Fed Bailout Requires Full Investigation

October 14, 1998

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At the same time that Bill Clinton and his economic aides are demanding billions more for the International Monetary Fund (IMF), the Federal Reserve arranged for a $3.65 billion bailout of its friends in an investment group running a ""hedge fund" in Connecticut. The Republican Congress should demand the details about this bailout and get the answers to some tough questions.

The failed investments were managed under the name Long-Term Capital Management (LTCM) even though its most of its investments were extremely short term. It has operated in near total secrecy since its founding a few years ago, and the bailout has been shrouded in secrecy.

Its most prominent partner is the former vice chairman of the Federal Reserve Board, David W. Mullins Jr. Its investors include top executives at the leading investment banks, including Merrill Lynch, as well as powerful foreign banks. Treasury Secretary Robert Rubin's former employer, Goldman Sachs, has a significant ownership stake.

At its peak, LTCM controlled contracts involving $160 billion. It placed large short-term bets on securities issued by foreign governments.

Unless Congress investigates what this fund was really doing, the public may never learn the full extent of the scandal. The Hong Kong government has blamed hedge funds like LTCM for disrupting its capital markets, and is currently trying to trace the money flows into and out of its markets.

What is known is that the Federal Reserve inexplicably arranged a multi-billion (that's billion) dollar bailout of LTCM without any public scrutiny. The softball questions asked of Alan Greenspan at the recent Congressional hearing revealed almost nothing about the reasons for LCTM's collapse or details about the bailout.

Greenspan cryptically testified that ""substantial damage could have been inflicted on many market participants, including some not directly involved with the firm, and could have potentially impaired the economies of many nations, including our own." He compared the LTCM bailout to the intervention by J.P. Morgan in the Panic of 1907, a disturbing comparison since most economists now admit that bad monetary policies were the leading cause of the Great Depression.

Since Greenspan asserted that LTCM was so-o-o important to the U.S. economy, the public has a right to know what is going on. The Fed can't have it both ways by arguing that LTCM is so vital that the Fed had to intervene, but that the public can be kept in the dark.

Greenspan's testimony was self-contradictory, which is an additional reason why Congress should investigate further. Greenspan testified that LTCM pursued ""a strategy that was destined to fail," and yet the bailout perpetuates that same strategy.

Greenspan also testified that it was regrettable that the LTCM partners were allowed to retain a small stake in the reorganized fund. Yet the bailout was designed to achieve precisely that result.

The same day that the Federal Reserve intervened, there was a pending private offer made by a group led by Warren Buffett, which would have provided $3.75 billion to fund LTCM, and another $250 million to buy out the interests of the current LTCM investors. This exceeded the funds provided in the Fed-arranged bailout, but the current investors would have lost 95 percent of their investments.

Instead, the Federal Reserve Bank of New York intervened and presented an offer that was far more advantageous to the LCTM management, but less good for the American public. LTCM's personal investors received $405 million for their interests, which was $155 million more than the private offer, plus a guarantee that an additional $3.65 billion would remain in LTCM for three years.

That's not all. Under the private Buffett offer, the LTCM investors would have been cut off from future recoupment of their investment. Under the Fed plan, the failed management will be kept in place indefinitely and the LTCM investors will likely be able to recoup an additional hundreds of millions of dollars.

So far, the Federal Reserve is saying that no taxpayer funds are involved in this enormous bailout. But how can we be sure when the details of the deal remain secret?

At a minimum, the involvement by Federal Reserve officials used government power, and taxpayers bear the risk of large losses at the banks used by the Fed to finance the bailout. The principal cost to the taxpayer may turn out to be in the form of guarantees, which can be just as costly as actual dollars, as the S&L collapse proved.

The real risk to the American public is this secret gambling by the Federal Reserve with our economy. The Fed's derailing of a private purchase of LTCM in order to advantage its politically well-connected friends is both an outrage and an endangerment of our country's economic well-being.

At a recent high-dollar fundraiser, Bill Clinton declared that more taxpayer funds for the IMF are essential to American prosperity. ""That's a big issue" in the upcoming elections, he warned.

A big issue, indeed. If the Republican Congress would do its job and uncover why LTCM collapsed and why the Federal Reserve arranged its bailout, then the voters can make sure that powerful men behind closed doors don't gamble with our prosperity.