Big Bank Failure Could Turn Credit Crunch Into Global Crash

by Paul Gallagher

The seizing up of the world credit markets—triggered by the collapse of the household debt bubble in the United States—may turn from a slow-motion collapse into a thorough crash, if one or more major investment banks fails in the near future.

This appears to be threatening in the market turmoil of the week of July 23, in which many big corporate "leveraged takeovers" have been exposed as falling apart, leaving big international banks holding the bag, with potentially hundreds of billions of dollars of junk-bond debt they cannot sell. Bear Stearns, Morgan Stanley, Lehman Brothers, and Goldman Sachs are the banks holding the most bad junk-bond debt, and they are potentially hit hardest with losses, according to an alarmed analysis published by the London *Financial Times* July 27.

Because the constant churning out by those markets of mergers and leveraged takeovers on a huge scale was what drove stock markets up during 2007, those stock markets also started to plunge during the same July 23 week.

In his webcast address from Washington, D.C., on July 25, economist Lyndon LaRouche sharply emphasized: "The world monetary financial system is actually, now, currently in the process of disintegrating. There's nothing mysterious about this; I've talked about it for some time. . . . What's listed as stock values and market values in the financial markets internationally is bunk! These are purely fictitious beliefs. . . . Only a fundamental and sudden change in the world monetary financial system will prevent a general, immediate chain-reaction type of collapse. At what speed we don't know, but it will go on, and it will be unstoppable! And the longer it goes on before coming to an end, the worse things will get."

As of July 27, the end of a week of international capital markets "seizing up," the world's major central banks appeared paralyzed to deal with the drying up of credit markets. The Bank of Japan was afraid to raise interest rates for fear of triggering the unwinding of the yen carry trade and collapse of the dollar. The Federal Reserve was afraid of any speculation about lowering rates, for the same reason—despite falling home sales, auto sales, industrial goods orders, industrial employment—and was overseeing the outright faking of GDP and jobs reports to justify its paralysis.

The Bank of England and European Central Bank, which had been raising rates, were forced by the crisis to leak that they would take no more such action. The International Monetary Fund put out an "update to its annual report" on July 25, specifically to deny that a global credit crunch was hitting, while acknowledging "dangerous risks have emerged."

'Never Before, Except the Great Depression'

That this financial disintegration was triggered by the meltdown of the $12 trillion U.S. home mortgage bubble, and the subsequent crumbling of mortgage-backed securities (MBS, a $6 trillion market) and their derivative collateralized debt obligations (CDOs, another $3 trillion), has become fairly well known. Billion-dollar-plus hedge funds are going bankrupt on a weekly basis, and the funds of the Credit Suisse/Tremont Hedge Index, as a whole, have lost 7.5% for the year to date. The exhaustion of the household debt bubble is dragging down auto sales, jobs, durable goods orders, and other physical economic measures.

That triggering condition continues to worsen rapidly. On July 27, following the announcement of big new falls in both new-home and existing-home sales in the United States in June, Moody's Economy.com, a division of the ratings agency, issued a dire new analysis of the mortgage

credit market by its chief economist, Mark Zandi. That analysis was that the housing-market plunge will continue for at least another year, at which time, average home prices will be 10% below their level of the beginning of 2006. Such a price collapse has not happened since the early 1930s, during the Great Depression. Moody's forecast U.S. unemployment to jump as a result. Two days earlier, the CEO of Countrywide, the largest American mortgage lender, said the condition of the home market had no precedent except the Great Depression.

In addition, Zandi projected that by Summer 2008, 3.6% of all American mortgages—prime as well as subprime—will be in default, and that 2.5 million more homeowners will default on first mortgages alone in two years. Second mortgages—that is, home equity and other forms of borrowing cash against homes—are defaulting at an even faster rate, 4.8%, as announced July 25 by Countrywide.

The market for the most widely used mortgage-bond derivatives, CDOs, seized up completely in June; JPMorgan Chase bank reported that only $3.7 billion in CDOs were sold in June, compared to $42.3 billion in May and much larger figures over the course of 2006.

Credit Markets 'Shaking Like an 8.0 Earthquake'

Less well known, but more important to this crisis, is the blow-up in July, of the corporate "junk debt" market, the supposedly inexhaustible supply of high-interest lending by which banks and hedge funds were financing corporate takeovers by so-called private equity funds, less politely called "predator funds" or "financial locusts." The junk bond markets have swelled from 10% to nearly 30% of the total corporate bond markets.

There have been more than $3 trillion "worth" of mergers and acquisitions in just the first half of 2007, a far higher rate than even the all-time record $4 trillion total for 2006. About $1.1 trillion of these 2007 acquisitions have been junk debt-laden "leveraged takeovers" mostly by private equity takeover firms.

But the actual financing of $300 billion or more of this predatory takeover activity, has not been accomplished yet; it is this mound of unsold junk debt for which the international banks, which pushed the takeovers with "cheap, unlimited credit," are now on the hook. European economists told *EIR* that interest rates on junk debt jumped 1.5% or more in one week, as the banks tried and largely failed to sell this debt.

As veteran bond trader William Gross, head of Pacific Investments Management Corp., stated July 25, "the credit market is shaking like an earthquake of 8.0 magnitude." Gross said that a "shock liquidity crisis" could hit those markets in the near future.

Showing the severity of the problem was the forced withdrawal of a $3.5 billion bond issue by General Motors' financial arm, GMAC, because the lack of bids for the bond sent the prospective interest rate on it soaring. This was an unprecedented event among the big automakers.

The Cerberus Capital Partners' takeover of Chrysler is the biggest deal now clearly in trouble. Six big international banks gave up trying to sell $12 billion in junk bond debt, even after the interest rate offered rose over 9%; and they took losses on $6 billion more, in an attempt to sell it now, according to the London *Financial Times.* This may surprise those who read that the buyout of Chrysler was, in total, a $7.5 billion deal! But *EIR* discovered at the time of the deal, that it was far, far more leveraged, involving $30-50 billion in planned junk debt, and that it could blow up the global junk bond markets.

"Banks left with $22 billion debt as crunch deepens," was the headline of one report, in the *Daily Telegraph*, on July 26. But that was only summing up the biggest and most notorious failing deals.

The Biggest Crash Threats

The *Financial Times* reported its own analysis July 27 that as much as $180 billion of this unsold—and now unsellable—$300 billion or more of takeover debt, is on the books of the four leading investment banks noted above. The paper's analysts estimate that these banks have failed in attempts to sell $40 billion (not $22 billion) of the junk in recent weeks.

Because these investment banks are not nearly as large, in core capital or assets, as the commercial banks which dominated the junk-bond lending for takeovers until 2006, their leap into hundreds of billions of junk debt has put them in a highly exposed position.

The second great danger is to the real economies and employment of leading nations. Hedge fund failures threaten wealthy investors, and now, many public pension funds, with big losses. But private equity funds, rather than piling debt—"leverage"—on top of cash assets invested in them, as hedge funds do, pile huge debts on top of little more than their own predatory activity of taking over and looting corporations. And these private equity funds have come to control companies employing 18% of the private workforce of Britain, 20% of the private workforce of the United States, including huge chunks of the auto sector, and so on.

A veteran London financial analyst emphasized to *EIR* on July 22, that, for this reason, the collapse of the private equity debt bubble could cause mass unemployment and hit remaining real economic activity very hard. The real risk to the world financial system, this analyst stressed, is the "risk reverse mentality" which is now striking the world's banking system.

In the face of the looming crash, the U.S. Congress must impose a bankruptcy reorganization of the banks themselves; act to halt the massive wave of home foreclosures; and take emergency measures to inject Federal credit into productivity-raising investments, particularly in new, high-technology infrastructure projects.