

# Financial Meltdown: You Ain't Seen Nothing Yet

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*"The problems we face today cannot be solved by the minds that created them"* Albert Einstein

Obama hasn't even been sworn in yet, and already the Wall Street cheerleaders are celebrating his first great triumph. According the pundits, the stock market staged a surprise 494 point rally on Friday because—get this—it was announced that Timothy Geithner would be appointed Obama's Treasury Secretary.

Timothy who?

What nonsense. The sudden turn-around in stocks had a lot more to do with short-covering than anything else, but don't let that get in the way of a good story. Even so, the last minute surge on the NYSE couldn't stop another week-long bloodbath that ended with the Dow and S&P 500 tumbling another 5 percent. That's not to say that Geithner is not bright and talented guy. He is; and so is his White House counterpart, Lawrence Summers.

But the media hype is way overdone. Geithner doesn't drive the markets and he isn't "change you can believe in". In fact, he's a protege of Henry Kissinger, a member of the Council on Foreign Relations, and has the same political pedigree as his predecessor, Henry Paulson. They're both part of the ruling fraternity and their views of the world are nearly identical.

There's no doubt that Geithner will be more competent and effective than Paulson but, then again, who wouldn't be? Paulson may be the biggest flop at Treasury since Andrew Mellon steered the country onto the reef during the Great Depression.

The recent flap over the Troubled Assets Relief Program (TARP) just proves the point. After convincing Congress to pass a \$700 billion bailout plan—by invoking the specter of economic Armageddon and martial law—the former G-Sax chairman proceeded to set up a program for buying back mortgage-backed securities (MBS) and other junk paper from his banking buddies. Paulson argued that removing the crappy loans would help the banks get back on their feet and start lending again. Of course, no one could really figure out how the process was going to be executed, but maybe that's just nit-picking. Fortunately, Paulson never got a chance carry out his plan. He was torpedoed by the stock market which plunged seven days in a row losing nearly 20 percent of its value until Paulson threw in the towel and did what 200 economists had suggested from the very beginning—buy preferred shares in the banks so they could rev-up their credit engines again.

Will Geithner be that stubborn? Not likely. And Paulson is a hard-nosed class warrior,

too. Notice how every dime of the bailout has gone to banksters while all the efforts to provide relief to autoworkers, consumers or struggling homeowners have been blocked. Anyone who isn't in the upper 1 percent income bracket can forget about getting a helping hand.

Paulson shoveled \$25 billion to Citigroup without even sending in the regulators to see if they were solvent or not. How smart was that? Citi's stock has dropped 93% from its all-time high in May 2007 and ended Friday at a measly \$3.77 per share. Its market cap. has gone from \$280 billion to a skinny \$20 billion in less than a year. Without a lifeline from the government, they won't make it through December; the short-sellers will carve them up like a smoked ham. Will Paulson come to Citi's rescue with more public cash? Absolutely. So why won't he support a similar bailout for the Big Three auto-makers who employ nearly a million people?

There was a clue in Sunday's paper as to why Paulson is stiffing the car companies. According to UPI :

"GMAC Financial Services said Thursday it had applied to the U.S. Federal Reserve for bank holding company status, a step toward securing federal aid. The auto and home financing company said it had also submitted an application to the U.S. Treasury to participate in the Capital Purchase Program set up in the \$700 billion financial firm bailout program known as the Emergency Economic Stabilization Act.

"As a bank holding company, GMAC would obtain increased flexibility and stability," the company said in a statement." (UPI)

So why would GMAC want to become a bank holding company if General Motors is headed for the chopping block? Could it be that the government is working out a secret deal with management to put the company through Chapter 11 (reorganization) just so it can crush the union and eliminate their pension and health care benefits in one fell swoop?

You bet. Car workers will be reduced to slave wages just like they are in sunny Alabama where sharecropping has moved indoors. And--no surprise--the Democrats are right on board with this labor-busting charade. The auto industry isn't going to be shut down. That's just more fear-mongering like the blather about martial law and WMD. Detroit is going to be transformed into a workers gulag; Siberia on Lake Michigan, which is why Paulson is withholding the \$25 billion. It's plain old class warfare.

Paulson has tried to spread the myth that his bailout eased the credit crunch, but it's not true. The stress in the credit markets was caused by very precise factors (Libor, the TED Spread, OIS-Libor) which were intentionally allowed to rise to perilous levels so Paulson could coerce Congress into giving him his bailout loot. It wasn't until Congress caved in that the FED addressed those market indicators by (setting up a new facility and) providing an explicit government guarantee on commercial paper and money markets. That's what made Libor go down, not Paulson's misguided TARP program which did absolutely nothing.

So, Yes, the banks do need to be recapitalized. But, No, TARP did not address the specific conditions in the credit markets which were causing the problems. And, Yes, Congress is too blind to see that they were duped by a top-hat Wall Street land-shark who pulled the wool over their eyes and made off with \$350 billion.

Geithner will never engage in the same cynical antics as Paulson. It was Paulson who set up the Super SIV (Structured Investment Vehicle) after 2 Bear Stearns hedge funds blew up so he could help Citigroup and other financial institutions pawn-off their off-balance sheets garbage to investors by placing the US treasury's seal of approval on the rotten paper; another shameless rip-off shrink-wrapped in the Stars and Stripes.

Paulson's "Hope Now" (1-888-995-HOPE) was another scam that was supposed to help banks and homeowners work out the details for a rate freeze on mortgage resets. Paulson assured the public that 500,000 homeowners would take advantage of the program which would dramatically reduce rate of foreclosures. As it stands, Hope Now hotline has provided counseling to just 36,000 borrowers. Representatives have suggested loan workouts for fewer than 10,000 of them, a small fraction of borrowers in need." (Earlier Subprime Rescue Falters; Wall Street Journal)

"Only 10,000 homeowners; and Paulson promised 500,000?"

Another slight miscalculation. The real purpose of Hope Now was to derail Sheila Bair's FDIC from enacting a program that has a real chance of helping people stay in their homes. Paulson doesn't like that idea; after all, there's still plenty of freeway overpasses for people to sleep under.

Paulson also initiated "Project Lifeline", which targeted homeowners who were delinquent 90 days or more on their mortgages. Here's the run-down of how it works:

"Project Lifeline involves servicers sending letters to borrowers — prime, Alt-A, or subprime, we're past pretense on that part — who are very seriously delinquent (90 days or three payments down or more). The letter says that if the borrower contacts the servicer within ten days, agrees to homeowner counseling, and provides sufficient financial documentation that the servicer can consider a case-by-case, deep-analysis style modification of the mortgage terms, the servicer will agree to put the foreclosure process on hold for 30 days while the workout is considered. If the borrower fails to respond to the letter, foreclosure proceeds."

Ever heard of Project Lifeline? No one else has either. That's because it was just another one of Paulson's PR chimeras that passed into oblivion as soon as it served its purpose of making it look like the administration really gives a damn. That's a laugh.

## **ENTER GEITHNER**

Geithner is nothing like Paulson. He's discreet, practical, non ideological and diplomatic. His job is to find a way to plug the holes in a banking system that is undercapitalized by a whopping \$2 trillion dollars while trying to keep the broader economy from crashing to earth. He's already concocted a stimulus plan (with Summers help) that should be big enough to get the country through the first quarter of '09 (\$700 billion), but it will take sustained government spending via infrastructure and green technologies programs to make up for the staggering losses to consumer spending. Expect the red ink to flow knee-deep from the purple mountains majesty all across the fruited plains, and pray that China and Japan keep buying US Treasuries or the country will face historic hyper-inflation.

Geithner knows that his mandate far exceeds his job description. Consumer confidence is at record lows because the public has lost faith in their institutions. The fear-mongering and the deception of the last 8 years have taken their toll; the pessimism is palpable. But market-based systems require confidence to function properly, otherwise people withdraw their savings and hoard their money. And that is exactly what is happening. We have entered a period of extreme risk aversion where there's been a steady run on the financial system; investors have pulled their money out of commercial paper, structured investments, money markets, corporate bonds, and securities. The markets are in a state of panic. Investors are moving into safe havens like Treasuries while consumers are cutting back on spending. The whole system is contracting. The same thing happened during the Great Depression. The similarities are stunning. In Jason Zweig's "1931 and 2008: Will Market history Repeat Itself" the author says:

"Over the two weeks ended Nov. 20, 2008, the Dow Jones Industrial Average fell 16%. Over the two weeks ended Nov. 20, 1931, the Dow fell 16%.

If you think that is scary, consider this: In the final five weeks of 1931, the Dow fell 20% further. Then it went on to lose yet another 47% before it finally hit rock-bottom on July 8, 1932

It is vital to realize that markets are never under some obligation to stop falling merely because they have already fallen by an ungodly amount. It also is vital to explore how bad the worst-case scenario can get and to think about how you would respond if it comes to pass.

When it comes to worst-case scenarios, 1931-1932 is it. When the Dow finally stopped going down, in July 1932, it had lost 88% in 36 months. At that point, only five of the roughly 800 companies that still survived on the New York Stock Exchange had lost less than two-thirds of their value from their peak in 1929." (Wall Street Journal)

Geithner's job is to restore confidence through transparency and consistency. No more lying. No more fudging the numbers to keep the public in the dark. Investors are already voting with their feet. It will take trust to get them to come back. Geithner has a clean slate to work with, but if he chooses Paulson's route—the path of deception—he'll fail, too. He's got one chance to make good; otherwise....To his credit, he has made statements confirming his determination to reform the system. This is what he said to Congress in recent hearings:

"The United States will have to have to undertake substantial reforms to our financial system. There was a strong case for reform before this crisis, our system was designed in a different era for a different set of challenges. But the case for reform is stronger today. Reform is important because a strong and resilient financial system is integral to the performance of any economy. ...I think the severity and complexity of this crisis makes a very compelling case for a broad and comprehensive reassessment of how we use regulation to achieve an appropriate balance between efficiency and civility. This is extremely complicated both in terms of the tradeoffs involved but also in terms of building the necessary consensus involved both here in the United States and around the world. It is going to require significant changes in the way we regulate and supervise financial securities; changes that in my view, need to go well-beyond modest adjustments to some of the specific capital charges in the existing capital regime as it applies to banks."

Good. Investors want rules, guidelines, supervision, regulations and most of all accountability. Justice should be the organizing principle in the financial system just as it is in the legal system. That means securities fraud has to be investigated and prosecuted. No free passes for banking mandarins and toffee-nose fund managers. Break the law and go to jail, just like Jeffrey Skilling. This is the biggest financial meltdown in US history and not one CEO or CFO has even been indicted. Instead, the SEC wastes its time harassing Dallas Maverick's owner Mark Cuban in a politically-motivated witch hunt. What a fiasco. Why not clean up the cesspool on Wall Street first. That's where the problem is and that's how one reestablishes credibility.

Then there's the heavy lifting of rebuilding financial markets while hedge fund redemptions are approaching 50 percent, corporate bonds have dropped by nearly half, commercial property is tanking, consumer spending is in the dumps, and the housing market continues to crumble. That's not an easy task. And, at the same time, banking behemoth Citigroup needs an immediate injection of capital just to maintain operations. Once again, the Treasury will assume a gigantic liability to avoid wider damage to the system. According to the Wall Street Journal:

"The federal government agreed Sunday to take unprecedented steps to stabilize Citigroup Inc. by moving to guarantee close to \$300 billion in troubled assets weighing on the bank's books, according to people familiar with details of the plan.

Treasury has agreed to inject an additional \$20 billion in capital into Citigroup under terms of the deal hashed out between the bank, the Treasury Department, the Federal Reserve, and the Federal Deposit Insurance Corp....

In addition to the capital, Citigroup will have an extremely unusual arrangement in which the government agrees to backstop a roughly \$300 billion pool of its assets, containing mortgage-backed securities among other things. Citigroup must absorb the first \$37 billion to \$40 billion in losses from these assets. If losses extend beyond that level, Treasury will absorb the next \$5 billion in losses, followed by the FDIC taking on the next \$10 billion in losses. Any losses on these assets beyond that level would be taken by the Fed."

What a nightmare. In a conference call held last Friday, Citi's chief executive Vikram Pandit boasted that Citi "had a fantastic business model" and that "we are one of the best counterparties in the world based on our capital, and based on our liquidity." Indeed, Pandit can count on virtually limitless liquidity from this point on.

Also, keep in mind, that when 2 Bear Stearns hedge funds went belly up in July 2007, the experts all agreed that there were probably only \$200 to \$300 mortgage backed securities (MBS) in the whole system. Now we find out that there are \$300 billion on Citi's balance sheet alone! More lies. In truth, there were more than \$5 trillion in MBS created between 2000 and 2006. A large portion of those are held by banks. That means more trouble ahead.

## **YOU AIN'T SEEN NOTHING YET**

So how will Geithner and Summers deal with the problems they'll be facing just two months from now?

They'll do whatever they need to do to stabilize the financial system and to get consumers spending again. That means at least another \$2 trillion added to the ballooning national debt and some extremely dodgy ways of getting liquidity into the system. (With the Fed Funds rate already at 1 percent, monetary policy is limited)

Larry Summers, who will serve as Obama's chief economics advisor, summed up his plan like this to Bloomberg News:

"At first I believed that any stimulus package should be timely, targeted, and temporary. But the situation has deteriorated so significantly from that point that I would now go for speedy, substantial, and sustained over a several year interval."

But how will Summers get money into the system if monetary policy has been ineffective and the banks are not providing sufficient credit?

Economist Nouriel Roubini answers that question in his latest blog entry on Global EconoMonitor web-site:

*"The Fed (will) directly purchase long term government bonds as a way of pushing downward their yield and thus reduce the yield curve spread. But even such action may not be very successful in world where such long rates depend as much as anything else on the global supply of savings relative to investment. Thus, even radical action such as outright Fed purchases of 10 or 30 year US Treasury bonds may not work as much as desired." (MW: In other words, the Fed will buy its own debt to control long-term rates)*

*Next, the Fed could make "outright purchases of corporate bonds (high yield and high grade); outright purchases of mortgages and private and agency MBS as well as agency debt; forcing Fannie and Freddie to vastly expand their portfolios by buying and/or guaranteeing more mortgages and bundles of mortgages; one could decide to directly subsidize mortgages with fiscal resources; the Fed (or Treasury) could even go as far as directly intervening in the stock market via direct purchases of equities as a way to boost falling equity prices. Some of such policy actions seem extreme but they were in the playbook that Governor Bernanke described in his 2002 speech on how to avoid deflation. They all imply serious risks for the Fed and concerns about market manipulation."*

*"Finally, the Fed could try to follow aggressive policies to attempt to prevent deflation from setting in: massive quantitative easing; such as letting the dollar weaken sharply, flooding markets with unlimited unsterilized liquidity; talking down the value of the dollar; direct and massive intervention in the forex to weaken the dollar." (MW: Intentionally weakening the dollar to spur consumer spending and exports)*

The bottom line is that Geithner and Summers will have to recapitalize the banks and deal with the massive corporate defaults at the same time they initiate their strategy for pumping liquidity into the system to keep the economy limping along. It's a tall order and there's no guarantee of success.



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