Erect a Firewall Now: Debt Is Not an Asset

by John Hoefle

"I don't know how the financial system is going to survive through October," Lyndon LaRouche commented on Aug. 31, after reviewing recent developments on the global financial front. We need to get the firewalls up fast to protect the population, he added.

The growth of the global financial system is premised upon a very simple fraud, namely the treatment of unpayable accumulated debts as assets. Those "assets" are then leveraged many times over, turning thousands into millions into billions into trillions of dollars of financial bets. With each passing year, the financial system gets further divorced from reality, further past the edge of the cliff.

Incurring debt can be useful, if the monies obtained by that debt are used to build up the productive capacity of a society, but when that debt becomes a substitute for productive activity, then it just makes the situation worse. That's the problem we face today. Since our economy operates upon borrowed money—households, businesses, and governments—every default carries the risk of triggering an avalanche of losses, and threatens to set off a chain reaction which will take down the system itself. Each loss brings us closer to that chain reaction, and the losses are coming fast.

Worse To Come

To keep their game going in recent years, the central banks increased the rate at which they were pumping money into the financial system. The rate of money being poured in was so great that the rate of the rate of increase in monetary emissions surpassed the rate of the rate of the growth of financial aggregates (the total of stocks, bonds, derivatives, etc.), creating hyperinflation of financial assets. We have long since passed the point where this is a debt problem which can be bailed out.

What is occurring can only be understood from the standpoint of LaRouche's Triple Curve pedagogy (**Figures 1-2**), with a decline in physical assets and hyperbolic growth in financial and monetary aggregates, not as separate developments, but as part of one continuous function. The more the physical economy is looted to provide assets for the bubble, the quicker the foundation upon which all the money and speculation erodes, in a self-feeding collapse. If you stop feeding the bubble, it collapses, and if you continue feeding it, it also collapses. Such concepts are well beyond the capabilities of Wall Street's algorithms.

When debts are treated as assets, the assets of the system become an enormous liability, and a bubble which is built on the leveraging of such worthless assets, will collapse in a reverse leverage chain reaction much faster than it was constructed. Each time an asset collapses, it increases the rate of collapse of other assets, and accelerates the rate of collapse of the system as a whole. During periods like the present, when nearly all of the speculators are trying to sell their risky assets and flee into the security of Treasuries, the value of the assets fall with each attempted sale. They are worthless if no one will buy them, and worthless even if someone does.

This collapse is playing out with different speeds in different countries, but all subsumed within an overall global decline in physical productivity and hyperinflationary increases in monetary and financial obligations. The rate of this collapse will increase hyperbolically, and the system will be gone by mid-October, LaRouche said. The explosions we are seeing now are mere grenades, with much larger ones to come. If the system hits a big landmine, it may not even make it to October. The greater the losses, the more unstable the system.

FIGURE 1
LaRouche's Typical Collapse Function

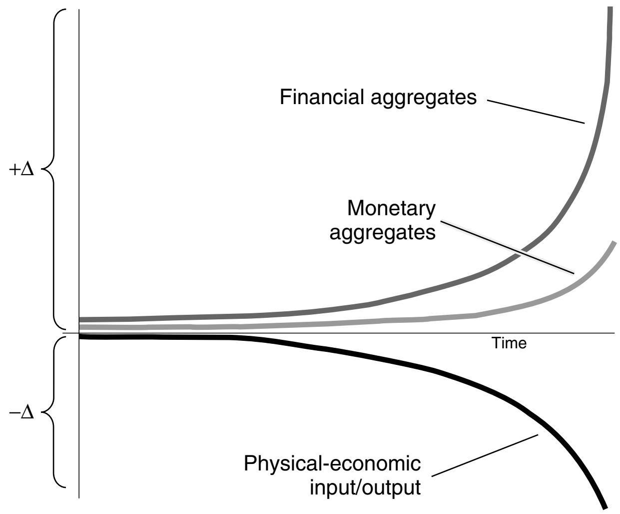
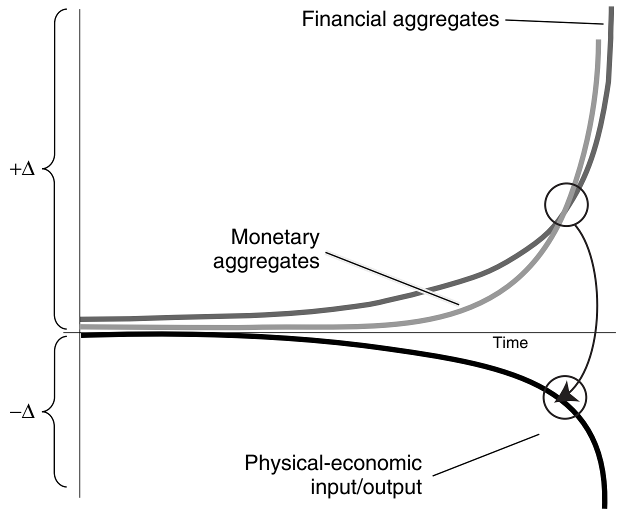


FIGURE 2
The Collapse Reaches a Critical Point Of Instability



The only way to avoid a catastrophic explosion, LaRouche said, is to freeze the system, to put up firewalls to protect the population and the productive part of the economy, as outlined in his Homeowners and Bank Protection Act. The problem must be treated as a whole; trying to deal with selected aspects individually will solve nothing.

Economic Deficit

Since the economic and political policy shifts of the 1967-70 period, at the direction of the financial oligarchy, the United States has deliberately dismantled what was once the most powerful industrial machine in the world, backed by a society committed to scientific and technological development, and replaced it with an information and service economy based upon computers, services, and financial speculation. Under this regime, the incomes—in real terms—for most of the population began to decline, particularly for those people who lost their higher-paying industrial jobs; at the same time, the costs of living began to rise. To make up the difference, households began taking on debt, primarily via credit cards, car loans, and home mortgages. Businesses also escalated the use of borrowed money, via bank loans, commercial paper, and the bond markets. Debt became a way of life, slowly losing its stigma, and after a while, we were so hooked that we began to pretend that we were managing our debt, instead of our debt managing us.

This debt grew and grew, and began piling up in the banking system. The banks could only hold so much. Everyone understood that while individual debts could be paid, the total debt could not, so an elaborate system of rolling over old loans into new loans was established, and the banks began packaging this debt into securities and selling them to investors, in amounts never before seen. These securities might be based on debt that could never be paid, but in accounting terms, they still qualified as assets on the books of the investors, who then borrowed against them or turned them into other securities, which they could sell. Pretty soon, the values of all the securities, derivatives, and other bets dwarfed the amount of debt upon which they were nominally based, and far outpaced the value of the physical assets upon which the entire edifice rested. As this mess grew, it got pushed farther and farther off the balance sheets of the banks, into the off-balance-sheet netherworld of the derivatives markets and the hedge funds, operating through unregulated pirate coves like the City of London's Cayman Islands.

This speculative casino grew so large that it took over the global economy, and the more it grew, the more voracious its appetite for funds became. Real estate prices were pushed up in the United States, in Europe, Japan, and elsewhere to create new debt to feed the machine, vacuuming money out of households, businesses, and governments, sucking the real economy dry. Eventually, as had to happen, the casino got so big that there wasn't enough money to keep it going.

One of the key components of this bubble, the U.S. housing market, hit the wall in 2005. The rate of increase of home prices stalled, and began to fall to the point where many areas are now seeing not just a slowing rate of increase, but absolute decreases in housing prices. To try to keep the game going in the face of this decline, the financiers began loosening mortgage standards and relaxing loan terms, anything to make a sale. This was not about selling homes, but about selling mortgages, keeping the money flowing into the casino. Houses, from the standpoint of the casino, were a byproduct of their debt-farming scheme.

Shock Waves

Since the global financial system is basically a giant pyramid scheme, which must grow lest it collapse, the shrinking of the money flow has triggered shock waves of losses reverberating through the system. As prices fall, those who bought at the peak of the market are the first to run into trouble, with mortgages worth more than their homes. Many of these buyers also had the loosey-goosey mortgages; some had adjustable-rate mortgages (ARMs), and are faced with escalating monthly mortgage payments even as their home values fall; other buyers lose their jobs or have health problems, and still others bought homes for speculative purposes. Whatever the reason, the defaults and foreclosures began, and continue to rise while prices fall, and that spells trouble for the trillions of dollars of financial paper based upon real estate values.

These defaults set off what has become known as the "subprime crisis," which is said to be the cause of our current turmoil. If only the buyers had been more responsible, if only the subprime lenders had been less greedy, then we wouldn't have this "contagion" infecting an otherwise healthy system, we were told. As cover stories go, it was pretty successful, pushed by the bankers and the media cartels.

Still, while a good cover story might shift the blame, it can't hide the losses, and the losses are growing day by day. Since assets these days are just someone else's debts, each default on a debt blows out someone's asset, and as the losses pile up, they trigger shock waves of defaults through the system. To make matters worse, there are trillions of dollars of leveraged assets in the system, the value of which depends upon rising real estate values. That is, they are perceived to have value based upon the expectation that you will be able to sell them to someone else for more than you paid for them. When prices stop rising, the game is over.

A good example of how this works begins with Bear Stearns, a leading subprime lender which poured billions of dollars of mortgage-backed securities and collateralized debt obligations into hedge funds it controlled, only to see those hedge funds blow up in mid-Summer. Merrill Lynch, which had loaned one of the funds some considerable amount, seized and tried to sell some of the fund's securities that had been pledged as collateral, but found it could only get some 50 cents on the dollar of face value, so it stopped the sale.

The implications of this failed sale are enormous, because it revealed publicly that the official valuations of the securities were fictitious. The scramble to cash in was on—and until LaRouche's approach is taken, it won't stop until we hit bottom.