

Dreams End With Collapse of Tinker Bell Market

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By Allan Sloan

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What in the world is going on here? Why is Washington spending billions to bail out [Wall Street](#) titans while leaving struggling homeowners to fend for themselves? Why are the [Federal Reserve](#) and the Treasury acting as if they're afraid the world may come to an end, while the stock market seems much less concerned? And finally, what does all this mean to those of us who aren't financial professionals?

Yesterday, [Treasury Secretary Hank Paulson](#) officially unveiled his new regulatory proposals; however, those have no bearing on today's problems. So, take a few breaths, pour yourself a beverage of your choice, and I'll tell you what's happening -- and what I think is going to happen. Although I expect our current mess will resolve itself without a catastrophic meltdown, I'll also tell you why I'm more nervous about the world financial system now than I've ever been in my 40 years of covering business and markets. Finally, I'll tell you why I fear that the Wall Street enablers of the biggest financial mess of my lifetime will escape with relatively light damage, leaving the rest of us, and our children and grandchildren, to pay for their misdeeds.

We're suffering the aftereffects of the collapse of a Tinker Bell financial market, one that depended heavily on borrowed money that has now vanished like pixie dust. Like Tink, the famous fairy from [Peter Pan](#), this market could exist only as long as everyone agreed to believe in it. So because it was convenient -- and oh, so profitable! -- players embraced fantasies like U.S. house prices never falling and cheap short-term money always being available. They created, bought, and sold, for huge profits, securities that almost no one understood. And they goosed their returns by borrowing vast amounts of money.

The fantasies began to fade last June when Bear Stearns let two of its hedge funds collapse because of problems with mortgage-backed securities. Debt markets, here and abroad, went sour big-time. That, in turn, became a huge drag on the U.S. economy, bringing on the current economic slowdown.

Whether we're in a recession is academic. What matters is that we're in a dangerous and messy situation that has produced an economic slowdown unlike those we're used to seeing.

How is this slowdown different from other slowdowns? Normally the economy goes bad first, creating financial problems. In this slowdown the markets are dragging down the economy -- a crucial distinction, because markets are harder to fix than the economy.

The last time this happened was in 1929. And it touched off the Great Depression. The precedent is unsettling, to say the least. You can only imagine how unsettling it is to Federal Reserve Chairman [Ben Bernanke](#), a former economics professor who made his academic bones writing about the Great Depression.

Academics now feel that the 1929 slowdown morphed into a Great Depression in large part because the Fed tightened credit rather than loosening it. With that precedent in mind, you can see why Bernanke's Fed is cutting rates rapidly and throwing everything but the kitchen sink at today's problems. (Bernanke will probably throw that in too, if the Fed's plumbers can unbolt it.)

So why hasn't the cure worked? The problem is that vital markets that most people never see -- the constant borrowing and lending and trading among huge institutions -- have been paralyzed by losses, fear and uncertainty. And you can't get rid of losses, fear and uncertainty by cutting rates. Giant institutions are, to use the technical term, scared to death. They've had to come back time after time and report additional losses on their securities holdings after telling the market that they had cleaned

everything up. It's whack-a-mole finance -- the problems keep appearing in unexpected places. We've had problems with mortgage-backed securities, collateralized debt obligations, collateralized loan obligations, financial insurers, structured investment vehicles, asset-backed commercial paper, auction rate securities, liquidity puts.

To paraphrase what a top Fednik told me in a moment of candor last fall: You realize that you don't know what's in your own portfolio, so how can you know what's in the portfolio of people who want to borrow from you? Combine that with the fact that big firms are short of capital because of their losses (some of which have to do with accounting rules I won't inflict on you today) and that they're afraid of not being able to borrow enough short-term money to fund their obligations, and you can see why credit has dried up.

The fear -- a justifiable one -- is that if one big financial firm fails, it will lead to cascading failures throughout the world. Big firms are so linked with one another and with other market players that the failure of one large counterparty, as they're called, can drag down counterparties all over the globe. If the counterparties fail, it could drag down the counterparties' counterparties, and so on. Meltdown City. In 1998, the Fed orchestrated a bailout of the Long-Term Capital Management hedge fund because it had \$1.25 trillion in transactions with other institutions. These days that's almost small beer.

Add to that the Wall Street ethos: If you take big, even reckless, bets and win, you have a great year and you get a great bonus -- or in the case of hedge funds, 20 percent of the profits. If you lose money the following year, you lose your investors' money rather than your own, and you don't have to give back last year's bonus. Heads, you win; tails, you lose someone else's money.

Bernanke and his point man on Wall Street, [New York Fed](#) president [Tim Geithner](#), know everything I've said, of course. They know a lot more, too, such as which specific institutions are running out of the ability to borrow and have huge obligations they need to refinance day in and day out. Walk by Fed facilities in [New York](#) or Washington and you can feel the fear emanating from the buildings.

Because these aren't normal times, the Fed has tried to reassure the markets by inventing three new ways to inundate the financial system with staggering amounts of short-term money. This is in addition to the Fed's existing mechanisms, which are vast. The three newbies -- the term auction lending facility, the primary-dealer credit facility and the term securities lending facility -- total more than half a trillion dollars, with more if needed. Much of this money is available not only to commercial banks but also to investment banks, which normally aren't allowed to borrow from the Fed.

How can the Fed afford this largesse? Easy. Unlike a normal lender, the Fed can't run out of money -- at least, I don't think it can. It can manage monetary policy while in effect creating banking reserves out of thin air and lending them out at interest. That's how the Fed reported a \$34 billion profit in 2006, the last available year, of which \$29 billion was sent to the Treasury. The Fed can even add to its \$800 billion stash of Treasury securities by borrowing more of them from other big players.

Then there's the Treasury. In March, the Treasury unleashed [Fannie Mae](#) and [Freddie Mac](#) and the [Federal Home Loan Banks](#) to buy hundreds of billions of dollars of mortgage-backed securities, supporting a troubled market that was seeing prices drop sharply because of large forced sales from the collapse of Carlyle Capital and from hedge funds desperate to pay off some of their borrowings.

Still with me? Good. Now let me show you how we taxpayers are picking up the tab for much of this rescue mission to the markets, even though Uncle Sam isn't sending checks to Wall Street. Here's the math: Say the Fed extends \$500 billion of emergency loans to firms in need of short-term money. They're paying about 2.5 percent interest to Uncle Ben (or Uncle Sam, if you prefer). That rate is way below what they'd pay to borrow in the open market, if they could borrow. The difference between the open-market price and 2.5 percent is a gift from us, the taxpayers. I think that's better than letting the world financial system collapse, but it's a serious subsidy to outfits that made a lot of money on the way up and that are now whining about losses. You gotta love it -- private profits, socialized losses.

Now to the infamous Bear Stearns deal. Bear shareholders are set to get \$10 a share -- about \$1.2 billion -- from J.P. Morgan Chase. That's \$1.2 billion more than they were likely to realize in a bankruptcy had the Fed and the Treasury dared let Bear go broke. More important, Bear's creditors, who were asleep at the switch and ought to be forced to pay for it, got out whole because J.P. Morgan agreed to take over Bear's obligations.

The only reason Morgan did that is its deal with the Fed, in which the Fed is taking over \$30 billion of Bear's financial toxic waste. J.P. Morgan eats the first \$1 billion of losses -- a concession it made to the Fed, which was embarrassed and enraged when Morgan raised the price it was paying for Bear to \$10 a share from the \$2 originally agreed to.

The securities that Bear is shedding aren't worth \$29 billion in today's markets. If they were, Morgan wouldn't need the Fed's dough. The Fed -- which is to say the taxpayers -- is eating the difference between \$29 billion and what that stuff is worth. It wouldn't surprise me to see the Fed end up with a \$4 billion haircut, but we'll probably never know. (Once you take that haircut into account, you see why Bear shareholders should stop complaining about getting "only" \$10, and why Bear debt-holders should erect a statue to Bernanke.)

Fedniks are furious about the Wall Street enablers of the mortgage mess and other financial excesses being able to escape the full cost of their folly, with the public picking up the cost. But as one of them asked, "Is it better to let Bear Stearns fail and risk setting off a market collapse that costs a million jobs?" The answer, of course, is no. Bear had about \$13 trillion of derivatives deals with counterparties, according to its most recent financial filings. If Bear had croaked, large parts of the world could have croaked. And the economic damage could have been catastrophic.

Okay. Is there good news here? Indeed, there is. Sooner or later, all this money being thrown at the debt markets will stabilize things.

But the costs will be steep. Those of us who have been prudent, lived within our means, and didn't overborrow are paying a huge price for this. Income on our Treasury bills, money market funds, and CDs has dropped sharply, thanks to the Fed's rate cuts, and our wealth has eroded relative to foreign currencies and commodities. As an indirect result of the Fed cutting short-term rates, we've already seen a loss of faith in the dollar by our foreign creditors. That's helped run up the price of commodities that are priced in dollars and may well be stirring up inflation even as the Fed lowers retirees' incomes.

It's going to get harder and harder to finance our country's trade and federal budget deficits, with our seemingly ever-falling dollar carrying such low interest rates. The dollar has been the world's preeminent reserve currency, but I think those days are drawing to a close. Don't be surprised if in the not-too-distant future the United States is forced by its lenders to borrow in currencies other than its own. It could get really ugly.

It's going to take years to work out our country's excess borrowings, with lenders and borrowers -- and quite likely American taxpayers -- all bearing the cost.

So, after all this, we end up with the same old story. Whenever you see a financially driven boom and people tell you, "This time it's different," don't listen. It's never different. Sooner or later, the bubble pops, as it has now. And you and I end up paying for it.

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