Near-panic atmosphere as US Federal Reserve chairman testifies before Congress

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On Thursday, one day after American stock markets plummeted in the face of mounting bank losses, soaring oil prices and record lows for the US dollar, Federal Reserve Board Chairman Ben Bernanke gave a gloomy economic forecast in testimony before Congress' Joint Economic Committee.

Bernanke admitted that the US housing slump and the credit crisis resulting from soaring defaults of subprime mortages had worsened since credit markets froze last August, and predicted that US economic growth would fall sharply in the fourth quarter of 2007 and the beginning of 2008.

He said the housing crisis would worsen in the coming months, as millions of homeowners with adjustable rate mortgages faced sharply higher interest payments when new rates kicked in, and hinted that the crisis on Wall Street could spiral into a full-blown recession.

On Wednesday, the Dow Jones Industrial Index fell 360.92 points, wiping out all the gains since the Fed's half-point interest rate cut on September 18. The Standard & Poor's 500 index dropped by 44.65, while the Nasdaq Composite Index shed 76.42 points. The rout on Wall Street was precipitated by a series of developments underscoring the depths of the financial crisis.

As the dollar hit record lows against the euro and other currencies, Chinese officials said the weakness of the US dollar could lead them to diversify their $1.43 trillion in foreign exchange reserves into stronger currencies, such as the euro. A Chinese central bank vice director told a conference that the dollar was "losing its status as the world currency."

The US economy, saddled with massive trade and current account deficits, depends on daily inflows of billions of dollars in capital from China, Japan and other countries for the functioning of its financial system. Any significant contraction of these capital flows would lead to a collapse in the dollar, massive interest rate increases, deep recession and the possibility of a US and global depression.

Also on Wednesday, French President Nicolas Sarkozy, in an address to the US Congress, criticized Wall Street "excesses" and the weak dollar and warned that "monetary disorder risked turning into economic war." Sarkozy was speaking for a European bourgeoisie that is increasingly angered by a US monetary policy that has cheapened the price of US exports, made European imports more expensive, and begun to seriously impact European business.

The same day, oil futures, up more than 65 percent in the past year, topped $98 a barrel for the first time. Gasoline prices in the US—already significantly higher than last month—are now expected to follow the surge in oil, and Americans' winter heating bills are expected to rise even more sharply than initially feared.

The meltdown of so-called collateralized debt obligations (CDOs) and other subprime-linked securities continued with the announcement by Wall Street investment bank Morgan Stanley that it was writing off $3.7 billion for the fourth quarter, and that its losses could rise to $6 billion. It joined such other giants as Citigroup, Merrill Lynch and Goldman Sachs which have announced multi-billion-dollar write-downs in high-risk, high-yield investments in the housing market and other forms of financial speculation.

So far this year there have been an estimated $55 billion in losses suffered by financial institutions, but this is just the tip of the iceberg. The chief credit strategist at the Royal Bank of Scotland Group issued a report Wednesday estimating that the credit crunch will cause $250 billion to $500 billion in losses at banks and brokerage houses around the world. The upper range of his estimate is equal to the combined stock market value of the three largest US banks, Citigroup, JP Morgan Chase and Bank of America.

Adding to the mood of fear and crisis on Wall Street was the announcement by the American International Group, the world's largest insurance company, that it had written down nearly $2 billion in investments related to mortgages in the third quarter and expected to write down an additional $550 million in the next quarter, and a warning from the savings and loan firm Washington Mutual that it faced massive credit losses. Washington Mutual stock fell more than 17 percent for the day.

Finally, General Motors took a $39 billion charge to its third-quarter results to offset the value of deferred tax assets.

The crisis atmosphere surrounding Bernanke's appearance before Congress was further stoked by weaker-than-expected data on US retail sales released Thursday morning. The data, showing sluggish sales by such retail giants as Wal-Mart, Macy's and Kohl's, suggested that US consumer spending, which accounts for 70 percent of the economy, was falling off as a result of declining home values, rising foreclosures, soaring gasoline and heating costs, and pervasive economic insecurity. The reports made for a bleak prognosis for the holiday season, upon which retailers and the US economy as whole are hugely dependent.

The mood for Bernanke's appearance before Congress was set by the opening statement from New York Senator Charles Schumer, the chairman of the Joint Economic Committee. The Democratic senator, known as a reliable mouthpiece for Wall Street interests, began by noting that since Bernanke's previous appearance before the committee in March, "contrary to what you said at the time, the subprime mess has not been 'contained,' but instead has proved to be a contagion that has spread in dangerous ways throughout not just the housing market, but our economy and the global financial system."

Schumer said that in the aftermath of the "seizing up of the credit markets" in the summer, "there is now a lack of confidence in credit-worthiness throughout the market."

He continued: "However, while we did weather that summer storm, I'm very concerned that there may be a bigger storm on the horizon. Quite frankly, I think we are at a moment of economic crisis stemming from four key areas: falling housing prices, lack of confidence in credit-worthiness, the weak dollar and high oil prices. Each of these problems alone would be enough of a threat to our economic well-being. But taken together, they are essentially the four horsemen of economic crisis...

"Even our bedrock assumptions are being put into doubt. As housing prices decline, there are real fears that we won't be able to depend on consumers, the engine of our economy over the past few years, to keep spending. And now we hear that foreign investors may no longer be confident in the dollar as the global currency of choice. I'm not surprised to hear experts, such as your predecessor Alan Greenspan, warn about the threat of recession. I've begun to worry about worse.

"In particular, as I watch bank after bank write down bad investments tied to baroque financial instruments that even sophisticated investors don't understand, I fear for the stability of our financial system."

Bernanke provided little solace. While noting that the US gross domestic product rose at a strong 3.9 percent rate in the third quarter, he warned that such a rate could not be sustained because of the "ongoing correction" in the housing market, and added that inflation was bound to rise because of "recent increases in energy prices."

He admitted that financial markets remained under "significant pressure," saying the "financial turmoil" was triggered by "investor concerns about the credit quality of mortgages, especially subprime mortgages with adjustable rates." He spoke of the "continuing increase in the rate of serious delinquencies for such mortgages," and warned that they were likely to rise further "as a sizable number of recent-vintage subprime loans experience their first interest rate resets."

He explained that on average, from now until the end of 2008, nearly 450,000 subprime mortgages every quarter were scheduled to undergo their first interest rate reset, and that the resulting "payment shock" would be compounded by the decline in home prices and a tightening in lending terms. "A sharp increase in foreclosed properties for sale," he said, "could also weaken the already struggling housing market and thus, potentially, the broader economy."

Bernanke related the housing and mortgage crisis to the crisis in credit markets by explaining that while in the past most mortgages were held by the companies that originated them, today mortgages "are commonly bundled together into mortgage-backed securities or structured credit products, rated by credit agencies, and then sold to investors."

Commenting, in rather diplomatic terms, on the collapse of the resulting edifice of financial speculation, he said, "As mortgage losses have mounted, investors have questioned the reliability of credit ratings, especially those of structured products"—such as CDOs.

Since no one really knows the value of these assets, "the loss of confidence in the credit ratings... led to a sharp decline in demand for these products." In other words, banks and other financial institutions holding these securities are unable to unload them except at fire-sale prices, leading to potentially catastrophic losses on their balance sheets.

Bernanke went on to say that the collapse in confidence in subprime-backed securities had spread to virtually every sector of the credit markets, including securities backed by jumbo mortgages to home buyers with good credit and commercial paper traded between corporations. The market for leveraged buyouts, which had largely fueled the stock market boom of the last few years, had dried up, and banks were increasingly reluctant to lend to their customers and to each other.

"These events do imply," the Fed chairman said, "a greater measure of financial restraint on economic growth as credit becomes more expensive and difficult to obtain."

The short-term result, Bernanke said, would be a further contraction in "housing-related activity" and a slower growth in household spending." Overall, the Fed "expected that the growth of economic activity would slow noticeably in the fourth quarter from its third quarter rate." Putting an optimistic face on a dire situation, he said that growth, while remaining "sluggish" in the first part of 2008, would strengthen "as the effects of tighter credit and the housing correction began to wane."

However, he acknowledged the "downside risks" of a worsening financial crisis "causing credit conditions to become even more restrictive than expected" and a more-than-expected weakening of housing prices, "which could further reduce consumers' willingness to spend and increase investors' concerns about mortgage credit."

He also spoke of the "upside risks" of sharply higher inflation from soaring oil prices and a continuing weakening of the dollar.

He concluded with his standard statement that the Fed would "continue to carefully assess the implications for the outlook of the incoming economic data and financial market developments and act as needed to foster price stability and sustainable economic growth."

The initial response on Wall Street to Bernanke's testimony was a sharp fall in stock prices, with the Dow Jones index slumping more than 200 points. However, by the end of Thursday the Dow had recovered most of its losses, closing down 33.7 points. However, the technology-laden Nasdaq fell 52.76, or 1.9 percent. This was largely due to a negative projection from the networking giant Cisco, whose shares fell 10 percent, sparking a broader sell-off of hi-tech stocks.

The recovery, particularly in banking and financial stocks, may have reflected a consensus that Bernanke's report was so dismal as to suggest a third successive interest rate cut when the central bank's Federal Open Market Committee meets next on December 11. While many on Wall Street continue to clamor for rate cuts, in the hope that an expanded flow of cheap credit will save them from the consequences of years of financial manipulations and outright swindling, such an action can in no way resolve the mounting crisis of US and global capitalism.

In the short term, it will only intensify the crisis of the dollar and fuel the conditions for rampant inflation. More fundamentally, such policies compound the underlying instability and insolvency of the financial system.

Bernanke's own testimony points to an inevitable reckoning, in which the vast global economic imbalances, the inherent anarchy of the capitalist market, and the rampant parasitism, of American capitalism in particular, produce an economic and social disaster.