Bear Stearns and the New Federal Reserve

On March 14th, Bear Stearns, the fifth-largest investment bank in the United States, entered a period of insolvency. As growing lack of confidence in the firm's subprime exposure grew, other banks eventually refused to lend to the stricken company, which has existed for over 85 years. Were Bear Stearns a commercial bank, (i.e. institutions that loan money to people or businesses) it would be able to, as a last resort, take advantage of the Federal Reserve's so-called "discount window," thus receiving a government loan at the lowest available interest rate. The reasoning behind making loans to private businesses is sound, because overall confidence in banks is much stronger. But for equally obvious reasons, the discount window cannot by definition extend to institutions that take on risk as their business because they have less or no accountability to taxpayers. However, after Bear Stearns seemed on the brink of collapse, everything changed. Bear Stearns shares began to falter as investors took flight. The Federal Reserve took decisive action to save the beleaguered bank by guaranteeing a $30 billion loan to their biggest competitor, JPMorgan Chase, so they could buy BS without fear of acquiring more dangerous subprime mortgage-related debt. In effect the government has now bought a troubled investment bank for pennies on the dollar, (their first offer was $2 a share, when BS traded at a high of $170 a year ago) knowing that taxpayers might have to foot the entire bill themselves. At the same time, the Bush administration has maintained that no government bailouts would extend to the financial sector. Moreover, wealthy BS shareholders balked so much at the firesale of their investments that the Fed, under pressure from potential litigation, increased the bid for BS by five times, to $10 a share. This means that, while the potential losses will be felt by millions of taxpayers (many of whom are in danger of losing their homes to foreclosure), while profits will most certainly be reaped by the corporate executives at JPMorgan. Even with its exceptional exposure to subprime securities, BS is still worth well over a billion dollars. Profit-taking was the name of the game on the heels of the announcement, as day traders bought up huge amounts of BS stock at $2 or $3 a share and sold after the bid increased. By taking responsibility for the BS takeover, the Fed has changed the course of America's financial future. By guaranteeing the discount rate to BS, they implicitly must be able to do so for other investment banks in trouble in the future, which implies continued taxpayer absorption of Wall Street failures without any corresponding kickback from banks. Unless the Fed intend to rein in on banks more as the economy struggles through the recession, this policy clearly demonstrates a dramatically different view of finance than the Federal Reserve of 1913, when there was a real discount window you could use to keep your bank alive. Now, it seems, the most secure economically secure institutions are those most separated from average American lives. Politicians who recognize the increasing resonance of populist messages in the present climate are sure to turn this takeover into a major issue.

About the Author

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