

# What Glass-Steagall Will Do

*EIR Economics Editor Paul Gallagher engaged in this dialogue with LaRouchePAC organizers on Jan. 24, 2013.*

**Q:** In our intelligence update today, we received very interesting reports, particularly from Europe, indicating that there may be a blowout in the European banking system, particularly that in France, and I wondered if you could say something about how close you see us being to a crash, and how would you compare the current situation in terms of the imminence of a blowout to where we stood in 2007-08.

**Gallagher:** Well, first of all, the signs that a crash is imminent, or that the potential for it is very strong, is something that you've already been discussing. This Lanny Breuer [outgoing head of the Justice Department Criminal Division] episode with the HSBC bank and his fear—refusal on principle, perhaps, but also fear—of prosecuting it, is a very clear indication. No one with any familiarity with this case doubted that HSBC had committed some very serious crimes over an extended period of time.

It had been documented by the Senate Permanent Subcommittee on Investigations. That committee had referred it to the Justice Department, and effectively called for the bank to be prosecuted. To step back from any prosecution was an extraordinary step, and Breuer acknowledged—sort of blurted out on a couple of occasions—that he just couldn't do it. That he wouldn't do it, and he couldn't do it.

If he had prosecuted the bank, he would have wound up almost necessarily removing its license to do business in the U.S. as a bank. Remember, HSBC is Europe's largest bank, but its speculative operations in the United States are immensely important to it. Cutting off that license for banking business would probably have been fatal to it, and what Breuer was clearly thinking of,



EIRNS/Stuart Lewis

*Paul Gallagher*

was an all-out banking panic and crash following from that, and thought that it was better to let the criminality go unpunished than to get into his fears of this kind of crash. But it indicates the overhang of this crash, which is there.

Similarly, there is the fact that the banks in the United States and in Europe are not lending; they are manifestly *not* lending. The Federal Reserve has printed nearly \$3 trillion since early 2008, and some members of the Congress and some of their aides who are kind of pro-[Fed chairman] Ben Bernanke, have been sent a line that this isn't true in Europe, that

the Fed has helped us out by all this printing, whereas the European Central Bank has been tight. They were a little bit surprised when we informed them that the ECB has printed a great deal more money than the Federal Reserve has, has a much bigger asset book as a result, although presiding over a net smaller economy, and one that is shrinking fairly dramatically.

So, they're not lending.

## Monte dei Paschi

Then you look at situations like the Monte dei Paschi bank in Siena, in Italy, which is right now near the precipice of a failure, and consider that this is the oldest bank in the world, and one of the biggest in Europe. The bank was formed in 1472.<sup>1</sup> Derivatives are bringing it down. Derivatives contracts and dealings with banks in Europe and Asia on the derivatives market, are suddenly hitting it with huge losses and putting it into a situation to fail. The consequence of that won't be funny.

But, aside from the signs, you have to look at why

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1. See Claudio Celani, "Italy's Monte dei Paschi: A Four-Century-Old Nemesis Casts Its Shadow Over Upcoming Elections," *EIR*, Feb. 1, 2013.

we are close to that. There is a hyperinflationary policy on the part of the world's major central banks,<sup>2</sup> which of course has been justified by saying, in every case—Swiss, Japanese, ECB, Federal Reserve, Bank of England—that this will make the banks lend money again. If we print trillions of dollars and buy securities from them, to give them lots of liquidity and capital, they will lend. The printing of something like \$11 trillion in five years, by those five major central banks, has resulted in the fact that we are now, in the United States, at a record low level of lending. That is, the share of banks' deposits which are lent out is at a record low of about 70%, and the sheer amount, the absolute volume of lending, in addition to the share of it, is nearly 6% lower than it was two years ago, and still shrinking.

In Europe, the situation of those banks is far worse. The ECB has printed a great deal more money than the Federal Reserve has, and those banks are not only *not* lending into the economy, they are virtually not even lending to each other. The focus on France is certainly possible, because the French banks have been the most aggressive in the last decade in lending and speculating on the debt in Greece, Spain, and Portugal, in particular, the countries whose debt has collapsed in the last two years.

In the case of Greece now, in particular: Greece is in multiple levels of default. Portugal is in at least one level of default; Spain is very near to that. The major bank exposure to all that debt is in France, which puts a great focus on the possibility of a crash there, and our friend [former French Presidential candidate] Jacques Cheminade is somewhat in the middle of that right now, with the French government trying to figure out what the hell to do in February about separating the banks, and how much to separate, and whether to go with Glass-Steagall, and Jacques being interviewed both privately, and publicly in the media, on this.

It's a sign of how close things are in France. There are just huge volumes of bad debt on the books of those banks. The reason that all the money that's been printed for them has not been loaned by them is that they are using those trillions to hedge in various ways against the bad debt on their books, and this is quite clearly acknowledged. In fact, Bernanke himself has acknowledged in Congressional testimony that the banks are

withholding trillions from lending because of their fears of what's happening, and what's about to happen, to the various forms of toxic securities on their books. This is a downward spiral with the European economies contracting at a significant rate, even more than the United States. At some point, the downward spiral hits the bottom and blows up.

One other thing: Aside from simply hiding this money, that is, putting it back with the Federal Reserve as reserve deposits, the banks are also acting to blow up, again, this very same bubble that we all learned about in 2008—the collateralized debt obligations bubble, the residential mortgage-backed securities bubble, the commercial mortgage-backed securities bubble, the various derivative bubbles, including credit default swaps. They're not quite back up to the size of 2008, but they have very very rapidly leapt up close to that again, and been joined by other bubbles like the student debt bubble, the bubble in U.S. Treasury debt itself, which is another subject. So, this really puts them on the edge.

## Derivatives: The Biggest Crime in the World

**Q:** The next question is to somewhat prepare people for some of the activity when you go to your legislator, or talk to someone on the phone, or your community banker, about the question of Glass-Steagall, because one of the differences between Glass-Steagall and what has been presented around the phony Glass-Steagall, Dodd-Frank, is the toleration of what are known as derivatives.

My question simply is this: The way that derivatives are presented—and if there are farmers on the phone, I'm sure you've heard this from the standpoint of hedging on various commodity futures. Banks justify purchasing these instruments by claiming that these are a hedge, and since they are just simply two parties involved taking different sides on whether a commodity or an instrument is going up or down, then why is there any particular risk? Why does that argument not actually hold?

**Gallagher:** I think the most fundamental response to that is the fact that the vast majority of our commercial banks, 6,000 or so, really 99% of our banks and bank holding companies, have no exposure to derivatives whatsoever. They simply don't do that as part of their business, and nothing could be clearer since these are, in most areas of the economy, the backbone of lending. Nothing could make it clearer than that: that

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2. See Paul Gallagher, "Fed Policy of Hyperinflation Sparks Revolt," [EIR](#), Feb. 1, 2013.



*Moving industrial production jobs out of the U.S., into areas of much lower labor costs, even into modern facilities, like this electronics factory in Shenzhen, China, lowers the productivity of the entire world economy.*

derivative exposure is not necessary to a bank under, say, market conditions, nor to other financial interests.

There's such a thing as "forwards," which in many occupations need to be bought, and need to be managed because of the unpredictability of prices over the period of time when you're producing. But that's not what derivatives are, and the derivatives exposure of the overwhelming majority of commercial banks and holding companies in the United States, is zero. Contrast to that what I just referenced in terms of the Monte dei Paschi bank in Italy, this huge bank which may fail because of derivatives, as AIG did, as Lehman did, and so forth.

The best book on derivatives that I've ever read was written almost 20 years ago now, by a Morgan Stanley derivatives trader named Frank Partnoy, who got out of that business because he was convinced he would go to jail if he stayed in it.<sup>3</sup> He gave a really unvarnished account of what derivatives are and how you make them. And his basic definition was that derivatives are sold in order to cover up losses and make losses appear to be gains for short periods of time.

Nothing could be clearer in the Monte dei Paschi case than that they got into a hole, have now made that hole five times as big by buying derivatives on a mass scale in order to make their loss appear to be a gain for a short period of time, and disaster struck. It's exactly what Lehman was doing when it failed. That's what

AIG was offering to major banks in the United States and Europe when it failed.

Then look at the Libor inter-bank rate manipulation; look at the destruction wrought to the cities and states across Europe and the United States by the interest-rate derivatives which were sold to them by the major banks, and which have them in a vise grip, and that bankrupted many of these cities.

It's a form of crime, is really what it is, which the book by Partnoy really makes graphically clear. It's by far the largest form of crime in the world.

And this exposure is simply not necessary under Glass-Steagall regulation of an orderly, clean commercial banking system. There's no necessity for it. Zero.

### **A Credit System vs. Globalization**

**Q:** I'd like to go into a slightly different area which raises the underpinnings of what we refer to as a credit system. Oftentimes we hear of a cumulative deficit of investment into physical infrastructure. Less frequently, the deficit is also referred to in terms of the training of a new generation of skilled operatives in areas like machine tools.

My question is, in a credit system, how do such actual, shall we say, physical manifestations play a role? In other words, how exactly should we be defining value in an economy? How does that actually work, for example, in terms of a credit system?

**Gallagher:** We're saying, as Hamilton did, and as was realized in the First and Second National Banks, and as Lincoln definitely did with his Greenback policy—we're saying that the issuance of Federal credit, and combining the Federal credit with private capital which gives it more leverage, that whatever the precise form of national banking or national credit issuance that takes, what makes it work is that this is a vehicle for making sure that that credit goes into the most productive areas that economic growth can offer, and the core of those areas involves modern infrastructure, when infrastructure is being really transformed.

3. Frank Partnoy, *FIASCO: Blood in the Water on Wall Street*, 1997.

Actually, as long as 30 years ago, *EIR*'s economics section did econometric modeling of this question, and found that increases in productivity resulting from investments in modern infrastructure on a large scale exceeded the level of increases in productivity from any other source within the economy as a whole.

Another way of looking at it is that the quality of energy, the flexibility and reliability of electrical energy, for example, the quality of the heat—how high the heat of an energy source is, the energy density and power density of it—matter much more to the productivity of the industrial processes that it's going into, than does its cost, its cheapness. Nuclear has tremendous advantages, irrespective of its cost, which is why the power companies even to this day, with no plants having been built, or almost none, for so long, still want to own nuclear power plants. Because of the superior quality of that form of energy.

It's the principle of infrastructure investment. If you look at the last century in the United States, and the older generations of really skilled productive workers that we have in the labor force still today, or retired from the labor force but still active in various ways: Why do they have that level of general industrial and technical skill that came from the new infrastructure-building programs of the Franklin Roosevelt administrations? It also came from the Manhattan Project and the development of a completely new potential infrastructure of power, of scientific applications, of medical applications.

It came from Kennedy's space program and the training in that. It came from the fact that unions were being organized in the same 30-to-40-year period—from the 1930s to the '70s—and those unions were providing a higher standard of living, and they were also acting as a conduit for training of younger generations of workers. They have virtually disappeared now. We're down to 10% of the workforce in unions, and they're disappearing at an accelerating rate as we move completely into a really de-skilled and de-employed work force, which is scrambling just to survive.

A point was made quite a number of years ago by Lyndon LaRouche, a very important point about globalization and infrastructure: that if you take an economy which is characterized by a high-productive, high-technological level of modern infrastructure, as for example, the United States economy of 35 years ago; if you then start to move a lot of industrial production jobs out of the United States or a similar country, into areas

of much lower labor costs, which we obviously know happened; and even if you build very modern industrial plants in those low-wage countries to which you're moving the jobs—and again, we know that happened, they didn't build old shacks in Singapore and in Vietnam and in China; they built new infrastructure, new industrial plant. But even if you do that, and you're removing them from the higher infrastructural-productivity economy, the result is that the infrastructure itself is left to decay, it's neglected, it's not reinvested in; and the productivity.

As LaRouche put it in a kind of shocking way, what this does is lower the productivity of the whole world. The entire world economy sinks in its productivity, because you have moved industrial production away from the most modern infrastructure to areas where it is lacking. And you can make the shiniest new labor-intensive plants you want, and the productivity will still go down.

So, when we talk about a credit system, we mean one that will cause that mobilized credit—both public and private—to be in a manageable way put into revolutionizing our infrastructure, from water management to speed and flexibility of transportation, and the integration of the whole continental United States and the whole continent with high-speed transportation, weather protection, and so on. These things are what will make that capital productive, and therefore profitable.

It's always the way that national credit systems of this kind have worked. They do not dissipate the credit involved. They produce more wealth than the credit that's put into them. So that's an idea of it.

### **Glass-Steagall and the Fed**

**Q:** This is Karl Anthony Cooper from New Jersey. Could you please crisply relate Glass-Steagall's restoration to halting the Federal Reserve's \$50 billion-a-month purchase of failed mortgages and mortgage-backed securities? This is important for communicating with my local Congressman.

**Gallagher:** This is important. The policy that the Federal Reserve has carried out—these purchases, under Glass-Steagall, would have been, *prima facie*, illegal. The Fed would not have been allowed to deal with the units of banks in most cases that have sold these securities to it, and the securities themselves, the quality of those securities themselves, are ineligible for Federal Reserve lending, let alone purchase.

In other words, ineligible, even as collateral for



Federal Reserve lending under Glass-Steagall regulations, particularly under the one which is called Section 23A of the Federal Reserve Act, but which is actually an amendment to the Federal Reserve Act by the Glass-Steagall Act. In other words, it came from Glass-Steagall, and it's not only part of the Federal Reserve Act, but that, in particular, would bar any of these purchases.

It would also bar the transfer of derivatives in huge nominal values from the investment banks to the insured commercial banks, as for example, Merrill Lynch derivatives were transferred onto the books of Bank of America's commercial bank, and therefore, implicitly subject to Federal insurance. All of this, as [Dallas Fed President Richard] Fisher is making clear, [FDIC Vice Chairman and former Kansas City Fed President Thomas] Hoenig is making clear, and other bankers are making clear, you cannot do it under a Glass-Steagall regime.

And, in fact, once it's enacted, it's very much in the spirit of that, to demand that the Federal Reserve turn around and do what's called a "put-back," that is, make the banks buy those securities back. Not dumping them

on the market, but make the banks buy them back at the same value that the Federal Reserve paid for them. That, right now, would be, in terms of what they're holding, in MBS [mortgage-backed securities], about \$1.6 trillion. Make them buy it back at that value. That's what a put-back is called, because they were illegitimate purchases of securities that did not qualify for Federal Reserve deposit window support. So there you get a nice reduction in the burden of the Federal debt, as a result as well; but the Fed could not, should not, cannot be doing this.

One of the critical things in passing Glass-Steagall, is to stop this \$85 trillion-a-month bond-buying/money-printing dead in its tracks.

**Q:** I'm here in Burlington, Texas. My question is a little more general in scope. I understand the three-point plan—Glass-Steagall, National Bank, internal infrastructure, all of that—and I'm just wondering why the subject of protective tariffs hasn't been added to your plan, being a key part of the American System; and is that something that you will be pushing for in the future? I understand that the infrastructure development will foster levels of production within the United States, but without the productive tariffs, a lot of other industries will be left out in the cold, and still having to compete against slave-labor wages in China. And I was just wondering if that was something that you guys were going to try to fight for on the Hill, to get rid of these free-trade agreements and that kind of stuff?

**Gallagher:** Just to take one minute on it: It has always been part of the American System. LaRouche has been around for a long time fighting for the American System, you have to remember, and he has fought for tariff protection. And there's no change in that in his view, and in what we put forward, for example, with steel right now. But, at the same time, you have to recognize in terms of U.S. industrial production, the cat has long since been out of the bag; most of the horses have long since left the barn.

At this point, what will bring the economy back is infrastructural investments and productivity. By itself, tariff protection is really not going to produce very much. It's got to be a principle that we have in the course of a recovery. It's not the engine, it's not the engine at all now, simply because it's, in a certain sense, too late. You've got to have industries again in order to protect, and as we build them up, we will.

## NAWAPA 1964



PUEBLO, COLORADO  
AUGUST 11, 1964

Released on Thanksgiving 2011, the LPAC-TV documentary "NAWAPA 1964" is the true story of the fight for the North American Water and Power Alliance. Spanning the 1960s and early '70s, it is told through the words of Utah Senator Frank Moss. The 56-minute video, using extensive original film footage and documents, presents the astonishing mobilization for NAWAPA, which came near to being realized, until the assassination of President Kennedy, the Vietnam War, and the 1968 Jacobin reaction, killed it

... until now.

<http://larouchepac.com/nawapa1964>