

# 'Dynamite Is Everywhere' In Financial System Now

by Paul Gallagher

As Presidential candidate Lyndon LaRouche was addressing his Australian movement on March 5 ("This World Monetary System Is on the Way to the Burial Grounds," see below), alarm bells were indeed tolling very loudly for the global financial system, which threatened to explode before the U.S. Democratic Party holds its nominating convention in July in Boston.

While the bomb the International Monetary Fund (IMF) and monetary authorities were working hardest to defuse was the Argentine debt bomb, even bigger explosives lay elsewhere. One London banker told *EIR*, "Argentina may be a difficulty for the Fund and for the financial world, but if you're looking for the really big crisis, look at the United States. A giant crisis is coming there, sooner than most people think. It is now clear, that what has been keeping the system going, is just pumping of liquidity. . . . The United States is the place to look, for where the really big crisis will hit." A series of U.S. economic disasters were announced in early March, like blows which sent the stock markets reeling, made pathetic the Bush Administration's "recovery" bravado, and deepened the fears of Fed Chairman Alan Greenspan and his international counterparts about "systemic threats" of a collapse.

## U.S. Debt Bomb Gets Worse and Worse

The U.S. Labor Department's March 5 report on unemployment in February, though shocking in its major announcement of the complete lack of job creation in the economy, was much worse for its small print. Nearly 3 million Americans have dropped out of the labor force since March 2001, and *almost 400,000 abandoned the labor force in February 2004 alone*—in addition to the 8.2 million unemployed and 5 million forced to work only part-time—making real unemployment well over 10%. A steadily shrinking labor force has never appeared in any U.S. "post-recession" in 100 years—only in the first years of the Great Depression. The February report also revealed that the average American employee's wage had grown only 1.6% in a year, while his or her household's average debt had grown by 10.4%, and home prices were inflating at a 15% annual rate. The unemployment report was claimed, politically, to lock the Federal Reserve into "no rise in interest rates until 2005" from their current 40-year low. This is a fatal trap for the central bank, as some Fed governors clearly see, in an economy actually bursting with inflation as the dollar falls (see article, page 6).

Then on March 10 came the worst-ever trade deficit report from the U.S. Commerce Department, a \$48.4 billion trade deficit in January (approaching a \$600 billion annual rate), as U.S. exports fell during the month despite the dollar decline; and a \$43 billion current-account deficit in that month. This, and the \$5-600 billion Federal budget deficit, had scared Greenspan, during Senate testimony on Feb. 25, into demanding drastic austerity against government entitlements, including Social Security and Medicare, and other desperate measures, in order to preserve the system of free trade. One newsletter, published by a senior Republican Party figure, reported that Greenspan frankly "fears another great depression," and believes that all that has held off disaster so far "is the exponential growth of credit derivatives" which have "sheltered the banking system from a catastrophic collapse."

But a potential derivatives-driven collapse was the third major shock, a March 10 report involving the huge national mortgage company known as Fannie Mae. Greenspan had already, on Feb. 25, told a Senate committee that Fannie Mae—a giant Federally-subsidized corporation with \$2.4 trillion in mortgage-debt securities outstanding—had too much debt and could cause a "systemic" crisis if it failed. Fannie Mae was supposedly protecting its vast exposure with credit derivatives, but on March 10 the London *Financial Times* reported, "An independent analysis of Fannie's accounts suggests it may have incurred losses on its derivatives trading of \$24 billion between 2000 and third-quarter 2003. . . . The potential scale of the liabilities, which have yet to be recognized in the company's earnings or in the minimum capital adequacy required by its regulator, raise fresh doubts about the financial health of the mortgage finance giant. Regulation of Fannie Mae and its sibling Freddie Mac is rapidly moving up the agenda in Washington, amid concerns that the two government-sponsored entities have grown so big that they pose a systemic risk to the U.S. financial system."

Fannie Mae and Freddie Mac have been the huge bellows blowing up the tremendous U.S. real-estate mortgage bubble, which has become both the financial "lifeline" of American households' consumption, and the engine of their ruinous and rapidly increasing indebtedness.

Fannie Mae acknowledged the derivatives losses, though refusing to quantify them until a report to be issued on March 15. In Congressional testimony on March 9, Treasury Secretary John Snow had warned that the idea that the two mortgage giants were "too big to fail" was wrong, and that the Bush Administration did not want to be seen as guaranteeing a subsidy of their debt in order to bail them out in a mortgage-debt crisis. But should one of the mortgage enterprises fail, or be taken over by regulators as Greenspan had mooted, the shock to the super-heated American mortgage bubble would cause an explosion.

A City of London financial expert commented that the problem of the large derivatives losses was not limited to



*What does Ex-IMF Director Horst Köhler (left) fear? What does he know that others don't? Köhler suddenly, on March 4, fled his IMF position—one of the world's most powerful offices—supposedly to seek the largely ceremonial Presidency of Germany! Here he's pictured with one mooted candidate to fill his abruptly-vacated office, Brown of the U.K.*

Fannie Mae, but involved the very large number of counterparties to its derivatives contracts. If the government formally withdraws the implicit public guarantees of Fannie Mae's debt, the counterparties would most likely suffer huge losses. "Look at JP Morgan Chase, which holds 50% of these derivatives. And other banks are heavily exposed to this as well. Then you get into yet another 'too big to fail' situation." Then it would be up to the Federal Reserve to step in, and that's why Fed governors Susan Schmidt Bies and Mark W. Olson recently sounded alarm about the mortgage risk."

In other words, what threatens is another, and much larger, LTCM-style failure: When the large derivatives-dealing hedge fund Long Term Capital Management went bust in 1998, the global financial system nearly melted down, as Federal Reserve officials, including Greenspan, admitted—later. A Fannie Mae or Freddie Mac failure would dwarf the explosive charge of LTCM.

## Fears at the BIS and IMF

The Bank for International Settlements' Quarterly Review issued in March, also pointed to a rising number of "factors of systemic risk" in the financial system, including the rush of banks and investors worldwide into high-risk markets, and a 26% increase in just the past year in the turnover of financial derivatives contracts at the official derivatives exchanges.

The IMF itself was "hit like a bombshell" by the abrupt resignation of its Managing Director, Horst Köhler, on March 4, less than a week before the deadline at which an Argentine

default to the Fund was feared. The day after Köhler jumped ship, the IMF website put up a press release reporting on a Feb. 25 meeting of the Fund's directors, to discuss "financial risk" to the institution, and the need to bolster "precautionary balances" against the "risk of an income shortfall." Specifically, the directors "stressed that sound risk management requires the Fund to be prepared for the possibility of payments disruptions, which could arise from the increase and concentration of its outstanding credit."

The greatest credit risk to the IMF, its release said, "is mainly from large arrangements with middle-income countries and the Fund." Conveying urgency, if not panic, the directors agreed that the "adequacy of the level of precautionary balances, and the pace of their accumulation, as well as the application of the burden-sharing mechanism, will need to be kept under close review."

Argentina's *Pagina 12* newspaper put this a good deal more plainly in its March 7 coverage, "Who Will Save the Fund?" Argentina and Brazil alone account for 50% of the IMF's loans outstanding. Add Turkey, and three IMF debtors—all which have been suffering foreign-debt crises—account for 72% of its assets. "If the Fund were a private bank," *Pagina 12* stated irrefutably, "the central bank of any country would have already suspended it"; another way of putting LaRouche's insistence that it is the IMF, World Bank, and central banks which need to be put into bankruptcy reorganization in a New Bretton Woods.

This was the situation, of growing fears of a coming global financial blowout, in which some right-wing Synarchist financial forces in the United States and Europe were demanding a brutal confrontation with Argentina on March 9. These forces wanted an end to the IMF/Federal Reserve "wall of money" policy, which went into effect from 1997 on, with the debt crises of Asian nations, then Brazil, Russia, Mexico, Turkey, and Argentina. Ironically, these Synarchists were blaming this money-printing, debt-bailout policy on Argentina, which had had nothing to do with its formulation by their opposite numbers, "left-wing Synarchists" like George Soros and Felix Rohatyn. In this Argentine crisis, U.S. monetary authorities in particular, apparently decided they needed the "wall of money" for a while longer—to feed the debt bubble in the United States. But before long, it will look like the walls of Jericho after Joshua blew his horn, unless LaRouche's New Bretton Woods conference is urgently convened.