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U.S. Bankers Herald Financial Breakdown

by Nancy Spannaus

President George W. Bush, and most of the financial pages of the U.S. press, may still be touting the "wonderful economy" in the United States, but over recent days, warnings of a systemic crisis, and impending financial blowout, have been issued by leading representatives of major U.S. financial institutions. All are talking of the risk of out-of-control financial chaos, as a result of the massive, unpayable debt bubble created by Alan "Derivatives" Greenspan. There is not a hint of a *solution* to the onrushing crisis in any of these alarums, but, as Lyndon LaRouche noted in his Nov. 16 webcast, if they serve to wake people up to the danger ahead, they will be useful indeed.

Until now, with the exception of New York Federal Reserve head Timothy Geithner, warnings about imminent implosion of the doomed financial bubble have come from European personalities, especially in London. Now, it appears that reality is about to strike home.

Danger to the Dollar

Former Clinton Treasury Secretary Robert Rubin, now an executive at Citigroup, has been up-front for months in warning of the unsustainability of the Greenspan "wall of money" economy. In statements widely circulated on the Bloomberg financial wire Nov. 15, Rubin said the failure to stem the growing U.S. budget deficit may spook the central banks, hedge funds, and others who have been buying U.S. Treasury notes. "It seems almost inconceivable that this will continue indefinitely," Rubin said, in a videotaped message for a dinner hosted by the Concord Coalition. In a panel discussion at the event, former Federal Reserve chairman Paul Volcker concurred, saying that the U.S. borrowing requirements raise the risk of "crisis." "It's incredible people have gone on so long holding dollars. At some point, you will get a situation where people have had enough."

While the time frame Rubin cited for a dollar collapse—two and a half years—is highly understated, he has done his best to convey a sense of urgency about the crisis which the unsustainable borrowing, and speculation, promoted by the Bush Administration, has created.

On Nov. 16, a report by the Treasury Department confirmed the directionality Rubin has been pointing to. Foreign capital flows into the United States in September were at "only" $53 billion, starting to fall below the level of funding the monthly U.S. current account deficit. After eight to nine months of inflow in the $80-$100 billion range, it dropped in August to about $65 billion. Net purchase of U.S. Treasuries was also at just about $53 billion, with a net foreign sell-off of short-term T-Bills, and big inflow into long-term T-Notes and Bonds.

While the value of the U.S. dollar is already falling, the collapse in foreign capital inflow could turn it into a rout.

Those Ballooning Derivatives

On Nov. 10, none other than Administration insider, Comptroller of the Currency John C. Dugan, issued his own warning about the danger of a shock to the financial system. He spoke to the New York Bankers Association meeting in Phoenix, Arizona, specifically on the question of derivatives.

Although Dugan's statement was couched in all sorts of reassuring language about the ability of the large banks to "control" the situation, to anyone in the know, his message read more like a warning. Derivatives (i.e., gambling) dominate the world financial environment, whether individual banks are involved in them or not, Dugan emphasized, and if

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Comptroller of the Currency John C. Dugan, smiling but warning of the danger of a shock to the financial system.

James B. Lockhart III, director of the Office of Federal Housing Enterprise Oversight, warned of the "systemic events" that could be precipitated by the housing bubble.

the large U.S. commercial banks—which represent 20% of the total global volume of derivatives—should stumble, that would affect the health of all banks in the United States (he could have also said, the world).

Why should all bankers be concerned about "risks" in the derivatives markets? Dugan asked rhetorically. "Because significant mismanagement of these risks could precipitate market disruptions that affect public confidence in financial institutions generally."

With one in six national banks using derivatives, he said, total credit exposure has now hit $199 billion. This, he stressed, is much less than the total notional value of outstanding derivatives, $119 trillion (an understated figure, according to *EIR* estimates), but vigilance is required. There must be "constructive cooperation between government and the industry," Dugan said, citing the President's Working Group on Financial Markets (known as the Plunge Protection Team, for its obvious work in pumping liquidity into failing stock markets), and cooperation between derivatives traders and supervisors as examples.

In moving to the question of risk, Dugan understates the case, but, in bankers' language, he succeeds in conveying the danger. I quote:

"As I've already noted, at $199 billion, the net current credit exposure numbers in the banking system are very large. . . [discussion of how derivatives traders demand additional collateral]. In sum, the very large amount of net current credit exposures arising from derivatives activities of large banks is not quite as worrisome as it may first appear. . . .

"Nevertheless, *derivatives credit exposure remains a real and quite significant risk.* Fierce competition can have the effect of reducing the level of collateral protection that banks require. Unexpected market disruptions or other stress events can produce dramatic increases in credit exposures that can blow through the collateral required for more predictable market scenarios. Many derivatives counterparties are highly leveraged, producing less room for error in credit judgments. And the balance sheets of such counterparties are frequently opaque, making it impossible for bank dealers to assess risks embedded in 'away trade' that don't involve that bank. For all these reasons, we and other regulators will continue to closely monitor margin levels, stress testing, scenario analysis, and other tools that derivatives dealers need to use effectively to manage derivatives credit risk" (emphasis added).

Of course, monitoring will *not* stop a blowout, which could occur any day.

That Imploding Real Estate Bubble

Another U.S. financial overseer, director of the Office of Federal Housing Enterprise Oversight James Lockhart, weighed in with a warning on Nov. 9, involving the thoroughly alarming and dramatic statistics on the melting U.S. housing bubble. Also speaking to the New York Bankers Association conference, Lockhart called for bank-regulatory-like powers in order to address "significant" implications to financial markets and institutions of the potential "severe financial difficulties" at the "highly leveraged" Federal mortgage lending agencies known as Fannie Mae and Freddie Mac.

As of the end of 2005, these two government-sponsored enterprises together owned or guaranteed more than 40% of the residential mortgages in the United States, or about $4 trillion in debt, including mortgage-backed securities. Such rapid growth of portfolios held by Fannie/Freddie, he insisted, has increased "their own potential for causing systemic events."

Banks now face great risk through their overwhelming exposure to mortgage debt, which has since 2000 grown so explosively that it dominates bank and brokerage assets—and which is now falling more and more sharply, as plunging rates of new home starts reported again on Nov. 17, clearly showed. Lockhart said. "In particular, banks with large amounts of this debt could experience losses and liquidity problems, "resulting in a reduction in bank lending or even bank failures." More than 60% of banks held Fannie/Freddie debt, and mortgage-backed securities, and in combination these are worth over 50% (!) of those banks' Tier 1 capital, as of the end of 2005. Many mortgage lenders also "would have difficulties maintaining their business models," Lockhart said blandly.

In fact, none of these impending crises—in the banks, derivatives markets, and housing market—can be prevented, or dealt with, without junking the current bankrupt system, dumping masses of unpayable speculative debt, and putting the financial system back on a sound basis. If these warnings result in alerting policy-makers to study that solution, which has been put forward by Lyndon LaRouche, they will have served a good purpose.