Inflation surge hits consumers, compounds global banking crisis

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Amidst mounting losses by major US and European banks and extraordinary measures by central banks to avert a financial meltdown, a dramatic increase in US inflation has further roiled global markets, raising the specter of a slide into “stagflation”—economic slump combined with sharply rising prices.

On December 13, the US Labor Department reported that producer (wholesale) prices jumped a seasonally adjusted 3.2 percent in November. Led by a 35 percent increase in gasoline prices, the spike in producer prices was the biggest monthly increase since 1973.

The following day the Labor Department announced an increase in consumer prices for November of 0.8 percent, which translates into an annual rate of 4.3 percent. It was the biggest monthly increase in consumer prices since September of 2005. Energy prices were up from October by 5.7 percent, and food, apparel, housing and medical care prices also rose steeply.

The inflation figures sparked major sell-offs on Wall Street, with the Dow Jones Industrial Average falling 178 points on Friday and more than 172 points on Monday. The flight from stocks was driven, in the first instance, by fears among the banks and big investors that the acceleration of inflation would prevent the Federal Reserve Board from continuing to slash short-term interest rates.

Wall Street roundly denounced the Fed on December 11 and sent stocks plummeting by more than 294 points when the US central bank reduced the benchmark federal funds rate—the target interest rate for inter-bank loans—by only a quarter of a point. This was despite the fact that the rate cut was the third consecutive one enacted by the Fed, which has reduced the federal funds rate by a full percentage point since the credit crisis erupted last August.

The banks and major investors see interest rate cuts as a means of flooding the financial market with cheap credit and staving off further losses from subprime mortgage-linked investments that have collapsed as a result of the US housing slump and surge in home foreclosures. However, further rate cuts can only accelerate the already steep decline of the US dollar on world currency markets and fuel an even more rapid rise in prices.

The inflation figures reported last week are just the tip of the iceberg. The prices of basic commodities—energy, foodstuffs, metals—are soaring at record rates around the world. At the Chicago Board of Trade, wheat and rice prices for delivery in March 2008 have jumped to an all-time record, soybean prices are at a 34-year high and corn prices at an 11-year peak.

The head of the United Nations Food and Agricultural Organization warned Monday that the world food supply is dwindling rapidly and food prices are rising to historic levels. There is a “very serious risk that fewer people will be able to get food,” particularly in the “developing world,” said Jacques Diouf.

In the US, dairy prices were up 14 percent in the past year; meats, poultry, fish and eggs, 5.4 percent; cereal and baked products, 5.2 percent; and fruits and vegetables, 4.5 percent. Researchers at Iowa State University predict that soaring corn prices—in part the result of the diversion of corn to ethanol production—will push retail prices for meat up by 7.5 percent and raise egg prices by 13.5 percent over the next year.

Meanwhile, unprecedented moves by major central banks to inject cash into the financial markets have done little to reduce sharply higher lending costs and induce banks to lend more freely to other businesses, including fellow banks. In an attempt to loosen near-frozen credit markets, the Federal Reserve Board and central banks in Europe, Britain and Canada last week jointly announced low-interest rate auctions of cash and currency swaps worth a total of $64 billion.

But the move only exacerbated fears of a global financial meltdown, revealing the level of anxiety among central bankers over the precarious state of the US and European banking system. Stock markets in Europe turned downward amidst fears that the coordinated action was woefully inadequate to seriously address the crisis.

On Monday, the European Central Bank announced an even larger injection of capital, saying it would extend unlimited short-term credit to Eurozone banks in need of cash before year-end, when bank balance sheets must be closed out for the year. On Tuesday it reported that it had pumped over $500 billion into the financial system.

Many commentators are acknowledging that even such massive infusions of cash will only delay the inevitable reckoning resulting from years of vastly inflated home prices, which served as the basis for an explosive growth of inflated, speculative asset values. A very small layer of bankers, hedge fund managers, private equity executives and big investors raked in fabulous sums in the course of the speculative boom, while living standards for the vast majority of working people continued to stagnate or decline.

Writing in the *Financial Times* on Monday, Wolfgang Münchau said of last week’s coordinated central bank action: “The idea was that a coordinated response would reassure the markets, but it had the opposite effect. It turned out that market participants are not infinitely stupid. They know by now that this is not a liquidity crisis at its core. If it had been, it would be over by now.

"It is a fully fledged solvency crisis that has arisen because two giant and interlinked bubbles burst simultaneously—one in property, one in credit—leaving banks and investors on the brink of bankruptcy, some hanging on by their fingertips."

Fresh developments over the past week have substantiated this diagnosis. Last week, Vikram S. Pandit, the new chief executive of Citigroup, the largest US bank, announced that the bank would bail out seven affiliated investment funds, bringing their $49 billion in assets onto Citi's balance sheet. This move will inevitably result in further write-offs of billions of dollars in subprime mortgage-linked investments that have essentially collapsed.

The subprime-backed securities were held by Citi's structured investment vehicles (SIVs). These are off-balance-sheet and nominally independent entities that are, in fact, managed by the banks that sponsor them. Not subject to regulatory oversight, these funds engage in high-risk, high-yield speculative investments, generating profits by investing cash from the sale of low-yield short-term loans, called commercial paper, in longer-term, higher-yielding ventures. They depend on their ability to continually raise new cash from the sale of their commercial paper to pay off their short-term debt.

The implosion of the US housing market has undermined the SIVs, much of whose assets are tied to subprime mortgages. Unable to find buyers for their commercial paper, they have been forced to sell off assets at sharply reduced prices, and face full-scale collapse. Citi's seven SIVs have seen their nominal assets fall since August from $87 billion to $49 billion.

Under its previous CEO, Charles Prince, who was forced out at the beginning of November, Citi had insisted it had no financial responsibility for its SIVs and would not rescue them. This only further undermined confidence in the bank, which has reported some $11 billion in losses from subprime-linked investments.

Now that it has taken its dubious SIV assets onto its balance sheet, Citi will have to generate billions in cash to cover added potential losses. The bank's capital cushion is already well below that of its major rivals, and its woes were heightened when Moody's Investor Services, one day after the SIV announcement, downgraded the bank's long-term ratings, saying its expected the bank to report further losses.

Citi has already announced it is working on a major restructuring plan and is expected to announce large-scale layoffs. In addition, most Wall Street investors have concluded it will be forced to cut or entirely eliminate its stock dividend.

On Wednesday, Morgan Stanley, the second largest US investment bank, announced it was writing down an additional $5.7 billion in mortgage-related assets, bringing its fourth quarter write-off to $9.4 billion. The bank reported a loss from continuing operations of $3.9 billion for the fourth quarter ended November 30—its first ever quarterly loss.

At the same time, the bank said it was selling some $5 billion of equity units convertible into common stock to an investment arm of the Chinese government, in effect giving the Chinese state-run company a 9.9 percent stake in Morgan Stanley.

Morgan Stanley thus becomes the third major international bank to raise desperately needed cash by selling part of itself to Asian or Middle Eastern state investment entities. Last month Citigroup sold a 4.9 percent stake to Abu Dhabi's investment arm, and earlier this month the Swiss banking giant UBS, after announcing $10 billion in subprime-linked write-downs, sold stakes to the Singapore government and an unnamed Middle Eastern investor.

Also on Wednesday, Standard & Poor's said it may downgrade the AAA ratings of leading bond insurers Ambac and MBIA due to rising delinquencies and foreclosures on subprime mortgages. The ratings service also slashed the rating of ACA Capital, another bond insurer, from A to CCC, that is, junk bond status.

Merrill Lynch, Bear Stearns and other major banks are reportedly in talks to bail out ACA Capital, which has guaranteed $26 billion in mortgage securities.

The downgrading or collapse of major bond insurers would have a devastating impact on banks, whose insured securities would have to be downgraded or written off. It could have a whipsaw effect, leading to a collapse in confidence in the broader bond market and a bond market fire sale.

Most estimates place the total write-down of subprime-linked assets thus far at $90 billion, and many analysts predict that, before the dust settles, $400 billion will have gone up in smoke. According to Goldman Sachs economist Jan Hatzius, a loss on this scale could result in a reduction in lending of $2 trillion.

The *Financial Times*, commenting Monday on the accelerating financial crisis, wrote of the collapse of the "shadow" banking system. "A plethora of opaque institutions and vehicles," it wrote, "have sprung up in American and European markets this decade, and they have come to play an important role in providing credit across the financial system. Until this summer, structured investment vehicles (SIVs) and collateralized debt obligations (CDOs) attracted little attention outside specialist financial circles. Though often affiliated to major banks, they were not always fully recognized on balance sheets. These institutions, moreover, have never been part of the 'official' banking system: they are unable, for example, to participate in today's Fed auction."

The newspaper went on to quote Bill Gross, head of Pimco Asset Management Group, who recently wrote: "What we are witnessing is essentially the breakdown of our modern-day banking system, a complex of leveraged lending [that is] so hard to understand. Colleagues call it the 'shadow banking system' because it has lain hidden for years, untouched by regulation yet free to magically and mystically create and then package subprime loans in [ways] that only Wall Street wizards could explain."

It is this vast edifice of speculation, swindling and greed—driven by the contradictions and crisis of modern global capitalism—that is now imploding.