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Is there yet another 'Plan B' in the pipeline?

The Fed has announced a veritable alphabet soup of new economic programs

SUMMING IT UP

William Rutherford

As the housing crisis broke, the Federal Reserve proceeded at a rather leisurely pace to address the issue. "No bailouts," was a common cry. "People need to be responsible for their own actions," was another. Even though it was not clear that those now responsible were the same people that were originally responsible, responsibility became a murky thing. Many remembered Alan Greenspan appearing before Congress to urge that Americans load up with variable debt on their homes and use them as an ATM. Responsibility, it seemed, might lay closer to Greenspan than to many others. Or, as The Economist said on March 8, 2008, "the story has no single villain, but Alan Greenspan comes close." Mr. Greenspan ignored warnings about sub prime excess from with in his own board … while eagerly championing 'new paradigms' from hybrid mortgages to credit derivatives."

By fall of 2007, the scope of the problem was beginning to emerge. Estimates of the write-offs necessary to recognize the losses grew into the hundreds of billions of dollars. Financial stocks, and then consumer discretionary stocks, began to fall.

The dollar, now down 40 percent from the time of George Bush's "axis of Evil" speech, continued to fall. As the dollar fell the price of commodities rose dramatically. Oil breached $100 per barrel. Wheat traded at $25 per bushel. Corn, soybeans, eggs, meat and other commodities set record prices – which found their way to the consumer. Since the beginning of the year, the price of eggs has increased 25 percent. In the same time, milk is up 17 percent, beans and peas are up 17 percent, cheese is up 15 percent, rice and pasta are up 13 percent and bread is up 12 percent. Prices on food rose worldwide, putting pressure on governments everywhere. Embargoes on rice shipments caused the price of rice to skyrocket as it became scarce. In a single day, the worldwide price of rice rose 30 percent, creating anxiety about civil unrest among 2.5 Billion people. World food organizations warned of food shortages and the problems food shortages would cause. History shows us that food shortages and high prices are often the cause of unrest and revolutions. In a moment reminiscent of his father's presidency, where senior Bush expressed surprise at the price of a pair of socks, President Bush expressed surprise that gasoline was selling for $4 per gallon, and acknowledged "strains on the economy."

By December, all of this was becoming too much for the consumer. Consumer confidence and spending began to lag. Financial markets also encountered liquidity issues and banks began to decline to lend to one another to avoid "counterparty risk." Markets tumbled. In response, at their December meeting, the Fed cut interest rates – but not enough to avoid a market rout. The next day the Fed went to Plan B and announced a new type of credit facility to inject liquidity into the credit markets – as it was now clear that interest rate cuts alone would not solve the problem. The problem, however, became bigger not smaller – as the economy slowed and home prices dropped.

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Just when it seemed that things could not get worse, they did. A rogue trader at Societe Generale in Paris was found to have entered into massive trades, far in excess of his authority, and lost billions for his bank. Knowledge of his perfidy broke on Friday, Jan. 18, the beginning of a three-day weekend in the U.S. By Monday, as the story became better known, European and Asian markets were down sharply. Ben Bernanke, perhaps the only bureaucrat at his desk working that weekend, became aware of the problem and summoned an emergency meeting of the Federal Reserve Board. Even though the Board was to meet a week later and was expected to cut rates at that meeting, the Fed slashed rates at their emergency meeting. Markets rallied for awhile, but resumed their fall. Another large rate cut followed at the regularly scheduled meeting, but that too proved inadequate – because the problem was not only rates, but liquidity.

Lack of liquidity and write-offs were taking their toll. Several banks in Europe had already failed. Rumors of problems at other financial institutions spread. Finally Bear Stearns, the fifth largest investment bank in the U.S., which had earlier written off Billions, fell to liquidity issues. A new Plan B was required. In a rapid move, the Federal Reserve engineered a buyout of Bear by J.P. Morgan – the only bank in the U.S. with the capital and appetite for such a move. At the same time the Fed opened the discount window to investment banks, a tool which had not been used since the Great Depression. The Fed began to accept home loans as collateral for

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its loans to financial institutions and continued on the path that I wrote about in my previous column of nationalizing the debt problem.

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Within days, the Fed went beyond Plan B, and announced a veritable alphabet soup of new programs to deal with the crisis, in addition to the ones already in place. Then Treasury secretary Henry Paulson, in conjunction with Bernanke, announced even more sweeping plans for solutions both short and long term.

Alan Greenspan, as his contribution, fires back at his critics, with such nuggets as: "Counterfactuals from such flawed structures cannot form the basis of policy." Well, now we know.

As soon as the new programs were announced, they ran into problems. It is not at all sure what will happen with a lame duck administration – especially one where the President has all but left the scene. However, the public cry came full circle as people wondered if a buy/bail out of Wall Street types could be engineered, why not homeowners? Even the pro-market Bush administration spoke of guaranteeing underwater home loans.

The last chapter of this sorry story has not been written as more write-downs will come. But more will also be done for homeowners, as the mingy plans so far have done little.

Bonus material: it is reported that we are spending $5,000 per second in Iraq, with the eventual cost estimated at $3 trillion or about $40,000 for a family of four.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a four-star rating from Morningstar. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com.