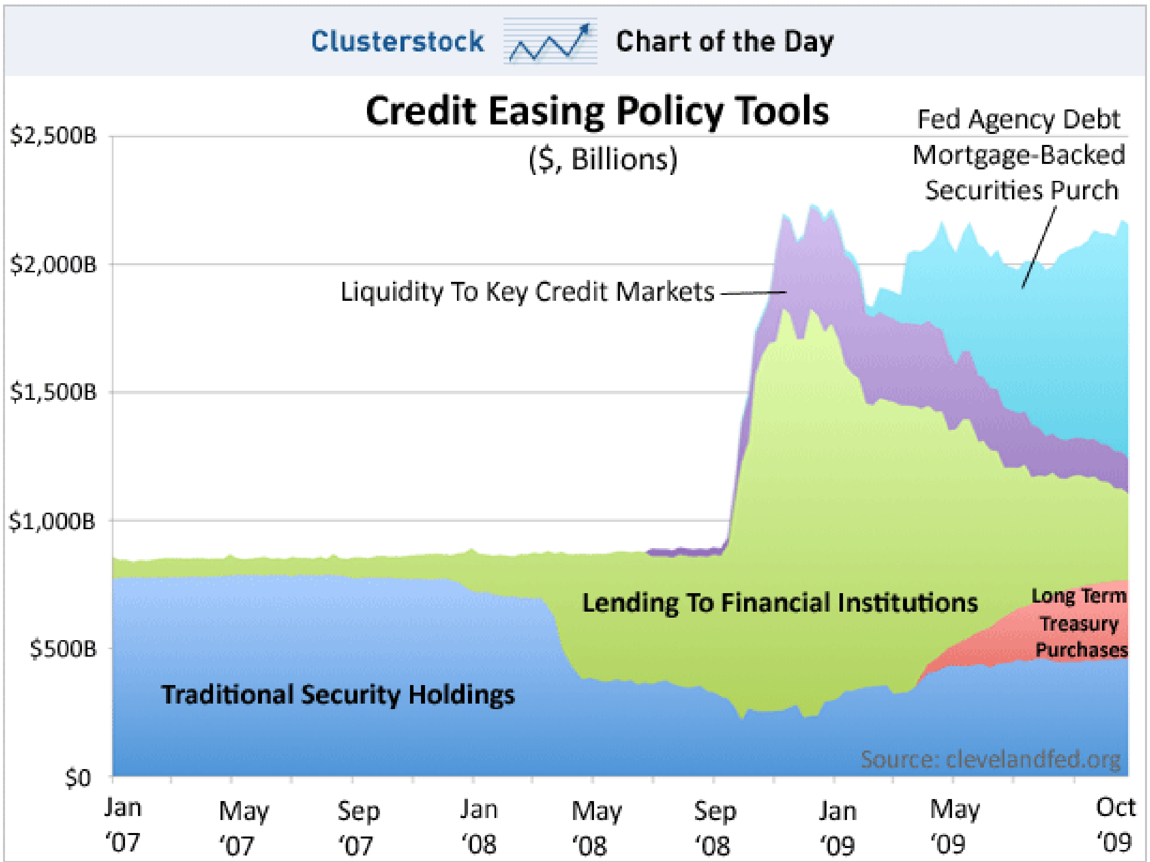
The Federal Reserve Becomes the 'Buyer of Last Resort'

November 29, 2009 – While the debate continues whether inflation or deflation will be the dollar's eventual fate, the Federal Reserve is pursuing a pernicious policy that is insidiously debasing the dollar. This policy has generally been met with indifference, if it has even been noticed at all.

The inflation/deflation debate focuses only on the 'quantity' of dollars and completely fails to address an equally important monetary facet, the 'quality' of the dollar. The Federal Reserve is debasing the dollar by purchasing inferior assets of poor quality. These assets are mortgage-backed securities issued by federal agencies like the insolvent and for all practical purposes bankrupt, Fannie Mae.

These are assets neither the banks nor other investors want. If there was a demand for these assets, the Federal Reserve would not need to buy them. Instead of acting in its historical role as the 'lender of last resort', the Federal Reserve has on its own expanded its mandate to become the 'buyer of last resort'.

By purchasing mortgage-backed securities, the Federal Reserve is debasing the dollar. Just how pervasive – and therefore serious – this debasement has become is apparent from the following chart prepared by BusinessInsider.com.



According to its latest report, the Federal Reserve now owns over $1 trillion of mortgage-backed securities, which is 45.6% of all assets owned by it. One year ago mortgage-backed securities were only 0.6% of the Federal Reserve's total assets.

The Federal Reserve is very highly leveraged, much more than most banks. It is carrying $2,157.0 billion of debt on $52.8 billion of capital, giving it a leverage of 40.8-times more debt than capital. The mortgage-backed securities it owns are 19-times greater than the Federal Reserve's capital, meaning that if the true value of these assets is less than 5.3% of their book value, the Federal Reserve's capital is depleted, effectively making it another insolvent institution.

Given that Fannie Mae is itself insolvent and most other mortgage generating federal agencies are not far from perilously sliding down to that same dire financial condition, it is reasonable to assume that the true value of these mortgage-backed securities is less than 94.7% of their book value. Consequently, the Federal Reserve is therefore – on a strict accounting basis – insolvent. It remains liquid because banks continue to provide it with funding and because people continue to accept in commerce and use without question the Federal Reserve's liabilities, i.e., the paper currency it issues. But for how much longer?

On December 3rd, Federal Reserve chairman Ben Bernanke will be center-stage at the Senate for his re-confirmation hearing for another term. What should be center-stage and examined closely, however, are this professor's chalk-board theories that he is using in his untried and untested experiments to solve the ongoing financial crisis.

One doesn't even have to read a book on monetary history to know what the Federal Reserve should be doing. We only have to recall what Paul Volcker did when he was Federal Reserve chairman at the end of the last boom-bust cycle. He kept raising interest rates to defend the dollar.

Mr. Bernanke of course is doing the exact opposite with his zero interest rate policy, on the theory that he can save the economy without damaging the dollar. However, it is becoming clear – and the above chart is only one example – that the dollar is being irreparably damaged. Consequently, rather than saving the economy, Mr. Bernanke is hastening the further downfall of the economy and the dollar's inevitable collapse.

http://www.fgmr.com/federal-reserve-buying-mortgage-backed-securities-debases-the-dollar.html