US Federal Reserve announces $85 billion bailout of insurance giant AIG

By Bill Van Auken
17 September 2008

Following emergency consultations between the Federal Reserve, the US Treasury and the Democratic leaders of both houses of Congress, the Federal Reserve on Tuesday night announced a bailout of the Wall Street insurance giant American International Group (AIG).

According to reports posted by the *New York Times* and the *Wall Street Journal*, under the emergency plan the Fed will provide the failing firm with an $85 billion loan in exchange for 80 percent of its assets.

The reported bailout is a reversal of the policy adopted by the federal government just last weekend, when it failed to intervene to stop the collapse of Lehman Brothers, the country's fourth largest investment bank. According to the *Journal*, government officials believed "it would be 'catastrophic' to allow AIG to fail."

Fed Chairman Ben Bernanke and Treasury Secretary Henry Paulson, the newspaper said, "concluded that federal assistance would be necessary to avert an AIG bankruptcy, which they feared would have disastrous repercussions throughout the financial markets."

The bailout is one more demonstration of the systemic crisis confronting American and world capitalism. It is unprecedented and, in some respects, goes even further than the government takeover of Fannie Mae and Freddie Mac barely a week before. Unlike the two mortgage finance giants, AIG is not a government-sponsored institution and is not even directly regulated by the federal government.

Pressure for a rescue of AIG grew after all three major rating agencies downgraded its credit Monday night, raising the prospect that lenders would recall their loans.

It was feared that the failure of AIG, with $1 trillion in paper assets, would have a domino effect, threatening banking and corporate failures throughout the world economy. AIG is one of the largest players in the global, unregulated market (estimated at $62 trillion) in credit default swaps, i.e., private contracts under which companies like AIG guarantee the debt, including mortgage-backed bonds, held by other companies.

While ostensibly an insurance company, AIG engaged in the same financial parasitism as the rest of Wall Street, investing heavily in mortgage-backed securities and writing derivatives on collateralized debt obligations (CDOs) tainted by subprime exposure.

Now, once again, millions of ordinary working people will be forced to pay the price for this reckless speculation carried out in pursuit of super-profits.

AIG was forced in recent weeks to take massive write-downs on its assets. In August, the company announced second-quarter results that included a staggering $25 billion in losses on its derivatives.

The government intervention at AIG follows the collapse over the weekend of two of Wall Street's largest investment banks. The bankruptcy of Lehman Brothers and the takeover of Merrill Lynch by Bank of America sent shockwaves through financial markets around the globe and sparked fears of a chain reaction of banking failures.

A worldwide sell-off of stocks was capped by Monday's 504-point drop on Wall Street, the steepest one-day loss since markets reopened following the September 11, 2001 attacks.

In response to the deepening financial crisis, the Federal Reserve Board and its counterparts in Europe and Asia poured hundreds of billions of dollars in fresh credit into the economy. Between them, the Fed, the European Central Bank, the Bank of England and the Bank of Japan pumped $210 billion into the money markets on Tuesday in an attempt to prevent a seizing up of the global credit system. Central banks in India and Australia also carried out major injections into their banking systems.

The immediate trigger for the massive cash infusion was the doubling of the interbank lending rate in the wake of the Lehman Brothers collapse. The sharp rise in short-term lending rates, which hit a seven-year high of 6.79 percent, was a measure of deep concern that AIG would follow Lehman into bankruptcy, saddling world financial institutions with hundreds of billions of dollars in losses in credit derivatives.

The interbank lending rate rise fed into the global stock market decline, as investors dumped financial stocks. On Tuesday, London's FTSE 100 fell below 5,000 for the first time in seven years, with HBOS, Britain's largest mortgage lender, seeing its shares plummet by 40 percent.

The Tokyo stock market fell by more than 4 percent, while in Paris and Frankfurt markets were down more than 2 percent. In Russia, the country's main stock market halted trading after suffering losses of 11.47 percent.

The Federal Reserve Board shocked Wall Street Tuesday afternoon by leaving US interest rates unchanged. Speculation had run rife in the financial markets that the Fed would cut its federal funds rate by as much as 75 basis points in light of the deepening credit crisis.

The statement the US central bank issued in announcing its decision to stand pat painted a grim picture of the US economy. “Strains in financial markets have increased significantly and labor markets have weakened further,” it stated. “Tight credit conditions, the ongoing housing contraction, and some slowing in export growth are likely to weigh on economic growth over the next few quarters.”

It likewise cited “increases in the prices of energy and some other commodities” that left the outlook for inflation “highly uncertain.” It concluded that the “downside risks to growth and the upside risks to inflation are both of significant concern.”

The decision not to heed the demands of the stock market was attributed by some analysts to the Fed’s conviction that, given the depth of the banking crisis, lowering interest rates would have little or no effect in terms of generating credit for the economy.

“You could cut the Fed funds rate from 2 percent to 1.5 percent. It won’t cause any more lending. The banking system has no capital base to lend,” George Feiger, chief executive at Contango Capital Advisors in Berkley, California, told Reuters news agency.

The announcement of the Fed decision provoked sustained booing from the floor of the New York Stock Exchange, and stocks resumed their downward slide before rebounding later in the afternoon. The Dow Jones Industrial Average closed up 1.3 percent, or 141.5 points, at the end of the day.

Most analysts saw the rebound from Monday’s dramatic market decline as a response to predictions that the government would mount a rescue of AIG.

Furious trading in the company’s shares churned the market. At one point in the day, AIG stocks had lost 74 percent—falling to $1.25, compared to a year high of $70. By the end of the day, they were down 21.2 percent.

In the face of these developments, there was recognition within ruling circles and the major media internationally that world capitalism is facing a crisis of historic dimensions. Comparisons of the present crisis to the onset of the Great Depression of the 1930s were widespread.

The *Financial Times* of London, the sober voice of British finance capital, commented in its editorial Tuesday, “The world has not ended. The international economy has not yet collapsed. But one thing is now quite clear: the banking system as we know it has failed.”

Denunciations of the American financial establishment and the “free market” ideology that Washington has sought to ram down the rest of the world’s throat over the course of decades were also prevalent.

In Germany, the *Frankfurter Rundschau* stated: “The Americans are exposing the world to a highly dangerous experiment. For ideological reasons they don’t want to save another bank with taxpayers’ money and nationalize it. They are accepting the risk that this policy could end up costing a lot more money and lead to upheavals that no one had even dared imagine.”

The German newspaper added, “If things take a sharp turn for the worse, European taxpayers ... will have to pay billions of euros to save local banks, returns from life insurance and other retirement provisions will decline sharply, and the crisis will bestow upon Europe millions of unemployed. Thank you America!”

For its part, the *Wall Street Journal*, the unwavering champion of “free market” capitalism, published an editorial Tuesday entitled “Surviving the Panic.” It argued for a massive government intervention to buy up all of the worthless paper on the books of Wall Street’s finance houses and thereby secure their profits together with the multi-million-dollar incomes of their top executives.

The newspaper warned ominously, “More major bank failures are a certainty, including some very large ones.”

Its solution? The setting up of a new Resolution Trust Corporation, of the type created during the savings and loan crisis of the 1980s, which would “provide a buyer for securities for which there is no market.” In other words, the US Treasury’s vaults should be opened up to bail out major Wall Street investors and CEOs who made billions off of a speculative housing bubble that has now burst, precipitating the greatest financial crisis since the 1930s and threatening millions of working people with the loss of their jobs and homes.

Wall Street’s newspaper of record offered no indication of how it would pay for such a bailout for the rich. Undoubtedly, the answer will come after the November election, in the form of a ferocious assault on working class living standards and the dismantling of what remains of America’s tattered social safety net, including Social Security, Medicare and Medicaid.