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Paulson and Bernanke ratchet up the blackmail talk

Posted by Jerome a Paris on September 24, 2008 - 10:45am in The Oil Drum: Europe
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> Paulson, Bernanke Tell Lawmakers Urgent Action Needed on Treasury Plan
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> WASHINGTON -- U.S. Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke urged swift action on a Treasury Department plan to buy illiquid mortgage-linked securities and avoid severe spillover effects on the economy.
>
> Mr. Paulson cautioned lawmakers against letting the plan get bogged down in a debate over **unnecessary additions**.

"Unnecessary additions" - things like accountability, transparency, making sure that the crisis does not happen again, and making sure that it solves the underlying problem. But nope, no "bogging down"...

The message could not be clearer - they are not avoiding the brinkmanship - they are escalating it, in the (not wholly unreasonable, given the recent past) expectation that the Democrats in Congress will fold, out of fear of being blamed for the tumbling stock market prices as the plan is delayed.

So, just for the record, a few arguments:

- the stock market is going down again *NOT because the plan is delayed* but because, even if the $700 billion gift to the banks is granted, **it will still not solve the underlying situation**;
- as the plan is currently drafted, giving $700 billion to the banks to relieve them of their bad assets protects the very institutions or people that lost money by taking stupid risks (and having seen it from the inside, believe me, it was truly stupid) without proposing any upside for taxpayers, nor any reform that would at least avoid the same mistakes from happening again;
- in the up leg of the bubble, the problem WAS too much liquidity (which helped take silly risks when these were not properly assessed); today's problem is massive deleveraging - that deleveraging is NOT caused by lack of liquidity, but by risk aversion (investors no longer want to invest in anything that looks even remotely risky). Throwing more money at that problem will do nothing to solve it. It will create simply a circuit whereby the government creates new Treasuries, hands them over to the FED, which uses them to create more cash, which it trades with the banks for dubious assets; the banks will use the cash to buy Treasuries. It's a closed circle which helps no one but the banks (and the Fed, see below).
- the real worry is on actual economic activity, which is straining under the twin burdens of

> asset price depreciation (house prices crashing, leading to lower incomes for people, less construction activity and foreclosures) and the credit crunch (business no longer having access to credit to develop their activity). Given that companies and households are also deleveraging (reducing their debts or increasing their savings), or are about to be forced to do so, the real need is to inject actual revenues, ie wages coming from real activity, in the economy, and NOT debt. What government needs to do is to spur real economic activity - as it were, there are whole sectors begging for it, like investment in public transporation or renewable energy infrastructure.

The plan from the Bushies helps stricly no one beyond providing TEMPORARY relief to banks, which might be enough but does not quite explain their willingness to engage in such brinkmanship.

Which makes the following suggestion, emailed to me by a US central banker friend, all the more intriguing:

> Jerome,
>
> I've been puzzling why Paulson would propose legislation which is so obviously dictatorial, extra-legal and dangerous, even with the careful orchestration of the Lehman Brothers/Reichstag Fire.
>
> I think I've just figured out why they are doing it.
>
> All the Fed's alphabet soup of emergency liquidity facilities innovated over the past year were structured around repurchase agreements. Toxic waste securities were used as collateral for US Treasuries and dollar credit at 85 percent of face value. But as each facility expires, it has to be rolled over and increased to keep pace with the implosion of credit in the interbank markets. Well over half the balance sheet assets of the Fed have been loaned out in this way, perhaps a critical amount in excess of this estimate. Without recapitalisation, the Fed is at risk of failure in the midst of this crisis. Its Enron-style accounting for the toxic waste makes it very vulnerable to a default by any of the repo counterparties it oversees and limits its ability to enforce any constraints as well.
>
> The Paulson plan will provide a one off opportunity for banks to take their toxic collateral back and sell it at a Paulson-determined price for cash. He issues Treasuries to finance the plan which increases the supply available. He selectively decides winners and losers, of course in making the scheme available and pricing assets, creating arbitrage opportunities and survivor bias in the process.
>
> In the meanwhile, the removal of the toxic waste from the Fed balance sheet and redeposit of Treasuries and cash as the repos unwind gets the Fed off the hook for having hypothecated most of its assets against worthless toxic waste at Enron-styled false valuations.
>
> If I'm right, the Paulson Plan recapitalises the Fed without ever publicly admitting that it was dangerously overextended.

My friend provides this video which says Fed has lent out $600 billion of its $800 billion balance sheet.

http://video.msn.com/video.aspx?mkt=en-US&brand=money&vid=25f132d8-4c5d-...

and concludes a follows:

> Real question in my mind is whether the $1 trillion from the Paulson Plan goes to recapitalise the Fed as I suggest, or whether it goes into offshore flight capital before the criminal mafia in Washington and Wall Street flees the jurisdiction.

The theory here is that the Fed has destroyed its balance sheet by taking on increasingly large chunks of non performing assets (the "toxic waste" made from mortgage-backed securities and the like) in exchange for loans of "real" cash to banks that may still end up not repaying them.

It is effectively "broke." This is not what is supposed to happen to a central bank, which can print money without restriction, so let me explain what this means: **it can no longer help the banks in a non-inflationary way**. In order to take on more toxic collateral from the banks, it would need to actually print money, which would immediately be visible and would be seen as very inflationary. Instead, by getting government to take on more public debt, the impact is diluted in a much larger pool (public debt, rather than cash).

So this is a desperate gamble by Paulson and Bernanke to avoid the run on the dollar that would be triggered by direct cash creation.

Obviously, as the market shows (with the euro up by 6 cents since the plan was announced Thursday night, and gold and oil similarly massively up), worries about inflation have not quite been killed, but they have been kept to a manageable scale.

At this point, of course, the goal is to avoid a bigger crash before the election.