The Federal Reserve Has Become Irrelevant

by John Hoefle

Could they really be that stupid? That is the question which comes to mind watching the recent spate of statements by government officials discussing what they see as the problems facing the economy, and what needs to be done to solve them. Rather than admitting the global financial system has failed, and must be put through bankruptcy, they blather on about whether or not we have entered into a recession, and about the need to protect asset values from the effects of what they prefer to call the "housing crisis."

Take the case of poor Ben Bernanke, who had the misfortune of taking over as chairman of the Federal Reserve just in time for the worst financial crash in six centuries. Bernanke has a reputation for being an expert on the Crash of 1929 and the banking problems which surrounded it, but judging from his public statements, he still believes we are in the midst of a housing crisis.

"Many of the challenges now facing our economy stem from the continuing contraction of the U.S. housing market," Bernanke told the House Committee on Financial Services in his Feb. 27, Semiannual Monetary Report to Congress.

We do not dispute that there is a housing crisis in the U.S.; home sales and home prices are indeed falling, precipitously, with predictable effects. What we reject, and emphatically so, is the idea that housing is the *cause* of the present crisis: As we have detailed in prior articles, it is the bankruptcy of the system as a whole, which blew out the real estate markets. The so-called "subprime crisis" is actually an *effect* of a financial system which depended upon ever-higher mortgage debts to feed a financial bubble. The subprime loans were a response from the banking system to continue to sell homes when prices rose so high people could no longer afford them.

What we are facing is a crisis of the banking system itself, and of the securitization and off-balance-sheet apparatus which the banks created to hide their own bankruptcy, and anyone who is afraid to say that, is irrelevant.

Banking Crisis

The fact that they refuse to say it, doesn't mean they don't understand it, at least in part. It is clear from the Fed's money-pumping and collateral-soaking operations that the Fed realizes the banking system is in meltdown mode, and it is fair to suspect that the Fed is doing far more than it would dare publicly admit, to keep the banks' doors open.

The problem facing the regulators is that the financial system is collapsing, held together more by denial than anything else. The vaporization of trillions of dollars of nominal wealth has triggered an avalanche of losses, losses which the system cannot withstand, and so considerable effort is being expended to maintain the fiction that the bond market hasn't exploded, the paper still has value, and the banks are not broke. The problem is that the event—the collapse of the global financial system—has already occurred, and what we are now witnessing are the effects of that collapse.

The FDIC has already begun adding staff to its Division of Resolutions and Receiverships in preparation for a wave of bank failures, and has placed job postings on its website for those with the skills in "duties associated with a financial-institution closing." Three banks failed in 2007, compared to none in the two previous years, and the number of institutions on the FDIC's "problem" list jumped 50%, from 50 in 2006, to 76 in 2007.

One need but look at the headlines of the agency's latest Quarterly Banking Profile to see signs of trouble ahead. "Quarterly Net Income Declines to a 16-Year Low," said one; "One in Four Large Institutions Lost Money in the Fourth Quarter" said another. The banks still reported a

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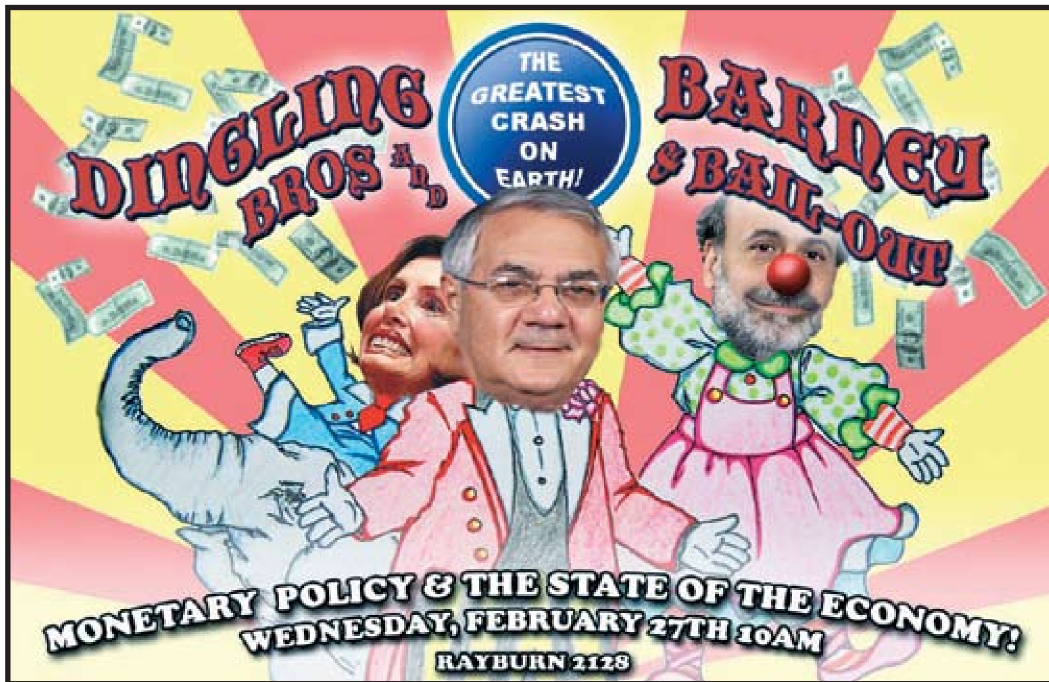

Chris Jadatz

Financiers, technocrats, and elected officials are putting on a clown show, as they push to bail out the already dead financial system. Circus performers, left to right: House Speaker Nancy Pelosi, Rep. Barney Frank, and Fed Chairman Ben Bernanke.

profit of $5.8 billion for the quarter, the lowest such total since 1991, and down 84% from the $35 billion the banks reported for the fourth quarter of 2006. For the year, the banks claimed $105 billion in profits, down 27% from $145 billion in 2006. In an era where write-offs of double-digit-billions have become almost common, the handwriting is on the wall.

The ominous tone of the normally upbeat FDIC report continues well beyond the headlines. Non-current loans—loans 90 days or more behind in payments—rose by $27 billion, or 33% in the last three months of the year, the largest percentage rise in the 24 years the FDIC has been tracking the figure, and net charge-offs jumped sharply. The banks as a whole added a net $15 billion to loan loss reserves, despite which, the level of reserves fell to just 93 cents for every dollar of reported non-current loans, the first time since 1993 that non-current loans have exceeded reserves.

In a development of significant interest, the level of derivatives reported by the banks fell during the quarter, to $165 trillion at year-end from $173 trillion on Sept. 30. The level of derivatives for 2007 was still up 25% over 2006, and quarterly drops in derivatives holdings have happened before, but in dollar terms, the $8 trillion drop in the fourth quarter was the largest quarterly drop ever, and in percentage terms, at 5%, it was second only to the $6 trillion (12%) drop in the fourth quarter of 2001, the quarter following 9/11. If the derivatives markets have peaked, then the problems facing the banks are far worse than anything the banks and their regulators have admitted.

Other signs of a banking crisis abound. The big banks which own Visa, the world's largest credit-card processor, are planning on selling roughly half of the company in an initial public offering. The IPO is intended to raise some $15-19 billion, giving the banks some badly needed capital, and helping them reduce their exposure to credit cards, one of the many nightmares on the horizon. Raising capital has become serious business for the banks, with Citigroup, Merrill Lynch, Morgan Stanley, Bank of America, and Wachovia raising over $55 billion in the last few months, to offset some of their losses.

While the biggest banks are the most bankrupt, the smaller banks are also in trouble. Figures from the Comptroller of the Currency (OCC) show that the commercial real estate exposure of the nation's community and mid-sized banks is in the range of 275% of their capital as of 2006, compared to about 80% for the large banks.

Bailouts

Numerous bailout proposals are circulating in Washington, all of them based upon the idea that the current asset decline is an aberration, and that the government should step in and protect the asset valuations until the market returns to normal. FDIC chairman Sheila Bair has proposed freezing scheduled interest rate hikes on troubled mortgages. Sen. Chris Dodd (D-Conn.), head of the Senate Banking Committee, proposed that the Federal government purchase and refinance mortgages headed for foreclosure. Bank of America and Crédit Suisse are circulating their own proposals. Many of these proposals involve having the Federal Housing Administration insure loans, and then having Fannie Mae and Freddie

Mac buy them; Freddie and Fannie have been instructed to begin buying so-called jumbo loans—those over $417,000—despite the fact that both institutions are already hemorrhaging money. Freddie Mac reported a loss of $2.5 billion for the fourth quarter, while Fannie Mae lost $3.6 billion.

All of the plans, while claiming to protect the public, are actually intended to protect the valuations of mortgage-related securities, as a way of protecting the banking system. Rather than admit that housing prices are too high, that debt levels are unsustainable, and must be adjusted through bankruptcy proceedings, the plans would convert the debt to government obligations, in effect shifting the huge asset losses to the taxpayers.

Treasury Secretary Henry Paulson has attacked some of these proposals as bailouts of speculators, even while advancing his own bailout plans. While some bankers are clamoring to be saved, Paulson is smart enough to realize that the bankers—or at least some of them—will have to take their lumps. He has been adamant that banks must write down their losses and recapitalize, even while he has attempted to organize private-sector bailouts like his ill-fated M-LEC Super-SIV plan, and his Hope Now Alliance.

Paulson, as a former Goldman Sachs banker, knows quite well that the financial system is finished, and is determined to save the core institutions of that old system—a handful of big banks, investment banks, and other institutions—to survive as part of the new system the bankers are attempting to put into place. Much of the old system will have to be let go, with the new system to be raised, Phoenix-like, out of its ashes. The politicians are to be kept out of this as much as possible, in Paulson's view, because the new system will rely much more on technocrats than politicians, much more on the private sector than the government.

While the technocrats attempt to decide our fate, the news media is doing its best to distract us with minor dramas like the fate of the monoline bond insurers, and all the losses that will follow should the monolines fail to retain their crucial AAA credit ratings. If they fail, we are repeatedly and breathlessly told, all hell will break loose. But, all hell has already broken loose. The monolines wouldn't even be an issue were the bond market not collapsing, a point which ought to be obvious, but which the media continually misses.

California Gov. Arnold Schwarzenegger and New York Mayor Michael Bloomberg, acting on behalf of fascist bankers like Felix Rohatyn, are touring the country pushing privatization of public infrastructure. They claim the private sector, with all its cash, can afford to build projects the governments cannot, but it is the old bait and switch scam. These private sector funds are rapidly evaporating. The bankers don't intend to spend billions, they intend to make billions by charging ordinary citizens for using infrastructure the citizens have already paid for. It is a very old-fashioned rip-off, and you can expect to pay through the teeth. Assuming, of course, that you survive.

Ethanol Won't Solve Food Price Inflation

by Marcia Merry Baker

The World Food Progam—the UN food relief agency—said in its February "emergencies" report, that it is has begun plans for rationing scarce aid among 73 million people in 2008, because food prices are out of control, and supplies are so scarce. This is just one of many responses to the fast-worsening inflation of food prices; others include street riots in Southweast Asia and unilateral, defensive actions by China, the Philippines, and other governments to secure food.

Three major factors are at play. First, grains and other staples are in short supply after decades of underproduction; globalization of farming and food trade has downgraded agriculture output potential, as ratios fell per unit area of availability of water, power, high-tech inputs, and transport. Worldwide, grain production has been less than consumption in seven of the last ten years. Stocks of rice, wheat, and corn are at severe danger levels.

Second, the switch of farm land to producing biofuels instead of food crops, has turned a crisis into a catastrophe, especially since the 2005 ethanol-use mandates were set in the United States, France, and elsewhere. In 2008, fully 12% of the world's corn output will go to ethanol, up from barely 1% a few years ago.

Finally, the impact of wild speculation on the Chicago Board of Trade and other grain exchanges in Kansas, Minneapolis, London, and elsewhere, is driving up prices by the hour. In February alone on the CBOT, the daily allowable limit for the price of a bushel of wheat was raised multiple times, to accommodate the fact that it kept being hit, and trading had to be suspended. Before Feb. 11, the limit was 30¢; then upped to 60¢; then 90¢. On Feb. 26, it was at $1.35 a bushel limit, but still it was hit. The futures price for a bushel of wheat (May delivery) in Minneapolis has doubled since September. **Figure 1** shows the past year's rise in wheat futures prices on the Kansas City Board of Trade, reaching the vertical stage by the end of February.

No wonder that the food chain is breaking down all along the line. For example, vast liquidations of livestock are threatened, because feed prices have shot up. **Figure 2** shows monthly cattle futures prices during 2007, indicating that cattle producers are taking a hit by having to pay soaring feed prices, while what they receive for their beef stays relatively the same. Hog producers are hit very hard.

In Britain on March 4, pig farmers plan to stage a demonstration against the fact they are losing 4 to 7 pounds a head on every animal marketed. Feed-grade wheat is one of their prin-