# Worldwide market panic compels central banks to intervene

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The world financial system remained on a precipice over the weekend, awaiting the opening of markets Monday, after central banks in Europe, the United States, Japan and several other Asian countries were compelled to intervene Thursday and Friday with massive commitments of funds to stave off a global panic.

A total of $323 billion was poured into the markets over two days, an injection equivalent to that carried out in the aftermath of the terrorist attacks of September 11, 2001. The bailout came too late to stem the fall in Asian and European markets, but the New York Stock Exchange rallied after a fall of nearly 200 points, with the Dow Jones average ending 31 points down. For the week, the US market was virtually unchanged after a series of colossal moves up and down, including Thursday's plunge of 387 points.

European and Asian markets ended Friday's trading down between 2 and 4 percent before the second round of support from the European Central Bank (ECB) and the US Federal Reserve. The FTSE index of London stocks dropped 3.7 percent, the French CAC index fell 3.1 percent, while Germany's DAX declined 1.5 percent. Japan's Economy Minster Hiroko Ota told reporters, "The effect of US subprime loans is spreading to financial markets around the world."

The ECB and the Fed had to intervene Friday as it became clear that Thursday's actions had failed to stem the rout. The ECB followed Thursday's $130 billion in loans with an additional $84 billion, while the Fed injected $38 billion on top of Thursday's $24 billion worth of support.

Friday's Fed intervention came in three stages—$19 billion in the morning, $16 billion more in the early afternoon, and $3 billion towards the end of the trading day, indicating that the central bank was gauging the effect of its actions hour by hour and reinforcing its support when the market began to give way again.

While the sums expended by the central banks were far larger than their everyday operations, the amounts are small compared to the scale of world financial markets—an estimated $175 trillion in stocks, bonds and other debt instruments—and the trillions in paper value already wiped out in the convulsions of the past several weeks.

The events of Thursday and Friday demonstrate that, despite the common desire to forestall a chain reaction collapse of the world financial system, the various central banks have differing and in some cases directly conflicting agendas based on disparate national policies and concerns.

The European Central Bank, for example, pumped more than three times as much into the financial system as the US Federal Reserve, although European and American markets are approximately the same size and the immediate focus of the financial crisis is in the United States, with the collapse of the market for securities based on subprime mortgages.

The major concern in Frankfurt was the shaky state of confidence in the continent's banking system, with the state-organized bailout of the German IKB Deutsche Industriebank followed by the announcement by BNP Paribas, the biggest publicly held French bank, that it was suspending redemptions from three of its hedge funds caught up in the US mortgage market crisis.

The IKB crisis was a direct product of the American mortgage-lending debacle, as the regional bank, specializing in lending to small and medium companies, had become deeply committed to the US property market. *Der Spiegel* magazine reported Friday that IKB and its affiliates had more than $10 billion in loans to the US mortgage sector, twice the previous estimate, including nearly $8 billion invested by Rhineland Funding Capital Corporation, which is managed by the bank.

The German government and the national central bank, the Bundesbank, organized a bailout of IKB, with credits totaling nearly $10 billion routed through the state-owned KfW bank, which owns the majority of the shares in IKB. Prosecutors in the Ruhr capital of Düsseldorf have begun a criminal investigation into IKB's operations, and the bank's chief financial officer resigned August 7, eight days after CEO Stefan Ortseifen.

The biggest German private bank, Deutsche Bank, announced Friday that the value of its DWS ABS investment fund fell 30 percent, although it did not follow the example of BNP Paribas in suspending redemptions. Ominously, the bank said that the American subprime mortgage crash was not the immediate cause of the losses, but affected the fund indirectly because "The uncertainties surrounding the US mortgage crisis has constricted liquidity."

While the European Central Bank intervened massively, the Bank of England, by contrast, did nothing Thursday or Friday. It was the only one of the world's major central banks to offer no support to the financial markets. The Japanese central bank offered relatively minimal support, about $8 billion, while central banks in smaller countries like Canada and Australia mustered greater support in proportion to their own resources.

The role of China, whose central bank has accumulated assets of over $1.1 trillion, is potentially critical in this crisis, and there was widespread consternation and comment in financial circles after the British newspaper *Daily Telegraph* published a report August 8 that the Chinese government “has begun a concerted campaign of economic threats against the United States,” and was hinting that it might liquidate its holdings of US Treasury notes if Washington imposed trade sanctions, as demanded by Democratic congressional leaders and presidential candidates.

A Chinese central bank official issued a statement declaring, “US dollar assets, including American government bonds, are an important component of China’s foreign exchange reserves as the dollar enjoys a major position in the international monetary system based on the large capacity and high liquidity of US financial markets.” That such a statement had to be issued at all is extraordinary. Moreover, it suggested a more modest role for the US dollar, failing to refer to it as the major world reserve currency.

In the United States, the Federal Reserve’s public posture has been to downplay the seriousness of the crisis. The Fed’s board of governors met Tuesday and decided to leave interest rates unchanged, issuing a statement reiterating that inflation rather than financial instability was still the main danger to the US economy.

On Thursday, the Fed belatedly pumped $24 billion into the financial system as the New York Stock Exchange was plunging. On Friday morning, after Asian and European markets had plunged further, the Fed began further efforts to increase liquidity and issued a statement that it “is providing liquidity to facilitate the orderly functioning of financial markets.”

In a highly unusual move, the entire $38 billion the Fed expended Friday was directed to purchasing mortgage-backed securities, which might otherwise have gone without buyers. The two-day total of $62 billion compares to a daily average of $75 billion during the week after the September 11, 2001 terrorist attacks.

Despite the brief respite in the stock market rout Friday afternoon, the full impact of the crisis in US mortgage-based securities is still to be felt. Two large home mortgage firms, Countrywide Financial, the largest, and Washington Mutual filed declarations Thursday night with regulatory agencies that they were having difficulty funding new home loans. The stock price of both companies fell precipitously Friday.

Another large home lender, HomeBanc of Atlanta, Georgia, filed for bankruptcy Friday, showing debts of $4.9 billion. Its creditors included both a long list of American financial institutions—the largest being Fidelity, the biggest mutual fund—and such European banks as the German Commerzbank, the French BNP Paribas and the Dutch-based Fortis.

“Recent disruptions in the mortgage loan and real estate markets have been dramatic, in terms of both magnitude and timing,” CEO Kevin Race said in a statement. HomeBanc was now in an “untenable business position” and would seek “an orderly wind-down of the company.”

Wall Street financial markets have become indissolubly linked to the financing of home mortgages in the last eight years, as the process of “securitization” of mortgages has become widespread. Mortgage lenders no longer hold mortgages to maturity, collecting monthly payments. Instead, they sell the mortgages to the huge federally backed mortgage repackaging companies, Fannie Mae and Freddie Mac, or directly to hedge funds and other financial institutions. In 2006, Wall Street firms issued $773 billion in mortgage-related securities, according the Securities Industry and Financial Markets Association, up from $217 billion in 2001.

The subprime market accounts for about $2.5 trillion in lending, much of which is expected to go into default in the next six months. About ten percent of all subprime borrowers are already behind on their payments, with $212 billion in loans in default through May and another $325 billion estimated to default in the future.

Mortgage lending using highly leveraged instruments like option Adjustable Rate Mortgages (option ARMs) and interest-only ARMs has skyrocketed, with $581 billion in option ARMs in 2005 and 2006 and nearly $1.4 trillion in interest-only ARMs.

For a period of time, this suited both the low-income borrowers, who could afford to buy a house, perhaps for the first time, and billion-dollar lenders, who reaped enormous paper profits since they could book the interest payments and record the principal as assured by the underlying value of the house.

With the slump in home prices over the past year, however, it has become impossible to disguise the deterioration of the market. Homeowners struggling to make payments can no longer refinance their mortgages easily to avoid default. And these defaults are not only leading to foreclosures and a glut of unsalable houses, they are compelling many home lenders to erase profits that they have already booked under the lax accounting rules that allow them to record income even on loans where money is not coming in.

The credit crisis could have a more immediate effect on the stock markets next month, when bank commitments to finance nearly $300 billion in corporate takeovers, mainly by hedge funds and private equity firms, will fall due. In the current liquidity squeeze, the banks may be compelled to revoke some of the loan agreements and pay huge cancellation fees, or they may have to finance the loans from their own capital, putting their own solvency at risk.