

# Global Economic Tremors

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On October 28, the Financial Times' columnist Martin Wolf wrote: "Preventing a global slump must be the priority." He cited Nouriel Roubini back in February listing "twelve steps to financial disaster," all of which the US took and dragged the whole world down with it.

Priority one is to rescue it and avoid a possible depression. "Given the near-disintegration of the western world's banking system, the flight to safe assets, the tightening of credit to the real economy, collapsing equity prices, turmoil on currency markets, continued steep declines in house prices, rapid withdrawal of funds from hedge funds and ongoing collapse of the so-called "shadow banking system." More worrisome is that "next year could be far worse" so what does Wolf think should be done?

Nothing to purge past excesses or everything possible to prevent the worst of all possible outcomes. Wolf calls the former path "a recipe for xenophobia, nationalism and revolution" and in combination like "let(ting) a city burn in order to punish someone who smoked in bed." In short, madness at a time world economies need huge amounts of proactive remedies:

- to prevent deflation;
- help the private sector delever with liberal amounts of government debt;
- sustain lending inside and among economies; if banks won't do it, central banks must;
- aid hard-hit emerging economies and keep them afloat; and
- rebuild domestic demand with substantial fiscal measures.

At risk is the "legitimacy of the open market economy itself." It's wobbly and on life support because of what Roubini spotted early on. All having occurred or now happening. His 12-stage "systemic financial meltdown" scenario:

(1) the worst ever US housing recession with prices falling up to 30% from their peak and matching their Great Depression decline; most recently Roubini thinks a 40% drop is likely with a market bottom still way off;

(2) the subprime disaster causing hundreds of billions in losses and throwing millions of homeowners into foreclosure;

(3) a sharp increase in other defaults - credit cards, auto and student loans, and other borrowing; add bank losses to the mix (including from their securitized assets), and we've got a severe credit crunch;

(4) monoline losses will mount more severely than expected and other writedowns will follow;

(5) commercial real estate will be impacted; the housing crisis will cause a bust in non-residential construction;

(6) large regional or national banks may go bankrupt and worsen the already severe credit crunch;

(7) losses from large leveraged loans will impair banks' ability to syndicate and securitize them; today the market is dead; earlier losses froze it up; these assets were then stuck on bank balance sheets at well below par values and are headed lower; they're still there at undisclosed valuations most likely scraping bottom because no buyer will touch them above fire sale prices and most often not even those;

(8) a massive wave of corporate defaults will accompany a severe recession;

(9) the shadow banking system (hedge funds and the like) is heading for serious trouble;

(10) world stock markets will price in a severe recession; at the time, Roubini saw the S & P 500 falling about 28% or around the average decline for US recessions; it fared much worse, and he now sees a far lower valuation ahead;

(11) the worsening credit crunch will cause liquidity to dry up; it will require massive central bank intervention; and

(12) "a vicious circle of losses, capital reduction, credit contraction, forced liquidation and fire sales of assets at below fundamental prices will ensue leading to a cascading cycle of losses and further credit contraction." The massive credit crunch will spread around the world. Monetary and fiscal measures won't prevent a systemic financial meltdown "as credit and insolvency problems trump illiquidity" ones. As a result, US and global financials will experience their most severe crisis in the last quarter of a century."

Roubini now sees the greatest one since the 1930s. Grudgingly, only small numbers of economists agree with him, and the majority think the worst is past and 2009 will bring recovery. Barrons economics editor, Gene Epstein, for one. He asks: "How long will the slump linger? (It's) already under way. But hopefully, it won't extend into 2009." An astonishing assessment at a time virtually all macro data point to hard times in the new year, and the big unknown is how hard and protracted.

It's the reason for unprecedented global amounts of monetary stimulus with limited effect so far. It's also why Congress may add hundreds of billions more in fiscal medicine on top of an orgy of past and upcoming government borrowing.

The Treasury already announced \$550 billion more in Q 4. An amount greater than the announced FY 2008 \$455 billion fiscal deficit. In addition, Goldman Sachs now believes Washington will have to borrow \$2 trillion to finance an \$850 billion federal deficit, buy \$500 billion in toxic assets, and roll over \$561 billion in maturing Treasury securities. Add to it unknown factors and another trillion may be needed.

For loans, investments and commitments, Washington already earmarked:

- \$700 billion for TARP;
- another \$150 billion tacked on to EESA funding for pork barrel spending;
- \$200 billion in the Fannie and Freddie takeover, and Fannie now says the amount is inadequate after reporting a record \$29 billion loss and its difficulty in issuing and refinancing debt; in a November 10 SEC filing it stated: “This commitment may not be sufficient to keep us in solvent condition or from being placed into (effective bankruptcy) receivership” if further “substantial” losses occur or if the company can’t sell unsecured debt;
- \$25 billion to the auto companies and another \$50 billion more they may get; the industry is effectively insolvent; on November 11, General Motors stock hit a 65 year low and is down over 90% this year; the nation’s once largest company is a mere shadow of its former self and won’t survive without a bailout; the same holds for Ford and Chrysler;
- \$29 billion for Bear Stearns;
- \$85 billion to AIG; upped to \$129 billion and again to \$150 billion after the company reported a \$25 billion Q 3 loss; add \$15 billion more for its commercial paper with no end of this looting in sight - to a single company, albeit a big one;
- \$144 billion to buy mortgage-backed securities, in part included above;
- \$300 billion for the Federal Housing Administration Rescue Bill for FHA to insure up to that amount in new 30-year fixed-rate mortgages for at-risk borrowers in owner-occupied homes if their lenders agree to write down loan balances to 90% of the homes’ current appraised values;
- \$87 billion to JP Morgan Chase for financing bad Lehman Brothers’ trades;
- \$200 billion in loans to banks under the Fed’s Term Auction Facility (TAF);
- \$50 billion to support commercial paper held in money market funds; \$1.3 trillion worth qualifies so a far greater liability may be incurred;
- \$620 billion in currency swaps with developed nations - central banks in Western Europe (the ECB, UK, Denmark, and Switzerland), Japan, Canada, and Australia;
- another \$120 billion for emerging markets - to Brazil, Mexico, South Korea and Singapore; and
- potential great liabilities to cover the FDIC’s expanded bank deposit insurance up to \$250,000 per account.

These numbers are staggering in size and may go much higher. A trillion here, a trillion there, and pretty soon we’re talking about real money, but if enough of it swirls around, today’s deflation may one day become severe inflation.

#### Two Views on Potential Depression

The dreaded “D” word. Unmentioned and unconsidered in the mainstream but not off the table given the severity of today’s crisis. What Michel Chossudovsky isn’t alone calling “the

most serious (one) in World history.” He says the Treasury “bailout” isn’t a solution. Just the opposite – “it is the cause of further collapse. It triggers an unprecedented concentration of wealth, which in turn contributes to widening economic and social inequities both within and between nations” – on top of how inequitable they are already.

President of the London-based Independent Strategy consultancy group, David Roche, disagrees in a November 8 Wall Street Journal article headlined “How Far Will Deleveraging Go?” He acknowledges the severity of the crisis and asks: “Will this lead to depression? And, if not, how long and deep will the recession be?” He examines the extent of deleveraging for the answer in the following analysis.

He says the amount of a bank’s “risk-free” or “tier-one” capital is a “good reverse indicator of how leveraged it is.” Financial institutions globally had about \$5 trillion of it at the credit crisis’ onset. For America and the EU, it was \$3.3 trillion “supporting a loan book of some \$43 trillion. Then came the crisis.”

He gives three answers to the amount they lost:

- using mark-to-market rules (what an asset would bring if sold today), an estimated 85% of their tier-one capital was lost; but this assumes selling today at fire-sale prices which largely isn’t happening;

- using “economic value,” or the present value of future cash flows (assuming there are any), current losses are about half their mark-to-market valuations; and

- if only so far recognized losses are considered, the amount taken is around \$700 billion.

Despite these losses, loan portfolios have grown during the crisis. Shrinkage has only occurred for investment banks, prime brokers and hedge funds, Roche believes. All bank losses have been offset by “\$420 billion from private sources” and another “\$250 billion from governments.”

At the onset of the crisis, US and EU leverage was about 13 times tier-one capital. Under mark-to-market rules, it’s now more than double that. “But using economic value or declared losses reveals that leverage is now back to what it was before the crisis began” because of capital injections. Nonetheless, conditions remain dire, and growth isn’t ready to resume. For three reasons, according to Roche:

- financial sector leverage was too high in the first place, which is why the credit bubble collapsed;

- the world economy uses \$4 to \$5 of credit for every \$1 of GDP growth; a profligate amount; even at half that amount, between a 10 – 15% rate of credit expansion is needed to achieve real GDP growth of 2 – 3%; recapitalization amounts so far are only enough to maintain existing credit assets, not expand them; so the crisis continues; and

- current bank-asset losses don’t include allowances for future ones – from recession and its fallout; Roche estimates they’ll be another \$900 billion for a total \$1.7 trillion during the whole crisis period; others estimate a much higher figure; if Roche is right, these losses will deplete new capital infusions and reduce US and EU tier-one capital back to \$2.3 trillion at a leverage ratio of over 18 times.

Roche believes leverage and credit will shrink even with further capital injections. They're "temporary, expensive, and impose constraints on shareholders and management." It makes them unattractive.

In addition, banks need to reduce their "customer funding gap" and focus on "deposit rather than loan growth." It's a slow process during recession and can only be achieved "by reducing assets and liabilities" which means "cutting credit on the asset side of the balance sheet." And do it during a risk aversion period in wholesale and longer-term debt markets. It makes the task a lot harder at a time regulation is coming that "will reduce bank leverage to well below what it was before the crisis began."

Bottom line: if further credit losses reduce US and EU tier-one bank capital to where it was before crisis-induced infusions, financial sector credit "would have to shrink 37% just to keep leverage constant at pre-crisis levels," and if it happens we're talking about global depression.

But governments are now "part of bank management so may limit credit losses to less than 10%, Roche believes, but at a cost - more capital injections, further longer-term liability guarantees, tolerating higher leverage in "socialized banks," plus more than a little "dirigisme," or directing banks to lend. Under this scenario, Roche thinks global depression will be avoided - but "at the high long-term cost of a socialized financial system. And it still heralds a very long, gray, global recession as the world learns to use less capital to meet its needs."

Financial expert and investor safety advocate Martin Weiss disagrees with Roche and sees depression coming. He's not alone, and he's said it repeatedly, including in his latest commentary titled "Why Washington Cannot Prevent Depression." He cites what he calls "dire reality. Washington is not God. It cannot save the world. It cannot prevent the next depression," and he gives five reasons why:

#### (1) The Debt Crisis

It's far too big to control. Based on Fed Flow of Funds figures, "there are now \$52 trillion in interest-bearing debts in the US." According to US Government Accountability Office estimates, add another \$60 trillion in contingency debts and obligations - for Social Security, Medicare, Medicaid, and other pensions. In addition, the Bank of International Settlements (BIS) earlier cited a staggering global debt total, including derivatives, of \$1 quadrillion, or 1000 trillion. In a separate report, it says \$596 trillion, but even this number is unimaginable and unmanageable.

So far, reckless government outlays amount only to a fraction of this amount - around \$2.7 trillion. Weiss says the numbers aren't directly comparable, but "to get a sense of the magnitude of the problem, compare the size of the debts and (derivatives) bets outstanding" to the tiny amount injected to combat it. It's miniscule and may fall way short of being effective. Weiss is blunt in calling "the debt build-up in the US today far greater than it was on the eve of Great Depression I." Pre-1930, it was between 150 - 160% of GDP. Today, excluding derivatives, it's nearly 350% or more than double the earlier. Include them, and debt levels go off the charts. Weiss concludes: "government bailouts are too little, too late to end this crisis."

#### (2) Bailout Costs Are Too Great to Be Financed

Given the dire economy, higher taxes and expenditure cuts are off the table. Going forward, “the government will try to finance its folly largely by borrowing the money.” The next tranche – \$550 billion in Q 4 and \$2 trillion in total, or four times the size of the entire official FY 2008 deficit. As a result, a tsunami of new Treasury supply is coming. It will crowd out private borrowers and pressure interest rates higher when lower ones are desperately needed.

### (3) Supply Can't Stimulate Lending and/or Borrowing

Washington wants households to borrow and spend more, but they're doing the opposite. Banks are also urged to lend, dispense more access to credit cards, and provide capital for troubled businesses. They refuse and are using their handouts for acquisitions, bonuses and dividends. “No matter what the government says, it is the natural survival instinct of billions of people and businesses around the world that will determine the outcome” of today's crisis: “Depression and deflation.”

### (4) Powerful Debt and Deflation Cycles

Debt can continue accumulating for years as long as borrowers have enough income to repay it. Deflation (or disinflation) can increase the affordability of homes and other major purchases. But when debt and deflation converge, depression is inevitable. It happened in the 1930s, and (in different form) it's happening today. “We are witnessing powerful vicious cycles in which deflation brings down debts and debts help accelerate the deflation.”

For example:

- widespread mortgage delinquencies and foreclosures trigger massive real estate liquidations followed by severe price declines, and more delinquencies and defaults;
- fear of bankruptcies causes equities, bonds, commodities and virtually every type asset to fall; more bankruptcies result the way today they threaten US auto makers; and
- the same downward spiral affects households, small and mid-sized businesses, city and state governments, and entire countries; spending is slashed; workers laid off; assets sold, and revenues lost precipitating more of the same.

“In every sector of the economy and every corner of the globe, debt defaults are causing deflation; and deflation is causing debt defaults. No government can stop this powerful vicious cycle. It has to play itself out.”

### (5) The Ultimate Power of Markets

Why can't governments simply print enough money to buy up excess debt and inflate? Because governments need buyers for their bonds and to finance all new planned spending and deficits. “The power of the market is stronger than any politician or government bureaucrat. It is more powerful than any law. It is even more powerful than the gold standard.”

Trust is needed to raise money. It's not built by “run(ning) the printing presses or destroy(ing) your money.” Instead, deflation and depression must run its course. “It's preposterous to believe that Washington can save every failing individual, company, country and government on this planet.”

It can't stop investors from dumping their assets or reverse decades of financial excesses. "It cannot win the battle against depression. It cannot stop the Dow or S & P from losing half their value from current levels, if not more. It cannot stop the collapse in real estate, commodities, and corporate bonds." It can't convince people to use their cash to invest or do anything they wish not to do. It can only reap the whirlwind.

## Two Other Views on the Dire State of Things

One from Russian economist Mikhail Khazin in a recent (Russian web site) kp.ru/daily interview. He predicted the current crisis early on, but his views were largely dismissed. No longer, and today they're more dire than before.

In 2000, he wrote an Ekspert magazine article titled: "Is the US Digging for an Apocalypse?" At the time, he saw declining demand destroying 25% of the US economy. Today it's maybe one-third, he believes. Why? Because of an early 1980s policy "to stimulate demand through state support....(by) switch(ing) on the printing press" and building debt at a rate way above GDP growth. He mentioned 8 - 10% in an economy growing at around 2 - 3% or a maximum 4%.

It let America "create a very high standard of living by stimulating consumer demand....But it's impossible to live forever in debt. Household debt has now surpassed the national economy - more than \$14 trillion. Now it's time to pay up. Of course, Wall Street tried to postpone this collapse....but this was just a gasp for air before an inevitable death....Whatever decision Wall Street takes right now, the demand is going to fall."

It points to "an uncontrollable increase in unemployment, a horrible depression, a sharp increase in the effect of social services on the budget....Now, the US is jumping all over the place doing everything it can to rescue this fraction of the economy (the portion Khazin thinks will evaporate). The government is stimulating banks and manufacturing....But regardless, in 2 - 3 years, the US will face a crisis similar to the Great Depression."

Harvard president Drew Faust is also alarmed in a recent letter to alumni and friends. She cites the "current global financial situation and its effect on the University." She mentions "extraordinary turbulence, the most serious (uncertainty and financial distress) in decades (as part of) our new economic reality."

Despite over three and a half centuries of surviving challenges, "Harvard is not invulnerable to the seismic financial shocks in the larger world. Our own economic landscape has been significantly altered. We will need to plan and act" accordingly.

Her focus, of course, is on revenue and the school's endowment. It provides income for over one-third of its operating budget, now severely impacted by today's crisis. Despite past outperformance in turbulent times, Harvard fared poorly in its current fiscal year ending June 2008 (before the worst of today's crisis struck). In FY 2007, an impressive 23% return was registered, and it lifted the total endowment to \$34.9 billion. In FY 2008, it fell an estimated 30% or a \$10.5 billion hit. Even mighty Harvard is impacted enough to "need to be prepared to absorb unprecedented endowment losses" in the current environment. Drew Faust wants help, of course, but clearly she's worried to the point of alarm at the gravest financial time in our lives.

## Credit Normalization Is Stuck in a Debt Trap

It affects Harvard and world economies everywhere. Even mighty America isn't immune from its impact. From having lived way beyond our means for years. The chickens are now home to roost – big time.

In spite of extraordinary liquidity injections globally, risk markets remain paralyzed. Frozen. Uncertainty and turbulence continue, and economies are reeling in distress. They're like buckets leaking more out their bottoms than whatever flows in at their tops. Fed credit creation is counterbalanced by deleveraging and collapsing balance sheets, and there's no end to this in sight.

True enough, unclogging has occurred in inter-bank and money markets, but it hasn't freed up credit or its price for the vast majority of borrowers. In addition, junk and investment grade bond spreads have widened. Municipal bond yields have soared as their prices fell. Some offer tax-free returns topping 6% compared to taxable 10-year Treasuries under 4%. According to some analysts, they're screaming buys, and so are high-grade corporate bonds that are much more attractive (and safer at a time no financial asset is safe) than equities in the same companies, and a big reason why stock prices are falling. But by no means the only one.

The world pre-mid-2007, no longer exists. Risk is a dirty word. Leverage is out the window, and asset-backed securities (ABSs), collateralized debt obligations (CDOs), and securitization markets are closed and padlocked. All the king's horses and all the king's men can't reconstitute them. No amount of liquidity injections, rate-cutting, or high-minded rhetoric will reflate that air that's now leaving the bubble.

Today's debt overhang is unmatched by a factor of more than three to one over any previous period without including derivatives. Add them, and it's unquantifiable in uncharted waters. Issue one for policy makers is how to keep economies from crashing. How to create enough new credit and get it flowing at a time lenders won't lend and borrowers are so indebted they can't assume more if they could get it.

Viable or not, the Fed will keep expanding its balance sheet to never before imagined amounts, and the government will run even greater multi-trillion dollar deficits. Amounts impossible to repay so they never will be with dark forebodings of how that problem will be resolved. It portends a very unpleasant future far worse than most now imagine. It also suggests another vicious downward spiral as recession deepens, and potential depression looms. The likes of which no one has experienced in our lifetimes or wishes to. Today's bubble economy is unlike anything ever in the past. Worse than all post-war excesses and what led to the Great Depression.

Can the worst of all possible outcomes be avoided? It's beyond this writer's ability to imagine. It's for the Fed, Treasury, GSEs (government sponsored enterprises like Fannie, Freddie, Sallie, Ginnie, etc.) and banks, if they're able and willing, to try. To create money, get it flowing, inflate or die, but it already may be too late. Things that can't go on forever, won't, and as writer Ellen Brown observes: "The parasite has run out of its food source." The engine is now out of fuel.

A Secret Revival Plan for the November 15 G-20 Summit

According to Webster Tarpley (on Rense.com, 11/10/08), a "British (and, of course, Washington) steered....confidential strategy paper (aims) to impose (an IMF) dictatorship on



the entire planet, wiping out all hope of economic recovery, the modernization of the developing countries, and national sovereignty” as well.

It proposes the usual form of IMF orthodoxy - “austerity, sacrifice, deregulation, privatization, union busting, wage reductions, free trade, the race to the bottom, and prohibitions on advanced technologies.” Quite literally an agenda from hell. So outlandish that BRIC countries are reportedly objecting - Brazil, Russia, India and China. China wants policies of the type it may pursue in its just announced \$586 fiscal stimulus plan - for various internal needs like infrastructure. The IMF plan is mirror opposite in its five points. To:

(1) “require the credit rating agencies to be registered and monitored and submit to rules of governance;

(2) halt the principle of a convergence of accounting standards and re-examine the application of the fair market value rule in the financial field, so as to improve its coherence with the rules of prudence and conservatism;

(3) resolve that no market segment, territory, or financial institution shall escape from a proportionate and adequate regulation, or at the least, surveillance;

(4) set up a code of conduct to avoid excessive risk-taking in the financial industry, including in the area of compensation. Supervisors will have to follow this code in evaluating the risk profiles of financial institutions; (and)

(5) entrust to the IMF the primary responsibility, along with the FSF (Financial Stability Forum - Basel), to recommend the necessary measures to restore confidence and stability.

The IMF must be equipped with the essential resources and suitable instruments to support countries in difficulty, and to exert its role of macroeconomic surveillance to the fullest.”

Translation: This is a Washington-UK-IMF scheme to increase their collective power at the expense of and to the detriment of the civilized world. An attempt to suck more of its wealth to the top by extracting it from all others.

Economist Michael Hudson reports that 1% of the US population owns 70% of its wealth, a huge increase over earlier periods. This plan aims to increase it. To turn the US and world economies into banana republics. To make its workers de facto serfs. To crush competition and empower corporate giants. Mostly ones in America.

To end any hope for progressive change at a time all humanity craves it. To revive Chicago School fundamentalism when it’s totally discredited. To step back from a new direction that appears little more than a pipe dream. To harden the old failed one and suck us deeper into its quicksand.

It’s hoped enough nations will balk, render this scheme dead on arrival, and consign it back to its hellish origins. The alternative is a view of our future. One too disturbing to imagine. That no one should tolerate and be willing to be disruptingly defiant enough to prevent.

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