Hallmarks of a "hit job" ordered from the very top: Forget Spitzer, fire Bernanke

By Chan Akya
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There must be something about men achieving power that exposes them to frequent misuses of authority. In particular, infidelity seems a particular curse for the powerful across the world. This week's events involving the governor of New York, Eliot Spitzer, may however have helped to hide a more egregious misuse of authority, namely that of Federal Reserve chief Ben Bernanke and his central banking cohorts around the world.

In another one of those nice coincidences that seem to happen whenever Wall Street is down and out, the unpopular governor of New York was found consorting with prostitutes through a Federal investigation that has all the hallmarks of a "hit job" ordered from the very top. Spitzer was deeply unpopular in the corridors of power, and especially with the current Treasury Secretary Hank Paulson, for daring to take various Wall Street firms down a few notches earlier this decade.

After also hitting other sacred cows such as large insurance companies, Spitzer was readying ammunition to strike at the heart of the current subprime crisis by attacking the monoline insurers and rating agencies. It is almost too convenient that the disclosures of his extracurricular activities came this week. Still, let us take everything said at face value and not attempt to conjecture any conspiracy behind all this.

People in Europe and Asia always find curious the preoccupation of Americans with sex, especially as the country appears to look askance at acts of immeasurable violence. This has been the formula for Hollywood – nary a nipple in sight but more than a few torsos getting blown to smithereens.

Be that as it may, the focus of the Spitzer case on two separate legal areas, namely using a prostitute and secondly for potential money laundering, both appear strangely exaggerated in the rest of the world. So the guy was having sex with a hooker; that's essentially a problem between the married couple rather than being subject of intense public debate. Spitzer is said to have been neither crooked nor incompetent.

If anything, his personal use of prostitutes may have contradicted his public crusade against brothels and pimps. In essence, Spitzer had to resign because he was a hypocrite. Reading that line, perhaps a few of you would wonder as I did about the implications of other politicians around the world being asked to resign for being hypocritical. Nope, I couldn't think of anyone who'd survive that either.

Sleight of hand

The sorry story of the governor and his extramarital affair though helped to achieve something much more important, namely to hide a brewing problem in the securities industry.

On Monday, when the Federal Reserve announced a new facility to help banks finance themselves by posting previously unacceptable collateral, stock and credit markets jumped for joy. That is, until someone started asking slightly cute questions on the lines of just who was in so much trouble that the Fed had to rush through an ill-prepared intervention.

As with the Sherlock Holmes dictum of "who benefits from the crime", it is clear that this week's moves were intended to help beleaguered brokers. While it is perhaps impossible to speculate just which company is in most trouble because of poor disclosure and the use of opaque valuation techniques, the most important brokers whose failure would have systemic implications include the likes of Bear Stearns, Lehman Brothers, Merrill Lynch and Morgan Stanley. Coming as it does so close to the expected announcement of first-quarter earnings (most brokers close their financial year in November, hence their first quarter ends February), the fear being expressed on the street was that it had to be one of the bigger firms as otherwise the Fed would not have bothered.

Brokers hold billions of dollars in the very securities that are suddenly eligible for refinancing with the Fed, such as mortgages and other securities that have proven well nigh impossible to sell to investors for the past few months. This has spilt over into the rest of the financial system, hurting various cities and towns across the US as they try to refinance themselves. That in turn must have gotten the government and its central bank all hot under the collar.

At this stage perhaps readers will be wondering why I implied a crime had taken place on Wall Street when all that seems to have happened is that a central banker has tried to quietly save one of the large financial firms in its backyard. The answer is a little more complicated than that, and touches upon the curiously ignored principles of central banking.

Walter Bagehot, the patron saint of central bankers, suggested the following basic principles for central banks to help the banks under their supervision to avoid liquidity runs.

A. Only lend against good collateral to avoid losses for taxpayers at a later date.
B. Lend at extremely high interest rates to avoid the facility being used willy-nilly by greedy bankers.
C. Make public the availability of such facilities, so as to prevent doubts and suspicions in the minds of depositors and other creditors.

This week's announcement by the Fed violates EVERY one of those principles. Firstly, the collateral being accepted by the Fed is tainted as the market's complete lack of appetite (at any price) for the securities shows. By providing the ability to liquefy these securities, the Fed has effectively signaled that it would accept just about any junk.

Secondly, the cost of borrowing is not punitive; indeed it is agreeably low for anyone who cares to fill out a couple of forms. Thirdly, this facility was not used previously; therefore the market has been in some doubt about really how useful it could be.

In essence, this is a US$200 billion facility that is being misapplied to rescue a specific part of the financial system at a preferential rate, and without any disclosure required on usage. Given all this, it is impossible for anyone to expect that the ultimate cost of this facility will not be borne by US taxpayers.

In my last article on Europe (Euro-trash, Asia Times Online, March 11, 2008) I pointed to the failures of the European Central Bank, which similarly violated the Bagehot principles when widening the range of acceptable collateral and lowering the discount rate made available to banks at the refinancing window. The Fed has entered into an arrangement that is eerily similar to that of the European Central Bank, whose actions have resulted in parts of the European financial system essentially becoming "zombie" companies, ie dead but still walking around.

From where I sit, it appears that Bernanke has opened a whole new can of worms in his efforts at maintaining the structural integrity of the US financial system. The financial means used are clearly at odds with what Americans have preached to the rest of the world, including Asia following its 1997 crisis.

To that extent, it is clear that Bernanke suffers from a similar complex to Spitzer, ie that rules do not apply to them because of magical exclusions that are self-derived. Once we decide that both have committed acts that are essentially illegal, it then becomes a question of gauging just who committed the worse crime.

Spitzer through his actions hurt his family and a small band of friends very badly. That however pales in comparison to the wide-ranging systemic damage being wrought by Bernanke through his ill-considered actions. The wrong government official resigned this week.