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World Economy

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4 April 2008

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The failure of the investment bank Bear Stearns marks a new stage of the banking crisis, as the liquidity-solvency spiral continues its downward course.

At the same time, the Fed-financed bailout, together with calls for a wider state rescue of failing banks, is opening up an ideological crisis for ultra-free-market capitalism.

The salvage of the major investment bank, Bear Stearns, by the US Federal Reserve marks a new stage in the development of the US and global financial crisis. The fifth biggest investment bank, the weakest link in the chain, was brought down by a bank run, not of depositors, but of creditors – other investment banks - that are themselves facing runs, as their creditors in turn demand additional security or repayment of loans. Bear Stearns was 'too big to fail', so the Fed has pumped in \$30 billion to prevent a complete shipwreck, a state-financed rescue under cover of JP Morgan Chase, which is buying Bear Stearns at a fire-sale price.

Financial Times columnist, Martin Wolf, designated 14 March "the day the dream of global free-market capitalism died... By its decision to rescue Bear Stearns, the Federal Reserve, the institution responsible for monetary policy in the US, chief protagonist of free-market capitalism, declared this era over". (The Rescue of Bear Stearns Marks Liberalisation's Limit, 25 March). At the same time, a state bank in Germany was forced to undertake a second rescue operation to prevent the collapse of IKB Deutsche Industriebank. This prompted the chief executive of Deutsche Bank to proclaim: "I no longer believe in the market's self-healing power".

Whether the Fed's action is enough to halt the downward liquidity-solvency spiral now gripping the financial sector remains to be seen. The US recession is deepening, especially the housing sector, and this will further undermine the financial sector and work through the global economy. Those representatives of the capitalist class who have any insight at all are now bracing themselves for a major economic crisis, more serious than 1973-74 and most likely the worst since the great de-

pression of the 1930s.

A rapacious Bear

Bear Stearns has always had a reputation as one of the most rapacious investment banks, taking big risks in pursuit of big profits. The firm profited during the depression of the 1930s, and profited from trading in New York City bonds after the city went bankrupt in the 1970s. Bear's chief executive, James Cayne, was seen as an arrogant maverick: Bear refused to contribute to the Fed-led rescue of the hedge fund, Long Term Capital Management, in 1998.

Recently, Bear's main activity has been trading bonds, especially the complex, mortgaged-linked bonds that have poisoned the finance system. Like other investment banks, Bear's activity was highly leveraged, that is, financed by huge amounts of credit. On the strength of \$11.8 billion of shareholders' capital, the bank ran a balance sheet of \$395 billion.

Last July, two of the hedge funds run by Bear Stearns went bankrupt, with losses of \$2.6 billion. Throughout the crisis, Cayne continued to play golf and participate in bridge tournaments. He also negotiated a \$1 billion investment from the state-owned Chinese bank, Citic Securities – which failed to stop Bear Stearns slide (Citic is now pulling out of the deal).

Bear Stearns' activities are not at all untypical of Wall Street investment banks: Bear just happened to be the weakest link. As the bank teetered on the brink of collapse, the Financial Times clearly described the vicious cycle that was pulling it down: "To finance that balance sheet [\$395bn] Bear relies on short-term loans secured against its portfolio of bonds. This week those loans dried up; Bear hardly had a chance. A poisonous cycle has taken hold. As mortgage-backed bonds fall in value – even those backed by quasi-government entities, Fannie Mae and Freddie Mac – banks demand more security to lend against them. That pushes leveraged investors to sell bonds, depressing prices still further, prompting more margin calls [demands from creditors

for more security] and the collapse of some funds, such as Peloton and Carlyle Corporation. Bear Stearns is not just heavily leveraged, it was a lender to CCC [Carlyle]". (Editorial: Exit Bear, 15 March)

As the FT's editorial remarked, "there is a whiff of 1929 about all this". At that time, banks were forced to sell off assets to provide more collateral to their creditors, triggering one spasm of liquidation after another. The Fed, at that time, failed to intervene, standing back while a string of banks collapsed.

This time, the Fed has energetically intervened, making liquidity available to the markets (starting with \$38bn last August, after the collapse of the Bear Stearns hedge funds). However, the additional \$100 billion and \$200 billion tranches of credit made available by the Federal Reserve on 7 and 11 March came too late to save Bear Stearns. By the weekend of 15-16 March, the bank was clearly on the verge of collapse, and the Federal Reserve and the US Treasury department urgently convened a meeting of bankers to discuss a rescue package. Ben Bernanke and Hank Paulson (US Treasury secretary) were desperate to rescue Bear Stearns before Asian financial markets opened on Monday morning. Clearly, news of the failure of a major New York investment bank could have triggered a massive collapse on the stock exchanges of Japan, China, and elsewhere, detonating a worldwide financial collapse.

JP Morgan Chase, one of the US's biggest (regulated) commercial banks, emerged as the only likely purchaser. On the basis of a \$30 billion guarantee from the Federal Reserve to cover Bear's 'less-liquid assets' (that is, insuring JP Morgan against Bear's most toxic bonds), JP Morgan agreed to buy out Bear Stearns for \$270 million – that is, \$2 a share, compared with a share value of \$170 a year ago. Later, JP Morgan was forced to raise its bid to \$10 per share. Many of Bear's 14,000 workers will lose their jobs. Cayne has now sold his \$6 million shares – walking away with 'only' \$61 million (the same shares would have been worth about \$1.2bn in January 2007).

Role of the Federal Reserve

In recent weeks, the Federal Reserve, with the support of the US Treasury department, has intervened decisively in an attempt to halt the wave in subprime writedowns and defaults on margin calls (demands for additional collateral for outstanding loans). The actions of the Federal Reserve have been described as 'dramatic', 'unprecedented'. A Morgan Stanley economist refers to the 'hyper-proactive' role of the Fed. Since last August, the Fed has injected three major liquidity packages into the banking system. Moreover, also last August, the Fed effectively bailed

out Citigroup, the US's biggest commercial bank, a regulated bank entitled to borrow from the Fed, by allowing it to borrow \$25 million and pass it on to two of its insolvent brokerage affiliates, unregulated investment firms that were not entitled to borrow directly from the Fed.

The Fed's liquidity injections reached a new scale in the week before the collapse of Bear Stearns. On 7 March the Fed made a further \$100 billion available to commercial banks (deposit institutions) that have had access to the Federal Reserve as a lender of last resort. However, the Fed was now prepared to accept "a wider range of collateral", that is, some of the potentially dubious (if not worthless) securities at the heart of the credit crisis. The Fed also extended the period for money loans. A few days later, in an even more dramatic move, the Fed (11 March) made \$200 billion available to investment banks (that deal in bonds, shares, and other securities on their own account and on behalf of hedge funds and other clients). Previously, these banks had no access to the Fed's reserves. Once again, they would be allowed to borrow on the basis of potentially dodgy collateral.

Alongside the provision of massive extra liquidity, the Federal Reserve drastically cut its base lending rate. In five moves after September, it cut the overnight lending rate from 5.25% to 3%. There was another 0.75% cut on 17 March, following the Bear Stearns rescue, bringing the nominal rate to 2.25%. Given the current levels of inflation (officially 4% 'headline' inflation, 2.3% 'core' inflation excluding food and fuel), this is a negative real rate of interest.

This course of action represented a dramatic u-turn in Fed policy. In his first period of office after February 2006, Bernanke advocated 'orthodox banking principles'. Highlighting the dangers of inflation, Bernanke said there would be no cutting of interest rates to preempt a slowdown (the US housing market was already slowing down at the beginning of 2007), there would be no ad hoc bending of the rules to help financial institutions facing problems as a result of their reckless activities. There would be no bail-outs because bail-outs give rise to 'moral hazard', that is they allow irresponsible banks to escape the consequences of their actions. This approach was based on Bernanke's complacent view of the US economy. In February 2007, Bernanke portrayed (in the words of the New York Times) "a Goldilocks economy that is neither too hot, with inflation, nor too cold, with rising unemployment". Even after the collapse of two Bear Stearns hedge funds in August 2007, Bernanke played down the effects this would have on the wider economy.

But as the subprime crisis unfolded in August, Bernanke, like many others, was forced to abandon his rosy view and face the growing likelihood of a finan-

cial collapse. Having in early August rejected the idea of an interest rate cut, the Fed held an emergency meeting and implemented a 0.5% cut in the discount rate (to 5.75%) on 18 August. At the same time, Bush presented a \$168 billion (approximately 1% of GDP) stimulus package to Congress. And, as we have seen, the Fed was forced to make bigger and bigger injections of liquidity into the banking system in a desperate effort to relieve the tightening of the credit crunch.

Even the measures announced in the first week of March, however, were not enough. On 13 March it was announced that the Carlyle Group had defaulted on \$16.6 billion of loans (unable to meet a 'margin call', for additional collateral of only \$400m). At the same time, a mortgage lender, Thornburg, also failed to meet margin calls.

Then the Bear Stearns crisis, which had been simmering since the previous August, came to a head. This was when the Fed became 'hyper-proactive'. Bernanke, Tim Geithner (president of the New York Federal Reserve), and Paulson (Treasury secretary) recognised that they were on the brink of a catastrophe. Bear Stearns is only the fifth-largest investment bank, but it is highly 'interconnected', with tentacles stretching into a wide range of banks and financial institutions. For instance, Bear Stearns has been one of the biggest traders in credit default swaps (a type of derivative used to insure other securities), a sector of the derivatives market that has ballooned to a colossal total nominal value of \$45 trillion! A complete collapse of Bear Stearns would have triggered a financial meltdown, potentially far more serious than the collapse of the hedge fund, Long Term Capital Management, in 1998. The Fed's action was 'dramatic', 'sweeping'. The Economist recognised that the Fed undertook "extraordinary manoeuvres" to meet the "threat of catastrophe". (The \$2 Trillion Bail-Out, 19 March) Without the Fed's action, commented the New York Times, the Bear Stearns crisis "could have triggered potentially a collapse of the financial system".

There was no attempt to organise a consortium of banks to bail out Bear Stearns. Instead, the Fed in effect mounted a direct bail-out through the major commercial bank, JP Morgan Chase. The Fed is acting as a 'puppet master' for JP Morgan, which will effectively buy Bear Stearns at a fire-sale price. At the same time, the Fed is establishing a new 'shadow bank' that will acquire the most risky, illiquid securities (mostly subprime securities) using \$30 billion of Fed funds. If these dodgy assets turn out to be worthless, JP Morgan will lose \$1 billion while the Fed will lose \$29 billion. If, however, the new entity (to be managed by BlackRock, an investment management firm) turns a profit, JP Morgan could in the future make a profit once the \$30 billion is repaid to the Fed.

However, the main motive of JP Morgan appears to be its desire to acquire a primary bond dealer that can trade securities directly on behalf of JP Morgan and its clients. JP Morgan is in a relatively strong position compared to many other banks (with much lower write-offs of subprime mortgage loans).

It has become clear that the Fed, backed by Paulson, initially dictated that JP Morgan would pay only \$2 per share to buy out Bear Stearns. Bernanke and the government were desperate to avoid accusations that they had created 'moral hazard' by bailing out reckless speculators. However, after the initial deal was agreed, there was a rebellion of Bear Stearns executives and employees (who between them own 30% of Bear Stearns shares). JP Morgan faced the prospect of taking over an empty shell – Bear Stearns executives were scrambling to find other jobs, with the possibility of a mass exodus of key personnel. Moreover, Bear Stearns shareholders, including the staff and the hedge fund financier, Joe Lewis (who owns a big slice of Bear Stearns shares), threatened to block the Fed-sponsored deal with legal action. Delay in resolving the Bear Stearns crisis could have undermined the whole point of the rescue mission. The Fed was therefore forced to renegotiate the deal, offering \$10 for Bear Stearns shares. This time, the Fed ensured that the revised deal would go through by bending stock exchange rules to allow JP Morgan to instantly purchase nearly 40% of Bear Stearns shares – giving JP Morgan a decisive vote. (A Change of Heart at JP Morgan, International Herald Tribune, 26 March)

Inflation or deflation?

Will the Fed-JP Morgan bail-out do the trick? The leaders of US capitalism are desperately hoping that it will. So far, the banking sector has written off about \$150-200 billion of distressed, subprime assets, and the credit rating firm, Standard & Poors, estimates that the total writedowns will amount to about \$285 billion. But this is optimistic. The continued decline of the housing market is likely to bring an avalanche of new defaults in both the subprime and prime mortgage markets. These could further undermine the value of mortgage-backed securities. There is also the possibility of huge losses occurring as a result of trading in derivatives, credit default swaps, and so on. Some commentators estimate that the total losses to the financial sector could be in the region of \$1 trillion – but there are others who put the worst-case scenario at as much as \$3 trillion – an absolute catastrophe.

Representatives of big business are now debating what course of action should be taken by the government and the Federal Reserve. More voices are now advocating a major bail-out of bankrupt banks and finance houses, with the wholesale taking over of

risky, illiquid financial assets.

For instance, Paul De Grauwe (economics professor at Leuven University) argues that injections of capital by the Federal Reserve (or other central banks) will not halt the downward spiral of liquidity and solvency problems for banks and financial institutions. De Grauwe explains that when an investment bank or hedge fund is “hit by a withdrawal (a liquidity problem) and is forced to sell assets, the price of its assets declines and a solvency problem is created”. (Act Now to Stop the Markets’ Vicious Circle, Financial Times, 19 March) Injections of liquidity will, in themselves, not halt the downward spiral: there has to be a liquidation of worthless or unsellable assets. “The US Federal Reserve...” writes De Grauwe, “has no option but to buy distressed assets in an attempt to put a floor on the downward asset valuations spiral, which risks getting out of control”.

Also writing in the Financial Times, Mohammad El-Erian, a prominent US fund manager (Pimco), argues that “incremental steps using traditional policy instruments [ie interest rate cuts, injections of liquidity] are ineffective”. (Why the Fed must Act in Unfamiliar Ways, 17 March) Governments, he warns, must be prepared to break the rules. El-Erian argues that governments must contemplate “altering contracts so that stressed mortgage holders can avoid default and foreclosure; and/or explicitly using the government’s balance sheet to support the housing market”. This would involve using government funds to pay off unrepayable mortgages and buy unsellable assets from a variety of lenders. El-Erian accepts that such measures would undermine the “sanctity of contracts” and “erode the integrity of the market system”. However, these risks are “inevitable at this advanced stage of the crisis. Indeed, the question is not just what happens to irresponsible lenders and imprudent borrowers. It is also about the damage that is being inflicted on others as the finance system freezes”. In other words, faced with the survival of their system, the representatives of capitalism are prepared to discard their principles of moral hazard and sanctity of contracts, and draw on public funds (taxpayers’ money) to bail out the system.

At the same time, however, other commentators have pointed to the problems such action could create for capitalism. The obvious question is: where would the money come from for a massive bail-out? One financial analyst, Steve Randy Waldman (James Saft, Fed Move Won’t Halt the Slide, International Herald Tribune, 14 March), calculates that, after the \$200 billion made available to banks on 11 March, the Federal Reserve has another \$300-400 billion left. Therefore, to buy out even \$1,000 billion of unsellable securities the Fed – or the US government – would obviously require additional funds. These could be raised either by (1) additional capital from the government (that

would have to be paid for either through additional government borrowing or increased taxation), or (2) printing money (which would raise the very real spectre of inflation).

“If it’s too big there will have to be an element of monetisation, with the Fed financing it”, says Tim Drayson, economist in London with ABN AMRO. “Monetisation is rising from what was a small likelihood to what is now an increasing risk”. (Quoted in Saft, A Wider US Financial Bail-out Could Fuel Inflation, International Herald Tribune, 20 March) Monetisation is a polite way of saying printing money to pay off debts.

Saft writes: “Calls are increasing for the Federal government, either directly or through the Federal Reserve, to cut the knot of the credit crisis at a stroke by buying up mortgages that banks and investment banks are finding difficult to finance. If the government bought mortgage debt at or near 100 cents on the dollar, even though much of it is trading well below that amount, it would allow banks to pay back loans used to finance these holdings. If done in sufficient size, say \$800 billion or \$1 trillion, it would relieve the terrible pressure on bank balance sheets and allow other credit markets, like those for corporate loans, to return to something approaching equilibrium”.

One of the voices warning against prolonged, negative real rates of interest is Paul Volcker, the former Fed chairman, who ruthlessly squeezed out inflation from the US and world economies after 1979 through ‘monetarist’ policies – high interest rates and a restricted money supply. Volcker warns against lowering interest rates too far. The threat of resurgent inflation is “lurking not very far in the background”, he warns. That would be “the ultimate destructive result of this”. (Krishna Guha, Administration Urged to Share Credit Burden, Financial Times, 19 March)

This poses a dilemma for US capitalism. Faced with a catastrophic collapse, they will, at a certain stage, undoubtedly be prepared to print money in order to wipe out an unsustainable level of bad debt. In that case, however, they would certainly face the threat of inflation. On the other hand, the tightening of the credit crunch, with mountains of bad debt weighing down widening sectors of the US economy, could push the US into a deflationary spiral, similar perhaps to the situation in Japan in the 1990s. This would mean massive overcapacity, falling prices, an investment slump and escalating unemployment – with the prospect, as in Japan, of a prolonged period of stagnation. There is no easy way out for capitalism: both inflation and deflation, in their different ways, pose economic and political dangers for the system.

Historically, the US ruling class has feared depression more than inflation, having experienced capital-

ism's biggest ever slump in the 1930s. This is in contrast to the European bourgeoisie, who have not forgotten the period of hyper-inflation during the inter-war period (reflected in the European Central Bank's current resistance to lowering eurozone interest rates). In the past, US leaders have always tended to resort to printing dollars to inflate their way out of crisis. This was facilitated in the post-war period by the role of the US dollar as a reserve currency. Today, however, the situation has changed: a collapse of the dollar (combined with negative real interest rates) could provoke a flight of capital from the US (to euro assets and other stronger currencies, such as the Swiss franc) and make it even harder for the US to finance its federal budget deficit and current account deficit (which are overwhelmingly financed by the inflow of capital from abroad).

Political reaction against 'crony' capitalism

One thing is conspicuous when representatives of capitalism are calling for 'unconventional tools' for fixing the credit crunch. The various measures they are demanding, in one form or another state-finance bail-outs of the financial sector, are overwhelmingly aimed at rescuing the banks and other financial institutions. In other words, it would mean the state-backed rescue of the super-rich financiers and speculators responsible for the crisis. On the other side, the assistance so far proposed for millions of struggling home owners who were drawn into the financial mess by profit-hungry moneylenders are minimal, even token measures. This glaring disparity will inevitably have political repercussions in the next period.

Significantly, this issue has been raised by Financial Times columnist, Martin Wolf, who notes that there appears to be a financial system "where in good times the profits are privatised and in bad times the losses are socialised". The rescue of Bear Stearns is a backdoor state-funded bail-out through the agency of a massive private bank, JP Morgan Chase. However, a large-scale bail-out on a scale required to rescue the banking sector in general would require either direct nationalisation or, more likely, indirect nationalisation through an arms-length body such as the Resolution Trust Corporation that was set up in the early 1990s to rescue the bankrupt Savings and Loans institutions. The Savings and Loans crisis ended up costing US taxpayers the equivalent of \$450 billion at today's values, or 3.2% of GDP. In contrast, the bill for the current financial crisis is estimated at 7% of GDP by Wolf, who takes a relatively conservative view. On the other hand, Nouriel Roubini of RGE Monitor estimates that the bill for bailing out the banking and financial system in the event of a systemic crisis would be at least 12% of

GDP and could be as high as 19% (which would add another \$2.7 trillion to the public debt). As Roubini says, this would mean "saddling every US household with an additional \$30,000 of debt in perpetuity..." In addition, there could be, he estimates, a further \$10 trillion losses in the US private sector as a result of falling values in domestic housing and commercial real estate, together with stock exchange losses.

Warning of the political repercussions of the crisis, Wolf writes: "This is not a crisis of 'crony capitalism' in emerging economies, but of sophisticated, rules-governed capitalisms in the world's most advanced economy. The instinct of those responsible will be to mount a rescue and pretend nothing has happened... worse, the institutions that prospered on the upside expect rescue on the downside. They are right to expect this. But this can hardly be a tolerable bargain between financial insiders and wider society. Is such mayhem the best we can expect? If so, how does one sustain broad support for what appears so one-sided a game?" (Financial Times, Economists' Forum, 27 February)

Responding to this, Roubini writes: "This is indeed a one-sided game where financial insiders privatise profits while the massive losses of their reckless behaviour – searching dangerously for yield, gambling for redemption, being subject to distorted incentives not to monitor their lending and risky investments – are systematically socialised during a crisis. This is actually 'crony capitalism' of the worst kind, as bad as the one that plagued emerging economies and led to their severe financial crises in the last decade".

The financial-sector crisis has already had a devastating effect on millions of heavily-indebted home-buyers, but its full impact on the wider economy in the US and internationally has yet to be felt. The severe economic downturn that is now very likely will throw many millions of workers into unemployment and poverty. There will be a massive, world-wide political reaction against 'free-market' capitalism and the parasitic ruling class that reaps its profits at the expense of society. The economic crisis will inevitably bring with it an ideological and political crisis – and a search for an alternative system that can meet the needs of the majority who work to produce the wealth.

This article appears in the April 2008 issue of Socialism Today (monthly magazine of the Socialist Party – CWI in England and Wales)
