Ponzi Politics: The continuing saga of the U.S. debt crisis

By Yuram Abdullah Weiler
2013-10-15

"...a relatively small number of institutions, basically the global banks, investment banks, and credit hedge funds ... built a huge Yertle the Turtle-like tower of debt by selling it back and forth *among themselves*, booking profits all along the way. That is the definition of a Ponzi game." – Lawyer and former banker Charles R. Morris.[1]

As the United States approaches the financial witching hour when sufficient funds to cover all fiscal obligations will no longer be available, politicians continue to express hopes of finding a solution to avert a looming debt default deadline. "I'm very optimistic that we will reach an agreement that's reasonable in nature this week," said the U.S. Senate Majority Leader, Democrat Harry Reid of Nevada, whose optimism was shared by the Senate Minority Leader, Republican Mitch McConnell of Kentucky.[2] One analyst even claims that "the markets are speaking loudly that right now there is ZERO worry of a U.S. government debt default."[3]

However, with the current $11.9 trillion U.S. government public debt[4] at some 23 times Lehman Brothers $517 billion debt when it filed for bankruptcy in 2008, central banks around the world have been making contingency plans should the "world's benchmark debt," go into default. Since the start of the global credit crisis in June 2007, which was triggered by defaults on subprime mortgages backing commercial debt obligations (CDOs) owned by Bear Sterns,[5] exacerbated by the Lehman default in 2008, and then followed in 2010 by the still ongoing European debt crisis, central bankers have been fine-tuning their financial tactics to cope with a possible U.S. default,[6] which some are referring to as a "financial Armageddon."[7]

One such tactic used by the U.S. Federal Reserve is the dollar liquidity swap line, which is an agreement between the Fed and foreign central banks to exchange dollars for foreign currency, should market conditions require. Under this arrangement, the Fed loans dollars at the prevailing exchange rates to a European central bank, which auctions them locally to alleviate short-term liquidity problems. Then after the specified time period expires, the central bank is obligated to buy back its currency at the initial exchange rate and pay the Fed interest.[8] Inaugurated in December 2007 and now in effect until February 2014, the swap lines were terminated in February 2010 only to be revived three months later with the onset of the Eurozone debt crisis.[9]

It is precisely because of this interlacing of the Fed with the European central banks that there should be concern over a possible default by the U.S. government and the resulting negative financial impact worldwide, but the anxiety seems hidden under a layer of hopeful optimism. "It's unthinkable that an agreement won't be found," insisted European Central Bank President Mario Draghi. Echoing his words, Japanese Finance Minister Taro Aso said that "there's no other way than for the U.S. government itself and the U.S. Congress to sort it out."[10]

Even President Obama admitted, "Ultimately, what matters is: What do the people who are buying Treasury bills think?"[11] Certainly, based on the 23 to 1 ratio of the Lehman Brothers debt to the current U.S. Treasury public debt, and recalling the devastation caused by the previous global credit collapse, most anyone would shudder to think of the resulting financial

Received by NSD/FARA Registration Unit 11/16/2020 6:29:21 PM

fallout if the United States actually defaulted on its obligations. However, to better understand the precariousness of the present U.S. turtle-tower of debt, and why the U.S. Congress has worked feverishly to strike a deal, we must briefly examine some of the highpoints in history that led to the previous U.S.-initiated financial crisis that began in 2007.

Emerging victoriously from World War II, the U.S. was able to impose its economic will upon the rest of the world by means of the World Bank and the International Monetary Fund (IMF) that were created by the Bretton Woods Agreement in 1944, which had designated the dollar as the world's reserve currency and pegged it to gold at $35 per ounce. But by 1971 after years of high inflation and budget deficits due to the U.S. aggression in Vietnam, Nixon decreed a fiscal package of price controls, tax cuts and tariffs, and took the U.S. dollar off the gold standard.[12]

When the price controls, originally touted by Nixon as a 90-day freeze, finally were lifted in 1974, double-digit inflation took hold of the U.S. economy that was not broken until mid-1982. At the peak in 1981, the Fed Funds rate was 19 percent and 3-month Treasury Bills were yielding 20 percent,[13] which compares to current rates of 0.1 percent and 0.07 percent respectively.[14] Looking at it from the investor's point of view, T-bills were 285 times more profitable in those days but from the U.S. government's perspective, the cost of financing its debt was astronomical. Nowadays, it's just the reverse, which at least partly explains the prevailing nonchalance over increased U.S. indebtedness, which is even deemed irrelevant by some.[15]

Glossing over other arguably major economic factors, such as the 1970s surge in venture capital, the 1978 capital gains tax cut and the 1981 decontrol of oil, it was Reagan's implementation of the Chicago school's neoliberal mantra of free markets, deregulation and low taxes, that propelled the U.S. economy into the so-called Decade of Greed. Featured were leveraged buyouts using increasingly complex financial arrangements, where missed bond payments were often paid back in kind with more junk bonds, which theoretically at least could increase debt without limit.[16] Again, we see an analogy with what is happening today with U.S. public debt.

Next was the crisis of the savings and loan associations (S&Ls), which were effectively ruined by the hyperinflation rates of the late 1970s that pushed mortgages out of reach for most prospective homebuyers. As the neoliberalists held sway, deregulation was prescribed as the cure, resulting in so-called self-dealing, where S&Ls would create separate units for land purchasing, home building and management, then extend loans to these subsidiaries with depositors' money. Frequently, these affiliates were only fronts for charlatans, such as the son of former president Bush I and brother of Bush II, Neil Bush of Silverado Savings notoriety,[17] who used S&L deposits to purchase private jets, yachts and other personal luxuries.[18]

Since the time of the New Deal in the 1930s, S&Ls depended on federally created entities such as the Federal National Mortgage Association (FNMA) and later, the Government National Mortgage Association (GNMA) to buy mortgages and bundle them into pass-throughs for sale to financiers. Unfortunately, these mortgage-backed securities, with their bland yields and monthly payment streams, lacked broad investor appeal. However, with the advent of the collateralized mortgage obligation (CMO) in 1983, which divided mortgage-backed securities into tranches, each of which had its own bonds with different yields and associated risks, the problem of investor appeal was largely overcome. The top tranche bonds, which had the first claim on cash

Received by NSD/FARA Registration Unit 11/16/2020 6:29:21 PM

flows from the underlying mortgages, and thus received the highest triple-A ratings and low but secure yields, appealed to a majority of investors. Similarly, the lowest tranche bonds, which were the riskiest, absorbing losses but having high yield potential, appealed to speculators.[19]

Over the interceding years until the mid-2000s, numerous classes of structured financial instruments were developed that appealed to a broad spectrum of investor risk appetite. These new types of investment vehicles were a result of three main factors: computer and network technology advances, innovations by individuals with mathematics Ph.D.s, and necessity due to three financial crashes. After each crash – the stock market in 1987, residential mortgages in 1994 and Long Term Capital Management (LTCM) in 1998 – the instruments became more complex in an effort to overcome the weaknesses exposed by each crash. While CMOs evolved from the original 3-tranche model of 1983 to a 125-tranche model by the 1990s, the basic problem of how to dispose of the "toxic waste" in the bottom tranche remained.[20]

Innovations such as the Black-Scholes formula gave portfolio managers a universal pricing tool which led to explosive growth in the options and futures markets.[21] At the same time, portfolio insurance strategies and computerized trading led to the October 19, 1987 "Black Monday" market crash.[22] Later on, relative-value trading and other arbitrage tactics led to the LTCM crash in 1998. In a relative-value transaction, the trader will short sell the most recently issued bonds and buy long on older issued bonds in hopes that the price spread will diminish with time, thus yielding a profit. Such transactions are usually leveraged in the range of 18 to 20, meaning that the trader has borrowed 18 to 20 times the amount of his own equity.[23]

At the core of the 2007 meltdown that set off the global credit collapse, we see the same type of risky financial instruments like the CMOs that were behind the 1994 mortgage crash.[24] Also involved were speculative risk-taking as well as outright risk avoidance due to the nature of a CMO. With a traditional residential mortgage, the S&L issuing it keeps the risk: if the homeowner defaults, the thrift is stuck with the loss. With a CMO, since the originator sells the mortgage to an investment firm, which packages groups of mortgages to form a CMO, the risk is also passed on. Because the profit to the loan originator from an origination fee is risk free, there is no incentive to carefully screen prospective homeowners. In fact the reverse is true; there is every incentive to sell as many mortgages as possible and hence earn more origination fees.[25]

In addition, new mortgage products were introduced such as adjustable rate mortgages (ARMs) and loans for down payments. As a result, there was a 50 percent increase in the market value of homes in America from 2000 to 2005, which was the so-called credit bubble.[26] The mortgages were assembled into collateralized debt obligations (CDOs), structured investment vehicles (SIVs) and other arcane derivatives, which Warren Buffett, then the richest man in the U.S., called "financial weapons of mass destruction."[27] And by 2008, he was proven correct when the plutocrats' Ponzi game collapsed over the Lehman Brothers debacle, which compared to a U.S. Treasury default would "look like a children's exercise," according to one bond trader.[28]

Unfortunately, the 2008 monetary meltdown may be repeated, as there is still a cache of financial WMDs, derivatives with a notional value of over $600 trillion,[29] waiting to detonate given the right primer charge, such as a U.S. credit default. And since the Potomac plutocrats apparently failed to learn from the last fiscal fiasco, Ponzi politics in the U.S. seems likely to continue.

Received by NSD/FARA Registration Unit 11/16/2020 6:29:21 PM

Endnotes

[1] Charles R. Morris, *The Trillion Dollar Meltdown: Easy Money, High Rollers, and the Great Credit Crash* (New York: Public Affairs, 2008), 135, 136.
[2] Richard Rubin, Kathleen Hunter and Chris Strohm, "Senate Leaders Say They're Optimistic on Debt-Limit Deal," *Bloomberg*, October 14, 2013, accessed October 14, 2013, http://www.bloomberg.com/news/2013-10-14/senate-leaders-say-they-re-optimistic-on-debt-limit-deal.html.
[3] Richard Finger, "The U.S. Debt Ceiling Fallacy: Agreement Or Not, There Will Be No Default," *Forbes*, October 4, 2013, accessed October 15, 2013, http://www.forbes.com/sites/richardfinger/2013/10/04/the-u-s-debt-ceiling-fallacy-agreement-or-not-there-will-be-no-default/.
[4] Note that as of October 14, 2013, $4.8 trillion is intragovernmental debt. See "The Debt to the Penny and Who Holds It," *U.S. Treasury Direct*, October 10, 2013, accessed October 14, 2013, http://www.treasurydirect.gov/NP/debt/current.
[5] Charles R. Morris, ibid., 114.
[6] Simon Kennedy, Jeff Black & Jennifer Ryan, "Central Banks Begin Gaming Out U.S. Default as Deadline Nears," *Bloomberg*, October 14, 2013, accessed October 14, 2013, http://www.bloomberg.com/news/2013-10-14/central-banks-begin-gaming-out-u-s-default-as-deadline-nears.html.
[7] "Plan B: Central banks getting ready for financial Armageddon," *Russia Today*, October 15, 2013, accessed October15, 2013, http://rt.com/business/plan-b-central-banks-217/.
[8] "Central Bank Liquidity Swap Lines," *Board of Governors of the Federal Reserve System*, August 2, 2013, accessed October 14, 2013, http://www.federalreserve.gov/newsevents/reform_swaplines.htm.
[9] Simon Kennedy, Jeff Black & Jennifer Ryan, ibid.
[10] Simon Kennedy, Jeff Black & Jennifer Ryan, ibid.
[11] David J. Lynch and Cordell Eddings, "Obama Says Real Boss in Default Showdown Means Bonds Call Shots," *Bloomberg*, October 11, 2013, accessed October 14, 2013, http://www.businessweek.com/news/2013-10-11/obama-says-real-boss-in-default-showdown-means-bonds-call-shots.
[12] Dilip Hiro, *After Empire: The Birth of a Multipolar World* (New York: Nation Books, 2010), 17.
[13] Charles R. Morris, ibid., 10-11, 25-26.
[14] "United States Government Bonds," *Bloomberg*, October 14, 2013, accessed October 14, 2013, http://www.bloomberg.com/markets/rates-bonds/government-bonds/us/.
[15] Tito Cordella, Luca Antonio Ricci, and Marta Ruiz-Arranz, "Debt Overhang or Debt Irrelevance? Revisiting the Debt-Growth Link," *IMF Working Paper*, 223 (2005), accessed October 15, 2013, http://www.imf.org/external/pubs/ft/wp/2005/wp05223.pdf.
[16] Charles R. Morris, ibid., 20, 27-29.
[17] Stephen Pizzo, Mary Fricker and Paul Muolo, *Inside Job: The Looting of America's Savings and Loans* (New York: McGraw Hill, 1989), 250.
[18] Charles R. Morris, ibid., 29-31.
[19] Charles R. Morris, ibid., 39-40.
[20] Charles R. Morris, ibid., 37-38, 41.
[21] Charles R. Morris, ibid., 45.
[22] Charles R. Morris, ibid., 45-47.
[23] Charles R. Morris, ibid., 49.
[24] Charles R. Morris, ibid., 43.
[25] Charles R. Morris, ibid., 69.
[26] Charles R. Morris, ibid., 66, 68.
[27] Dilip Hiro, ibid., 67-68.
[28] Richard Finger, ibid.
[29] "BIS over-the-counter derivatives statistics: data at end-December 2012," *The Bank for International Settlements*, May 2013, accessed October 15, 2013, http://www.bis.org/publ/otc_hy1305.pdf.

Received by NSD/FARA Registration Unit 11/16/2020 6:29:21 PM