Opinion

The internet is caught in a sinister web of conspiracy

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Hank Paulson has turned drama into a crisis

By punishing shareholders, the US Treasury Secretary had made the rescue of other troubled banks almost impossible

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It looks as if the prophets of doom may have been right after all. With the demise of Lehman Brothers and Merrill Lynch — and the threatened collapse of the world's largest insurance company, American International Group — we are now unquestionably in the worst financial crisis since the Great Depression.

But does this mean that the "real" economy of non-financial jobs, investment, consumer spending and housing also faces its greatest disaster in 60 years, as Alistair Darling has said?

Probably not. The real economy and the world of finance can easily move in opposite directions. Most of the truly imprudent borrowing and lending of the past few years has occurred within the financial sector, with one bank or hedge fund lending insane amounts of money to another. Much of this debt could, in principle, be wiped away without affecting anybody apart from the financiers who were riding this crazy merry-go-round — and that has been pretty much the story of the past 12 months. Tens of thousands of jobs have been lost in Wall Street and the City, but the impact beyond that has been quite modest, except on property values and some of the luxury goods and services previously bought by these millionaires.

The past few days' events, however, have raised two alarming qualifications to this generally reassuring story. The first is that the decoupling between financial and economic conditions that I have been expecting — and which has broadly happened — can only be a matter of degree. The non-financial economy can shrug off a certain amount of bloodletting in the City and Wall Street, but if the turmoil escalates to the point where a country's entire financial structure starts collapsing, the consequences are bound to be dire for non-financial businesses and jobs.

This tipping point has not yet been reached in America or Britain. But it suddenly seems perilously close — with stock market prices plunging on Monday to the point where serious questions could be raised for the first time about the viability of key financial institutions such as AIG, Citibank and Bank of America, or of UBS in Switzerland or of Halifax, Royal Bank of Scotland and Barclays in the UK.

Why are these banks suddenly in such deep trouble? This brings us to the second alarming qualification to my optimism about economic and financial decoupling.

It could be that the divergence between the financial and real economies, instead of resulting in a better-than-expected performance of the real economy, will take the form of a much more catastrophic financial crisis than the economic fundamentals seem to justify. Such a financial catastrophe could then turn what would have been just a modest economic slowdown or mild recession into a genuine disaster.

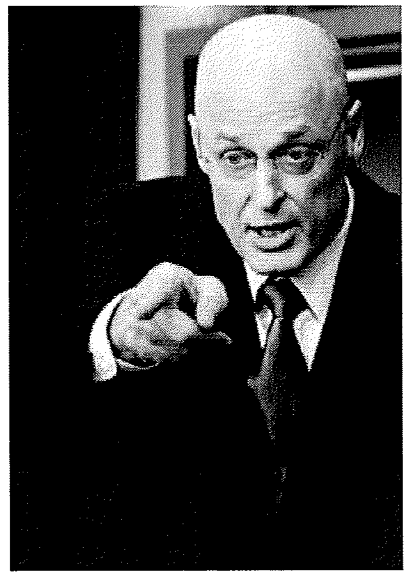
The risk of such a disastrous divergence between the worlds of finance and economics, with the financial system spinning completely out of control despite an otherwise decent outlook for the US and world economies, is much greater today than two weeks ago. And the reason can be reduced to one name — Henry Paulson, the Secretary of the US Treasury.

By deciding essentially to wipe out shareholders in Fannie Mae and Freddie Mac and acting even more harshly to the shareholders of Lehman Brothers this weekend, Mr Paulson has sent the clearest possible message to investors around the world: do not buy shares in any bank or insurance company that could, under any conceivable circumstances, run short of capital and need to ask for government help; if this happens, the shareholders will be obliterated and will not be allowed to participate in any potential gains should the bank later recover.

This punitive policy towards the shareholders in Fannie, Freddie and Lehman, who had put more than $20 billion of capital into these companies in the hope of keeping them alive, means that no US bank or insurance company can hope to raise any extra capital in the foreseeable future.

This is true of both domestic investors and the Middle Eastern and Asian sovereign wealth funds, whose trillions of dollars of assets were, until a month ago, viewed as an ultimate safety net for the Western financial system.

Both groups have been so badly burnt by Mr Paulson that they are unlikely to support any refinancing by an American bank. And because governments and central bankers elesewhere, particularly in Britain,



Basic point: Henry Paulson is a former chairman of Goldman Sachs

have loudly praised Mr Paulson's punitive treatment of shareholders, investors would presumably reach similar conclusions about the folly of helping any British bank.

The upshot is that any US or British bank that suffers unexpected losses or is subject to a powerful speculative attack by stock market short-sellers has nowhere to turn. And that in turn means that the total liquidation of a large financial institution in America, Britain or Europe is now seriously conceivable for the first time.

What makes the situation even more alarming is the perversity of the hardline approach taken by the US and British authorities. The investors who were "punished" by the loss of shareholder wealth in Fannie Mae, Freddie Mac and Lehman were not the speculators who encouraged and financed their reckless lending in 2004-06. They were value-orientated investors betting on a long-term recovery in the US economy and whose willingness to invest on the basis of such recovery could have prevented these companies' collapse.

By wiping out these investors — and instead rewarding the speculators who were trying to drive the share prices of these companies down to zero and thereby put them out of business — Mr Paulson has tilted the balance of power in the financial markets to a point where it is impossible to say for certain that any financial institution will survive.

In short, Mr Paulson has created an open season for speculators to attack financial companies around the world. These attacks are likely to continue and grow in ferocity until the point when governments start supporting not just the deposits and bonds, but also the shares of financial institutions whose survival is essential to keeping their economies running.

But surely it is impossible to suggest such a misunderstanding of basic finance from Mr Paulson, a former chairman of Goldman Sachs? Perhaps.

But then it is worth recalling that Andrew Mellon, the US Treasury Secretary under Herbert Hoover in 1929, was also considered the leading financier of his generation, It is also worth recalling that Donald Rumsfeld was supposed to know something about military strategy and President Bush, a former governor of Texas, about emergency flood control.