Bernanke's Financial Rescue Plan: The growing prospect of a U.S. default

By Mike Whitney
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Fed chief Ben Bernanke has embarked on the most radical and ruinous financial rescue plan in history. According to Bloomberg News, the Fed has already lent or committed $12.8 trillion trying to stabilize the financial system after the the bursting of Wall Street's speculative mega-bubble. Now Bernanke wants to dig an even bigger hole, by creating programs that will provide up to $2 trillion of credit to financial institutions that purchase toxic assets from banks or securities backed by consumer loans. The Fed's generous terms are expected to generate a flurry of speculation which will help strengthen the banking system while leaving the taxpayer to bear the losses. It is impossible to know what the long-term effects of Bernanke's excessive spending will be, but his plan has the potential to trigger hyperinflation or spark a run on the dollar.

Bernanke's zero-percent interest rates, multi-trillion dollar lending facilities and bank bailouts do not fit within the Fed's narrow mandate of "price stability and full employment". With unemployment soaring to 8.5 percent and increasing at a rate of 650,000 per month (with 15 percent under-employed) it is a wonder that Bernanke hasn't been fired already. There are also myriad problems with Bernanke's lending facilities which are nothing more than a crafty way of transferring wealth from the Fed to private industry via low interest loans. The Central Bank is not supposed to "pick winners" as it is blatantly doing through its market-distorting facilities. Businesses outside the financial sector cannot exchange their downgraded garbage with the Fed for semi-permanent, rotating loans; so why should underwater investment banks and hedge funds get special treatment? The facilities represent a gift to financial institutions giving them an unfair advantage in the marketplace.

Besides the $2 trillion for the Term Asset-Backed Lending Facility (TALF) and the Public-Private Investment Program (PPIP), the Fed will also provide a multi-billion dollar backstop for the FDIC as bank closures continue to snowball and more reserves are needed to shore up the system. That means that the Fed's balance sheet could mushroom to over $4 trillion by the end of 2010. The Treasury has already agreed in principle to assume full responsibility for the Fed's lending facilities (as well as the bailouts of AIG and Bear Stearns) as soon as the financial system stabilizes. By providing loans and US Treasurys to failing companies, instead of capital, Bernanke has sidestepped Congress, thus, undermining the spirit and the letter of the law. Congress has approved a mere $1.5 trillion of the nearly $13 trillion for which taxpayers are now responsible.

The recent 22 percent uptick in the stock market is a sign that Bernanke's monetary stimulus is beginning to kick in. Oil rose from $33 per barrel to over $50 in little more than a month. Other raw materials have followed oil. The dollar has plunged every time the stock market has gone up. These are all signs of nascent inflation which is likely to accelerate after the current period of deleveraging ends. Food and energy prices will rise sharply and the dollar will come under greater and greater pressure. This is Bernanke's nightmare scenario; a surge in inflation that forces him to raise rates and kill the recovery before it ever begins. The Fed's unwillingness to be proactive in dealing with credit bubbles has created a situation where there are no easy answers or pain-free solutions.

Bernanke's approach to the crisis has been wrongheaded from the get-go. It makes no sense to commit nearly $13 trillion to prop up a grossly oversized financial system while providing less than $900 billion stimulus for the real economy. The whole plan is upside-down. It's consumers, homeowners and workers that create demand (consumer spending is 72 percent of GDP) and yet, they've been left to twist in the wind while the bulk of the resources have been directed to financial speculators who are responsible for the mess. Middle class families have seen their retirements slashed in half and their home equity vanish, while their jobs become increasingly less secure. The Fed and the Treasury should be focused on debt relief, mortgage cram-downs, jobs programs and open-ended support for state and local governments. Rebuilding the financial infrastructure for extending more credit to people that are already underwater is beyond shortsighted; its cruel. The financial system needs to shrink to fit the new reality of a smaller economy. That means that Bernanke should aggressively mark-down the dodgy collateral he's been accepting (the collateral should reflect current market prices) and force many of the weaker institutions into bankruptcy. This is the fairest and fastest way to shake the deadwood from the financial system. Keeping asset prices artificially inflated only puts off the inevitable day of reckoning.

The IMF Communique to the G 20:

"The prolonged financial crisis has battered global activity beyond what was previously anticipated. Global GDP is estimated to have fallen by an unprecedented 5% in the fourth quarter, led by the advanced economies, which contracted by 7%. GDP declined by around 6% in both the United States and Europe, while it plummeted at a post-war record of 13% in Japan. Growth also plunged across a broad swath of emerging economies … against this backdrop, global activity is expected to contract in 2009 for the first time in 60 years."

Bernanke's monetary stimulus strategy will do little to mitigate the severity of the contraction which has already gripped every sector of the economy. Credit more than doubled in the first few years of the new millennium. In fact, that total system credit jumped from $1.75 trillion in 2000 to $4.4 trillion in 2007. At the same time, the Current Account Deficit–which averaged about $100 billion per year during the 1990s– ballooned to a whopping $788 billion in 2006. Clearly, the Fed's flood of low interest credit coupled with unsustainable deficits put the country on course for a major catastrophe. (Greenspan still says he never saw it coming) Now that the bubble has burst, Bernanke, has gone into panic-mode, frantically firehosing the entire financial system with liquidity, but with little effect. The sheer magnitude of the deflationary tidal wave is unprecedented. Here's author and economist Henry Liu:

"Globally, the dollar-denominated financial system has seen its equity market capitalization value fall by between 40-60% by February 2009….On October 31, 2007, the total market value of publicly-traded companies around the world was $62.6 trillion. By December 31, 2008, the value had dropped nearly half to $31.7 trillion. The gap of lost wealth, $30.9 trillion, is approximately the combined annual Gross Domestic Product of the US, Western Europe, and Japan…. Family net worth hit a record high of $64.36 trillion in 2nd quarter of

2007. By 4th quarter 2008, it fell to $51.48 trillion, a loss of $12.88 trillion.

To restore the wealth lost in the current financial crisis, the Treasury would have to monetize some $30 trillion of toxic assets, almost ten times what the Geithner Treasury is currently contemplating, and twice the size of current US annual GDP. Add to that about $10 trillion of value lost in the collapse of commodity prices and another $10 trillion in real property values, and we have a wealth loss of $50 trillion."
(Obama's Politics of Change and US Policy on China, asia Times, Henry Liu)

Nearly half of the world's wealth has been consumed in one gigantic capital bonfire. No amount of "quantitative easing" will undo the damage to the economy. Here's a clip from Merrill Lynch's David Rosenberg adding more perspective to Liu's comments:

"Government cannot prevent nature from taking its course. While an additional $1.15 trillion expansion of the Fed's balance sheet is large as a stand-alone event, it really is just a drop in the bucket when one considers that there is still almost $8 trillion of combined household and business sector credit that must be unwound in order to mean-revert the private sector-to-GDP ratio (which is still close to a record-high). Once again, the government is cushioning the blow, but cannot prevent nature from taking its course.

(We) feel much more confident that corporate earnings are going to slide again this year….The economy continues to contract … job losses, declining equity and housing wealth, and tight credit conditions have weighed on consumer sentiment and spending. Weaker sales prospects and difficulties in obtaining credit have led businesses to cut back on inventories and fixed investment. US exports have slumped as a number of major trading partners have also fallen into recession". This is with the Fed funds rate effectively at zero. It's pretty clear that the Fed does not see any flicker of light at the end of the tunnel just yet. Mr. Market may be in for yet another surprise." (Interview with David Rosenberg, Tech Ticker)

The system-wide contraction can't be stopped by supporting financial institutions that made bad bets or took on perilous amounts of debt leaving them deep in the red. Fed lending should be aimed at companies that need temporary help only, like rolling over loans or getting through a rough patch while inventories are trimmed and consumers retrench. Similarly, the stimulus (monetary or fiscal) shouldn't be used to reflate assets or to try to reverse the market correction, but to maintain aggregate demand, take up slack in the sluggish economy, create jobs, and soften the blow for the victims of Wall Street's bubblenomics. Bernanke has used monetary stimulus in precisely the way it should not be used, to keep asset prices artificially high despite the cooling off in the stock market, falling corporate profits, and the steeply rising unemployment. There should be a sharp reduction in the amount lending to financial institutions, reflecting the decline in the value of the underlying assets which are now priced at roughly 30 cents on the dollar. Bernanke's job is to wind-down these positions, not perpetuate the problem at the taxpayer's expense.

According to Bloomberg: "The Federal Reserve's top two officials assured that they will pull back their emergency- credit programs once the crisis fades, even as they prepare to flood the system further with an excess of $1 trillion.

Chairman Ben Bernanke said yesterday in Charlotte, North Carolina that the Fed must retain the flexibility to withdraw its record cash injections to restrain prices. Vice Chairman Donald

Kohn said in Wooster, Ohio, “the trick will be unwinding this balance sheet in a timely way to avoid inflation.”

This is pure fiction. Bernanke has no exit strategy because the collateral the Fed now holds on its books will never regain anything near its original value. Securitization turned 80% of shaky subprime loans into AAA assets for which the Fed is now providing full value vis a vis its low interest loans. The Fed chief has made the same bad bet that the financial institutions made, and is now adding to that mistake by buying $750 billion in junk loans from Fannie and Freddie and $300 billion in US Treasurys to push investors out of the safety of cash back into the market. It’s lunacy. All of this is putting more and more pressure on the dollar which could experience severe dislocation if Bernanke does not make a reasonable attempt to do what is necessary to resolve the banks, shore up consumer spending, shut down underwater financial institutions (auction their toxic assets through a RTC government-run facility) and stop trying to reassemble a broken system.

Bernanke is in way over his head. He has no plan for expanding conventional lending or strengthening the parts of the system that still work. All his efforts have been focused on salvaging insolvent banks and restarting securitization. Securitzation–transforming pools of loans into securities—was Wall Street’s Golden Goose, a privately-owned credit-generating mechanism which created windfall profits by selling radioactive waste to over-trustful investors. Securitization is the epicenter of the shadow banking system, the mostly-unregulated universe of opaque debt-instruments, off balance sheet operations, and massively over-leveraged financial institutions. Securitization broke down after subprime mortgages began defaulting in record numbers sending risk-adverse investors scuttling for the exits. To illustrate how frozen the securitzation market is at present, here’s a blurp from the Wall Street Journal:

“Outside the market where the Fed is a buyer for securities backed by mortgage loans that conform to Fannie and Freddie standards, there hasn’t been a new deal since 2007, according to FTN Financial, a fixed-income broker dealer.” (Wall Street Journal, Credit Markets Still Navigate in a Choppy Sea of Liquidity)

Repeat: “No new deals since 2007.”

Again from the Wall Street Journal:

“Banks and other finance companies making loans for autos, credit cards and college tuition are having virtually no success in selling those loans to other investors, a potent sign of just how tight credit markets remain.

The market for selling such loans — by packaging, or securitizing, them into bonds — had just one $500 million deal for all of October, according to Barclays Capital. That compares with $50.7 billion worth of deals made one year earlier, according to market-research firm Dealogic.” (Bond Woes Choke off some Credit to Consumers, Wall Street Journal, Robin Sidel)

Securitzation is dead, and yet, Bernanke and Geithner want to shovel another $2 trillion into this black hole hoping to lure investors back to the market. Why? Because Wall Street financiers and bank mandarins see securitization as an efficient model that can be exported into any market around the world. The repackaging of debt into complex instruments, that can be stealthily created in off balance sheet operations requiring smaller and smaller slices of capital, is the essential flimflam product that Wall Street intends to use to dominate global financial markets. Keeping secutization alive is ultimately about power; pure, unalloyed economic power. That is why Bernanke will spare no expense trying to resuscitate this failed system.

What’s so destructive about securitzation is that it allows the banks to create credit out of thin air through unregulated, clandestine operations, which eliminate transparency and makes it impossible for the Fed to control the money supply. David Roache explains how this works in an excerpt from his book “New Monetarism” which appeared in the Wall Street Journal:

“The reason for the exponential growth in credit, but not in broad money, was simply that banks didn’t keep their loans on their books any more-and only loans on bank balance sheets get counted as money. Now, as soon as banks made a loan, they “securitized” it and moved it off their balance sheet.

There were two ways of doing this. One was to sell the securitized loan as a bond. The other was “synthetic” securitization: for example, using derivatives to get rid of the default risk (with credit default swaps) and lock in the interest rate due on the loan (with interest-rate swaps). Both forms of securitization meant that the lending bank was free to make new loans without using up any of its lending capacity once its existing loans had been “securitized.”

So, to redefine liquidity under what I call New Monetarism, one must add, to the traditional definition of broad money, all the credit being created and moved off banks’ balance sheets and onto the balance sheets of nonbank financial intermediaries. This new form of liquidity changed the very nature of the credit beast. What now determined credit growth was risk appetite: the readiness of companies and individuals to run their businesses with higher levels of debt. (Wall Street Journal)

The banks have been creating trillions of dollars of credit without maintaining adequate capital reserves to back them up. That explains why the banks were so eager to provide mortgages to millions of loan applicants who had no documentation, no income, no collateral and a bad credit history. They believed there was no risk, because they were making enormous profits without tying up any of their capital.

THE ECONOMY’S LIFE’S BLOOD IN PRIVATE HANDS

As Barak Obama says, “Credit is the economy’s life’s-blood”. It should not be part of a secretive process which is kept off-book and controlled by men whose solitary goal is fattening the bottom line for short-term gain. The reason securitization failed is because the banks put profit above their responsibility to perform due diligence on their loans. In other words, securitization created incentives for fraud, which is why the system eventually collapsed. Still, Bernanke is determined to do Wall Street’s bidding and spend another $2 trillion trying to rev up the securitization engine. A recent letter by the Federal Reserve Bank of Dallas, “Fed Confronts Financial Crisis by Expanding Its Role as Lender of Last Resort” helps to shed some light on the Fed’s real intentions:

“In a modern financial system, securities-funded lending has replaced the banking system as the predominant credit source for households and nonfinancial firms. Because of this development, it can be appropriate to extend the lender of last resort role to temporarily support some nonbank credit sources….

It’s against this backdrop that the Fed has extended its role as lender of last resort beyond banks. Since late 2007, the central bank has supported key credit flows funded by securities, extending loans on nonfinancial corporations’ commercial paper, residential mortgage-backed securities and nonbank financial companies’ loans to consumers and businesses.

The Fed actions recognize the dramatic shift toward debt funded through securities markets. At the end of 1979, securities funded about 33 percent of household, nonfinancial corporate and nonfarm business debt. By the third quarter of 2008, that figure had risen to around 64 percent .

A closer look reveals that household debt became significantly more dependent on market funding, largely reflecting the increased importance of asset-backed securities (ABS) in funding mortgages and consumer loans. Even the share of nonfinancial corporate debt funded by securities rose considerably over the same period—from 57 percent to 76 percent.”

76 percent! Is it any wonder why the global economy has been sucked into a bottomless abyss; why auto sales are down 40 percent or more, why global trade is down 35 percent or more, why unemployment is skyrocketing, manufacturing is stalling and consumer confidence is plunging?

The Fed has allowed an unregulated and untested privately-controlled “credit generating” shadow banking system to infect the broader economy and create a nation of credit addicts which are entirely at the mercy of unpredictable market fluctuations. Is this how the economy’s “life’s blood” should be distributed?

The only reason this occult system was allowed to flourish–with the tacit support of the Fed and the Treasury– was because it threw open the profit-sluicegates for the banks and Wall Street speculators who made more money than anyone ever thought possible. Clearly, this is what motivates Bernanke and Geithner. These are their real constituents.

WILL THE U.S. DEFAULT AGAIN?

Meanwhile–as Bernanke fiddles–the prospect of a US default grows more and more likely. Spreads on credit default swaps (CDS) have progressively widened with every new Fed program and every new multi-billion dollar bailout. Here’s journalist Greg Ip in The Washington Post:

“In its battle against the financial crisis, the U.S. government has extended its full faith and credit to an ever-growing swath of the private sector… (But) Can the United States pay the money back?..

The most important is the coming surge in the federal debt. At the end of the last fiscal year, in September, the total public debt held by the American people stood at $5.8 trillion, or 41 percent of gross domestic product — about what the debt-to-GDP ratio has averaged since 1956. But the Congressional Budget Office projects deficits of $1.9 trillion over the next two years. Add almost $800 billion of stimulus spending, and U.S. debt soars to 60 percent of GDP by 2010 — the highest level since the early 1950s, when the nation was working off its World War II and Korean War debts.

The federal government has taken on massive “contingent liabilities” — loans and guarantees that don’t become actual costs until the borrower defaults and the federal guarantee has to be honored.” (Greg Ip, We’re Borrowing Like Mad. Can the U.S. Pay It Back? Washington Post)

Keep in mind, the United States defaulted on its debt in 1933 when Roosevelt took office and pulled the country off the gold standard, thus, shrugging off the claims of foreign investors who were assured the US would honor its obligations in gold. The dollar plummeted. Bernanke’s muddled strategy has the nation walking down that same path once again.
