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World financial crisis has **long roots**

The true roots of the U.S. and world financial crisis are rarely discussed. The patient is running a high fever, and so we recommend "Take two aspirins and drink plenty of fluids"—just to get some relief from the symptoms. But the true cause is infection, and effective antibiotics should be applied. In order to do that—and avoid recurrence of the illness—a causal diagnosis becomes indispensable.

BY MILAN ZELENÝ

As we listen to U.S. Treasury Secretary Henry M. Paulson Jr. and U.S. Federal Reserve Chairman Ben Bernanke during their Congressional hearings, we are struck by how clueless these macroeconomists appear to be, by their lack of foresight, competence and ability to think clearly. They seem to be fanning the fires of the unease, mistrust, fear and panic which they are being paid to help extinguish. Without a sound diagnosis there can be no intelligent remedy.

It all started with the Community Reinvestment Act (CRA), a United States federal law that requires banks to offer credit throughout their entire market area and prohibits them from targeting only wealthier neighborhoods. The purpose of the CRA is to provide credit and mortgages to poor neighborhoods and their small businesses. The CRA was passed into law by the U.S. Congress in 1977, during the Carter administration.

The CRA was normally monitored by the financial regulators such as the **Federal Deposit Insurance Corporation** (FDIC), the Office of the Comptroller of the Currency (or OCC), the Office of Thrift Supervision (OTS), and the Federal Reserve System (FRB). Then something happened: In 1995, as a result of urging from President Bill Clinton, the CRA regulations were radically changed.

The Clinton Revision introduced systematic ratings of banks in terms of CRA compliance. This implied serious sanctions and forced banks into substantially increasing the number and aggregate dollar amount of loans to low-income borrowers. The banks were forced to pressure their subsidiaries and non-CRA institutions into loosening their lending criteria and standards. New lenders have emerged, forming the secondary market for mortgage loans, based on the new subprime authorization. The Clinton Revision further allowed the securitization of CRA loans containing subprime mortgages. The first public securitization of CRA loans occurred in 1997 by First Union Bank (taken over by Wachovia Corporation) in concert with the now defunct Bear Stearns Companies. Securitization allowed investment bankers to purchase subprime mortgages, break them up and re-package them for the purpose of reselling at premium to clients all over the world. These practices further stimulated demand for issuing additional subprime mortgages in poor neighborhoods. The number of CRA mortgage loans skyrocketed.

This intentional loosening of underwriting standards was clearly a time bomb waiting to explode. Toxic mortgages were being issued on a mass-production scale, with no verification of income or assets, little consideration of the applicant's ability to make payments and no down payment. The "free ride" peaked when Federal Reserve Bank of Boston ruled that participation in a credit-counseling program should be taken as evidence of an applicant's ability to manage debt! Clinton politics and political goals have significantly curtailed principles of free markets and sound business.

The spirit of the time was bordering on surreal. On Dec. 8, 1993, in the critical "Hi, I am Bob Rubin" press conference, Robert E. Rubin, the assistant to the president for economic policy, introduced new the CRA enforcement initiative "to deal with the problems of the inner city and distressed rural communities." Treasury Secretary Lloyd Bentsen came with the fatal wording: "What we're proposing to do is to make it easier for lenders to show how they're complying with the Community Reinvestment Act. We said the Clinton administration was going to get money flowing into community development financial institutions, and we're doing just that."

The CRA-covered lenders and their affiliates did increase mortgage lending to low- and moderate-income borrowers and communities. The number of mortgage loans made by CRA-covered institutions and their affiliates increased by 39 percent between 1993 and 1998, while such institutions' loans to other borrowers increased by only 17 percent.

On April 19, 2000, Treasury Secretary Lawrence H. Summers was ebullient in evaluating the success of the revised CRA: "The first lady [Hillary Clinton] likes to say it takes a village to raise a child; at Treasury we say it takes capital to build a village. This study is further evidence that a strong Community Reinvestment Act is critical to ensuring that all neighborhoods are part of our national economic prosperity." Today we see clearly that it takes a village to get capital.

Clinton politics and political goals have significantly curtailed principles of free markets and sound business.

The names are important here because the Clintonites like Robert E. Rubin, Larry H. Summers, Laura D'Andrea Tyson, etc., now form the core of presidential candidate Senator Barack Obama's circle of economic advisors. Obama intends to "fight" the financial crisis with the same people who were at its genesis.

By early 2003, just the direct CRA-regulated subprime market had already reached $600 billion. The unregulated part of it was many multiples of this amount, never to be known precisely. The subprime momentum was creating money flows, which were increasingly difficult to resist by morally weak bosses of Wall Street.

In 2003 the Bush Administration recommended strong governmental supervision of two of the primary agents guaranteeing subprime loans, the now bailed out **Federal National Mortgage Association** (Fannie Mae) and **Federal Home Loan Mortgage Corporation** (Freddie Mac), under a new agency created within the Department of the Treasury. However, it did not alter the implicit guarantee that Washington will bail the companies out if they run into financial difficulty; that perception enabled them to issue debt at significantly lower rates than their competitors. The Bush revisions were not enacted but rather quickly "killed" by a strong opposition from Democrats.

Typical was the notorious Representative Barney Frank (Democrat-Massachusetts) who claimed that "These two entities—Fannie Mae and Freddie Mac—are not facing any kind of financial crisis, the more people exaggerate these problems, the more pressure there is on these companies, the less we will see in terms of affordable housing." This was echoed and repeated by other Democrats with equally surreal claims: these two super factories for subprime mortgages do not face financial crisis, and Bush is limiting poorer families and their ability to get affordable housing.

So in 2003 the ill-crafted efforts of the Democrats to increase affordable housing received another green light and put the wheels of the subprime crisis into a high gear. Until then, all institutions over $250 million (now Kč 4.1 billion/€171 million) in assets were subject to a three-part CRA test that covered lending (including community development loans), qualified investments and services to their assessment areas.

However, as of Sept. 1, 2005, only those institutions with more than $1 billion in assets were subject to the three-part test. These changes were not received positively by all community groups. Racial inequities in mortgage acceptance rates were cited as a primary reason to maintain or even increase the scope of the CRA. No politician was willing to be politically incorrect and to challenge the racial line of reasoning. Politics won again over sound economics. The crisis was spinning out of control. Even the institutions not subject to CRA and bank subsidiaries not fully under CRA have now gotten mired in the lucrative project of greed, fear and deception.

It is therefore clear that there is no economic crisis, or even a recession in the US. The crisis is financial and more specifically: it is a Wall Street crisis. What the U.S. government is worried about is that the financial crisis becomes economic crisis, that Wall Street will affect the Main Street. So, the real crisis is political, the failure of politicians to allow their political interests to be moderated by common sense and economic realities. In the end, it was the poorest and most underprivileged citizens who got hurt most by the CRA. ➤


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Politicians fail to understand that it is in the interest of Wall Street firms to claim that the crisis is economic, not just financial. It is in their interest to sow fears about how much threatened is the real economy (recall Bernanke's warnings about economic "meltdown"). Only through fanning such potent fears could they receive over $1 trillion in bailouts of taxpayers' money for just a few big firms (like Bear Stearns, Fannie Mae, Freddie Mac, financial service firm **Merrill Lynch & Co.**, and insurer **American International Group** (AIG))—all these bailouts have failed. So the "mother of all bailouts" has to be rolled out: the $700 billion state corpus that is to purchase all toxic mortgages, both CRA and non-CRA, for taxpayers' money.

We can now better understand why crucial advice is sought from people who actively aggravated the subprime crisis. For example, Secretary Paulson Jr. *(pictured)*, a Wall Street investment banker, was previously chairman and CEO (1999–2006) of **Goldman Sachs Group**; past CEO of Fannie Mae Jim Johnson (who found vice presidential candidate Senator Joe Biden of the "paying higher taxes = patriotism" fame) is Obama's adviser, as are the Clinton administration's White House budget director Franklin Raines, who ran Fannie, and Jamie Gorelick—a Clinton Justice Department official—who also worked for Fannie. All are fabulously wealthy from their lucrative jobs, all friends and close advisers to Obama. It is now easier to understand why Obama is the second largest recipient of Fannie Mae, Freddie Mac and **Lehman Brothers** campaign contributions.

It is a strange "old boys network" Obama has chosen for "fighting" this financial crisis. This is a strange vision of the "change" that Obama is promising, and even stranger is the quality of judgment he is exhibiting. It is not surprising that he has Wall Street, Clintonites and Hollywood on his side: the vision of state handouts and bailouts to the rich are very hard to resist. His knowledge of economics lags well behind his skillful rhetoric and old-fashioned politics.

It is then also understandable that even the "capitalistic" *Wall Street Journal* (WSJ) blasts McCain because he promises strong regulation of Wall Street and swears to fire ineffective U.S. Securities and Exchange Commission (SEC) chairman Christopher Cox, who eliminated a rule last year that had served to keep in check hedge funds and others from destroying companies by short selling their shares. "The primary regulator of Wall Street, the Securities and Exchange Commission kept in place trading rules that let speculators and hedge funds turn our markets into a casino," McCain said.

A WSJ editorial immediately attacked McCain's claim that the SEC allowed "naked short selling" and eliminated the "up tick rule" that has protected investors for 70 years. The way this attack was carried out is worthy of quoting at length: "Take 'naked' shorting, in which an investor sells a stock short—betting that it will fall in price—without first borrowing the shares he is selling from an investor who owns them. The SEC has never condoned the practice, and since 2005 it has clamped down on short selling in any stock that shows evidence of naked shorting. The SEC further tightened its rules against naked shorting just hours before Mr. McCain excoriated Mr. Cox for doing nothing."

Yes, just hours before McCain made his speech! Cox was appointed in August 2005. Talk about doing nothing. No comment is needed. So, WSJ concluded: "He'll never beat Mr. Obama. ..."

The Democrats and Wall Street have to attack McCain because they know that his cleansing of financial markets would be ruthless and uncompromising. (They even attack the less experienced Alaska Governor and vice presidential candidate Sarah Palin, the self-proclaimed "pit bull with lipstick," because her fight against greed and corruption promises to be similarly determined and "dogged.") Yet, Obama's "change" is clearly nothing more then artificial cosmetics, essentially preserving the old-boys networks—like "putting lipstick on a pig."

This is not to say that McCain is not similarly interconnected with Wall Street and Washington bosses and lobbyists. It is unfortunate that the current political campaign happens to be concurrent with the financial crisis, and so blatantly polarizes and muddles its perceptions.

Still, the SEC did nothing about naked short selling, but more importantly nothing about credit default swaps (CDS), which remain unregulated even today. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the product. By doing this, the risk of default is transferred from the holder of the security to the seller of the swap. So, if a bad mortgage defaults, the insurer compensates the insured for his loss. This is what AIG engaged in. Over the past two weeks, large price declines in brokerage stocks were often accompanied, or preceded, by big moves in CDS tied to those firms. These swaps are not carried out through the exchanges but privately between the two parties, i.e. unregulated and without oversight. They have become an increasingly popular way for firms to speculate and gamble on the fortunes of financial companies without actually trading securities issued by the firms.

The CDS represent a serious betrayal of public trust on the side of SEC: speculation with the fate of Wall Street investment banks has reached formidable proportions and directly contributed to the credit crisis. For both Bear Stearns and Lehman Brothers the elevated swap prices fueled worries about the investment banks' solvency, triggering mass defections among clients and ultimately the companies' demise. Clearly, any group of speculators, competitors or potential buyers can drive down the price of stocks of target companies without trading their stocks—just through targeted betting and market manipulation. The value of CDS tied to **Morgan Stanley** and Goldman Sachs has increased phenomenally.

CDS are clearly at the core of the financial crisis climax, now roiling the global economy. Because prices of CDS have often swung sharply ahead of major corporate news events, the suspicion is that nonpublic information was fraudulently leaking into the dealer market. The role of CDS, although mostly ignored by the public and politicians and certainly not talked about by Wall Street bosses, is overwhelming: The market for credit-default swaps is more than $60 trillion—roughly five times the U.S. gross domestic product (GDP)! AIG's portion of that was just about half a trillion dollars.

This ruthless attack on free-market capitalism has almost succeeded. Without this backdoor speculation and deception, without the swaps and other derivative instruments, nobody would lend such bad money. The Fed had to take action; CDS could bring the economy to its knees very fast.

There is nothing wrong with the real American economy of goods and services. The virtual economy of financial greed and speculations is all wrong, and its size has overwhelmed the size of the real economy. Clearly, all the previous Paulson-Bernanke "bailouts" were useless and wasteful because they did not address the CDS problem. That is why this new mega-bailout is needed, to vacuum off all those toxic CRA-type mortgages, the roots of current problems. Yet, it does not address market foreclosures (current rate at 10,000 per day) or their prevention, nor CDS or any other crucial factors of the crisis.

There is a tendency to blame President George W. Bush for the crisis: Europeans, Democrats, Wall Street and Senator Obama appear to be united in this perception. Bush had eight years to deal with the crisis. He got distracted by 9/11 and two wars. He is to be blamed for inaction and passivity on the matters of economy, as well as for the mindless support of current bailout processes. But not more: he accurately foresaw the danger posed by Freddie Mac and Fannie Mae, and called as early as 2002 for greater regulation. In 2003 his efforts were torpedoed by Congress. The Democrats demanded that Fannie Mae keep buying subprime loans. The Bush administration did propose reforms of real estate settlement procedures and the Federal Housing Administration, two areas it had identified as posing the greatest systemic risk to markets. Democrats in Congress, again, blocked these efforts.

Bush is guilty of not resisting their deregulation efforts on CRA. He was simply following a deregulatory pattern set by his successful predecessor, President Clinton. So, it remains the fact that the most significant recent deregulation of the banking industry—the landmark act that allowed commercial banks to expand into other financial activities, like investment banking and insurance—was signed into law by Clinton in 1999.

I have lived and worked in the United States for more than 40 years and have never seen a more naked attack on free-market capitalism and democracy, never seen politics so crudely overriding all common sense, economic considerations and concerns of the hard working people of America. Yet, this attack shall fail, and the free-market society will be restored to its health and prosperity. Efforts to stop natural processes of [economist Joseph Schumpeter's] "creative destruction," the replacement of old, unreformable and corrupt institutions by the new, agile, competitive and morally cleansed institutions is unstoppable. The new Wall Street is already emerging as the largest "ethnic cleansing"—an unprecedented moral and economical catharsis is taking place in America. Every crisis of the old presents an opportunity for creating the new. Just "fixing" the old is not enough. ■

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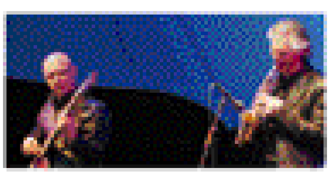
Ostrava region a new centre for cultural events?

The Colours of Ostrava festival has now been held for seven years and come a long way in that time. However "Barvičky", as the festival is known by local enthusiasts, is not the only major cultural event which the people of Ostrava look forward to each year, and thanks to the helping hands of local sponsors the same is true again.

Colours of Ostrava involves hundreds of performers and tens of thousands of visitors to northern Moravia. Initially a local showcase of world music, Colours has grown in stature beyond the borders of the region and the Czech Republic, featuring major acts such as Sinead O'Connor or the Gypsy Kings. The festival received the Anděl Prize for musical event in 2005 and 2006. Since 2005 the festival has been supported by the strongest companies in the region, with OKD in the lead. The mining company's director of communications Petra Mašínová explained the reasons for sponsorship: "The festival is one of the symbols representing the entire region. Everybody in the Czech Republic knows that, in addition to miners and coal, Ostrava is home to Stodolní street and the best



Jazzman Jan Garbarek – a pleasant surprise from this year's Colours

music festival of the year. So it was a natural match for us."

Local people also enjoy Colours and are proud of the festival, just as they are of the Baník football club, the local dialect, and local traditions. All of these are important factors which are taken into account when selecting various projects to sponsor.

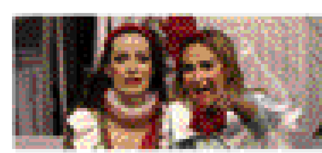
This unique region began hosting this year the Summer Shakespeare

Ostrava – a region for life

Celebration, a theatre festival which in past years has captivated audiences in venues such as the Prague Castle, Špilberk castle in Brno and Bratislava Castle.

Outstanding performances this year by Jan Tříska, Jan Langmajer, and Petra Špalková were complemented by favourite actors from Ostrava theaters. And for Polish-speaking theatregoers, Ostrava hosted the Teatr ludowy from Krakow led by renowned director Jerzy Stuhr.

Aside from large festivals, the northern Moravian metropolis can boast of a number of projects for specialized public interests. International respect has been gained by the Ostrava Days classical and experimental music festival, which takes place every two years at the end of summer. In its most recent incarnation, there were musicians, composers, and directors from 18 countries. Another shining beacon is the TUR film festival for films about ecology and the environment. This year 56 films were presented, mainly produced abroad. Next year, the OKD company hopes to gain recognition for its documentary work about land reclamation. Older people in the region also have plenty of cultural events to choose from, especially the largest and oldest miner's orchestra in the Czech Republic, Májovák, celebrating its 100th anniversary this year. In addition to contemporary brass band music, the seventy-member group also plays melodies closely associated with the local region. The orchestra represents Karviná and OKD not only within the Moravian/Silesian region, but also in many European countries.



The Summer Shakespeare Celebration's performance of "As You Like It"

Do you know that...

- in addition to large cultural events the OKD mining company also supports smaller and new events? It has established the OKD Foundation just for such purposes.
- this year the Májovák miner's orchestra is celebrating its 100th anniversary?
- Ostrava will be a candidate for the European capital city of culture in 2015?
- TUR film is one of the largest showcases of ecological films in Central Europe?

OKD, a.s. is the largest hard-coal mining company in the Czech Republic. It is also the largest employer in the North Moravian Region.

OKD