Contradictions mount in US and world economy in wake of Fed rate cut

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While a half-percentage-point cut in the federal funds rate sent Wall Street soaring Tuesday, and had a lesser but still positive impact on stock trading Wednesday, there is growing evidence that the move by the Federal Reserve Board can have only a short-term effect, and that the unraveling of financial markets under the impact of the home mortgage collapse will continue.

At a hearing Wednesday on the mortgage crisis convened by the Joint Economic Committee of Congress, several prominent economists warned of the long-term consequences of the deflation of the housing market bubble.

Robert Shiller, a liberal Yale economist who correctly predicted the collapse of the dot.com bubble, told the panel that "the collapse of home prices might turn out to be the most severe since the Great Depression." The housing slump would have a major impact on consumer spending, and posed a "significant risk" of recession over the next year, he said. "Low income people will be especially hard hit," Shiller warned, because they hold a disproportionate number of the subprime mortgages which are now being liquidated.

Rising home prices have been the major factor in the steady rise of consumer spending over the past seven years, despite stagnant or declining real incomes. Homeowners extracted an average of nearly $1 trillion a year in additional spending money from 2001 through 2005, through a combination of home sales, home equity lines of credit and mortgage refinancing. One quarter of this vast sum went directly into consumer spending.

Now this process is going into reverse. According to a forecast released Wednesday by Moody's economy.com, more than three-quarters of the housing markets across the US will suffer a decline in home prices in the next several years, and price declines will average 7.7 percent nationally, exceeding 10 percent in 86 of the 379 largest markets.

The worst-hit areas are in Sunbelt boomtowns (Stockton, California, predicted to be down 25 percent, Melbourne and Sarasota/Bradenton, Florida, down 24.9 percent and 24.8 percent respectively), and older Midwest industrial cities (Saginaw, Michigan, down 31.8 percent, and Detroit, forecast to fall 21.3 percent).

Six of the ten largest cities would face price declines of one percent or more, Moody's predicted, led by Phoenix, down 17.8 percent; San Diego, down 10.9 percent; Los Angeles, down 10.6 percent; New York City, down 5.3 percent; San Jose, down 4.4 percent; and Philadelphia, down 3.1 percent.

Economist Alex Pollack of the American Enterprise Institute, a conservative think tank, told the Joint Economic Committee that a 15 percent decline in real estate values over the next several years would have a staggering effect, wiping out $3 trillion in household wealth. "Residential real estate is a huge asset class, with an aggregate value of about $21,000 billion," he said, "and is of course the single largest component of the wealth of most households."

Other economic figures released on Wednesday suggest the extent of the housing debacle. The Commerce Department reported that new home construction fell 2.6 percent in August, reaching the lowest level in 12 years. The day before, the National Association of Home Builders reported that its index of builder confidence had fallen to the lowest level on record.

Foreclosure filings in August were up 115 percent from the same month a year ago, according to RealtyTrac Inc., which collects such statistics. A total of 243,947 foreclosure filings were reported in August, up 36 percent from the 179,599 in July. One in every 500 US households faced foreclosure in August.

The Federal Reserve rate cut will do nothing to stave off economic ruin for the estimated two million subprime-mortgage borrowers, the millions more homeowners with

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adjustable-rate mortgages that are set to rocket upwards in the coming months, or the millions of others with conventional mortgages that they cannot sustain because of the loss of jobs or medical bills.

The immediate purpose of the rate cut is to bail out the giant lending institutions—hedge funds, investment banks, private equity firms—that plunged heavily into speculation in the mortgage markets and now face enormous financial strains. Some 156 mortgage lending institutions have already filed for bankruptcy in the subprime collapse, which is now predicted to cost Wall Street at least $300 billion.

The securitization of US mortgages, a process which has accelerated over the past decade, has created new and more complex financial instruments, which have linked the struggling US homeowner to big capitalist speculators, not only in the United States, but throughout the world.

Two banks in Germany have already failed because of heavy losses in the US mortgage market. They were taken over by other banks in government-organized bailouts. The fifth-largest mortgage bank in Britain, Northern Rock, remains in deep crisis despite an emergency bailout by the Bank of England, which stepped in amid scenes of depositors lining up outside branches of the bank, seeking to withdraw their funds.

The Northern Rock case is considered even more ominous than the German failures, because the bank had little exposure to the US mortgage market. Its crisis was the byproduct of the more general credit crisis sparked by the mortgage debacle, which threatened to escalate out of control and compelled the intervention of the Bank of England, which had previously resisted any role in bailing out the mortgage speculators.

The US central bank's intervention was particularly dramatic because of the size of the cut, the largest in five years. There is no doubt that it acted in this way because of pressing—and undisclosed—concerns about the imminent failure of one or several large US financial institutions, and the impact that this would have on financial markets worldwide.

But the move only exacerbates the contradictions of the US economy, particularly in relation to global investment flows and the value of the dollar, which has plunged to historic lows against both the euro and the Japanese yen. It carries with it the danger of a major new burst of inflation, reflected already in soaring oil prices, which hit $82.51 a barrel Wednesday in the futures markets.

The rise of the euro and the yen will have an additional inflationary impact in the US, by driving up the cost of imports from Europe and Japan. Moreover, there will be increasing pressure on China and other countries that have accumulated huge dollar-denominated reserves to offset the dollar's decline by shifting into euro- or yen-denominated financial assets.

Thus, while the short-term impact of the Fed rate cut is to ease lending constraints in the United States, the consequent depreciation of the dollar threatens one of the major sources of liquidity for the financial markets, the inflow of capital from China, Japan, Taiwan and other countries that enjoy large trade balances with the US and have plowed back much of these surpluses into Treasury bonds and other US securities..

Both the US economy and the world financial system are in an increasingly precarious situation, facing the danger of a chain-reaction collapse, as defaults on mortgages produce major bankruptcies and confidence in the financial structure as a whole is undermined. Debt fuels the consumer spending that has increasingly become the sole basis for US economic growth, since consumers are spending far beyond their means.

The US personal savings rate has dropped from 11 percent of national income in 1982 to a negative one percent last year, and US consumers are carrying a record $2.456 trillion in debt, not counting mortgages. Credit card debt has been rising at an unsustainable 6-7 percent a year. The average US family spent 14.3 percent of its disposable income to service consumer debt during the first three months of 2007, up from 13 percent in 2001.

On Wall Street, the situation is even more dire. The creation and manipulation of debt, rather than the production and sale of goods, has become the principal driving force of American capitalism. The Federal Reserve action, rather than curbing the addiction to debt, has given a new fix to the addict, one which could well produce catastrophic consequences, sooner rather than later.

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