Bankrupt US Financial System: The Bubble Bursts and the Economy goes into a Tailspin.

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The World needs a breather from the US. And they'll get it sooner than many think

We're making this way too complicated. It's simple really.

The Fed has only one tool at its disposal; to create more money. Typically, the way the Fed adds to the money supply is by lowering interest rates. When the Fed lowers rates below the rate of inflation; they're basically selling dollars for under a buck. That's a good deal, so, naturally, speculators jump on it and trigger a credit expansion. What follows is a frenzy of market activity that ends in a housing, credit, tech or equity bubble. Eventually, the bubble bursts and the economy goes into a tailspin. Then, after a period of digging-out, the process resumes again. Wash, rinse, repeat. It's always the same. The moral is: Cheap money creates bubbles; and bubbles move wealth from workers to rich motherporkers. It's as simple as that. That's why the wealth gap is wider now than anytime since the Gilded Age. The rich own everything.

The Federal Reserve is the policy arm of the big banks and brokerage houses. Period. Ostensibly, its mandate is to maintain "price stability and full employment". Right. Anyone notice how many jobs the Fed has created lately? How about the dollar? Is it really supposed to zig-zag like it has been for the last decade? The central task of the Fed is to shift wealth from one class to another. And it succeeds at that task admirably. The Fed's "mandate" is public relations claptrap. Bernanke hasn't lifted a finger for homeowners, consumers or ordinary working stiffs. "Yer on yer own. Just don't expect a handout. That's socialism!" All the doe is flowing upwards…according to plan. The Fed is a social engineering agency designed to serve as the de facto government behind the smokescreen of democratic institutions. Did you really think a black, two year senator with no background in foreign policy or economics was calling the shots?

Puh-leeese! Obama is a public relations invention who's used to cut ribbons, console the unemployed, and convince Americans they live in a "post racial" society. Right. (Just take a look at the footage from Katrina again) The Fed has complete control over monetary policy and, thus, the country's economic future. Bernanke doesn't even pretend to defer to Congress anymore. Why bother? After Lehman caved in, Bernanke invoked the "unusual and exigent" clause in the Fed's charter and declared himself czar. Now he has absolute power over the nation's purse-strings.

The $13 trillion the Fed has committed to the financial system since the beginning of the crisis –via loans and outright purchases of mortgage-backed garbage and US sovereign debt–was never authorized by Congress. In fact, the Fed stubbornly refuses to even identify which institutions got the "loans", how much the loans were worth, what kind of collateral was accepted for the loans, or when the loans have to be repaid.

In truth, the loans are not loans at all, but gifts to the industry to keep asset prices artificially high so that the entire financial system does not come crashing down. Check this out:

"In an analysis written by economist Gary Gorton for the Federal Reserve Bank of Atlanta's 2009 Financial Markets Conference titled, "Slapped in the Face by the Invisible Hand; Banking and the Panic of 2007″, the author shows that mortgage-related securities ballooned from $492.6 billion in 1996 to $3,071.1 in 2003, while asset backed securities (ABS) jumped from $168.4 billion in 1996 to $1,253.1 in 2006. All told, more than $20 trillion in securitized debt was sold between 1997 to 2007. "

$20 trillion! How much of that feces paper–which is worth just pennies on the dollar– is sitting on the balance sheets of banks and other financial institutions just waiting to blow up as soon as the Fed asks for its money back? And the Fed will never get its money back because the prices of complex securities and derivatives will never regain their pre-crisis values. Why? Because these derivatives are linked to underlying collateral (mortgages) which have already declined 33% from their peak and are headed lower still. Also, these toxic assets were sold as risk-free (many of them were rated triple A) and have now been exposed as extremely risky or fraudulent. Because these assets were heaped together in bundles to strip out their interest rates, they cannot be easily separated which means that they are worth considerably less than the 33% that has been lost on the underlying collateral (mortgages) The securitization markets are not expected to rebound for a decade or more, which means that the Fed will have to find other more-creative way to goose the credit system to avoid a downward spiral.

But how?

Zero percent interest rates haven't worked because qualified borrowers are cutting spending and saving their disposable income, while people who need to borrow, no longer meet the banks' tougher lending standards. Bank credit is shrinking even though excess bank reserves are nearly $900 billion. When banks stop lending, the economy contracts, business activity slows, unemployment soars and growth sputters. Presently, the economy is still contracting, but at a slower pace than before. "Less bad" is the new "good". All the recession indicators are still blinking red–income, employment, sales, and production–all down big! But it doesn't matter because it's a "Green Shoots" rally; plenty of cheap liquidity for the markets and a freeway off-ramp (for sleeping) for the unemployed.

The Fed's lending facilities are designed to pump liquidity into the system and inflate another bubble by generating more debt. Unfortunately, most people accept Bernanke's feeble defense of these corporate-welfare programs and fail to see their real purpose. An example may help to explain how they really work:

Say you bought a house at the peak of the bubble in 2005 and paid $500,000. Then prices dropped 40% (as they have in Calif) and your house is now worth $300,000. If you only put 5% down, ($25,000) then you are underwater by $175,000. Which means that you own more on the mortgage than your house is currently worth. (This is essentially what has happened to the entire financial system. The equity has vaporized, so institutions are using dodgy accounting tricks instead of reporting their real losses.) So Bernanke comes along and gives you $175,000 no interest, rotating loan to you so that no one knows that you are really busted and you can continue spending just as you had before. Not bad, eh? This is what the lending facilities are all about. It is a charade to conceal the fact that a large portion of the nation's financial institutions are insolvent and propped up by state largess.

But there's more, too.

Now that Bernanke has given you $175,000 no interest, rotating loan; you expect that eventually he will ask for his money back. Right? So your only hope of saving your home, in the long run, is to engage in risky behavior, like dabbling the stock market. It's like playing roulette, except you have nothing to lose since you are underwater anyway.

This is exactly what the financial institutions are doing with the Fed's loans. They're betting on equities and hoping they can avoid the Grim Reaper.

Here's how former hedge fund manager Andy Kessler summed it up last week in the Wall Street Journal: "By buying U.S. Treasuries and mortgages to increase the monetary base by $1 trillion, Fed Chairman Ben Bernanke didn't put money directly into the stock market but he didn't have to. With nowhere else to go, except maybe commodities, inflows into the stock market have been on a tear. Stock and bond funds saw net inflows of close to $150 billion since January. The dollars he cranked out didn't go into the hard economy, but instead into tradable assets. In other words, Ben Bernanke has been the market." (Andy Kessler, "The Bernanke Market" Wall Street Journal)

Only a small portion of the money that has gone into the stock market in the last 6 months (since the March lows) has come from money markets. The fed's loans are being laundered into stocks via financial institutions that are rolling the dice for their own survival. The uptick in the markets has helped insolvent banks raise equity in the capital markets so they don't have to grovel to Congress for another TARP bailout. Everybody's elated with Bernanke's latest bubble except working people who have seen their wages slashed by 4.5%, their credit lines cut, the home values plunge, and their living standards sink to third world levels. And the Fed's spending-spree is not over yet; not by a long shot. The next wave of home foreclosures (already 1.9 million in the first half of 2009) is just around the corner–the Alt-As, option arms, prime loans. The $3.5 trillion commercial real estate market is capsizing. The under-capitalized banking system will need assistance. And there will have to be another round of fiscal stimulus for ailing consumers. Otherwise, foreign holders of US Treasurys will see that the US can no longer provide 25% of global demand and head for the exits.

Bernanke's back is against the wall. The only thing he can do is print more money, shove it though the back door of the stock exchange and keep his fingers crossed. The rest is up to CNBC and the small army of media cheerleaders.

There is some truth to the theory that Bernanke saved the financial system from a Chernobyl-type meltdown. But that doesn't change the facts. Accounts must be balanced; debts must be paid. The Fed chief has committed $13 trillion to maintain the appearance of solvency. But the system is bankrupt. The commercial paper market, money markets, trillions of dollars of toxic debt instruments, and myriad shyster investment banks and insurance companies are now backed by the "full faith and credit" of the US Treasury. The financial system is now a ward of the state. The "free market" has deteriorated into state capitalism; a centralized system where all the levers of power are controlled by the Central Bank. If Bernanke's Politburo withdraws its loans–or even if he raises interest rates too soon–the whole system will collapse.

The economy is now balanced on the rickety scaffolding of the dollar. As the Obama stimulus wears off, the rot in the economy will become more apparent. Household red ink is at record highs, so personal consumption will not rebound. That means US assets and US sovereign debt will become less attractive. Foreign capital will flee. The dollar will fall.

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