Federal Reserve opts for small interest rate rise

US "bubble" continues to inflate

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Market reaction to Wednesday's decision by the US Federal Reserve Board to increase interest rates by only a quarter of a percentage point, coupled with its signal that it does not envisage a further rise in the immediate future, seems likely to set in motion a further expansion of the US financial bubble.

After dropping earlier in the day, the Dow Jones index climbed 150 points after the announcement of the Fed's decision, representing a 1.4 percent increase, to close within 150 points of its all-time high reached on May 13. The Nasdaq and Standard & Poor's 500 indexes both ended at new highs.

The jump in the markets was fuelled not so much by the fact that the increase was only 0.25 percentage points—that had largely been anticipated—but by the Fed's announcement that it was shifting its stance to "neutral" after indicating only weeks ago that it was more likely to tighten rates.

The move seemed to indicate more a state of confusion among monetary authorities, rather than any confidence in the direction of the economy. According to the Fed's statement: "Owing to the uncertain resolution of the balance of conflicting forces in the economy going forward [the bank] has chosen to adopt a directive that includes no predilection about near-term policy action." In other words, when you are not sure what to do, do nothing.

The further escalation of financial markets in response to the Fed's decision will heighten concerns that the US economy is increasingly being driven by a financial bubble, based on the expansion of credit.

In an article published in the *Washington Post* on Tuesday, well-known financial journalist William Greider warned of the threat posed by "Wall Street's dangerous bubble of inflated stockmarket prices."

Greider called for a "measured application of credit restraints" in order to curb Wall Street's "credit binge" in the hope that these could defuse the "unstable situation gradually, rather than violently through a full-blown panic and crash".

But a study of the US financial system published by a private think tank, the Federal Markets Center, upon which Greider based his warnings, reveals that the expansion of credit has become deeply embedded within the US economy, particularly in the finance sector.

According to data compiled by the FMC, and published under the headline "Credit to the Creditors," whereas a decade ago financial firms accounted for less than 30 percent of the total borrowing in US credit markets, today they receive some 54 percent. In other words, financial institutions, which used to function as intermediaries, supplying credit to traditional borrowers in industry and commerce, have now themselves become the biggest single consumers of credit.

According to the FMC report: "Between 1992 and the end of the first quarter of 1999, non-financial sectors increased their debt an aggregate 36 percent while total financial sector debt mushroomed by 124 percent. Over the course of the past decade, annual borrowings by non-financial sectors have declined from three-fourths to less than half of the total borrowing in US credit markets.

"This tectonic shift suggests that larger volumes of credit are being used to support increased trading activity in US markets and to bankroll investment in fast-appreciating equities. Since 1992, for example, the assets and liabilities of securities brokers and dealers have more than doubled."

The study noted that "the amount of credit now required to accommodate US financial activity may be stronger evidence of a bubble than asset prices

themselves”.

Other reports on the US economy note the same frenzied financial activity. In its latest monthly report, issued on Monday, the Levy Institute's Forecasting Center claimed that the stockmarket was no longer a “subplot in the economy” but the “central story”.

“The same euphoria that has infected much of the household sector,” it noted, “has also permeated executive suites and board rooms ... executives and directors know that at current stock prices, the market expects red-hot growth in many companies. Firms that exercise caution may appear uncommitted to rapid expansion, a sin punishable by stock price decapitation.”

However, this increase in financial activity is not being accompanied by rising profit rates. The forecast noted that “profit margins have been generally narrowing for six quarters, and in all postwar periods until 1998 sagging profits were accompanied by declines in GDP growth.”

Other figures indicating that the financial boom is unsustainable in the long term include the net savings rates, now down to -1.2 percent—the lowest level since the 1930s Depression—and the growing US balance of payments deficit, which is expected to exceed $300 billion this year.