US Federal Reserve accedes to Wall Street demands with another interest rate cut

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The Federal Reserve Board, the nominally independent US central bank, bowed to pressure from Wall Street banks and major investors on Wednesday by lowering short-term interest rates for the second time in two months.

The Fed's Federal Open Market Committee (FOMC), which consists of the heads of five Federal Reserve banks in Washington and twelve regional banks, announced a quarter-point cut in the key federal funds rate, the rate charged for overnight loans between banks, to 4.5 percent. It also cut the discount rate, at which the Fed loans money to major banks, by a quarter-point, to 5 percent.

Wall Street celebrated the announcement by driving up share prices on all three major US stock indexes. The Dow Jones Industrial Average rose 137.5 points to 13,903, a 1 percent increase; the Standard & Poor's 500 index climbed 18.4 points to 1,549, a 1.2 percent rise; and the Nasdaq Composite Index went up 42.4 points to 2,859, an increase of 1.5 percent.

Particularly significant were the large gains registered by the major US investment banks. Lehman Brothers' stock rose 3.2 percent, Goldman Sachs gained 3.2 percent and Morgan Stanley added 2.7 percent. Bear Stearns stock rose 0.7 percent and Merrill Lynch gained 1.2 percent.

Just six weeks ago, following a freeze in credit markets and stock market plunge resulting from the meltdown in the housing market and the collapse of securities linked to subprime mortgages, the Fed took the unusual step of cutting the federal funds rate by half a percentage point.

Since then, the crisis in the housing and banking sectors has intensified, with home sales and prices plunging, foreclosures soaring and Wall Street banks announcing tens of billions of dollars in write-downs of speculative mortgage-based investments. The US dollar has declined to record lows on major world currency markets and crude oil prices have climbed above $90 a barrel.

The dollar slide and explosive rise in oil prices—up nearly 40 percent since early summer—portend a sharp rise in inflation and a major financial crisis in the US and internationally, with the potential for a severe and protracted recession.

Despite these ominous developments, stocks are up nearly 11 percent this year and continue to rise. A major factor in the ongoing stock market boom is the assumption among big investors, banks, hedge funds and other financial institutions that the Fed will continue to provide easy credit to bail out those who have been caught in various forms of highly risky and speculative investments.

Just last week Merrill Lynch announced that in the third quarter it lost $2.2 billion and wrote off $8.4 billion in assets linked to subprime mortgage debt. It is estimated that banks in the US and around the world wrote off $30 billion in bad investments in the third quarter.

Earlier this month it was announced that the US Treasury Department, with the official blessings of the Fed, had engineered a scheme to raise $80 billion-$100 billion in capital to prevent a collapse of so-called structured investment vehicles (SIVs)—off-balance-sheet entities set up by major banks to engage in highly risky investment bets. Citigroup, the largest US bank, faces the greatest exposure from the SIV crisis.

By cutting interest rates again, the Fed added further fuel to both the dollar decline and the related rise in oil and other commodity prices. Both the British pound, at $2.0788, and the euro, at $1.4485, hit new highs against the US currency.

In a cautious statement issued by the Federal Open Market Committee, the Fed attempted to dampen expectations on Wall Street of a further rate cut when the Fed meets again in December. The FOMC said: "The Committee judges that after this action, the upside risks to inflation roughly balance the downside risks to growth. The Committee will continue to assess the effects of financial and other developments on economic growth prospects and will act as needed to foster price stability and sustainable economic growth."

Disappointment among many on Wall Street that the Fed did not cut interest rates by half a percentage point, combined with the FOMC's elevation of the danger of inflation to an equal level with the threat of recession—and the implied preference for a pause in further rate cuts—initially prompted a downward slide on the stock market. But the market rebounded, taking comfort in that day's cut and the belief that continuing distress in the housing and credit markets will sway the Fed to continue to open the sluices of cheap credit.

On Tuesday, the Conference Board issued its report on US consumer confidence, showing a decline for October—the third straight monthly fall. The previous Friday, another report on consumer sentiment showed a decrease to the lowest level in 17 months.

However, on Wednesday morning, prior to the Fed's announcement, the Commerce Department reported a bigger-than-expected increase in the US gross domestic product of 3.9 percent for the third quarter. This relatively high figure, following a second quarter GDP growth report of 3.8 percent, made all the more remarkable the Fed's decision to make a further cut in interest rates.

The Commerce Department report showed a sharp 20 percent decline in housing investment, but this was offset by a continuing surge in US exports. The export rise is due to the steep decline in the dollar, which makes US exports to Europe and Asia cheaper and imports from these regions more costly.

The US government and the Fed are pursuing a highly risky policy of allowing the dollar to plummet in order to gain short-term advantage over America's trading rivals—in effect, conducting a trade war by dint of the dollar's devaluation. This has potentially disastrous longer-term implications for American capitalism, which is ultimately dependent on the strength of its currency.

It also encourages overseas investors and governments to disinvest from dollar-denominated holdings and shift to regions with higher interest rates and stronger currencies, such as Europe and Asia. Given that the US economy, with its massive trade and current account deficits, is dependent on huge inflows of capital from abroad, the continued decline in the dollar increases the likelihood of a withdrawal of foreign capital and a resulting worsening of the financial crisis in the US.

The controversial nature of the Fed's decision to cut interest rates was reflected in the dissenting vote of one of the ten voting members of the FOMC. Federal Reserve Bank of Kansas President Thomas Hoenig voted against the cut, saying he preferred no reduction in interest rates. In addition, six of the twelve regional banks opposed the rate cut.

The Wall Street banks, financial institutions and speculators engaged in the equivalent of a high-stakes game of chicken, letting it be known they would respond to a decision against cutting interest rates with a massive sell-off on the stock market, which could, in turn, precipitate a new collapse in the credit markets.

International Herald Tribune As put it: “Fed the officia were under very heavy pressure from financial markets. Prices of Fed-funds futures, which provide a way of betting on the Fed's fund rate, showed that investors placed the odds of a rate cut Wednesday at 96 percent.

“Had the central bank decided to leave interest rates unchanged, without any advance warnings from policy makers, markets would likely have plunged in panic.”

Thomas D. Higgins of the firm Payden and Rygel put it more bluntly: “The financial markets have been like a playground bully, sitting on the Fed's chest waiting for [Federal Reserve Chairman] Ben Bernanke to hand over his Holloween candy. Well, today they got their wish.”

The web site *Street.com* cited James Bianco, president of Chicago-based Bianco Research, as saying, “We should just change Bernanke's title to chief investment officer of the United States,” and adding that “the markets are never going to relinquish their hope for more rate cuts.”

There are no suggestions from the government, the Fed or either of the two big business parties that the banks and investment houses should be reined in and held accountable for the hundreds of billions squandered in various forms of speculation and financial swindles—or that small investors, pensioners and workers hit by wage cuts and layoffs should be recompensed for the social impact of this orgy of self-enrichment on the part of the financial elite.

Rather, the Fed's open subordination to those layers of the corporate-financial elite most directly involved in such financial manipulations underscores the degree to which the operations of American capitalism have become wedded to the most parasitic and socially-destructive forms of profit-making.