US: New bank losses shake financial markets

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Lehman Brothers announced a projected $2.8 billion second-quarter loss on Monday, its first since going public in 1994. The Wall Street firm concurrently announced its intentions to raise $6 billion of capital and reduce its reliance on borrowed funds.

Both Moody's and Fitch Ratings downgraded Lehman's creditworthiness in response to the announcements. The investment bank's stock has fallen sharply since last Friday.

The losses at Lehman's were coupled with Monday's announcement by Standard & Poor's that it had cut the AAA credit ratings of bond insurers MBIA and Ambac Financial Group, effectively lowering the credit ratings of some $100 billion in debt. Analysts, meanwhile, announced that they expect Washington Mutual, the United States' largest savings and loan association, to suffer mortgage losses of some $21 billion over the next three years. The firm's stock has tumbled by 34 percent over the past two weeks.

Erin Callan, Lehman Brothers' chief financial officer, played down the current risks to the bank's balance sheet, but said that the capital-raising was engineered to "end the chatter about Lehman Brothers." The "chatter" is persistent speculation that the firm is teetering on the brink of insolvency.

At the time of the March 14 bailout of Bear Stearns by the Federal Reserve Board, it was widely believed in US financial markets that Lehman Brothers would soon follow Bear Stearns into bankruptcy. The Fed's decision to extend direct loans to investment banks—something unprecedented since the Depression of the 1930s—was in part prompted by fears that a Lehman failure would trigger a wave of Wall Street collapses and a general financial meltdown.

Lehman, the smallest and most vulnerable of the major US investment banks, was among the major beneficiaries of the new Fed policy, and used the loans to temporarily stabilize its positions.

Lehman Brothers is attempting to trim its leverage—the ratio of its assets to borrowings—from 32 to one to 25 to one. The firm had previously been able to provide high returns to its shareholders by using the easy credit conditions that then prevailed to make very large investments with borrowed money.

This approach has become unviable as credit has dried up, leaving Lehman with what appears to be a crisis of both short-term and long-term profitability. Within financial circles there is talk that a further deterioration of credit conditions could result in more bank failures along the line of Bear Stearns, and Lehman Brothers is generally considered to be the most endangered.

Of the big Wall Street investment banks, Lehman remains the most closely tied to mortgage-backed securities and speculation in leveraged corporate buy-outs—two markets that have imploded since last summer. The firm's announcement served as a rude awakening to markets that the banking crisis is by no means over, and that more Federal Reserve bailouts may be in the offing.

The Federal Reserve has made clear its intention to prevent the failure of major Wall Street firms, ultimately with public funds. There are those within the financial establishment who see large-scale bailouts as detrimental to financial stability in the long run.

A criticism along these lines was put forward June 5 by Jeffrey Lacker, president of the Federal Reserve Bank of Richmond, who observed: "The danger is that the effect of recent credit extension on the incentives of financial market participants might induce greater risk-taking, which in turn could give rise to more frequent crises, in which case it might be difficult to resist further expanding the scope of central bank lending."

Lacker's public dissent, coming on the same day as a major speech by Fed Chairman Ben Bernanke, is highly unusual, and underscores the internal tensions and

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divisions fueled by the ongoing financial crisis.

The cheap and abundant credit injected into the financial system by the Fed's policies has contributed to an inflationary upsurge in the United States and internationally and accelerated the fall of the dollar relative to the euro, the yen and other major currencies. This depreciation has in turn fueled the eruption of oil prices and rampant speculation in commodities prices.

In a speech delivered June 3, Bernanke said that the Federal Reserve would take measures to fight inflation and prop up the dollar. This led to a temporary strengthening of the US currency, but by Friday markets panicked in response to the release of higher-than-expected US unemployment figures. Investors dumped dollars and poured into commodities futures, driving the price of oil up $10 in a single day.

Bernanke again attempted to take an anti-inflationary stand on Monday evening, telling a conference in Massachusetts that the Fed will "strongly resist an erosion of longer-term inflation expectations, as an unanchoring of those expectations would be destabilizing for growth as well as for inflation."

Asian markets tumbled at the announcement on Tuesday, with China's stock index falling 8 percent. China's currency is unofficially pegged to the dollar, and is especially responsive to US policy. The country is also experiencing significantly higher inflation, which has reached an annual rate of 8 percent and has resulted in negative real interest rates.

The European Central Bank (ECB) showed no signs that it would cooperate with the Fed's new exchange rate policy. Last week, ECB President Jean-Claude Trichet indicated that the central bank would raise its interest rate by 0.25 percent, undercutting a short-lived rally of the US dollar on currency markets.

The conflict between the Federal Reserve and the European Central Bank is in many ways unprecedented. As Wolfgang Münchau of the *Financial Times* noted, "In the past, European central bankers tended to follow the US Federal Reserve, often with delay, never perfectly, but generally in the same direction."

A major and common aim of both the Fed and the ECB is to soften the labor market through job-cutting, in order to prevent the development of a wages movement by workers seeking to offset soaring fuel and food costs. The US unemployment rate has increased for five straight months, culminating in last week's announcement that the official jobless rate jumped from 5 to 5.5 percent during the month of May.

Long-term layoffs have increased significantly over recent months, spearheaded by job cut announcements at major airlines, which have eliminated 22,000 jobs this year alone. The trend is by all indications accelerating, as indicated by recent figures showing that planned layoffs increased by 15 percent in May over April.

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