

The Global House of Cards Is Collapsing

by Helga Zepp-LaRouche

The core meltdown of the world financial system, which has been in preparation for a long time, has now occurred, with the collapse of the subprime mortgage market in the United States. Beginning with two hedge funds belonging to Bear Stearns, a series of such funds have gone to ground due to speculative failures, and the turbulence has finally spilled over into the international markets and implicated financial institutions in Germany, France, Great Britain, and Australia. And that is only the beginning.

While most of the press internationally is in full cover-up mode, the near collapse of the German “industrial credit bank” IKB has shocked some in Germany into recognizing the situation (see accompanying article). Jochen Sanio, head of the German banking regulatory agency BAFIN, admitted that this amounted to the “worst banking crisis in Germany since 1931.” According to the *Süddeutsche Zeitung*, the “whole German banking system” was in danger, which was obviously the reason for a temporary rescue of the IKB by the German government and the Kreditanstalt für Wiederaufbau (Reconstruction Finance Agency), at the tune of 8.1 billion euro (over \$11 billion).

But this is only the tip of the iceberg; more U.S. mortgage banks, such as American Home Mortgage, are in serious distress. One reason for that lies in the practice of so-called “adjustable mortgages,” whereby the buyers can acquire real estate they cannot afford, and in which, for a certain period of

time, rather low interest rates on the mortgages fall due, but then, after a prescribed period, at most two years, are automatically raised. When the higher rate goes into effect, the payments rise in the range of hundreds of dollars per month. The adjustable mortgage market went into full swing in the Spring of 2005, thus, an avalanche of increases in the rates has occurred precisely at the present time.

All in all, increases in the interest rates on adjustable rate mortgages affect 12% of all mortgages in the United States, raising mortgage payments by a trillion dollars. In October alone, mortgages will be jacked up by over \$50 billion, and eventually all categories of mortgages will be threatened. According to Moody’s Economy.com, between 1995 and 2005, about 3.2 million homeowners bought houses on the basis of subprime mortgages or similar credit-terms, and thus, it is expected that about 2 million of these homes will be lost in the next months. The flood of housing foreclosures has led to a dramatic collapse in real estate prices; because of the exposed position of the financial institutions, it will become considerably harder to get new mortgages, and the effect on the real economy, including jobs in the construction sector, will be catastrophic.

End of the Yen Carry Trade

Much more dramatic than this situation, is the fact that the collapse has been accelerated by another process with very much more far-reaching consequences, namely the drying-up of the Japanese yen carry trade. With it, dried up the paradise of cheap liquidity, which for years permitted investors to borrow advantageously in yen at a zero interest rate, in order to invest in higher-interest-rate sectors around the world. The flood of liquidity from this source amounted to \$500 billion, which has been as good as cut off. In the face of rising interest rates, now speculators who have contracted cheap yen credit, and were met with losses in the American mortgage market and in the hedge funds, have sought desperately to turn their investments into cash in order to pay back their yen loans, which has led to an up-valuation of the yen. Again, this increases the losses of the speculators. The reverse leverage,

leading to the collapse of the speculative pyramid, is in full swing.

Banks and financial institutions are suffering from a kind of withdrawal shock. Because, while the takeover mania by the hedge funds and private equity funds has recently reached dimensions never known before—worldwide, the hedge funds in the first half of 2007 have taken over companies worth \$2.3 trillion—they are sitting on a debt mountain of \$1.5 trillion, of which a portion, in light of the always growing reach of the capital markets, threatens to become bad debt. The credit institutions, in a panic, are trying to get these debts off their books by year's end, because they could otherwise not undertake any new financial operations. For the market of mergers and takeovers, the honeymoon is definitely over.

Analysts from *Crédit Suisse* are warning that the banks are having great difficulties in selling new bonds—if they can't do this, the credit lines to the hedge funds and other market participants must be cut off, which must lead again to a cascade of liquidations.

We are now experiencing how the greatest liquidity bubble in the history of the financial markets is beginning to burst. Lyndon LaRouche incisively recognized the beginning of this development when he identified Nixon's intervention on Aug. 15, 1971, namely the loosening of the fixed-exchange-rate system, the separation of the dollar from the gold reserve standard, and the creation of the Eurdollar market, and with it, of private credit creation, as the beginning of a process which would lead to a new depression.

Alan Greenspan, who can take dubious credit for his part in this development, going down in history as "Mr. Bubble," is responsible for the recent explosion of the casino economy. After the Crash of 1987, which showed parallels with "Black Friday" of 1929, he had the glorious idea of inventing "creative financial instruments." To that category belonged, among other things, credit derivatives. By 1998, the volume of credit derivatives amounted to \$180 billion. When, in September of 1998, the LTCM hedge fund, in the context of the Russian state bankruptcy and the GKO crisis, threatened to go bankrupt, the G-8 nations decided to set a huge liquidity-pumping machine into motion. In 2006, the volume of the "wonder-weapons" of financial transactions, the so-called collateralized debt obligations (CDOs), reached a fabulous \$3 trillion.

Through these "structural products," the bankers package credit risks of totally different kinds of debtors into bundles, divide them into different classes of risk, and sell them to investors. The defenders of this practice argue that the hedge funds thereby play a positive role, because they spread the risk onto many shoulders. This theory has only one devastating flaw: As long as all asset prices are rising, everything functions wonderfully—because there is also no risk; but at the moment a reverse-leverage collapse sets in, the linkage between the different market segments through the hedge funds drags the whole system into collapse.

A Drying Up of Liquidity

A further problem arises from the fact that, through the instrument of the credit derivatives, a house of cards has been built up. The difference between creditors and debtors is wiped out, the debtor appears at the next moment as a creditor to another debtor, who again gives out credits from his side, and so on. This is, at the same time, the mechanism for the wondrous multiplication of money. Because when the market participant receives such a loan, this loan becomes the reserve capital for loaning a new credit to someone else. And thus, a further spiral goes into effect. Greater credit issuance provides more room for greater securitization; the creation of more liquidity again allows for greater credit issuance.

As they say, as long as the speculative bubble can inflate further, as long as the credit issuance increases, everything is fine (at least in the monetary realm, but not in the real economy, which has been sacrificed in this process). But if, as now, in the event of poor quality mortgage markets, there comes a break, and, as a result of the drying up of the liquidity pump which follows from the end of the yen carry trade, there occurs a reverse-leverage process in this pyramid, then the illusion bursts, and the system crashes. What we experience today, is the psychologically highly interesting process of how limitless greed, in the nature of physical lust, turns, almost overnight, into limitless angst. If no one believes any more that the emperor has new clothes, everyone sees that he is naked.

At the moment that the subprime mortgages, which were bundled into interest-bearing securities such as CDOs, fell in value, the banks and other financial institutions could no longer loan or borrow on the basis of these CDOs, as reserve capital or collateral. As a result, the global wave of liquidity dried up. A further aspect of the sell-off began when the banks had difficulties in financing the takeover of Chrysler through the private equity firm Cerberus (the locust fund which significantly bears the name of the hound of Hell).

Then where do we stand? Are those right, who say that there need only be a "straightening out" of the markets, and a little bloodletting, and then let the central bankers and established powers again take control?

It is interesting that an unorthodox newsletter in France, *La Chronique Agora*, asked July 31, under the headline, "Stockmarket Crash: Can You Still Escape?" The writer answered: "I don't think so. This time the crisis is too deep and the worry well installed.... This time the alert on the credit markets is of unprecedented magnitude. Long minimized, its gravity is becoming more obvious each day.... The ongoing phenomenon marks the end of an epoch: that of the illusion of unending world liquidity."

The next weeks will leave no doubt that Lyndon LaRouche is right, and all his critics will be discredited. There is nothing to expect from the Bush Administration, as long as Vice President Dick Cheney remains in office. Therefore, everything depends upon whether the world heeds what former Mexican President José López Portillo recommended in 1998: "Listen to the wise words of Lyndon LaRouche."