CHRISS STREET AND COMPANY

220 Newport Center Drive
Suite # 11-800
Newport Beach, CA 92660
(949) 466-0376
chriss@chrissstreetandcompany.com

BANKING CRISIS WILL SPARK DEFLATIONARY SPIRAL

The European Sovereign Debt Crisis that morphed into the European Banking Crisis is about to morph into a powerful worldwide deflationary spiral. The bankruptcy of MF Global, a former primary dealer for the U.S. Federal Reserve, has propelled a growing electronic bank run as many depositors have lost faith in the liquidity and solvency of many of their financial institutions. The banks, brokers and other lenders are responding by firing bankers to slash costs, selling off assets, and curtailing lending. As borrowing becomes more difficult large companies and virtually unavailable for smaller firms; production will fall and unemployment will rise.

On February 2, 2011 MF Global was accepted as one of the 21 “primary dealers” for the U.S. Federal Reserve Bank on the strength of the economic and political clout of Jon Corzine, former CEO of Goldman Sachs and Governor of New Jersey. Primary dealer is a formal title for the world’s most elite financial institutions that are allowed to act as direct market-makers with the U.S. Federal Reserve System ("the Fed"). The stellar credibility of this designation gave the firm inside access about funding requirements for the U.S. budget deficit and implementation of Fed monetary policy. Primary dealers legally use this information to distribute debt of the U.S. at home and around the world.

Less than eight months later on October 30, 2011, MF Global announced a “material shortfall” in client funds. The next day regulators froze assets and the company filed the 8th largest bankruptcy in U.S. history with $1.2 billion of missing customer funds. What creditors are now learning is the “hypothication agreements” banks routinely require their customers to sign, allow banks to re-hypothecate customer funds to invest repurchase agreements (repos).

Repo is the primary vehicle for banks lend and borrow from each other. A repo is the sale of securities for cash to another bank with a guarantee to later repurchase the securities at a slightly higher price. Problems arise if the securities held as collateral for the loan decline in value. Problems multiply if the lender allowed the borrower to leverage the repo by only requiring a down-payment percentage, referred to as a “haircut”. As the value of securities fall, the lender will demand more collateral and may increase the haircut percentage to demand even more securities in a leveraged repo. If the borrowing bank cannot bring in more collateral, the lending bank will liquidate the securities to pay off the loan. But in a credit crisis, the sale of collateral will further drive down the value of the securities as the lenders engage in panic selling.

MF Global strategically moved its repo business from the tightly regulated U.S. markets to the leniently regulated London market to get lower haircuts and maximize leverage on their repos. But just like in 2008 when lender haircut increases on mortgage-backed repos forced Lehman Brothers in bankruptcy; lender haircut increase on sovereign debt bankrupted MF Global.

International confidence in bank solvency was weak before the MF Global bankruptcy, but has plummeted since the filing. Credit rating agencies citing "Liquidity and funding conditions have deteriorated significantly"; downgraded BNP Paribas, Société Generale, Credit Agricole, Citigroup, Wells Fargo, JPMorgan Chase, Barclays and HSBC, UBS, and Rabobank. Fitch added downgrades of Bank of America, Morgan Stanley, Goldman Sachs, Germany's Deutsche Bank and Switzerland's Credit Suisse. The downgrades caused big bank depositors to electronically withdrawal funds. But Twitter rumors that Latvian banks were lenders to MF Global, caused bank runs as panicked small depositors desperately tried to pull-out their cash.

Occupy Wall Street's rallying cry has been to punish bankers. As Michael Moore said; "The people want a perp walk. They want to see people led away in handcuffs with a coat over the head and because that's going to be some form of justice." But with the credit downgrades, banks are now scrambling to deleverage by selling assets, laying-off bankers, and curtailing lending. As asset sales volume increases, asset prices will fall. Banks will be forced to sell even more assets, fire more bankers, and strangle lending. The vicious circle of falling asset prices and the evaporation of lending is setting-off a "deflationary spiral" that will hurt the sales and production of goods and services in the real economy, causing more lay-offs.

Occupy Wall Street people may enjoy watching a steady stream of dejected bankers slink out of fancy buildings lugging boxes of their personal effects. But the blow-back from punishing bankers will be a deflationary spiral that reinforces my prediction of an "Election Year Recession and Higher Unemployment Ahead." Is this the change the Occupy Wall Street was looking for?

Feel free to forward this Op Ed and or follow us at www.econservativenews.com

Or at our Blog: www.chrissstreetandcompany.com

Thank you also for the success of Chriss Street's latest book: "The Third Way"
Available at Amazon in print or for Kindle: www.amazon.com