US Fed rate cut fires up Wall Street

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In a desperate bid to prevent the crisis in credit and housing markets from sparking a recession, the US Federal Reserve Board has cut its base federal funds interest rate by half a percentage point (50 basis points).

The decision, which came as something as a pleasant surprise for Wall Street's big finance houses—they had factored in a rise of 25 basis points—set the Dow Jones index soaring by more than 335 points. This was the biggest percentage rise since April 2, 2003 and the first 300-point gain since October 15, 2002.

But the upsurge on Wall Street, which has put billions of dollars into the coffers of the major financial corporations—their shares were among the leaders of the rally—by no means signifies an end to the crisis that has gripped credit markets since August. On the contrary, the very volatility of the market is indicative of fundamental problems. If the decision had been to keep interest rates on hold, then the market would have responded with a drop of hundreds of points in a matter of minutes.

Even as the market was celebrating, questions were being asked as to whether the size of the increase indicated that the Fed may have information that the economic situation is more serious than previously believed.

In its statement accompanying the decision, the Fed made clear that the prospect of recession was the chief motivating factor.

"Economic growth was moderate during the first half of the year," it noted, "but the tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally. Today's action is intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from disruptions in financial markets and to promote moderate growth over time."

It said that developments since the last meeting of the Federal Open Market Committee, on August 7, when the Fed statement pointed to the pressures of inflation, "have increased uncertainty surrounding the economic outlook." The statement noted that while "some inflation risks remain", the committee would continue to assess the effects of uncertainty and "act as needed to foster price stability and sustainable economic growth." This was widely interpreted as meaning that it could cut rates further if financial market instability continued.

While the rate cut may provide a short-term adrenalin-like shot to the US economy, its impact on the global economy as a whole could bring further problems. Some of those are immediately apparent.

As a direct response to the interest rate cut, the price of oil hit a new record on Tuesday, touching $82 per barrel, amid predictions that it could go to as high as $100. West Texas Intermediate, which functions as benchmark for the whole oil market, is up 34 percent so far this year.

In another indication of expected inflation, gold prices rose to a 26-year high of $733.40 per ounce.

The announcement also had an impact on currency markets where the dollar continued its downward slide against the euro, reaching an all-time low of 1.3964. This has renewed fears that if the slide continues, the $2 billion a day capital inflow, which the US needs to finance its balance of payments deficit, will start to dry up and previous investments in US Treasuries and other financial assets could even be withdrawn.

Former International Monetary Fund chief economist and now Harvard economics professor Kenneth Rogoff said there was "no question the dollar will continue its slide in the next twelve months."

In a comment to the *International Herald Tribune* last week, Rogoff, who has pointed to the dangerous implications of the imbalances in the world economy created by the US deficit, warned there was an increased risk of a "serious decline of the dollar." "We could finally see the big kahuna hit," he said.

The last major collapse of the dollar at the end of the 1970s was followed by the lifting of interest rates to record highs and a severe recession in 1982-83—the deepest since the Great Depression of the 1930s.

Apart from fuelling increases in the prices of oil and other commodities, a further consequence of a dollar slide could be the onset of slower growth or even a recession in Europe as exporters find that they are increasingly priced out of world markets by the rising value of the euro.

This scenario was the subject of an article by *Financial Times* columnist Wolfgang Munchau on Monday. "Short spikes in an exchange rate do not have much economic effect," he wrote, "but if the exchange rate [of the dollar to the euro] were to remain in the $1.40-$1.45 trading range for a long period, it would no doubt affect eurozone exports and growth. Add to this the more direct effects of the credit crisis plus the global cyclical slowdown that has already started and you have the ingredients for a sharp downturn."

The bankers, share dealers and highly-paid chief executives on Wall Street no doubt entertain hopes that the interest rate cut will bring about a new financial bonanza, such as they experienced in the heyday of Fed chairman Alan Greenspan. At that time, record low rates helped create a series of financial bubbles, while steering the economy clear of a major recession.

However the so-called "maestro" doubts the same trick can be carried off twice. In a series of interviews to launch his new book, Greenspan made clear that in his view times had changed.

"We are in a period when it is far more difficult than it was when I was chairman," he told the *Financial Times*. "We were not worried about inflationary resurgence but now you have to be. You have got to be a lot more careful in lowering rates in response to crises."

According to Greenspan, the pressures of disinflation in an earlier period, which tended to lower prices, were related to the integration of cheaper labour from the former Soviet bloc and China into the world market. However, once that process is completed "the rate of change goes to zero."

"In the [present] intermediate period, the disinflationary pressures I was fortunate enough to operate under are gradually disappearing."

If this is the case, then Monday's rate cut will intensify the problems confronting the US economy rather than alleviating them.