Draining the Boat

The central bankers are cutting a bigger hole in the bottom of the boat to drain out the water.

Say you've got a system which is drowning in debt, so much debt that everyone knows it can never all be repaid; so much debt that just making the interest payments has become a herculean task; so much debt that you go into shock just thinking about it. What do you do in a crisis? If you're a modern central banker, a commercial or investment banker, or a money manager, the answer is obvious: Pile on more debt!

Wait! you say; that's insane! You're right, of course, but that is what the central bankers did in the first three weeks of August, and they may very well still be doing it as you read this. Faced with the seize-up of the biggest debt bubble in history—they prefer to call it a "credit crunch" or a "liquidity crisis," to make it sound less like it's their own damn fault—the central bankers turned the money pumps on, poured several hundred billions of dollars into the financial system, and prayed to whatever gods they follow that it wouldn't all blow up in their faces.

It wasn't supposed to happen this way. For months, the central bankers had been sending signals that the era of sloshing liquidity was over. They knew their policies had created the largest speculative bubble in history; they knew it was unsustainable; they knew that it was in fact beginning to crash down around them, and like the addict who promised to go clean, they swore that this time they would control themselves. This time, they promised, it will be different.

Then, when the latest withdrawal symptoms hit, they did what junkies always do; they grabbed their hypodermic needle and injected money into the veins of the financial system. Then, after taking their narcotic fix, they assured us that all was well. It's okay, they said.

Of course, they've lied before, and not just to us, but also to themselves. It's a subprime crisis, they insisted when the subprime loans started failing—it's not us; it's those sleazy subprime guys, but we're sound and it is all containable. We promise. But they lied. The Bear Stearns hedge funds blew up; the mortgage-backed securities and collateralized debt obligations markets froze up when the creditors of those B.S. funds tried to sell their collateral and found they couldn't get anywhere near book value. Suddenly, seemingly inexplicably, the "subprime" crisis blossomed into a full-blown global financial blowout, with money vaporizing right and left.

At that point, the markets panicked, the banks panicked, and the central bankers panicked. Faced with the consequences of their own follies, the speculators demanded that the central banks save them, and the central banks did, their weakened sense of reason overridden by blinding fear. They blinked, big time.

The problem that they have is simple: The system is awash in worthless paper, with financial claims soaring while the productive capability of the economy, and thus the ability to pay off those claims, crashes through the floor. Adding new debt—which is what the central banks do when they add liquidity—only makes the problem worse.

What is playing out before our eyes is the death of the financial system: The debt-farming mechanism based upon ever-rising real estate mortgage flows has stalled, setting off a chain-reaction vaporization of financial "assets" supposedly worth billions of dollars—and that's just the tip of the iceberg.

As the panic spread, speculators began fleeing into the relative safety of Treasury and other government bonds while trying to unload mortgage-backed securities, CDOs, derivatives, and other evaporative paper. With speculation drying up, the carry trade also slowed dramatically, cutting another leg out from under the bubble.

Among the hardest hit players have been the "quants," the guys whose trading strategies revolve around complex mathematical algorithms designed to predict market behavior. But, like the humans who devise these strategies, these formulae are unable to deal with the breakdown of the system itself.

"The market has gone freaky," was how one befuddled hedge fund operator described it to *Bloomberg.*

The global financial market has long operated on the "greater fool" theory, the idea that no matter how risky the game gets, there will always be someone willing to buy what you own; but the even greater fool is someone who believes that such a game can continue forever. Casino chips may have value inside the casino, but they have no value when the casino fails, and the same applies to financial paper, much of which is now about as valuable as the confetti left on the streets after a parade.

The commercial and investment bankers, the fund managers, the so-called investors, the whole bunch is in denial, pretending that their Humpty Dumpty is still perched on the wall. But no matter how often they say it, it just isn't so.