Greater Financial Collapse Looms in 2017; Glass-Steagall Must Be Restored To Stop It

by Paul Gallagher

April 29—Ten years ago the cover feature of this magazine's March 23, 2007 issue was titled, "How U.S. Mortgage Crisis Can Trigger Global Crash." Analyzing the exposure of the post-Glass-Steagall megabanks of the United States and Europe, to the securities and derivatives related to the then-$11 trillion mortgage bubble, *EIR* warned of the blowout which would accelerate over the following 18 months, leading to full-blown global bank panic in September 2008. We emphasized that Lyndon LaRouche was the only economist who had foreseen this.

In meetings with elected officials over the weeks following the publication of that article, leading Members of Congress and others rejected *EIR*'s warning as impossible. A decade earlier, the Glass-Steagall Act had been eliminated after it had preserved banking system stability against panics and crashes for 60 years. In early 2007, the idea that this was bringing on a general financial crash within less than 10 years, was dismissed out of hand.

EIR Editor-in-Chief Lyndon LaRouche's July 2007 proposal to stop the coming crash with emergency legislation, combining Glass-Steagall bank reorganization with a national moratorium on foreclosures, was kept out of Congress by Wall Street, despite broad constituency support.

The blood and tears are still running from the economic collapse, the mass unemployment, and the impoverishment of Americans which that 2008 crash brought on. Again the choice was posed in 2009-2010: Restore Glass-Steagall to prevent this from happening again, or accept Obama's Wall Street-approved substitute, the Dodd-Frank Act. Again, the wrong choice was made.

Now *EIR* is warning that another, worse collapse is looming, this time from the Wall Street megabanks' exposure to an even larger bubble in speculative corporate debt which is showing alarming patterns of defaults.

The Signs of Crisis

• The debt of U.S. non-financial corporations has reached over $13.5 trillion—$11 trillion owed to banks

wikipedia

It is up to the U.S. Congress to restore the Glass-Steagall Act. Here, the U.S. Capitol, home of Congress.

and the remainder to "shadow banks" such as money market mutual funds, pension funds, and similar funds. That debt has grown from $8 trillion in 2008—by 75% in eight years. **Figure 1** shows the extraordinary rate at which the banks' portion—only—of that debt bubble grew, both leading into the 2008 crash and after it, up through mid-2015. Feeding this explosion of corporate debt was the vast money-printing of the central banks of the United States, UK, Japan, and the Eurozone: their $15 trillion in lending facilities to big banks, with effective zero interest rates, is now in the tenth consecutive year for these central banks.

FIGURE 1
Nonfinancial Corporate Debt

• That debt growth has levelled off in 2017. Growth in total U.S.-based banks' credit has suddenly dropped from 4.5% to 2% annually; commercial and industrial lending growth stopped entirely six months ago and it is now falling. Bloomberg reported April 26: "Total loans at the 15 largest U.S. regional banks declined by about $10 billion to $1.73 trillion in the first quarter, compared with the previous three-month period, the first such drop in five years, according to data compiled by Bloomberg. . . . A slump in commercial and industrial lending sapped growth." One example from *American Banker* April 25, involving Fifth Third Bank, a large Cincinnati-based regional, was reported as follows: "The withdrawal from auto lending was said to be a conscious choice to reduce lower-return auto originations to improve returns on shareholders equity, while the decline in C&I [commercial and industrial—ed.] lending was described as a deliberate exit."

• In the years since 2013, some 80% or more of this borrowing has been used by larger corporations for "financial engineering"; that is, buying their own stock to drive it up, or buying other companies' stock in mergers and acquisitions which have the same effect. Some $500 billion *each year* has gone into driving up stock market indices, while betting on them. But total non-financial corporations' profits have not increased since 2011; and in the three years since 2013, they have fallen.

• Thus, debt leverage has jumped up. Morgan Stanley bank itself published a detailed research note on April 20 which reported that the ratio of non-financial corporate debt to cash-from-operations is at an all-time-high of 3.2:1 (2.7:1 is the highest it has ever been before, the bank reported). Companies have low and falling "interest coverage," or ability to even pay interest from earnings—coverage levels like those in the 2001 recession and the 2008 crash (**Figure 2**. With debt flying up relative to operating cash, and profits declining, companies can keep servicing debt by borrowing more. But the banks' decision to put the brakes on new credit, means they are aware the bubble has rolled over its top and is headed for big trouble.

• The IMF 2017 "Global Financial Stability Report" finds that in the United States, the debt service to income ratio of non-financial corporations has risen quickly from 37% in 2014, to 41% in 2016. Those corporations have $7 trillion more debt than at the 2008 crash, but $3 trillion *less* equity invested in them.

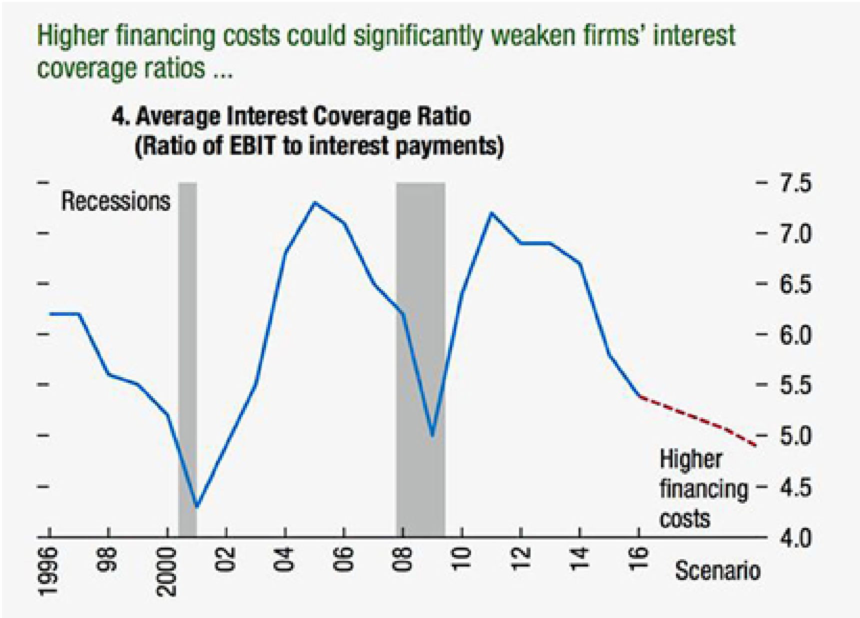
Wave of Defaults Begins

Now increased corporate default rates have appeared like the dark clouds Shelley called "the locks of the approaching storm." A telltale came last week from the top, Goldman Sachs.

Goldman makes corporate and "industrial" loans from its Salt Lake City division. The *Salt Lake Tribune* reported April 24:

> Goldman Sachs's fixed-income revenue was so unexpectedly weak in the first quarter that last week's earnings report left the stock tumbling and Wall Street buzzing over what happened. Traders got burned by a constellation of souring debts. . . . The bank incurred tens of millions of dollars in losses on companies including Peabody Energy and Energy Future Holdings Corp. Borrowings from retailers including Rue 21 Inc., Gymboree and Claire's Stores also soured, the people said.

FIGURE 2



The default rate for all non-financial corporations has jumped from 3.0% at the start of 2016 to 5.0% at its end. It is continuing to rise, and S&P Global Fixed Income Research warns it will be at 5.6% in June. It estimates that 99 U.S. companies will default in the June 2016-June 2017 period, compared to 79 in the preceding year, and the liabilities involved will be 85% higher.

The *Wall Street Journal* reports that 10 retailers with more than $50 million in liabilities filed for bankruptcy in the first quarter of 2017, whereas there were nine such in all of 2016. Some 8,650 retail stores will close in 2017, estimates Credit Suisse research, three times the 2,700 which closed in 2016, and higher than the previous 2008 peak in retail busts.

The default rate for "high-yield" (i.e., subprime) corporate debt had more than doubled in a year to 6% at the end of 2016. (**Figure 3**). And the corporate "subprime" debt bubble—junk bonds and leveraged loans—exceeds $2 trillion.

The IMF, in the "Global Financial Stability Report, 2017" cited above, made the shocking estimate that if U.S. interest rates climb sharply again—as they did in November through January—20% of *all* U.S. corporations could default. That is higher than the highest mortgage default rate ever reached in the crash ten years ago, even for subprime mortgages, which did not exceed $1.5 trillion in debt.

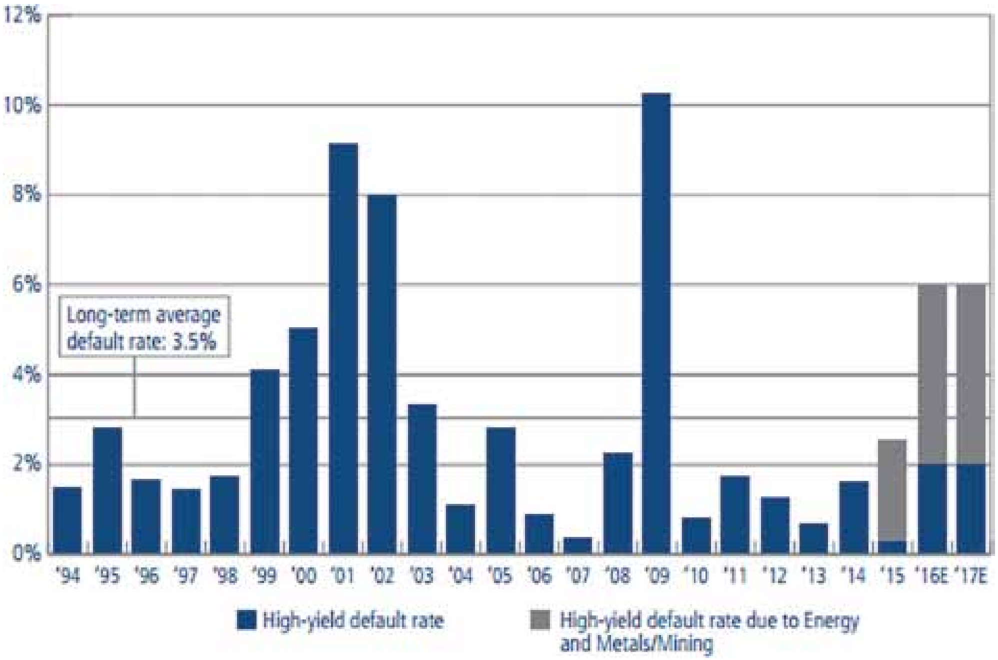
A new report on corporate debt defaults by Standard & Poor's (covering only companies with credit ratings) finds:

"Despite oil prices rising for most of the year, the energy and natural resources sector had increased default activity over an already elevated 2015, and the sector accounted for over 50% of all defaults in 2016. This helped push the corporate default count up to 162." This is double the average annual number since the crash. "These 162 defaulted issuers accounted for $239.8 billion in debt, which is more than double the $110.3 billion total for 2015."

That 2015 rate was already equal to that of 2007; 2016's rate was the highest since the collapse of 2009. S&P's report is global; but 68% of all the debt originated in, or is held by. U.S.-based financial institutions.

Defaults have gone still higher in credit card and

FIGURE 3
Corporate Debt Default Rate



auto loan debt, and are above 25% in student loan debt; but none of these bubbles is near the size of the deteriorating corporate debt bubble.

No Growth Increases the Danger

The gigantic bubble of corporate debt used for own-stock-buying, mergers and acquisitions, financial engineering, and general Wall Street-pumping, is made more unpayable, and more dangerous, by the continuing lack of economic growth, productivity growth, or growth in business capital investment. The miserable 0.7% rate of GDP growth in 2017's first quarter was a sign of the hole the underlying economy is sliding into, unless entirely different policies are adopted immediately.

The practices major banks engaged in 10-11 years ago—to "dump" their exposure to toxic mortgage derivatives debt onto other funds and individual savers around the world before it became worthless—were fully exposed in 2011 hearings of then-Sen. Carl Levin's Senate Permanent Investigations Subcommittee. They were dramatically revealed in the book and movie, *The Big Short*. Those practices were not enough to save the big banks from their own losses, and those were bailed out with tens of trillions in taxpayer loans, investments, and guarantees.

Now the same banks, 30-40% larger from absorbing 2,000 small banks which disappeared, are doing the same thing with their corporate debt and related categories like subprime auto loans: turning off the credit spigot, packaging the loans into securities, and then dumping them along with derivatives—JPMorgan and Wells Fargo are even lending to money managers so as to sell them more of the trash.

To stop those banks' increasing practices, at this moment, of repackaging and transferring the risk from this huge mass of endangered debt and derivatives to their own depositors and to taxpayers, Glass-Steagall *must* be restored now before the mass of increasingly unpayable debt collapses.

This critical situation underlies the sudden appearance of high-profile attacks on Glass-Steagall in leading media of New York, London, and Washington, D.C. Glass-Steagall is the wolfsbane of Wall Street and the City, and they fight it even more aggressively as a crisis rises around them. *All* of the attacks date from the April 5 introduction of the Senate 21st Century Glass-Steagall Act, and the reporting that its sponsors (now six) had received some form of encouragement from President Trump's head of the National Economic Council, Gary Cohn.

The attacks on Glass-Steagall, in number, volume, and tone have become indicative that the City of London and Wall Street, knowing the signs of an approaching financial crisis, are very nervous about Glass-Steagall's prospects and are commissioning well-fed "scholars" and "fellows" to try to debunk it. American elected officials, dangerously, are not aware of those signs or have dismissed them.