This Is Not A Normal Recession: Moving on to Plan B

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"The Winter of 2008-2009 will prove to be the winter of global economic discontent that marks the rejection of the flawed ideology that unregulated global financial markets promote financial innovation, market efficiency, unhampered growth and endless prosperity while mitigating risk by spreading it system wide." Economists Paul Davidson and Henry C.K. Liu "Open Letter to World Leaders attending the November 15 White House Summit on Financial Markets and the World Economy"

The global economy is being sucked into a black hole and most Americans have no idea why. The whole problem can be narrowed down to two words; "structured finance".

Structured finance is a term that designates a sector of finance where risk is transferred via complex legal and corporate entities. It's not as confusing as it sounds. Take a mortgage-backed security (MBS), for example. The mortgage is issued by a bank (the loan originator) which then sells the mortgage to a brokerage where it is chopped up into tranches (pieces of the loan) and sold in a pool of mortgages to investors that are looking for a rate that is greater than Treasurys or similar investments. The process of transforming debt ("the mortgage") into a security is called securitization. At one time, the MBS was a reasonably safe investment because the housing market was stable and there were relatively few foreclosures. Thus, the chance of losing one's investment was quite small.

In the early years of the Bush administration, Wall Street took advantage of the gigantic flow of capital coming into the country ($700 billion per year via the current account deficit) by creating more and more MBSs and selling them to foreign banks, hedge funds and insurance companies. It was real gold rush. Because the banks were merely the mortgage originators, they didn't believe their own money was at risk, so they gradually lowered lending standards and issued millions of loans to unqualified applicants who had no job, no collateral and a bad credit history. Securitization was such a hit, that by 2005, nearly 80 percent of all mortgages were securitized and the traditional criteria for getting a mortgage was abandoned altogether. Subprimes, Alt-As and ARMs flourished, while the "30 year fixed" went the way of the Dodo. Lenders were no longer constrained by "creditworthiness"; anyone with a pulse and a pen could get approved. The mortgages were then shipped off to Wall Street where they were sold to credulous investors.

The disaggregation of risk–spreading the risk to many investors via securitization–was as much of a factor in the creation of "the largest equity bubble in history", as the banks lax lending standards or Greenspan's low interest rates. By spreading risk throughout the system, securitization keeps interest rates artificially low because the real risks are not properly priced. The low interest rates, in turn, stimulate speculation which results in equity bubbles. Eventually, credit expansion leads to crisis when borrowers can no longer make the interest payments on their loans and defaults spiral out of control. This forces massive deleveraging and the fire-sale of assets in illiquid markets. As assets lose value, prices fall and the economy enters a deflationary cycle.

There are many types of of structured instruments including asset-backed securities (ABS), mortgage-backed securities (MBS), collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs) all of which provide a revenue stream from loans that were chopped into tranches and turned into securities. There are many problems with these complex securities, the biggest of which is that there is no way to unravel the individual pools of loans to isolate the bad paper. That's why subprime mortgages had such a destructive affect on the secondary market, because–even though subprimes only defaulted at a rate of roughly 5 percent–MBS sales slumped nearly 90 percent. Why? Former Secretary of the Treasury Paul O'Neill explained it like this: "It's like you have 8 bottles of water and just one of them has arsenic in it. It becomes impossible to sell any of the other bottles because no one knows which one contains the poison."

Exactly right. So why weren't these structured debt-instruments "stress tested" before the markets were reworked and the financial system became so dependent on them?

Greed. Because the real purpose of these exotic investments is not to provide true value to the buyer, but to maximize profits for the seller by increasing leverage. That is the real purpose of MBS, CDOs and all the other bizarre-sounding derivatives; higher profits with less capital. It's a scam. Here's how it works: A mortgage applicant buys a house for $400,000 and puts 10 percent down. His mortgage is sold to Wall Street, chopped into pieces, and stitched together in a pool of similar loans. Now the brokerage can use the debt as if it were an asset, borrowing at ratios of 20 or 30 to 1 to fatten the bottom line. When Fannie Mae and Freddie Mac were taken into conservatorship by the government, they were leveraged at an eye-popping 100 to 1. This shows that nearly an infinite amount of debt can be precariously balanced atop a paltry amount of capital. This explains why the $4 trillion aggregate value of the 5 big investment banks and the $1.7 trillion value of the hedge funds is now vanishing more quickly than it was created. Once the mighty gears of structured finance shift into reverse, deleveraging begins with a vengeance pulling trillions into a credit vacuum.

It all started when two Bear Stearns hedge funds defaulted in July 2006 and there were no offers for their MBS and other structured investments. Panic quickly spread to every corner of Wall Street as the alchemists of modern finance began to see that their worst nightmare might be realized, that trillions of dollars of Frankenstein investments could be worth nothing at all.

Since the Bear Stearns funds fiasco, there have been huge explosions in the financial markets. Fannie Mae, Freddie Mac, Wachovia, Washington Mutual, Indybank, AIG, Lehman Bros and other industry giants have either gone under or been forced into shotgun weddings by the FDIC. The stock market has plunged over 40 percent and suffered wild gyrations not seen since the 1930s. The entire Wall Street landscape has changed completely. Investment banking is no longer a viable business model; the Big 5 have either vanished or transformed themselves into holding companies to escape short sellers. The hedge funds have been deleveraging with a ferocity that has sent sent stocks and commodities crashing. In one day last week, the stock market plunged 300 points in the morning only to bounce back 550 points a few hours later; a whopping 850 point-spread in one trading day! No one but a madman would dabble in this market. Cautious investors have pulled up stakes and moved to the safety of Treasurys. Meanwhile, the financial tsunami is roaring through the real economy where consumer confidence has plummeted, unemployment is soaring and retail sales have fallen to historic lows. The downdraft from the financial markets has flattened Main Street and set the stage for a humongous $500 billion stimulus package to be delivered in the first few months of the Obama administration. The meltdown appears to be playing out much like Henry Paulson anticipated. According to Bloomberg News : "Shortly after leaving Wall Street as Goldman Sachs' CEO, Henry Paulson was at Camp David warning the president and his staff of "over-the-counter derivatives as an example of financial innovation that could, under certain circumstances, blow up in Wall Street's face and affect the whole economy." (PAUL B. FARRELL, "30 reasons for Great Depression 2 by 2011", MarketWatch)

So far, the Federal Reserve has provided nearly $2 trillion through its lending facilities just to keep the financial system upright. The Treasury is currently distributing $700 billion to key banks and other financial institutions that are perceived to be "too big to fail". In truth, the "too big to fail" mantra is a just public relations hoax to conceal the web of counterparty deals that make it impossible for one institution to fail without dominoing through the rest of the system and wreaking havoc. That's why AIG is still on life-support with regular injections of taxpayer money; because it had roughly $4 trillion of credit default swaps (structured "hedges" that are not traded on a regulated exchange) for which AIG does not have sufficient capital reserves. In other words, the taxpayer is now paying the debts of an insurance company that didn't set aside the money to pay its claims. (As yet, No SEC indictments for securities fraud) In fact, the Fed and Treasury are now providing a backstop for the entire structured finance system which is frozen solid and shows no sign of thawing any time soon.

This is not a normal recession, which is a downturn in the business cycle and "a period of reduced economic activity" usually brought on by a mismatch between supply and demand. (that ends in two quarters of negative growth) The present situation is much more grave; it is the utter destruction of a system that was developed fairly recently and has proven to be thoroughly dysfunctional. It cannot withstand the effects of tighter credit or adverse market conditions. This is not a cyclical downturn; the structured finance system has collapsed leaving behind a multi-trillion dollar capital hole that is bringing the broader economy to its knees.

One by one, we have seen the structured instruments fail; mortgage-backed securities (MBS), collateralized debt obligations (CDOs), credit default swaps (CDS), commercial paper (CP), auction rate securities. Now we are seeing investors boycott anything related to structured investments. This is from Mish's Global Economic Trend Analysis:

"There were NO sales of bonds backed by credit-card payments in October, the first time since 1993, when the asset-backed securities market was in its infancy. Yields on top-rated credit card bonds relative to benchmark interest rates reached a record high of 525 basis points more than the London interbank offered rate, or Libor, last week, according to Bank of America Corp. data."

Wall Street has turned off the faucet for securitized investments. That market is toast. The only reason that Libor and the other gauges of interbank lending have normalized is because the Fed guaranteed money markets and commercial paper. It has nothing to do with trust between the banks themselves. There is no trust. Even so, the banks are not capable of making up for the vast amount of credit which was produced by the now-defunct investment banks and hedge funds which are constrained by losses of nearly $3.5 trillion; half of their total value. In the best case scenario, bank credit will only shrink 15 or 20 percent, which will put the US on track for a deep "18 month to 2 year" recession rather than another Great Depression.

Paulson's attempt to divert $30 billion to non-bank financial institutions to revive loan securitization when there is no appetite among investors for such structured junk is pure folly. More troubling, is that neither Paulson nor Bernanke have a Plan B; an alternate scheme for rebuilding the financial markets on a solid, sustainable foundation rather than low interest rates and pools of debt. Everything they have done so far, suggests that they are focused on one thing alone; inflating another equity bubble. "Inflate or die", as the saying goes; and Bernanke intends to achieve this objective using the same tools that brought us to the brink of catastrophe. Here's a clip from a recent speech by Bernanke which shows his determination to prop up the broken system:

"The ability of financial intermediaries to sell the mortgages they originate into the broader capital market by means of the securitization process serves two important purposes: First, it provides originators much wider sources of funding than they could obtain through conventional sources, such as retail deposits; second, it substantially reduces the originator's exposure to interest rate, credit, prepayment, and other risks associated with holding mortgages to maturity, thereby reducing the overall costs of providing mortgage credit."

Sorry, Ben, the funding has dried up and the banks have shown no interest in going back to the days of conventional "30-year fixed" mortgages. It's a dead letter. The Fed and Treasury need to stop looking for ways to reflate the bubble and work to restore confidence in the markets by increasing regulation and reducing the amount of leverage that's allowable to 12 to 1. After all, it's no coincidence that AIG, Fannie and Freddie, Lehman Bros, General Motors, General Electric have all fallen off a cliff at the very same time. They are all victims of the same low interest, easy money finance swindle which allowed them to roll over huge amounts of short-term debt at artificially low cost. When Bear blew up; lending tightened, demand weakened, and credit was flushed from the system at an unprecedented pace. Borrowing short for long-term investments is not feasible when credit becomes scarce, but it's not because the banks aren't lending. That's just another myth that keeps the public from seeing what's really going on. As Jon Hilsenrath points out in his Wall Street Journal article, "Banks Keep Lending, but that isn't easing the crisis", that is not the case:

"Banks actually are lending at record levels. Their commercial and industrial loans, at $1.6 trillion in early November, were up 15% from a year earlier and grew at a 25% annual rate during the past three months, according to weekly Federal Reserve data. Home-equity loans, at $578 billion, were up 21% from a year ago and grew at a 48% annual rate in three months….The numbers point to one of the great challenges of the crisis. The credit crunch is surely real, but it is complex and not easily managed. Banks are lending, but they're also under serious strain as they act as backstops to a larger problem — the breakdown of securities markets..The worst of the credit crisis is being felt not in banks but in financial markets…"

The banks are not to blame. There is a generalized contraction of credit in the non-bank financial system where structured finance has blown up and taken half of Wall Street with it. It's the end of an era. Here's how economist Henry C. K. Liu sums it up in his "Open Letter to

World Leaders attending the November 15 White House Summit on Financial Markets and the World Economy":

"Neoliberal economists in the last three decades have denied the possibility of a replay of the worldwide destructiveness of the Great Depression that followed the collapse of the speculative bubble created by unfettered US financial markets of the 'Roaring Twenties'. They fooled themselves into thinking that false prosperity built on debt could be sustainable with monetary indulgence. Now history is repeating itself, this time with a new, more lethal virus that has infested deregulated global financial markets with 'innovative' debt securitization, structured finance and maverick banking operations flooded with excess liquidity released by accommodative central banks. A massive structure of phantom wealth was built on the quicksand of debt manipulation. This debt bubble finally imploded in July 2007 and is now threatening to bring down the entire global financial system to cause an economic meltdown unless enlightened political leadership adopts coordinated corrective measures on a global scale."

Rome is burning. It's time to stop tinkering with a failed system and move on to "Plan B" before it's too late.