**Thoughts on the Bear-Sterns "Bail-Out"**
**WLUW "From the Trenches," hosted by Rita Sands**
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I. What actually happened.

A. Last Monday, March 17, St. Patrick's Day it was announced that as a result of intense negotiations over the weekend, J.P. Morgan Stanley had agreed to buy Bear-Sterns, one of the biggest investment banks on Wall Street, for $2 a share--less than a tenth of what it was worth the previous Friday, barely 1/100th of what it had been worth a year ago.

B. To help the deal go through, the Federal Reserve agreed to loan BS $30b, using as collateral, a slice of its suspicious portfolio. In a sense this was a "bail-out," since no private bank would have made such a loan. At the same time, stockholders at BS took a huge loss. (One of its principle shareholders, former CEO James Cayne saw the value of his holding plummet from $1.2b in January 2007 to $13 million today.) Of course shareholders would have lost even more had the company gone bankrupt, but as it was, they did take a huge hit. The people who *were* saved were the bondholders--those who had loaned money to BS. JP Morgan-Stanley took over those debts. (I don't know how much money was at stake here. I haven't seen the figures. But whatever it was, JP Morgan figured it worth the risk.)

II. The ethical question: Is it right for the Federal government to intervene, putting taxpayers' dollars at risk, to save a company from bankruptcy, particularly when the bankruptcy is due to the company taking on risks that it should have know were severe? (These guys are supposed to be very smart, after all, and are exceedingly, exceedingly well paid). The government never intervenes when a small business fails, or when a consumer runs up a credit card debt he cannot pay.

A. We all know the rationale, don't we? The company is "too big to fail." More precisely, the announcement that one of the largest and oldest investment banks on Wall Street (85 years old, to be exact) was filing for bankruptcy would cause the financial markets to panic. Stock values would plunge. Hundreds of billions of dollars might be lost--far more than the $30b put at risk by the "bail-out."

B. But this raises a deeper question? So what if the stock market plunges? Stock certificates are just pieces of paper, mostly owned by the rich. No one forced these people to buy them. They knew they were taking a risk. They gambled and lost. Isn't that what capitalism is all about? You take risks. You can win big--very, very big, as we've seen in recent years. But you can also lose. Isn't that the justification for those very big gains--that the risks are large.

C. There's an obvious rejoinder to this line of reasoning. It's not only the rich who will be hurt. There are millions of ordinary people who are invested in the stock markets, most often via intermediary agencies. For millions their pensions are so invested. So a stock market crash will affect them as well. Surely it's worth a few billion dollars to preserve millions of pensions.

*D.* There's a deeper reason still why the government cannot sit by and let the financial markets implode. The health of a capitalist economy depends on what Keynes called the "animal spirits" of investors. A healthy capitalism requires a steady stream of real investment flowing into the economy. This keeps the construction industry busy, the machine tool industry busy, and all those other industries producing the things businesses need to expand. But investors won't invest if it doesn't appear profitable to do so. And they can't be forced to invest. It's their money, after all. But notice--if they *don't* invest--or if they decide to invest outside the country--then workers start getting laid off. And when workers lose their jobs, they buy less--which means the companies producing the products these workers would buy must also cut back, laying off their workers. Etc. The familiar downward spiral. The economy slides into recession--or worse.

E. Notice how cleverly the system is structured. In essence everyone has a stake in keeping the investor class, i.e., the wealthy, happy, keeping up their "animal spirits." Because if investors become unhappy, if they "panic," then pretty soon almost everyone is negatively affected--not just the rich, but almost everyone in the private sector, whose jobs are now threatened, lots of people in the public sector, since tax revenues are falling, all those dependent on government social programs--same reason. No one benefits. So the government *must* intervene. No one says "get the government off our backs" when the financial markets melt.

III. Now here's something that's never mentioned in polite company: it wouldn't have to be this way. The root cause of the problem we are facing now is the fact that we have an economy *that relies on the private savings of private individuals to provide for the investment that any healthy economy needs.* But in depending on private savings, we are compelled to keep up the spirits of those with money to invest. This means insuring that they can make a healthy return on their investment, and, above all, not letting too many fail.

A. But this "solution" can be problematic, for it generates what the economists call "moral hazard." If investors are allowed to keep all their gains when times are good, but can be pretty sure that that the government will step in if things turn suddenly sour, the temptation to take *ever greater risks* becomes irresistible. (Recall the case of poor James Cayne, mentioned a moment ago. A year ago his Bear Sterns holdings were worth $1.2 billion. Now they are down to a *mere* $13 million. Is this a catastrophe that will cure him from ever taking big risks again? I mean, if I'm pretty sure I'll never fall below $10 million or so, but can make really, really big money if I gamble big--am I going to be cautious?)

B. A lot of big risks have been taken in recent years--there are $11 trillion in U.S. mortgages outstanding right now, many of them very shaky. Indeed, the whole financial edifice--with all the new, brilliant "financial innovations" that have made their innovators so fabulously wealthy may well be out of control. Princeton economist--and NYT columnist Paul Krugman--remarked recently, "I've never seen financial insiders this spooked. This time market players seem truly horrified--because they've suddenly realized that they don't understand the complex financial system they created."

IV. What is to be done?

A. Short term--hope the Fed can bail out enough failing institutions to keep the house of cards from collapsing. (So I do support the "bailouts.")

B. Medium term--tax those excess financial institution gains. A capital gains tax of only $15% is obscene. Warren Buffett--second richest man in America--recently calculated that, without any creative accounting at all, he pays a lower percent of his income in taxes than do the secretaries and office clerks who work for him. If the rich are going to be protected--by us, the taxpayers--when times are tough, they ought to be compelled to pay a lot more taxes than they do when times are good.

C. Long term--ultimately we need to realize that it's stupid and counterproductive to rely on private savings for our investment--the root cause of this whole mess. It would be more transparent, more efficient, more equitable, and vastly more stable to generate our investment funds publicly, via taxation--a flat tax on businesses--and allocate them to a network of *public* investment banks. We really don't need the vast and complicated financial architecture we've created. We don't even need stock markets. There is a better way. But that's a radical proposal to be discussed, perhaps, another time.