Financial System at the Brink of Collapse: The Point of No Return

By Mike Whitney
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Following another erratic day of trading on the stock market, Treasury Secretary Henry Paulson and Federal Reserve chairman Ben Bernanke convened an emergency meeting of the Senate Banking Committee and other congressional leaders to request fast-track authority for a sweeping plan to buy back illiquid assets and other complex securities from distressed and under-capitalized banks. The turbulence in the financial markets has intensified and there is every indication that the situation will get worse before it gets better.

There are a number of signs that the financial system is at the brink of collapse and that Wall Street is headed for a 1929-type crash. Depositors have begun to withdrawal their savings from money market funds alarmed by the gyrations in the market and the daily deluge of bad economic news. According to the Washington Post, funds dropped "by at least $79 billion, or about 2.6 per cent" on Wednesday alone. The withdrawals are the equivalent of a slow bank run just at the time when stressed commercial banks need access to cheap capital to finance daily operations and provide loans for a steadily weakening economy. There's also been a surge of panic-buying of US Treasurys which is considered the safest of investments. According to the Wall Street Journal, during Wednesday's market-rout, "investors were willing to pay more for one-month Treasurys than they could expect to get back when the bonds matured. Some investors, in essence, had decided that a small but known loss was better than the uncertainty connected to any other type of investment. That's never happened before." (Wall Street Journal) Also, the VIX, or "fear gauge", has soared to levels not seen since the crisis began in August just over a year ago.

On Tuesday, interbank lending rates spiked upwards causing banks to abruptly stop lending to each other. When banks stop lending to each other, they cannot perform their primary function of transmitting credit to consumers and businesses, and the economy shuts down. That is why the Fed and other members of the western banking cartel made a surprise announcement at 3 AM (EST) Wednesday morning.
From the Fed:

> "Today, the Bank of Canada, the Bank of England, the European Central Bank (ECB), the Federal Reserve, the Bank of Japan, and the Swiss National Bank are announcing coordinated measures designed to address the continued elevated pressures in U.S. dollar short-term funding markets. These measures, together with other actions taken in the last few days by individual central banks, are designed to improve the liquidity conditions in global financial markets....The Federal Open Market Committee has authorized a $180 billion expansion of its temporary reciprocal currency arrangements (swap lines). This increased capacity will be available to provide dollar funding for both term and overnight

liquidity operations by the other central banks."

Before the end of the day, the Fed had quadrupled the amount of dollars (to $247 billion) that central banks around the world could access in an effort to loosen up trading between the banks and resume lending to loan applicants and businesses. According to Bloomberg: "The Fed will spray dollars around the world via swap lines with other central banks. They can then auction them in their own markets." At first, the stock market reacted positively to the Fed's announcement, but by noon the market was 200 points down and losing altitude fast. It took another surprise announcement by the Treasury Dept — of a massive government intervention to remove the bad loans and withering mortgage-backed securities from banks' balance sheets — of to jolt the market out of its funk and send it climbing 410 points higher on the day.

Paulson's emergency session with Congress last night was characterized by lawmakers who attended as "chilling". The situation is much worse than government officials have let on so far. The resurrecting of the Resolution Trust Corporation (RTC) is a desperate attempt to address the banking systems troubles head-on by providing a taxpayer-funded clearinghouse for illiquid assets and toxic mortgage-related securities for which there is presently no market. The taxpayer is being asked to pay up to $1 trillion for the speculative excesses of Wall Street investment banks and their fraudulent securities scam. Homeowners who are likely to lose their homes through foreclosure will not benefit from Paulson's RTC. Both presidential candidates have already declared their support for the plan.

According to the New York Times: "Rumors about the Bush administration's new stance swept through the stock markets Thursday afternoon. By the end of trading, the Dow Jones industrial average shot up 617 points from its low point in mid afternoon, the biggest surge in six years, and ended the day with a gain of 410 points or 3.9 percent."

If ever there was proof of Plunge Protection Team activity; Thursday's market is it. The market was sinking fast at midday even though the Fed just added nearly $250 billion in liquidity to the global system. Investors were buying short-term Treasurys in record numbers, the VIX "fear gauge" was soaring, money markets were collapsing, and the aftershocks from defaulting AIG and Lehman were still being felt around the world. Were investors really that eager to buy back battered investment bank stocks or was the PPT busy panic-buying up futures and forcing the market upwards 617 points?

Bloomberg News: "Options under consideration (by congress) include establishing an $800 billion fund to purchase so-called failed assets and a separate $400 billion pool at the Federal Deposit Insurance Corp. to insure investors in money-market funds, said two people briefed by congressional staff who spoke on condition of anonymity because the plans may change."

Not a dime of public money is provided for over-extended mortgage-owners trying to stay in their homes. Not one congressman or senator at Thursday's meeting rejected the bailout plan or called for a criminal investigation of to establish whether laws were broken in the sale of fraudulent securities which have clogged the global system; pushed banks, hedge funds, insurance companies and homeowners into default, and precipitated the greatest financial crisis in the nation's 230 year history.

Ironically, the very people who created this mess, are the ones who will decide how to resolve it; the Federal Reserve and the US Treasury. Where else, but Washington would such massive failure be rewarded with more power and authority.

The investment giants and the Federal Reserve are entirely responsible for the current meltdown. Currency deregulation brought foreign capital flooding into the equities and bond markets while the real economy suffered. Businesses were off-shored while good paying manufacturing jobs were moved overseas. Wall Street gorged itself on foreign capital while America was transformed into a nation of construction workers and service industry workers. Now those jobs are vanishing by the millions and unemployment lines are swelling.

The ratings agencies, prevaricating mortgage applicants, and appraisers all played a part, but it's Wall Street that's really to blame. They lobbied to deregulate the system so investment banks could merge with commercial banks and allow the world's biggest risk takers to have unrestricted access to the cheapest capital available; deposits. They even crafted a bogus ideology, "market fundamentalism"; touting trickle-down, free market, Voodoo economics that was entirely designed to further enrich the wealthy and savage the middle class. Earlier this week, former Senator Jack Kemp appeared at a whistle-stop with John McCain in Jacksonville, Florida. Kemp was one of the primary architects of "supply side" economics, the thoroughly discredited Reagan-era doctrine which has led us to our present economic catastrophe. Kemp's theories fit with Milton Friedman's "greed is good" Chicago School mumbo jumbo. Both Friedman and Kemp believe that what is good for the stock market is good for America, ignoring the shocking economic polarization that has divided the nation. Now, more and more people are beginning to see that Friedman was a charlatan who provided ideological cover for obscenely rich financiers and their dodgy investment scams.

Economist and author Henry Liu summed it up brilliantly in a recent article in the Asia Times:

> "The collapse of market fundamentalism in economies everywhere is putting the Chicago School theology on trial. Its big lie has been exposed by facts on two levels. The Chicago Boys' claim that helping the rich will also help the poor is not only exposed as not true, it turns out that market fundamentalism hurts not only the poor and the powerless; it hurts everyone, rich and poor, albeit in different ways. When wages are kept low to fight inflation, the low-wage regime causes overcapacity through over investment from excess profit. And monetary easing under such conditions produces hyperinflation that hurts also the rich. The fruits of Friedman test are in – and they are all rotten."

Whatever headwinds the country now faces economically can be directly attributed to the inherently flawed ideology of market fundamentalism.

Tuesday's 449 point bloodbath on Wall Street is the beginning of an unavoidable market crash. Regardless of Paulson's plan, there's more pain on the way. According to Bloomberg: "More than $19 trillion has been wiped off global stock market value since a high on Oct. 31 as the worst U.S. housing recession since the Great Depression and a resulting global credit crisis slowed the world economy." All of the economic indicators point to greater losses. Once the system begins to deleverage, there's nothing anyone can do to stop it. Paulson can place himself in front of a market avalanche if he chooses, but it won't change the outcome. Market corrections are as inexorable as the force of gravity. That's why equity bubbles cannot be allowed to develop without interest rate intervention. Responsible action by the Central Bank could have prevented the present crisis.

On Wednesday, Forex.tv reported that the net long-term TIC flows came in below the consensus forecast, totaling $6.1 billion in July, while total TIC flows for the month fell to $74.8 billion, according to data released by the U.S. Treasury on Tuesday morning. Economists had been expecting net long-term flows to rise to $55.0 billion compared to the previous month's previously reported figure of $53.4 billion.

$6.1 billion will not meet the requirements of our current account deficit of $700 billion. The dollar is headed for a fall.

On Wednesday, New York Mayor Michael Bloomberg warned that the "next wave" of financial pain may come from overseas if foreign entities stop buying U.S. debt." It's not clear who's going to be buying our debt," said Bloomberg. "It may very well be that the next wave is going to come back and bite us."

The New York Times tells a similar story except this time about Asia:

> "Asia's savings have, in essence, bankrolled American spending for decades (but) Asian interest in American assets is wilting, a trend that seems to have started over the summer…Little-noticed data released by the Treasury Department on Tuesday showed that a sharp shift in international capital movements began in July. Private investors pulled a net $92.9 billion out of the United States, after putting $46.8 billion into American securities in June. ("Asia rethinks American Investments Amid Market Upheaval", Keith Bradsher, New York Times)

Foreign central banks and investors have turned off the tap. They can see that the US financial system is teetering and that the dollar is weakening. "The perceived risk of U.S. government debt, long held to be absent of any default risk, also climbed to a record yesterday as the government's involvement in bailing out financial markets weighed on its own balance sheet." (Bloomberg News) The "full faith and credit" of the United States government is slipping. US debt will be downgraded. Triple A is no longer guaranteed. America's stock just moved to Level 3 assets. The US is now a subprime economy on life support.

Presently, "there is roughly $6.84 Trillion in bank deposits. $2.60 Trillion of that is uninsured. There is only $53 billion in FDIC insurance to cover $6.84 Trillion in bank deposits. Of the $6.84 Trillion in bank deposits, the total cash on hand at banks is a mere $273.7 Billion." (Mish's Global Economic Trend Analysis)

$273.7 Billion is a paltry sum, insufficient to meet the needs of even a minor run on the banking system. The storm hasn't even touched ground yet in middle America, and already the system is buckling. 2009 will be bleak, indeed.
The battered and over-leveraged US financial system is facing its greatest challenge in the months ahead. The frantic search for capital has already begun, but with predictably disappointing results.

Neither China nor the Saudi princes are buying any more failing investment banks. They'll leave that for the US taxpayer. What started off as a brilliant plan to pedal garbage mortgage-backed paper to gullible investors around the world has suddenly backfired and now threatens to bring the entire system crashing down and change the geopolitical power paradigm for the forseeable future.

On Monday night, Senate Majority Leader Harry Reid was briefed on the gravity of the situation in a secret meeting with the Treasury Secretary and Federal Reserve Chairman. Reid's remarks are the best summary yet of the troubles that lie just ahead. He said, ""We are in new territory, this is a different game…No one knows what to do."