After the Bear Stearns bailout: Fears of more Wall Street failures

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In the aftermath of Friday's emergency action by the Federal Reserve Board to prevent the immediate collapse of the Wall Street investment bank Bear Stearns, US and global markets are bracing for signs that other major US financial institutions will similarly implode.

In a move than has no precedent since the Great Depression of the 1930s, the US central bank brokered an arrangement whereby JP Morgan Chase borrows money from the Federal Reserve Bank of New York and makes it available to Bear Stearns, in the form of a 28-day loan. The Fed explicitly stipulated that it, not JP Morgan Chase, would assume the risk of a default on the loan by Bear Stearns.

The Fed acknowledged that it took this extraordinary action to prevent a run on Bear Stearns, the fifth largest investment bank in the US, from causing an immediate failure of the institution. Noting the danger of "systemic" consequences of such a development, the Fed in effect signaled that it feared a collapse of Bear Stearns would lead to a panic on financial markets and collapse of confidence in the US banking system.

In an article published on Saturday, headlined, "Debt Reckoning: US Receives a Margin Call," the *Wall Street Journal* summed up the significance of Friday's events as follows:

"The US is at the receiving end of a massive margin call: Across the economy, wary lenders are demanding that borrowers put up more collateral or sell assets to reduce debts.

"The unfolding financial crisis—one that began with bad bets on securities backed by subprime mortgages, then sparked a tightening of credit between big banks—appears to be broadening further. For years, the US economy has been borrowing from cash-rich lenders from Asia to the Middle East. American firms and households have enjoyed readily available credit at easy terms. No longer.

"Recent days' cascade of bad news, culminating in yesterday's bailout of Bear Stearns, is accelerating the erosion of trust in the longevity of some brand-name US financial institutions. The growing crisis of confidence now extends to the credit-worthiness of borrowers across the spectrum—touching American homeowners, who are seeing the value of their bedrock asset decline, and raising questions about the capacity of the Federal Reserve and US government to rapidly repair the problems."

In its lead editorial, the *Financial Times* of London sounded a similarly ominous note, writing:

"Bear Stearns is a leverage machine: with only $11.8 billion of capital from its shareholders it supports a balance sheet of $395 billion, most of it in bonds, and many of those backed by mortgages. To finance that balance sheet, Bear relies on short-term loans secured against its portfolio of bonds...

"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 and the collapse of some funds, such as Peloton Capital and Carlyle Capital Corporation...

"There is a whiff of 1929 about all this... Now the question is: what else is out there? Will the liquidity and solvency of other large banks and brokers be called into question?"

The *New York Times* on Saturday quoted James L. Melcher, president of Balestra Capital, a hedge fund based in New York, as saying, "You get to where people can't trade with each other. If the Fed hadn't acted this morning and Bear did default on its obligations, then that could have triggered a very widespread panic and potentially a collapse of the financial system."

The Fed's action was aimed at buying time for an orderly disposition of the Bear Stearns debacle, most likely involving the sale of the 85-year-old company, either in whole or in parts, to other banks or financial institutions. Talks were launched on Friday to find one or more buyers of the firm, with speculation centering first on JP Morgan Chase, the clearing bank for Bear Stearns. Other possible takers mentioned in press accounts include the Royal Bank of Scotland and J. C. Flowers, a private equity firm.

Even as these talks were underway, doubts were being raised about another Wall Street titan, the investment bank Lehman Brothers. Bear Stearns was particularly vulnerable to the pressure of a growing credit crisis, combined with a slide into recession, mounting inflation and a rapid fall in the US dollar, in part because it was the second biggest underwriter of mortgage-backed securities. Lehman, however, is the largest underwriter of these distressed and largely unmarketable investments.

While Lehman's capital position is reportedly stronger than Bear Stearns', it is the weakest of the other major Wall Street investment houses and commercial banks. The price of Bear Stearns' stock plummeted by 47 percent on Friday, but Lehman Brothers' stock also took a gigantic hit, losing 15 percent.

In an unambiguous sign of investor nervousness over Lehman's prospects, the price for insuring the firm's debt jumped to $478 per $10,000 in bonds on Friday, from $385 in the morning, according to Thomson Financial.

Another indication of problems was Lehman's announcement Friday that it had obtained a $2 billion, three-year line of unsecured bank credit from a consortium of 40 banks. JP Morgan Chase and Citigroup led the effort to shore up Lehman's balance sheet.

The near-panic mood in US and global markets is not likely to improve this week, as four of the five biggest Wall Street investment banks report their fourth quarter earnings. Bear Stearns was due to report on Thursday, but moved the timing up to Monday after Friday's developments. The others due to report are Goldman Sachs, Morgan Stanley and Lehman Brothers. It is widely expected that the firms will report billions more in write-downs and losses from failing mortgage-backed securities and other distressed debt holdings.

On March 7, Goldman Sachs upped its projection of total bank losses likely to be suffered as a result of the credit crisis to $1,156 trillion—$500 billion in mortgage-backed securities and $656 billion in other soured investments.

The Fed's action in throwing a temporary life-line to Bear Stearns was the latest in a series of increasingly desperate measures taken by the central bank to avert a financial meltdown. Already this month, the Fed has allocated an additional $400 billion in credit to major banks and investment houses, agreeing to accept as collateral for Treasury bonds privately issued mortgage-backed securities.

On Tuesday, the Federal Reserve's Federal Open Market Committee meets and is expected to announce a further cut in short-term interest rates of at least 0.5 percent. Market players are betting heavily that the Fed will go even further and slash rates by 0.75 percent or even a full 1 percent. This will bring the federal funds rate, the rate banks charge one another for overnight loans, to 2.5 percent or less. It will mean a cumulative cut of at least 2.75 percent since the Fed began slashing interest rates last September in response to the credit crunch brought on by the collapse of the housing market and soaring home loan defaults and foreclosures.

The massive injections of liquidity and rapid reduction in interest rates can only accelerate the rise in commodity prices, stoking inflationary pressures, and further undermine the dollar on world currency markets. On Friday, Gold reached new records, surpassing the $1,000-per ounce mark and crude oil hit new highs. The dollar reached a twelve-year low against the Japanese yen, hit record lows against the euro, and for the first time ever fell below parity with the Swiss franc.

These are devastating expressions of the decline of confidence worldwide in the US financial system. "Gold is not only an inflation hedge," said James Turk, founder of GoldMoney.com, "it's a catastrophe hedge." He added, "Gold is becoming increasingly important as the credit crunch continues to spiral out of control."

US Treasury Secretary Henry Paulson's appearances on Sunday talk shows could not have improved the view of investors on the prospects for the US and global economy. Asked point blank by moderator Chris Wallace of Fox News and George Stephanopoulos of ABC News whether there were other major banks or finance houses likely to suffer a fate similar to that of Bear Stearns, Paulson evaded the question, but pointedly did not rule it out. When asked whether the Bush administration would take stronger measures to bolster the dollar, he similarly demurred, merely repeating the official mantra that "a strong dollar is in the national interest of the United States."

Notwithstanding the assurances by the Bush administration that the present crisis is little more than a "rough patch," the signs of impending disaster are mounting. As the *Wall Street Journal* reported Saturday, there are indications that the massive flow of capital into the US that has sustained the increasingly indebted American economy is markedly slowing. The *Journal* noted:

"While cash continues to pour into the US from abroad, this flow has been slowing. In 2007, foreigners' net acquisition of long-term bonds and stocks in the US was $596 billion, down from $722 billion in 2006, according to Treasury Department data. From July to December, as jitters about securities linked to US subprime mortgages spread, net purchases were just $121 billion, a 65 percent decrease from the same period a year earlier. Americans, meanwhile, are investing more of their own money abroad."

Agence France-Presse carried a story Saturday on one indication of the historical decline in the global position of American capitalism that is at the heart of the current crisis. Under the headline "Dollar's Plunge Pushes Eurozone Past US," the news agency cited a report issued last week by Goldman Sachs noting: "With the euro now trading around 1.56 against the dollar, the size of its annual output (at market value) has exceeded that of the United States."