

In the wake of the Bear Stearns collapse

US Federal Reserve cuts interest rates again

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In a further move aimed at easing the credit crisis and propping up US banks, the Federal Reserve Board on Tuesday cut the federal funds rate, the key short-term interest rate, from 3 percent to 2.25 percent.

This is the Federal Reserve's sixth rate cut since September of last year, slashing a full 3 percent from the target rate for short-term inter-bank loans. The Fed also cut the discount rate, the rate it charges banks for direct loans, from 3.25 percent to 2.5 percent.

Interest rate futures markets and many financial commentators had indicated they were expecting cuts of 1 percent in both the federal funds and discount rates. However, after a brief 150-point plunge following the Fed's announcement, the stock market rallied sharply, with the Dow Jones Industrial Average closing at 12,391.52, up 419.27 points, or 3.5 per cent, for the day.

The Fed's rate cuts came one day after it brokered and largely financed the takeover of Bear Stearns, the fifth largest US investment bank, by JP Morgan Chase. The fire sale of Bear Stearns, which was on the verge of filing for bankruptcy protection, followed a week of unprecedented moves by the Fed to stave off a broader collapse in financial markets by offering huge loans, not only to commercial banks, but also to investment banks and brokerage houses, in return for billions in mortgage-backed securities that have plummeted in value since the collapse of the US housing market.

By agreeing to swap Fed funds for potentially worthless mortgage bonds, the Fed intervened into the financial system in a manner not seen since the Great Depression of the 1930s. It only convinced JP Morgan Chase to take over the bankrupt Bear Stearns by agreeing to insure some \$30 billion in illiquid assets held by the 85-year-old investment bank.

This means that the Fed is pledging its own funds to

bail out financial houses and commercial banks that have been staggered by billions of dollars in losses from the collapse of mortgage-backed securities and other risky investments. Ultimately, the cost will be borne by US taxpayers in the form of curtailed remittances from the Fed to the US Treasury.

More than the Fed's interest rate cuts, these extraordinary moves to bail out Wall Street accounted for the euphoria, however short-lived, that prevailed on the stock exchanges Tuesday.

That deep anxieties and uncertainty remain was indicated by a front-page article in Tuesday's *Wall Street Journal*, which began: "The past six days have shaken American capitalism."

Share prices for the stock of investment banks Goldman Sachs and Lehman Brothers rose substantially despite first quarter reports that showed sharp declines in earnings from the previous year and billions more in mortgage-related write-downs. This was because the market had feared even worse results.

Lehman Brothers, in particular, has been the subject of growing default rumors largely because it, like Bear Stearns, is based largely on business related to the underwriting of subprime mortgages. At the end of last week, some clients began withdrawing funds and creditors indicated they might stop lending money to the firm.

Goldman Sachs' profits fell 53 percent compared to 2007, and the firm wrote off another \$ 2 billion in bad investments. Lehman Brothers reported a fall in profits of 57 percent and an additional \$1.8 billion in write-downs.

The new interest rate cuts can only exacerbate the decline in the dollar, which has already fallen to record or near-record lows against the euro, the yen and other currencies. There are already signs that the dollar's

plunge is having serious effects on the financing of US trade.

As the dollar falls, foreign investors suffer losses on the money they invest in the US to finance the US' current account deficit. Carlos Asilis of Glovista Investments told the *Wall Street Journal*, "The whole world is focused on the financial crisis and the US is really the epicenter of the tension. As a result, we're seeing capital flow out of the US."

The *Wall Street Journal* commented: "That is a troubling prospect for a savings-short, debt-heavy economy that relies on \$2 billion a day from abroad. [...] But while foreign cash continues to pour into the US from abroad, this flow has been slowing. In 2007, foreigners' net acquisitions of long-term bonds and stocks in the US was \$596 billion, down from \$722 billion in 2006, according to Treasury Department data."

According to a new US Treasury Department report, January inflows dropped to \$37.4 billion from \$72.7 billion in December—not enough to cover the \$58.2 billion trade deficit.

Such concerns explain why the 0.75 percent rate cut was controversial in the Federal Reserve's policy-making Federal Open Market Committee. Two of the ten members—Richard W. Fisher of the Federal Reserve Bank of Dallas and Charles I. Plosser of the Federal Reserve Bank of Philadelphia—voted against the action, specifying they would have preferred a smaller rate cut.

Economic data reported Monday and Tuesday pointed to the growing impact within the broader economy of the financial turmoil shaking Wall Street.

A government report released Monday showed an unexpectedly steep decline of 0.5 percent in February US manufacturing activity. US retail sales fell 0.6 percent, led by falls in consumers' purchases of furniture, appliances, and automobiles. Car production fell 1 percent, and utilities production fell 3.7 percent.

Housing starts fell 0.6 percent in February, according to US Commerce Department data. Building permit activity, a sign of future construction plans, fell 7.8 percent to a rate of 978,000 units per year, the slowest since September 1991.

Inflation is also rising. The core producer price index rose 0.5 percent last month—an annual rate of 6.2 percent—surpassing Wall Street's expectations of a 0.2 percent increase.

US airline companies, hit by soaring fuel prices, announced major cutbacks and job reductions. Delta Airlines said it would offer early retirement buyouts to 30,000 employees, adding that it would eliminate at least 2,000 jobs through layoffs if it failed to achieve sufficient staff cuts through buyouts.

It also said it would ground up to 45 planes and eliminate 10 percent of its transport capacity inside the US. United Airlines also announced plans to ground up to 20 planes.



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