BANKING CRISIS:

Recovery Is Possible Only if Central Bank Bailouts Stop

by Paul Gallagher

Do not watch the stock markets, or the wildly fluctuating levels of "confidence" in them; they are merely the tail of the global banking and credit crisis which has hit, and the tail is not wagging the dog. The condition of the globalized international credit markets, and banking systems, has steadily deteriorated since the end of July, and the liquidity drought is getting worse day by day, despite the multi-hundred-billions in cash injections by central bankers to the world's banking systems.

This is what economists, bankers, and money managers in the United States and Europe have told *EIR* without exception, over the first three weeks of August.

Since late July, both of the two "bookends" of Sir Alan Greenspan's last and greatest debt bubble have been collapsing in on it: the U.S. mortgage-securities bubble, on which the banks of Europe and Asia were feeding, and which had already grown to 49% of all bank assets in the United States; and the now-unwinding "yen carry trade," which was feeding some $500 billion annually in "free money," by some estimates, into that and related financial bubbles. That cheap-yen carry trade shrank as the yen rose steadily against the dollar during August, and more rapidly against the euro and, especially, the British pound sterling.

By the second half of August, financial news services were also reporting that the $1 trillion-plus asset-backed commercial paper (ABCP) market was in crisis, and thus the credit-market meltdown was starting to hit the savings of the general public directly. Some 40 million Americans, for example, invest savings in "money-market funds"; and those funds commonly invest in ABC paper because it is supposed to be both very safe—keeping the constant $1 value of every share in those money-market funds—and very liquid, allowing people to write checks on those funds.

Now, the ABC paper market is apparently anything but safe, and anything but liquid, with one big British bank, HBOS, attempting to organize a rescue Aug. 21 of its ABPC fund which could neither roll over, nor redeem, $30 billion of the stuff. The entire Canadian ABCP market froze up in the week of Aug. 13, and when temporarily bailed out, some of that "immediately liquid" commercial paper involuntarily became eight-year loans! One Canadian economist told *EIR* that the money-market funds—worth about $3 trillion total—have $100 billion invested in ABC paper, and another $100 billion in the mortgage derivatives called collateralized debt obligations (CDOs) which are laying low hedge funds and banks around the world.

The failures of major hedge funds, and banks, is now a matter of time. By early Fall, in the judgment of Lyndon LaRouche, the financial system will be unable to continue functioning, without bankruptcy reorganization carried out by governments to save their people's jobs, homes, and savings, and to invest in restoring their productivity.

Central Banks' Folly

The case of America's biggest mortgage lender, the $200 billion-asset Countrywide Financial Corp., is vital not only because its looming collapse involves the credit of the U.S. government-backed housing/mortgage enterprises known as Fannie Mae and Freddie Mac, but because the Countrywide case shows the folly of the bank-bailout policies pursued in this crisis so far by the Federal Reserve, European Central Bank, and other central banks.

Some $400 billion in *extraordinary* injections of central bank liquidity, into the banking systems, were carried out Aug. 9-21, and are still continuing.

On Aug. 16, a big chunk of that new Federal "bank bailout

credit" clearly went to save Countrywide, which, as a Merrill Lynch analysis had just reported, was staring at a huge bankruptcy. Countrywide had been originating 17% of all new mortgages and home loans in the U.S. residential real estate bubble, and had accounted for fully one-third of all the mortgages being purchased by Fannie Mae and repackaged into mortgage-backed securities (MBS).

Even as the Federal Reserve injected $17 billion into the banking system on the morning of Aug. 16, an $11.5 billion emergency credit line for Countrywide was provided by 40 banks, organized by Treasury Secretary Henry Paulson and at the insistence of the Fed. One of those banks, for example, Impac Mortgage Holdings, was a real estate investment trust whose stock had fallen 80%; yet it put $500 million into that credit line. Another emergency lender, Capital One Financial Corp., had to shut down its own mortgage company four days later, laying off 1,900 employees.

The connection between the Fed injection into the banks, and the banks' bailout of Countrywide, was unmistakable. Equally unmistakable was the source of the $2 billion that the Goldman Sachs investment bank used to attempt to bail out one of its failing hedge funds, Global Equity Opportunities Fund, on Aug. 13. But the Countrywide salvage operation was a much more massive use of an emergency injection of Federal credit to try to save a huge financial corporation and its mortgage-backed securities. The day after the $11.5 billion credit line was organized, the Fed lowered its discount lending rate to banks by 0.5%, and New York Fed governor Timothy Geithner called the major banks, begging them to borrow from the Fed against their (so-called) AAA-rated (failing) MBS.

For the real economy of the United States, this attempted salvage of Countrywide did no good whatsoever. Countrywide's debt now being rated "distressed," the banks giving the credit line set interest rates too high for the loan to be used to originate new mortgages. Countrywide had already cut back its mortgage originations 15% from June to July, and announced on Aug. 16 more categories of mortgages it would no longer offer, and higher interest rates on those it would offer. It also immediately began laying off employees. What purpose, then, the $11.5 billion in credit lines—which Countrywide immediately drew down in full? Simply to enable the huge company to continue to refinance, and to buy back its MBS outstanding—to bail out Wall Street's mortgage securities holders.

Further, the salvage of Countrywide will not work. Its stock price fell so far after the credit line was announced that it triggered a general stock selloff on Aug. 16. After briefly and partially recovering, it fell 7.6% further on Aug. 20. Countrywide Bank, which boasts $100 billion in assets, had to start offering 5.50% on its (Federally insured) money-market accounts with balances over $10,000, the highest yield offered by any bank in the country, to try to stop a panicked run by depositors which began Aug. 16. Since Countrywide can't invest its money-market funds into commercial paper—that market is in crisis—it must invest them in short-term Treasury securities, paying Countrywide only half that 5.50% rate. So it is subsidizing its accounts—using the Federal credit-based bailout—to keep investors from taking their money elsewhere.

The bankruptcy of Countrywide, had it been allowed to occur, would not have thrown mortgage holders from their homes or damaged the underlying "real economy" of the United States. But the bailout of Countrywide, aiming to save rotting MBS financial paper and derivatives contracts, *does* damage the real economy.

An Unsalvageable Bubble

Nearly half a trillion dollars of extraordinary central-bank injections of funds into banks, *for just such purposes*, have been provided in just three weeks since the failure of the Bear Stearns and other hedge funds, and the near-failure of Germany's IKB bank on Aug 2. Despite the pious claims by the Federal Reserve and its cheerleaders in the Wall Street media, that "it is only intervening to prevent the financial crisis from harming the economy," its interventions have precisely the purpose of saving the toxic-to-radioactive MBS and their derivatives, which have blown the whole international banking system into an unsalvageable bubble.

These interventions do not save hedge funds and bank funds for more than a few days or weeks; they do harm the economy, and if kept up, they will accelerate into a disastrous, Weimar-style hyperinflation of money supply. By the beginning of September, half of the entire $1.1 trillion asset-backed commerical paper market has to be rolled over, with private banks unwilling or unable to do so for the investment funds which they themselves created. Major mortgage-lending banks, probably including Countrywide, will be going bankrupt, and Moody's Investment Service has already posted the sign that says, "Huge hedge fund failures dead ahead." If the central banks are not stopped from rushing the bailout injections of cash to the banks for every seized-up market, they will collapse the dollar and trigger an inflation which deeply wounds the economy.

At least European Central Bank head Jean-Claude Trichet admitted, in an anguished statement Aug. 17, that the financial system he and Fed chairman Ben Bernanke were directing, requiring a 15% increase in money supply to get any claimed GDP growth, "has gone mad."

As Lyndon LaRouche has put it repeatedly, the real economy cannot be saved and returned to real long-term growth, without ceasing the fruitless attempt to salvage the speculative paper of Greenspan's bubbles. New Federal bank agencies need to be set up, LaRouche said, to create new economic infrastructure investment, and to take charge of the writing down of inflated mortgages into sound, fixed-rate mortgages while protecting the households involved from a mass of foreclosures.