Trouble in Banktopia: The financial system is blowing up

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The financial system is blowing up. Don't listen to the experts; just look at the numbers. Last week, according to Reuters, "U.S. banks borrowed a record amount from the Federal Reserve nearly $188 billion a day on average, showing the central bank went to extremes to keep the banking system afloat amid the biggest financial crisis since the Great Depression." The Fed opened the various "auction facilities" to create the appearance that insolvent banks were thriving businesses, but they are not. They're dead; their liabilities exceed their assets. Now the Fed is desperate because the hundreds of billions of dollars of mortgage-backed securities (MBS) in the banks vaults have bankrupt the entire system and the Fed's balance sheet is ballooning by the day. The market for MBS will not bounce back in the foreseeable future and the banks are unable to roll-over their short term debt. Game over. The Federal Reserve itself is in danger. So, it's on to Plan B; which is to dump all the toxic sludge on the taxpayer before he realizes that the whole system is cratering and his life is about to change forever. It's called the Paulson Plan, a $700 billion boondoggle which has already been disparaged by every economist of merit in the country.

From Reuters:

> "Borrowings by primary dealers via the Primary Dealer Credit Facility, and through another facility created on Sunday for Goldman Sachs, Morgan Stanley, and Merrill Lynch, and their London-based subsidiaries, totaled $105.66 billion as of Wednesday, the Fed said."

See what I mean; they're all broke. The Fed's rotating loans are just a way to perpetuate the myth that the banks aren't flat-lining already. Bernanke has tied strings to the various body parts and jerks them every so often to make it look like they're alive. But the Wall Street model is broken and the bailout is pointless.

Last week, there was a digital run on the banks that most people never even heard about; a "real time" crash. An article in the New York Post by Michael Gray gave a blow by blow description of how events unfolded. Here's a clip from Gray's "Almost Armageddon":

"The market was 500 trades away from Armageddon on Thursday…Had the Treasury and Fed not quickly stepped into the fray that morning with a quick $105 billion injection of liquidity, the Dow could have collapsed to the 8,300-level – a 22 percent decline! – while the clang of the opening bell was still echoing around the cavernous exchange floor. According to traders, who spoke on the condition of anonymity, money market funds were inundated with $500 billion in sell orders prior to the opening. The total money-market capitalization was roughly $4 trillion that morning.

The panicked selling was directly linked to the seizing up of the credit markets – including a $52 billion constriction in commercial paper – and the rumors of additional money market funds "breaking the buck," or dropping below $1 net asset value."

The Fed's dramatic $105 billion liquidity injection on Thursday (pre-market) was just enough to keep key institutional accounts from following through on the sell orders and starting a stampede of cash that could have brought large tracts of the US economy to a halt." (New York Post)

Commercial paper is the lubricant that keeps the financial markets functioning. When confidence vanishes (because the stewards of the system in Washington are buffoons), investors withdraw their money, normal business operations become impossible, and the markets collapse. End of story. So, rather than restore the public's confidence by strong leadership and behavior designed to reassure investors; President Bush decided to give a major prime-time speech stating that if Paulson's emergency bailout package was not passed immediately, the nation's economy would vaporize into the ether. Go figure?

Last week, the commercial paper market, (much of which is backed by mortgage-backed securities) shrunk by a whopping $61. billion to $1.702 trillion, the lowest level since early 2006. So, Paulson's bailout will effectively underwrite CP as well as the whole alphabet soup of mortgage-backed derivatives for which there is currently no market. The US taxpayer is not only getting into the plummeting real estate market, he is also backstopping the entire financial system including defaulting car loan securities, waning student loan securities, flailing home equity loan securities and faltering credit card securities. The whole mountainous pile of horsecrap-debt is about to be stacked on the back of the maxed-out taxpayer and the ever-shriveling greenback. Paulson assures us that its a "good deal". Booyah, Hank!

PAULSON'S $700 BILLION BOONDOGGLE

How did Treasury Secretary Paulson figure out that recapitalizing the banking system would cost $700 billion? Or did he just estimate the amount of money that could be loaded on the back of the Treasury's flatbed truck when it sputters off to shower his buddies at G-Sax with freshly minted greenbacks? The point is, that Paulson's calculations were not assisted by any economists at all, and they cannot be trusted. It is a purely arbitrary, "back of the envelope" type figuring. According to Bloomberg: Swiss investor Marc Faber, known for a long track record of good calls, believes the damage may come to $5 trillion:

> "Marc Faber, managing director of Marc Faber Ltd. in Hong Kong, said the U.S. government's rescue package for the financial system may require as much as $5 trillion, seven times the amount Treasury Secretary Henry Paulson has requested…. "The $700 billion is really nothing," Faber said in a television interview. "The treasury is just giving out this figure when the end figure may be $5 trillion."(Bloomberg News)

Most people who follow these matters would trust Faber's assessment way over Paulson's. In his latest blog entry, economist Nouriel Roubini said that "no professional economist was consulted by Congress or invited to present his/her views at the Congressional hearings on the Treasury rescue plan." Roubini added:

"The Treasury plan is a disgrace: a bailout of reckless bankers, lenders and investors that provides little direct debt relief to borrowers and financially stressed households and that will come at a very high cost to the US taxpayer. And the plan does nothing to resolve the severe stress in money markets and interbank markets that are now close to a systemic meltdown."

Roubini is right on all counts. So far, more than a 190 prominent economists have urged Congress not to pass the $700 bailout bill. There is growing consensus that the so-called "rescue package" does not address the central economic issues and has the potential to make a bad situation even worse.

BANKER'S COUP?

Financial industry rep. Paulson is the ringleader in a banker's coup the results of which will decide America's economic and political future for years to come. The coup leaders have drained tens of billions of dollars of liquidity from the already-strained banking system to trigger a freeze in interbank lending and hasten a stock market crash. This, they believe, will force Congress to pass Paulson's $770 billion bailout package without further congressional resistance. It's blackmail.

As yet, no one knows whether the coup-backers will succeed and further consolidate their political power via a massive economic shock to the system, but their plan continues to move jauntily forward while the economy follows its inexorable slide to disaster.

The bailout has galvanized grassroots movements which have flooded congressional FAXs and phone lines. Callers are overwhelmingly opposed to any bailout for banks that are buckling under their own toxic mortgage-backed assets. One analyst said that the calls to Congress are 50 percent "No" and 50 percent "Hell, No". There is virtually no popular support for the bill.

From Bloomberg News: "Erik Brynjolfsson, of the Massachusetts Institute of Technology's Sloan School, said his main objection "is the breathtaking amount of unchecked discretion it gives to the Secretary of the Treasury. It is unprecedented in a modern democracy."

"I suspect that part of what we're seeing in the freezing up of lending markets is strategic behavior on the part of big financial players who stand to benefit from the bailout," said David K. Levine, an economist at Washington University in St. Louis, who studies liquidity constraints and game theory." (Mish's Global Economic Trend Analysis http://globaleconomicanalysis.blogspot.com/2008/09/take-back-america.html)

Brynjolfsson's suspicions are well-founded. "Market Ticker's" Karl Denninger confirms that the Fed has been draining the banking system of liquidity in order to blackmail Congress into passing the new legislation. Here's Denninger:

"The Effective Fed Funds rate has been trading 50 basis points or more below the 2% target for five straight days now, and for the last two days, it has traded 75 basis points under. The IRX is demanding an immediate rate cut. The Slosh has been intentionally drained by over $125 billion in the last week and lowering the water in the swamp exposed one dead body – Washington Mutual – which was immediately raided on a no-notice basis by JP Morgan. Not even WaMu's CEO knew about the raid until it was done….The Fed claims to be an "independent central bank." They are nothing of the kind; they are now acting as an arsonist. The Fed and Treasury have claimed this is a "liquidity crisis"; it is not. It is an insolvency crisis that The Fed, Treasury and the other regulatory organs of our government have intentionally allowed to occur."

Bingo. This is a banker's coup cooked up and facilitated by the deep-money guys who operate stealthily behind the political sideshow. The only time they emerge from their stinkholes is when they're flushed out by a crisis that threatens their continued dominance. Grassroots resistance, spearheaded by Internet bloggers (like Mish, Roubini and Denninger) are demonstrating that they can mobilize tens of thousands of "peasants with pitchforks" and be a factor in political decision making. It also helps to have elected officials, like Senator Richard Shelby, who stand firm on principle and don't faint at the first whiff of grapeshot (like his weak-kneed Democratic counterparts) Shelby has shouldered the full-weight of executive pressure which has descended on him like a Appalachian rockslide. As a result, there's still a slight chance that the bill will have to be shelved and the industry reps will have to go back to Square 1.

Market Ticker has provided charts from the Federal Reserve that prove that Bernanke has withdrawn $125 billion from the banking system in the last 4 days alone to create a crisis situation that will incite credit market mayhem and increase the liklihood of passing the bill. This is coercion of the worst kind. http://market-ticker.denninger.net/archives/2008/09/24.html

The country's economic predicament is steadily deteriorating. Orders for manufactured durable goods were off 4.5 percent last month while inventories continued to rise. Unemployment is soaring and the housing crash continues to accelerate. Credit Suisse now expects 10.3 million foreclosures (total) in the next few years. Numbers like that are not accidental, but part of a larger scheme to use monetary policy as a way to shift wealth from one class to another while degrading the nation's overall economic well-being. More alarming, the country's primary creditors are now staging a rebellion that is likely to cut off the flow of capital to US markets sending the dollar plummeting and triggering a deflationary credit collapse. This is from Reuters:

"Chinese regulators have asked domestic banks to stop lending to U.S. financial institutions in the interbank money markets to prevent possible losses during the financial crisis, the South China Morning Post reported Thursday. The China Banking Regulatory Commission's ban on interbank lending of all currencies applied to U.S. banks, but not to lenders from other countries, the report added."

Bloomberg News reports that Dallas Federal Reserve Bank President Richard Fisher has broken with tradition and lambasted the proposed bailout saying that it "would plunge the U.S. government deeper into a fiscal abyss."

From Bloomberg: "The plan by Treasury Secretary Henry Paulson to buy troubled assets from financial institutions would put 'one more straw on the back of the frightfully encumbered camel that is the federal government ledger,' Fisher said today in the text of a speech in New York. 'We are deeply submerged in a vast fiscal chasm.'…The seizures and convulsions we have experienced in the debt and equity markets have been the consequences of a sustained orgy of excess and reckless behavior, not a too-tight monetary policy," Fisher said to the New York University Money Marketeers Club." (Bloomberg)

Surely, the cure for hyperbolic "credit excesses and reckless behavior" cannot be "more of the same." In fact, Paulson's bailout does not even address the core issues which have been obscured by demagoguery and threats. The worthless assets must be written-down, insolvent banks must be allowed to go bust, and the crooks and criminals who engineered this financial blitz on the nation's coffers must be held to account.

The carnage from Greenspan's low interest rate, "easy money" binge is now visible everywhere. Inflated home and stock values are crashing as the gas continues to escape from the massive equity bubble. The FDIC will have to be recapitalized–perhaps, $500 billion–to account for the anticipated loss of deposits from failing banks caught in the cross-hairs of asset-deflation and steadily contracting credit. Recession is coming, but economic collapse can still be avoided if Paulson's misguided plan is abandoned and corrective action is taken to put the country on solid financial footing. Market Ticker lays out framework for a workable solution to the crisis, but they must be acted on swiftly to rebuild confidence that major systemic changes are underway:

1–Force all off-balance sheet "assets" back onto the balance sheet, and force the valuation models and identification of individual assets out of Level 3 and into 10Qs and 10Ks. Do it now. (Editor: In other words, no more Enron-type accounting mumbo-jumbo and no more allowing the banks assign their own "values" to dodgy assets)

2–Force all OTC derivatives onto a regulated exchange similar to that used by listed options in the equity markets. This permanently defuses the derivatives time bomb. Give market participants 90 days; any that are not listed in 90 days are declared void; let the participants sue each other if they can't prove capital adequacy.(Ed: If trading derivatives contracts can damage the "regulated" system, than that trading must take place under strict government regulations)

3–Force leverage by all institutions to no more than 12:1. The SEC intentionally dropped broker/dealer leverage limits in 2004; prior to that date 12:1 was the limit. Every firm that has failed had double or more the leverage of that former 12:1 limit. Enact this with a six month time limit and require 1/6th of the excess taken down monthly. (Ed: The collapse in the "structured finance" model is mainly due to too much leverage. For example, Fannie Mae and Freddie Mac had $80 of debt for every $1 dollar od capital reserves when they were taken into government conservatorship)

If there's going to be a bailout, let's get it right. Paulson's $700 billion bill does nothing to fix the deep structural problems in the financial markets; it merely pushes the day of reckoning a little further into the future while shifting the burden of payment for toxic assets onto the taxpayer. It's a real turkey. The entire system needs transformational change so that the activities of Wall Street mesh with the broader objectives of the society it's supposed to serve. Paulson's business-model is busted; it does no one any good to try to glue it back together.

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