Landmines in the graveyard of high finance

By Elisa Barwick

The era of financialisation of the economy (see back page) is over and the relics of various interventions of recent years, aimed at saving the collapsing financial system, are going off like landmines. Efforts to keep the system afloat have created bubbles upon bubbles and mechanisms that unleashed entirely new domains of financial speculation.

Even some of the most prominent players can see it. In a 20 January article for his GMO investment and asset management fund, British investor Jeremy Grantham warned that we are approaching the end of "the first US bubble extravaganza: housing, equities, bonds, and commodities". The piece, titled "Let the wild rumpus begin", spells out the dimensions of what Grantham has dubbed a "superbubble", only the fourth superbubble the USA has experienced in the last hundred years. These included 1929, 2000 and 2006. Japan played host to the only other one—in 1989. Today's superbubble has reached its end phase, he states. A supercharged 20 per cent gain bringing house prices to the highest multiple of family income ever and an "incipient bubble in commodities", have tipped the country into superbubble status, Grantham reports, occurring on top of the existing bubbles in both stock and bond markets.

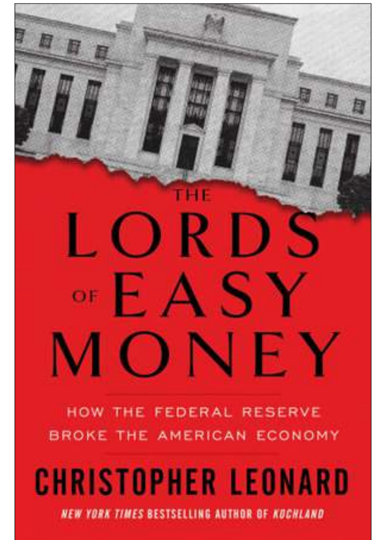
If valuations return even two-thirds of the way back to historical norms, losses in the order of US$35 trillion could be realised, wrote Grantham. "If this negative wealth and income effect is compounded by inflationary pressures from energy, food, and other shortages, we will have serious economic problems." As seen in 2008, the combination "of still-rising commodity prices with a deflating asset price bubble is the ultimate pincer attack on the economy and is all but guaranteed to lead to major economic pain."

President of the Hussman Investment Trust, John Hussman, who, like Grantham has called past crashes (2000 and 2008), has warned, according to *Business Insider* on 23 January: "We enter 2022 amid the most extreme financial bubble in US history, driven by yield-seeking speculation, amplified by a Federal Reserve that has abandoned any tether to systematic monetary policy." Assessing overblown markets using a number of different measures, Hussman suggests the S&P 500 share index could lose 70 per cent of its value before it returns to a realistic valuation.

American economist Harry Dent told *Express UK* on 6 February that a "great reckoning" is coming: "This bubble has to crash, it will crash, it will be the crash of your lifetime, it has only just been a question of when will it crash." He added that it could be "such a blow to investors they will not buy in next time, they will not jump back in and buy the dip. … They'll say something's wrong."

The easy money trap

A new book by American investigative journalist Christopher Leonard, *The Lords of Easy Money: How the Federal Reserve Broke the American Economy*, features interviews with American central banker Thomas Hoenig and shows how easy central bank money has turned everyone into a speculator, according to Rana Foroohar in the 21 January *Financial Times*. This ranges from teenagers "buying the dip", to "meme stocks" on popular trading apps, to pension funds pouring into cryptocurrencies in search of yield.



The new book by bestselling American author Christopher Leonard.

As author Leonard puts it, the 2008 crisis didn't end, it just morphed into another crisis. And the next phase, the unwinding of easy money, will have catastrophic implications. We've built an entire economic system around a "zero rate", Hoenig says in the book. "Not only in the US but globally. It's massive. Now, think of the adjustment process to a new equilibrium at a higher rate. Do you think it's costless? Do you think that no one will suffer? Do you think there won't be winners and losers? No way."

Hoenig worked for the US Federal Reserve for 38 years, including as leader of the Kansas City Federal Reserve Bank, and served as Vice Chairman of the Federal Deposit Insurance Corporation for six years.

In their review of the book for watchdog site Wall Street On Parade, Pam Martens and Russ Martens wrote that easy monetary policy was *designed* to force "millions of people into riskier and riskier areas of investment, which has led to the unprecedented bubble".

Hedge funds minting billions

Furthermore, as the Leonard book shows with its "eye-popping revelations", wrote the Martens, the system was rejigged so that "hedge funds have been able to effectively mint billions by designing trades to take advantage of the Fed's repo bailouts and quantitative easing."

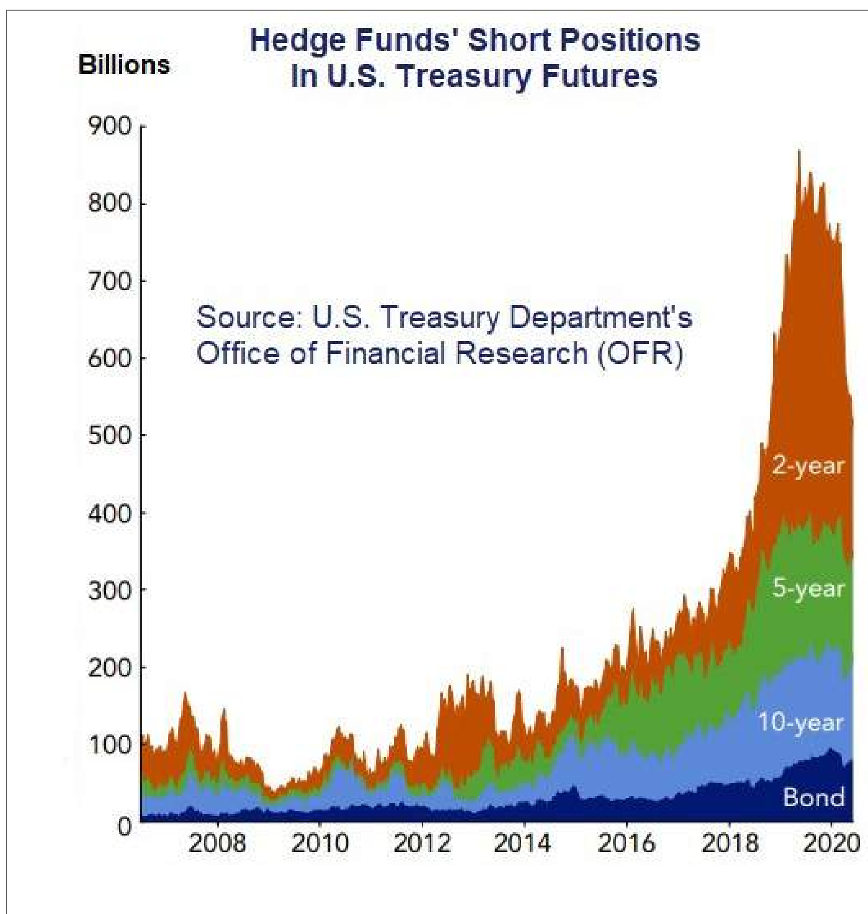
The Fed's "repo" (repurchase agreement) market intervention, which began in September 2019, was yet another effort to save the collapsing system, again unleashing a gale of blowback, most of which is yet to be realised.

In order to boost liquidity the Fed began offering larger and larger overnight (or similarly short-term) loans to its "primary dealers" on a daily basis, by purchasing government securities such as Treasury bonds from the banks, which the banks agree to repurchase the next day at interest. These injections were dramatically expanded in March 2020, with even larger loan values, a greater variety of term-lengths, and multiple daily and weekly offerings. ("March 2020 meltdown dwarfed September 2019 precursor!", *AAS*, 21 Oct. 2020)

The primary dealers are large banks authorised to deal directly with the Fed, buying and reselling Treasury bonds. Not only was the increased repo liquidity fuelling speculation by the trading houses of these banks rather than lending into the economy, another shift allowed the masters of short-term speculation, hedge funds, to tap into the easy cash. Over several years, regulatory changes have provided hedge funds greater and more direct participation in repo markets. As primary dealers committed less capital to dealing in Treasuries due to higher capital requirements

and increased high-risk speculation to drive up profits, hedge funds took up the slack, including with speculative "basis trades" betting on the difference between Treasuries and Treasury futures. They were also engaging in repo operations to facilitate their trades, under the sponsorship of the dealers, a practise that expanded in early 2019. (This is explained in more detail in "The rise of the hedge funds", *AAS*, 14 July 2021.)

Leonard describes the critical role of the hedge funds in the money-pumping: "The primary dealers were not just selling the Treasury bills and mortgage bonds that they happened to have on hand. If that had been the case, it would have limited how much money the Fed could have pushed into the banking system (even the primary dealers only had a finite amount of such assets on hand). Instead, the Fed set up a conveyor belt of sorts, which used the primary dealers as middlemen. The conveyor belt began outside the Fed, with hedge funds that were not primary dealers. These hedge funds could borrow money from a big bank, buy a Treasury bill, and then have a primary dealer sell that Treasury bill to the Fed for new cash. In this way, the hedge funds could borrow and buy billions of dollars in bonds, and sell them to the Fed for a profit. Once the conveyor belt was up and running, it began magically transforming bonds into cash…."



This chart from a July 2020 research paper by the US Treasury Department's Office of Financial Research (OFR) shows that in 2019, hedge funds' short positions in US Treasury futures skyrocketed to more than $800 billion. Photo: Wall Street On Parade

To exploit the very slight margin between Treasury bills and futures contracts on Treasury bills the hedge funds needed the repo market, to scale up to profitable enough volumes. Explains Leonard: "The hedge fund takes the Treasury bill, uses it as collateral, and gets the cash needed to load up on Treasury futures contracts. The hedge funds were able to lever up their bets by a factor of fifty to one, meaning every dollar they had allowed them to borrow fifty more dollars to use for trading. Ultimately, the hedge funds built a mutually reinforced tripod of debt and risk between Treasury bills, repo loans, and Treasury futures. It was easy money, like collecting millions of loose pennies off the sidewalk."

Ending financialisation is simple

This is just one example of the convoluted machinery of life support that has kept the global financial system going. In an Opinion Editorial for *Eurasia Review* titled "The Curse of Financial Entrepreneurship", former US Labour Secretary under Bill Clinton, Robert Reich, provided a historical vignette for such schemes. Quoting from a *New York Times* op-ed he had written in May 1980, he reviewed how the financial sector took over the economy. In the three decades following World War II, the finance sector accounted for 15 per cent of US corporate profits, he wrote. By the mid-1980s, that figure was 30 per cent. By 2001 it reached 40 per cent—"more than four times the profits made in all US manufacturing".

The dominance of finance was facilitated by politicians who "changed laws and regulations to encourage it". This included the repeal of the *Glass-Steagall Act*, he specified—"the Depression-era law that required the separation of commercial and investment banking". This allowed the creation of megabanks.

America's turn to "financial entrepreneurship" did not change after the 2008 crash; the crisis response made matters worse. Reich concluded: "It doesn't have to remain this way. We are not prisoners of bad decisions made in the past. We can and should rein in Wall Street, break up its five giant 'too-big-to-fail' banks, support local and state banks, resurrect the *Glass-Steagall Act*'s divide between investment and commercial banking, tax all financial transactions—and rebuild jobs and wages on the product side of the American economy."

There is similar, growing, recognition of this phenomenon in the UK, where it is referred to as the "finance curse". In his 2018 book *The Finance Curse: How Global Finance is Making Us All Poorer*, British author and finance expert Nicholas Shaxson revealed the hijacking of the global economy by high finance. An October 2018 report, "The UK's Finance Curse? Costs and Processes", published by the Sheffield Political Economy Research Centre, estimated that £4.5 trillion was lost in just 1995-2015 as a result of the City of London smothering the natural growth of the UK economy. ("How the 'finance curse' is ripping off Britain", *AAS*, 24 Oct. 2018; "Destroying Bretton Woods: The rise of the Neoliberals", 4 Aug. 2021)

The growth of finance did not create "a fountain of investment for other sectors in our economy", stated Shaxson, but a misallocation of resources as finance became "an end in itself: unmoored, disconnected from the real economy and from the people and real businesses it ought to serve."

Every politician, regardless of nation or political persuasion, must support the sort of injection of credit into the real economy that only a national bank can create—or prepare to face the consequences of an imploding financial order built upon hot air.