

The most Radical Financial Intervention in History: Every Trick in the Book

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Global Research, November 30, 2008

[Information Clearinghouse](#) 30 November
2008

Region: [USA](#)

Theme: [Global Economy](#)

Without any public debate or authorization from Congress, the Federal Reserve has embarked on the most expensive and radical financial intervention in history. Fed chairman Ben Bernanke is trying to avert another Great Depression by flooding the financial system with liquidity in an attempt to mitigate the effects of tightening credit and a sharp decline in consumer spending. So far, the Fed has committed over \$7 trillion, which is being used to backstop every part of the financial system including money markets, bank deposits, commercial paper (CP) investment banks, insurance companies, and hundreds of billions of structured debt-instruments (MBS, CDOs). America's free market system is now entirely dependent on state resources.

With interest rates at or below 1 percent, Bernanke is "zero bound", which means that he will be unable to stimulate the economy through traditional monetary policy. That leaves the Fed with few choices to slow the debt-deflation which has already carved \$7 trillion from US stock indexes and another \$6 trillion from home equity. Bernanke will have to use unconventional means to stabilize the system and maintain economic activity in the broader economy.

Last Tuesday, Treasury Secretary Henry Paulson announced that the Fed would buy \$600 billion of toxic mortgage-backed securities (MBS) from Fannie Mae and Freddie Mac, in effect, buying up its own debt. This is one of the unconventional strategies that Bernanke outlined in a speech he gave in 2002 on how to avoid deflation. By moving the MBS from Fannie's balance sheet to the Fed's, Bernanke was able to drop interest rates by a full percentage point overnight, creating a powerful incentive for anyone thinking about buying a home. But Bernanke's plan is not risk free; it increases the Fed's long-term liabilities which, in turn, undermines the dollar. This calls into question the creditworthiness of the US Treasury which is becoming more and more uncertain every day.

The Fed also initiated a program to purchase \$200 billion of triple A-rated loans from non bank financial institutions to try to revive the flagging securitization market. It's another risky move that ignores the fact that investors are shunning "pools of loans" because no one really knows what they are worth. The appropriate way to establish a price for complex securities in a frozen market is to create a central clearinghouse where they can be auctioned off to the highest bidder. That establishes a baseline price, which is crucial for stimulating future sales. But the Fed wants to conceal the true value of these securities because there are nearly \$3 trillion of them held by banks and other financial institutions. If they were priced at their current market value (\$.21 on the dollar) then many of the country's biggest banks would have to declare bankruptcy. So the Fed is trying to maintain

the illusion of solvency by overpaying for these securities and providing the financing companies more capital to loan to businesses and consumers. Once again, the Fed is stretching its balance sheet by trying to resuscitate a structured finance system which has already proved to be dysfunctional.

Bernanke would be better off letting the market decide what these debt-instruments are really worth. There are always buyers if the price is right. Just look at what happened in Southern California last month, where there was a shocking turnaround in the housing market. Home sales in Orange Country shot up 55 percent year over year in October. That's because prices have dropped 36 percent from their peak in 2007. This proves that real estate—like complex securities—will recover when investors feel that prices are fair.

Does Bernanke really believe that his maneuvering will change the direction of the market or convince investors to pay full-price for dodgy securities?

No one knows; but we do know that the Fed has no mandate to prop up asset values which the market has already decided are worth considerably less. It's the equivalent of price fixing.

BERNANKE'S BAG O' TRICKS

In the coming weeks, the Fed chairman will probably employ many of the radical policy options he laid out in his 2002 speech. Economist Nouriel Roubini points out that nearly all of these choices “imply serious risks for the Fed” as well as the American people. Roubini says:

“Such risks include the losses that the Fed could incur in purchasing long term private securities, especially high yield junk bonds of distressed corporations.... Pushing the insolvent Fannie and Freddie to take even more credit risk may be a reckless policy choice. And having a government trying to manipulate stock prices would create another whole can of worms of conflicts and distortions.

Finally, the Fed could try to follow...massive quantitative easing; flooding markets with unlimited unsterilized liquidity; talking down the value of the dollar; direct and massive intervention in the forex to weaken the dollar; vast increase of the swap lines with foreign central banks... aimed to prevent a strengthening of the dollar; attempts to target the price level or the inflation rate via aggressive preemptive monetization; or even a money-financed budget deficit.”(Nouriel Roubini's EconoMonitor)

Last Tuesday's announcement suggests that Bernanke may be dabbling in the stock market already. This forces anyone who is planning to short the market to reconsider his strategy because Bernanke could be secretly betting against him by dumping billions in the futures market to keep stocks artificially high. It just goes to show that all the bloviating about the virtues of “free market” is just empty rhetoric. When push comes to shove this is “their” system and they'll do whatever they can to preserve it. If that means direct intervention; so be it. Principles mean nothing.

Bernanke's actions are likely to wreak havoc in the currency markets, too. If currency traders suspect that Bernanke is printing money (“unsterilized liquidity”) to rev up the economy, there will be a sell-off of US Treasuries and a run on the dollar. “Monetization” -the printing money to cover one's debts-is the fast-track to hyperinflation and the destruction of

the currency. It's not a decision that should be taken lightly. And it is not a decision that should be made by a banking oligarch who has not been given congressional approval. Bernanke's shenanigans show an appalling contempt for the democratic process. He needs to be reigned in before he does more damage.

Bernanke's attempts to revive the securitization market is understandable, but it probably won't amount to anything. The well has already been poisoned by the lack of regulation and the proliferation of subprime loans. The problem is that the broader economy needs the credit that securitization produced via the non bank financials (investment banks, hedge funds etc) In fact, the non bank financial institutions were providing the lion's share of the credit to the financial system before the meltdown. But, now that the 5 big investment banks are either bankrupt or transforming themselves into holding companies (and the hedge funds are still deleveraging) the only option for credit is the banks, and they are incapable of filling the void. The Wall Street Journal estimates that the loss of Bear Stearns and Lehman Bros. will mean "\$450 billion in lending capacity missing from markets". Think about that. If we include the other investment banks in the mix, then more than \$2 trillion in credit will vanish from the system next year alone. Bottom line, the breakdown in securitization is choking off credit and pushing the country towards catastrophe. If the slide continues, there could be a 40 percent reduction in credit in 2009 making another great Depression unavoidable.

Does that mean we should revive the failed system?

No, just the opposite. The markets need to be re-regulated now to restore credibility. But the Fed should looking for ways to create an emergency National Bank, which operates like a public utility, so that credit can be made available to businesses and consumers who need it now. The Treasury should also be working with Congress on a plan for public education to forestall a panic as well as recommendations for stimulus to soften the economic hard landing just ahead.

The financial system is broken and institutions will not be able to releverage fast enough to normalize the credit markets or stop the impending collapse in consumer demand. What's needed is a constructive plan to rebuild the system while minimizing the suffering of normal people. There's no sense in trying to put the genie back in the bottle or re-energize a failed system. What's past is prologue. There needs to be a serious analysis of the factors which led to the present crack-up and a plan for course-correction. It's not enough to throw stones at the Fed and its misguided serial bubble-making escapades.

REAGAN'S LEGACY

Our present dilemma can be traced back to the 1980s-the Reagan era-and the rise of an organized, industry-funded movement, which advanced their business-friendly, "trickle down" ideology which, when put into practice, has led to greater and greater income disparity, unprecedented expansion of credit and, ultimately, economic disaster.

The problem is the way that the system has been reworked to serve the interests of the investor class at the expense of working people. As Wall Street has tightened its grip on the political parties, more of the nation's wealth has gone to a smaller percentage of the population while the chasm between rich and poor has grown wider and wider. The United States now has the worst income and wealth disparity since 1929 and a whopping 75 percent of the labor force has seen a drop in their living standard since 1973. The average

American has no savings and a pile of bills he is less and less able to pay. Apart from the ethical questions this raises, there is the purely practical matter of how a consumer-driven economy (GDP is 70% consumer spending in US) can maintain long-term growth when wages do not keep pace with productivity. It's simply impossible. The only way the economy can grow is if wages are augmented with personal debt; and that is exactly what has happened. The fake prosperity of the Bush and Clinton years can all be attributed to the unprecedented and destabilizing expansion of personal debt. Wages have been stagnate throughout.

The architects of the present system knew what they were doing when they cooked up their supply side theory. They were creating the rationale for shifting wealth from one class to another. But the theory is deeply flawed as the current crisis proves. Economic conditions do not improve when the rich get richer. All boats do not rise. Class divisions intensify and imbalances grow. Equity bubbles may be an effective means of social engineering, but they always lead to disaster. In fact, the crash of the Fed's massive debt bubble could bring down the whole system in heap. There are better ways to allocate resources so that everyone benefits equally.

It all gets down to wages, wages, wages. If wages don't grow, neither will the economy. Author Ravi Batra sums it up like this in his book "Greenspan's Fraud":

"A bubble economy is born when wages trail productivity for some time and result in ever-rising debt. Then profits grow faster than productivity gains, and share prices outpace GDP growth. However, a time comes when debt-growth slows down, and demand falls short of output, resulting in profit decline and a stock market crash. Thus, the very force that generates the stock market bubble seeds its crash." ("Greenspan's Fraud": Ravi Batra, Palgrave Macmillan, p 152)

The "trickle down" Voodoo economic model was destined to fail because it was built on a fiction. Prosperity is not possible when workers are not fairly compensated and wealth is not equitably distributed. Our focus should be on creating a system that is sustainable, which means that the needs of workers should take precedent over those of Wall Street.

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