Fed moves to halt market meltdown

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If a week is a long time in politics, then two days in the financial markets can be even longer. Last Wednesday, William Poole, president of the St Louis Federal Reserve Bank, told Bloomberg TV that the subprime mortgage rout did not threaten US economic growth and that only a "calamity" would justify an interest rate cut.

It was premature, he said, to suggest that "this upset in the market is changing the course of the economy in any fundamental way" and no one had "called up and said the sky is falling."

It seems that the Federal Reserve Board and its chairman Ben Bernanke had different information. In a hastily summoned video conference on Thursday night they decided to cut the discount rate that banks have to pay on overnight loans. While the federal funds rate remains at 5.25 percent, the discount rate was reduced by 50 basis points from 6.25 percent to 5.75 percent.

Announcing the decision before the stock market opened on Friday, the Fed said that the deterioration in market conditions and tighter credit, coupled with increased uncertainty, had the "potential to restrain economic growth" in the future. It judged that "the downside risks to growth have increased appreciably." Inflation, which, up to now the Fed had insisted was the main problem facing the economy, did not rate a mention—pointing to the strong possibility of a cut in the federal funds rate when the Fed's open market committee meets on September 18.

The Fed maintained it was taking the action to "promote the restoration of orderly conditions in financial markets" and that the changes would "remain in place until the Federal Reserve determines that market liquidity has improved materially." It would continue to accept a broad range of collateral for "discount window" loans, including home mortgage and related assets. One of the chief causes for the drying up of credit has been the inability of financial companies holding such assets to obtain short-term funds through the normal operations of financial markets.

The Fed intervention came after a wild day on Thursday, in which stocks fell by as much as 343 points. Had the plunge continued, the market would have dropped more than10 percent from its previous high, giving rise to concerns that, rather than a "correction", something more serious was occurring.

With barely half an hour to go, a seemingly miraculous turnaround occurred. The market gained more than 200 points and, at one stage, entered positive territory, before closing just 15.69 points down.

The sudden turnaround suggests an organised intervention, possibly orchestrated by the President's Working Group on Financial Institutions, sometimes known colloquially as the Plunge Protection Team.

Last Monday the *Wall Street Journal* reported that the group had already initiated action in response to growing instability:

"The market turmoil prompted the President's Working Group on Financial Markets—the Treasury, the Fed, the SEC and the Commodities Futures Trading Commission—to trigger protocols established by Mr. Paulson shortly after he took office last year. They include a detailed list of who is going to call financial institutions, risk managers, traders and chief executives to keep tabs, how often they should call and the like. When he first joined Treasury from Goldman Sachs, Mr. Paulson instructed Emil Henry, then the Treasury official in charge of financial institutions, to craft guidelines for five or six 'meltdown' scenarios. One was a catch-all 'General Withdrawal from Risk Taking'. Others include a liquidity crisis, stock-market meltdown and oil shock. The Working Group has held conference calls, principally among staff, at least once a day in recent days."

Whether or not there was a direct intervention, it was clear that Thursday's revival would not be sustained, and that unless immediate action were taken, the market would fall rapidly when trading opened on Friday. This was the immediate impetus for the Fed's decision.

The necessity for action was underlined by Friday's developments in Asian markets. Steady falls were recorded across the region in the morning and, in the afternoon, the Japanese share market plunged.

The benchmark Nikkei 225 index fell by 5.4 percent, its most rapid decline since the September 11, 2001 terrorist attacks. The chief cause of the slide was the 10 percent fall in the shares of export-oriented companies in the wake of a rise in the value of the yen.

Komatsu, the construction equipment manufacturer, which obtains most of its revenue from abroad, dropped 11.6 percent, Nippon Yusen, the country's biggest shipbuilder, fell 10.4 percent and Toyota, the world's biggest carmaker, fell 7.2 percent.

The increase in the yen's value has been precipitated by the unwinding of the so-called carry trades, in which money borrowed in Japanese markets, where interest rates are relatively low, is invested in markets where the interest rate is higher. With credit tightening across world markets, investors moved out of riskier assets funded by loans in the Japanese currency, causing the yen's value to rise.

In a bid to stabilise the situation, the Bank of Japan added 1.2 trillion yen ($10.7 billion) to money markets on Friday, making it the tenth time this year it has intervened to provide liquidity to the banks.

At Friday's market closure, the Dow Jones index was 233 points up, no doubt bringing a sigh of relief from central bankers and government officials. But no serious observer believes the Fed's intervention has solved the underlying problems in credit markets that are responsible for the crisis. It was, at best, a holding measure—until further problems bubble to the surface.