Evolving Financial Crisis: It's Time to Dump the Fed

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"Facts do not cease to exist because they are ignored." ~ Aldous Huxley

The credit storm which began in July when two Bear Stearns hedge funds were forced to liquidate, has continued to intensify and roil the markets. Last week the noose tightened around auction-rate securities, a little-known part of the market that requires short-term funding to set rates for long-term municipal bonds. The $330 billion ARS market has dried up overnight pushing up rates as high as 20% on some bonds – a new benchmark for short-term debt. Auction-rate securities are now headed for extinction just like the other previously-vital parts of the structured finance paradigm. The $2 trillion market for collateralized debt obligations (CDOs), the multi-trillion-dollar mortgage-backed securities market (MBSs) and the $1.3 asset-backed commercial paper (ABCP) market have all shut down, draining a small ocean of capital from the financial system and pushing many of the banks and hedge funds closer to default.

The price of insuring corporate bonds has skyrocketed in the last few weeks making it more difficult for businesses to get the funding they need to expand or continue present operations. Much of this has to do with the growing uncertainty about the reliability of credit default swaps, a $45 trillion dollar market which remains virtually unregulated. Credit-default swaps are a type of financial instrument that are used to speculate on a company's ability to repay debt. They pay the buyer face value in exchange for the underlying securities or the cash equivalent if a borrower fails to adhere to its debt agreements. When the price of CDSs increases, it means that there is greater doubt about the quality of the bond. Prices are presently soaring because the entire structured finance market – and anything connected to it – is under withering attack from the meltdown in subprime mortgages. As foreclosures continue to rise, the securities that were fashioned from subprime loans will continue to unwind, destroying trillions of dollars of virtual-capital in the secondary market.

It all sounds more complicated than it really is. Imagine a 200-ft. conveyor belt with two burly workers and a mountain-sized pile of money on one end, and a towering bonfire on the other. Every time a home goes into foreclosure, the two workers stack the money that was lost on the transaction – plus all of the cash that was leveraged on the home via "securitization" and derivatives – onto the conveyor-belt where it is fed into the fire. That is precisely what is happening right now and the amount of capital that is being consumed by the flames far exceeds the Fed's paltry increases to the money supply or Bush's projected $168 billion "surplus package." Capital is being sucked out of the system faster than it can be replaced, which is apparent by the sudden cramping in the financial system and a more generalized slowdown in consumer spending.

According to a recent Bloomberg article:

> "A year ago $20 million would have gotten Luminent Mortgage Capital Inc. access to $640 million in loans to buy top-rated mortgage-backed securities. Now that much cash gets the firm no more than $80 million. …(Only) 6 lenders are offering 5 times leverage, while a year ago, 20 banks extended 33 times."

The banks are not providing anywhere near as much money for leveraged investments as they did just last year. And, when credit shrinks on a national scale – as it is – so does the economy. It's a simple formula; less money means less economic activity, less growth, fewer jobs, tighter budgets, more pain.

Bloomberg continues:

> "Wall Street firms, reeling from $146 billion in losses on their debt holdings, are fueling a credit crisis by clamping down on lending to investors and hedge funds that use borrowed money to buy securities. By pulling back, (the banks) are contributing to reduced demand and lower prices throughout the fixed-income world."

The banks are in no position to be extravagant because they're already saddled with $400 billion in MBSs and CDOs – as well as another $170 billion in private equity deals – for which there is currently no market. They've had to dramatically cut back on their lending because they either don't have the resources or are facing bankruptcy in the near future.

An article which appeared on the front page of the Financial Times last week, illustrates how hard-pressed the banks really are:

> "US banks have been quietly borrowing massive amounts of money from the Federal Reserve…$50 billion in one month."

The Fed's new Term Auction Facility "allows the banks to borrow money against all sort of dodgy collateral," says Christopher Wood, analyst at CLSA. "The banks are increasingly giving the Fed the garbage collateral nobody else wants to take … [this] suggests a perilous condition for America's banking system."

The move has sparked unease among some analysts about the stress developing in opaque corners of the US banking system and the banks' growing reliance on indirect forms of government support." ("US Banks borrow $50 billion via New Fed Facility," *Financial Times.*) (The story appeared nowhere in the US media.)

At the same time the banks are getting backdoor injections of liquidity from the Fed, banking giant Citigroup has been trying to off-load some of its branches so it can cover its structured investment losses. It all looks rather desperate, but scouring the planet for capital to shore up flagging balance sheets is turning out to be a full-time job for many of America's largest investment banks. It is the only way they can stay one step ahead of the hangman.

In the last few days, gold has spiked to $950, a new high, while oil futures passed the $100 per barrel mark. The battered greenback has already taken a beating, and yet, Fed chairman Bernanke is signaling that there are more rate cuts to come. The prospect of a global run on the dollar has never been greater. Still, Bernanke will do whatever he can to resuscitate the faltering banking system, even if he destroys the currency in the process. Unfortunately, interest rates alone won't cut it. The banks need capital; and fast. Meanwhile, the waning dollar has sent food and energy prices soaring which is leaving consumers without the discretionary income they need for anything beyond the basic necessities. As a result, retail sales are down and employers are forced to lay off workers to reduce their spending. This is all part of the self-reinforcing negative-feedback loop that begins with falling home prices and then rumbles through the broader economy. There is no chance that the economy will rebound until housing prices stabilize and the rate of foreclosures returns to normal. But that could be a long way off. With housing inventory at historic highs and mortgage applications at new lows, the economy could keep somersaulting down the stairwell for a full two years or more. Only then, will we hit rock-bottom.

The country is now headed into a deep and protracted recession. Low interest credit and financial innovation have paralyzed the credit markets while inflating a monstrous equity bubble that is wreaking havoc with the world's financial system. The new market architecture, "structured finance" has collapsed from the stress of falling asset-values and rising defaults. Many of the banks are technically insolvent already, hopelessly mired in their own red ink. Public confidence in the nations' financial institutions has never been lower. Monetary policy and deregulation have failed. The system is self-destructing.

Now that the credit crunch has rendered the markets dysfunctional, spokesmen for the investor class are speaking out and confirming what many have suspected from the very beginning; that the present troubles originated at the Federal Reserve and, ultimately, they are the ones who are responsible for the meltdown. In an article in the *Wall Street Journal* this week, Harvard economics professor and former Council of Economic Advisers under President Reagan, Martin Feldstein, made this revealing admission:

> "There is plenty of blame to go around for the current situation. The Federal Reserve bears much of the responsibility, because of its failure to provide the appropriate supervisory oversight for the major money center banks. The Fed's banking examiners have complete access to all of the financial transactions of the banks that they supervise, and should have the technical expertise to evaluate the risks that those banks are taking. Because these banks provide credit to the nonbank financial institutions, the Fed can also indirectly examine what those other institutions are doing.
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> The Fed's bank examinations are supposed to assess the adequacy of each bank's capital and the quality of its assets. The Fed declared that the banks had adequate capital because it gave far too little weight to their massive off balance-sheet positions – the structured investment vehicles (SIVs), conduits and credit line obligations – that the banks have now been forced to bring onto their balance sheets. Examiners also overstated the quality of the banks' assets, failing to allow for the potential bursting of the house price bubble. The implication of this for Fed supervision policy is clear. The way out of the current crisis is not."

How odd? So, when all else fails, tell the truth?

But Feldstein is right; the Fed refused to perform its oversight duties because its friends in the banking industry were raking in obscene profits selling sketchy, subprime junk to gullible investors around the world. They knew about the "massive off balance-sheet positions" which allowed the banks' to create mortgage-backed securities and CDOs without sufficient capital reserves. They knew it all; every last bit of it, which simply proves that the Federal Reserve is an organization which serves the exclusive interests of the banking establishment and their corporate brethren in the financial industry.

Surprised?

The upcoming global recession/depression will give us plenty of time to mull over the ruinous effects of Fed policy and to devise a plan for abolishing the Federal Reserve once and for all. That is, if they don't destroy us first.

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