
Time To Pay the Piper

Let's cut our financial losses and save what's left of the real economy of the United States.

Rumor has it that when you open a new account at one of the big banks these days, you are offered a choice between a \$1 million mortgage-backed security and a toaster, and that most people are taking the toaster. Rumor also has it that some Wall Street firms are lining up deals to sell their securities portfolios to paper recycling companies for a few dollars a ton.

Look how quickly the so-called “subprime mortgage” crisis has become a full-fledged international financial crisis, the “subprime contagion” sweeping around the world, with banks faltering, central banks turning on the spigots, speculators fleeing into the Treasury market, derivatives markets seizing up, *ad infinitum*. Nearly every day we hear about some new concern, some previously hidden time bomb waiting to explode. Today, it is the asset-backed commercial paper conduits; tomorrow, who knows? The whole system is unraveling.

We now have the spectacle of the biggest banks in the country borrowing billions from the Federal Reserve, of the Fed taking in paper it knows to be worthless as collateral, of the Fed allowing the bank holding companies to use their Federally insured commercial bank subsidiaries to bail out their securities operations, all in a vain attempt to stop the implosion.

This is, and was from the start, a systemic crisis, a problem resulting from the way in which the financial system was structured, and depended upon ever-increasing levels of debt for its survival. Real estate values were

driven up to increase the flows of mortgage debt into the system; that debt was then leveraged into mortgage-backed securities and related instruments, which were created out of thin air and given higher values on the books than the mortgages upon which they were nominally based. Those securities were then used as the basis to create even more securities, leverage piling upon leverage, all based upon the perception of value. The whole thing was a scam, doomed to failure, and failing it is.

The debt machine has broken down, because there is a limit to how much debt a falling economy can support. Mortgage prices got too high, gasoline got too high, the debt service got too high, the cost of life got too high, and the system choked. The mortgage pump began to run dry in 2005, as the money to sustain the increases began drying up; the rate of increase began to slow, and then prices began to fall. This triggered what was called the subprime crisis or the housing crisis, but it was actually a banking crisis, a crisis of the global casino itself.

What the Fed and the other major central banks appear to be doing at this stage, is to try to protect the core of the financial system with targeted liquidity. In times of crisis, there is a flight to the relative safety of government bonds and away from the riskier bets, which causes the system itself to seize up. All sellers and no buyers not only makes it impossible to unload bad paper, but the attempt to sell that paper also drives down its market value.

However, if an institution tries to raise cash by selling its better assets, it increases the percentage of junk in its portfolio.

This is why the Fed lent \$500 million each to Citigroup, J.P. Morgan Chase, Bank of America, and Wachovia; exempted Citigroup and Bank of America from the rules restricting the use of commercial bank funds for securities affiliates; and why the Fed is taking in mortgage-backed securities, asset-backed commercial paper, and who knows what else. The Bank of England's loan to Barclays and the loans to continental banks by the European Central Bank are also intended to prevent the collapse of a major bank holding company or investment bank, and the likely chain reaction of failures that would flow from such an event.

The only real issue is what comes next: Do we continue down the road of bailouts until the whole system vaporizes, or do we use the sovereign power of government to put the system through bankruptcy, save the necessary banking functions, and begin the process of rebuilding our economy?

Sir Alan Greenspan admitted, in 2002, the “remote possibility of a chain reaction, a cascading sequence of defaults that will culminate in financial implosion if it proceeds unchecked,” adding that, “only a central bank, with its unlimited power to create money ... can thwart such a process before it becomes destructive.” The central banks, he said, will provide “catastrophic financial insurance coverage,” but the cost of picking up the tab “will not lie with the private sector alone.”

The implosion to which Greenspan alluded is upon us, and the public is going to have to pay. The question is, do we pay to bail out the architects of this mess, or do we pay to rebuild the economy and save the nation?