LESSONS NEVER LEARNED WHEN SENATORS OWN STOCKS

The COVID Bail-Outs show that citizens get nothing, seniors are ignored and cronyism, led by dirty lobbyists, still rules the day even ten years after the last lesson!

The Financial Crisis and Crony Capitalism

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The financial crisis and the profound economic reversals reverberating around the globe caught up last week with Citigroup, the world's largest financial institution. Citigroup is still solvent, but it holds several hundred billion dollars of heavily-leveraged, troubled assets" and once the market began to focus on the potential losses, as it did last week, the bailout became a foregone conclusion. But the terms of that bailout " on top of the deals for AIG, taxpayer infusions for solvent institutions such as Wells Fargo and State Street, and new Federal Reserve loans for any financial firm holding a wide range of assets" are beginning to look like an American version of crony capitalism. The critical distinction lost or forgotten in much of Treasury and Fed™s dealings is that the government™s proper role in rescuing or bolstering private companies during a crisis is to help them only under specific terms that directly benefit the taxpayers footing the bill.

Crony capitalism is usually associated with the way many governments in Africa, Asia and Latin America conduct public business, where government contracts, budgets and other public activities are routinely channeled to the families, friends and associates of political elites, rather than being allocated through some open bidding or other democratic processes. Variants of crony capitalism occur in the United States, too. In one infamous example, Halliburton billions of dollars in no-bid contracts for Iraq while its former CEO was Vice President; and crony capitalism lurks behind billions in pork barrel appropriations passed every year by Congress. But when it begins to infect huge government operations taken to deal with an emergency, it has more serious and insidious effects. Japan famously practiced crony capitalism in its multi-trillion-yen rescue operations for its failing banking system in the 1990s, and bought itself a decade of stagnation and at least another decade as the worst-performing advanced economy in the world.

The terms of the Citigroup deal raise the specter of crony capitalism. The taxpayers will invest $20 billion in the company, receiving preferred stock that will pay 8 percent dividends, and Citigroup will bear the first $29 billion in losses from its current portfolio of $306 billion in troubled loans and assets. After that, the taxpayers absorb 90 percent of any additional losses in exchange for another $7 billion in preferred stock. The likelihood that Citigroup™s losses will far exceed the first $29 billion is disturbingly high. The financial crisis almost certainly will deliver additional shocks, because the current policies have done little to address the forces driving the crisis. The housing market continues to unravel; and with business investment, consumption and jobs all contracting rapidly, foreclosures continue to rise. As they do, more mortgage-backed securities and the derivatives based on them will go bad, and the consequent losses could claim much of the capital infusions that taxpayers have already provided.

As the IMF and others have warned, large additional losses also could come from other sources. Most notably, the spreading global recession, on top of national banking crises in other countries, are producing enormous pressures on government financing operations in a number of nations, including some in the Eurozone, which in turn may produce sovereign debt defaults. And most of the sovereign debt that could well default in coming months is held today by financial institutions, especially ours.

While the administration's program barely acknowledges the implications of these dangerous dynamics in its bailout policies, President-elect Obama has at least pledged to address the underlying foreclosure problem and provide very large stimulus that could begin to ease the U.S. downturn and, with it, the global recession. The larger question is whether the new administration will also reject creeping crony capitalism by requiring that the bailouts almost certain to come next year oblige the financial institutions claiming all that cash to conduct themselves in ways that directly benefit the taxpayers picking up their bills.

Remarkably, the current administration has imposed no such requirements while doling out hundreds of billions of dollars to insulate our large financial firms from the worst consequences of their own decisions. In fact, even last week, as the Treasury was bailing out Citigroup, the Federal Reserve announced another $200 billion program for financial companies holding securities backed by consumer debt, now threatened by the recession triggered by the financial meltdown. Here™s a notion for the next administration: Since the essential reason to bail out all of these various institutions is to unfreeze the routine lending that keeps the U.S. economy going, tie future bailouts to specific commitments to reboot lending American businesses and households. This is precisely what Sweden did in the early 1990s when its financial sector melted down, and the strategy of tying capital assistance to renewed lending helped produce a genuine recovery.

Crony capitalization may be signature moral hazard of an administration which continues to believe that, even when taxpayers provide hundreds of billions of dollars to bail out powerful institutions, the government should have as little say as possible in the way they conduct themselves. It shouldn't be good enough for an Obama presidency. When the next shocks hit our financial system and those institutions come back for more, the new administration should opt for democratic capitalism over crony capitalism, and apply lending requirements to actively open up the national credit markets.