

# US stocks plunge on Federal Reserve rate cut announcement

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US stocks plummeted Tuesday after the Federal Reserve Board announced a quarter-point cut in short-term interest rates and indicated in an accompanying statement that it remained concerned over the potential for an inflationary surge.

The sharply negative reaction on Wall Street, which was looking for a half-point cut in interest rates and a statement clearly giving primacy to the risks of recession and a meltdown on financial markets above inflation concerns, is a measure of the near-panic gripping big investors and some of the largest banks in the US and Europe over the implosion of the US housing market and resulting crisis on credit markets.

Immediately after the Federal Reserve Board's Federal Open Market Committee announced its decision, at 2:15 PM Eastern Standard Time, all of the major New York stock indexes began to plunge. By the end of trading, the Dow Jones Industrial Average had fallen 294.26 points, a drop of 2.1 percent. The Nasdaq Composite Index declined by 66.60 points, down 2.5 percent, and the Standard & Poor's 500 Index fell 38.31 points, a 2.5 percent decline.

The sharp fall on the markets came despite the fact that Tuesday's rate cuts marked the third consecutive reduction in interest rates by the Fed since the credit crisis erupted last August. Since then, the US central bank has slashed rates by a full point, the greatest easing of borrowing costs since the recession of 2001.

The Fed cut its target federal funds rate, the overnight rate at which banks lend money to one another, from 4.5 percent to 4.25 percent. At the same time, it reduced the so-called discount rate, at which the Fed directly lends money to banks, from 5.0 percent to 4.75 percent.

These moves are aimed at cheapening the cost of loans and pumping liquidity into the credit markets. They come at a time when major banks and investment houses in both the US and Europe are reeling from massive losses resulting from the collapse of assets linked to US subprime home loans.

The depression in US home sales and prices and soaring mortgage delinquencies and foreclosures of homes purchased with high-interest subprime loans have undermined the stability of banking giants that leveraged such loans into a multi-trillion-dollar edifice of highly profitable securities that were sold to banks and other investors around the world.

According to an ~~article~~ in Monday's *Street* "Over the past decade, Wall Street built a market for more than \$2 trillion in securities sold globally and backed by loans to US homeowners." That market has come crashing down—as it was destined to do, since it was built on the most speculative and unstable of foundations.

Facing huge losses from the collapse of these investments, and unable to determine the real value of exotic securities derived from dividing up, bundling, repackaging and reselling loans—many to subprime borrowers with shaky credit—to other investors and financial institutions, the banks have sharply cut back their lending to consumers and businesses. Lending is down, its cost is rising and the result is a credit crunch that is driving the US economy into recession, with dire consequences for the global economy.

This crisis is an expression of the increasingly parasitic and speculative character of American and world capitalism. Its effects are rapidly spreading throughout the US economy, with job growth slowing, consumer spending falling off, US corporate profits tending downward and rising delinquencies on all forms of consumer credit—from home loans to auto loans and credit card payments.

Most analysts are now forecasting minimal or negative economic growth in the US for the current quarter, and some are predicting the economy will fall into recession in 2008. On Monday, Morgan Stanley became the first major Wall Street bank to predict a US recession next year.

Last week, the Bush administration announced a scheme for mortgage lenders, servicers and investors to voluntarily agree to freeze interest rates for a small minority of the estimated 2 million subprime borrowers whose adjustable-rate loans are scheduled to reset sharply higher over the next 18 months.

The plan, which will do little to relieve the suffering of millions of Americans who fell victim to predatory lending practices during the housing boom, is above all aimed at buying time for the big banks and mortgage companies and reassuring financial markets that a full-scale collapse will be averted. There is, however, little likelihood that it will prevent a deepening of the credit crunch and stave off an economic downturn that could prove severe and protracted.

The *Wall Street Journal* carried a front-page article Monday

headlined “US Mortgage Crisis Rivals S&L Meltdown,” referring to the US savings and loans collapse of the late 1980s and early 1990s that ended with a multi-billion-dollar government bailout of Wall Street. The article had a sub-headline that read: “Toll of Economic Shocks May Linger for Years; A Global Credit Crunch.”

The *Journal* wrote that an examination of the current crisis “shows that it is comparable to some of the biggest financial disasters of the past half-century.”

Developments this week appear to vindicate that prognosis. The Zurich-based banking giant UBS, the world’s largest provider of banking services to the wealthy, announced Monday that it was writing down the value of its subprime assets by an additional \$10 billion. The bank had already taken a \$4.4 billion third-quarter write-down. It issued a statement that the “ultimate value of our subprime holdings... remains unknowable.”

UBS said it would post a loss for the fourth quarter and possibly for the year as a whole. It further said it had received an \$11.5 billion investment from a fund owned by Singapore and an unnamed Middle Eastern investor, equivalent to selling as much as 12.4 percent of the company in return for a cash bailout.

With the announcement, UBS became the biggest casualty outside of the US of the American housing slump, but banks in other countries, such as Britain and Germany, have also been hit by the fallout from the US housing and credit crisis.

“That UBS, long known as a conservative lender, could take such a financial hit suggests that the wave of industry write-downs, which so far total about \$50 billion, may be far from over,” wrote the *Wall Street Journal*.

Just two weeks ago, Citigroup, the largest US bank, agreed to sell a \$7.5 billion stake, 4.9 percent of the company, to the Abu Dhabi Investment Authority in order to shore up its capital base, after announcing write-downs of \$8 billion to \$11 billion related to bad subprime investments. The bank had already disclosed \$5.9 billion in write-downs.

Merrill Lynch, which has \$20.9 billion in remaining exposure to subprime-linked investments, may also need to take a further write-down, as could Morgan Stanley, according to analysts. Merrill already disclosed a third quarter write-down of \$7.9 billion. Morgan Stanley has announced subprime-linked losses of \$3.7 billion in the first two months of the fourth quarter, which could increase, based on its \$6 billion in remaining subprime exposure.

Washington Mutual, the largest US savings and loan bank, this week widened its expected fourth quarter loss to \$1.5-\$1.6 billion due to deteriorating credit and mortgage markets. The S&L said it would abandon subprime lending entirely, close 190 of its 336 home loan center and sales offices as well as 9 loan and processing call centers, and cut 3,150 jobs. It also announced it would cut its dividend 73 percent to 15 cents a share.

Bank of America announced it was liquidating a money market fund for institutional investors that was worth \$40 billion only a few months ago but now has only some \$12 billion in assets. The bank said the losses were related to the subprime mortgage crisis.

Meanwhile, Fannie Mae, the US government-sponsored mortgage company, predicted house prices would continue to fall for two or three more years, with no normalization until 2010.

Wall Street is clamoring for a bailout by the Fed, in the form of drastic interest rate cuts, with scant concern for the medium- and longer-term implications for the status of the dollar and the position of American capitalism in the global economy. The Fed is attempting to balance the threat of a US banking collapse with the dangers arising from soaring energy, food and commodity prices and the relentless fall of the dollar on world currency markets.

The dollar has already lost a quarter of its value against all other currencies since 2002 and 40 percent against the euro, and further interest rate cuts can only push the US currency lower. The position of the dollar, which has been further undermined by the current US housing and credit crisis, is a barometer of the declining relative strength of American capitalism on the world market.

Gerard Lyons, chief economist at Standard Chartered in London, published a column in the December 7 *Financial Times* entitled “The Middle East Must Loosen its Ties to the Dollar.” In the article, he recommended that the oil-rich Persian Gulf regimes sharply revalue their currencies and cease pegging them to the dollar. He wrote: “The region should shift from the dollar peg to managing exchange rates against a basket of currencies of the countries with which they trade. The dollar would form a big part of this basket, but so too would the euro and Asian currencies. Over time, the dollar’s weight would fall.”

Commenting Tuesday on the bailout of UBS by Singapore and a Middle East investor, he said it was a “reflection of the current fragile state of the financial sector in the West” and “a further sign of how the balance of the world economy is changing.”



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