A WEEKLY COMMENTARY

ON TARGET

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The price of Freedom is eternal vigilance –

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THOUGHT FOR THE WEEK: "In the old days, this futures or risk business served only as a kind of insurance for the real economy. Exporters, for example, could use it to protect themselves against fluctuations in the value of their trading partners' currency. But since the capacity of computers became virtually unlimited, the derivatives trade has made itself completely autonomous and an 'age of financial revolution' (as the former BIS [Bank of International Settlement] president Alexandre Lamfalussy euphorically described it) has dawned. All the big financial centres have long had their own exchange just for the futures trade. Between 1989 and 1995, the nominal value of contracts doubled every two years and reached the unimaginable sum of 41,000 billion dollars worldwide.

This figure alone signals the dramatic change in the nature of financial transactions, only 2 to 3 per cent of which now directly serve to protect trade and industry. All other contracts are bets organised among themselves by those who conjure with the market. Their formula is: 'I bet that in a year's time the Dow Jones will be 250 points higher than now. Otherwise I'll pay...'" – "The Global Trap: Globalization and the Assault on Prosperity and Democracy" by Hans-Peter Martin and Harald Schumann, 1998.

"The four biggest investment banks on Wall Street, which included Bear Stearns and Lehman Brothers, shelled out $US30 billion in bonuses last year. Lehman just went under and Bear Stearns was bailed out earlier in the year.

While pushing through his emergency deal, Paulson says he wants to defer the debate on salaries. Someone should take him aside and tell him, "Pal, it's over". The moral and philosophical underpinning for $US50 million salaries is gone, let alone $US10 million salaries care of government.

These remuneration structures were struck on the basis of a compact with the market, that is that pay is "at risk" and should reflect performance. That compact is finished. What is the risk if the losses are nationalised?" – from "The mother of all rip-offs: Could there be a finer reward for failure?" by Michael West in *The Age*, 24/9/08.

HIP-POCKET-NERVE PAIN MIGHT GRAB THEIR ATTENTION by Betty Luks: First there was the collapse of the sub-prime market and now with the collapse of the U.S. investment bank Lehman Brothers, hundreds of Australian charities, churches, local councils and even credit unions are looking at losses calculated at AUS$2 billion (Michael West in *The Age*, 16/8/08).

Before the declaration of bankruptcy by the U.S. bank, local councils and other organisations throughout Australia had only just come to the realisation that the U.S. sub-prime collapse had destroyed the value of the investments they had acquired through Lehman Brothers. Their securities were turning into worthless bits of paper.

One of the councils, Wingecarribie Shire in the N.S.W. Southern Highlands had already filed proceedings in the Federal Court against the Australian arm of Lehman Brothers. But the situation changed with the U.S. Lehman Brothers bank going into receivership. The Australian arm of the bank is now at risk of being roped into the U.S. bankruptcy proceedings. Once that happens, the ratepayers of Wingecarribie Shire Council could find that if they want to continue the legal battle to recoup their funds, they might have to write off all the expenses already outlaid on the Federal Court proceedings, and start again – this time in the U.S. And they will have to wait in line along with all the other hundreds, maybe even thousands, of groups who have lost their funds.

Treating the symptoms but never the causes: Notice how the issues are 'compartmentalised"? What is at issue here is the further centralisation of the nation's financial system in the hands of the private banking system. Here in Australia, the N.S.W. Opposition has called for the State government to co-ordinate a response to the crisis. The Opposition's local government spokesman Chris Hartcher likened the losses confronting local councils as a 'financial crisis'. Of course, as is typical of politicians these days, they are intent on treating the symptoms of the problem but will never get to the causes. But one does wonder what the local ratepayers will think when they are hit for higher rates to make up for the losses.

And what about the homeowners of America? Have pity for them. It is reported that over 9 million homeowners find the market value of their home is now about one-tenth of what they owe on their mortgage.

One also wonders, with the substantial losses of the various community groups, as well as the churches, will we now be able to gain the attention of the community leaders of this nation on the whole question of the fraudulent money system now oppressing and destroying us all? The leaders could start by giving serious thought to what is – or should be – the true purpose of a nation's financial system – and who should have the authority to create and issue its money? Money, or credit, is a social instrument and should be administered on behalf of the people. Historically, it was governments' prerogative to create and issue the peoples' money. In 1948 the Catholic bishops of Australia proclaimed in their pastoral letter that "the nation's credit policy is a basic function of the public authority." They went further declaring, "It is opposed to right order that the sovereign economic power of formulating the nation's credit policy should be in the hands of private individuals." (*Michael Journal*, July-August 1993). But then, that was sixty years ago! I don't know that we have heard from then since then.

GOVERNMENTS SAVING CORRUPT BANKS – TO HELL WITH THE PEOPLE! "I can calculate the movement of the stars, but not the madness of men." – Sir Isaac Newton, after losing a fortune in the South Sea bubble

"It's the Derivatives Stupid! Why FANNIE, FREDDIE and AIG all had to be bailed out" by Ellen Brown, September 18, 2008: Something extraordinary is going on with these government bailouts. In March 2008, the Federal Reserve extended a $55 billion loan to JP Morgan to "rescue" investment bank Bear Stearns from bankruptcy, a highly controversial move that tested the limits of the Federal Reserve Act. On September 7, 2008, the U.S. government seized private mortgage giants Fannie Mae and Freddie Mac and imposed a conservatorship, a form of bankruptcy; but rather than let the bankruptcy court sort out the assets among the claimants, the Treasury extended an unlimited credit line to the insolvent corporations and said it would exercise its authority to buy their stock, effectively nationalizing them. Now the Federal Reserve has announced that it is giving an $85 billion loan to American International Group (AIG), the world's largest insurance company, in exchange for a nearly 80% stake in the insurer . . . .

The Fed is buying an insurance company? Where exactly is that covered in the Federal Reserve Act? The Associated Press calls it a "government takeover," but this is not your ordinary "nationalization" like the purchase of Fannie/Freddie stock by the U.S. Treasury. The Federal Reserve has the power to print the national money supply, but *it is not actually a part of the U.S. government*. It is a private banking corporation owned by a consortium of private banks. *The banking industry just bought the world's largest insurance company, and they used federal money to do it.*

Yahoo Finance reported on September 17: "The Treasury is setting up a temporary financing program at the Fed's request. The programme will auction Treasury bills to raise cash for the Fed's use. The initiative aims to help the Fed manage its balance sheet following its efforts to enhance its liquidity facilities over the previous few quarters."

Treasury bills are the I.O.U.s of the federal government. We the taxpayers are on the hook for the Fed's "enhanced liquidity facilities," meaning the loans it has been making to everyone in sight, bank or non-bank, exercising obscure provisions in the Federal Reserve Act that may or may not say they can do it. What's going on here? Why not let the free market work? Bankruptcy courts know how to sort out assets and reorganize companies so they can operate again.

Why the extraordinary measures for Fannie, Freddie and AIG? The answer may have less to do with saving the insurance business, the housing market, or the Chinese investors clamoring for a bailout than with the greatest Ponzi scheme in history, one that is holding up the entire private global banking system. What had to be saved at all costs was not housing or the dollar but the financial derivatives industry; and the precipice from which it had to be saved was an "event of default" that could have collapsed a *quadrillion dollar* derivatives bubble, a collapse that could take the entire global banking system down with it.

The Anatomy of a Bubble: Until recently, most people had never even heard of derivatives; but in terms of money traded, these investments represent the biggest financial market in the world. Derivatives are financial instruments that have no intrinsic value but derive their value from something else. Basically, they are just bets. You can "hedge your bet" that something you own will go up by placing a side bet that it will go down. "Hedge funds" hedge bets in the derivatives market. Bets can be placed on anything, from the price of tea in China to the movements of specific markets.

"The point everyone misses," wrote economist Robert Chapman a decade ago, "is that buying derivatives is not investing. It is gambling, insurance and high stakes bookmaking. Derivatives create nothing."[1]

They not only create nothing, but they serve to enrich non-producers at the expense of the people who *do* create real goods and services. In congressional hearings in the early 1990s, derivatives trading was challenged as being an illegal form of gambling. But the practice was legitimized by Fed Chairman Alan Greenspan, who not only lent legal and regulatory support to the trade but actively promoted derivatives as a way to improve "risk management". Partly, this was to boost the flagging profits of the banks; and at the larger banks and dealers, it worked. But the cost was an increase in risk to the financial system as a whole.[2]

Since then, derivative trades have grown exponentially, until now they are larger than the entire global economy. The Bank for International Settlements recently reported that total derivatives trades exceeded one quadrillion dollars – *that's 1,000 trillion dollars*.[3] How is that figure even possible? The gross domestic product of all the countries in the world is only about 60 trillion dollars. The answer is that gamblers can bet as much as they want. They can bet money they don't have, and that is where the huge increase in risk comes in.

Credit default swaps (CDS) are the most widely traded form of credit derivative: CDS are bets between two parties on whether or not a company will default on its bonds. In a typical default swap, the "protection buyer" gets a large payoff from the "protection seller" if the company defaults within

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a certain period of time, while the "protection seller" collects periodic payments from the "protection buyer" for assuming the risk of default. CDS thus resemble insurance policies, but there is no requirement to actually hold any asset or suffer any loss, so CDS are widely used just to increase profits by gambling on market changes.

In one blogger's example, a hedge fund could sit back and collect $320,000 a year in premiums just for selling "protection" on a risky BBB junk bond. The premiums are "free" money – free until the bond actually goes into default, when the hedge fund could be on the hook for $100 million in claims.

And there's the catch: what if the hedge fund doesn't have the $100 million? The fund's corporate shell or limited partnership is put into bankruptcy; but both parties are claiming the derivative as an *asset* on their books, which they now have to write down. Players who have "hedged their bets" by betting both ways cannot collect on their winning bets; and that means they cannot afford to pay their losing bets, causing other players to also default on their bets.

The dominos go down in a cascade of cross-defaults that infects the whole banking industry and jeopardizes the global pyramid scheme. The potential for this sort of nuclear reaction was what prompted billionaire investor Warren Buffett to call derivatives "weapons of financial mass destruction." It is also why the banking system cannot let a major derivatives player go down, and it is the banking system that calls the shots. The Federal Reserve is literally owned by a conglomerate of banks; and Hank Paulson, who heads the U.S. Treasury, entered that position through the revolving door of investment bank Goldman Sachs, where he was formerly CEO.

The Best Game in Town – Financial Derivatives: In an article on FinancialSense.com on September 9, Daniel Amerman maintains that the government's takeover of Fannie Mae and Freddie Mac was not actually a bailout of the mortgage giants. **It was a bailout of the financial derivatives industry, which was faced with a $1.4 trillion "event of default" that could have bankrupted Wall Street and much of the rest of the financial world.** To explain the enormous risk involved, Amerman posits a scenario in which the mortgage giants are not bailed out by the government. When they default on the $5 trillion in bonds and mortgage-backed securities they own or guarantee, settlements are immediately triggered on $1.4 trillion in credit default swaps entered into by major financial firms, which have promised to make good on Fannie/Freddie defaulted bonds in return for very lucrative fee income and multi-million dollar bonuses. The value of the vulnerable bonds plummets by 70%, causing $1 trillion (70% of $1.4 trillion) to be due to the "protection buyers."

This is more money, however, than the already-strapped financial institutions have to spare. The CDS sellers are highly leveraged themselves, which means they depend on huge day-to-day lines of credit just to stay afloat. When their creditors see the trillion dollar hit coming, they pull their financing, leaving the strapped institutions with massive portfolios of illiquid assets. The dreaded cascade of cross-defaults begins, until nearly every major investment bank and commercial bank is unable to meet its obligations. This triggers another massive round of CDS events, going to $10 trillion, then $20 trillion. The financial centres become insolvent, the markets have to be shut down, and when they open months later, the stock market has been crushed.

The federal government and the financiers pulling its strings naturally feel compelled to step in to prevent such a disaster, even though this rewards the profligate speculators at the expense of the Fannie/Freddie shareholders who will get wiped out.

Amerman concludes: "[I]t's the best game in town. Take a huge amount of risk, be paid exceedingly well for it and if you screw up – you have absolute proof that the government will come in and bail you out at the expense of the rest of the population (who did not share in your profits in the first place)."[4]

Continued in The Bulletin

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