US Federal Reserve chairman warns of recession danger, promises more rate cuts

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US Federal Reserve Board Chairman Ben Bernanke warned Wednesday that the US economy is slowing dramatically and broadly hinted that the Fed would aggressively cut interest rates in response, perhaps before its next scheduled policy meeting at the end of January.

Bernanke's remarks reflect growing anxieties within US ruling circles, heightened by the continuing decline of share prices and mounting signs that the credit crisis, sparked by the collapse of the US housing market, is worsening. US banks are reporting tens of billions of dollars in write-downs of investments backed by subprime mortgages, and the increasing economic distress faced by millions of Americans is beginning to have a major impact on consumer spending.

Recession fears rose sharply last week when the US Labor Department reported that the official jobless rate shot up by 0.3 percent in December from the previous month, to 5 percent. The Labor Department report suggested that job creation had virtually ceased, with a net gain of only 18,000 jobs and an actual loss of 13,000 jobs in the private sector.

Reacting to worries about the financial stability of US banks and fears of a drop in consumer spending, the stock market fell sharply on Friday, with the Dow Jones Industrial Average closing down 246 points, or nearly 2 percent. Since the New Year, all of the US stock market indexes have plummeted, falling well below the ten percent decline from the previous high that denotes an official "correction."

Bernanke's speech marked a departure from the line of the December meeting of the Federal Open Market Committee (FOMC), the Fed's policy-making body. At that meeting, the Fed cut its key short-term interest rate, the federal funds rate, by a quarter point, the third consecutive rate cut since September. In its statement, however, the FOMC suggested that the risks of inflation were roughly equal to the risks of recession, indicating a reluctance to continue a policy of aggressive rate cuts.

On Wednesday, speaking in Washington, Bernanke went out of his way to make clear that the Fed now considers the greater risk to be a sharp contraction in economic activity. This is in line with the demands of major financial institutions and big investors, who are calling with increasing insistence for further rate cuts to pump more liquidity into financial markets and bail out banks, mortgage companies and other firms that have been caught dangerously short because of risky speculative investments made during the frenzied housing boom of previous years.

For the most part, Wall Street is demanding a rate cut of half a point this month, followed by further cuts to bring the federal funds rate down to 3 percent or even lower from its current level of 4.25 percent.

However, inflation is also on the rise, and the prices of basic commodities—from foodstuffs, to metals to oil—are soaring at record rates. Further interest rate cuts can only stoke inflationary pressures and further undermine the US dollar, which continues to fall sharply on global currency markets.

In his Wednesday speech, Bernanke began by noting that since late last summer "the financial markets in the United States and in a number of other industrialized countries have been under considerable strain." In a calculated signal to the financial markets, he declared, "We stand ready to take substantive additional action as needed to support growth and to provide additional insurance against downside risks...[I]ncoming information has suggested that the baseline outlook for real activity in 2008 has worsened and the downside risks to growth have become more pronounced."

Many economists are predicting that the official report on the growth in the US gross domestic product (GDP) for the third quarter of 2007 will come in at only 1 percent, or even less. Prominent figures such as former Federal Reserve Chairman Alan Greenspan and former Treasury Secretary Lawrence Summers are putting the chances of a recession this year at approximately 50 percent. A recent poll conducted by *The Wall Street Journal* found that on average economists placed the odds of a recessions at 43 percent, up sharply from 26 percent six months ago.

Bernanke placed the change in his assessment within the context of the financial and home foreclosure crises, which started in the US but have rapidly spread to other countries. He said the current crisis was set off by a decline in home prices. The most recent data show that both housing starts and new home sales continue to fall sharply.

The Fed chairman made reference to the way in which the speculative boom and bust of the housing market has placed millions of Americans in a highly precarious economic position. "When house prices were increasing at double-digit rates," he said, "subprime ARM [adjustable rate mortgage] borrowers were able to build equity in their homes during the period in which they paid a (relatively) low introductory ("teaser") rate on their mortgages. Once sufficient equity had been accumulated, borrowers were often able to refinance, avoiding the increased payments associated with the reset in the rate on the original mortgages."

The collapse of the housing market, however, has made this strategy impossible. As housing prices fell, Benanke noted, "borrowers could no longer rely on home price appreciation to build equity; they were accordingly unable to refinance and found themselves locked into their subprime ARM contracts. Many of these borrowers found it difficult to make payments at even the introductory rate, much less at the higher post-adjustment rate." As a result, there has been a surge in foreclosures.

What Bernanke did not spell out is the fact that lenders, including major Wall Street banks, lured homebuyers into taking loans they could not repay unless housing prices continued to soar. Mortgage originators sold these risky loans to banks, whose managers readily bought up the dubious assets, which were a source of high return so long as the speculative bubble in the housing market continued.

Subprime loans were "securitized," i.e., bundled and resold as mortgage-backed securities to other banks, insurance companies, pension funds and big investors in the US and around the world. The entire speculative enterprise was sustained by rating agencies such as Moody's and Standard & Poor's, which gave the subprime mortgage-backed securities "investment grade" ratings, including the highest triple-A rating. The *Wall Street Journal* has reported that Wall Street created in this manner over $2 trillion in inflated assets.

The subprime securities racket became a source of immense profits and a major contributor to the explosive accumulation of personal wealth by financial executives and market speculators.

Throughout all the years that the housing speculation was taking place, the government did nothing to rein in the process. On the contrary, official regulatory agencies such as the Fed encouraged it.

Now that the bubble is collapsing and millions of people are at risk of losing their homes, the Federal Reserve's answer is to attempt to bail out the banks and major investors by slashing interest rates and pumping tens of billions of dollars into the financial markets through auctions of credit at discounted interest rates. Such measures will do next to nothing to save millions of working families—including heavily indebted holders of prime mortgages—from falling into a financial abyss.

Even as he all but pledged that the Fed will continue to cut interest rates, Bernanke warned of the continued threat of inflation, placing particular emphasis on the danger of increasing demands from workers for wage increases. "In the months ahead we will be closely monitoring the inflation situation, particularly as regards inflation expectations," Bernanke said. "Inflation expectations" is, to a great extent, a Wall Street euphemism for growing wage demands.

A series of poor economic indicators have contributed to predictions of a recession. On Thursday, major retail chains reported very weak December sales.

Wall Street is also nervous about upcoming reports from banks and other corporations on fourth quarter financial data. Merrill Lynch has already announced that it will write down $15 billion in losses in mortgage-linked investments. Thomason Financial predicts that fourth quarter profits for financial companies will fall 72 percent.

American Express, a major issuer of credit cards, said it would write down $440 million in the fourth quarter due to missed payments—another sign that the credit crisis is far broader than just the housing market. The credit card company led the fall on Wall Street Friday, losing over 10 percent of its stock price. Shares of Capital One Financial, another major credit card company, also fell sharply.

In an attempt to shore up their balance sheets, US banks are increasingly turning to foreign investors for cash infusions. An article in the *Wall Street Journal* on Thursday, referring to Merrill Lynch and Citigroup, noted, "Two of the biggest names on Wall Street are going hat in hand, again, to foreign investors."

Merrill is expected to seek $3 billion to $4 billion from a Middle Eastern government to help it deal with its $15 billion loss. Citigroup is expected to seek $10 billion more, on top of the $7.5 billion deal it secured from Abu Dhabi in November.

On Friday, Bank of America announced a deal to buy Countrywide Financial, the nation's largest mortgage lender. Countrywide is facing bankruptcy due to the collapse of the housing market.

The acquisition, acquired at a steep discount, is an attempt by Bank of America to avert the consequences of a Countrywide bankruptcy. The bank had already sunk $2 billion into Countrywide, an investment that would be lost if the company failed. The effect, however, is to transfer to Bank of America the financial problems arising from Countrywide's aggressive selling of subprime and adjustable-rate mortgages.

There was much speculation on Wall Street and in the media that the US Treasury Department encouraged Bank of America to acquire Countrywide in order to avert a financial panic in the wake of the mortgage company's collapse.

The implications of the financial crisis for ordinary Americans was suggested by the announcement by Moody's on Thursday that it would reduce the United States government's credit rating within the next ten years unless deficits in such entitlement programs of Medicare and Medicaid were sharply reduced. This statement could be described as an injunction from Wall Street to the two big business parties and their presidential candidates to impose drastic cuts in benefits.

It underscores that the American ruling elite will respond to the economic crisis by seeking to place the burden of its economic problems—fueled by the speculative mania of Wall Street investors—upon the backs of working people.