INTERVIEW WITH NOMI PRINS

The Coming Banking Panic

Paul Gallagher interviewed financial expert Nomi Prins on March 16. See https://www.youtube.com/watch?v=kqQqsvRhtFc Edited excerpts follow.

Former investment banker and author Nomi Prins.

Paul Gallagher: Hello. This is Paul Gallagher with LaRouche PAC television (https://larouchepac.com/). I'm co-editor of economics for *EIR*, and today I'm talking to Nomi Prins, who was for years—I think more than a decade—in investment banking with Goldman Sachs, Chase, and Lehman, as an analyst and also as a manager. She has been a very widely published analyst and expert on the banking system and banking history, and has published both as a speaker, and also in leading newspapers in the country. She has also written, if I'm not mistaken, something like nine books.

Nomi Prins: Only seven.

Gallagher: Seven books on the subject, including the award-winning *Other People's Money* in 2004, the most recent one, *All the President's Bankers*, and the forthcoming *Partisans of Money*, about the history of the central bankers. She is also in the middle of a number of meetings with offices of the Congress right now.

So let me start, Nomi, by asking you: You've written an analysis piece on 2017, and what you expect for this year, in which you say that the stock and bond markets in the United States may crumble by the end of the year; that there will be a large upsurge in corporate defaults—and I think you give the figure that there already was quite an upsurge in 2016, in the European banks and the major losses that some of those banks have been reporting. Do you think that these events threaten another bank panic, like 2008?

Prins: I think that because the 2008 crisis, or bank panic, has not really been resolved, what has happened is that it's been shifted forward. And by that I mean, when we had the crisis in 2008, and we had all the interdependencies between the largest banks—not just in the United States, though prevalently in the United States, but then throughout the world—the solution to that was for the Federal Reserve to cut rates to zero, and launch a quantitative easing program, and to basically expand that program, not just in the United States to help liquidity and credit flow, but throughout the world.

So there's been an almost decade-long coordinated period of elevating the markets, and helping banks maintain liquidity, and keeping reserves from these banks that don't then get loaned into the main economy, or at least the lower echelons of the individual citizens, or smaller businesses of that main economy. And that's really what's been happening for almost a decade. So, at some point, there will be a "give" in that strategy. We've already had the Federal Reserve raise rates now by 75 basis points, beginning in December 2015 through March 2017, so effectively 25 basis points [one quarter of one percent] per year—which

isn't a very big number. But what that is doing, while other central banks are keeping rates at either negative or close to zero—so still keeping the equilibrium of zero-cost money throughout the world—is that it's hedging the possibility of more defaults to creep into the system.

So, on the one hand, the reaction of markets to all this cheap money, is to go up. There's nowhere else for money to go. Bonds are not returning any real interest, and high-grade bonds certainly aren't, so money has been pushed into the stock market, and it's kind of had a self-fulfilling bubble quality to it. But when these rates start going up, all the debt that's been created during this period starts to have to repay at potentially higher levels than it expected to repay. And so all the corporate debt that's been issued, all the money that's flowed throughout the world, all of a sudden has to consider retracting.

We've already started to see that since the 2015 hike in the Fed rates, which is that we had higher default rates in corporates, and also in U.S.-dollar denominated corporates throughout the world, than we've had in any of the years since the crisis started. And then we had a second bout of that in 2016. So we have the defaults in the corporate world increasing, almost in tandem with rates being raised. And so at some point that's going to create a situation where those companies start to have difficulties repaying, particularly in emerging markets outside the United States—that's going to hurt their markets. When those markets start going down, it starts to hurt the main markets. It starts to hurt the U.S. market, because it comes back, because confidence and credit starts to crumble throughout the world. It might start peripheral to the United States, but then it comes back to the United States.

And the same thing with Europe. There's a lot of volatility in the European markets—even though their stock markets have been doing very well, because the policy of the European Central Bank has been to keep rates at negative, and to continue to buy securities, and to basically flush the system with money. If that starts to become more expensive, then you will start to have corporate defaults increase more in Europe.

So we're really set up in a way, at a much more dangerous point than we were before the financial crisis of 2008, because now the world is sitting on a tremendously larger amount of debt. Right now, debt to GDP in the world is about three times—there's $325 trillion of debt relative to [perhaps $100 trillion of] GDP. It was less than one time debt to GDP before the financial crisis started. So, it's elevated quite a lot throughout the world.

Leverage Has Tripled

Gallagher: It went from one to one, to three to one?

Prins: Three to one. Basically the ratio since before the crisis, to after the crisis, has almost tripled. And we see that in the United States, it's gone from—it's over 100% now, or close to 100%, of debt to GDP, and that's not unique to the United States. Of course, in countries like Greece, it's 160% or 170%. This has all taken place because debt has been cheap to issue. When debt becomes more expensive to issue, and you have to repay debt that has been issued at a higher amount, but you don't have real growth to compensate for that, you don't have real profit to compensate for that—that's when markets start to get wobbly; that's when credit starts to tighten again. And that's when this entire quantitative easing—this central bank-coordinated process of keeping the money so cheap

and so flowing for the banking system, and then out to the markets—starts to become much more shaky. And I think that's what we're going to have by the end of this year, because now we're sort of in this period of the Fed raising rates, and other central banks have not. Mexico has. Some countries have done it in tandem, because they want to keep their currencies somewhat in an unofficial band relative to the dollar, but for the most part, it's still cheap money across the board.

But again, as it creeps up ever so little, everything becomes more expensive, everything becomes tighter, and that's when what has happened to the markets, and to the banking system, in terms of subsidies, starts to crumble. And I think we're kind of at that breaking point. It might be after another 25 basis points, maybe another 50 basis points, if the Fed goes there—but we're at a point where debt just starts to become very expensive, and then falls start to come in.

Gallagher: And you've been talking this week to a number of people on the Hill about Glass-Steagall. What's the importance of the role of Glass-Steagall? Is it in preventing this threatening situation, or do you think it's just a question of whether we need it in order to get the banks in order, in order for them to do sound banking?

Prins: Well, I think it's both. First of all, when we had Glass-Steagall repealed in 1999, it unleashed a tremendous amount of mergers throughout the banking industry. So we already have big banks dominating a lot of the trading, and a lot of issuance, and a lot of deposit holding anyway, because we've had the 1994 act where they could go across state lines, and we had a 1999 act of repealing Glass-Steagall, so they could now connect to insurance companies, asset management firms and investment banking, all within one roof, connected to commercial banking and deposits and loans.

So as that was all happening, banks were consolidating; they were becoming either bigger—if they were sort of a supermarket commercial bank, like a JPMorgan Chase, or Citigroup where they chose to merge a sort of classic commercial banking company with an investment banking company—or else they became more leveraged, like what happened with Goldman Sachs and Morgan Stanley. Because Goldman and Morgan Stanley didn't merge with a bank and have that extra balance sheet, those extra deposits from which to leverage new securities, or trade, or bets, to create more risky opportunities for themselves in the market, they chose to compete against these supermarket banks that were created in the wake of Glass-Steagall repeal, by leveraging themselves even more. That's what Lehman Brothers did before it imploded; that's what Bear Stearns—which I used to work at before they imploded. So there was a sort of competition in leverage that was unleashed by Glass-Steagall being repealed.

What that created was this hunt, as it turned out in this period, for subprime loans, which could be leveraged into securities, and they could be merged into new securities and CDOs (collateralized debt obligations), where there were all sorts of layers on top of these individual loans, but all of those layers were leveraged within a security. And then the banks themselves were borrowing more and more to buy, or create, more of these securities, so they were leveraging their balance sheets even more.

So you had leverage on the balance sheets, and leverage on the security.

Gallagher: Just so people understand, who aren't familiar with the language: By leverage, you mean putting a lot more debt on their balance sheets, to make their assets seem more profitable.

Prins: Yes, for book leverage. You're putting more debt—you're basically borrowing money in order to create securities, and that could be by borrowing money to buy more loans, in order to create securities out of them and then resell them. It could be borrowing money to get more involved in the derivatives markets. It could be a lot of different things, but you're effectively—it's like if you were to go to, say, Vegas, and bet on a table. You can either do it with your ten dollars, or your hundred dollars in your pocket, or you can use your credit card—and you can sort of leverage up. It could be like I want an extra hundred, an extra hundred, and I'll go to the machine and then you keep on sort of doubling, tripling, quadrupling, and 20 times down on one bet. So you lose 20 to 1 instead of one to one, if it goes against you. And that's basically what happened in the markets, on the back of these subprime loans.

The only reason that was allowed, that that was *able* to happen, was because of the structure of Wall Street, that enabled banks to take loans, both off their own books and to buy them onto their books, and repackage them and resell them into more complex, more risky securities. If Glass-Steagall had existed, they would not have been able to do that. If Glass-Steagall had existed, banks would not have borrowed and been allowed to leverage as much in competition with the banks that had the loans to begin with, in order to do that. So the repeal of Glass-Steagall allowed the crisis to happen, because it allowed this instability in the banking system; it allowed banks to become bigger; it allowed them to become too big to fail after they began to implode—and the Treasury Department, the Federal Reserve, and the government decided, we need to basically save the economy, save citizens, from the implosion of these banks.

And so we're going to plug the holes. We're going to plug the holes with TARP, we're going to plug the holes with bailouts, we're going to plug the holes with lending more to these banks, because they can't even get any money, because they sort of shot what they've had into these bets, into the market, and that's not working right now. We'll give them zero interest rates, so that money can come more cheaply back to them. All of these remedies they just talked about a little bit before, were really created to subsidize a very flawed system from a structural perspective.

And so now we have this flawed system that never got readjusted back to something that would be more stable for everybody. But now it's elevated by all this extra subsidy, and extra debt, that was thrown in, to keep it from completely dying in 2007-2008. So that's why the risk of implosion right now, the downside is much greater, because we never really bothered to dissect these deposits and these loans from all the securities that were created, and can still be created, and the leverage that can still be created upon them.

So now it's almost more imperative to reinstate Glass-Steagall, to bring back that separation, because we're actually on the hock for more money. The books, for example, of the Federal Reserve are now four and a half or so trillion dollars, and they've increased their reserves from these banks, including with excess reserves the banks don't even have to put there, of something like two trillion or so dollars. That's two trillion dollars that's off the top of our economy, that effectively was created in debt by the Treasury Department, went through the primary dealers, these biggest conglomerate banks, and was sold back, basically given back to the Fed to receive interest from the Fed.

So there's a sort of triangle of debt and money moving around doing absolutely nothing—that's something like two trillion, and that's only the United States. There's mortgages and other things on the Fed books. The same thing has happened in Europe, the same has happened in Japan—there's been this circle of debt creation by governments to go through the biggest banks, and go back to their central banks without ever going into the economy. And that shows you the problem. The reason these big banks need to be split up, is so that they don't have to have emergency money in excess reserves at these central banks, in case their risky bets go south again—which is why they have it there, why they're not necessarily putting the rest of that into the individuals' or citizens' part of the economy.

They would have to do that if they were split up, as they were under Glass-Steagall, into banks that just dealt with deposits and loans, and banks that could trade all they wanted to, and buy and sell all the risky securities they wanted to, but on their own dime, and not be bailed out by the government if they fail.