The U.S Financial System, the Debt Bubble and the Cancer of Excessive Deregulation

By Prof Rodrigue Tremblay
Global Research, February 23, 2008
23 February 2008

Region: USA
Theme: Global Economy

> "It's...poetic justice, in that the people that brewed this toxic Kool-Aid found themselves drinking a lot of it in the end."
>
> Warren Buffett, American investor
>
> "By a continuing process of inflation, government can confiscate, secretly and unobserved, an important part of the wealth of their citizens."
>
> John Maynard Keynes (1883-1946)
>
> "New money that enters the economy does not affect all economic actors equally nor does new money influence all economic actors at the same time. Newly created money must enter into the economy at a specific point. Generally this monetary injection comes via credit expansion through the banking sector. Those who receive this new money first benefit at the expense of those who receive the money only after it has snaked through the economy and prices have had a chance to adjust."
>
> Friedrich A. Hayek (1899-1992), Austrian economist

When Fed Chairman Ben Bernanke says the economic situation is worsening, you'd better believe him. In fact, the U.S. credit markets are collapsing under our very eyes, and there is no end in sight as to when this will stop, let alone reverse itself. 1- Leading economic indicators for the U.S. economy are falling; 2- Consumer confidence sentiment is falling as mortgage equity withdrawals are drying up; 3-employment numbers are falling; 4- the January 2008 report on the U.S. service economy indicates that it contracted early in the year for the first time in 58 months; 5- the number of new jobless claims is still dangerously high; 6- The housing crisis is getting up steam; banks have to place larger and larger subprime losses on their balance sheets, thus undermining their capital bases and bringing many of them to the brink of insolvency; 7- the credit-ratings agencies are under siege; 8- bond guarantee insurance companies are in the process of loosing their triple-A ratings and some are on the brink of bankruptcy; 9- the $2.6 trillion municipal bond market is about to take a nose dive, if and when the bond insurers do not pull it through; 10- the leveraged corporate loan market is in disarray; 11- the more than a trillion dollar market for mortgage- and debt-backed securities could collapse completely if the largest American mortgage insurers continue to suffer crippling losses; 12- large hedge funds are losing money on a high scale and they are suffering from a run on their assets; 13- in the U.S., total debt as a percentage of GDP is at more than 300 percent, a record level (N.B.: in 1980, it was 125 percent!); 14- and, finally, the worldwide hundreds-of- trillion dollar derivatives market could implode anytime, if too many financial institutions go under during the coming months, as most of these transactions are inter-institution trades.

There are a few positive straws in the wind, such as the fact that manufacturing output seems to be holding up pretty well, as the devalued dollar stimulates exports, but the overall economic picture remains bleak. This is a tribute to the U.S. economy's resiliency.

This mess all begun in the early 2000s, and even as far back as the early 1980s, when the Fed and the SEC adopted a hands-off approach to financial markets, guided by the new economic religion that "markets can do no wrong." What we are witnessing is the failure of nearly thirty years of so-called conservative debt-ridden and deregulation-ridden economic policies.

It must be understood that the most recent subprime problem really began in 2000, when the credit-rating agency of Standard & Poors issued a pronouncement saying that "piggyback" mortgage financing of houses, when a second mortgage is taken to pay the down-payment on a first mortgage, was no more likely to lead to default than more standard mortgages. This encouraged mortgage lending institutions to relax their lending practices, going as far as lending on mortgages with no down-payment whatsoever, and even postponing capital and interest payments for some time. And, with the Fed and the SEC looking the other way, a fatal next step was taken. Banks and their subsidiaries decided to follow new toxic and risky rules of banking.

Indeed, while traditionally banks would borrow short and lend long, they went one giant step further: they began transforming long term loans, such as mortgages, car loans, student loans, etc., into short term loans. Indeed, they got into the alchemist business of bundling together relatively long term loans into packages that they sliced into smaller credit instruments that had all the characteristics of short-term commercial paper, but were carrying higher yields. They then sold these new "structured investment vehicles" (SIVs), for a fee, to all kinds of investors who were looking for higher yields than the meager rates that alternatives were paying. And, since banks were behind these new artificial financial assets, the credit-agencies gave them an AAA-rating, which allowed regulated pension funds and insurance companies to invest in them, believing they were both safe and liquid. —They were in for a shock. When the housing bubble burst, the value of real assets behind the new financial instruments began declining, pulling the rug out from underneath the asset-backed paper market, (ABCP) which became illiquid and toxic. With hardly any trading on the new instruments, nobody knew the true value of the paper, and thus nobody was willing to buy it. This crisis of confidence has now permeated to other credit markets and is threatening the entire financial system as the contagion spreads.

As late as 2003-04, then Fed Chairman Alan Greenspan was not the least worried by the subprime-financed-housing-mortgage bubble but was instead encouraging people to take out adjustable-rate mortgages, even though interest rates were at a thirty-year low and were bound to increase. Even in late 2006, newly appointed Fed Chairman Ben Bernanke professed not to be preoccupied by the housing bubble, saying that high prices were only a reflection of a strong economy. Mind you, this was more than one year after the housing market peaked in the spring of 2005. History will record that the Fed and the SEC did nothing to prevent the debt pyramid from reaching the dangerous levels it attained and which is now crushing the economy.

On a longer span of time, when one looks at a graph provided by the U.S. Bureau of

Economic Analysis (BEA) and which shows the relative importance of total outstanding debt (corporate, financial, government, plus personal) in relation to the economy, one is struck by the fact that this ratio stayed around 1.2 times GDP for decades. Then, something big happened in the early 1980s, and the ratio started to rise, with only a slight pause in the mid-1990s, to reach the air-rarefied level of 3.1 times GDP presently, nearly 200 percent more than it used to be.

The adoption of massive tax cuts coupled with government deficit spending policies, and deregulation policies, by the Reagan and subsequent GOP administrations, all culminating in a grotesque way under the current administration, contributed massively to this unprecedented debt bubble. It took many years to build up the debt pyramid, and it will take many years to unwind it and to reduce this cumulative mountain of debt to a more manageable size.

That is the big picture behind this crisis. It is much bigger than the S&L crisis of the 1980s, which looks puny in comparison with the current one. That is why I think this crisis will linger on for at least a few more years, possibly until 2010-11.

Rodrigue Tremblay is professor emeritus of economics at the University of Montreal and can be reached at rodrigue.tremblay@yahoo.com

He is the author of the book 'The New American Empire'

Visit his blog site at: www.thenewamericanempire.com/blog.

Author's Website: www.thenewamericanempire.com /

Check Dr. Tremblay's coming book "The Code for Global Ethics" at: www.TheCodeForGlobalEthics.com /