The Libor Scandal In Full Perspective

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The article about the Libor scandal, coauthored with Nomi Prins, received much attention, with Internet repostings, foreign translation, and video interviews. To further clarify the situation, this article brings to the forefront implications that might not be obvious to those without insider experience and knowledge.

The price of Treasury bonds is supported by the Federal Reserve's large purchases. The Federal Reserve's purchases are often misread as demand arising from a "flight to quality" due to concern about the EU sovereign debt problem and possible failure of the euro.

Another rationale used to explain the demand for Treasuries despite their negative yield is the "flight to safety." A 2% yield on a Treasury bond is less of a negative interest rate than the yield of a few basis points on a bank CD, and the US government, unlike banks, can use its central bank to print the money to pay off its debts.

It is possible that some investors purchase Treasuries for these reasons. However, the "safety" and "flight to quality" explanations could not exist if interest rates were rising or were expected to rise. The Federal Reserve prevents the rise in interest rates and decline in bond prices, which normally result from continually issuing new debt in enormous quantities at negative interest rates, by announcing that it has a low interest rate policy and will purchase bonds to keep bond prices high. Without this Fed policy, there could be no flight to safety or quality.

It is the prospect of ever lower interest rates that causes investors to purchase bonds that do not pay a real rate of interest. Bond purchasers make up for the negative interest rate by the rise in price in the bonds caused by the next round of low interest rates. As the Federal Reserve and the banks drive down the interest rate, the issued bonds rise in value, and their purchasers enjoy capital gains.

As the Federal Reserve and the Bank of England are themselves fixing interest rates at historic lows in order to mask the insolvency of their respective banking systems, they naturally do not object that the banks themselves contribute to the success of this policy by fixing the LIbor rate and by selling massive amounts of interest rate swaps, a way of shorting interest rates and driving them down or preventing them from rising.

The lower is Libor, the higher is the price or evaluations of floating-rate debt instruments, such as CDOs, and thus the stronger the banks' balance sheets appear.

Does this mean that the US and UK financial systems can only be kept afloat by fraud that harms purchasers of interest rate swaps, which include municipalities advised by sellers of interest rate swaps, and those with saving accounts?

The answer is yes, but the Libor scandal is only a small part of the interest rate rigging scandal. The Federal Reserve itself has been rigging interest rates. How else could debt issued in profusion be bearing negative interest rates?

As villainous as they might be, Barclays bank chief executive Bob Diamond, Jamie Dimon of JP Morgan, and Lloyd Blankfein of Goldman Sachs are not the main villains. The main villains are former Treasury Secretary and Goldman Sachs chairman Robert Rubin, who pushed Congress for the repeal of the Glass-Steagall Act, and the sponsors of the Gramm-Leach-Bliley bill, which repealed the Glass-Steagall Act. Glass-Steagall was put in place in 1933 in order to prevent the kind of financial excesses that produced the current ongoing financial crisis.

President Clinton's Treasury Secretary, Robert Rubin, presented the removal of all constraints on financial chicanery as "financial modernization." Taking restraints off of banks was part of the hubristic response to "the end of history." Capitalism had won the struggle with socialism and communism. Vindicated capitalism no longer needed its concessions to social welfare and regulation that capitalism used in order to compete with socialism.

The constraints on capitalism could now be thrown off, because markets were self-regulating as Federal Reserve chairman Alan Greenspan, among many, declared. It was financial deregulation–the repeal of Glass-Steagall, the removal of limits on debt leverage, the absence of regulation of OTC derivatives, the removal of limits on speculative positions in future markets–that caused the ongoing financial crisis. No doubt but that JP Morgan, Goldman Sachs and others were after maximum profits by hook or crook, but their opportunity came from the neoconservative triumphalism of "democratic capitalism's" historical victory over alternative socio-politico-economic systems.

The ongoing crisis cannot be addressed without restoring the laws and regulations that were repealed and discarded. But putting Humpty-Dumpty back together again is an enormous task full of its own perils.

The financial concentration that deregulation fostered has left us with broken financial institutions that are too big to fail. To understand the fullness of the problem, consider the law suits that are expected to be filed against the banks that fixed the Libor rate by those who were harmed by the fraud. Some are saying that as the fraud was known by the central banks and not reported, that the Federal Reserve and the Bank of England should be indicted for their participation in the fraud.

What follows is not an apology for fraud. It merely describes consequences of holding those responsible accountable.

Imagine the Federal reserve called before Congress or the Department of Justice to answer why it did not report on the fraud perpetrated by private banks, fraud that was supporting the Federal Reserve's own rigging of interest rates (and the same in the UK.)

The Federal reserve will reply: "So, you want us to let interest rates go up? Are you prepared to come up with the money to bail out the FDIC-insured depositors of JPMorganChase, Bank of America, Citibank, Wells Fargo, etc.? Are you prepared for US Treasury prices to collapse, wiping out bond funds and the remaining wealth in the US and driving up interest rates, making the interest rate on new federal debt necessary to finance the huge budget deficits impossible to pay, and finishing off what is left of the real estate market? Are you prepared to take responsibility, you who deregulated the financial system, for this economic armageddon?

Obviously, the politicians will say NO, continue with the fraud. The harm to people from collapse far exceeds the harm in lost interest from fixing the low interest rates in order to forestall collapse. The Federal Reserve will say that we are doing our best to create profits for the banks that will permit us eventually to unwind the fraud and return to normal. Congress will see no better alternative to this.

But the question remains: How long can the regime of negative interest rates continue while debt explodes upward? Currently, everyone in the US who counts and most who don't have an interest in holding off armageddon. No one wants to tip over the boat. If the banks are sued for damages and lack the money to pay, the Federal Reserve can create the money for the banks to pay.

If the collapse of the system does not result from scandals, it will come from outside. The dollar is the world reserve currency. This means that the dollar's exchange value is boosted, despite the dismal economic outlook in the US, by the fact that, as the currency for settling international accounts, there is international demand for the dollar. Country A settles its trade deficit with country B in dollars; country B settles its account with country C in dollars; and so on throughout the countries of the world.

For whatever the reason–perhaps to curtail their accumulation of suspect dollars or to bring Washington's power to an end–the BRICS countries, Brazil, Russia, India, China, and South Africa, are agreeing to settle their trade between themselves in their own currencies, thus abandoning the use of the dollar.

According to reports, China and Japan have reached agreement to settle their trade between themselves in their own currencies.

The moves away from the dollar as the currency of international transactions means that the dollar's exchange value will fall as the demand for dollars falls. Whereas the Federal Reserve can create dollars with which to purchase the Treasury's debt, thus preventing a fall in bond prices, the Federal Reserve cannot prop up the dollar's exchange value by creating more dollars with which to purchase dollars. Dollars would have to be taken off the foreign exchange market by purchasing them with other currencies, but in order to have these currencies the US would have to be running a trade surplus, not a long-term trade deficit.

In the short-run, the Federal Reserve could arrange currency swap agreements in which foreign central banks swap their currencies for dollars in order to supply the Federal Reserve with currencies with which to soak up dollars. However, only a limited number of swaps could be negotiated before foreign central banks understood that the dollar's fall in value was not a temporary event that could be propped up with currency swaps.

As the value of the dollar will fall as countries move away from its use as reserve currency, the values of dollar-denominated assets also will fall. The Federal Reserve, even with full cooperation from the banking system employing every fraud technique known, cannot prevent interest rates from rising on debt instruments denominated in a currency whose value is falling.

Think about it this way. A person, fund, or institution owns bonds or any debt instruments carrying a negative rate of interest, but continues to hold the instruments because interest rates, despite the increase in debt, are creeping down, raising bond prices and producing capital gains in the bonds. What happens when the exchange value of the currency in which the debt instruments are denominated falls? Can the price of the bond stay high even though the value of the currency in which the bond is denominated falls?

The drop in the exchange value of the currency hits the bond price in a second way. The price of imports rise, and this pushes up prices. The inflation measures will show higher inflation. How long will people hold debt instruments paying negative interest rates as inflation rises? Perhaps there are historical cases in which bond prices continue to rise indefinitely (or even hold firm) as inflation rises, but I have never heard of them.

As the Federal Reserve can create money, theoretically the Federal Reserve's prop-up schemes could continue until the Federal Reserve owns all dollar-denominated financial assets. To cover the holes in its own balance sheet, the Federal Reserve could just print more money.

Some suspect that the Federal Reserve, in order to forestall a declining dollar and thus declining prices of dollar-denominated financial instruments, is behind the sales of naked shorts every time demand for physical bullion drives up the price of gold and silver. The short sales–paper sales–cancel the impact on price of the increased demand for bullion.

Some also believe that they see the Federal Reserve's hand in the stock market. One day stocks fall 200 points. The next day stocks rise 200 points. This up and down pattern has been ongoing for a long time. One possible explanation is that as wary investors sell their equity holdings, the Federal Reserve, or the "plunge protection team," steps in and buys.

Just as the "terrorist threat" was used to destroy the laws that protect US civil liberty, the financial crisis has resulted in the Federal Reserve moving far outside its charter and normal operating behavior.

To sum up, what has happened is that irresponsible and thoughtless–in fact, ideological–deregulation of the financial sector has caused a financial crisis that can only be managed by fraud. Civil damages might be paid, but to halt the fraud itself would mean the collapse of the financial system. Those in charge of the system would prefer the collapse to come from outside, such as from a collapse in the value of the dollar that could be blamed on foreigners, because an outside cause gives them something to blame other than themselves.

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