Friends helping friends: Lessons from the Mexican Bank Bailout for the United States

Wesley C. Marshall*

On July 14, 2008, the investor Jim Rogers, co founder of the Quantum Fund along with George Soros, declared that the Chairman of the Federal Reserve (Fed), Ben Bernanke, and the Secretary of the Treasury, Hank Paulson, "are ruining what has been one of the greatest economies of the world." The two are "are bailing out their friends on Wall Street but there are 300 million Americans that are going to have to pay for this" (Bloomberg, 2008a). This article will seek to defend the position taken by Rogers. Specifically, it will argued that the same bias towards the maximization of the profits of the largest American banks that financial authorities had maintained before the eruption of the crisis in 2007, continues during the current phase of the management of the crisis. While in years past the free market position of the government permitted and encouraged the speculative mania and fraud that tend to accompany moments of financial euphoria, from mid-2007 onwards, authorities have continuously intervened in financial markets. However, even though this unconditional protection, exempt of all economic ideology, has avoided the sharp and deep financial collapse that has indeed been threatening financial markets, the total bailout of the principal Wall Street banks by the state is creating a less dramatic and sudden outcome, although one which is equally damaging to the American financial system. As the experience of the Mexican bailout showed a decade ago, when the same bankers that caused the financial crisis are allowed to expand their operations, and when they do not have to share the burden of financial losses that a financial crisis implies, the effectiveness of a bank bailout tends to be minimal, while fiscal costs often soar?

This article will be divided into several sections. First, the principle characteristics of the classic banking crisis will be presented, with a particular emphasis on the features that its development and resolution have in common. The article will later examine how the regulatory capture of the United States' (US) financial authorities has fostered the creation of the current crisis, and how this phenomenon is also cultivating an unbalanced bailout that attends to the short term interest of the nation's largest banks at the cost

* The author thanks the DGAPA (UNAM) for their generous support.

of the cleansing of the banking system and the long term viability of the country's public finances. In addition to detailing the specific manifestations of these general tendencies, a comparison will be drawn with the Mexican bank bailout, which was conditioned by many of the same circumstances that are currently present in the US crisis, and which produced disastrous results.

The Classic Banking Crisis

As hundred years of history and various perspectives of economic theory teach, unregulated financial markets tend towards self-destruction, most commonly through the classic banking crisis, as has been described by Charles Kindleberger. When an economy experiences relatively long periods of increases in the prices of financial assets, a growing number of actors perceives the incentives to bet, or to increase existing bets, on financial assets that apparently will not lose their value. This dynamic establishes the two basic conditions for the development of the classic banking crisis: speculative mania and monetary expansion. With a large and increasing number of actors purchasing financial assets, banks provide the money demanded by clients and also place their own bets. But in moments of financial gains, banks and other actors not only use their own resources to meet greater demands for money, but they also borrow heavily to continue to finance and increase bets. While such leveraging of financial positions involves a growing number of economic actors, the conditions imposed by a speculative mania also assure that all banks must enter into the game. During moments of large financial gains, if a bank is tentative in making bets similar to those of its peers, it will face pressure from its investors to employ more aggressive strategies. Upon failing to significantly expand its positions, the bank runs the risk of being bought by other banks that have taken greater risks and have recorded greater gains, therefore increasing their strength relative to more cautious competitors.

But in addition to fanning the flames of speculative activity among a multitude of economic actors and being principal speculators during moments of financial euphoria, banks are also usually one of the greatest perpetrators of financial fraud. During periods of rapid expansion, banking regulation and supervision often become overcome by, or subordinated to dynamic financial markets. Taking advantage of the greed, inexperience and gullibility of growing numbers of new entrants into the world of finances, and operating under little or no government restrictions, banks tend to defraud an appreciable portion of their clientele.

Due to the described market pressures, private sector banks enter *en masse* into the highly profitable practices of speculation, monetary expansion and fraud. However, the growing number of relationships between financial actors and the greater quantities of money in play significantly increase financial fragility in periods of expansion, and when the euphoria invariably comes to an end, the prevailing emotion among financial actors quickly transforms from greed to fear. Accompanying this shift in mentality is a loss of confidence in banks. While many actors begin to doubt the security of their loans and deposits, banks themselves, especially if their own balances are unsustainable, also begin to doubt their peers. When a bank believes that others banks are equally inviable, it will raise the price and reduce the quantity of loans to them. But due to the fact that interbank lending represents the lion's share of the debt that lubricates the practices of leveraged speculation, when a sufficient number of banks adopts such a position, it becomes increasingly difficult for banks to maintain their financial positions. With reduced sources of financing, the holders of assets become obliged to sell them to meet commitments on maturing debt, and a generalized deflation of asset prices takes hold. The dynamic of simultaneous increases in funding costs and reductions in the price of financial assets places a growing number of actors in positions of insolvency. And due to the highly interconnected (fragile) financial system, the well being of each actor is tightly linked to the well being of a multitude of others. As such, when a sufficient numbers of actors go bust, a severe systemic crisis that affects the entire economy, can often only be avoided with a massive and timely intervention by the government.

The complicated resolution of the classic banking crisis

While the development of this type of crisis, engendered within the banking system, is a historically and theoretically reproducible phenomenon, the same is true of the failed attempts to resolve this type of crisis. As will be analyzed later, when banks have assumed risky positions in moments before the eruption of the crisis, it is imperative that they take on commensurate losses during the crisis's resolution and that their activities are limited and strictly supervised during these moments. If these conditions are not met, economic incentives are established for the same banks whose imprudent activities provoked the crisis to undertake activities and strategies directed towards conserving previous profits and maintaining control over their banks, usually through fraudulent or highly risky speculative activity. As will be examined, if such activities are permitted during the bailout of a banking system, achieving a successful crisis resolution becomes extremely difficult.

However, the implementation of these types of policies is an extremely difficult task. On the one hand, as powerful political actors, bankers often resist measures that restrict their economic liberties. On the other hand, the greatest concern to the authorities, even above the restriction of problem banks' activities, must be to guarantee the integrity of the system of payments, whose functioning is indispensable to any modern economy. As such, financial authorities find themselves in a difficult position. If banks' financial losses or the punishment meted out to them by the government are grave enough for the banks' creditors to lose confidence in them, the collapse of the financial system becomes a possibility. But if regulatory and financial burdens are too light, the resolution of the crisis becomes very complicated. Therefore, for a crisis of this type to be resolved in a reasonably successful manner, authorities must walk a fine line and not fall into excesses in the protection or punishment of banks.

Due to the complications that arise during attempts to resolve the classic banking crisis, and the widespread and profound economic destruction that it produces, the most pressing task for financial authorities must be its avoidance. In the US, in response to the excesses of the financial system that led to the Great Depression of the thirties, the passing of various laws established a regulatory and supervisory framework to stabilize the financial system. Among these laws, the Glass Steagall Act, which separated the commercial bank from the investment bank, was of particular relevance. Under its stipulations, the commercial bank could not be involved in speculative activity, but in exchange for this limitation, their deposits were guaranteed (up to a certain limit) by the state, and the state could act as a lender of last resort in the eventuality of a bank's illiquidity. Investment banks, on the other hand, were exempt form regulations that prohibited speculation, but did not enjoy any state guarantee. While this act was in effect, from 1934 to 1999, there were no systemic banking crises in the US. However, even though the Glass Steagall act produced long term stability, it limited short term financial profitability. During the eighties and particularly the nineties, Wall Street exerted constant pressure for more relaxed regulation, and achieved a gradual deregulation until the law was completely revoked in 1999.

Regulatory Capture

Since the eighties, the US has witnessed the greatest bull run in history, which gained particular strength around the turn of the century with the consolidation of the parallel banking system, in which structured finances became positioned as the most profitable area of business for universal and investment banks operating on Wall Street. Unlike traditional banking, in which banks make loans and hold them on their books until maturity, the parallel banking system functions under the formula of originate and distribute, in which loans are divided and reorganized by banks to be sold to other actors in the financial system as structured products.

Even though this business model permitted enormous speculative financial gains for years, its foundations were never solid. Products such as Structured Investment Vehicles (SIVs), residential mortgage backed securities (RMBS) and collateralized debt obligations (CDOs) are backed by underlying assets with relatively high possibilities of default. However, upon paying a sufficient fee to the ratings agencies, higher ratings were attained. Therefore, financial products that held significant default risks were sold to a multitude of national and international actors as if they held little risk. Due to the widespread and growing use of derivatives and off-balance sheet financial vehicles, the final destination of structured products has remained in large part a mystery. When the largest banks sold and distributed these products, most actors did not perceive any relevant credit risk, and effectively, a common characteristic of many episodes of financial euphoria is the widespread belief by market participants of the arrival of a new economic dynamic that permits continuous gains in the prices of financial assets without significant risks of financial instability. In regards to the parallel banking system, many argued that the risks were so dispersed throughout the world's financial system that the banks that originated structured products were not exposed to any meaningful credit risk.

However, once underlying assets began to enter into default, with subprime mortgages being the most noteworthy example, ratings agencies lost all credibility, and due to the fact that all major banks knew that they had significant quantities of assets of low and decreasing value, they also lost confidence in each other. With this lack of trust, interbank loans have become increasingly costly and volatile. But well before these signs of instability began to manifest themselves, there were clear indications of a developing classic banking crisis. However, the characteristic fraud, monetary expansion and speculative mania were both ignored and encouraged by the government.

With the bursting of the Nasdaq bubble in 2001-2002, the Fed and other government entities explicitly adopted a strategy of guiding speculative capital toward the real estate sector, through fiscal and tax incentives, and through financial innovation that allowed mortgage financing to be extended to new clients in new ways. The monetary policy of the Fed also played an important role, by maintaining low interest rates, which reached negative rates in real terms, and by facilitating the international monetary system known as "Bretton Woods II", in which the US exports capital via its commercial deficit to be later repatriated via external savings. At the same time, widespread and recurring financial fraud was ignored and even silenced in many cases by the authorities entrusted with the investigation of such abuses. As such, even though the financial crisis that broke out in 2007 was generated within the banking sector, its development would not have been possible without the complicity of the government.

As will be analyzed, the collusion between Wall Street and the government has been perhaps even more evident in the actions undertaken by the Fed and the Treasury during 2007 and 2008. Willem Buiter, former member of the Bank of England's Monetary Policy Committee, decried the regulatory capture of the Fed in this year's symposium of the Kansas City Fed in Jackson Hole, Wyoming (Buiter, 2008a). On a different occasion, Buiter claimed that, "Since 1997, the Fed has long been the least operationally independent central bank in the industrial world. This latest episode suggests its main current purpose is to be an unaccountable quasi-fiscal agent for the US Treasury" (Buiter, 2008b). The episode to which Buiter refers was the approval of the rescue package of the government sponsored entities (GSEs) Fannie Mae and Freddie Mac. But before examining the specific circumstances of the GSEs, the recent measures taken by the Fed and the Treasury will be evaluated under the lens of their regulatory capture, evident since the early developing stages of the present crisis.

The Fed and Treasury to the rescue

Since the first manifestation of the crisis in early 2007, the Fed, and to a lesser degree the Treasury Department, have been overseeing a management of the crisis in collaboration with the largest banks of the country, under various modalities. In general terms, the authorities have sought to provide liquidity to all financial actors, to minimize their costs of funding, and to control the financial losses announced by the principle banks. The first attempts at reducing funding costs were made through reductions in the federal funds rates (and rates charged at the discount window), which were lowered from 5.25% in August of 2007 to 2% in April of 2008. However, due to the fact that higher levels of funding faced by banks have been due to a lack of trust and not to a lack of liquidity, the Fed has created additional liquidity mechanisms for all types of banks. These facilities, which include the Term Auction Facility, the Primary Dealer Credit Facility and the Term Securities Lending Facility, allow financial actors, even those that are not regulated by the Fed, to access its funds in exchange for assets that can include CDOs and RMBS, two asset classes that have been heavily devaluated.

Lastly, the losses registered by the largest banks have been administered by the government and upper management of the banks, as affirmed by economist Nouriel Roubini (Roubini, 2008). There are various ways to manipulate banks' balance sheets. One of the most common, and most powerful, is the shifting of level one assets, whose value is based on the prices of similar assets exchanged in active markets, to level two, where values are calculated according to criteria observable in active markets, and to level three, where values are calculated using criteria that is not observable in active markets.[1] Due to the more flexible pricing criteria of level 2 and 3 assets, this accounting transfer gives banks the opportunity to not report the market value of their assets; as such, they can maintain inflated asset values on their books and not register losses. In recent months, many of the largest banks, including the GSEs, have significantly raised their level 2 and 3 assets in comparison to their holdings of level 1 assets.

Another way to hide lower asset values is through their transfer between financial actors. In May of 2008, the Swiss bank UBS sold 22 billion dollars of CDOs and RMBSs to Blackrock at 68% of their face value, but UBS also lent three quarters of the funding necessary for the purchase (Financial Times, 2008a). Likewise, in July of 2008, Merrill Lynch sold more than $30 billion worth of CDOs to Lone Star at 22% of their face value. However, Merrill also financed approximately 75% of the deal, and like the UBS case, the loan was also granted under very favorable terms. As such, the value of the CDOs sold to Lone Star is closer to 5% than the 22% officially claimed (The Wall Street Examiner, 2008). This form of asset price manipulation obeys a different

1 The three levels of assets correspond to rules enacted by the Financial Accounting Standards Board (FASB).

logic than that of the transfer of assets to levels 2 and 3. While both seek to minimize losses charged to individual banks, when assets are interchanged, a market price is established, and all holders of similar assets have to lower their book values and register the loss, unless they can internally transfer assets to levels 2 and 3.

Another form of accounting manipulation is the transfer of worthless assets from a bank to other entities also owned by the bank. One example of such practices was the transfer of $4.5 billion from the investment bank Lehman Brothers to a hedge fund created by the same bank (Bloomberg, 2008b). Even though the opacity of the deal has avoided its classification as a related loan, it has been one of the most reported transactions of its type. There are currently an estimated $11 trillion of assets held by off-balance sheet entities (Bloomberg, 2008c), over which almost no regulation exists. The internal transfer of assets between level 1 and 2 and 3, the transfer of assets between separate institutions, disguised as sales, and the very probable transfer of assets between related parties has not been seen as grounds form investigation by the Security and Exchange Commission (SEC), nor by institutions charged with maintaining accounting standards. The opaqueness of the current financial system, dominated by derivates and exempt of any regulation, establishes propitious conditions for the massive transfer of assets of low and falling value to off-balance sheet entities.

While accounting manipulation, the reduction in interest rates established by the Fed and the opening of mechanisms for the unconditional financing of investment banks have the objective of controlling the rate of financial losses, financial authorities have also acted in conjunction with the largest banks to apply timely and more specific measures for sectors of the financial market whose precipitous losses have threatened the integrity of the entire system. Examples of this type of strategy include: the failed attempt by the Treasury to establish a super SIV to buy the worthless assets of individual SIVs; the decision to exempt Bank of America from the established limits for lending between banks and their brokerages so that the bank could buy the distressed bank Countrywide; the decision to modify the rules regarding asset classes eligible for exchange with the Fed to include CDOs and RMBS; the decision to allow a universal bank, JP Morgan Chase, access to the Fed's discount window in order to make a loan to Bear Stearns; the decision taken shortly after by the Fed to assume the vast majority of the financial risk of JP Morgan Chase's purchase of Bear Stearns; the decision to suspend the downgrade of the monoline insurer's credit ratings; the creation of a rescue plan for the GSEs; the temporary abolition of the practice of "naked short selling" shares of 19 banks, and the recent execution of the GSE rescue package. In addition, the decision to apply measures that affect large portions of the market, such as cuts in the interest rates, the opening and posterior extension of the Fed's various liquidity facilities, have also corresponded to moments of sharp losses in the world's equity markets. In the following two sections, two particular episdos, the toppling of Bear Stearns and the bailout of the GSEs, will be more closely examined.

The rescue and fall of Bear Stearns

The demise of Bear Stearns in March of 2008, together with the freezing over of financial markets in 2007, represent the two episodes within the current crisis that posed the greatest risks of a collapse of the US, and global financial system. Regarding the hypothesis of this article, the rescue of Bear Stearns is the most relevant of the two events, as it demonstrates the authorities' strategy of having the state absorb all financial losses in order to protect private investors, and also, to a lesser degree, the strategy to rescue "friends". The case of Bear Stearns continues to be somewhat of a mystery. On March 6th, a Thursday, its share price was slightly under $70, a in spite of the fact that the bank was highly exposed to the most deteriorated asset classes, its positions were no different from those of other large investment banks. In addition, during these moments, the bank had an $18 billion liquidity cushion, (Wall Street Journal, 2008), which likewise represented a normal level for a bank of its size. However, rumors began circulating that it was facing liquidity problems, and in a question of days, its largest sources of credit, on which all large US depend for their enormous daily financing needs, had cut off their lines of credit. Without these, no bank can survive, and in a lapse of three days the fifth largest investment bank in the system, apparently viable, was brought to its knees and sold at a bargain price.

The first reaction by the authorities was the granting of a $30 billion loan on Friday, using JP Morgan Chase as a bridge. Although this type of arrangement had not been used since the Great Depression, it followed the strategy that the government had been employing to the date of assuring the viability of the largest banks through public funding. In the case of Bear Stearns, this course of action was also based on convincing fundamentals. Bear Stearns was highly exposed in the Credit Default Swap market, and was also an important actor in the tri-party repurchase market (*Financial Times*, 2008b). Its bankruptcy would have represented a significant systemic risk.

However, in the evening of the same Friday, Paulson informed the management of Bear Stearns that the loan would expire by Sunday. Shortly thereafter, working with the upper management of JP Morgan Chase, Paulson dictated the price of Bear Stearns's sale, $2 per share. According to the terms of the deal, JP Morgan Chase would buy Bear Stearns for $30 billon, but the fed, through a Special Purpose Vehicle, would finance $29 billon of the transaction. The reasoning behind the forced deal, and the way in which it occurred, leave many open questions. However, the financial journalist Brian Burroughs points to an interesting theory shared by many Bear Stearns executives. According to Burroughs, Bear Stearns maintained the institutional character of a maverick and in large part operated on the outer fringes of the Wall Street establishment. Perhaps the clearest manifestation of this attitude was the refusal of Bear Stearns to participate in the consortium of Wall Street firms that in conjunction with financial authorities organized an orderly unwinding of the mini financial crisis that Long Term Capital Management's collapse in 1998 provoked (*Vanity Fair*, 2008). In the midst of the administration of the current crisis, a large bank that is unwilling to cooperate could logically hinder the fulfillment of the government's strategy, and Burroughs suggests that a concerted effort was made to break the bank through destructive financial operations. Other sources confirm the placement of put options on 5.7 million shares of Bear Stearns, essentially betting that their price would fall from $63 to less than $25 in a question of days. Peter Chepucavage, a former SEC lawyer, stated that such a transaction represented either a manipulation or insider trading (Bloomberg, 2008d). While the sources of these bets are still unknown and under investigation by the SEC, many people, including Bear Stearns executives cited by Burroughs, point to the investment bank Goldman Sachs, where Paulson was CEO before his current post as the Secretary of the Treasury.

Even though the theory that Bear Stearns was intentionally eliminated from the market supports the hypothesis of this article, its veracity is impossible to confirm at this moment. But the undeniable facts are that JP Morgan Chase was able to buy another bank at a price that was far below its value, a point admitted to even by JP Morgan Chase's upper management (CNBC, 2008); that through a SPV named Delaware, the Fed purchased $30 billion of Bear Stearns's most toxic assets (Buiter, 2008c), and that no investor related to Bear Stearns, except for its stockholders, was exposed to financial losses.

The GSEs

The same dynamic is present, although with important differences, in the rescue package that was recently implemented for the GSEs. After several days of significant losses in Fannie Mae and Freddie Mac's share prices, on July 13 the Treasury presented a rescue plan, subsequently approved by Congress, with the following elements: first, the Treasury would be able to buy stocks in both companies at its discretion; second, the Treasury would be able to expand, also at its discretion, its lines of credit to the GSEs, previously set at $2.5 billion each; and third, the GSEs would be able to access the Fed's discount window. As such, the Fed and the Treasury have been granted any and all public funding necessary to rescue the GSEs.

The GSEs hold assets in excess of $5 trillion, and their collapse would represent a systemic risk much greater than that of Bear Stearns. But in both cases, the need for a state rescue does not mean that the state must assume all financial losses caused by the deterioration of the banks' assets. As stated, this type of rescue would in all likelihood impede a cleansing of the system and would elevate the fiscal costs of the bailout. However, the GSEs' case offers an important exception. Due to their size, an explicit guarantee of their debt by the government would mean raising the US public debt of over $9 trillion by another $5 trillion. In addition, around $1.3 trillion of this amount is held by foreign central banks (Bloomberg. 2008e), with China and Russia's figuring prominently among them. Even though both countries have reduced their holdings of agency debt, (*Financial Times,* 2008c; Reuters, 2008), a massive abandonment of these positions could trigger a significant fall in the price of the dollar and could lead to higher mortgage rates, two flanks of the US economy that are currently both weak and exposed.

Yet these considerations do not change the fact that under the terms of the recently announced bailout, almost all investors are protected at the cost of public finances. Pimco, which controls the world's largest bond fund, holding more than 60% of its $132 billion under management in mortgage debt, was immediately rewarded by the news of the GSE bailout with a $1.7 gain in the Lehman Aggregate bond index (*Financial Times*, 2008d). Pimco's CEO Bill Gross had previously made public statements calling for the purchase of privately held financial assets by the government (Bloomberg, 2008f). As part of the bailout, the Treasury Department announced that it will "temporarily" purchase GSE MBS (Department of the Treasury, 2008).

As stated at the beginning of the article, when the state unconditionally rescues the same banks that caused the crisis, incentives are established for the banks to turn to fraud or highly risky speculative activity, greatly hindering the process of cleansing the system and raising the costs of the bailout.[2] As will be detailed in the following sections, by establishing ideal conditions for banks to adopt strategies that are counterproductive to these objectives, the financial authorities of the US are falling into the same excesses as their Mexican peers did a decade ago.

The Mexican banking bailout

To the present date, the incipient US banking bailout has shown important similarities to the Mexican bank rescue, (known as Fobaproa, the Spanish initials of the public entity originally commissioned with the bailout). In both cases, the banks were the principal driving force behind the development of the banking crisis, and in both cases, the bankers wielded significant political power, both in periods prior to the crisis and during the bailout. In the Mexican case, the government offered absolute protection to the bankers. No bank was allowed to fail in the months after the crisis erupted; all banks received public funding, and no bank was subject to a sufficiently stringent supervision. Therefore, the conditions were in place for one of the least successful bailouts in modern history. Despite the fact that the government committed enormous sums of money to the effort, the banking system was never cleansed, and almost all of the country's largest banks were subsequently purchased by foreign banks at prices far below their values.

Among the various measures that together produced such results, the purchase of worthless financial assets by the government was of particular importance. In the months following the crisis, all bankers knew that any non-performing loan would be absorbed by the state, but at the same time, if the fortunes of their banks did not quickly change, they would be shuttered or transferred to new ownership. Therefore, the incentives were in place for the bankers to employ strategies of gambling for resurrection and for bankers to loot their institutions. In the first case, bankers sought to maintain control of their institutions through risky, yet potentially lucrative bets. If these gambles paid off, the bankers could retain control of their banks, and if they lost, the losses would be passed on to the state. And if gambling for

2 Due to the fact that the GSEs are semi-public entities that operate exclusively in secondary markets, such incentives are notably reduced. See Marshall (2008).

resurrection did not bear fruit, there was always the possibility that bankers could issue credit to friends, family, and to themselves with no intention of repayment, and once again pass all losses along to the state. This tactic was widely employed in Mexico, and so even thought many bankers lost their banks, they did not lose their fortunes. Among the banks that were eventually closed, the proportion of related credits to total loan portfolios more than doubled in just the first six months of Fobaproa's implementation. 87.8% of these loans were never recovered (La Porta, López de Salinas y Zamarripa, 2000:7).

The bailout of the Mexican banking system represented a complete socialization of its losses. While no banker was saddled with losses that corresponded to the profits reaped during the previous period of financial euphoria, the government charged the state with billions of dollars of losses that will have to be paid by future generations and which translate into a greatly reduced capacity for the government to finance other activities. Worse yet, the constant weakening of bank balances during the bailout made a cleansing and recovery of the banking system impossible, and the system was transferred, almost in its entirety, to foreign owners. Therefore, any possibility of carrying out a coherent credit policy has been eliminated, and the banking system has since operated as a cash generating center for foreign banks and has ignored the needs of the local economy.

All signs point to a similar dynamic in the current US bailout, although its final results obviously cannot be known at this point. The government has offered an almost unconditional support to major banks both during the crisis and in the period prior to it. With the rescue of Bear Stearns, the government has established the important precedent of the outright purchase of banks' assets, as was done in the Mexican bailout. The Fed and European central banks currently hold hundreds of billions of dollars of practically worthless bank assets in a temporary fashion. And while their outright purchase, or simply their nominally temporary, but *de facto* permanent holding, may soon become reality, bankers are already responding with actions that correspond to the outright purchase of their toxic waste by the government.

On the one hand, banks continue to expand their speculative operations, both through conventional bets made largely through their hedge funds, and through the generation of new structured products, even though their null market value means that they cannot be sold to private actors. "Zombie" CDOs have been created by the English banks HBOS and Lloyds (*Financial Times*, 2008e; *Financial Times*, 2008f) and the creation of $9.3 billon of "CDO Re-Remeces" by American banks (*Financial Times*, 2008g), have been designed with the sole objective of unloading worthless paper on the Fed and European central banks in exchange for government securities. Analysts at Deutsche Bank estimate that since January 2008, over $386 billion of asset backed securities have been created for the same purpose (*Financial Times*, 2008h).

Yet while banks are responding to the government protection with the expansion of their speculative activities, the greatest risk to the stability of the financial system is that bankers continue to obey their incentives and loot their institutions, as happened in Mexico. Due to the entrenched presence of derivatives and structured finance, fraud of this type will not occur via the same traditional mechanisms used during the Mexican bailout. However, the same bankers that relied on fraudulent activity during the years leading up to the crisis will surely use other fraudulent practices during the bailout to retain as much of their previous earnings as they can. As many analysts have stated, the US financial system faces the enormous risk of another Enron-type situation, in which the same banks that have had a starring role in the current crisis designed the financial vehicles that Enron used to hide the firm's losses. Using the time bought by accounting manipulation, Enron executives were able to loot the company before the authorities charged with its supervision raised their voice. The same opacity of structured finance that has allowed banks to reap huge profits in previous years, and that has caused a systemic distrust that breathes continuous life to the current crisis, will be utilized to conduct financial fraud on a massive scale in the current period of crisis resolution.

Conclusion

Much like the Mexican banking crisis, the American crisis is a classic banking crisis. Although this type of crisis can be easily avoided with adequate regulation and supervision, once unfolded, it is very difficult to combat. Due to the contradictions between guaranteeing the viability of the payments system and ensuring that the system is cleansed at a reasonable fiscal cost, in operational terms the successful resolution of a classic banking crisis requires great skill. However, when the authorities entrusted with the rescue are more committed to the protection of banks' interests than to the recovery of the banking system and the long-term health of public finances, the possibilities of a minimally successful resolution diminish significantly.

The current US banking crisis is an event of immense proportions. It not only represents the culmination of the longest speculative run in history, but also involves the largest economy of the world. If the country's financial system is not cleansed and the fiscal costs of a failed rescue are exorbitant, the US will lose its highly favorable financial position in the world. But this is far from the worst possible result. Even though a different resolution with greater chances of success continues to be possible, more likely is another possibility: that the authorities are incapable of containing the crisis, and the financial system of the US, and the world, collapses.

Bibliography

Bloomberg, 2008a, "Fannie Plan a 'disaster' to Rogers; Goldman Says Sell", July 14. New York.

Bloomberg, 2008b, "Lehman's Hedge Fund Deal Leaves Public in Dark", July 3. New York.

Bloomberg, 2008c, "FASB Postpones Off-Balance Sheet Rule for a Year", July 30. New York.

Bloomberg, 2008d, "Bringing Down Bear Began as $1.7 Million of Options", August 11. New York.

Bloomberg, 2008e, "Fannie's Mudd Soothed Asian Investors as Yields Rose", August 4. New York.

Bloomberg, 2008f, "US Must Buy Assets to Prevent 'Financial Tsunami', Gross Says ", September 4. New York.

Buiter, Willem, 2008a, "Central Banks and Financial Crises. Federal Reserve Bank of Kansas City. 2008 Annual Symposium", Jackson Hole, Wyoming. United States.

Buiter, Willem, 2008b, "Time for comrade Paulson to pull the plug on the Fannie and Freddie charade", Financial Times Maverecon Blog. July 12. London.

Buiter, Willem, 2008c, "The Rescue of Fannie and Freddy by Hankie and Feddy", Financial Times Maverecon Blog. July 14. London.

CNBC, 2008, "JP Morgan Chase: We Got Bear Stearns on the Cheap", July 17. New York.

Department of the Treasury, 2008, Press Room, "Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers". September 7. Washington, DC.

http://www.treasury.gov/press/releases/hp1129.htm

Financial Times, 2008a, Alphaville, "UBS sells subprime debt for steep loss", May 21. London.

Financial Times, 2008b, "Fed Focus on Tri-party Repo Risk", July 8. London.

Financial Times, 2008c, "Bank of China Flees Fannie-Freddie", August 28. London.

Financial Times, 2008d, "Bail-out hands Pimco $1.7bn payday", September 9. London.

Financial Times, 2008e, Alphaville. "HBOS's 9 billion pound zombie RMBS", June 16. London.

Financial Times, 2008f, Alphaville. "Securitization is dead, long live securitization", April 25. London.

Financial Times, 2008g, Alphaville. "The Re-Remic Gimmick?", July 8. London.

Financial Times, 2008h, "Asset-backet securities markets suffer", August 26. London.

LaPorta, Rafael, Lopez de Silanes, Florencio y Zamarripa, Guillermo, 2000, "Soft lending and hard landing: related lending in México", Harvard University, United States.

Marshall, Wesley, 2008, "La quiebra de Fannie Mae y Freddie Mac vista desde la experiencia latinoamericana", *Ola Financiera*. Numero 1. September – December. México, DF.

http://www.economia.unam.mx/ola/

Reuters, 2008, "Russia says cut investments in US agency debt by 40pct", July 31, New York.

Roubini, Nouriel, 2008, "The Coming Systemic Bust of the U.S. Banking System: 'Dead Stocks Rallying'", RGE Monitor. July 20. New York.

The Wall Street Examiner, 2008, "The Real Value of Merrill's CDO Sale", July 29. United States.

Wall Street Journal, 2008, "Fear, Rumors Touched Off Fatal Run on Bear Stearns", May 28. New York.

Vanity Fair, 2008, Bringing Down Bear Stearns. August. New York.