Federal Reserve transcripts show top US policymakers vastly underestimated crisis

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In the run-up to the 2008 financial crisis, top US regulators and monetary policy officials were largely blind to the impending financial collapse, according to transcripts of discussions within the Federal Reserve's policy-making Federal Open Market Committee (FOMC) released last week.

The documents, totaling 1,566 pages and covering all of 2007, show that top officials of the US central bank were unable not only to predict, but even conceive of a crisis of the magnitude that broke out in 2008. The transcripts echo the sentiment expressed by Federal Reserve Chairman Ben Bernanke earlier this month in an appearance at the University of Michigan. In response to a questioner who asked what had surprised him the most since the eruption of the crisis, Bernanke replied, "The crisis."

In the year prior to the period covered in the transcripts, US home values, which had up to that point been growing at double-digit rates, leveled off and gradually began falling. This caused a surge in foreclosures, particularly among sub-prime borrowers, many of whom had been lured into taking out mortgages they could not afford based on lenders' assurances that home values would continue to rise indefinitely.

Major financial houses, which were holding billions of dollars in securities consisting of bundles of mortgages, known as collateralized debt obligations (CDOs), saw the default rates on their holdings grow sharply.

As the Senate Permanent Subcommittee on Investigations reported in April 2011, during January and February 2007, Goldman Sachs "rapidly sold off or wrote down the bulk of its existing sub-prime RMBS [residential mortgage-backed securities] and CDO inventory, and began building a short position that would allow it to profit from the decline of the mortgage market." In other words, Goldman Sachs, like other banks, was aware of the disaster that was about to befall the housing market, and was betting that it would collapse.

Yet according to the FOMC transcripts, in January of 2007, Federal Reserve Chairman Ben Bernanke said that the "worst outcomes" for the housing market were looking more improbable, while there were "good fundamental reasons to think that growth" would be "moderate."

The following month, the Federal Home Loan Mortgage Corporation (Freddie Mac) announced that it would no longer purchase the riskiest sub-prime mortgages or mortgage-related securities. But in March, Bernanke said, "The impact on the broader economy and financial markets of the problems in the sub-prime market seems likely to be contained," according to the transcripts.

New Century Financial, a leading sub-prime mortgage lender, filed for bankruptcy the following month, and by July, Bear Stearns was forced to liquidate two of its hedge funds that focused on mortgage-backed securities after credit rating agencies downgraded a significant portion of these assets.

Even as signs of a major crisis in the sub-prime mortgage market continued to mount, the FOMC remained largely impervious to the gathering crisis. Frederic Mishkin, an FOMC member and author of a widely-used college textbook on monetary policy, downplayed the importance of the collapse in sub-prime securities at the August 7, 2007 FOMC meeting. "Of course," he said, "the media are making the sub-prime market into the whole story, but I think it is just not the right story. The sub-prime market is really a very small percentage of the total credit markets."

He went on to turn the metaphorical frown upside-down: "Basically, what I think is happening in a way is quite a good thing: We were concerned that the markets were a little too optimistic, that there was too much opacity, and that people weren't worried about it. Now, in fact, they are worried about it, and I think that is fundamentally a healthy situation."

By August, American Home Mortgage Investment Corporation had filed for bankruptcy, and by September home values had fallen five percent since the beginning of the year. Under these circumstances, Fed officials cut the benchmark federal funds interest rate for the first time in the year.

But even while making this move, they denied that the sub-prime problem reflected a systemic crisis. In October 2007, David Stockton, the Federal Reserve's chief economist, observed that "we are not forecasting a deep credit crunch. If you were more concerned that that was what you were facing, I don't think this forecast is consistent with it."

Aside from the regulators' apparent blindness, the minutes provide a glimpse into the incestuous relationship between the major banks and the Federal Reserve, one of their principal regulators.

In August 2007, as the committee was deliberating whether to cut interest rates, Timothy Geithner, then president of the New York Federal Reserve Bank, said that bank executives "obviously don't have any idea that we're contemplating a change in policy."

However, Jeffrey M. Lacker, president of the Federal Reserve Bank of Richmond, implied that Geithner had informed the banks of the Federal Reserve's plans, saying, "I spoke with Ken Lewis, president and CEO of Bank of America this afternoon, and he said that he appreciated what Tim Geithner was arranging by way of changes in the discount facility. So my information is different from that."

If Geithner did, in fact, tell Lewis and other bank executives about the Fed's plans, he enabled them to make millions of dollars at the expense of less powerful rivals.

Not all of the FOMC members were blind to the looming disaster in the mortgage market. Janet Yellen, then the president of Federal Reserve Bank of San Francisco, warned about the broader impact of the housing downturn. "I still feel the presence of a 600-pound gorilla in the room, and that is the housing sector," she observed in June.

She added, "The risk for further significant deterioration in the housing market, with house prices falling and mortgage delinquencies rising further, causes me appreciable angst." The previous month, she had said that while a forecast by the Federal Reserve staff "assumes that national house prices are flat going forward, I am worried that they may actually fall."

Yellen's concerns were largely brushed off until the end of the year, when the real economy began to rapidly deteriorate.

The question arises: how was it possible that the Federal Reserve officials, many of them considered to be among the best economists in the country, failed to foresee the financial collapse?

In part, the answer lies in the fact that they had spent their entire careers apologizing for, justifying and facilitating the very processes that led to the catastrophe.

Instead of warning about the growing influence of the banks and their speculation in mortgage-backed securities and exotic derivatives, the representatives of official economics, including Bernanke and the members of the Federal Reserve Board, did everything they could to promote the deregulation of the financial industry, removing virtually all government oversight from the banks, while pursuing an expansionary monetary policy to feed the speculative frenzy.

The drive to deregulate the financial industry, associated most closely with the school of economist Milton Friedman, reflected the growing domination of US capitalism by the most parasitic sections of capital, centered in the financial industry. Friedman's theories of unrestrained free market capitalism, previously frowned upon as near quackery, came to dominate official economics, with Bernanke considering himself a disciple of Friedman.

The blindness of the Fed was rooted in definite material and social interests. The entire financial and political establishment had a vested interest in keeping the housing bubble, based on little more than a Ponzi scheme, going.

Wall Street had driven the frenzy of sub-prime lending, buying up toxic mortgages by the fistful in order to bundle them into securities and CDOs, which they then sold to investors all over the world at an enormous profit. The regulatory agencies, including the Fed, blessed the operation and gutted all government oversight to allow the banks to engage in reckless and quasi-criminal activities. The credit rating firms such as Moody's and Standard & Poor's made huge profits by giving the mortgage-backed bonds their highest ratings.

While industry was being decimated, productive investment scaled backed, and the wages and living standards of the working class driven down, American capitalism generated an ever-increasing share of profits from financial machinations and outright fraud.

By downplaying the disastrous implications of a collapse in sub-prime mortgages, the Federal Reserve objectively aided and abetted the Wall Street banks, providing them with the time they needed to offload their sub-prime mortgage holdings and begin making large bets against the housing market and the securities they themselves had created.

Yet the release of the transcripts has been met with a deadening silence from lawmakers as well as the media. There are no calls for congressional hearings or any public accounting for the abject failure of these supposed custodians of the economy to detect the greatest economic crisis since the Great Depression. This only underscores the complete subordination of the entire political system, and both of its parties, to the financial aristocracy.