Great Decisions Katonah Chapter
Summary: March 15, 2011
"Banks, Government, and Debt Crises"

by Elizabeth Hall

No matter how we view the financial crisis, three factors will have a major effect on the speed with which we pull out: 1) current Middle East uprisings and their effect on oil production; 2) Japanese earthquake; 3) European debt crisis.

The fairness of the financial system is on trial.

We should rename this group "Great Depressions." Foreigners say we periodically question our own system. Liberalism has become a "bad word"; today we say "progressivism." We've had surges of progressivisms, followed by backslides. Today we have the worst inequalities of income since the days of the robber barons.

Because of the flood of money into politics, people have lost control of the government. As long as money is flowing into Washington, we won't regain control. We need an equal and opposite reaction on the left comparable to the Tea Party on the right. Part of our problem is that when the Republicans were cutting taxes for years and years, they kept on spending.

We need to activate people from the center. The aim of those in control is to keep the people divided. What could people from the center agree with in the views of both sides?

Is polarization really the issue? If the financial industry were muzzled, who would be talking? It's all about money, which is just going down the drain—spent in advertising and buying influence. We need to cut "influence spending" and keep on with general spending.

One of the primary causes of the recession is the diminishing wealth and spending of the middle-class. We need to <u>nurture</u> the middle-class. The median income has been losing to inflation for decades. The top 10th of each high-bracket income is zooming.

If we stop income loss (caused by job loss) with a protective wall around the country, the barrier would increase the cost of goods.

Economists say that reducing income through taxation would decrease effort, but I didn't stop working when taxation increased.

The equity market demands growth. Companies comply, both by buying and selling. The financial crisis got bigger because of leverage.

How can we attack the crisis? Are people willing to share and sacrifice? Think about the fact that both private and public pension funds are looking for profit.

Financial communities did lots of things that were very, very wrong. Those who benefited and those who profited were not just those at the top. Lots of people in middle financial positions were making lots of money—even clerks.

The first wave of mortgage defaults was subprime mortgages; the current wave is Alt-As. [Alt-As, which are mortgages without documentation, are considered riskier than prime, but less risky than sub prime. Borrowers with Alt-A mortgages tend to have less than full documentation, lower credit scores, higher loan-to-values, and more investment properties. Alt-As rose from 2.7% of mortgages issued in 2001 to 13.4% of those issued in 2006. At that time more than half of all Alt-As also had simultaneous second mortgages.] Lots of things were done which were blatantly illegal—and not just by the heads of companies involved.

Most Alt-A loans were made by a few lenders, including Countrywide Financial [bought by Bank of America] and Washington Mutural [taken over by Chase Bank].

The housing industry lobbied for the repeal of the Glass-Steagall Act. Alan Greenspan, a disciple of Ayn Rand, also lobbied for its repeal. In late 1999, the Gramm-Leach-Bliley Act repealed provisions of the Glass-Steagall Act that removed the separation between investment banks and depository banks.

Some theorists believe that financial crises are inevitable. Economies go through capital-hungry and capital-sated periods. During capital-hungry periods, there is not enough capital to meet demands in the economy; during-capital sated periods, not enough investment opportunities to consume available capital. We've been through capital-sated periods of petro-dollars looking for yield with the financial industry creating investment opportunities. Repeal of the Glass-Steagall Act was absolutely disastrous. Every credit-default swap is a bet.

For a start, we need to go back to the Glass-Steagall Act. We have a dependence of banks on government, because they've been allowed to get too big to fail. If they're too big to fail, they can gamble with our money. We need to make banks smaller so they aren't too big to fail.

The Dodge Frank Act was signed by Obama in July 2010, with provisions to be worked out in committee. The Act is supposed to make sure that banks are not too big to fail. Volcker's original rule had teeth in it [no bank could use more than three percent of its Tier I capital in proprietary trading; hedge-funds and private equity funds could use no more than 3% of their Tier I capital) The rule will be subject to exceptions, limits and implementing rules. When the provisions are worked out, only lobbyists will be paying attention, and the rule will be watered down.

Why doesn't the U.S. have strong banks? Our highest-rated bank is New York Bank of New York Mellon, which is rated 33 in the world. Our banks have gone from the highest rated in the world to simply mediocre. That's in good part because we don't impose any real costs on people who fund them. People shouldn't be totally protected, but we protect the first $250,000. We should put a 5% deductible on bank insurance. Then everyone would put their money in the strongest banks. Bank bondholders shouldn't be bailed out with all their money guaranteed. Greater risks would also mean greater returns. Banks would automatically become stronger.

Rescues have treated only symptoms of disasters. Without restructuring, the economic seeds for the next disaster are planted. In today's crisis, with Feds keeping interest rates so low, we are stuck in a sated period, again planting seeds for the next disaster.

We also need to keep capital requirements for our banks higher. [Basel III: the latest requirement for European Banks is to be 7 percent by 2019, up from today's 2 percent. Today U.S. banks must have a Tier 1 capitalization of 4%; a combined Tier 1 & Tier 2 capitalization of 8%. Sheila Bair, who is Chairman of the FDIC, is one of the creditable regulators. In October 2010 she said that U.S. requirements should be stricter than those of Europe.

We still don't know the actual strengths of our banks. Bank of America has been buying Countrywide crummy mortgages at 7% on the dollar. As housing market comes back, the mortgages might be worth what BoA has been paying.

Banks try to get rid of risks, but they don't remove risk from the system; they create more. The aggregate amount of risk in the system is greater than we think, because of the credit default swap market. [The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the product. This transfers the risk of default to the seller of the swap.] Credit default swaps bring up the problem of moral hazard. This is the idea that when individuals know they are insured against some outcomes they may alter their behavior. Risk becomes less costly, as when the credit default swap puts the risk on other parties.

Those in Congress who are working on reducing the deficit talk mostly about reducing spending in only a small part of the budget. About one-half of the budget is defense. We need to work on military and on entitlements like Medicaid. Medicare is actually funded [until 2019], but Medicaid is set up so that states say what must be paid out, which is wasteful. We need to cut out a trillion to get back to the stage where tax-cutting is unnecessary.

Is the system of market capitalism the best? The economic crisis is not over. We need to understand the situation. What are the merits of the system?

It's more dynamic and resilient than any other system.

It gives more freedom to the individual.

Our banks are doing better than those under other systems.

Stress tests of banks brought private capitalism back into the system.

Money and politics have gotten the better of democracy and capitalism. Demographics are unfavorable toward the future as baby boomers retire and the proportion of workers to retirees drops.

Our continuing budget deficits are likely to send us in to a period of isolationism, now called "noninterventionism." We spend more than the rest of the world put together on the military and are major suppliers of arms to the rest of the world.

We seem to be following a noninterventionist policy with Libya. Yet we are helping out in Japan.

We need to restore our infrastructure, but our money is going to support military bases and troops abroad. According to Wikipedia: There are 761

US Military Bases across the planet. 156 Countries with US bases. 46 Countries with no US presence. 63 countries with US Military Bases and Troops. 7 Countries with 13 New Military Bases since 09/11/2001. In 2001 the US had 255,065 Troops Posted Abroad.

What's the framework for dealing with U.S. States that go bankrupt? States are not allowed to go bankrupt, but municipalities can. State and local debt makes the economy sluggish.

Article in New York Times on March 11 on the European Debt Crisis. Germany is calling for raising retirement age in return for writing the retirement checks. Europe is considering a stability mechanism—a fund of 500 billion Euros to prepare for a bankrupt state. Greece would go through the fund quickly.

Canadian banks remain strong, because they are highly regulated.

Rating industries were rating subpar investments AAA. Rating agencies say their ratings are only opinions; therefore they are not responsible for the high ratings they gave in the early 90s. Clearly, they did not exercise due diligence. There are three rating agencies. When the company I worked for in the 1980s wanted ratings, they went only to the two who gave the highest ratings.