The Capitalism Reformers Caper and Prance

From Whiskey and Gunpowder

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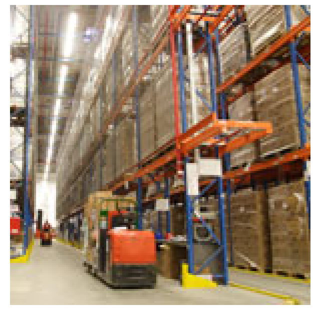
Mar 27th, 2009 | By Bill Bonner | Category: Featured, Macro Economics



Free market capitalism is the "god that failed," writes Martin Wolf. Thus does *Financial Times* lead off a feeble chorus of lament in its "Future of Capitalism" series. What do we do now? is the question. **Can capitalism be tamed? Can it be harnessed? "Yes we can!" says America's president.** Richard Layard from the London School of Economics, offered a way forward:

"We should stop the worship of money and create a more human society," he writes. "Happiness has not risen since the 1950s in the US or Britain," he points out, despite big increases in wealth. "Modern happiness research can help find answers," he believes.

"Old fashioned socialist planning is the only coherent alternative to a collapsing capitalist economy," an alert *FT* reader added.

Given the depth of these insights, we decided not to dive into this discussion headfirst. Instead, we will simply mock the swimmers from the bank. Brazil's president, Lula da Silva, for example, could only come up with a campaign slogan: "The future of human beings is what really matters." But who can blame them? They want a capitalism that makes people happy…fairer, gentler, greener… they want to reform it…to housebreak it…to cut its balls off so they can safely put it on a leash and introduce it to their daughters. **But they miss the point of it altogether: we can't reform capitalism; it reforms us.** Capitalism punishes mistakes and rewards virtue (or good luck) - not necessarily quickly or gently…but roughly and imperfectly, like a hanging judge in a frontier town. On paper, of course, we can do better. Imagine a world where public employees are saints and geniuses who do such a swell job of allocating capital that we want for nothing. But then, when we get a chance to see them in action, we find that they are bigger rascals than the capitalists themselves.

This week, under pressure from its new proprietor - the U.S. government - AIG released a list showing who had gotten more than $100 billion of its bailout money. At the top of the list of recipients was a familiar name - Goldman Sachs. In a truly astonishing co-incidence, Goldman is the firm that had been run by the very person who headed up the AIG rescue - former Treasury Secretary Hank Paulson. And what serendipity! Lloyd Bankfein - Goldman's top man now - was actually in the room with the feds when the AIG rescue plan was put together.

In the room; in the deal. But the big scalawags ducked out of the press almost immediately. Instead, the headlines focused on the small fry. AIG paid bonuses of $450 million - some charged it was $1 billion - to its executives. These guys shouldn't get bonuses, came the popular outcry; they should get a firing squad. You'll recall the story. The insurance giant AIG lost money on a series of gambles. For example, it gambled that it could insure the mortgage payments of people who couldn't afford to buy a house. During the bubble years, people bought houses at outrageous prices. They could borrow 80% of the purchase price from government-backed debt mongers Fannie Mae and Freddie Mac. Buyers were supposed to put up the other 20% themselves, giving lenders a margin of safety in case the transactions didn't work out as planned. But, if an insurance company would guarantee the other 20%, Fannie could cover 100% of this "enhanced" mortgage loan. AIG found that insuring this part of the loan was profitable - as long as nobody asked questions. But then the market price for the collateral dropped - by as much as 50% in some areas.

Suddenly, people were walking away from their houses. Defaults on these "enhanced" loans ran at 5 times the rates on normal Fannie-backed mortgages.

An ordinary person would look at these facts and pronounce the same judgment as the capitalist market: AIG and Fannie both deserve to go broke. But give him enough higher education in the economics department, or a job in government, and the fool rushes in –with someone else's money.

In the theory of bailouts, an ailing firm is given a helping hand when it needs it. This gives it time to get back on its feet, and prevents it from dragging down its employees, lenders, investors and counterparties. But what actually happens is much simpler. Money goes from the pocket of the person who earned it…to the pocket of someone who didn't…from the innocent bystander to the fellow who caused the accident. **Capitalism takes money away from erring capitalists; the capitalism improvers give it back to them.** And who decides who gets the loot? Ah…as soon as you hold them up to the light, the angels' wings fall off. By and large, these are the same cherubim and seraphim - such as Hank Paulson - who were supposed to be leading…regulating…and controlling capitalism when it ran into a ditch. Not a single one raised a warning. Instead, they whooped for the free market and passed the whiskey bottle to the driver! And now, thanks to their bailouts, AIG continues writing insurance against mortgage loans. Seventy-three AIG executives continue getting $1 million bonuses. A long line of reckless counterparties goes unpunished. And Hank Paulson offers advice to *Financial Times* readers on how to make capitalism work better. But that is always the problem with improving capitalism…even in the slapstick American way. The reformers promise a 'new deal,' but they've always got an ace up their sleeve somewhere.

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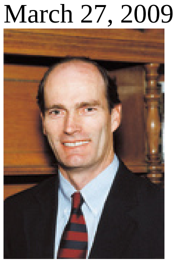

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Along with Addison Wiggin, his friend and colleague, Bill has written two *New York Times* best-selling books, *Financial Reckoning Day* and *Empire of Debt.* Both works have been critically acclaimed and internationally. With political journalist Lila Rajiva, he wrote his third *New York Times* best-selling book, *Mobs, Messiahs and Markets*, which offers concrete advice on how to avoid the public spectacle of modern finance.