How Long Can Congress Deny The Depression Crash?

by Paul Gallagher

Over the two weeks, between U.S. Treasury Secretary Henry Paulson's strange Oct. 15 announcement about a mysterious "Master Liquidity" scheme to save huge banks from huge losses, and Moody's Investors Service's Oct. 26 move to a massive international downgrade of bonds collateralized by mortgage securities, every economic sign has flashed the raw red of depression collapse underway.

The U.S. dollar, after Paulson's giveaway announcement that the fear of bank collapses is widespread in his high financial circles, rapidly sank by another 5% against the euro (for example) within ten days. The Treasury's Oct. 16 report of net investments into/out of U.S. securities in August (Treasury International Capital Statistics, or TICS) was a shock that opened a view of the financial crash. One Royal Bank of Scotland economist quoted by the *Financial Times* called the report "a truly stunning TICS number, the likes of which I have never seen." The Treasury reported that there was a huge net *outflow* of $163 billion from U.S. securities in August, as everything but short-term U.S. T-bills (the flight to safety) was massively dumped. The U.S. mortgage-based bubble was where the junk, subprime, high-interest action was for banks and funds worldwide, blowing that bubble to $20 trillion proportions until it collapsed—and everybody had to dump the toxic crap.

Central banks of Asia and other countries holding major dollar reserves, dumped U.S. government securities to the tune of nearly $80 billion in the past six months, according to Treasury reports; only the Bank of England and British investors bought them on a large scale, masking the effect until now. According to *China Daily,* Chinese and Japanese sales of U.S. treasuries grew in August, "at a pace unprecedented in the last five years, as the U.S. subprime mortgage crisis triggered the biggest sell-off of dollar assets since Russia's 1998 default." China cut its holdings of U.S. treasuries by 2.2% or $9 billion, to $400 billion, while Japan dumped 4% of its total holdings [or $24 billion], the most since March 2000. Taiwan's ownership of U.S. government bonds fell sharply by 8.9% to $52 billion.

The sales of homes in the United States during the July-September period was revealed, by official reports, to have sunk to 5.5-5.7 million per year—when 6 million sales a year was typical *three decades ago*. Median home sale prices—of new homes and resales—were shown by the same reports to have fallen by 8-10% during 2007, a drop unique to the Great Depression, but only just accelerating now. Medium-sized homebuilders, like Neumann Homes in Chicago, are following mortgage lenders into bankruptcy, and the biggest builders spent the last two weeks reporting multi-hundred-million-dollar losses. 100,000 construction jobs, net, have disappeared this year. Home ownership is back to the level of 2000.

That 2 million or more households could lose their homes to foreclosure next year, after 500,000 this year, is agreed by every report of the situation.

No Action on Industrial Collapse

Despite $700 billion in defense spending, orders for durable goods in the U.S. economy have fallen by 6% over the past 12 months, from $223 billion in September 2006, to $211 billion as of latest statistics, including drops in June, August, and September 2007, according to Commerce Department reports. Sales of autos in 2007 are heading for a total below 16 million—back to the level of 1994-95, and a level after which at least one of the big automakers will go into bankruptcy during 2008. Auto plants continue to be closed down, and some 150,000 U.S. manufacturing jobs were lost in the first three quarters of the year.

In a sad drama enacted throughout the auto shops during September-October, 250,000 unionized auto workers are being forced to accept new contracts under which the average wage is falling to $15-18/hour, wiping out the largest remaining source of middle-class incomes in the United States. This is a major factor in the explosion of home foreclosures across the Midwest and Mid-Atlantic states.

Banks and other financial corporations have announced, or carried out, about 100,000 layoffs during 2007, as they are hit by mounting losses in the mortgage-bubble meltdown. Another 30-40,000 people have been laid off by mortgage lending companies, from New Century Financial to Countrywide.

U.S. non-financial corporations, according to Federal Reserve reports, continue to spend *more than their total net profits in dividends and similar payouts*—in other words, they are not investing.

Just what "economic fundamental" is it, that remains strong?

Has Congress enacted a halt to foreclosures to prevent social chaos and impoverishment? So far, it has refused to do so. Has it lifted a finger to stop three years of collapse of the auto/machine-tool sector? It has not. Has it issued credit for investments in economic infrastructure to reverse this collapse? That is "off the table" in Speaker of the House Nancy Pelosi's Congress. Would President Bush allow such investments by Congress? Not if he can stop them by veto, as he showed with Congress's one attempt, the Water Resources Development Act.

Outrageous and Desperate Fed

At the time of publication of this issue of *EIR*, the Federal Reserve board will likely be cutting short-term interest rates by another one-half percent, in a worried attempt to keep Countrywide Financial Corp., Citicorp, Merrill Lynch, and other banks, mortgage lenders and insurers, and brokerages from failure. The broad U.S. money supply, what was called "M3" until the Fed suppressed reports on it last year, is estimated by private economists to be growing at a nearly 15% annual rate as of October—an absolute flood of Fed money-printing. As the dollar sank after Paulson's Oct. 15 forced blunder, an explosion of hedge-fund speculation and hyperinflation hit oil, energy commodities, metals, and agricultural commodities. This will accelerate further, after another "emergency" rate cut by the Fed.

Most outrageously, *EIR* learned that on Oct. 12, the Fed agreed to extend huge lines of credit to two *British* banks—$10 billion to the Royal Bank of Scotland (RBS), and $20 billion to Barclays, two of Britain's Big Four banks—to cover their "need of short-term liquidity to finance their holdings of securities and certain other assets," including "residential and commercial mortgage loans and mortgage-backed securities, asset-backed securities, commercial paper and structured products."

These mortgage-backed securities (MBS)—as shown in a sale of them just made by bankrupt American Home Mortgage Holdings—are sellable *at best* for 80 cents on the dollar, where the underlying mortgages are being paid completely up to date, and for no more than 55-60 cents on the dollar when *any* of the underlying mortgages are delinquent. Thus the structured investment vehicles (SIVs) that hold them, and the banks that are on the hook for them, want at all costs to avoid their sale, and instead to repurchase them internally, and hold them off their books. For that, they want bailouts from the central banks.

In a signal of desperation, the Fed explicitly authorized RBS and Barclays to extend these entire credit lines from the Fed, totalling $30 billion, to their "affiliated broker-dealers," which would then extend the funds to the two banks' collapsing SIVs. RBS did so immediately, with the failed Cheyne Finance, a $6-7 billion SIV of London-headquartered Cheyne (that's pronounced "Cheney") Capital.

Thus the Fed is creating hyperinflationary funds for multi-billion-dollar, super-leveraged instruments designed in London for speculation in the $20 trillion U.S. mortgage bubble, registered in offshore British protectorates to avoid taxes and regulation, and now at the center of the global banking crisis.

On Oct. 25, the Bank of England's desperate cash infusions to Northern Rock bank officially reached $40 billion; this big mortgage bank was hit by huge runs by depositors in September, and is headed for failure.

All of the hedge fund SIVs designed to spread the risk of huge losses *away* from the big banks in a bubble implosion and credit crisis, are now coming back to hit . . . the banks.

In September, bank analysts estimated publicly that $1.3 trillion in losses had occurred in the August-September crisis. But a very knowledgeable European banker consulted by *EIR* in late October, estimated that at least $2.4 trillion in *unrealized losses*—that is, losses unacknowledged, so far, in the collapse of mortgage and mortgage-securities bubbles—remain on and off the books of U.S. and European banks and financial institutions. In the next several months, those losses will have to be acknowledged and taken. The "super-conduit bailout" Paulson had talked up, of somewhere between $80 billion and $200 billion, might bail out the dead assets *of Citicorp alone*, the banker said—not the losses of the system.

All of the desperation money-printing of central banks, epitomized in the actions of the Federal Reserve described above, is an attempt to postpone those losses, and liquefy those dead, illiquid assets—whose only effect is to collapse the dollar, and create hyperinflation and financial markets chaos.

Yet the banks could take those losses and survive, under new policies by the most important governments, to create "national firewalls" protecting both essential economic sectors and chartered banks from the unstoppable collapse of the rotten financial and monetary system.

The Merrill Lynch Revelation

The fact that Merrill Lynch's estimate of the mortgage-bubble losses it would have to write off, rose rapidly from $4.5 billion on Oct. 10, to $7.9 billion in its Oct. 24 third-quarter report, exposed the entire banking system, in the United States and Europe, as sitting on the kind of losses indicated to *EIR* by the European banker. "A couple of weeks ago, we thought the line had been drawn under the losses [of the mortgage bubble collapse]—and it hasn't," said a scared London securities dealer to Reuters on Oct. 25. Some estimates were that Merrill Lynch would soon have to fess up to, and write off, $20 billion more, which could sink it for good.

Many money-center banks, and nationally chartered banks, have reported big write-downs, and in some cases large net losses overall, in their third-quarter reports. Bank of America immediately cut 3,000 jobs, and National City Bank in Ohio, the ninth-largest U.S. bank, cut 2,500.

But, Reuters quoted a Bear Stearns banker, "The Merrill result means all bets are off." The banks have only been showing the tail of the dog of what their real losses are, denying the illiquidity of the assets in all their "special investment vehicles" and so forth, for as long as possible. "We are somewhat nervous" about European announcements about to come, said a bank analyst for Royal Bank of Scotland.

On Oct. 26, Moody's, having just downgraded $33 billion in mortgage-backed securities in one fell swoop, downgraded an even bigger mass of collateralized debt obligations (CDOs), tied to $52 billion of downgraded mortgage bonds. The widely watched index of value on these securities dropped to about 82 cents on the dollar. This shock began to collapse the stocks of large insurance companies that insure mortgage securities—most notably Hank Greenberg's AIG Corp., and also MBIA, Ambac Insurance, Radian Group, and other insurance giants—which also insure municipal bonds and mutual funds.

The credit collapse of July-August—after roughly $1.5 trillion in liquidity injections has been thrown at it by the Fed, Bank of England, and European Central Bank through October—is back on again going into November, and on a bigger scale.

The financial system is collapsing. Congress must act to put a "firewall"—a Homeowners and Bank Protection Act—between the financial collapse, and real households and the real economy. That opens the door to other emergency actions to invest in a new national economic infrastructure, to revive the industrial economy. Congressional leaders who are denying this systemic collapse, and basing their response to the foreclosure crisis on that denial, will have to eat their words.