Financial meltdown: the roots of one of the new Four Horsemen

Contributed by Igor Stalew
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Editor's note: This essay by Igor Stalew delves into the problem of the economy's debt and Wall Street-caused vulnerability from a big-picture perspective. He has done so with the aid of his financial-management background. Culture Change readers will see that Igor's deep and impassioned analysis is in keeping with our past insightful efforts. He wrote this in December, but we did not publish it due to a couple of minor items to perfect, and our small staff was distracted from following up. Now we see that Igor's article is standing the test of time. - JL, Publisher

Introduction by Jan Lundberg

Today's Four Horsemen of the modern apocalypse are Climate Chaos, Petrocollapse, Financial Meltdown, and Nuclear Holocaust. The good news: whichever one comes first, the other three can become canceled out. This may or may not unfold that way, but all four riders of modern apocalypse have already made claim to be reckoned with. The traditional four -- Death, Famine, Pestilence and War -- have not been canceled.

We may or may not have any control over much of this, but that doesn't mean there's nothing we can do. Igor Stalew's informative analysis calls upon our sense of responsibility and self-preservation to reject forever the scams of the few that hurt the many.

The impending financial collapse, or what we can call the debacle involving massive, unprecedented debt, is now in play. It cannot be undone when it has invaded too far inside us, like a huge barbed hook. There is no leader or culprit to take responsibility and solve the problem. Our dominant culture's consumerism and materialism have featured individuals running away with vast riches that were not real! If the wealth had been defined and limited, this could allow the crisis to pass without taking down the country economically. But these desperate or naive individuals -- and the mutated system they created -- depended on endless growth of false wealth, whether on paper or electronic.

We have put ourselves at risk with our economic lives more so than any time since at least as far back as 1929. Two questions pose themselves: (1) How bad is it, or will be? (2) What are the implications for the continuity of American society as we know it?

Things are going to get worse, but no one knows to what degree the fabric of society will be further destroyed. Millions of people were put at risk by the little-regulated money masters. The system does not hold people accountable for this vast risk, because short-term gain is enshrined as the freedom of enterprise and unlimited material wealth. The only silver lining is that the system's collapse will do away with much that we do not need, and we'll see that the collapse will encourage people to come together again, and quickly, for mutual survival. - JL

How the debacle began

"Those that do not learn from history are condemned to repeat it" again comes back to warn us that it might already be too late to avoid major damage. We have lost our way and are proceeding in a drunken stupor, closer ever to economic calamity.

One of the first studies about collective insanity was the 1841 book by the Scotsman Charles Mackey. "Extraordinary Popular Delusions and the Madness of Crowds" examined financial bubbles and crowd behavior in the two centuries preceding his. Three famous incidents were featured:

The Tulip Mania

A speculative fever struck the Netherlands in the early 1600's. Tulips became a highly sought-after commodity. Prices rose and tulip trading flourished. The price of a single tulip peaked at about 40 times the average citizen's yearly salary. When at about 1637 people began to realize, "it's only a flower" the bubble burst and many experienced financial ruin.

The South Seas Bubble

The South Seas Company was formed in the early 1700s and was to profit from trade with South America. The company's stock was sold and promoted at a feverish pace in 1720 and its price rose almost 1000% that year. When it was discovered that the trading rights were less then touted by the company, the price collapsed and many who bought with credit were ruined.

The Mississippi Company

The Mississippi Land Company (renamed Compagnie d'Occident) was formed about 1717 by John Law and soon afterward was given an exclusive right to trade with the West Indies and North America. Law soon exaggerated the wealth of Louisiana and created a marketing scheme to encourage speculation in the company's shares. The scheme worked and the shares rose over
30 times in price by 1720. By 1721 the share prices collapsed as reality about the true value set in.

The pattern that repeats itself is growth schemes for unrealistic, unsustainable profits with little or no legitimate regulation. Early in this decade, our penultimate bout of financial madness came to an abrupt halt. The Dot-com bubble burst. The fall-out of destruction and financial mayhem had been taking a serious toll but well before the worst was delivered, the natural process of “cleansing” was rudely interrupted. The Federal Reserve, among other financial entities, created a strategy to avoid more pain. Interest rates were cut to 40 year lows and a subsequent easing of credit created an orgy of lending and spending. Huge portions of speculative capital abandoned the stock market to find a new home and promise in Real Estate. The “smart money” was of course “in” first and then the American public followed; at first prudently. It is a maxim that owning one's home is is good for the individual and good for the economy. So why not make this piece of the American dream available to everyone, and make a killing too?

Here’s where the “best and brightest”came in. Wall Street hired many a brilliant graduate from elite institutions such as Harvard, Stanford, Wharton, etc. They, along with their already established brilliant minds (some who had given us a prior Economic disaster and bailout called the “Long Term Capital Management fiasco”), created new financial instruments loosely called “Structured Debt.” These fresh and exotic instruments served to make it possible for more Americans to participate in the “own your own home real estate dream.” But what about financial regulation and the limits of the legal capacity for banks and mortgage companies to lend money? No problem. These new instruments could operate outside of banking regulations. They could create even greater liquidity then the banks with their pesky “reserve requirements” and watchful regulators.

Structured Debt developed its own nomenclature: terms like CDOs (collateralized debt obligations), CMOs (collateralized mortgage obligations) and derivatives, among others. Not quite as transparent as the loans on the books of banks, and not as easily understood, they grew in size with little, if any, outside questioning. These instruments usually pooled various other financial instruments such as mortgages together into a much larger package. Their “genius” was pooling mortgages of different quality together in the same package. So high quality loans (like those from wealthy people with much collateral) would be placed alongside lesser quality loans with greater degrees of risk. How could they get away with selling these riskier linked instruments? They got co-operation. The “best and brightest” convinced the stalwart and “conservative” rating agencies such as Standard & Poors and Moodys that the new risk math was less risky.

They opined that mixing AAA loans (highly rated) with Alt-A loans (less highly rated) and Subprime loans (rated poorly) in one large CDO package made the whole package AAA. They claimed that even if some of the subprimes failed, the strength of the rest of the package would maintain its integrity and quality. These were the experts, and the ratings agencies bought the concept hook, line and sinker. Why is this AAA rating so important? Because many large institutions who manage retirement funds for vast amounts of employees (like the State of California Employees Pension Fund) can only, by law, invest in AAA (highest quality) instruments.

These numbers made everybody happy, and with interest rates at 40 year lows, more people than ever before could afford the monthly payments -- even on overpriced properties. The word began to spread, and as more of the public wanted to get in, the savings and loan industry and others began to help make getting a loan even easier. The subprime quality standards were further reduced. Welcome to “The Savings and Loan, Banking and Wall Street Subprime” disaster.

Revelations about the severe Subprime problems are plentiful and likely to get worse. John Stumpf, CEO of Wells Fargo Bank said late last year, “The housing slowdown is the worst since the Depression.” But subprime is not the topic of this article; it is but a symptom of a much larger problem.

Growth and Debt: yesterday’s answer

The United States has been the engine for most of the world's wealth since the Second World War. Every other nation has envied the economic power and standard of living created here. Abundant natural resources, an ambitious, stable work force and just the right amount of government contributed to this historic prosperity, often called “an economic miracle.” The dollar became the “world's currency” because of the USA's strength and stability.

But there is growing evidence that something is going very wrong. The regulators and watchdogs that monitor our political and economic structure have allowed out-of-control expansion built on sand, and they are caught in denial. The never-ending pattern of growth and consumption has been ratcheted up to an unsustainable extreme. It has become more than appropriate to examine the “Emperor's new clothes” and finally speak up.

Fewer and fewer of us really believe we can sustain a heavily indebted consumer society forever -- without paying for it. “Conservative” used to mean cautious and discrete. In terms of America's present economics, this term has lost all meaning.

“Our saving habits have been doing a gradual slide since May 1985 when we saved 11.1 percent of our disposable income. Here's a chart illustrating our choppy savings habits over the last 10 years.

Americans spent more than they earned in 2005 -- a negative savings rate of 0.5 percent for the year. That's the first time that's happened since the Great Depression.” [12/8/06 Bankrate.com]

“The savings rate has been negative for an entire year only twice before — in 1932 and 1933 -- two years when the country was struggling to cope with the Great Depression, a time of massive business failures and job layoffs.” [AP 1/30/06]

How bad is the present situation? No one really knows yet, but the hints are ominous. We've all heard negative developments about the Subprime disaster and now the banking “liquidity crisis. Many businesses are now starved for cash and cannot borrow easily because they are already so deeply indebted. But there is so much more to the unfolding crisis of our teetering House of Cards.

New and surprising areas of concern

Credit card delinquencies and defaults are rising dramatically. Some households are even making some mortgage payments using their credit cards. Fees and rate increases happen now with one late or missed payment. “Penalty rates are over 20% and in some cases up to 36%.” [Wikipedia] What ever happened to the punishment for usury?

“The value of credit card accounts at least 30 days late jumped 26 percent to $17.3 billion in October from a year earlier at 17 large credit card trusts examined by the Associated Press. That represented more than 4 percent of the total outstanding principal balances owed to major banks and retailers.”

“Serious delinquencies also are up sharply: Some of the nation's biggest lenders -- including Advanta, GE Money Bank and HSBC -- reported increases of 50 percent or more in the value of accounts that were at least 90 days delinquent when compared with the same period a year ago.”
[12/23/07 (AP)]

- Automobile loan delinquencies and defaults are also on the rise. “US car loan delinquencies have climbed markedly, raising another potential red flag for financial institutions and the automotive industry.”

"We are beginning to see deterioration in auto asset-backed securities (ABS) credit conditions," Lehman Brothers said in a report on Monday [Nov. 2007], drawing on data from two of the US's biggest car finance companies - GMAC, 49 per cent owned by General Motors, and Ford Credit. -- *FT.com Nov. 19, 2007

- Silent Seconds. “Many subprime borrowers used 'silent second' mortgages from different lenders to refinance and cash-out equity. No one tracks the extent of these borrowers obligations.” [Business Week, March 19, 2007]

- Derivatives and their misuse. This could be the granddaddy of all financial problems due to its size and depth. Everything else pales in comparison. Banks and Security firms are able to create $20 worth of capital off the books for every $1 they put up -- but leverage works both ways; up and down. This liquid money is not regulated as normal bank assets are. According to Satyajit Das, one of the original creators of these instruments “This spiral of borrowing on an increasingly thin base of real assets, writ large and in nearly infinite variety, ultimately created a world in which derivatives outstanding earlier (in 2007) stood at $485 trillion -- or eight times total global gross domestic product of $60 trillion.” See interview by Jon Markman at MSN Money (9/20/07). Search engine exercise: Satyajit Das derivatives - MSN Money

Other Disturbing Events

- Corporate borrowing against pension funds –- General Motors posted a $39 billion loss in 2007 which is one of the biggest losses in corporate history. They have already "borrowed" against the assets in their employees pension funds. Where are they ever going to get the money to fully pay their obligations to these funds?

- Commodity inflation and the End of cheap Food -- We all know about heating oil, gasoline and natural gas prices but some food items have risen by double digits in the last year. “Wheat for March delivery shed 14 cents to $9.52 a bushel, after hitting an all-time high above $10 a bushel on Monday.” Newsvine.com 12/17/07

- Wars that will cost us in the $trillions -- Does anyone really believe we can spend the $trillions on wars without sacrifice or cost to us as a nation? Reflect on our history from a little more than a generation ago. "Sacrifice was patriotic." We were actually attacked by a foreign power and we all had to do our part to win this battle. We bought bonds, we rationed fuel, we saved and re-used all sorts of goods.

- No true accounting for cost of energy’s pollution and using toxic products. -- Who pays for the increased cases of lung cancer and other damage from energy and chemical pollution? The FDA warns pregnant women not to eat salmon more than twice a month. Mercury and other toxins could damage the brains of a developing fetus. The examples are endless.

- The lack of maintenance for America's infrastructure and most valuable resource; its people -- Recent bridge collapses in Minnesota and elsewhere reveal that we are not keeping up with our obligation to maintain our public “plant and equipment.” As a nation, are we really preparing and educating our population to deal with the future? Are we teaching anything more than how to be better consumers?

- Weakness in the U.S. Dollar -- The Dollar has reached record lows against the Euro and other major currencies. More and more countries are diversifying out of the Dollar as the only world currency standard. This shows us in a profoundly simple way that the world no longer looks to us as the leader in world ecomomic matters. We have become the bloated consumer of last resort.

How bad could this really be?

Any of these situations alone could pull an economy into a downturn or recession but taken together they could create a perfect storm of financial calamities, enough to create a serious dislocation of lives and assets. Who is responsible for this developing fiasco? It seems we all are. We have enjoyed the good life and have ignored the lessons of history -- "Seven years of feast, seven years of famine.”

Our core values of hard work and community have increasingly been co-opted to perform for the sake of consumption and convenience. How many of us question our needs and lifestyle? Everywhere we are encouraged to "buy and buy more." Just run up the National Credit Card. We don't worry about who'll pay the bill. "Consuming is patriotic." We've gone on a rampaging spending spree so that someone else will pay up later. There is so much denial that it seems at times we are characters from the film "The Matrix." We don't want to see what is real anymore. But the signs are here and harder to avoid.

We have forgotten to ask the tough and necessary questions that always need to be asked of our business and government leaders. So we are negligent and are getting what we deserve. We have elected and chosen the wrong people. These "leaders" have put us at risk like no one else in many years. Like getting into a car with a drunken driver who threatens all of our lives: even if the worse case crash doesn't occur, our lives have been put irresponsibly at risk. Should we ever trust this driver again; how about our own stupidity for getting in the car in the first place?

No one knows for sure what will happen to our society in the coming years and how bad a financial meltdown will occur. The government and business leaders are currently looking for a quick fix to the extraordinary financial excesses of the last decade. Bailouts are coming from many sources. The Federal Reserve and Treasury Dept have lowering interest rates to the maximum, and along with the weakened banking sector are giving "breaks" to some overextended investors, businesses and homeowners (at taxpayer expense).

The financial industry is looking for equity and support from those countries flush with petrodollars. "Citigroup Inc., the biggest U.S. bank by assets, will receive a $7.5 billion cash infusion from Abu Dhabi to replenish capital after record mortgage losses wiped out almost half its market value."
[Bloomberg 11/27/07].

The financial morass is likely to get worse, for if we as responsible citizens do not demand accountability, transparency and intelligent leadership, we will repeat this debacle and severely damage our lives and those of future generations.

What does all this mean for us as a society?

The pressures of world competition, the lack of health care for a growing number of our citizens, the scarcity of resources, pollution, global warming and potential economic upheaval are upon us. There is much disagreement about the immediacy and degree of these dangers but the writing is on the proverbial wall. Fewer people are able to deny that "something's happening here." A national and hopefully international dialogue -- recognizing that we all have a stake in cooperating to find solutions to these problems -- is urgently needed.

America seems to be politically divided to extremes we haven't experienced in many years. This doesn't bode well for progressive, cooperative solutions to our necessary problems. Does it really take a major breakdown to enable an intelligent and forceful change of direction?

When we as individuals are consumed with worry over debt and paying the current bills becomes our major preoccupation; do we have time for strategic thinking? Thus far, the fresh, tough and realistic solutions to our unrealistic lifestyles and consumer values are ignored.   We turn away from reality because in the past our resources and national spirit were available in abundance. We don't want to see that that the world has changed. OPEC and the Oil companies are charging us ever increasing prices for a resource that is dwindling rapidly. And so will every other country that has what we think we need. Our economic and military power can only bully other countries for so long. We don't control the world any more. We are going to have to pay the full price for our indulgences. For a country with about 5% of the world's population, we consume about 25% of the world's resources.

In the new book Reinventing Collapse, author Dmitry Orlov reminds us about the dramatically declining value of the dollar and how this will influence inflation and further drive up the cost of our "things."

On a personal level, what happens to us? Do we start to grovel and fight each other to protect a declining, unsustainable way of living? We are seeing signs of a breakdown everywhere. Take the example of apartment rentals in major cites. Tenants are increasingly renting out space to subtenants and becoming the new "Evil landlords." The City of San Francisco has a very strong Rent Board and sees this Master Tenant/SubTenant as a current major problem. How about the price of food? It's obviously better to buy fresh, organic meat and produce but how affordable is this better quality food? Families will increasingly have to make cost-versus-quality choices.

We have been led astray with false concepts of wealth and prosperity. The wake up call is here. It is up to all of us to recognize we must start now on every level: family, local economy, church, club, business, state, national, to ask the tough questions. If not, the drunken ride could come to a very nasty end.

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Further Reading:

"Financial Monsters" by Alice Friedemann

culturechange.org

"Woes at Loan Agencies and Oil-Price Spike Roil Markets" by Michael M. Grynbaum, July 12, 2008

nytimes.com