US Federal Reserve injects $200 billion into credit markets to avert financial meltdown

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In the face of a mounting panic on US financial markets, the Federal Reserve Board on Tuesday announced it would lend major Wall Street investment banks up to $200 billion in Treasury bonds and accept as collateral mortgage-backed securities for which there are currently no buyers on the market.

The so-called “term securities lending facility” announced by the US central bank was coordinated with four other central banks—the European Central Bank, the Bank of England, the Bank of Canada and the Swiss National Bank.

Under the plan, the Fed will loan up to $200 billion of its more than $700 billion hoard of Treasury bonds for a period of 28 days, in effect vouching for the credit-worthiness of mortgage-backed assets that have plummeted in market value along with the collapse in US home sales and prices, and which otherwise would have to be written off as losses by the finance houses.

By accepting privately originated mortgage-backed securities—in the past the Fed had accepted only securities issued by the government-sponsored mortgage lenders Fannie Mae and Freddie Mac—the US central bank agreed to take as collateral some $1 trillion in securities that previously would not have qualified.

In announcing the massive debt relief plan for Wall Street, the Fed said it was prepared to take further action if market conditions warranted, suggesting it would be willing to roll over the loans for additional 28-day periods.

Tuesday’s Fed action followed its announcement the previous Friday that it would expand its short-term loan program for the big commercial banks, the so-called “term auction facility” initially launched last December, from $60 billion to $200 billion.

Since August, when the collapse in the housing market led to a credit crunch, the US government has provided nearly $1 trillion in direct and indirect backing to financial firms in an attempt to unfreeze credit markets. At the same time, the Fed has slashed short-term interest rates five times, bringing them down from 5.25 percent to 3 percent. It is believed all but certain that the Fed will announce a further reduction in its federal funds rate of at least 0.5 percent when its policy-making committee meets again on March 18.

None of this, however, has resolved the massive crisis caused by the collapse of a housing bubble and credit bubble that were inflated in large part on the basis of sub-prime mortgage loans sold to home-buyers who lacked the financial means to sustain their mortgage payments.

Bankers, mortgage company executives, and speculators raked in huge profits and compensation packages on the basis of a vast pool of cheap credit backed by little more than the expectation that home prices would continue to rise forever. The resulting crash threatens a social catastrophe—with record home foreclosures and growing unemployment—and a financial breakdown of historical proportions.

The Fed’s action on Tuesday sparked a frenzied rally on US stock exchanges. Wall Street snapped a three-session losing streak—prompted in part by last week’s Labor Department report showing a net loss of 63,000 jobs in February—and share prices soared, led by financial sector stocks. The Dow Jones Industrial Average rose 416 points, its biggest one-day rise in five years.

However, credit markets remained more subdued, and the price of many forms of debt continued to fall, reflecting underlying anxiety about the solvency of major banks and financial institutions.

The Fed took its extraordinary action Tuesday in the hope that by temporarily relieving investment banks and brokerage firms of mortgage-backed assets that are losing value and depleting the firms' capital, and placing the prestige of the Fed behind the tarnished securities, the Wall Street finance houses will be spurred to loosen their credit requirements and lend money more freely to other banks, companies and individuals.

However, Steven Romick, a partner at First Pacific Advisors in Los Angeles, told the *Los Angeles Times,* "It's only a stay of execution. It gives them some time to work through their problems, but it doesn't solve their problems. We believe this euphoria is temporary."

Press accounts provide some indication of the panic conditions that prompted the Fed's move on Tuesday. Steven Pearlstein, the financial columnist for the *Washington Post*, wrote on Wednesday:

"But the real problem began in late February, as several of Wall Street's biggest investment banks prepared to close their books for the quarter and realized they were looking not only at big declines in profit from issuance of new stocks and bonds and fees from mergers and acquisitions, but also at another round of write-offs in the value of their holdings. In response, the banks began to hunker down, instructing their trading desks to raise margin requirements for hedge funds and other customers, requiring them, in effect, to post more collateral on their heavy borrowings.

"Thus began a chain reaction in which hedge funds began selling what they could—largely mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae—to raise cash to meet their new margin calls. That wave of forced selling drove down the price of those bonds, which prompted more margin calls and more forced selling. By the end of last week, the interest rate spread on those securities—the difference between their yield and that of risk-free US Treasury bonds—had jumped four, five, even ten times the normal rate.

"Among those caught up in the vicious cycle were hedge funds run by such blue-chip names as KKR and Carlyle Group, along with Thornburg Mortgage, a big mortgage lender. News of their troubles swept through Wall Street, heightening the sense of panic, as did rumors that Goldman Sachs was about to post big losses and Bear Stearns was about to run out of cash. Meanwhile, Lehman Brothers announced that it would lay off 5 percent of its staff in what was viewed by many as a first installment of a consolidation that would eventually eliminate 20 percent of the jobs on Wall Street. Analysts began to warn that financial-sector losses from mortgages, commercial real estate, failed takeover loans and other bad bets would reach as high as $1 trillion."

The *New York Times* described the situation as follows: "The main point of the effort on Tuesday was to prevent or at least slow down a chain reaction of forced selling on Wall Street. In recent days, market prices for seemingly safe debt had fallen so much that major financial institutions were being forced to put up more capital to secure their debt."

The *Wall Street Journal* provided an account Wednesday of the crisis atmosphere that attended the emergency consultations which led to the $200 billion initiative. "The Fed began considering its latest steps last week," the *Journal* wrote, "as credit jitters intensified. Fed officials finalized details on their plan on Sunday with foreign counterparts attending a meeting of the Bank for International Settlements, the Switzerland-based central bank for central bankers. The Fed's policy-making Federal Open Market Committee met by videoconference for an hour and a half Monday night to approve the measures."

As these reports make clear, the Fed, far from pursuing a long-term, well considered strategic plan, is scrambling, along with its central bank counterparts internationally, to keep abreast of a rapidly widening and worsening economic crisis and contrive stop-gap measures to avert an immediate crash.

At the same time, the flood of liquidity being pumped into the credit markets is fueling inflation and further undermining the US dollar, creating the conditions for an even deeper and more protracted crisis. One sign of this process is the accelerating rise in crude oil prices. On Tuesday, crude oil futures soared above $109 a barrel, setting a new record.