US Federal Reserve announces massive increase in government debt

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The US Federal Reserve Board on Wednesday announced that it will massively expand its moves to pump liquidity into near-frozen credit markets, including a highly unusual plan to purchase up to $300 billion in longer-term Treasury securities over the next six months.

The plan also includes an additional $750 billion in Fed purchases of mortgage-backed securities guaranteed by the federally owned mortgage finance companies Fannie Mae and Freddie Mac and an additional $100 billion in Fed purchases of Fannie Mae and Freddie Mac debt. These measures came as a surprise to global financial markets and triggered a simultaneous rush to buy Treasury bonds and a sharp sell-off of US dollars on world currency markets.

The announcement came in the statement issued by the Fed's policy-making Federal Open Market Committee (FOMC) following its scheduled two-day meeting. As expected, the FOMC said it would continue to keep the Fed's benchmark federal funds rate—the interest charged by banks for overnight loans to one another—in a range of 0 to 0.25 percent, and would do so for the indefinite future.

But the announcement that the Fed would inject up to $1.15 trillion in additional funds into the US financial system—essentially printing that amount of additional dollars—was widely seen as something of a desperate gamble, motivated by concern over the deepening economic crisis as well as the mounting political crisis arising from public outrage over the $165 million in bonuses awarded to executives and traders at the bailed-out insurance giant, AIG.

The gamble is that the Fed's emergency measures will drive down mortgage rates and yields on corporate as well as government bonds and kick-start lending without precipitating a run on the dollar. One of the motives behind the move is to encourage investors, in the face of lower Treasury yields, to buy higher-yielding private corporate bonds.

In recent weeks, interest rates on US government debt have risen as the massive deficits from bank bailouts and the stimulus program have required the Treasury to attract an ever larger inflow of capital from abroad. The flood of private and government funds into the US, freezing out many smaller and weaker economies in desperate need of capital, led to a rise in the dollar on world currency markets. The Fed's moves announced Wednesday could rapidly reverse the dollar's fortunes.

Last December, when the Fed cut the federal funds rate to its present level, effectively zero, it indicated that it was considering directly buying longer-term Treasuries, something that had not been done for 50 years. But in recent days Fed Chairman Ben Bernanke had indicated a reluctance to take such a drastic measure in the hope that existing government lending and bailout programs, combined with a new plan to allow banks to offload their "toxic assets" at taxpayer expense, would be sufficient to stabilize the financial system and stem the slide toward a full-scale depression.

However, soaring unemployment in the US and a rash of economic reports showing an accelerating slump in the US and internationally have compelled the Fed to abandon its previous projections of a recovery beginning later this year and accelerating in 2010. At the same time, the Fed and the Treasury have in recent weeks handed over tens of billions of additional taxpayer funds to AIG, Citigroup, Bank of America and other firms to avert bankruptcy, while the worsening slump has raised the prospect of a new wave of bank losses that could eclipse the losses from the collapsed subprime housing market.

In addition, the Obama administration's plan to use public funds to subsidize and virtually guarantee large profits to hedge funds and other investors who purchase unmarketable subprime-backed securities and other "toxic assets" weighing down the balance sheets of major banks, initially announced last month by Treasury Secretary Timothy Geithner, is now in doubt. It faces mounting opposition both from Congress, buffeted by public anger over the bailouts and corporate bonuses, and from Wall Street, which is increasingly balking at the minimal limits on executive pay imposed in return for government handouts.

The administration had said that Geither would announce the details of the new bank bailout program—expected to exceed the $700 billion Troubled Asset Relief Program (TARP) enacted under the Bush administration—sometime this week, but in the wake of the AIG furor the announcement has evidently been postponed.

The Fed's action had the character of a pre-emptive move aimed at averting a financial panic should the Obama administration fail to obtain Congressional approval for its bailout plan. The Fed has the legal power to take such action without recourse to Congress.

In its Wednesday statement, the FOMC painted a grim picture of the economic situation. It began: "Information received since the Federal Open Market Committee met in January indicates that the economy continues to contract." It went on to note job losses, declining equity and housing wealth, tight credit, falling consumer sentiment and spending, declining business investment and shrinking exports resulting from the global contraction. Significantly, the statement omitted any reference to the economy recovering "later this year."

In addition to the purchase of Treasury securities and the increased purchase of mortgage-backed securities, the statement indicated that the Fed and the Treasury would widen the scope of their Term Asset-Backed Securities Loan Facility (TALF), which officially began on Thursday. Under this plan, hedge funds and other investment firms can receive low-cost loans from the Fed to purchase new securities backed by auto loans, credit card debt and other consumer financing. The Fed and the Treasury plan to enlarge the class of asset-backed securities under TALF to include commercial real estate and other investments.

However, many hedge funds and other Wall Street firms have indicated a reluctance to participate in TALF because they object to having any strings imposed that would limit executive pay and bonuses and are wary of the public fallout should it become known that they are reaping huge profits from the government program.

In recent days, major banks such as JPMorgan Chase and Bank of America have declared their intention to pay back the billions they received under the TARP bailout as early as possible in order to remove themselves from the modest government restrictions that accompany the government cash.

Stunned economic commentators and analysts referred to the Fed's announcement as a "shocking" admission that its previous efforts had failed to stabilize the banking system. The Financial Times carried a commentary under the headline "Fed's Shock and Awe," which began: "The Federal Reserve is on a war footing and is using the Powell doctrine—only go to war as a last resort, and do so with overwhelming force.

"The stunning news that it would buy $300 billion in Treasury bonds (and spend a lot more on many other fixed-interest securities) also used another classic military strategy. It had the element of surprise…"

The article noted that the Fed's move "provoked a drastic market response. Ten-year Treasury yields dropped half a percentage point in minutes. The dollar dropped more than 3 percent against the euro."

The plunge in Treasury yields was the steepest one-day drop since the 1987 stock market crash. Thirty-year, fixed rate mortgages, which are pegged to the yields on ten-year Treasury notes, fell below 5 percent.

Deutsche Bank economist Peter Hooper said, "This is effective life support… keeping things from getting a lot worse."

Nick Kalivas, an analyst at MF Global, wrote, "The effectiveness of the Fed's panic move of Treasury and mortgage-backed buy-back is an open question. The aggressive move by the Fed is stoking inflation expectations and there is a belief that a lot of money could flow into commodities or other inflation hedges."

There are indications that this is already occurring. The dollar fell sharply on Wednesday, as the euro staged its biggest one-day percentage gain since it was launched 10 years ago. The dollar fell 4.5 percent against the euro between Wednesday and Thursday. The US currency also fell against sharply against many other currencies.

Thursday morning the British pound advanced to a four-week high of $1.4593. The pound has gained about 7.5 US cents from its intraday low Wednesday to its Thursday high. The dollar fell to its lowest levels against the Japanese yen in a month.

Commodity prices have surged. Gold futures, down before the Fed announcement, jumped 5.7 percent during after-hours electronic trading on Wednesday. Gold prices rose $26.60 an ounce, hitting $942, a sign of declining confidence in the dollar.

Oil prices rose sharply on Thursday to reach their highest levels this year.

US stock markets, which rose Wednesday in response to the Fed's announcement, gave up most of their gains on Thursday, as the longer-term implications of the massive increase in Fed lending and doubts about the Obama administration's bank bailout plan took hold. Bank stocks, which had led Wednesday's rally, drove the downward move on Thursday.

The Fed is taking advantage of the privileged and unique position of the United States due to the role of the dollar as the world's reserve and trading currency. That status gives the US a degree of leeway to print money to paper over its debts far beyond that of any other nation. In taking the actions announced Wednesday, the US is, in effect, offloading the brunt of its crisis onto its international creditors.

However, there are limits to this license. Since last September, the Fed's lending programs have doubled the size of its balance sheet, to about $1.8 trillion from $900 billion. The actions announced Wednesday are likely to expand that to well over $3 trillion over the next year.

Such an immense expansion of US debt inevitably calls into question the value of the dollar and the credit-worthiness of the US government itself. Already last week the Chinese premier, Wen Jiabao, warned that China was losing confidence in the value of its more than $1 trillion in US debt holdings.

A United Nations panel of experts is looking at creating a new "accounting unit" or basket of currencies to replace the dollar as the world's central currency. Reuters reported that Russia is anxious to begin a discussion of such a move at the Group of 20 summit of leading economic nations in early April.

The Fed's extraordinary measures highlight the impossibility of resolving the economic crisis within the framework of capitalism without a massive destruction of living standards and a growth of economic nationalism and militarism. The more the failure of the profit system has become evident, the more emphatically President Barack Obama has declared his support for the capitalist market.

The essence of all of the measures taken in response to the crisis—from the bank bailouts to the stimulus program to the housing plan—is an effort to rescue the system and protect the wealth and power of the financial elite at the expense of the broad masses of the population. The ability of the American ruling class to reassure its global creditors in the face of an unprecedented expansion of US government debt increasingly hinges on its pledge to ruthlessly slash basic social programs such as Medicare and Social Security and impose poverty conditions on the working class.