The end of American capitalism as we knew it

This is what I read this morning on FT.com: “The US Federal Reserve announced that it will lend AIG up to $85bn in emergency funds in return for a government stake of 79.9 per cent and effective control of the company - an extraordinary step meant to stave off a collapse of the giant insurer that plays a crucial role in the global financial system. Under the plan, the existing management of the company will be replaced and new executives will be appointed. It also gives the US government veto power over major decisions at the company.”

I almost decided to go back to bed, convinced I must be dreaming.The proximate cause of the demise of AIG as a private firm were its ‘monoline’ activities, its exposure to massive amounts of credit risk derivatives like CDS, many of them linked to the US real estate sector. The largest insurance supermarket in the world, with a balance sheet in excess of $1 trillion nationalised because it was deemed too big and too globally interconnected to fail! The fear that drove this extraordinary decision is that AIG’s failure would increase counterparty risk, actual and perceived, throughout the financial system of the US and the rest of the world, to such an extent that no financial institution would have been willing to extend credit to any other financial institution.Credit to households and non-financial enterprises would have been the next domino to fall, and voilà! , financial Armageddon.

I cannot judge the likelihood of the disaster scenario, but if there ever was a case for applying the precautionary principle in economic analysis, then this is it. It was also done in the right way, by insisting on controlling public ownership, i.e. nationalisation, of the company.The existing management is gone - again as it should. We will find out whether they left with golden parachutes or with just a carton box packed with their personal belongings.

The precise implication of the deal for the old shareholders will also matter for the ultimate judgement on its fairness and on what it does to incentives for future risk taking. Since the existing shareholders were obviously not completely wiped out by the deal, they do well out of it - probably too well. The public take-over appears to imply that all creditors other than the ordinary and preferred shareholders will be made whole. From the perspective of incentives for future excessive risk taking, this is regrettable.

A charge on the creditors, modulated according to the seniority of the debt, would have been preferable.But perhaps my concern about incentives for future risk taking is moot, because it assumes that private, profit-seeking enterprises will again, in the future, pursue the kind of financial activities engaged in by AIG.

If financial behemoths like AIG are too large and/or too interconnected to fail but not too smart to get themselves into situations where they need to be bailed out, then what is the case for letting private firms engage in such kinds of activities in the first place?

Is the reality of the modern, transactions-oriented model of financial capitalism indeed that large private firms make enormous private profits when the going is good and get bailed out and taken into temporary public ownership when the going gets bad, with the tax payer taking the risk and the losses?

If so, then why not keep these activities in permanent public ownership?There is a long-standing argument that there is no real case for private ownership of deposit-taking banking institutions, because these cannot exist safely without a deposit guarantee and/or lender of last resort facilities, that are ultimately underwritten by the taxpayer.

Even where private deposit insurance exists, this is only sufficient to handle bank runs on a subset of the banks in the system. Private banks collectively cannot self-insure against a generalised run on the banks. Once the state underwrites the deposits or makes alternative funding available as lender of last resort, deposit-based banking is a license to print money.

That suggests that either deposit-banking licenses should be periodically auctioned off competitively or that depostit-taking banks should be in public ownership to ensure that the tax payer gets the rents as well as the risks.The argument that financial intermediation cannot be entrusted to the private sector can now be extended to include the new, transactions-oriented, capital-markets-based forms of financial capitalism.

The risk of a sudden vanishing of both market liquidity for systemically important classes of finanial assets and funding liquidity for systemically important firms may well be too serious to allow private enterprises to play. No doubt the socialisation of most financial intermediation would be costly as regards dynamism and innovation, but if the risk of instability is too great and the cost of instability too high, then that may be a cost worth paying.

These are issues that must be pondered not just in Washington but everywhere modern financial intermediation has taken root or is threatening to do so - in the financial heartland (Wall Street, the City of London, Frankfurt, Zurich, Tokyo and Dubai) and in the emerging markets that until recently were having their ears bent on the desirability of precisely the kind of financial institutions and markets that have now turned into trillion dollar collapsing dominos.

From financialisation of the economy to the socialisation of finance. A small step for the lawyers, a huge step for mankind. Who said economics was boring?