the cause of the damage to come.

Coverups

What is required, is for the public to be told the truth about the condition of the financial system, and the costs—monetary and societal—of the bailout operation. No constitutional republic can function properly when the citizens are lied to, repeatedly and systematically, about the most important matters before them. The citizens have a right to know the true condition of their financial system. Instead, what we get are lies and coverups, designed to hide the damage.

Perhaps the most egregious case of this is the speculation in oil and food. Much of the money being stolen from the population through this oil and food speculation is being funnelled into the financial system to fund the restructuring now under way. Despite a series of Congressional hearings on the subject, nothing has been done to curb this speculation. Regulators like the Commodity Futures Trading Commission (CFTC), which are supposed to defend the citizens, are instead captives of the financial markets, and protect the looting apparatus. The CFTC, like its regulatory peers, is determinedly oblivious to what is so obvious to the rest of us. "We see no evidence" is the mantra they repeat over and over.

Not only that, but this deadly price-gouging is being actively protected by Wall Street. After a recent House Agriculture Committee hearing in which he testified on the need to rein in speculation, Rep. Bart Stupak (D-Mich.) reported that a "Wall Street warroom" had been set up to block any action by the government against speculation. Later, Stupak told *EIR* that this warroom was being run by investment banking giant Morgan Stanley, and that the banks and other financial companies are doing all they can to stop any action aimed at ending speculation in food, oil, and other commodities.

Blowing Out

This "Wall Street warroom" operation is another sign of the desperation of the bankers to avoid dealing with the truth of their situation. Despite their efforts, and in many cases, *because* of their efforts, the banking system continues to disintegrate. Mortgage lender Countrywide has now been absorbed into Bank of America, at a cost of making the problems faced by Bank of America even worse. Now we see IndyMac Bank, a spinoff of Countrywide, disintegrating before our eyes; it's laid off over half its workforce and ceased making loans. It is but the latest in a never-ending series of disasters.

The regulators and the financiers assured us that the "subprime crisis" was contained and would not pose a threat to the banks—but they were wrong. The regulators and financiers assured us that the "credit crunch" was contained and did not pose a threat—but they were wrong. Now, after hundreds of billions of dollars of admitted losses to the world's banks, they tell us that the banking system is safe despite its problems—but they are wrong. They tell us that Fannie Mae and Freddie Mac are safe, even while they use them as vehicles to transfer enormous losses from the speculators to the taxpayers.

The bankers' plan is to save themselves by sticking the government, and thus the taxpayers, with their losses, to protect their looting rights at all costs, and to eliminate any laws, regulations, and government efforts which get in their way. They will accept consolidation among their ranks, and even the demise of some important institutions, in order to protect the system itself.

The irony is that their own efforts to protect themselves will destroy them. They cannot bail themselves out, even via the government, because our economy can not support the debt. It can't be paid, and all their bailout schemes do is add more debt to a dead system.