US Fed report reveals depth of financial crisis it helped create

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The Financial Stability Report issued by the US Federal Reserve last Friday outlines, at least to some extent, the depth and breadth of its market interventions from mid-March in order to try to stave off a complete collapse of the financial system, resulting in the handing over of trillions of dollars of digitally created money to Wall Street.

Notably, however, the report passs over the role the Fed played following the crisis of 2008 by pumping money into the financial system, thereby helping to create the conditions for an even bigger disaster.

As the Fed report was being released, an article in *Foreign Policy* provided some broad details of the central bank's intervention. It noted that "buying all manner of private and public debt," the Fed has expanded its balance sheet from $4.1 trillion in late February to over $6.5 trillion by mid-April (now probably around $7 trillion).

The $4.1 trillion in asset holdings itself represented a massive expansion from the level of around $800 billion in 2007, resulting from the Fed's intervention following the 2008 global financial crisis, including the lowering of interest rates to historic lows and the purchases of financial assets under its "quantitative easing" program.

These measures were touted as being temporary, to be removed when "normal" conditions returned. In fact, they now have been expanded at an accelerating rate as the author of the article, Trevor Jackson, makes clear.

"Analysts," he writes, "have predicted its balance sheet is on course to reach $9 trillion by the end of the year. Suffice it to say, at its present pace, the Fed is injecting about $1 million into the financial system *every second*, with a declared upper bound of infinity."

This amounts to around $86.4 billion per day.

In a summary presentation of its actions, the Fed's report provides an account of the scale of the meltdown taking place in mid-March that reached into all corners of the financial system.

As the effects of the COVID-19 pandemic became apparent, following weeks in which the Trump administration had said it would miraculously disappear, investors were "prompted to move rapidly towards cash and shorter-term government securities." This resulted in strains for the markets for longer-term assets, in particular US Treasuries and mortgage-backed securities. As these markets are "critical to the overall functioning of the financial system," the Fed moved in with increased purchases.

But the effects rapidly spread, causing "strains in many other financial markets, reducing the flow of credit to businesses needed to fund critical operations." The liquidity squeeze meant that short-term funding dried up "even for companies in good financial standing."

This led to a crisis in the commercial paper (CP) market, in which companies raise short-term loans varying between three and six months to finance day-to-day operations, such as the payment of health care costs, salaries and suppliers' invoices, which they are generally able to roll over every few weeks.

"As market strains rose, many investors were unwilling to advance funds for longer than a few days, so businesses were forced to issue CP on a near-daily basis, with no guarantees that investors would accept it."

At the same time, investors pulled out of money market mutual funds that generally hold CP and other short-term debt. The scale of investor redemptions "threatened to exhaust these funds' holdings of their most liquid assets," fueling concerns that funds would restrict or suspend redemptions, leading to even bigger withdrawals. "The consequences of a failure of the CP markets would have been dire," the report says.

In response, the Fed set up two funds, with $10 billion backing from the US Treasury, to effectively provide a backstop for the short-term market.

The markets for longer-term debt--corporate bonds, longer-term municipal debt and asset-backed securities--also suffered severe strains, with the result that the issuing of new debt in these areas "slowed substantially or stopped altogether." The report states: "Effectively, the ability of households, businesses, and state and local governments to borrow, even at elevated rates, was threatened."

The Fed responded by setting up a $2.6 trillion line of credit, backed by the Treasury and authorised under the CARES Act, to support the flow of money to businesses, households and state and local governments.

The Term Asset-Backed Security Loan Facility (TALF), which had been used in the 2008-2009 crisis, was revived to underpin the market in auto loans, equipment leases, credit card debt and student loans.

And the Fed went well beyond the measures it had developed in response to the financial crisis 12 years ago. It intervened into corporate bond markets, directly purchasing corporate bonds as well shares of exchange-traded funds, in which investors do not purchase individual bonds, but buy a share in a security based on an index of all bonds. This operation is being organised by the BlackRock hedge fund.

The purpose of this measure is to allow the Fed to support corporate bonds, the ratings of which have been reduced from investment grade to what the Fed called "the upper end of the speculative-grade range following the pandemic shock." In other words, the Fed entered the scene as a backstop for what is known as the junk-bond market.

The body of the report provides further details of the crisis and how pre-existing conditions (created by the Fed, though not acknowledged as its responsibility) meant that the pandemic produced a crisis such that in "March and April, even the deepest and most liquid financial markets experienced poor liquidity and extreme price volatility."

The essential meaning of this assessment, stripped of technical financial jargon, is clear. Literally overnight, all classes of financial assets could not find a buyer.

The Fed's own analysis, in effect, confirms that of scientific political economy, that is, Marxism, which maintains, contrary to the myths of bourgeois economics that these assets somehow embody intrinsic value, that their real value content is zero.

They do not represent value as such, but a claim on value, which has to be extracted from the exploitation of the labour of the working class in the form of surplus value. This discloses the source of the drive for a return to work, no matter what the health dangers to workers, so that this process can be resumed and intensified.

While it claims to have brought the immediate crisis in mid-March under control, the Fed report makes clear the crisis is far from over. It is not the beginning of the end, nor even the end of the beginning.

It notes that asset prices remain vulnerable to “significant declines” should the pandemic worsen, citing the fact that prices in the commercial real estate market were high relative to fundamentals before the pandemic and are sensitive to the pace of economic activity. The chief reason for the elevation was the ultra-cheap monetary policies of the Fed after 2008, which have boosted property prices.

Likewise it notes that “vulnerabilities arising from business debt were elevated at the end of 2019,” and the “business debt-to-GDP ratio has risen significantly over the past several years, surpassing its historical high.”

The closest it comes to acknowledging any responsibility is when it notes that “historically low interest rates [that it set in place] likely lessened investor concerns about default risks arising from higher leverage.” It warns that as the economic effects of COVID-19 spread, the rising ratio of interest payments to earnings “could trigger a sizeable increase in firm defaults.”

It also points out that at the beginning of this year, about half of all investment-grade debt was rated at triple-B, that is, one notch above junk status, close to the all-time high. One reason for this is that the Fed’s monetary policies over the past period have led to the floating of riskier loans for speculation, including the financing of merger operations and share buybacks, which rose to close to $1 trillion last year.

Life insurance companies, which in previous times have acted as a kind of bedrock for the stability of the financial system, are now under increasing risk.

The report says that the market capitalization of these firms is “likely to deteriorate in coming quarters because of lower-than-expected asset valuations and lower long-term interest rates."

Insurance companies are important investors in commercial real estate, corporate bonds, collateralized loan obligations and corporate bonds, exposing them to risks, including from sharp drops in asset prices, rising corporate defaults and liquidity problems.

But the reason life insurance firms have engaged in these riskier operations is the massive purchases of government debt by the Fed. This led, under its quantitative easing program, to a rise in Treasury bond prices and a fall in their yield (the two move in an inverse relationship), which meant insurance firms could not obtain sufficient income to meet their obligations from the traditional source--investment in government debt.

In addition to covering up its own role in creating the conditions for the financial crisis triggered by the pandemic, the Fed’s report is marked by a glaring contradiction.

In the Overview section it says: “While the financial regulatory reforms since 2008 have substantially increased the resilience of the financial sector, the financial system nonetheless amplified the shock, and financial sector vulnerabilities are likely to be significant in the near term.”

The obvious question is: if the resilience of the financial sector had been “substantially increased” over the past 12 years, why did the Fed consider it necessary to intervene with a series of bailout measures for Wall Street that put its actions in the wake of the global financial crisis in the shade?

The reality is that the very measures adopted after 2008, based on a massive injection of money that enabled the speculation that sparked the crash to continue at an accelerated rate, together with the largely toothless regulatory measures, created the conditions for the even bigger disaster now unfolding.

The Overview is forced to acknowledge that debt owed by businesses was high relative to GDP at the start of the year, “with the most rapid increases concentrated among the riskiest firms amid weak credit standards.” This was the direct product of the policies of the Fed as it shovelled ever greater amounts of money into the financial markets, increasing the siphoning off of the wealth of society to the corporations and financial oligarchs occupying its upper echelons.

The Fed report has provided material for drawing a political and economic balance sheet of past experiences.

First of all, it has completely shattered one of the most longstanding myths of capitalist society: namely, that the fabulous wealth accumulated by a tiny minority at its heights is the product of its entrepreneurship, intelligence and acumen, and is therefore justified because of the innate “superiority” of this clique over the rest of humanity--the mass of the working class, which produces all wealth.

Second, it has revealed that the entire system of wealth accumulation at the top depends on the power of the state acting in its interests. In normal times, this essential function is covered with claims that institutions such as the Fed operate in the interests of the “economy,” that is, society as whole. But the value of every crisis, and this one is no exception, is that it lays bare essential class relations.

Recognition of these economic and political facts of life--laid bare in black and white in the Fed’s report--raises the most decisive political question of our times: in whose hands is this state power to be held?

If it remains in the grip of the corporate and financial oligarchs, the outcome is clear: The resources of society will continue to be used to enrich the elites, while the exploitation of the working class will continue in the most extreme forms--economic conscription to enforce a return to work in life-threatening conditions in order to pump value into a mountain of fictitious financial assets.

State power is essential for the running of a modern society. The nostrums of the “free market” have been forever exposed. But this state power must be utilised for the resolution of the economic and health problems now confronting society.

The WSWS has put forward a series of necessary immediate demands to meet and resolve these problems. But the fight for their advancement is essentially a political struggle directed towards and leading unalterably to the taking of political power by the working class, the representative of the interests of the whole of society, and the establishment of a workers’ government.