Bond Crash Is Sign of System Bound For Financial Catastrophe

by Lothar Komp

The drive by Presidential pre-candidate Lyndon LaRouche to force Vice President Dick Cheney out of office, aims to end the strategic crisis and put serious actions for economic recovery on the agenda. George W. Bush's strategy for re-election in 2004 is based on the illusion of an economic recovery, supposedly materializing at some point in the second half of this year. But financial insiders point out that already by early Autumn these illusions will most likely be torn apart. And as soon as economic reality sets in, a re-activation of the three-year stock market crash is inevitable.

But precisely because Dick Cheney's neo-conservative gang in Washington, and its banking and multinational backers, are under such political, strategic, and economic pressure, they are a threat to strike out, if they remain in power, in a "flight forward" mode—either in new military confrontations, as with North Korea or Iran; or, with the launching of a "financial Sept. 11." As the global financial system is anyway hopelessly bankrupt, these forces might accelerate the disintegration process in order to control its outcome.

A sudden sharp rise of interest rates—already indicated during July as Fed Chairman Alan Greenspan's three-year rate-cutting policy "hit the wall"—would probably be enough to cause a meltdown of the U.S. bond and housing bubbles, driving millions of private households into bankruptcy. At that point, with calls for a public bailout of financial markets by governments already running huge deficits, "Schachtian"-style emergency measures, including the dismantling of traditional social programs, could easily be implemented by the frontmen of high finance.

A historic reference point for such a development is the collapse of the post-World War I Versailles monetary-financial system, which was based on using the German war debt to prop up creditors worldwide. As LaRouche noted on July 26: "Then, when the financial system was threatened with a blowout, you had two ways to go: One way was typified by Franklin Roosevelt's recovery program, the other way was Adolf Hitler. And for a time, Adolf Hitler won. He was put into power by key financial interests, which were afraid that, under conditions of financial collapse, governments would intervene to save the economy, at the expense of the financiers' interest-control over the economy."

Greenspan and Co. Laid Interest-Rate Trap

In the second half of the 1990s, central banks in the United States, Japan, and Europe opened their monetary floodgates in a attempt to sustain, by financial "bubbles," a bankrupt global system. Products of this liquidity pumping were a worldwide stock market bubble and, in particular in the United States, the most excessive credit generation in centuries. After March 2000, crashing stock market bubbles eliminated $16 trillion of financial asset value worldwide within three years. The central banks responded with even more liquidity pumping. While the accelerated flooding of markets wasn't too successful in boosting the stock markets or the economies, the central bankers' efforts created some new financial asset bubbles.

The U.S. Federal Reserve pushed down short-term interest rates from 6.0% to 1.0% within 30 months and thereby helped create a giant bubble on the bond market. The scheme worked in two ways. First, commercial banks could borrow short-term funds from the Fed at low interest rates and then invest the borrowed money into bonds offering higher interest, a special kind of "carry trade." Second, the Fed rate cuts immediately pushed up the market prices of bonds. Bonds are debt titles issued by governments or large corporations. The bond issuers promise a fixed interest rate, usually being paid

Has the has-been Federal Reserve Chairman Alan Greenspan incompetently set into motion an "economic 9/11," by triggering a bond-market crash he has been unable to stop?

at a specific date once a year, and of course the repayment of the bond's nominal value after a specific number of years, ranging between 2 and 30 years.

Take as an example a 10-year U.S. government bond with a $10,000 nominal value and a fixed interest rate of 4%. If an investor keeps such a security until its maturity, he knows the income stream exactly: In each of the next 10 years he will receive $400, plus $10,000 in 10 years, all in all $14,000—of course under the premise that the bond issuer doesn't go bankrupt in the meantime.

Most bonds are not held by investors until maturity, but constantly traded on the bond market. The market price of such a bond is determined by discounting all the remaining future income streams, by a comparison of the bond's fixed interest rate to the momentary short-term interest rate. As an example, that 4% bond's promised $10,000 payment in 10 years has a discounted cash value of only $5,580, if short-term interest rates are at 6%, as they were in the United States at the beginning of 2001. But with short-term interest rates pushed down to 1%, as they are now, the present cash value of a $10,000 payment in 10 years amounts to $9,050, that is 62% more than in the previous case. The Fed's policy automatically pushed up the market prices of all outstanding bonds, and by signalling further rate cuts, it invited millions of investors to join the ongoing bond market frenzy.

Furthermore, Greenspan and Fed governor Ben Bernanke publicized their commitment to buy up, if needed, an unlimited amount of U.S. Treasury debt from commercial banks in order to fight the so-called threat of deflation. In conclusion, a giant bubble was created, which itself helped to build up an extreme expansion of mortgage credit, as interest rates for mortgage loans are priced in reference to Treasuries of similar maturities. Millions of private households were lured by record-low mortgage rates and rising home prices to sharply increase their mortgage debt. The refinancing of old mortgages, often including a "cash-out" component. at the same time helped to prevent private household consumption in the U.S. from collapsing. But now the party is over.

Bond Bubble Is Bursting

Still in early May 2003, Greenspan and other Fed governors were making public speeches on the possible outbreak of deflation, promising extraordinary measures of liquidity pumping to fight it, including direct purchases of long-term government bonds by the Fed. In its official release following the May 6 Federal Open Market Committee (FOMC) meeting, the Fed said that over the next quarters, "the probability of an unwelcome substantial fall in inflation, though minor, exceeds that of a pickup in inflation from its already low level." The foreseeable reaction was yet another frenzy on the bond market, pushing down Treasury yields in mid-June to the lowest levels in half a century.

But suddenly, probably under pressure by the White House to present an upbeat economic outlook, Greenspan changed his line. The first indication for this was the decision by the Fed on June 25 to lower its key interest rates by just 0.25%, not the .50% investors had expected. Bond markets worldwide started to go down. As bond prices fell, bond issuers were forced to promise higher interest rates. Already by July 2, yields for 10-year U.S. Treasuries shot up to 3.64%, compared to the 45-year low of 3.07% reached on June 16.

The repercussions were felt worldwide. Japanese government bonds (JGB) on June 30 suffered their biggest slump in two years. On July 3, a bond auction by the Japanese Finance Ministry drew just half as many bids as the previous sale in June, leading on the same day to the biggest JGB plunge since September 1999. Japanese 10-year bond yields reached a record low of 0.435% on June 12, but by July 3 had shot up to 1.125%. On July 4, the JGB crash continued, driving 10-year yields at one point to 1.40%. Japan has the largest government bond market in the world, with $4.7 trillion in outstanding debt, compared to $3.3 trillion U.S. government bonds. Both the German and the British government bond auctions on July 2 drew the lowest demand in several years.

The bond market decline accelerated when Greenspan testified to Congress on July 15, presenting an inexplicably rosy outlook for the U.S. economy. He enthused about the stimulating effects of the Bush Administration's tax cuts on top of the Fed's rate cuts. In sharp contrast to previous statements, he now downplayed the threat of deflation: "The

FOMC devoted considerable attention to this subject at its June meeting, examining potentially feasible policy alternatives. However, given the now highly stimulative stance of monetary and fiscal policy and well-anchored inflation expectations, the Committee concluded that economic fundamentals are such that situations requiring special policy actions are most unlikely to arise." Within hours, Greenspan's comments triggered the biggest massacre on the bond market since the Long-Term Capital Management collapse in Autumn 1998. The yields on 10-year U.S. Treasuries rose by 0.26% in a single day, to 3.98%. German government bonds on July 15-16 suffered their biggest two-day sell-off since June 1995.

The potential effects on the mortgage market reached such an alarming dimension, that on July 23, the Fed was forced to deploy its most outspoken "deflation fighter," governor Ben "Bubbles" Bernanke, to say *exactly the opposite* of Greenspan's claim eight days before: that there is a real threat posed by deflation, which indeed could require unconventional liquidity creation actions by the Fed. In his address to the Economics Roundtable of the University of California at San Diego, Bernanke said the Fed "should be willing to cut the funds rate to zero, should that prove necessary." Should still more monetary stimulus be needed, the Fed could use "non-traditional" methods, such as buying long-term bonds.

However, indicating the complete loss of confidence in the Federal Reserve, Bernanke's intervention failed; The bond market sell-off continued. On July 29, the yields for 10-year U.S. Treasuries climbed up by 0.16% in one day to 4.45%, making a shocking 1.38% rise in six weeks.

Contributing to the selling of U.S. Treasuries were the recent announcements by the government on its record-high budget deficits. In February this year, the Office of Management and Budget (OMB) was still forecasting deficits of $304 billion for Fiscal Year 2003 and $307 billion for FY 2004. But now, the OMB is forecasting budget deficits of $455 billion and $475 billion, respectively; both figures would cross the $600 billion mark if counted according to law, without looting from the surpluses of the Social Security Trust Funds.

Apocalyptic Consequences?

The bond market turmoil is immediately affecting the U.S. mortgage bubble; applications for mortgage refinancing credit by households suddenly dropped by one-third in the second half of July. Rates for 15-year and 30-year U.S. mortgages reached historic lows in June, but now have climbed back to levels of December 2002. Just in the week ending July 25, rates for 30-year mortgages rose from 5.72% to 5.87%. By July 30, rates already hit 5.94%, compared to 5.21% in early June. Day by day, the debt-service burden on millions of U.S. private households is thereby rising. Already now, the insolvency rate on mortgage debt is at a record high. If mortgage interest rates go higher while the economy and employment stay depressed, an avalanche of private bankruptcies could push down house prices and burst the $7 trillion mortgage bubble.

According to the Mortgage Bankers Association of America, demand for refinancings of mortgages, of crucial importance in the last three years in keeping up the façade of the U.S. economy, crashed by 32.9% in the week ended July 25.

The events on the mortgage market are also turning the two giant mortgage finance corporations, Fannie Mae and Freddie Mac, into financial time-bombs. These two government-sponsored private "agencies" have bought up 44% of the entire mortgage debt of America from commercial banks, most of which they have then sold, in the form of mortgage-backed securities, to other banks, insurance companies, and investment funds. Fannie Mae and Freddie Mac further issue bonds in order to refinance their operations. Finally, the two "agencies" are engaged in multi-trillion-dollar high-risk derivatives contracts, to "protect" them from rapid changes in interest rates.

Since June 9, the bonds of both Freddie Mac and Fannie Mae have come under tremendous pressure. Selling by European and Asian investors accelerated after rumors spread on markets in the second half of July that the European Central Bank (ECB) is liquidating its holdings of "agency" debt—which lacks an explicit guarantee by the U.S. government—and has recommended the same to all the Euro-zone national central banks. On July 30, Fannie Mae chairman and chief executive Franklin Raines described the recent events on the bond and mortgage market, in particular the rise of long-term interest rates, as a "100-year storm" for the financial sector.

In his *Richebächer Letter* for July, former Dresdner Bank chief economist Kurt Richebächer wrote: "During the late 1990s, Mr. Greenspan was keen to foster the stock market bubble. . . . Now, he is keen to foster the three new bubbles that he has kindled in fighting the burst of the stock market bubble—the house price bubble, the mortgage refinancing bubble and the bond bubble. . . . Greenspan signalled to the marketplace his determination to accommodate unlimited leveraged bond purchases [and that] endless liquidity is available for the taking by the speculative financial community. The obvious result is a credit and bond bubble that vastly outpaces the excesses of the equity bubble. . . . Our greatest fear is now the bond bubble. Its influences are pervading the whole economy and the whole financial system, and its bursting may have apocalyptic consequences."

The stage is set for a deliberately triggered financial/economic disruption of unprecedented dimensions. Today, as in the 1930s, the fight is over what kind of policy changes will meet it. Will it be the LaRouche solution—a global "bankruptcy reorganization" aimed at re-starting productive investments to boost employment and living standards; or a "Schachtian" solution to maintain the power of "high finance," presently running the U.S. Administration through its frontmen around Vice President Dick Cheney?