Fallout from Washington crisis rattles world markets

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Stock prices fell precipitously in the US, Europe and Asia last week following President Barack Obama's surprise announcement Thursday that he was proposing new restrictions on the operations of US banks. The broad selloff, led by declines in bank shares, led to a 5 percent decline in the Dow Jones Industrial Average and similar falls in the Standard & Poor's and Nasdaq indexes between Wednesday and Friday.

The Dow's loss of 217 points on Friday brought the average to its lowest point since November and wiped out the gains that had been registered since the New Year. Amidst heavy trading, a gauge of stock volatility rose Friday to its highest level since August 2007.

Obama's announcement was a major factor, but not the only one, in the stock price decline. Also on Thursday, China announced measures to curb bank lending in the face of higher-than-expected growth rates and a sharp rise in prices. That move was seen by financial markets as a warning of slowing demand and the possibility of a double-dip recession.

Another factor was growing concern over the implications of the debt crisis in Greece, which could rapidly spread to Spain, Portugal and other highly indebted European countries and imperil the stability of the euro.

On Monday, stock prices rose modestly in the US and Europe, but continued their decline in Asia. The stanching, for now, of the selloff in the US and Europe was in part the result of assurances from the Obama administration that Federal Reserve Chairman Ben Bernanke had sufficient votes in the Senate to win confirmation this week for a second four-year term.

Obama's announcement on Thursday of what he called the "Volcker Rule," named for the former Fed chairman and current head of the White House's Economic Recovery Advisory Board, was clearly driven by political considerations. It came two days after the Democrats suffered a humiliating defeat in the election to fill the Senate seat from Massachusetts vacated by the death of Edward Kennedy. (It also came the same day that Goldman Sachs announced a record fourth quarter profit of $4.79 billion).

The loss of a Senate seat held since 1952 by the Democrats in one of the most liberal states in the country was the result of growing popular anger over the administration's failure to take any measures to address mass unemployment and growing poverty, while using taxpayer money to enable the banks to record huge profits and dispense near-record bonuses.

Popular disaffection was focused on Obama's cost-cutting health care plan. The Republican candidate framed his campaign as a referendum on the scheme, which would impose sweeping cuts in benefits and services on tens of millions of workers and middle-class people.

The Massachusetts debacle has thrown the administration and the Democratic Party into crisis, raising the possibility of an electoral rout in the November congressional elections.

On the eve of last Tuesday's Massachusetts election, and since, Obama has turned to populist rhetoric, focused on demagogic attacks on Wall Street. He is expected to continue this tack when he gives his first State of the Union Address Wednesday night.

Evidently, Obama's political advisers hope that by proposing measures targeting the banks, the administration can outflank the Republicans' populist posturing by getting them to go on record opposing bank "reform."

Obama's anti-banker crusade has no credibility. He has not only expanded the government bailout of banks and big financial firms by trillions of dollars, he has blocked legislation to cap bankers' compensation and allowed bailed out firms to exit the Troubled Asset Relief Program and thereby escape the minor restrictions on their operations under the bailout program.

He has staffed his administration with investment bankers and cronies of former Goldman Sachs executive and Clinton-era treasury secretary Robert Rubin, many of whom played key roles in deregulating the banks in the 1990s and organizing the bailout after the crash of September 2008.

Moreover, the administration is proposing no substantive measures to create jobs or stem the epidemic of foreclosures, personal bankruptcies, utility shut-offs and the other social effects of the economic crisis. On Monday, Obama previewed initiatives he will announce on Wednesday night which, he claimed, would show his commitment to rescuing the "middle class." He listed token proposals for increased child tax credits, more child care funding, student loan relief and easier access to retirement accounts that would likely cost less than $2 billion in total.

At the same time, Obama has effectively dropped proposals to extend health coverage to the uninsured, while placing deficit reduction and fiscal austerity at the center of his economic agenda.

Until last week, Obama had opposed the banking reforms he announced on Thursday. His tactical about-face reflected fissures among his top economic and political advisers. Volcker had for months been publicly advocating the measures Obama announced Thursday, with no effect.

The administration's top economic advisers, Treasury Secretary Timothy Geithner and Lawrence Summers, the head of the White House National Economic Council, had opposed Volcker's proposals and relented only reluctantly under pressure from a section of White House political advisers.

In his Thursday announcement, Obama proposed a ban on proprietary trading by commercial banks. The term refers to speculative trades carried out by banks using their own funds and for their own account. The ban would apply only to commercial banks, normally those which take deposits from retail customers. These banks' deposits are insured by the Federal Deposit Insurance Corporation, and commercial banks enjoy other forms of government support.

Obama also proposed to bar commercial banks from owning or investing in hedge funds and private equity funds, and spoke in vague terms of new measures to restrict the size of banks.

These proposals were couched in rhetoric about the "irresponsible" actions of the big banks and the claim that such measures would prevent the American people from again being "forced" to rescue banks deemed "too big to fail."

If ever passed by Congress and actually enforced, these measures could have a significant, although not sweeping, impact on major Wall Street firms. However, as Obama well knows, the likelihood of their being adopted by Congress is remote, at least in a form that would have any real impact. This is all the more the case in the wake of last week's Supreme Court ruling lifting all limits on corporate spending for political campaigns. Moreover, the banks would have little difficulty in devising legal dodges to evade any such regulations.

And the politicians and regulators who would be responsible for policing the rules are inseparably tied to the banking elite and subservient to its interests.

Volcker has promoted these measures as a return to the "spirit" of Glass-Steagall, the landmark Depression-era law that erected a wall between commercial banking and investment banking, banning deposit-taking commercial banks from engaging in the highly speculative activities of Wall Street brokerage and investment houses. The law was watered down and finally repealed by Bill Clinton and his treasury secretary, Summers.

The most important and lucrative branch of investment banking that was proscribed for commercial banks by Glass-Steagall was notably omitted in Obama's announcement—the underwriting and distribution of stocks and other securities. It was precisely this activity, in the form of exotic securities such as collateralized debt obligations based on subprime mortgages, that played the central role in the near-meltdown of the US and global financial system in 2008.

Nor would Obama's proposals curb or regulate the so-called "shadow banking system" which utilizes derivatives, credit default swaps and other risky bets to bolster bank profits on the basis of high levels of debt.

Proprietary trading accounts for only a relatively small percentage of bank revenues. At JPMorgan Chase and Bank of America, it garners 1-2 percent of revenue, according to a Citigroup report. Less than 5 percent of Citigroup's revenue comes from proprietary trading. The figure for Morgan Stanley is 3-4 percent and for Wells Fargo it is less than 1 percent.

The biggest dealer in proprietary trades is Goldman Sachs, which gets about 10 percent of its yearly revenue from such activities. However, Goldman Sachs and Morgan Stanley, the two investment banks that were granted commercial bank charters at the height of the banking crisis in 2008, in order to gain access to Federal Reserve loans and government backing for their debt, could get out from under the rules proposed by Obama by returning their commercial bank charters. The Treasury Department is reportedly drafting proposals to allow them to do precisely that.

Moreover, in his announcement Obama provided a loophole for banks whose proprietary trading is conducted on behalf of clients. Banks, with the aid of friendly regulators, would have little difficulty masking their own proprietary trades as client-related.

As for the proposed ban on commercial banks owning or investing in hedge funds and private equity funds, the banks could reposition such funds as "special purpose vehicles" and thereby evade the rule.

Many economists have dismissed as a chimera the claim that these measures would prevent taxpayers from having to bail out banks in the future. The financial markets assume, for good reason, that the government would rescue any big financial institution whose failure threatened the financial system as a whole. As Simon Johnson, the former chief economist at the International Monetary Fund, told the *New York Times*, "You can call them an investment bank, a hedge fund, or a banana, but they are still too big to fail."

Obama's talk about limiting the size of banks, furthermore, flies in the face of his actions. He has supported a vast consolidation of the US banking system.

Under Bush and Obama, the biggest banks have grown even bigger and more powerful. With government backing, JPMorgan Chase was allowed to take over Bear Stearns and Washington Mutual, Bank of America was allowed to buy Merrill Lynch, and Wells Fargo was allowed to take over Wachovia. Figures show that the top four US lenders controlled more than 35 percent of all deposits in 2009, up from just over 5 percent in 1998.

Notwithstanding these facts, Obama's announcement evoked bitter opposition from Wall Street as well as from international bankers.

The impact on the markets was compounded by the fact that Obama made the announcement without any previous consultation with Europe and Asia. This lack of preparation and advance warning underscored the political motivations underlying the proposals. Germany and Britain indicated they were opposed.

The *Financial Times* on Saturday cited "a Democratic adviser to the administration" as saying, "The Obama proposals were clearly politically motivated and came from the White House, not the Treasury."

The newspaper was scathing in its criticism of the vague and reckless character of Obama's announcement. On Saturday, it cited a "seasoned Asia-based banking executive" as saying, "The US government statement on this is so vague that I don't even know where to begin speculating."

The *Financial Times* also quoted Bill O'Donnell, a strategist at RBS Securities, who said: "The Obama administration is likely to release more details over the next few days and weeks, all of which could serve to temper the market's fears about the possible outcomes. Still, one of the most salient lessons here is that a complete lack of important details can often be worse than a bad rule."

The newspaper editorialized that "at least a modicum of attention was being paid to coordinating such reforms at a global level. All this has now been blown out of the water by a White House seized by political panic. The result is that no one knows what will happen. A return to radical insecurity was the last thing we needed."