Anatomy of the American Financial Crisis: How It is Turning into a Worldwide Crisis

By Prof Rodrigue Tremblay
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"The basis for optimism is sheer terror." Oscar Wilde

[After the March 2008 Bear Stears bailout] "As more firms lost access to funding, the vicious circle of forced selling, increased volatility, and higher haircuts and margin calls that was already well advanced at the time would likely have intensified. The broader economy could hardly have remained immune from such severe financial disruptions."Ben Bernanke, Fed Chairman (March 2008)

"In accounting 101 we learn that high yields equal high risk. We know the CEOs had an incentive to disregard this because they were getting huge bonuses." David Hartzell, dean of the University of Delaware's business college and a former vice-president of Salomon Brothers

"Intensifying solvency concerns about a number of the largest U.S.-based and European financial institutions have pushed the global financial system to the brink of systemic meltdown." Dominique Strauss-Kahn, Head of the IMF (October 11, 2008)

The Bush administration's way of dealing with the ongoing financial crisis has been frantic, but probably less than adequate. In fact, tragic errors may have been made that must be remedied as quickly as possible.

The most damaging error may have been to let the global investment bank **Lehman Brothers** fail ($691 billion of assets at the end of 2007), on Monday September 15. This fateful date may have to be remembered in the future. This was the largest failure of an investment bank since the collapse of Drexel Burnham Lambert in 1990. In contrast, the Fed and the U.S. Treasury moved quickly in mid-March (2008) to save a similar global investment bank in distress (but half the size of Lehman), **Bear Stearns**, by quickly lending and guaranteeing $29 billion to the large universal J. P. Morgan Chase bank in order to absorb it. —(N.B.: Let us keep in mind that it was the collapse in June 2007 of two internal Bear Stearns hedge funds that had been heavily invested in mortgage securities that kicked off the full-fledged market panic that unfolded in August 2007, and which today has turned into a full-fledged international financial crisis).

Why was the same treatment not offered to Lehman? Possibly because of a personal lack of empathy between Treasury Secretary **Henry M. Paulson Jr.** (a former chief executive of rival investment bank Goldman Sacks) and Lehman's CEO Mr. **Richard S. Fuld Jr.,** or possibly because the Bush administration wanted to make an example that all investment banks, no matter how large, could not count on being rescued by the government. The Bush administration did not even bother to appoint a trustee to supervise Lehman's liquidation in order to make it orderly.

Such a liquidation of a large international bank, known for its worldwide interconnections and unsound banking practices, was nearly a repeat of the mistake made in letting the large Vienna-based **Creditanstalt bank** fail, on May 13, 1931. This was a bank that had borrowed large amount of money in London and in New York to finance its activities. Its failure created a domino effect among other international banks that had lent to each other in the international credit chain. So much so that the failure of the Creditanstalt forced them to severely tighten their lending to absorb their sudden losses.

Seventy-seven years later, in 2008, the Bush administration's decision to let the Lehman Brothers bank fail has produced a similar ripple effect throughout the international financial system. And, perhaps more important politically, it signaled to the markets that the Bush administration was willing to let a dangerous **debt deflation** and an ominous credit crunch proceed. This may turn out to have been a most tragic mistake.

Indeed, Lehman's bankruptcy forced the global investment bank to quickly write down its huge portfolio of debt, a fair amount of it in **derivative products**. But since banks are creditors of each other, especially Lehman which dealt with large institutions, this had the consequence of spreading the American financial disease all over the world, and especially in Europe. Why? Because Lehman's London office was a huge center of sale and distribution for its more or less toxic derivative products all over Europe. Indeed, many European banks had invested in Lehman's securitized paper, and when it failed, they were left with large losses. As a consequence, they had to curtail their domestic lending and that's the reason the credit crunch is now moving to **Europe**.

The second mistake was to address the "liquidity problem" of American investment and mortgage banks without tackling at the same time their underlying **"solvency problem".**

As we wrote right at the very beginning, on **August 24, 2007**, the financial crisis in the U.S. is not only a classic "liquidity problem", when banks find themselves short of cash to pay immediate redemptions and withdrawals while their longer term loans are secure, but also and above all a "solvency problem", because the huge losses that banks had to absorb when they wrote down the value of their toxic assets-backed securitized paper, eroded their capital base to an extent that they became *de facto* insolvent. Market operators saw that and they sold the banks' shares short and the price of these shares plummeted.

With many banks' solvency now in doubt, inter-bank lending has nearly stopped, and because of a 'flight to safety', the **Ted spread** [the difference between three-month U.S. Treasury bills yields and yields on three month eurodollar contracts, as represented by the London Inter Bank Offered Rate, called Libor] exploded, and banks cut down their lending. Credit became tight and scarce. Because banks as a whole ordinarily lend between 10 and 12 times their capital base, the most liquid **money supply (M1)** began to contract in real terms. Even **money market funds** suffered heavy losses, and a run on them was in full swing when the Treasury stepped in a month ago to offer an emergency $50 billion guarantee.

The U.S. economy may be approaching what can be called a classic **"liquidity trap"** situation, wherein the Fed is lowering interest rates while lending through its discount window and printing money on a high scale, however the liquid money supply figures, in real terms, are not increasing, but are rather **falling**. Thus, there is no immediate inflation, but the money supply is contracting as banks reduce their lending and make a rush to T-bills (their yields nearly fell to zero). The short-term result is a net deflationary effect for the overall economy and on the stock market (although the long term bond market sees inflation ahead, and long term rates are rising). —The result is stock market crashes in repetition.

In fact, this is precisely what has happened over the last few weeks, not only in the United States, but also in the U.K and in other European countries. This is a very dangerous development for the real economy, because money data in real terms are a leading indicator of the future course of the economy. Six or nine months down the road, the consequences of the credit crunch will appear in production and employment declines, because the credit crunch has the effect of placing a serious squeeze on most companies. Since the credit contraction really began in June (2008), the early part of 2009 is bound to show severe economic weakness.

On Friday, September 19 (2008), the Bush administration announced its solution to the growing banking crisis. It made public the **$700 billion Paulson plan** (US Emergency Economic Stabilisation Act, EESA) that primarily focused on creating a government market for some of the bad mortgage-backed securities on the banks' books. —But this was only half of the problem. The other half of the problem was the need to stop the money supply from declining, by restoring bank credit lending and allowing companies to have access to working capital financing. The goal here is to prevent banking problems from morphing into a general contraction of consumption and capital investment plans, thus slowing down production and raising unemployement in the coming months.

For this to happen, however, banks must be allowed to find badly needed new capital. But in a time of crisis, with stock markets declining, it is doubtful that much private capital can be found. The recent **association of Warren Buffett** with Goldman Sachs may be more of an exception than a rule.

When private capital is not available, the government has no other choice but to inject equity (by buying the banks' preferred shares) into the national banking system, while taking steps to safeguard the public interest by obtaining common share warrants that can be resold profitably later, when the situation stabilizes.

In conclusion, we may ask if it is possible to avoid a repetition of the U.S. Great Depression of the 1930s or the more recent Japan's protracted recession of the 1990s, both the result of a similar severe banking crisis? The answer is yes, if the vicious cycle of asset price decline, banking credit crunch and money supply contraction can be avoided, or, at the very least, stopped and reversed. —In economics, as in medicine, it is never too late to do the right thing.

Rodrigue Tremblay *is professor emeritus of economics at the University of Montreal and can be reached at:*
rodrigue.tremblay@ yahoo.com.

*He is the author of the book **'The New American Empire'**.*

Visit his blog site at ***www.thenewamericanempire.com/blog.***

Author's Website: ***www.thenewamericanempire.com/***

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