US: Fed rate cut fails to stem recession fears

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The US Federal Reserve cut its target Federal Funds rate by .5 percent Wednesday, following the release of weaker-than-expected US growth statistics and amid concerns that more debt write-offs are on the horizon. US stocks failed to respond positively to the announcement, which brought the Federal Funds rate down to 3.0 percent.

The Fed's action comes just eight days after it cut rates by .75 percent at an emergency meeting last Tuesday. The combined adjustment of 1.25 points represents the sharpest change to the Federal Funds Rate since 1982, when the Federal Reserve had raised interest rates into the double digits as part of an aggressive anti-inflationary policy and then dropped them by almost ten points in two years. Wednesday's rate cut had been widely expected, with futures markets this week pricing in a 72 percent likelihood of a .5 percent reduction.

US stock indexes closed down after a volatile trading day. The Dow Jones Industrial Average fell by .3 percent, the Nasdaq by .4 percent, and the S&P 500 closed down by .5 percent. Stock indexes in Europe and Asia fell throughout Wednesday before the Federal Reserve made its announcement. Hong Kong's Hang Seng index fell 2.63 percent, and India's S&P/CNX 500 closed down by 2.35 percent.

The rate cut was partially outweighed by fourth-quarter growth figures released Wednesday, which indicate that the US economy grew last year at its slowest rate since 2002. US GDP grew at an annual rate of .6 percent in the fourth quarter of 2007, down from a rate of 4.9 percent in the previous quarter. The fourth quarter growth rate, which was only half the expected rate of 1.2 percent, serves as a further warning that the US is entering recession.

The growth statistics followed a report published Tuesday by the International Monetary Fund, revising its prognosis for world growth in 2008. While the US economy expanded by 2.2 percent in 2007, the IMF report expects growth to slow to 1.5 percent in 2008. Given the fact that the report was put out before the fourth-quarter growth statistics were available, even this figure is likely to be optimistic.

Most significant, however, is the extent to which the IMF expects a slowdown in the United States to affect the rest of the world. The report expects the European growth rate, which was 2.7 percent in 2007, to fall to 1.6 percent, only 0.1 percent higher than that of the US. Overall world growth is expected to slow to 4.1 percent, down from 4.9 percent in 2007 and 0.3 percentage points lower than what the IMF was expecting only three months ago. Simon Johnson, the IMF chief economist, noted that the slowdown in US consumer demand caused by the housing market decline would likely drag down the exports of emerging economies. "Reports of decoupling have been greatly exaggerated," he added.

The growth slowdown in the fourth quarter was largely driven by a rapid contraction in the housing sector, where a 16-year bubble has been rapidly deflating. Spending on housing fell by 23.9 percent in the fourth quarter, on top of a 20.5 percent decrease in the third.

In contrast to the weak overall growth figures, payroll statistics released Wednesday indicate higher-than-expected job growth for January. Virtually all of the growth, however, was in the service sector, with employment in the goods-producing sector falling by 11,000. The construction sector—hard hit by the freefall in the housing market—suffered its 14th straight month of decline, losing another 13,000 jobs. The number of US construction jobs wiped out since August 2006 is now approaching a quarter of a million.

Financial stocks were hard hit on Wednesday, after the Swiss bank UBS announced an additional $4 billion in write-downs in the fourth quarter, bringing its total

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to $14 billion. Furthermore, Standard and Poor's also announced Wednesday that it has or will cut ratings for some $534 billion worth of subprime-based securities. The credit rating cut is likely to put even more pressure on bond insurers already teetering on the verge of insolvency.

Meredith Whitney, an analyst at Oppenheimer Funds, told the *Financial Times* that she expects banks to write off up to $70 billion if bond insurance firms suffer declines in their credit ratings. "This is significant, as many investors are of the belief that the fourth quarter was a 'kitchen sink' for all outstanding capital hits this credit cycle," she said. "When it becomes clear that more charges are on the horizon, we believe the market will take another turn for the worse."

The Federal Reserve Board's rate-cutting policy has been met with nearly unprecedented dissension from within the board itself. Wednesday marked the fourth straight meeting when a member of the Federal Open Market Committee (FOMC) board voted against the majority. According to the Fed's statement, Richard Fisher, president of the Federal Reserve Bank of Dallas, preferred to keep the target federal funds rate at 3.50 percent, probably over of concerns about inflation.

Fischer has repeatedly warned about the inflationary risks in the US. In a recent speech given on January 17, he said, "One has to bear in mind that the seeds of inflation, once planted, can lie fallow for some time, then suddenly burst through the economic topsoil like kudzu, requiring a near-toxic dose of countermeasures to overcome." Wednesday's commerce department report raises concerns along similar lines, indicating that personal consumption spending, excluding food and energy, grew by 2.7 percent in the fourth quarter, up from 2.0 percent in the third.

Overall, there is a sense that the Federal Reserve is stuck between a rock and a hard place, and that the depth of the rate cut is indicative of the desperate predicament that the Fed finds itself in. According to many analysts, the Federal Reserve Board is attempting to re-implement its old tactic of avoiding a potentially explosive situation by pumping excessive liquidity into the financial system, with the consequent likelihood of creating another bubble. If it succeeds in doing so, it will at best only temporarily stave off a final reckoning at the cost of intensifying global imbalances.

As columnist Martin Wolf wrote in the *Financial Times* on Wednesday, "I find it impossible to look at what the US is now trying to do without feeling severely torn. If it succeeds it will renew and, at worst, exacerbate the fragility, both domestic and international, that triggered the turmoil. If it fails, the US and, perhaps, much of the rest of the world could well suffer a prolonged period of economic weakness. This is hardly a pleasant choice. But that it is indeed the choice shows how weakened the world economy and particularly the financial system has become."

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