EIR Economics

Parasitical U.S. Economy Reaching End of Bailout Road

by John Hoefle

You almost have to feel sorry for poor Federal Reserve Chairman Alan Greenspan, the man who was knighted by the Queen of England for service to the British Empire, and who was declared by no less an authority than the blowhard former Senator from Enron Phil Gramm, to be the greatest central banker in the history of the world. Greenspan is indeed one of the great bubble-blowers in history, but bubble-blowing is a dangerous occupation, because bubbles inevitably pop. It is a rare celebrity indeed who does not begin to believe his own press releases, and stay on long after the fans begin to tire of his act.

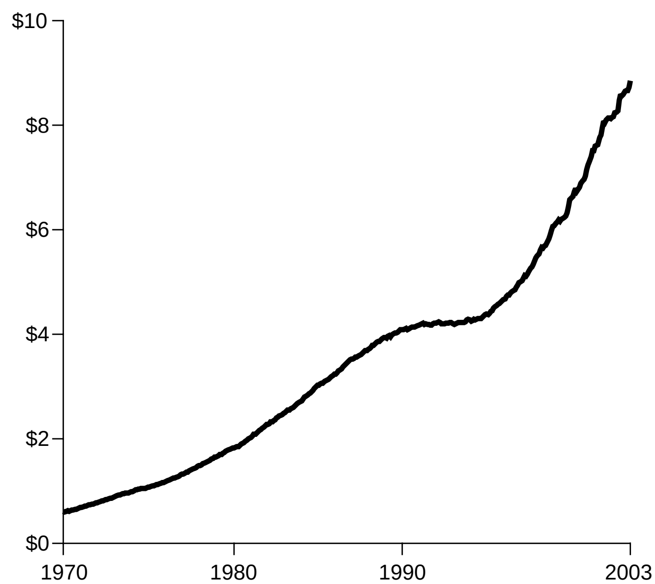
While the bubble was growing, Sir Alan was treated as a god by Wall Street, one who allowed The Street's aristocracy to loot and pillage the peasants at will, cook the books to a fine crisp, and treat the world as their casino. But Greenspan's system is now breaking apart, and there is very little left in his threadbare bag of tricks.

Bankrupt and Unstable

The reality behind the curtain is that virtually every sector of the economy is bankrupt, and robbing Peter to bail out Paul doesn't work when both are bankrupt and desperate for cash. Greenspan's dilemma is that the low interest rates which are necessary to keep debt service somewhere near manageable levels, undercut the usurious gouging upon which oligarchic finance is based. The Fed's policy of a steadily increasing money supply (**Figure 1**) and ever-lower interest rates has done wonders for the bond and real estate markets, allowing them to grow to levels well beyond economic reality, but the low interest rates also drain the profits from the system.

To make their money, the speculators have resorted to making large, highly leveraged derivatives bets. When they guess right, they make big profits; when they guess wrong, they lose big, and often disappear—unless they are a big bank,

FIGURE 1
Fed Pumps Up Money Supply M3, Monthly, 1970-July, 2003
($ Trillions)



Source: Federal Reserve.

in which case they are merged with a less insolvent peer, so they can live to go bankrupt yet again.

Making large bets on narrow shifts in the markets, and doing it with borrowed cash, is a dangerous practice, and often introduces tremendous volatility into the system, triggering sharp movements in interest and currency rates. This is not necessarily a bad thing from the standpoint of the speculators, since they depend on the instability to make money, but it can easily get out of their control.

To make the casino less dangerous and more lucrative, the central banks, and their favored banks, have taken to rigging the system, placing large bets and then manipulating the market to make those bets win. As long as there is wealth out there to steal, and lots of public money available to fund the central banks' manipulations, this is a good racket. Some have called it criminal, but as Sir Alan has said more than once, it's the price we must pay to have vibrant derivatives markets.

Sooner or later, however, all pyramid schemes must come to an end, and this one has. The Fed can't drop interest rates much lower, and lower rates are necessary to keep the illusion going that the debt can be serviced. Lower rates mean increasing the total debt outstanding, and will ultimately lead to a hyperinflationary collapse of the financial system. Higher rates would dry up some of this speculation and bolster pension funds, but would also increase debt-service costs, bankruptcies, and defaults, and ultimately trigger a deflationary collapse of the bubble. Standing pat and citing the nonexistent recovery, as the Fed did the week of Aug. 11, solves nothing.

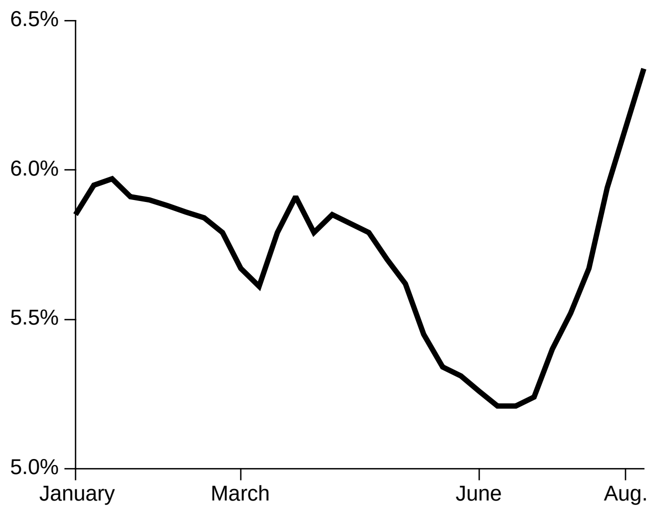
Housing Bubble Ready To Pop

One of the mainstays of asset inflation in recent years has been the residential real-estate market, where increases in prices have created trillions of dollars of fictitious capital in the form of new and expanded mortgages. Those overpriced mortgages were then used by Fannie Mae, Freddie Mac, and others to create mortgage-backed securities. To make this happen, the Fed artificially depressed long-term interest rates, creating a bubble in the bond markets. The Fed did this in part by buying long-term Treasuries, to which mortgage rates are pegged, effectively lowering rates on both.

As mortgage interest rates dropped, not only were households able to buy ever more expensive homes, but existing homeowners were able to refinance at the lower rates, often taking out cash as part of the refinancing. That cash was, in turn, used to pay down credit-card and other debt, or for increased consumer spending.

Homeowners took $83 billion in cash out of refinancings in 2001, $96 billion in 2002, and $50 billion in the first half of 2003, according to Freddie Mac, while Greenspan testified in March that, counting all forms of borrowing against residential mortgages, some $700 billion was extracted in 2002, nearly the equivalent of the gross domestic product of Spain.

FIGURE 2
Long-Term Mortgage Rates Soar
30-Year Conventional Mortage Rates, 2003
(Percent)



Source: Federal Reserve.

The re-fi party ended in June, when Greenspan helped blow up the bond market and the Fed halted Treasury debt purchases, sending mortgage rates soaring (**Figure 2**). Refinancing activity fell 60% over nine weeks. If current trends continue, mortgage rates, at historic lows as recently as eight weeks ago, could be well over 7-8% by next quarter.

It is only a matter of time now before residential real-estate prices start to fall off the table, even in formerly "hot" markets, like Colorado and Northern Virginia. As prices go into decline, homeowners who bought or refinanced in recent years will find themselves with mortgages which exceed the market values of their homes, resulting in a wave of defaults and even further declines in prices, wiping out banks, mortgage companies, and mortgage-backed securities.

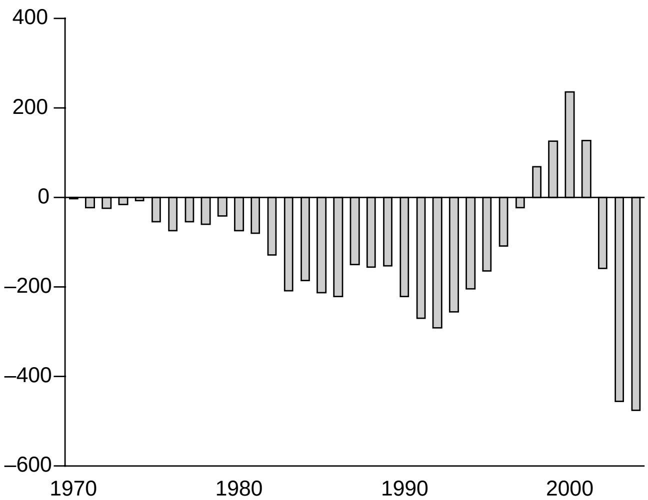
The Federal government, with its record quarterly deficits, is also facing a funding crisis. Through July, the Federal government reported a fiscal year-to-date deficit of $324 billion, with the Office of Management and Budget (OMB) projecting a $455 billion deficit for Fiscal 2003, and a $475 billion deficit for Fiscal 2004 (**Figure 3**). These deficits, though records, significantly understate the government's income shortfall by counting payments to the Social Security and other trust funds as general revenue. Without such Enron-style accounting tricks, the OMB's figure would likely top $600 billion.

Finding that money, and the funds needed to prop up U.S. financial markets, will not be easy. During the bubble years, when the U.S. stock market and the dollar were strong, money poured in from around the world to buy U.S. stocks and bonds, including large quantities of Treasury bonds. That party is also over, as both the dollar and the stock market have depreciated significantly, and foreign nations now have serious problems of their own. Japan, one of the largest purchasers of U.S. Treasuries in recent years, may even have to begin liquidating its holdings, to deal with its own financial crisis.

We also have the aforementioned problems in the bond markets, where bond prices have fallen sharply, with a rise in bond interest rates. When interest rates fall, the value of existing bonds rises, because the spread between the interest rates they pay and the prevailing rate increases; conversely, when rates rise, the value of existing bonds fall. However, as rates fall, it becomes harder to sell new bonds, because they pay such low rates. That difficulty is compounded as the economy declines, casting further doubts upon the viability of the bond issuers. The interest rates the issuers have to offer to attract buyers rise, increasing their debt-service burden.

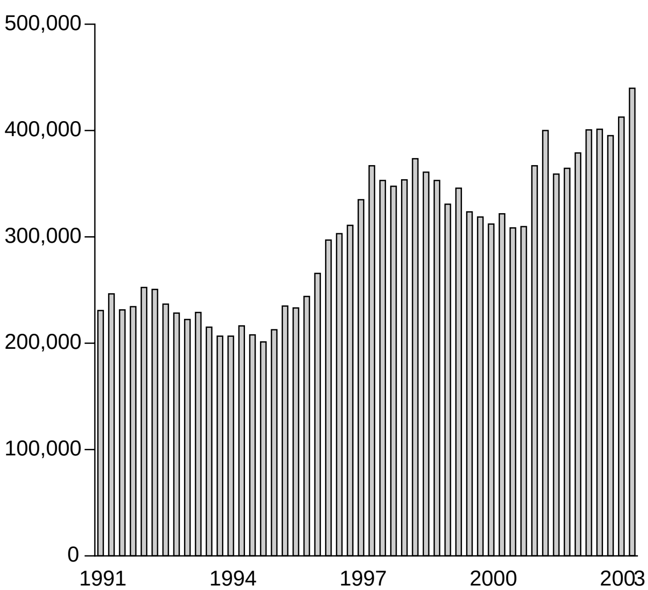
On top of all of this, we have the global derivatives market, where the sharp rise in long-term interest rates has undoubtedly already generated huge losses in some portfolios. Derivatives losses, especially at big financial institutions, are rarely announced, but are often dealt with by changes in leadership. In this regard, the recent shakeup at Merrill Lynch, and the addition of former Bank for International Settlements General Manager Sir Andrew Crockett to the top management level of J.P. Morgan Chase, bear close scrutiny.

FIGURE 3
Federal Deficit Spirals Out of Control
($ Billions)



Source: White House Office of Management and Budget

FIGURE 4
Quarterly Bankruptcy Filings



Source: Administrative Office of the U.S. Courts

Breakdown

While the financial markets are choking on their own bailout needs, the physical economy upon which the bubble feeds, and on which humanity depends, is rapidly falling apart. Manufacturing production employment, a reasonable proxy for the overall manufacturing sector, has fallen sharply back to the levels of the 1950s in terms of numbers of jobs, and bankruptcies are setting new records in practically every quarter (**Figure 4**). In the 12-month period ending June 30, 2003, a record 1.65 million bankruptcies were filed, including a record 440,257 in the April-June period. Bankruptcies have now topped 400,000 four of the last five quarters.

The dynamic these problems describe is what Lyndon LaRouche has termed a breakdown crisis, in which the same old bailout techniques only hasten the breakdown. The failure of these techniques is manifesting itself in a growing rage at Greenspan by the bond markets, where the players consider it their right to continue to make money, no matter what happens to the economy. Sir Alan certainly deserves criticism, but these bubbleheads have no room to talk. The real question is: Where do we go from here? Do we listen to the financiers who have brought us to this point, or do we listen to LaRouche, who has warned us repeatedly that we would come to this point, if we listened to the financiers? The financiers will try to keep their power, no matter how much of your money they have to throw down the rathole. With LaRouche, we tell the bankers they are bankrupt, and begin rebuilding the economy. The choice is clear.