



Is the Bailout Justified?

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Is the Bailout Justified?

BY MASON GAFFNEY, ON SEPTEMBER 22ND, 2008

QUESTION: We hear that the feds HAD to bail out Fannie and Freddie because of the terrible consequences of letting them fail. How much of that is real and how much is bunk? I'd have thought that if the companies go bankrupt, their stock sells for pennies on the dollar and the new owners can re-negotiate loans down to lower interest rates for people who can afford to pay something, while foreclosing and selling (cheap) those homes that had been bought on false pretenses and weren't going to be paid off at any positive interest rate. Where's the catastrophe? Am I missing something important?

ANSWER: Yes, you are missing something important. Banking is a confidence game because banks borrow short to lend long, making their income on the spread of interest rates. That means they are at all times technically insolvent, so when confidence hangs by a thread the whole system can crash, even though for years it has operated smoothly.

They insure all this with a cushion of capital and surplus that is a small fraction of their liabilities, well under 10%. So if a small fraction of their borrowers default it wipes out their capital and surplus, and they stop lending.

When they move too much of their funds into long-term investments like buildings, plus land purchases which are even slower to pay out, their loan turnover slows down so every year they have fewer funds to finance current production. This is the case today, and it chokes off lots of productive businesses.

Superficially the lower (commercial) banks avoid this slowdown by selling their assets to higher (investment) banks, but that just blows dust over what is really happening. The higher banks end up holding the bag, as now, and they collapse, as now.

Since FDR, strict banking regulations held the system in check. The Glass-Steagall Act of 1933 separated commercial banks from investment banks precisely to protect consumers and commercial borrowers from the risky behavior of higher banks. Since Newt Gingrich and Rush Limbaugh and Tom DeLay took over, these regs have been repealed, including Glass-Steagall in 1999. The ensuing crash, set up by doctrinaire neocons blinded by Chicago-school economic theology and Bush imperialism, is likely to match 1929.

In previous busts the U.S. Treasury could hold the final bag. Now, however, the U.S. Treasury itself is vulnerable, depending on loans from foreign nations. So we inflate the currency and devalue the dollar in a vain effort to prevent further collapse of real estate values and further seizing up of the commercial banking system.

Bernanke and Paulson, no fools, are making lemonade as best one could hope. I would nonetheless fault them for cooperating with an administration that refuses to raise taxes or cut military spending and related puppet-propping subventions. We need to do what Clinton did: "reverse crowding out"—paying off government bonds to put money back into the hands of consumers and, especially, investors.

Of course this leads right into income tax reform, which is more Paulson's business than Bernanke's. We need steeply progressive income and corporate taxes and an end to special treatment of real estate, oil and other natural resources.

Bernanke's business should be to promote selective credit controls, especially to restrict bank lending on real estate collateral.

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