Newsletter 61: Is This The End of The Dollar System?

Hello Dear Readers,

For months since the dramatic lockdown of the global economy amid a coronavirus whose effects in terms of human death have been compared to a severe annual flu mortality, a growing chorus of establishment economists and central bankers have begun to speak of the end of the dollar system as the basis of world trade. This is no small issue. It took two world wars to establish the dollar firmly at Bretton Woods in 1944 as the anchor currency of world trade, replacing the British Pound Sterling. If we look back to the 2007-2008 "sub-prime" financial crisis, amid the trillions of dollars in emergency USA covid19 Treasury money creation, it becomes more clear that the money interests who control those central banks have long planned the end of the dollar. What they plan, if we read their speeches carefully, is definitely not a Chinese yuan system based on another national currency. Rather, as articles at the website of the elite Davos World Economic Forum and elsewhere show, they plan to create a global digital currency in a cashless society where money will be totally controlled by state actors. If you think this is extreme, I urge you to make your own research. Here I share with you a chapter from my best-selling book, ***Gods of Money: Wall Street and the Death of the American Century***, written one year after the 2008 crash and the unprecedented Federal Reserve liquidity creation called QE.

Please consider to support my work via PayPal on my website, www.williamengdahl.com. Every support is important to keep my work available for you without cost.

Thank you and warm regards in these dangerous times,

William Engdahl
www.williamengdahl.com

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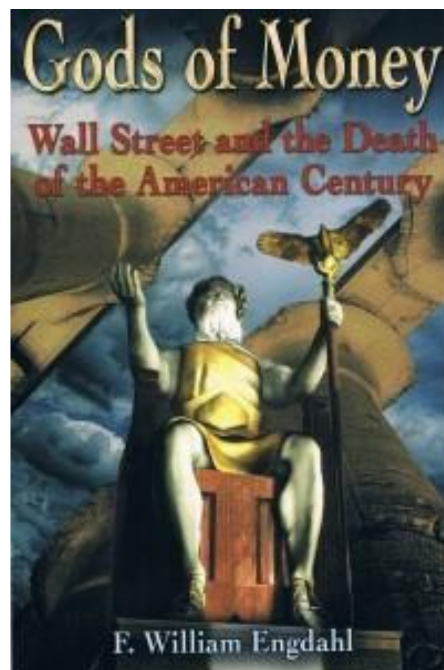

The End of the Dollar System?

'Behold, there come seven years of great plenty throughout all the land of Egypt: and there shall arise after them seven years of famine; and all the plenty shall be forgotten in the land of Egypt; and the famine shall consume the land'

-- Book of Genesis, 41:28-30

A little bank makes a big splash

The multi-trillion dollar US-centered securitization debacle began to unravel in June 2007 with the liquidity crisis in two hedge funds owned by the New York investment bank, Bear Stearns. One of the world's largest and most successful investment banks, it was also reportedly the bank used by the Bush family to handle a share of their vast wealth.

The two hedge funds were heavily invested in subprime mortgage securities. The damage soon spread across the Atlantic to a small German state-owned bank, IKB. In July 2007, IKB's wholly-owned funding conduit or subsidiary, Rhineland Funding, had approximately $24 billion in Asset Backed Commercial Paper (ABCP). In mid-July, investors refused to accept Rhineland Funding's ABCP. That triggered a global panic in the entire market for Asset Backed Securities as news spread like wildfire that IKB was insolvent. The panic forced the European Central Bank to inject record volumes of liquidity into the market to keep the banking system liquid.

Rhineland Funding asked IKB to provide a credit line. In turned out that IKB didn't have enough cash or liquid assets to meet the request, and was saved only by an emergency $10 billion credit from its state-owned major shareholder bank, the Kreditanstalt für Wiederaufbau (KfW). Ironically this was the same bank that had led the Marshall Plan reconstruction of war-torn Germany in the late 1940s. It was soon to become evident to the world that a new Marshall Plan, or some financial equivalent, was urgently needed, this time for the United States economy.

The intervention of KfW, rather than stopping the panic, led to widespread bank reserve hoarding and to a run on all commercial paper issued by international banks' off-books Structured Investment Vehicles (SIVs).

Asset Backed Commercial Paper was another one of the big products of the asset securitization revolution, described earlier, that had been fostered by Greenspan and Wall Street. They had been created to get risks off the balance sheets of the banks while at the same time allowing the banks to book handsome profits from the SIV gains. It was another example of having your cake and eating it too, only in the end it didn't function as Wall Street had planned.

A bank's SIV would typically issue Commercial Paper securities backed by a flow of payments from the cash collections received from the SIV's underlying asset portfolio. ABCP was short-term debt, generally no more than 270 days. Crucially, however, it was exempt from the registration requirements of the US Securities Act of 1933. They were unregistered securities, a huge loophole in terms of transparency.

ABCPs were typically issued from pools of trade receivables, credit card receivables, auto and equipment loans and leases, or collateralized debt obligations. An issuer would collect perhaps hundreds or several thousand small individual car loans from local banks, buy them at a discount, create a new bond whose value was based on the estimated future monthly cash inflow of those car loans, or credit card loans or similar sources.

In the case of IKB in Germany, the cash flow was supposed to come from its portfolio of sub-prime US home mortgages, mortgage-backed Collateralized Debt Obligations (CDOs). It was more than questionable what a European bank dedicated to lending to medium size German industry was doing buying such dicey securities as ultra-high-risk US subprime mortgage securities.

The main risk faced by ABCP investors was what bankers call asset deterioration—that the individual loans making up the security, whether home mortgage loans or car loans or whatever, would go into default—which is precisely what began to rumble through the US home mortgage markets during the summer of 2007.

The problem with CDOs was that once issued, they were rarely traded. They were new and no one had yet tested them in a distress sale. Their value, rather than being market-driven, was based on complicated theoretical models.

When CDO holders around the world in August 2007 suddenly and urgently needed liquidity to face the market sell-off, they found that the market value of their CDOs was far below their book value. So, instead of generating liquidity

by selling CDOs, they instead were forced to sell high-quality liquid blue chip stocks, government bonds, and precious metals to raise urgently needed cash to cover losses.

That meant the CDO crisis led to a collapse of value in both CDOs and stocks. The drop in the price of stocks spread to hedge funds. The possibility of a dramatic price collapse had not ever been factored into the theoretical models used by all the quantitative hedge funds, and it resulted in large losses in that part of the market, led by Bear Stearns' two in-house hedge funds. Major losses by leading hedge funds further fed increasing uncertainty and amplified the crisis.

That was the beginning of colossal collateral damage, a destruction of wealth without historical precedent. The banks' risk models all had manifestly broken down.

Lack of transparency was at the root of the crisis that had finally and inevitably erupted in mid-2007. The lack of transparency, as outlined earlier, was due to the fact that instead of spreading risk in a transparent way, as foreseen by accepted economic theory, market operators chose ways to 'securitize' risky assets by promoting high-yielding, high-risk assets, without clearly marking their risk. Additionally, credit-rating agencies turned a blind eye to the inherent risks of the products. They used the same flawed risk models to rate the securities. The fact that the bonds were rarely traded meant that even the approximate value of these financial products was not known. [1]

Ignoring lessons from LTCM

Among banks, confidence in the international inter-bank market -- the heart of a global banking system that relied on Asset Backed Commercial Paper -- collapsed in August 2007. And with that collapse, the banking system stared a systemic crisis in the face. The crisis now threatened a domino collapse of banks akin to what had happened in Europe in 1931, when French banks, for political reasons, had pulled the plug on the Austrian Creditanstalt. The Federal Reserve's New Finance was revealing itself to be but a colossal source of new instability.[2]

The world financial system had faced the threat of a systemic crisis as recently as the September 1998 collapse of the Long-Term Capital Management (LTCM) hedge fund in Greenwich, Connecticut. Only extraordinary, coordinated central bank intervention then, led by Greenspan's Federal Reserve, had prevented a global meltdown.

The LTCM crisis contained the seed crystal of all that was going wrong with the multi-trillion dollar asset securitization markets, and that, a mere decade later. Curiously, Greenspan and others in positions of responsibility systematically refused to take those LTCM lessons seriously.

One source of the awe over LTCM before it's colossal collapse in 1998 was the 'dream team' who ran it. The fund's CEO and founder was John Meriwether, a legendary Wall Street trader who had left Salomon Brothers following a scandal over purchase of US Treasury bonds. The scandal hadn't dented his confidence. Asked whether he believed in efficient markets, he once modestly replied, "I *MAKE* them efficient."

The LTCM hedge fund's principal shareholders included the two eminent experts in the 'science' of risk, Myron Scholes and Robert Merton. The Swedish Academy of Sciences had awarded the 1997 Nobel Prize for economics to Scholes and Merton for their work on derivatives. Myron Scholes and his colleague Fisher Black had developed the original options pricing theories in 1973, the Black-Scholes model, mentioned in the previous chapter that laid the basis for the multi-trillion dollar derivatives explosion twenty years later. LTCM also had on board a dazzling array of professors of finance, doctors of mathematics and physics and other "rocket scientists" capable of inventing extremely complex, daring and profitable financial schemes.

Black-Scholes—Fundamental flaws in risk models

There was only one flaw. Scholes' and Merton's fundamental axioms of risk, the assumptions on which all their models were built, were simply wrong. They had been built not just on sand, but on quicksand. They were profoundly and catastrophically wrong.

Their mathematical options pricing model assumed that there were 'perfect markets,' markets so extremely large or deep that individual traders' actions could not affect prices. They assumed that markets and players were also rational. Reality suggested the opposite—markets were fundamentally irrational in the long-term. But the risk pricing models of Black-Scholes and others over the previous two or more decades had allowed banks and financial institutions to argue that traditional lending prudence was old fashioned. With suitable options as a kind of insurance, risk was no longer a worry. Or so Wall Street believed. Eat, drink and be merry, and collect your million dollar bonuses....

The assumptions of the risk models developed by Black, Scholes and Merton, however, ignored actual market conditions as prevailed in every major market panic since the Black-Scholes model had been introduced in 1973 on the

Chicago Board Options Exchange. They ignored the fundamental role of options and 'portfolio insurance' in the Crash of 1987; they ignored the causes of the panic that in 1998 brought down Long Term Capital Management – the firm where Scholes and Merton were both partners. Wall Street, along with the economists and governors in the Federal Reserve, most especially Alan Greenspan, blissfully ignored the obvious.

Financial markets, contrary to the religious dogma that had been taught at every US and UK business school for decades, were not smooth, well-behaved entities following the Gaussian Bell-shaped Curve as if it were a fundamental law of the universe. The fact that the main architects of modern theories of financial engineering—now given the serious-sounding name 'financial economics'—had all been awarded Nobel prizes, surrounded the flawed models with the aura of Papal infallibility.

Only three years after the 1987 crash, a crash which had been driven by derivatives and the flawed risk models, the Nobel Committee in Sweden gave Harry Markowitz and Merton Miller the prize for advancing the same flawed risk notions. In 1997, amid the Asian financial crisis, where derivatives had played a central role, it gave the Nobel award to Robert Merton and Myron Scholes. [3]

The most remarkable aspect of the flawed risk models in use since the origins of financial derivatives in the 1980s and throughout the explosive growth of asset securitization twenty years later, was how rarely the risk models themselves were questioned.

The traders at LTCM, and all those who followed them to the edge of the financial abyss in August 1998, did not have a hedge against the one thing they now confronted—systemic risk. Systemic risk was precisely what they confronted when an 'impossible event,' the Russian state default, proved possible.

Despite the clear lessons from the harrowing LTCM debacle—that there was and is no derivative an investor or speculator can buy that insures against systemic risk—Greenspan, Robert Rubin and the New York banks continued to rely on their flawed risk models as if nothing had taken place. The Russian sovereign default was dismissed as a "once in a Century event."

The Wall Street bankers were moving forward to build the Dot.com bubble and, in its aftermath, the greatest financial bubble in human history—the asset securitization bubble of 2002-2007. The Wall Street strategy was to move risk off the banks' balance sheets through derivatives and other instruments such as securitization. Then by selling these novel securities to the rest of the world,

they clearly saw a way to build their money power over the rest of the world almost without limit. Wall Street banks became literally intoxicated with their own hype and their own flawed risk models. They regarded themselves as literally the "Gods of money."

Life is no Bell Curve

Risk and its pricing however did not behave like a bell-shaped curve, not in financial markets any more than in oilfield exploitation. In 1900, an obscure French mathematician and financial speculator, Louis Bachelier, had argued that price changes in bonds or stocks followed the bell-shaped curve that the German mathematician, Carl Friedrich Gauss, had devised as an idealized working model to map statistical probabilities for various events. Bell curves assumed a 'mild' form of randomness in price fluctuations, just as the standard I.Q. test, by design, defines 100 as 'average,' the center of the bell. It was a kind of useful alchemy, but alchemy nonetheless.

The assumption that financial price variations behaved fundamentally like the bell curve allowed Wall Street's 'rocket scientists' to roll out an unending stream of new financial products, each more arcane and complex than its predecessor. 'Rocket scientist' was the name given by Wall Street to the math geeks and physicists they were hiring to figure out complex new financial angles to make a bundle on financial derivatives. With America's industrial base long in terminal decline, the nation's most talented scientific minds were being pulled into Wall Street.

The 'Law of Large Numbers' was added to the cocktail of risk models, to argue that when the number of events became sufficiently large, like flips of a coin or rolls of dice, the value converged on a stable value over the long term. The 'Law of Large Numbers,' which in reality was no scientific law at all, allowed banks like Citigroup or Chase to issue hundreds of millions of Visa cards without so much as a credit check, based on data showing that in 'normal' times, defaults on credit cards were so rare as not to be worth considering.[4]

The problem with models based on bell curve distributions or laws of large numbers arose when times were not normal -- such as a steep economic recession of the sort the United States economy went into after 2007, comparable perhaps only to that of 1931-1939. Even worse, the risk models in play actually led to the creation of the asset bubble that collapsed with a thud in August 2007.

The remarkable thing was that America's academic economists and Wall Street investment bankers, Federal Reserve governors, Treasury secretaries, Sweden's

Nobel Economics Prize judges, England's Chancellors of the Exchequer, her High Street bankers, her Court of the Bank of England, to name just the leading icons -- all were willing to turn a blind eye to the fact that no economic theories, no theories of market behavior, no theories of derivative risk pricing, were capable of predicting, let alone preventing, non-linear surprises. [5]

The theory on which trillions of dollars of worldwide credit obligations ultimately rested was incapable of predicting the ultimate burst of speculative bubbles -- not in October 1987, not in February 1994, in March 2002, and most emphatically not since June 2007. It couldn't because the very model used had created the conditions that led to the ever larger and more destructive bubbles in the first place. Financial Economics was but another word for unbridled speculative excess, a process that inevitably would create bubbles, followed by collapsing of bubbles.

Nobel prizes notwithstanding, a theory incapable of explaining such major, defining, 'non-linear' surprise events was not worth the paper it was written on. Yet the US Federal Reserve Governors and Treasury Secretaries—from Alan Greenspan to Ben Bernanke, and US Treasury secretaries Robert Rubin, Larry Summers, Henry Paulsen and Tim Geithner—prevailed to make sure that Congress never lay a legislative or regulatory hand on the exotic financial instruments that were being created, instruments that had been created based on a theory that contradicted reality.

On September 29, 1998, Reuters reported,

> *Any attempts to regulate derivatives, even after the collapse—and rescue—of LTCM, have not met with success. The CFTC* [the government agency with nominal oversight over derivatives trading-w.e.] *was barred from expanding its regulation of derivatives under language approved late on Monday by the US House and Senate negotiators. Earlier this month the Republican chairmen of the House and Senate Agriculture Committees asked for the language to limit the CFTC's regulatory authority over over-the-counter derivatives echoing industry concerns.*

"Industry," of course, meant the big banks. Reuters added that,

> *When the initial subject of regulation was broached by the CFTC both Fed chairman, Alan Greenspan, and Treasury Secretary Rubin leapt to the defense of the industry claiming that the industry did not need regulation and that to do so would drive business overseas.*[6]

Relentless refusal to allow regulatory oversight of the explosive new financial instruments -- from Credit Default Swaps to Mortgage Backed Securities, and the myriad of similar exotic ‘risk-diffusing’ financial innovations – that had begun with the 1999 repeal of the Glass-Steagall Act strictly separating securities dealing banks from commercial lending banks, opened the gates in June 2007 to the second Great Depression in less than a century. It began what future historians will no doubt describe as the final demise of the United States as the world’s dominant financial power.

Fraud à la Carte

The lessons of the 1998 LTCM systemic crisis were forgotten within weeks by the major players of the New York financial establishment. They reckoned clearly that they would be bailed out by the Government, more accurately, the taxpayer when the next crisis broke. Why change things…

When Glass-Steagall was finally repealed in late 1999, banks were free to snatch up rivals across the spectrum from insurance companies to consumer credit or finance houses. The landscape of American banking underwent a drastic change. The asset securitization revolution was ready to be launched.

With Glass-Steagall gone, the only banks directly monitored by the Federal Reserve were bank holding companies and subsidiary pure lending banks. If Citigroup opted to close its government regulated Citibank branch in a subprime neighborhood and instead have a new privately-owned non-regulated subsidiary like CitiFinancial, which specialized in subprime lending, work the area, CitiFinancial could operate under entirely different and lax regulation.

CitiFinancial could then issue mortgages separately from Citibank. And this is precisely what happened. Consumer groups accused CitiFinancial of specializing in ‘predator loans’ in which unscrupulous mortgage brokers or salesmen would push a loan on a family or person far beyond his comprehension or capacity to handle the risks, let alone the payments. And Citigroup was typical of most big US banks and mortgage lenders.

On January 8, 2008 Citigroup announced with great fanfare publication of its consolidated “US residential mortgage business,” including mortgage origination, servicing and securitization. Curiously, the policy statement omitted CitiFinancial, precisely the subsidiary with the most risk on its books. [7]

Liars' loans, NINA and an orgy of bank fraud

It didn't take long before lending banks across the United States realized they were sitting on a bonanza bigger than the California gold rush. With no worry about whether a borrower of a home mortgage, say, would be able to service the debt for the next decades, banks realized they could make money on pure loan volume and loan resale to securitizers.

Soon it became commonplace for banks to outsource their mortgage lending to free-lance brokers. Instead of doing their own credit checks, the brokers relied, often exclusively, on various online credit questionnaires, similar to Visa card applications, where no follow-up was done. It became common practice for mortgage lenders to offer brokers bonus incentives to bring in more signed mortgage loan volume, another opportunity for massive fraud. The banks got more profit from making high volumes of loans, and then selling them on to Wall Street for securitization. The world of traditional banking was being turned on its head.

As a bank no longer had an incentive to assure the solidity of a borrower through minimum cash down payments and exhaustive background credit checks, many US banks, simply to churn loan volume and boost returns, gave out what they cynically called 'Liars' Loans.' They knew the person was lying about his credit and income to get that dream home. They simply didn't care. They sold the risk once the ink was dry on the mortgage.

A new terminology arose after 2002 for such loans, such as 'NINA' mortgages—No Income, No Assets. "No problem, Mr. Jones. Here's $400,000 for your new home. Enjoy."

With Glass-Steagall no longer an obstacle, banks could set up various separate entities to process the booming home mortgage business. The giant of the game was Citigroup, the largest US bank group, which had become a behemoth after repeal of Glass-Steagall, with assets totaling over $2.4 trillions (sic), an amount larger than the annual Gross Domestic Product of all but six nations of the world.

Citigroup included Travelers Insurance, a state-regulated but not nationally regulated insurer. It included the old Citibank, a huge retail lending bank. It included the Wall Street investment bank, Smith Barney. And it included the aggressive sub-prime lender, CitiFinancial, according to numerous consumer reports, one of the most aggressive predatory lenders pushing sub-prime mortgages on uninformed, ignorant or insolvent borrowers, often in poor black or Hispanic neighborhoods. [8] It included the Universal Financial Corp. one of

the nation's largest credit card issuers, who used the so-called 'Law of Large Numbers' to grow its customer base among more and more dodgy credit risks.

Citigroup also included Banamex, Mexico's second largest bank and Banco Cuscatlan, El Salvador's largest bank. Banamex was one of the major banks in Mexico indicted for drug money laundering. That was nothing foreign to Citigroup. In 1999 the US Congress and GAO investigated Citigroup for illicitly laundering $100 million in drug money for Raul Salinas, brother of then-President of Mexico. The investigations also discovered that the bank had laundered money for corrupt officials from Pakistan to Gabon to Nigeria.

Citigroup, the financial behemoth, was typical of what happened to American banking after 1999. It was a different world entirely from anything that had existed before, with the possible exception of the excesses of the Roaring '20s. The degree of lending fraud and abuse that ensued in the new era of asset securitization was staggering to the imagination.

The Predators have a Ball

One US consumer organization opposing predatory lending by the banks documented some of the most common predatory lending practices during the real estate boom:

> *In the United States in the first decade of the 21st century there are many storefronts offering such loans. Some are old -- Household Finance and its sister Beneficial, for example -- and some are newer-fangled, like CitiFinancial. Both offer credit at rates over thirty percent… Citibank pays under five percent interest on the deposits it collects. Its affiliated loan sharks charge four times that rate, even for loans secured by the borrower's home.*
>
> *The business is global: the Hong Kong & Shanghai Banking Corporation, now HSBC, wants to export it to the eighty-plus countries in which it has a retail presence….CitiFinancial and Household Finance both suggest to customers that insurance is needed. This they serve in a number of flavors -- credit life and credit disability, credit unemployment and property insurance -- but in almost all cases, it is included in the loans and interest is charged on it... Midway you'll be approached with a sweet-sounding offer: if you'll put up your home as collateral, your rate can be lowered and the term be extended... The rate will be high and the rules not disclosed. For example: if you satisfy the loan too*

quickly, you'll be charged a pre-payment penalty. Or, you'll pay slowly and then be asked to pay more, in what's called a balloon.

In prior centuries, this was called debt peonage. Today it is the fate of the so-called sub-prime serf. Fully twenty percent of American households are described as sub-prime. But half of the people who get sub-prime loans could have paid normal rates, according to Fannie Mae and Beltway authorities. Outside, it's the law of the jungle; the only rule is Buyer Beware. [9]

In the 1980s, this author interviewed a senior Wall Street banker, at the time recovering from career burnout. I asked about his bank's business in Cali, Colombia where he worked during the heyday of the Cali cocaine cartel. Speaking off the record, he related, "I was in Cali earlier. Men with sunglasses literally walked into the bank with suitcases stuffed with 100 dollar bills. No questions were asked. Banks would literally kill to get a slice of this business, it was so lucrative." Those same banks moved on to sub-prime lending with similar goals in mind, and with profits as huge as those of drug money laundering, according to government insiders.

And again, it was Alan Greenspan and the Federal Reserve who vigorously backed the extension of bank lending to the poorest ghetto residents, shamelessly pretending that this was some form of 'distributive justice.' Edward M. Gramlich, a Federal Reserve governor who died in September 2007, warned as early as 2001 when the real estate boom was in its early phase, that a fast-growing new breed of lenders was luring many people into risky mortgages they could not afford. When Gramlich privately urged Fed examiners to investigate mortgage lenders affiliated with national banks, he was rebuffed by Alan Greenspan. According to Fed insiders, Greenspan ruled the Fed with nearly the power of an absolute monarch. [10]

Revealing what was most certainly the tip of a gigantic iceberg of fraud, the FBI in January 2008 announced it was investigating 14 companies for possible accounting fraud, insider trading or other violations in connection with home loans made to risky borrowers. The FBI announced that the probe involved companies across the financial services industry, from mortgage lenders to investment banks that bundle home loans into securities sold to investors. Little more was heard of it.

At the same time, authorities in New York and Connecticut were investigating whether Wall Street banks had hidden crucial information about high-risk loans bundled into securities sold to investors. Connecticut Attorney General Richard Blumenthal said he and New York Attorney General Andrew Cuomo were

investigating whether banks properly disclosed the high risk of default on so-called ‘exception’ loans — considered even riskier than subprime loans — when selling those securities to investors. In November 2007 Cuomo issued subpoenas to government-sponsored mortgage companies, Fannie Mae and Freddie Mac, in his investigation into what he claimed were conflicts of interest in the mortgage industry. He said he wanted to know about billions of dollars of home loans they had bought from banks, including the largest US savings and loan, Washington Mutual Inc., and how appraisals were handled.

The FBI said it was looking into the practices of subprime lenders, as well as potential accounting fraud committed by financial firms that hold these loans on their books or securitize them and sell them to other investors. Morgan Stanley, Goldman Sachs Group Inc. and Bear Stearns Cos. all disclosed in regulatory filings that they were cooperating with requests for information from various unspecified, regulatory and government agencies. [11]

One former real estate broker from the Pacific Northwest, who quit the business in disgust at the pressures on her to push mortgages on unqualified borrowers, described some of the more typical practices of predatory brokers in a memo to this author about the writing of Adjustable Rate Mortgages (ARMs):

> *The sub-prime fiasco is a nightmare alright. But the* ***prime*** *ARMs hold potential for overwhelming disaster. The first ‘hiccup’ occurred in July/August 2007 - this was the ‘Sub-prime Fiasco,’ but in November 2007 the hiccup was more than that. It was in November 2007, that the prime ARMs adjusted upwards.*
>
> *What this means is that upon the ‘anniversary date of the loan’ the Adjustable Rate Mortgage adjusts up into a higher payment. This happens because the ARM was purchased at a ‘teaser’ rate, usually one or one and one half percent. Payments made at that rate, while very attractive, do nothing to reduce principal and even generate some unpaid interest which is tacked onto the loan. Borrowers are permitted to make the teaser rate payments for the entire first year, even though the rate is good only for the first month.*
>
> *Concerns about ‘negative amortization,’ whereby the indebtedness on the loan becomes more than the market value of the property, were allayed by reference to the growth in property values due to the bank-created bubble, which it was said was normal and could be relied upon to continue. All that was promoted by the lenders who sent armies of account executives, i.e., salesmen, around to the mortgage brokers to explain how it would work.*

Adjustable interest rates on home loans were the sum of the bank's profit - the margin - and some objective predictor of the cost of the borrowed funds to the bank, known as the index. Indexes generated by various economic activities - what the banks around the country were paying for 90 day Certificates of Deposit or what the banks in the London Interbank Exchange (LIBOR) were paying for dollars - were used. Adding the margin to the index produces the true interest rate on the loan - the rate at which, after 30 years of payments, the loan will be completely paid off ('amortized'). It is called the 'fully indexed rate.

I am going to pick an arbitrary 6% as the 'real' or inflation adjusted interest rate (3% margin + 3% inflation index). With a loan amount of $250,000.00 the monthly payment at 1% would be $804.10; that is the 'teaser rate' payment, exclusive of taxes and insurance. This would adjust with changes in the index, but the margin remains static for the life of the loan.

This loan is structured so that payment adjustments only occur once per year and are capped at 7.5 % of the previous year's *__payment__*. *That can go on, stair stepping, for a period of 5 years (or 10 years in the case of one lender) without regard to what is happening in the real world. Then, at the end of the 5 years, the caps come off and everything adjusts to payments under the "fully indexed rate."*

If the borrower has been making only the minimum required payments the whole time, this can result in a payment shock in the thousands. If the value of the home has decreased twenty-five percent, the borrower, this time someone with excellent credit, is encouraged to give it back to the bank, which devalues it at least another twenty-five percent and that spreads to the surrounding properties. [12]

According to a Chicago banking insider, during the first week of February 2008, bankers in the US were made aware of the following:

Chase Manhattan Bank ("CMB") has sent out an unlimited number of statements to its customers about Lines of Credit ("LOC's"). The terms of its LOC's, which, have been popular in the past, are now being manipulated and the values of the properties securing them are being unilaterally adjusted down, sometimes as much as 50 percent. This means homeowners are faced with making payments on a loan to buy an asset that is apparently worth half of the principal amount of the loan and

paying interest on top of that. The only sensible thing to do in many cases is walk away, which results in a major loss in equity, reducing the value of all surrounding properties and adding to the avalanche of foreclosures.

This is especially aggravated in cases of "Creative Financing" LOCs - those that were drawn on equal to between ninety and one hundred percent of the value of the property before the bubble burst…

CMB has automatically closed credit lines that have "open" credit on them - meaning that the borrower left some money in the LOC for the future - over an80% ratio of the amount of the loan to the value ("LTV") of the property. This has been done on a mass basis without any reference to the"property owners." [13]

"Loan to Value" limits mean that the amount of money that the lender is willing to loan cannot exceed the stated percentage of the property value. In common practice, an appraiser would be hired to assess the value of the property. The appraisal is informed by comparable sales of other properties which have sold in an area that, with a few exceptions, must be no more than one mile away from the subject property.

Those practices were merely the tip of the mortgage fraud bonanza that preceded the unfolding Tsunami.

The Tsunami was only beginning

The more home prices fell after the bubble burst in 2007, the more mortgages faced sharply higher interest rate resets, the more unemployment spread across America from Ohio to Michigan to California to Pennsylvania to Colorado and Florida. As more and more workers became unemployed or under-employed, the inevitable occurred: the dramatic increase in auto loan and credit card payment defaults. That process set off a vicious, self-feeding spiral of asset price deflation across America and in many parts of the world. By the early weeks of 2008 the process was just beginning to become ugly.

The subprime sector was merely the first manifestation of what was to unravel. The process would take years to wind down. The 'toxic waste' products, Asset Backed Securities, had been used as collateral for yet further bank loans, for leveraged buyouts by private equity firms, by corporations, even by municipalities. The vast pyramid of debt built on securitized assets began to go into reverse leverage as reality dawned in global markets that no one knew the worth of the securitized paper they held.

With shameless guile hiding their criminal negligence, trivializing its tragic impact on millions of Americans and others around the world, Standard & Poors, the second largest rating agency in the world, stated in October 2007 that they had “underestimated the extent of fraud in the US mortgage industry.”

Alan Greenspan feebly tried to exonerate himself by claiming that lending to subprime borrowers was not wrong, that it was only the later securitization of the loans that had been the problem. The very system the bankers had labored to created over the preceding decades had been premised on fraud and non-transparency. They were clearly not naïve to that.

As hundreds of thousands of Americans over the coming months found their monthly mortgage payments dramatically reset according to their Adjustable Rate Mortgage terms, hundreds of billions of dollars in home mortgage debt went into default. That, in turn, led to a snowball effect in terms of job losses, credit card defaults and another wave of securitization crises in the huge market for securitized credit card debt.

The sinews of the entire American financial system were tied in to the colossal housing bubble and the related mortgage securitization debacle. There had never been a crisis of such magnitude in American history.

At the end of February 2008, the *Financial Times* of London revealed that US banks had ‘quietly’ borrowed $50 billion in funds from a special new Federal Reserve credit facility to ease their cash crisis. Losses at all the major banks -- from Citigroup to J.P. Morgan Chase to most other major US bank groups --- continued to mount as the economy sank deeper into a recession that clearly would turn into a genuine depression over the coming months.

During the 2008 Presidential campaign, neither candidate had dared utter a serious word about their proposals to deal with what was becoming the greatest financial and economic meltdown in American history.

The bizarre Lehman Bros. debacle

By early 2008 it had become clear that Financial Securitization was shaping up to become the Last Tango for the United States as the sole global financial superpower. Urgent measures were called for to save Wall Street’s power, if it indeed could be saved.

In September 2008, amid growing panic within the Bush White House and, above all, in the office of Treasury Secretary Henry Paulson, the Administration

made several decisions about which financial institutions to save and, most fatefully, which to let go bankrupt.

The large insurance company, AIG, whose founder, Hank Greenberg, had been accused several years before of gross fraud in manipulating the company's financial books, was given a US Government bailout of tens of billions of dollars. At the same time, the Government essentially nationalized the two huge privately owned national mortgage-underwriting companies, Fannie Mae and Freddie Mac. [14]

Then on September 15, 2008 a serious banking crisis in the US exploded into a global systemic financial crisis. Federal Reserve chairman Ben Bernanke met in closed-door session with New York Fed President Tim Geithner -- later to be Obama's Treasury Secretary -- and former Goldman Sachs CEO, Treasury Secretary Henry Paulson. They fatefully decided to let the fourth largest Wall Street investment bank, Lehman Bros., an institution with a history going back 153 years, go bankrupt.

Financial markets from Tokyo to London and Frankfurt began to panic as they suddenly realized there was now no clear or at least consistent guideline indicating which US financial institutions were 'too big to fail.' No longer could any bank anywhere be confident that its counterparty in New York was solvent or, if not, that it would be supported by the US Government. A far smaller investment bank, Bear Stearns, had been rescued with Fed money a few months earlier. There was no clear logic. Yet that was precisely the intent of Paulson's decision.

Within hours, around the world, markets plunged as news about the decision on Lehman Bros. leaked out. What had been until then a major crisis in a smaller segment of the US subprime mortgage securitization market, at a scale of perhaps $800 billion, suddenly became a global systemic crisis in which banks questioned every asset they were asked to accept from other banks. A global crisis of confidence had erupted for the simple reason that, in the midst of a major crisis, the US Government and the private Federal Reserve had decided to deliberately let a major bank fail. Clearly, they did so with full knowledge of the consequences.

Within seconds of the announcement that Lehman Bros. would not be bailed out as Bear Stearns had been a few months earlier meant that suddenly US financial policy, the doctrine of Too Big To Fail, the insurance policy that world banks had relied on since the crises of the 1980s, no longer was a basis on which to calculate risk in dealing with other banks, especially American banks.

Had Henry Paulson at the Treasury and Geithner and Bernanke at the Fed decided instead to rescue Lehman Bros. and let Bear Stearns fail, perhaps the impact would have been significantly less. At least bankers around the world would have been assured that there was a consistent US Government bailout policy that financial institutions above a certain size were "too big to fail." Even former Goldman Sachs chairman, New Jersey Governor Jon Corzine came out and attacked his former Goldman partner, Paulson for being "inconsistent" and furthering the market panic by creating uncertainty. [15]

The only plausible explanation for the Lehman shock was that Wall Street and the US Treasury Secretary desperately needed an event to frighten Congress into giving Paulson a literal Carte Blanche or blank check to bail out his Wall Street cronies. September was two months from the 2008 elections, and Congress was in no mood to approve a politically explosive taxpayer bailout for the big banks that most people regarded as the cause of the crisis. The Lehman shock brought the financial world to the brink of global meltdown. It also concentrated the attention of Congress.

On September 23, Paulson announced an emergency bank bailout fund, the appropriately named TARP or Troubled Asset Relief Program. As the public later learned, with TARP the cover was also pulled over the banks; who got what was kept from the public by Paulson and by his Democratic successor Geithner.

In presenting the staggering bailout demand to Congress, Paulson and Bernanke said only that TARP would be $700 billion. They produced a hastily written 2-1/2 page draft of legislation with no mention of oversight or restrictions on the use of the money. At that point it was clear to the world that the US authorities had lost control. No bank dared trust any other international bank in such a climate. [16]

Then madness went into turbo-gear. TARP assumed the problem was that banks lacked 'liquidity.' TARP handed out hundreds of billions in taxpayer money to Citigroup, JP Morgan Chase, Goldman Sachs -- the very perpetrators of the gigantic Ponzi fraud of securitization in the first place.

The problem after September 2008, as former Under Secretary of Treasury John Taylor pointed out, was not interbank liquidity. It was lack of confidence among all major banks that their bank counterparty was solvent. No one knew, as Taylor put it, 'who is holding the Queen of Spades.'[17] Pumping hundreds of billions of taxpayer dollars into select banks was the wrong medicine for the wrong disease. But not for the Gods of Money.

The Citigroup Paradigm

Recipient banks like Citigroup loved TARP. Taxpayers were forced to pay the costs of the banks' unrestrained casino gambling. Vikram Pandit, Citigroup chief executive stated, "We completely remain in day-to-day charge of the company. We are going to run Citi for shareholders." The price of shareholders' stock at Citi was less than one dollar as he spoke. Citigroup had become a penny stock.

In effect Pandit said that the government's injection of capital would not change strategy, operations, or governance of Citigroup. 'Business as usual, boys.' However, prudence would have suggested his priority should have been to put the bank in a state in which it could operate without government support, and to reorganize its business so that such a disaster never again would happen. The interests of shareholders must be the last priority. That was the strict logic of risk in a real capitalist system. Wall Street preferred what some called 'bankers' socialism' instead: socialize the losses to the taxpayers and privatize the profits.

The Lehman Brothers bankruptcy spread panic around the world. Suddenly routine trade finance was frozen. In China, the world's primary exporter, companies were unable to obtain routine trade financing and factories began to close across the country. In the European Union, the European Central Bank turned on the liquidity spigot to try desperately to prevent wholesale bank failures.

In the UK, a bank panic had begun in early 2008 as Northern Rock, one of the country's largest mortgage banks, failed. It had a joint venture with Lehman Brothers in selling US sub-prime real estate securities in Britain. The bank had to be nationalized in a humiliating blow to the Labour Government of Gordon Brown. Brown had earlier been responsible for introducing bank-friendly legislation that deregulated banks like Northern Rock and opened the door to US-style casino banking.

What was to take place after the inauguration of a new US President, a President whose sole campaign slogan had been "for change," was soon clear to the world. It wasn't reassuring to those who expected real change.

Endnotes:

[1] UNCTAD Secretariat, *Recent developments on global financial markets: Note by the UNCTAD secretariat*,
TD/B/54/CRP.2, Geneva, 28 September 2007.
[2] For a treatment of the little-known political background to the 1931 Creditanstalt crisis that led to a domino collapse of German banks, see Engdahl, F. William, *A Century of War: Anglo-American Oil Politics and the New World Order* (London: Pluto Press, 2004), Chapter 6.
[3] John Oswin Schroy, *Fallacies of the Nobel Gods: Essay on Financial Economics and Nobel Laureates*, in http://www.capital-flow-analysis.com/investment-essays/nobel_gods.html.
[4] For a fascinating treatment of the fundamental theoretical flaws of economic and financial market models used today, and what he calls the high odds of catastrophic price changes, I recommend the book by Benoit Mandelbrot, the Yale mathematician and inventor of fractal geometry. Benoit Mandelbrot and Richard L. Hudson, *The (mis) Behavior of Markets: A Fractal View of Risk, Ruin and Reward*, (London: Profile Books Ltd, 2004).
[5] Donald MacKenzie, *An Engine, Not a Camera: How Financial Models Shape Markets* (Cambridge, MA: The MIT Press, 2008). MacKenzie documents the process by which the founder of the Chicago Mercantile Exchange hired University of Chicago economist, Milton Friedman to draft an argument for allowing trading of foreign exchange futures and options in the early 1970's and how the development of options pricing theory by Black and Scholes, after a time, gave Wall Street executives the certainty that their derivatives trading was based on 'real science.' It wasn't, of course, as the collapse of the securitization world in 2007 confirmed.
[6] Reuters, September 29, 1998.
[7] Cited by Inner City Press, *The Citigroup Watch*, January 28, 2008, accessed in www.innercitypress.org.citi.html.
[8] Rainforest Action Network, *Citigroup Becomes Mexico's Largest Bank after Banamex Merger*, August 10, 2001, in http://forests.org/archive/samerica/cibemexi.htm.
[9] Matthew Lee, *Predatory Lending: Toxic Credit in the Inner City*, 2003, InnerCityPress.org.
[10] Edmund L. Andrews, *Fed Shrugged as Sub-prime Crisis Spread*, The New York Times, Dec.18, 2007.
[11] Alan Zibel, *FBI Probes 14 Companies Over Home Loans*, AP, January 29, 2008.
[12] Private communication to the author from a former mortgage broker with a large US mortgage lender.
[13] Confidential email correspondence to the author.
[14] For a blow-by-blow description of the alleged discussions inside the US Government over the decision to bailout AIG and the role then New York Federal Reserve President, Tim Geithner, later Obama Treasury Secretary played, see Andrew Ross Sorkin, *Too Big To Fail*, (London, Allen Lane, 2009), pp. 234-237.
[15] Andrew Ross Sorkin, op. Cit., p. 470.
[16] Ibid., pp. 487-489.
[17] John B. Taylor, *The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong*, November 2008, accessed in http://www.stanford.edu/~johntayl/FCPR.pdf.