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Proposals Wall Street Won't Like

HISTORY IS A CRUEL TEACHER, especially when we're hard of hearing. The Mesopotamians carefully regulated money-making-money to avoid social chaos. Jewish law mandated periodic debt forgiveness (the "Jubilee Year") for a reason. The Koran and the Catholic Church forbade usury to prevent financial enslavement. Even if you don't buy Marx's dire predictions, our many booms and busts might make you wary of unrestrained financial markets. The Great Depression painfully forced us to rein in high finance. But by 1980, greed-driven amnesia had set in, and the elites in our society embarked on another disastrous experiment in deregulation. Now, yet again, money-making-money has brought us to our knees. The gods worshiped by our ancestors must be having a good chuckle.

History also has taught us that finance is not just another sector of the economy. It ties all sectors together. It also functions like a casino, only the bets are placed with other people's money—so the inevitable meltdowns destroy other people's lives. The largest financial institutions are considered to be too big and too central to fail. Because of their wealth and structural position in the economy, they exert enormous power over public policy. President Clinton was only half kidding when he noted the possible connection between his reelection and a "bunch of fucking bond traders."

This is not a bankers' conspiracy. It's structural. As long as financial institutions are permitted to move vast sums of wealth around the globe at will, those markets will dominate the economy. As long as financial compensation reaches into the multimillions and

even billions of dollars, the rules of the financial casino will be written by Wall Street. And as long as we fuse necessary economic financial functions and the speculative casino, the financial system will, sooner or later, melt down.

Unless your name is Rip Van Winkle, you have noticed that in the fall of 2008 the federal government "loaned" the financial community more than $1 trillion. (Some say that by February 2009, the total hit $2 trillion when you include Fannie, Freddie, AIG, the Bear Stearns merger, and Citigroup. And if the Obama Administration removes toxic assets from the banks, the price tag could hit $3 or $4 trillion.) Why such largesse? Because the economy collapsed when major financial institutions approached insolvency and stopped lending money to each other and to everyone else. This happened because the unregulated financial instruments these institutions had created, and profited wildly by, turned out to be toxic waste, with little current market value.

Please step back to take a cold, hard look. At least a trillion dollars was handed to big bankers in 2008 and 2009, with very little debate. This is borrowed money that we, the taxpayers and our children, are on the hook for. It's an immediate transfer of wealth from present and future generations to the largest financial institutions in the world. It may well be the largest wealth transfer since African Americans built the South. We went along because the financial markets had a gun to our heads. No bailout, no lending. No lending, no economy.

Maybe someday we'll get it back. Maybe we won't. If we're lucky, the capital infusion will prevent another Great Depression, and we hope that's worth the cost. And maybe one day we might even make a little extra from the bank stock warrants the government now owns. All of this, however, is pure speculation. As usual, we're rolling the dice.

If you're looking for a sure bet, here's one: Working people will suffer because of the reckless deployment of Wall Street–created derivatives. Even if the $787-billion stimulus package passed in

February 2009 works extremely well, millions of working people will suffer long periods of job loss and face declining state and local services.

There's nothing speculative about the collateral damage from the fantasy finance meltdown. Since the start of the recession in December 2007, and as of March 2010, the number of unemployed persons has doubled to 15 million, lifting the unemployment rate to 9.7 percent, reports the Bureau of Labor Statistics. The 7.5 million jobs lost during this crash is the worst since the Great Depression. The BLS also compiles the "Jobless Rate" (called U6) by adding together unemployed people who are actively seeking work, people who have stopped looking even though they want a job ("discouraged workers"), and people who are employed part-time only because they couldn't find full-time work. The jobless rate for March 2010 was 16.9 percent—more than 29 million people!

State budgets are withering all over the country. The Center on Budget and Policy Priorities estimates that forty-seven state budgets will be in the red by a total of more than $350 billion through 2011.[1] For example, in Alabama, state tax receipts are crashing, leading to cuts in public education. As one school official put it, "We're having programs cut, purchases of textbooks deferred, class sizes increased, programs like art, music and physical education cut, even more than in the last few years."[2] Superintendents have been told to let leaky roofs go on leaking. The children in those dilapidated classrooms—and millions more across the country—are paying for the financial toxic waste, right now.

And yet, some people are talking about the need for "shared sacrifice." You see, "we" have lived beyond our means. From the greedy executive, to the greedy credit card debtor, to the greedy subprime borrower, to the greedy child in a school that expects a roof that doesn't leak, we're all to blame. We used our home equity line as a private ATM. We went into hock to buy a car and a flat-screen TV. It's time we tightened our belts . . . *after* we've given a trillion dollars to the financial sector.

David Brooks, the *New York Times* columnist, writes that we are entering an era of scarcity "in which smart young liberals meet a stone-cold scarcity that they do not seem to recognize or have a plan for"[3] . . . *after* we've given a trillion dollars to the financial sector.

Nearly every Republican in Congress is attacking the Obama administration for wasteful social spending. They say we no longer can afford costly liberal dreams of student scholarships or massive investments in infrastructure and green technology. We've got to scale back our expectations . . . *after* we've given a trillion dollars to the financial sector.

But to fix the economy, are we supposed to rein in our spending or do we need to spend more to stimulate economic activity? John Maynard Keynes called this the "paradox of thrift." If we save more and spend less (which is what we started to do by early 2009), aggregate demand in the economy as a whole goes down, and we push the economy further and further into recession. While it makes sense for each of us as individuals to pay off our debts, if we collectively do so during this decline, we exacerbate the decline. As a result, Keynes argued, the government must step in to boost the aggregate demand—there's simply no one else to do it.

The Obama administration has pressed ahead with a $787-billion stimulus program to try to reignite the collapsing economy. It is acutely aware that if we're going to learn from the Depression we should get the lesson straight. After the New Deal programs enacted in his first term had begun to bear fruit, Roosevelt restrained federal spending during his second term in the name of fiscal probity. And in doing so, he dumped the economy into a second major depression in 1937–38. It took the massive expenditures of World War II to finally get us out. The New Deal did not, as conservatives argue, go too far. It didn't go far enough. And the current trillion-dollar bank bailout and stimulus package might not go far enough either.

Now that the U.S. Treasury vault has been smashed open, what should Main Street demand? The Obama administration is counting on a stimulus program combined with more support for the banks and housing to "create or save" 3.5 million jobs. This is further supported by an ambitious budget plan to increase investments in energy, education, and health care. It will certainly put in place an array of new financial regulations. It will try to bring transparency to the derivatives market through open trading on regulated exchanges. It will bring hedge funds under regulatory control. It will control mortgage companies that encouraged lax lending standards. It is even asking for certain limits on executive salaries at institutions that receive federal largesse. Also it is pressing to reform the rating agencies so that they might truly act independently of those they are supposed to evaluate.

All of these reforms would surely help. But the lessons of history show they will not provide us with sufficient protection from the casino. The financial industry is likely to resurrect itself and again dominate our economy. Financial institutions will remain too big and too important to fail.

We need to go beyond regulations to divert fantasy finance toward human needs—toward real investments in infrastructure, in renewable energy, in science, in health care, and in education.

The financial world has grown immeasurably more complicated than during the New Deal. It would be sheer hubris to claim that we understand the vast chains of financial ties that crisscross the world. Their size, speed, and complexity will make it extremely difficult (maybe impossible) to predict how regulatory reform will play out. No one really knows for sure how to prevent people from exploiting loopholes to create new financial casinos where they can again gamble with our resources. As long as the financial incentive is there, bright and clever financial innovators will find ways to speculate. They are likely to invent new financial products, undercutting the best intentions of the rule makers.

Besides, regulatory reform addresses a symptom but not one of the major root causes of the problem. Financial derivatives could

not work their magic were it not for surplus capital looking for investment opportunities. Unless we redirect that capital, we will never be able to rein in the fantasy-finance casino.

So what can we possibly do when faced with such vast uncertainties? For starters, we can take a page from the financial sector: We can hedge. We should develop a rock-solid insurance policy to protect us from fantasy finance and its propensity to create financial crises.

Extraordinary times call for extraordinary measures. The bankers and industrial giants have figured out bold survival strategies for themselves. Raid the vault! We should do the same. To be sure, the public coffers also should be opened to fund robust public investments. *But instead of just raiding only our own treasury, we should raid the fantasy-finance vault.* We need a piece of the casino's action, starting now.

Financial Disaster Insurance

We need protection from the big boys. We need a collective insurance policy against meltdown. Therefore, we, the taxpayers as represented by our government, should collect insurance premiums from every nook and cranny of the financial sector, beginning immediately. The premiums would pay us back both for the current raid on the treasury and for the recession created by fantasy finance. The premiums also would help indemnify us for the next financial tsunami. Unless we entirely eliminate private financial markets, we can expect a never-ending chain of booms and busts. Yes, we should mitigate them through wise regulations and consumer protections. But no one can assure us that we'll never see another bust. Therefore *we should demand insurance premiums against the probability of future financial meltdowns*—collective protection against the worst-case scenario. We need our own credit default swap on the entire financial sector.

The best way into the casino vault is to hit up all financial

transactions. How much casino action are we talking about? According to historian Niall Ferguson, "Every day two trillion dollars change hands on foreign exchange markets. Every month seven trillion dollars change hands on global stock markets." He also calculates there are about $3 trillion in CDOs out there and that the estimated value of credit default swaps "was just under $600 trillion."[4] By my back-of-the-envelope calculations, I estimate that the global casino sees about $900 trillion worth of transactions each year, plus or minus a few hundred trillion. If we collected a 3⁄10 of one percent insurance premium (less than 1⁄3 of a penny per dollar) on the face value of each and every transaction, we could collect about $2.7 trillion per year in total global premiums. I suspect the U.S. share would be at least $500 billion per year, year in and year out.[5] Of course, we would have to be careful not to exempt any kind of transaction: It would only invite our financial wizards to build new instruments based on the exempted activity.

You want to speculate against currencies? You want to dive in and out of the markets every few nanoseconds? You want to buy and sell credit default swaps and CDOs? Go to it. But on each transaction you've got to pay an insurance premium to the public. Why? Because history has taught us that at some point the activity you are engaging in will contribute to the next financial sector bust, and we'll have to suffer the damage and clean up the mess.

But won't this encourage even more of a moral hazard, since the financial community would know a bailout would be coming? First, these funds should *not* be designated for bailouts. They should be used to help us rebuild the economy after financial turmoil. When I say we need "financial disaster insurance," I don't mean that this is insurance the financial industry pays to protect itself. I mean insurance that protects us *from* the financial industry, paid for by the industry since it is the source of potential harm. This is like medical malpractice insurance. Doctors and hospitals pay for malpractice insurance to cover the cost to a patient if they have caused that patient harm.

Because of the critical role of the financial sector, when it malfunctions the entire economy suffers. We need income to help us survive the economic crashes since no one yet has figured out how to have private capital markets and *not* to have booms and busts.

But will this fund eliminate the need for bailouts of failed banks and systemically important financial institutions? No, but it might reduce their frequency by draining excess capital from financial markets and moving it into the real economy. We can't promise, nor can anyone else, that after this crisis, public money won't again be used to save the financial system. But in the meantime, under our financial disaster insurance plan, we'd be getting revenue to build a stronger real economy.

But shouldn't the fees depend on the instrument and its level of risk? No. Such micromanaging is asking for trouble. It would be hard to determine the risk profiles and it would be even harder to figure out how to translate them into a fee structure. But more importantly, such differentiation would be red meat for the derivative industry. Inventive quants and lawyers would certainly work long, hard hours to devise new instruments that avoided the higher fees and qualified for the lower ones.

In the United States, I would urge that the insurance premiums—the $500 billion or so each year—go directly to repair Main Street: for renewable energy, infrastructure, health care, and education—the most vital real investments a society can make. Again, we are not calling for the fund to be set aside to bail out the financial industry. Instead we're asking that the fund prop up the real economy that will, sooner or later, suffer, as we are suffering now, from collapsing financial markets. Again, we are draining money from the fantasy-finance casino and moving it toward the real economy.

But isn't financial disaster insurance really a tax? It's both. It is a tax because it moves money from the private financial sector to the public's coffers, as all taxes do. It is insurance because, acting collectively through our government, we are trying to insure

ourselves from the economic damage done when the financial sector gets into serious trouble, which it is prone to do with great regularity. We need the tax/insurance because *no one* can possibly assure us that our current disaster will end anytime soon, or that another one won't befall us in the next decade or two. No one can provide us with real collateral to back up the claim that regulation will prevent the next meltdown. At this point in human history, we'd be very naïve to believe that we can prevent free-market bubbles through regulations or more consumer protections and support. To ignore our boom-and-bust history is to engage in another round of bubble thinking, of irrational exuberance, of faith-based economics. Regulations will always be imperfect. And financial wizards are notoriously ingenious when there are billions of chips on the table. With financial-disaster insurance, they'll have to slide some chips our way each and every time they spin the wheel. The insurance premiums/tax should be viewed as the price financial institutions must pay for free financial markets, above and beyond income taxes, which all of us should pay as citizens.

Is this practical? Won't financial markets, which are electronic, just move to areas with no insurance premiums? This is a vexing problem that will require a great deal of diplomacy to solve. But it should be worth the effort. This proposal works best if the world's economic powers—offshore islands as well—join in a global insurance program. Financial markets connect us all. The tsunamis are truly global. And every nation has an interest in insuring itself from fantasy finance.

The core of this idea is not original. James Tobin (1918–2002), a Nobel laureate and Yale economist, proposed a global tax of 1 percent on the transfer of currencies between countries. He believed that this tax (which became known as the Tobin tax) would limit currency speculation, which can destabilize the financial system and several times has caused extreme hardship in developing nations. He also hoped funds collected through the tax would be used to eradicate poverty.

An outrageous proposal? A year ago, maybe. But outrageous is the new commonplace. Who would have expected a $1-trillion bailout of financial institutions? Who could have predicted that the ultra-free-market Bush administration would have essentially nationalized key banks and insurance companies? Financial chaos has cracked open the door of the financial casino. Outrageous is in, perhaps including the idea of having financial polluters pay to clean up their toxic wasteland.

We are in the middle of the largest bailout in history. "Innovative" financial instruments with questionable social utility have imperiled banks and corporations around the globe. These financial products have polluted the global financial system, putting the underlying economy at risk. CDOs and credit default swaps have wrought destruction in communities that invested in them—from Narvik, Norway, to Whitefish Bay, Wisconsin. If the companies in question had sold deadly prescription drugs instead of toxic financial instruments, we would expect the authorities to shut them down. Certainly, we would expect the government to develop strict controls for drug approval *before* such products could ever again be foisted on the populace.

But when it comes to financial-product safety, we let the market police itself. Apparently, Alan Greenspan honestly believed that it was in the self-interest of financial entities to contain their risk—or else investors would lose confidence. He was wrong and now admits it. The major derivative dealers were in a mad race to pump out more and more toxic products because the fees they yielded were staggering—a veritable fantasy-finance gold rush.

Milton Friedman didn't believe the government should regulate any product, including drugs, whether legal or illegal. The Food and Drug Administration, he once said, "has done enormous harm to the health of the American public by greatly increasing the costs of pharmaceutical research, thereby reducing the supply

of new and effective drugs, and by delaying the approval of such drugs as survive the tortuous FDA process."[6]

Most of us, however, know that we need the government to protect us from dangerous products rushed to market by profit-hungry food and drug companies. In today's world, it is simply impossible for individuals to research and verify all the claims that salesmen make. Is this actually a chemotherapy drug that will help cure me of cancer, or toxic waste repackaged in an IV drip bag? (In fact most of us worry that the FDA isn't protecting us enough because it is influenced by the corporations it's supposed to be regulating.) So why shouldn't we be protected from potentially toxic financial products?

What kind of protections did the five Wisconsin school districts deserve after losing more than $150 million while buying synthetic collateralized debt obligations? If there was no fraud involved, Milton Friedman would say, "Buyer beware." The officials were adults, and they should have known what they were doing. And truth be told, they are not entirely without fault. They no doubt were attracted to the higher rates of return embedded in their scheme, and therefore they should have known that higher rates meant higher risks. But when the top financial gurus of the country like Bernanke, Greenspan, and Soros all call these instruments "exotic and opaque," you wonder how a school official could possibly know enough. In Wisconsin, it was likely that neither the local broker, nor the most informed school officials, had any idea how synthetic collateralized debt obligations worked and what the risks actually were. It's highly doubtful that any financial advisor in the area would have known either. They needed protection *from* the "sound" advice they were getting. And when you realize that AIG bought billions of the same kind of synthetic CDOs as the Wisconsin schools purchased, it becomes clear that everyone needed protection.

Or did they? National Public Radio aired a disturbing interview with the reporters who helped produce the exposé on Whitefish Bay. When asked, "Is there an actual bad guy in this

story?" NPR's Adam Davidson had a golden opportunity to slam CDOs and the other toxic derivatives that had infected public finance. Instead he said:

> There is a tragedy here too. Over the last thirty years, there have been a series of financial innovations that have just been plain good. They have allowed city governments, local governments, to get money more cheaply, which means more hospitals, more schools, better sewers, you know, just basic good public services, and that whole system may be permanently broken by this crisis. And that means, really for the foreseeable future, there's just going to be less public service in the U.S.[7]

I am stunned by this comment. What are these "just plain good" financial innovations? Certainly not the synthetic CDOs that have proven so lethal to the Wisconsin school districts. And the other innovations mentioned in his story, like "variable rate municipal bonds" backed by Depfa (the failed Irish bank that loaned money to Wisconsin and many other municipalities) also have soured.[8] But how can these wholesome "innovations" produce needed revenue and reduce costs only *some* of the time, and then at other times, these same financial innovations are able to cripple municipal finances for years to come? By any definition, that's speculation, not prudent municipal financing.

These "just plain good" financing tools were inherently risky from the git-go. They were sold *as if* their risk were minimal. It wasn't. These public agencies were able to raise money (for a time) at lower costs precisely because these risks remained hidden. When times were good, these public agencies won a few hands at the casino and could build "more hospitals, more schools, better sewers." Then, when the real risks emerged, the school districts and municipalities lost bets they didn't even know they had made. These municipalities, and others, are now building fewer

hospitals and fewer schools, and letting their sewers decay, all as a result of those same "just plain good" financial innovations.

If these products went on trial, they would be found "guilty by design." They had no business being anywhere near public finance. The Orange County debacle should have taught us that nearly a decade ago. But the salespeople, the investment houses, and the banks collected enormous fees and pushed the risky products. The derivative gang feasted on the sweet public agency funds, like bears on a honey pot.

We should be worried indeed, if at this late date, one of the most able NPR reporters who has been investigating this story for months is still defending the wonders of CDOs and the like. All the more reason why we need to stop these dangerous products before they do more damage around the globe.[9]

Financial Product Safety Commission

Perhaps you agree that if these faulty financial products were prescription drugs, we'd demand careful testing before they were unleashed on the public. So why not develop an international body to approve and certify financial innovations before they are sold to unsuspecting buyers all over the planet?

Would forcing these derivatives to go through an FDA-like product-approval process have helped? That's a hard call. It is possible that in small quantities, a specific derivative creates value and can be safely bought and sold. The problem of systemic risk only emerges when there are hundreds of billions of dollars' worth circling the globe. But, under any circumstances are they appropriate investments for public agencies? It may be the case that we should limit the markets for these new investments so that public funds, pension funds, and endowments are off-limits. And in some cases the entire class of derivatives may have to be limited in order to prevent systemic risk. None of this will be easy to do.

But this is the time to try. The financial markets are in shambles. The economy is spiraling down. Banks, insurance companies, and even hedge funds are in severe distress. People are losing their jobs. Incomes are falling. State and local revenues are collapsing. We should review financial products before they do more damage.

We have allies in high places. Billionaire investor George Soros told the House Oversight and Government Reform committee on November 13, 2008, that the Obama administration should put a high priority on ensuring that new financial engineering products are approved by regulators. He argued that "financial engineering must also be regulated and new products must be registered and approved by the appropriate authorities before they can be used."[10]

However, such proposals face serious obstacles. For starters, they would require international cooperation. And then there's the question of how to find and retain regulators who are skilled enough to understand—let alone evaluate—these innovations. Soros has an interesting suggestion: If the derivative product is too opaque and difficult for regulators to comprehend, it should be banned from use. Not a bad notion. But we also need to do something about the revolving door to Wall Street's high salaries that shapes the career path of regulators. Besides, if we want a healthier economy and society, our system of compensation needs to be a lot less lopsided.

Next stop: Why tightening the growing wage gap between elites and the average working person is vital to our recovery.