# A Financial System under Siege

By Prof Rodrigue Tremblay
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"If these items [promised benefits in Social Security, Medicare, Veterans Administration and other entitlement programs] are factored in, the total [debt] burden in present value dollars is estimated to be about $53 trillion. Stated differently, the estimated current total burden for every American is nearly $175,000; and every day that burden becomes larger."

David Walker, comptroller general of the United States

"The economic forces driving the global saving-investment balance have been unfolding over the course of the past decade, so the steepness of the recent decline in long-term dollar yields and the associated distant forward rates suggests that something more may have been at work."

Alan Greenspan, former Fed Chairman, July 20, 2005

"The subprime black hole is appearing deeper, darker and scarier than they [the banks] thought. They've worked through … about 40 percent of the backlog of the leveraged loan side, and there's definitely some signs of thaw there."

Tony James, president and CEO of Blackstone Group LP

**T**he global **dollar-based financial system** is in crisis and is threatening the prosperity and stability of many economies. Financial excesses of all kinds have undermined its legitimacy and its efficiency. The U.S. dollar is losing its preeminence as the main international reserve currency while many banks are caught in the turmoil of the **subprime credit crisis.**

The overall background is the unprecedented real estate bubble that took place worldwide, from 1995 to 2005. In the United States, for example, owner-occupied home prices increased annually by an average of about 9 percent. The market value of the stock of owner-occupied homes in the U.S. rose from slightly less than $8 trillion in 1995 to slightly more than $18 trillion in 2005. It has been contracting ever since, confirming the working of the **18-year Kuznets realestate cycle**, which has gone from the top of 1987 to the 2005 top.

What makes this period especially dangerous is the fact that the average 54-year long

**inflation-disinflation-deflation Kondratieff cycle** is also at play, having begun in 1949 after prices were unfrozen. World inflation then rose for twenty years, until 1980, which was followed by a period of disinflation under the **Volcker Fed.** The entry of **China** into the World Trade Organization (WTO) on December 11, 2001, with its abundant labor and low wages, unleashed strong deflationary forces worldwide. This in turn led to lower inflation expectations paving the way for the **Greenspan Fed** to keep interest rates abnormally low.

Persistent low interest rates and low inflation expectations led to a binge in borrowing and to a vast increase in market valuation, not only in real estate but also in stocks and bonds. Banks and other mortgage lending institutions took advantage of the opportunity to introduce some financial innovations in order to finance the exploding mortgage market. These innovations resulted in the severing of the traditional direct link between borrower and lender and the reduction in the lending risk normally associated with mortgage loans.

Thus, with the connivance of the rating agencies and of the Federal Reserve System, large banks invented new financial products under various names such as "Collateralized Bond Obligations" (CBOs), "Collateralized Debt Obligations" (CDOs), also called **"Structured Investment Vehicles"** (SIVs), which had the characteristics of unfunded short term commercial paper. In the residential mortgage market, for example, mortgage brokers and retail lenders would sell their mortgage loans to banks, which in turn would package them together and slice them into different classes of **mortgage-backed securities** (RMBS), carrying different levels of risk and return, before selling them to investors.

Indeed, these new financial instruments were the end result of a process of "asset securitization" and were slices of bundles of loans, not only of mortgage loans but also of credit cards debts, car loans, student loans and other receivables. Each slice carried a different risk load and a different yield. With the blessing of rating agencies, banks went even one step further, and they began pooling the more risky financial slices into more risky bundles and divided them again to be sold to investors in search of high yields.

By selling these new debt instruments to investors in search of high yields and higher yields, including hedged funds and pension funds, banks were doubly rewarded. First, they collected handsome managing fees for their efforts. But second, and more importantly, they unloaded the risk of lending to the unsuspected buyer of such securities, because in case of default on the original loans, the banks would be scot-free. They had already been paid and had been released from the risk of default and foreclosure on the original loans.

The banks' residual role was to collect and distribute interest, as long as borrowers made their interest payments. But if payments stopped, the capital losses incurred because of the decline in the value of unperforming loans would instead be carried by the investors in CBOs and CDOs. The banks themselves would suffer no losses and would be free to use their capital bases to engage in additional profitable lending. In fact, the end of the line investors became the real mortgage lenders (without reaping all the rewards of such risky loans) and the banks could reuse their capital to pyramid upward their loan operations. These were the best of times for banks and they gorged themselves without restraint. Some of them paid their employees tens of billions of dollars in **year-end bonuses.**

Indeed, and it is here that the Fed and other regulatory agencies failed, first line mortgage lenders became more and more aggressive in their lending, with the full knowledge that they could profitably unload the risk downstream. This explains the expansion of the "subprime" mortgage market where borrowing was done with no down payment, no interest payments for a while and no questions asked as to the income and creditworthiness of the borrower. These were not normal lending practices. Such **Ponzi schemes** could not last forever. And when housing prices started to decline, foreclosures also increased, thus shaking the new financial house of cards to its foundations. Banks became the reluctant owners of some of the foreclosed properties at very discounted values.

Why then are so many banks in financial difficulties, if the lending risk was transferred to unsuspecting investors? Essentially, because when the housing boom burst, the banks' inventory of unsold "asset-backed securities" was unusually high. When the piper stopped playing and investors stopped buying the newly created risky investments, their value plummeted overnight and banks were left with huge losses still not fully reflected in their financial balance sheets. Indeed, banks that did not unload their stocks of packaged mortgages were forced to accept ownership of foreclose properties at very discounted values. With little or no collateral behind the loans, bad-debt losses became unavoidable.

Since noboby knows for sure the value of something which is not traded, it will take months before banks come to terms with the total losses they have suffered in their stocks of unsold pre-packaged "asset-based securities". It is more than a normal "liquidity crisis" or "credit crunch" (which results when banks borrow short term and invest in illiquid long term assets); it is more like a **"solvency crisis"** if the banks' capital base is overtaken by the disclosure of huge financial losses incurred when the banks are forced to sell mortgaged assets in a depressed real estate market.

This is this financial and banking mess which is unfolding under our very eyes and which is threatening the American and international financial system. There are four classes of losers. First, the homebuyers who bought properties at inflated prices with little or no down payment and who now face foreclosure. Second, the investors who bought illiquid mortgage-backed commercial paper and who stand to lose part or all of their investments. Third, the holders of bank stocks who profited when the system worked smoothly but who now face declining stock values. And, finally, anybody who stands to fall victim, directly or indirectly, to the coming economic slowdown.

*Rodrigue Tremblay is a Canadian economist who lives in Montreal; he can be reached at rodrigue.tremblay@yahoo.com*

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