# A Fed Panic and a Massive Bailout of American Banks Paid for by the Entire World

By Prof Rodrigue Tremblay
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> "Manias, panics, and crashes are the consequence of an economic environment that cultivates cupidity, chicanery, and rapaciousness rather than a devout belief in the Golden Rule." –
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> Peter L. Bernstein, Foreword to Manias, Panics, and Crashes (4th ed.) by C. P. Kindleberger
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> "In a crisis, discount and discount heavily."
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> Walter Bagehot (1826-1877), British economist
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> "The job of the Federal Reserve is to take away the punch bowl just when the party starts getting interesting."
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> William McChesney Martin (1906-1998), Fed Chairman (1951-1970)
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> "The dysfunctional state of American politics does not give me great confidence in the short run."
>
> Alan Greenspan, Fed Chairman (1987-2006)

**T**he mismanagement of money and credit has led to financial explosions over the centuries. The causes, cures and consequences of such financial catastrophes are most often repetitive. Indeed, such financial collapses are usually the result of the unbridled greed and cupidity of financial operators and of the lack of necessary supervision by public institutions designed to protect the public and the common good. For example, after the October/November **1907 financial crisis** in the United States, the idea initially advanced by banker Paul Warburg to establish a partially private and partially public **Federal Reserve system** of banking was finally adopted, in 1913. The Fed thus became the **lender of last resort** for banks that find themselves in an illiquid position. It is only after the stock market crash of 1929, however, that the **Security and Exchange Commission** (SEC) was established, in 1934.

But even with institutions and regulations in place, when they are inoperative, corrupt or ill-adapted, financial crises can still occur. And the current financial crisis is there to remind us of this fact.

On September 18 (2007), the Fed showed some panic and announced a larger than expected half percentage point cut in both the **Federal funds rate** and in the **discount**

**rate** , and this after having slashed its discount rate by a half point, on August 17, in order to facilitate borrowing by America's largest banks and to facilitate the bailout of their affiliates and other operators, such as **hedge-funds**, caught in the sub-prime loans crisis. In so doing, the Bernanke Fed is following **Bagehot's advice** for aggressive discounting in a situation of financial crisis. The only problem is that Bagehot's rule calls for the central bank to lend copiously in times of critical credit stringency … but at a high rate of interest. By lending to troubled lenders at reduced preferential rates, the Fed is acting as their "government", i.e. subsidizing their risky loans operations and taxing anybody else who holds American dollars. It is not only attempting to make them more "liquid", but also more "solvable" and less likely to fail.

This raises three interesting questions. First, who pays for the bailout of U.S. financial institutions; second, what are the longer-run consequences of the massive bailout undertaken by the Fed; and third, why did the Fed let the financial situation deteriorate to such an extent that an entire sector of the economy is being clobbered and its collapse is threatening the whole economy.

First, we must consider that the U.S. dollar is still a **key reserve currency**, although loosing ground to the **euro,** and it is still being held in massive amounts by most central banks **in their foreign reserves,** and also by private banks, commercial and economic entities and individuals around the world. For example, in early 2007, foreign central banks alone held some two and a quarter trillion in U.S. dollars reserves, which represented about 66 percent of their total official foreign exchange reserves, with a bit more than 25 percent being held in euros.

Since the dollar is loosing its purchasing power, both in absolute and relative terms, central banks and other foreign investors have been "taxed" by the American Fed's policy of benign neglect regarding the dollar. In real terms, the **seigneurage tax** on foreign holders of the dollar can be measured by taking the difference between the annual rate of depreciation of the dollar vis-à-vis major convertible currencies and the short-term rate of interest on these reserves. For example, if the annual rate of depreciation of the dollar is five percent and the short-term rate of return on U.S. T-bills is four percent, central banks are loosing some $22.5 billion on a yearly basis. Since private foreigners hold more than two trillion in dollar denominated debt, the net annual loss of foreign holders of U.S. dollars can easily reach $50 billion a year. The conclusion is easy to see: Not only have foreigners been heavily financing the large U.S. government's deficits over the last six years, but they are now being called upon to help finance the generous bailout of American financial institutions.

Investors both abroad and in the U.S. know that **official inflation figures** are tilted on the low side for many people, essentially because they are designed to reduce the weight given in the indexes to goods and services whose prices increase the fastest, but also because housing costs and asset prices are only partly taken into consideration. This could explain why inflation expectations are on the rise, even though official inflation figures do not register an increase in inflation. Too much easy money as experienced over the last few years at first fuel asset inflation, but sooner or later it shows its ugly head in the prices of all commodities and in the prices of all goods and services. With the current drop of the dollar, Americans can be expected to pay more for a lot of items, such as fuel and food. This will translate to a lower standard of living.

Already, the price of gold, the price of oil and the prices of other commodities are on their way up and can serve as inflation bell-weathers. The behavior of long-term interest rates that incorporate inflation expectations is also a good indicator of future inflation. With the Fed printing money and increasing the **money supply** on a high scale as if it was dropping money from an helicopter, thus the nickname of Fed Chairman Ben "Helicopter" Bernanke, short term interest rates will drop for a while, but long term interest rates will be edging up, unless a deep recession steps in.

Secondly, a massive bailout as the Bernanke Fed has undertaken raises the question of **moral hazard** present in any massive central bank rescue intervention, after it has failed to properly regulate the risky activities of the banks it supervises. Indeed, by accepting mortgage-backed securities as collateral for huge more or less longer term loans to American banks and brokers, at reduced interest rates, the Fed is in effect rewarding the very institutions which acted the most irresponsibly over the last four or five years, while saving its own face for having failed in its regulatory mission. The message is loud and clear: American financial institutions can indulge in creating "innovative" risky artificial credit instruments, shifting the risks to unsuspecting borrowers and investors while reaping juicy fees and rewards, and when things turn sour, as can be expected, the Fed will come to their rescue and bail them out with cheap and extended loans. That is a good way to carelessly encourage a greedy and out-of-control financial institution to create successive disorderly and disruptive **financial crises**.

Indeed, the Bernanke Fed is presently taking the pain of the consequences away from financial institutions that acted irresponsibly, and for some, as former Fed Chairman Alan Greenspan has said, which have **acted criminally**. —This is a clear case of moral hazard.

If old regulations are not implemented or if no new regulations are put into place, such a massive bailout will insure that American financial institutions will continue in the future to pursue the fast buck in creating risky artificial capital, without due regard to the risks involved for small borrowers and small savers, while the Fed will take responsibility for shifting losses partly on itself but mainly to holders of American dollars. In effect, the Fed is suspending market discipline for the big financial players it puts under its protection, while letting market discipline crush small homeowners and small investors who bought now foreclosed houses on shaky mortgages or who invested their savings in fraudulent and risky **collateralized debt obligations** (CDOs). That is the net result of applying Bagehot's rule only in part.

The third question is why both the Greenspan and the Bernanke Fed did not remove the punch bowl of easy money and easy credit sooner when things began getting ugly in the sub-prime mortgage market during the 2003-2007 period. Why did they appear paralyzed and do nothing? Former Fed **Chairman Alan Greenspan** has an easy and self-serving explanation. Before 2003, he was afraid of an onset of deflation and that is why the Fed brought its key lending rate to 1 percent (from June 2003 to June 2004) for only the second time in history. He also says that there were too much "global savings" around the world and that is what pushed interest rates down. This is a slight of hands explanation, because if globalization and global savings kept inflation low and term interest down, short term interest rates and money supply increases were under the Fed control at all times. The Fed had no obligation, after 2003, to keep real short term interest rates so negative for so long. Indeed, as the Bush administration was cutting tax rates to enhance its 2004 reelection prospects and was spending money like a drunken sailor in wars waged in remote lands, the Fed should have taken the contrary route to counterbalance the fiscal impetus this created for the macro economy. In other words, it should have taken the punch bowl away. —It did not.

As a consequence, mortgage debt as a percentage of disposable income in the U.S. is at the highest level it has been in seventy-five years, reaching 100 percent, while consumer debt has risen to its highest level in history. All this makes the economy more vulnerable than it has been since the 1929-39 depression. Another consequence of this binge of easy money has been the frenzy of leveraged buy-outs and industrial concentration that we have observed over the last few years.

Finally, let's put the cherry on the cake. Indeed, there is a most disturbing piece in former Fed Chairman Alan Greenspan's recent Memoirs (The Age of Turbulence) and in the explanations he gave in interviews granted to promote his book, and it is his confession that while he was acting chairman of the Fed he actively lobbied Vice President Dick Cheney for a U.S. **attack on Iraq**. [If this was the case, it was most inappropriate for a central banker to act this way, especially when he had other things to do than lobbying in favor of an illegal war. Does it mean that Mr. Greenspan was an active member of the **pro-Israel Lobby** within the U.S. government and joined the Wolfowitz-Feith-Abrams-Perle-Kissinger cabal? It would seem to me that such behavior would call for an investigation.

Indeed, to what extent was the pro-Israel Lobby responsible for the Iraq war and the deficits it generated? Already, polls indicate that **forty percent of American voters** believe the pro-Israel Lobby has been a key factor in going to war in Iraq and that it is now very active in promoting a new war against Iran. This figure is bound to rise as more and more people confront the facts behind this most disastrous and ill-conceived war. Indeed, how many wars can this lobby be allowed to engineer before being stopped? And, to what extent can the current financial turmoil in U.S. and world markets be traced back to the influence of this most corrosive lobby?

*Rodrigue Tremblay is a Canadian economist who lives in Montreal; he can be reached at: rodrigue.tremblay@yahoo.com*

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**Tremblay**