US stocks plunge following Fed Chairman Bernanke's testimony before Congress

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Share prices on US stock markets fell sharply Thursday and Friday following congressional testimony by Federal Reserve Board Chairman Ben Bernanke.

The Dow Jones Industrial Average declined 112 points (0.9 percent) on Thursday and plummeted another 315 points (2.5 percent) on Friday, wiping out gains from the four previous trading days and leaving the stock index with four consecutive monthly losses.

The other major stock indexes also fell sharply on Friday, with the Standard & Poor's 500 index falling 37 points (2.7 percent) and the Nasdaq Composite index down 60 points (2.6 percent). With Friday's close, the S&P 500 index has suffered its worst start to a year since 1941.

Bernanke appeared Wednesday before the Financial Services Committee of the House of Representatives and Thursday before the Senate Banking Committee to deliver the Federal Reserve Board's semi-annual report to Congress. While saying he believed the US could still avert a recession, he presented a grim picture of an economy reeling from a housing collapse, a credit and banking crisis, a slowdown in consumer spending, growing unemployment and virtually zero economic growth, combined with accelerating inflation and a weakening dollar.

Bernanke made it clear he intended to slash interest rates again when the Fed's policy-making board, the Federal Open Market Committee, meets next on March 18. The Fed is expected to cut its federal funds rate by another 0.5 points, or even 0.75 points, which would be the sixth rate cut since last September. A 0.5 point reduction would bring the benchmark short-term rate down to 2.5 percent from its level of 5.25 percent last August, when the collapse of the US subprime mortgage market all but froze credit markets in the US and much of the world.

While Bernanke's signals in regard to interest rates reassured Wall Street banks and investors, who have been pushing for rate cuts to pump liquidity into financial markets and aid banks facing billions in subprime-related losses, the gloomy substance of his testimony, combined with new recessionary indicators and record-high crude oil prices, sparked the sell-off of stocks.

In opening his remarks to the House committee, Bernanke said the economic situation had become "distinctly less favorable" since his previous report to Congress in July. He then cited persistent "strains" in financial markets, turmoil in credit markets leading to "tighter credit for many households and businesses," a sharp contraction in economic growth, a decline in job creation and growth of unemployment.

He indicated that the collapse in the housing market would continue to weigh on the economy for at least another year and noted that consumer spending had slackened markedly since the end of 2007. He predicted that business investment would slow in the first half of 2008, and that nonresidential construction would "decelerate sharply."

He projected a rise in the unemployment rate from the present 4.9 percent to 5.2 percent or 5.3 percent by the fourth quarter of this year.

He then warned that the reality could turn out considerably worse than his projections, citing the possibility that the housing market or the labor market could deteriorate more dramatically and that the credit crunch could worsen.

He took note of rising inflation and soaring energy and commodity prices and said the Fed would "monitor closely inflation and inflation expectations." But he clearly placed the emphasis on the dangers of recession, saying the Fed would "act in a timely manner as needed to support growth and to provide adequate insurance against downside risks"—a euphemistic way of saying the Fed was prepared to cut interest rates further.

In his appearance the following day before the Senate Banking Committee, Bernanke said that the US economy faced a more difficult situation than in the aftermath of the dotcom stock market crash in 2001. He noted that the US was then running a budget surplus, that the US dollar was strong, and that inflation was low. He pointed out that in 2001, crude oil was selling at $20 a barrel, as compared to $100 a barrel today.

Today, the federal government is running huge budget deficits and the US dollar is weak and growing weaker. As a result, he said, “Congress and the Fed have less freedom to combat economic weakness...”

He added, in a remark that reverberated through both US and international markets, that “there will probably be some bank failures.” He said he had confidence that none of the major banks would collapse, but suggested that some smaller banks would inevitably fail.

Bernanke’s testimony had an immediate impact on global currency and commodity markets. His virtual pledge to continue cutting US interest rates, as well as his gloomy assessment of economic conditions, produced a sharp fall in the dollar. On Thursday, the dollar hit a record low against the euro, closing at $1.52 per euro. It also fell to a record low against the Swiss franc and a three-year low against the Japanese yen.

Over the past six years, the dollar has fallen more than 40 percent against the euro and more than 20 percent against a basket of currencies. With its decline this week, it fell to its lowest level since the US allowed the dollar to float freely in 1973.

The sinking dollar led Thursday to a $2.95 jump in the price of crude oil, which is traded in dollars, with the price-per-barrel settling at a record-high $102.59 on the New York Mercantile Exchange. Gold, corn and soybeans also hit or approached new highs, with gold closing at $970.74 an ounce.

The decline in the dollar, the world’s preeminent reserve and trading currency, has led to a sharp increase in commodities speculation, contributing to an upsurge in basic commodity prices. So far this year, natural gas prices have risen by 26 percent, coal has increased by 56 percent, platinum is up by 41 percent, wheat prices have jumped 32 percent, and cocoa has gone up by 38 percent.

The upward spiral in world commodity prices is increasingly hitting consumers in the US in the form of sharply higher costs for gasoline, home heating and food. Last week, the US Labor Department reported that the Consumer Price Index had risen in January by 4.3 percent over a year ago, and this week government figures showed a jump in producer, or wholesale, prices for the month of 7.4 percent compared with a year ago. This was the worst year-to-year increase in producer price inflation since 1981.

The signs of growing inflation coincided with a series of economic indicators suggesting an existing or imminent recession:

* The Labor Department reported that first-time unemployment claims rose last week by 19,000, to 373,000, the highest level since late January. Economists had expected an increase of only 4,000.

* The government confirmed that the gross domestic product rose by only 0.6 percent in the fourth quarter of 2007. The GDP for all of 2007 rose by only 2.2 percent, the weakest performance since 2002.

* The National Association of Realtors reported that sales of previously owned homes fell for the sixth consecutive month in January, dropping 0.4 percent. Median home prices also continued to fall, declining by 4.6 percent from a year ago.

A different index of home prices, the Standard & Poor’s/Case-Shiller index, which measures home prices in twenty metropolitan areas, reported a decline in December of 9.1 percent from a year ago, and projected an annual rate of home price declines of 20 percent.

* Two reports on consumer confidence showed sharp declines in January.

* Other reports showed consumer spending barely keeping pace with inflation and a sharp decline in business activity in the Chicago region.

Markets were further shaken by reports of more losses from the collapse of the mortgage market and the resulting banking crisis. Fannie Mae, the government-chartered mortgage-financing giant, reported a fourth quarter loss of $3.56 billion. The next day its smaller rival, Freddie Mac, reported its own fourth quarter loss of $2.5 billion and warned that it expected to lose billions more.

Financial analysts on Friday predicted that US and European banks stood to lose an additional $350 billion from the collapse of subprime-linked securities. On the same day, American International Group, the world’s largest insurance company, reported a record fourth-quarter loss of $5.29 billion, resulting mainly from a write-down of $11.12 billion in insurance contracts tied to mortgages.

An additional factor in the sell-off of financial stocks was a statement by Treasury Secretary Henry Paulson, seconded by President Bush at his Thursday press conference, rejecting proposals being worked out between Wall Street banks and Democratic legislators for a government-funded bailout of mortgage lenders, banks and financial institutions that are holding tens of billions in bad investments linked to subprime and other shaky mortgages.