A Most Desperate Move by the Fed

Suspending the normal functioning of private credit

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> "In a crisis, discount and discount heavily."Walter Bagehot (1826-1877), British economist
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> "I believe that banking institutions are more dangerous to our liberties than standing armies. Already they have raised up a monied aristocracy that has set the government at defiance. The issuing power (of money) should be taken away from the banks and restored to the people to whom it properly belongs." Thomas Jefferson (1743-1826), 3rd U.S. President.
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> "By this means [printing money] government may secretly and unobserved, confiscate the wealth of the people, and not one man in a million will detect the theft." John Maynard Keynes (1883-1946), British economist

On December 16 (2008), the Bernanke Fed took the most unusual step of lowering the overnight inter-bank lending rate, the federal funds rate, to a level never reached before, i.e. zero percent with an upside limit of 0.25 percent. It also announced that it will buy "large quantities of" mortgage-backed securities and is considering doing the same thing with Treasury bonds of longer maturities, in order to lower the entire yield curve. What it did not say explicitly is that the Fed is ready to debase the U.S. dollar to artificially low levels in order to reflate the U.S. economy. What the Fed wants is to trigger monetary inflation and change deflation expectations at all costs through large-scale debt monetisation and thus floating excess debts in a sea of newly created money.

Overall, what the Fed has done, in effect, is to announce that it is suspending the normal functioning of private credit and capital markets, according to supply and demand, and has decided to micro-manage such failing markets for the foreseeable future, that is to say as long as deflationary pressures, in its own view, persist in the U.S. economy. The Fed is also taking big chunks of ownership in large private U.S. banks in order to recapitalize them and to let them deleverage themselves in an orderly way.

People may want to know why the Fed went to that "socialist" extreme and what will be the financial and economic intended and unintended consequences?

First of all, let's keep in mind that the Fed is the only central bank in the world that is partly public-owned and partly private-owned. Bankers sitting on the Fed board can make decisions to lend new money to themselves at whatever rate they choose. The entire American financial and fiscal system is run by bankers, either at the Fed or at the Treasury. Indeed, beginning on January 20 (2009), the Obama administration's Treasury Secretary will be the current president of the New York Fed, Mr. Timothy Geithner, who will be replacing Secretary Henry Paulson, himself a former CEO of the Wall Street investment bank Goldman

Sachs.

Although the U.S. President initiates and Congress approves the nominations of the seven members (currently only five in exercise) of the Federal Reserve Board of Governors (for a 14-year term), the *de facto* managing of the Fed is left to bankers. This is done through the Federal Open Market Committee (FOMC) which implements monetary policy through open market operations and other discounting policies and discount loans. It is comprised of the seven members of the Board of Governors and five presidents of the twelve Federal Reserve District Banks. The Chairman of the Fed Board is also the Chairman of the FOMC. The President of the New York Fed is always on the FOMC and acts as its Vice Chairman. [The remaining 4 fed member slots are shared and rotated among the remaining 11 District Banks. In fact, the presidents of all twelve Federal Reserve District Banks are present at the FOMC meetings, but only five are enabled to vote at any given time. But, since members of the Fed board often originate from the regional Fed banks or from private banks, bankers are often in the majority in deciding American monetary policy.]

Secondly, by taking over private financial markets, the Fed is, in effect, covering its own mistakes (and those of the SEC and of the U.S. Treasury) for having allowed the building up of a shaky pyramid of asset-backed securities (ABS), not the least being the toxic mortgage-backed securities, and the gambling-prone credit default swaps (CDS), that has been crumbling to the ground.

It is my feeling that the Fed, by creating a bond bubble, at this time is only postponing the day of reckoning and is buying time. When the bond bubble bursts, and believe me, it will burst, as all bubbles do, this will push the U.S. economy further down. For instance, when this happens, many capitalized pension funds could fail and many retirees could be then pushed toward poverty. Future spikes in interest rates will hurt investments and damage the economy even more.

Meanwhile, a bout of competing currency devaluations has been launched, since other governments and other central banks will have to try to debase their own currencies if they want to avoid importing the worst of the U.S. economic downturn. This will be reminiscent of what happened during the 1930s economic depression. Not a pretty perspective for the future of fiat currencies.

It seems that the Fed has an uncanny talent for creating financial and economic bubbles. In the late 1990s, after the Asian financial crisis and after the near failure of the hedge fund Long-Term Capital Management (LTCM), in September 1998, the Greenspan Fed flooded the U.S. economy with liquidity and created the 2000 tech bubble. The same Greenspan Fed aggressively lowered the Federal Funds rate from 6.5 percent to 1 percent in 2004, thus paving the way to the worst housing bubble in American history. Now, the Bernanke Fed is at it again, and, by lowering the federal funds rate to close to zero and by announcing that it stands ready to monetize U.S. Treasury debt, it is actively blowing into what has the appearance of one of the worst bond bubbles ever.

Of course, the Fed has bestowed so much money on banks in exchange for their bad debts while the banks themselves are unwilling to lend, that U.S. banks' excess reserves at the Fed have exploded to more than half a trillion (November '08), which is ten times what is required. This is a sign that the U.S. economy is currently in a liquidity trap.

There is a lot of money in the system, but it is not circulating. The velocity of money is down. In such a situation of excess liquidity, when the Fed creates more liquidity, it is like pushing on a string. Therefore, by lowering short-term interest rates to close to zero, the Fed is helping itself before helping others, since it will be paying less interest on Banks' excess reserves, most of which came from the Fed anyhow. Some of the excess liquidity can spill into the stock market and lift all boats for a while. However, the true test of the Fed's recent desperate move will be if banks increase their lending. We shall know in due course.

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