Financial Meltdown: We're on "the Edge of the Abyss"

By Mike Whitney
Global Research, October 06, 2008
6 October 2008

Region: USA
Theme: Global Economy

Years from today, when the current financial crisis is over, historians are likely to agree that it would have been far better if the Bush administration had declared a state of emergency earlier in the process so that the necessary steps could have taken to avoid a complete financial meltdown. The media could have been used to bring the American people up to date on market-related developments and educated in the bizarre language of structured finance. Knowledge is power; and power can prevent panic.

Now we're in a terrible fix. People are scared and removing their money from the banks and money markets which is intensifying the freeze in the credit markets and driving stocks into the ground like a tent stake. Meanwhile, our leaders are "caught in the headlights", still believing they can "finesse" their way through the biggest economic cataclysm since the Great Depression. It's madness.

If something is not done to increase the flow of credit immediately, the stock market will tumble, unemployment will spike, and many businesses will grind to a standstill. We could be just days away from a severe shock to the system. Secretary of the Treasury Henry Paulson's $700 billion bailout does not focus on the fundamental problems and is likely to fail. At best, it puts off the day of reckoning for a few weeks or months. Contingency plans should be put in place so the country does not have to undergo post-Katrina bedlam.

Does Congress have any idea of the mess they've made by passing the Bailout bill? Do they even read the papers or are they so isolated in their Capital Hill bubble-world that they're entirely clueless? Did any Senator or congressman even notice, that while they were busy mortgaging off America's future, the stock market was plummeting to new lows? Between the time the ballots were cast on Paulson's bailout, and the announcement of the final tally (which was approved by a generous margin) the market went from a 310 point gain to a 157 point loss; a whopping 467 plunge in less than two hours.

Thus spake the Market: "Paulson's bill is a fraud!"

Listen up, Congress: This massive trillion dollar deleveraging process cannot be stopped. The system is purging credit excesses which are unsustainable. The levies you're building with this $700 billion bill may plug a few holes, but it won't stop the flood. Economist Ludwig von Mises put it like this:

> "There is no means of avoiding the final collapse of a boom brought on by credit expansion. The question is only whether the crisis should come sooner as a result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved."

The best course of action is to soften the blow as much as possible for underwater homeowners and let the market correct as it should. Otherwise the dollar will be torn to shreds.

Look around; the six year Bush economic boom is vanishing before our eyes. Manufacturing is contracting, wages are stagnant, good paying jobs are headed overseas, unemployment is rising, and the middle class has shrunk every year since Bush took office. Is this the miracle of the "Washington consensus" and neoliberalism? The prosperity of the Bush era is as fake as the weapons of mass destruction; it's all smoke and mirrors. The Federal Reserve created the massive equity bubble in housing and finance through its low interest monetary policies. Cheap money is the rich man's method of social engineering; swift and lethal. The public be-damned. Now that the bubble is bursting, Congress needs to decide what it can do to soften the hard landing. Paulson's bill does not do that. In fact, even Paulson's supporters admit it's a flop. Here's what Martin Feldstein had to say in a Wall Street Journal editorial:

> "The recent financial recovery plan that Congress enacted will not rebuild lending and credit flows. That requires a program to stop a downward overshooting of house prices and the resulting mortgage defaults….The prospect of a downward spiral of house prices depresses the value of mortgage-backed securities and therefore the capital and liquidity of financial institutions. Experts say that an additional 10% to 15% decline in house prices is needed to get back to the prebubble level. That decline would double the number of homes with negative equity, raising the total to 40% of all homes with mortgages. The mortgages of five million homeowners would then exceed the value of their homes by 30% or more, which could prompt millions of defaults." (Martin Feldstein, "The Problem is still Falling house Prices", WS Journal)

Feldstein doesn't give a hoot about the struggling homeowner who is worried-sick about losing his home in foreclosure. He just wants to make sure that the banks get their money back, and the only way they can do that is by putting a floor under housing prices so mortgage-backed securities (MBS) and all the other derivatives that are gunking-up the financial system begin to stabilize. Even though the article is little more than a paean to human greed; it does admit that Paulson's bailout falls short of its objectives. It won't work.

Not only that, but it elevates G-Sax ex-chairman to Finance Czar, with almost unlimited powers to buy whatever toxic "structured" garbage he wants without any real oversight. Who will stop the Treasury Secretary if he decides to waste the taxpayers money on the full range of impaired assets including complex derivatives, collateralized debt obligations (CDOs), low-rated MBS, or even credit default swaps (CDS), which were sold in unregulated trading and which are oftentimes nothing more than side-bets made by speculators with no direct connection to the housing market?

Is that what Congress approved? What if he decides to spend the whole $700 billion buying back mortgage-backed bonds from China and Europe, leaving US banks still underwater? (except for Goldman, of course) It's possible; especially if he thinks China will stop purchasing our debt if we don't back up our worthless bonds with cold hard cash.

This bailout has DISASTER written all over it.

Consider this from a September 29 report in the Washington Post:

> “Twenty of the nation’s largest financial institutions owned a combined total of $2.3 trillion in mortgages as of June 30. They owned another $1.2 trillion of mortgage-backed securities. And they reported selling another $1.2 trillion in mortgage-related investments on which they retained hundreds of billions of dollars in potential liability, according to filings the firms made with regulatory agencies. The numbers do not include investments derived from mortgages in more complicated ways, such as collateralized debt obligations.” (from Paul Craig Roberts, “Can a Bailout Succeed”, counterpunch.org)

So, how does Paulson expect to recapitalize the banks–which are loaded up with $2.4 trillion in mortgage-related investments–when congress’s bill allocates a paltry $700 billion for the rescue plan? It’s impossible. Just as it is impossible to keep prices artificially high with this kind of government buy-back program. These structured investments were vastly overpriced to begin with due to the fact that the market was hyperinflated with the Fed’s low interest credit. As Doug Noland said, “This Credit onslaught fostered huge distortions to the level and pattern of spending throughout the entire economy. It is today impossible both to generate sufficient Credit and to main previous patterns of spending. Economic upheaval and adjustment are today unavoidable.” (Doug Noland’s Credit Bubble Bulletin)

Yes, and “economic upheaval” leads to political upheaval and blood in the streets. Is that what Bush wants; a chance to deploy his North Com. troops within the United states to put down demonstrations of middle class people fighting for bread crumbs?

In less than 8 years, the Financial Sector Debt tripled, mortgage debt doubled, and financial borrowing rose 75 percent. Why? Was it because the US was producing more goods that the world wanted? Was it because production rose sharply or demand doubled?

No, it was because of asset-inflation; a chimera created by the illusionists at the Federal Reserve and the investment banks. That’s the source of the massive credit expansion which is presently collapsing and pushing the world towards another Great Depression. As Henry Liu said in his article “Liquidity Boom and Looming Crisis” in the Asia Times:

> “Unlike real physical assets, virtual financial mirages that arise out of thin air can evaporate again into thin air without warning. As inflation picks up, the liquidity boom and asset inflation will draw to a close, leaving a hollowed economy devoid of substance. …A global financial crisis is inevitable”

The man who is most responsible for the current meltdown, Alan Greenspan, even admitted that he spotted the humongous equity bubble early on but refused to do anything about it. Here’s a clip from an article by Maestro in the Wall Street Journal:

> “The value of equities traded on the world’s major stock exchanges has risen to more than $50 trillion, double what it was in 2002. Sharply rising home prices erupted into major housing bubbles world-wide, Japan and Germany (for differing reasons) being the only principal exceptions.” (“The Roots of the Mortgage Crisis”, Alan Greenspan, Wall Street Journal)

This admission proves Greenspan’s culpability. If he knew that stock prices had doubled their value in just 3 years, then he also knew that equities had not risen due to increases in productivity or demand.(market forces) The only reasonable explanation for the asset inflation is the deeply-flawed monetary policies of the Fed. As his own mentor, Milton

Friedman famously stated, “Inflation is always and everywhere a monetary phenomenon”. Any capable economist would have known that the explosion in housing and equities prices was a sign of uneven inflation. Now the bubble has popped and the tremors are likely to be felt through the global economy.

No one in Congress has the foggiest idea of what is going on in the economy. They’re all in La-la Land. The credit markets are paralyzed. The capital-starved banks are dramatically cutting back on lending and making it nearly impossible for consumers to borrow or businesses to even carry out daily operations like payroll. The commercial paper market has slowed to a crawl, forcing cash strapped companies to try and access existing credit lines or sell corporate bonds. Money market rates are soaring but wary depositors keep withdrawing their money putting more pressure on financial institutions. The whole system is wading through quicksand. The banking system is breaking apart before our eyes. The $700 billion “rescue package” will not relieved the situation at all. In fact, the various rates (like Libor, Libor-OIS spread, or the TED spread) which indicate the amount of stress in interbank lending have stayed at record highs signaling huge dislocations in the near future. Are we headed for an October stock market crash?

This is from the Times Online:

> “US banks borrowed a record $367.8 billion (£208 billion) a day from the Federal Reserve in the week ended October 1. Data from the US central bank shows how much financial institutions are relying on the Fed in its role as lender of last resort as short-term funding becomes almost impossible to find elsewhere. Banks’ discount window borrowings averaged $367.80 billion per day in the week ended October 1, nearly double the previous record daily average of $187.75 billion last week.”

$368 billion a day, just to keep the banking system from collapsing. Did they forget to mention that on FOX News?

And, yes; the Fed has started up the printing presses as everyone feared from the beginning. This tidbit appeared on the op-ed page of Saturday’s Wall Street Journal:

> “Thursday, the Federal Reserve released the latest data on its balance sheet, which has ballooned by some $500 billion to $1.5 trillion in the past month. That may sound alarming, but it beats cutting interest rates across the board to prop up the banks. Those extra Fed assets and liabilities can be worked off as the crisis passes without the long-term inflationary impact of pushing interest rates still further into negative territory. By lending freely in a bank run until they stop running, the Fed can make banks pay for their desire for safety while contributing to financial stability.” (Wall Street Journal)

“$1.5 trillion”? But the Fed’s balance sheet is only $900 billion. Where is the extra money coming from? Gutenberg, no doubt.

Rep. Peter DeFazio made an impassioned plea on the floor of the House in a failed effort to stop Paulson’s bailout. It’s a good summary of the bill’s shortcomings as well as an indictment of its author:

Rep. Peter DeFazio:

> “This $700 billion bill is not aimed at the real economy in America. Not one penny of it will go to Main Street. It is aimed solely at the froth on Wall Street, the speculators on Wall Street, the non productive people on Wall Street the certifiably smart , masters of the universe, like Secretary of the Treasury Henry Paulson who created these weapons of financial destruction and now, lit the fuse by claiming there would be worldwide economic collapse if we didn’t pass this bill to bail out Wall Street….I believe there are simpler answers. I just came from a meeting with William Isaacs who was head of the FDIC, they deal with banks. Mr. Paulson was a speculator on Wall Street; he deals with speculation. He doesn’t understand regulative banking. (What is happening is) there is a tremendous amount of pressure being applied by some very powerful creditors such as the People’s Republic of China who own a lot of this junk ($450 billion) and they want their money back or they’re threatening us. That is not a good reason for going ahead with this faulty proposal. It does not deal with the underlying problems in housing.
>
> If we don’t deal with the foreclosures and the deteriorating values, then, when the values drop another 5 or 10 percent, we’re going to find there’s another trillion dollars in junk securities out there and we will have already maxed out our credit and more people will have already lost their jobs. People are not spending because they are afraid they will lose their jobs. Their wages haven’t increased. They are worried about the real economy, not the Wall Street economy. This bill will not solve the underlying problems.
>
> There is a cheaper, low cost alternative. The FDIC should declare an emergency. That would give them the power to assess the same guarantee to all bank depositors. (According to Isaacs) That would immediately free up all interbank lending. It would immediately bring a flood of foreign deposits into the US because we would be a safe haven for depositors. But Isaacs is a regulator; a regulator with experience who piloted this country out of the savings and loans crisis and saved us a bunch of money. He’s not a big-time Wall Street speculator who came down here and got appointed by George Bush with three-quarters of a billion dollars in his pocket from money he had made creating these financial weapons of mass destruction. So, we are listening to the wrong guy here…Don’t be stampeded!” (Watch the whole 5 minute video http://www.infowars.com/?p=5056)

DeFazio is exactly right, especially about Paulson. As the New York Times article on Friday, “Agency’s ’04 Rule Let Banks Pile Up New Debt, and Risk”, points out, Paulson, as chairman of Goldman Sachs, was one of the leaders of the five investment banks, who duped the SEC into loosening the rules on capital requirements which created the problems we are now facing.

According to the Times:

> (The Big 5 investment banks) “wanted an exemption for their brokerage units from an old regulation that limited the amount of debt they could take on. The exemption would unshackle billions of dollars held in reserve as a cushion against losses on their investments. Those funds could then flow up to the parent company, enabling it to invest in the fast-growing but opaque world of mortgage-backed securities; credit derivatives, a form of insurance for bond holders; and other exotic instruments.”

This is the crux of the matter. Paulson polluted the system by bending the rules for the prudent leveraging of assets so he and his dodgy friends could maximize their profits. It’s all about the bottom line. Paulson walked away with hundreds of millions of dollars in a scam that has now put the nation's economic future at risk.

Last year the five Wall Street behemoths had "combined assets of more than $4 trillion". Now, everyone can see that it was all froth created through extreme leveraging that was intentionally ignored by S.E.C. boss Chris Cox. Now the banks are getting clobbered by short-sellers that are going from one financial institution to the next making them prove that they are sufficiently capitalized. They know its all a smokescreen, so they are saying, "Show me the money". One by one, the investment banks have fallen by the wayside. If the SEC was really operating in the public's interest, they'd being thumbing through G-Sax and Morgan Stanley's balance sheets right now making them prove that they're solvent. Instead, Cox has declared a moratorium on short selling while the investment banks have positioned themselves to get multi-million dollar taxpayer treats for their crappy assets. Where's the justice?

As for Paulson's "No Banker Left Behind" boondoggle; it is not an effective way to recapitalize the banks and it doesn't fix the systemic problems in the credit markets. All it does is put the US at greater risk of losing its Triple A rating. If that happens it will be impossible to attract foreign capital which would be the equivalent of detonating a nuclear bomb in every city in the country. This is not the time to be putting more chips on the table like a riverboat gambler. It's time to show judgment and restraint, otherwise this whole thing will blow up. Emergency measures should be thoroughly examined so that liquidity is provided for the credit markets as fast as possible. The markets are already in meltdown-mode.

"Real" economists–not the ideological hacks and loose cannons in the Bush administration–understand the fundamental problems and have generally agreed on a solution. It is a difficult issue, but one that anyone can grasp if they make the effort. Watch this 8 minute video with Nobel Prize winning economist, Joseph Stiglitz, http://www.cnbc.com/id/15840232?video=874100965&play=1

Stiglitz says: "There is a growing consensus among economists that any bail-out based on Paulson's plan won't work." If so, the huge increase in the national debt and the realization that even $700bn is not enough to rescue the US economy will erode confidence further and aggravate its weakness.

Stiglitz's point is proven by the fact that the Dow Jones cratered after reports circulated that the House had passed the bailout. Paulson's fiasco has not calmed the markets at all; in fact, investors have begun to race for the exits. Confidence is draining from the system faster than the deposits in the dwindling money market accounts.

Stiglitz adds:

> "This is not a good bill…It is based on "trickle down" economics which says that is you throw enough money at Wall Street and than some of it will go into ways that help the economy, but it is not really doing what needs to be done to recapitalize the banking system, stem the hemorrhaging of foreclosures, and deal with the growing unemployment….. We have seen these problems with banks before we know how to repair them. (Stiglitz worked with the World Bank during many similar crises) So why didn't they use these "tried and proven" methods? They (Paulson) decided that rather than a capital injection; they would try the almost impossible task of buying up all these bad assets, millions of mortgages and complex products, and hope that this will somehow

> solve the problem. It doesn't fix the big hole in the banks balance sheets, unless they vastly overpay for these products (Mortgage-backed securities)"

This isn't rocket science. Many of the economists who disapproved of the bill have been through this drill before and they know what to do. The way to proceed is to have the US Treasury buy preferred shares in the banks that are not already technically insolvent. (The insolvent banks will have to be unwound by the FDIC) This will give the banks the capital they need to continue operations while protecting the taxpayer who gets an equity share with "upside potential" when the bank starts making profits again.

This is how one goes about recapitalizing the banking system IF that is the real intention. Paulson's phony-baloney operation suggests he has something else up his sleeve; some ulterior motive like rewarding his friends on Wall Street with boatloads of taxpayer money or buying-back the toxic mortgages from foreign investors so they don't stop buying US debt. Here's how Bloomberg's Jonathan Weil sums it up:

> "If the government wants to save dying banks before they take others down with them, it should choose the clean and direct path: Inject capital into them. Take ownership stakes in return. And, where that's not feasible, seize them and sell their assets in an orderly way, just as the Resolution Trust Corp. did after the 1980s savings-and-loan crisis.
>
> Infusing capital directly, though, was too simple for Paulson. It lacked subterfuge. He decided the way to save the financial system from the evils of structured finance was through more structured finance. Instead of asking Congress to let Treasury recapitalize needy banks, he proposed buying some of their troubled assets at above-market prices. This would have let other banks create phony capital by writing up the values of similar assets on their own balance sheets, using Treasury's prices as their guide. Small Wonder.
>
> In short, Paulson's plan was one part robbery (with the banks doing the robbing) and one part accounting sleight of hand. No wonder House members rejected it.(at first) If Paulson or congressional leaders devise a Plan B, they should look to the example of Fortis, Belgium's biggest financial-services company. This week, the governments of Belgium, the Netherlands and Luxembourg invested 11.2 billion euros ($16.3 billion) in Fortis. In exchange, they got ownership of almost half its banking business.
>
> That's how a government intervention is supposed to work. The company gets fresh capital, which has the added benefit of not being fake. The buyers get equity. Legacy shareholders get slammed with dilution. And if the company recovers, the government can sell shares to the public later, maybe even at a profit." (Jonathan Weil, Bloomberg News)

Direct capital injections is the best way to recapitalize the banks and save the taxpayer money. Paulson's plan is just more flim-flam intended to reflate the value of sketchy assets. So far, investors and taxpayers are equally skeptical about the bill's prospects. Interbank lending remains clogged and the VIX, the "fear gauge", is still rising to record levels. Paulson hasn't fooled anyone.

This bill does nothing to reduce foreclosures, reassure the markets, decrease unemployment, unfreeze the bond market, increase consumer spending, or put a floor under the stumbling dollar. All it does is hand out a few ripe plums to Paulson's buddies on Wall Street while (temporarily) soothing the frayed nerves of China's Finance Minister. That doesn't mean that China will be increasing its stash of US Treasuries or other US financial assets anytime soon. As the saying goes: "Fool me once, shame on you. Fool me twice, …"

Worst of all, Paulson's bailout bill wastes precious resources on a plan that is considerably wide of the mark. These problems have to be dealt with quickly to avert a larger catastrophe. Here's how Nouriel Roubini sees it:

> "It is now clear that the US financial system – and now even the system of financing of the corporate sector – is now in cardiac arrest and at a risk of a systemic financial meltdown. I don't use these words lightly…The Commercial paper market is shut down…Corporations have no access to long or short term credit markets. Brokers are increasingly not dealing with each other. The interbank market is seizing up…This cannot continue for more than a few days. It is the economic equivalent to cardiac arrest." (Nouriel Roubini's Global EconoMonitor)

The levies have already broken, and the water is flooding into the city. The Federal Reserve will be forced to act. Expect an emergency rate cut of 50 basis points or more in the next 10 days coordinated with cuts in the other G-7 countries. Also, expect another bailout by the time Obama or McCain take office. As the French premier, Francois Fillon, warned on Saturday the world is "on the edge of the abyss".