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Dollar plunges after record rate cut by US Federal Reserve

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Global Research, December 20, 2008
World Socialist Web Site 19 December 2008

Region: USA
Theme: Global Economy

In the two days since the Federal Reserve Board cut its benchmark interest rate to a record low range of 0 to 0.25 percent and announced that it will supply an unlimited amount of liquidity to near-frozen credit markets, the US dollar has fallen sharply on world currency markets. The panic sell-off of dollars is an expression of falling confidence in the solvency of US financial institutions and the credit-worthiness of the American currency, and mounting fears that the recession that began with the collapse of the US housing and credit markets could develop into a full-blown depression.

The Fed's unprecedented move, widely described by commentators as a "shock and awe" action, has evoked both relief in financial circles that the US government is prepared to take extraordinary measures and fears that it represents a desperate and reckless move with potentially disastrous implications for the US and world economy.

In essence, the Fed tacitly acknowledged Tuesday that the US economy is breaking down under the weight of trillions of dollars of bad debt and could enter into a deflationary spiral similar to that which took place in the Great Depression of the 1930s. It made clear that it will print an unlimited volume of dollars to buy mortgage-backed securities, credit card debt, car loans and even long-term bonds issued by the US Treasury in an attempt to get banks to begin lending once again to businesses and consumers.

This is the financial equivalent of emergency triage on an expiring patient. It means a massive increase in US indebtedness and a further dilution in the value of the US dollar, a recipe down the road for an explosive growth of inflation, a further decline in the world economic position of American capitalism, and the further impoverishment of large sections of the US population. It takes place under conditions where US private sector gross debt has already soared from 118 percent of gross domestic product in 1978 to 290 percent this year.

The fact that the Fed, whose core legal mandate is to maintain the stability and value of the dollar, is nevertheless prepared to take such action is an indication of growing alarm over the depth of the economic crisis and the rapidity with which it is developing.

On Wednesday, the euro jumped as much as 4 cents against the dollar, the biggest single-day move since the euro was launched in 1999. The dollar plunged against the yen to its lowest level in 13 years. The dollar also fell in relation to the British pound and the Swiss franc.

In the space of two hours Wednesday, the euro soared from $1.4058 to an 11-week high of $1.4440. The dollar gained back some ground against the euro on Thursday, closing at

$1.4180, after the European Central Bank moved to stem the rush from dollars into euros by cutting its interest rate on deposits from 2.0 percent to 1.5 percent. However, the dollar continued to fall against the yen. Gold futures surged.

Only a month ago the euro was at $1.24. In just the two days since the Fed's announcement, it has jumped nearly 7.5 percent.

US stock markets, which had a sharp rally Tuesday after the Fed announcement, fell back on Wednesday and Thursday. The Dow Jones Industrial Average fell 99 points Wednesday and 219 points Thursday, giving up most of its gains from Tuesday. The retreat reflected mounting concerns over the implications of the Fed's actions as well as new economic data indicating a continuing surge in joblessness and a further contraction in the economy in the coming months.

Financial commentators in both the US and abroad expressed concern over the deeper significance of the Fed's moves. The Financial Times published a lead editorial Thursday entitled "The Fed Rips Up the Rule Book," which began, "We are flying blind."

It continued, "The Federal Reserve's announcement this week that it was abandoning conventional rate measures in favour of directly propping up lending represents a bold experiment in policy. Ben Bernanke, Fed chairman, is taking a gamble, but he had little choice…

"The US real economy is crumbling and continues to deteriorate, the global downturn has been exacerbated by a crippled domestic financial system. Credit is not flowing to consumers and businesses because risk spreads are too high…. Restoring credit may be the Fed's primary aim, but its measures are also an insurance policy against falling into a deflationary spiral… As growth returns, inflation might come back with a vengeance."

A report by Credit Suisse Group said the Fed's "easing and very low US rates will ultimately undermine the dollar across the board."

C. Fred Bergsten, director of the Peterson Institute for International Economics, wrote, "The risk is that the deceleration of the dollar could cascade and push interest rates up as the rest of the world demands a higher return on US investments."

Nouriel Roubini of the Stern School of Business at New York University summed up the Fed's actions as follows: "Traditionally, central banks have been the lenders of last resort, but now they are becoming the lenders of first and only resort. As banks curtail lending to each other, to other financial institutions and to the corporate sector, central banks are becoming the only lenders around.

"Likewise, with household consumption and business investment collapsing, governments will soon become the spenders of first and only resort, stimulating demand and rescuing banks, firms and households. The long-term consequences of the resulting surge in fiscal deficits are serious."

The backdrop to the Fed's action is a raft of economic data showing an accelerating economic decline. Earlier this week there were reports showing a continuing fall in industrial production, a record drop in homebuilding and a record decline in consumer prices. These deflationary indicators were supplemented by a fall in crude oil prices below $36, despite a record production cutback announced Wednesday by OPEC, another massive increase, 554,000, in first-time jobless benefit applications for the week ended December 13, and the Conference Board's report that its leading economic indicators gauge of future economic performance posted its biggest annual fall since 1991 in November, dropping 3.7 percent from the year before.

JPMorgan Chase analysts now estimate that the global economy will contract at a 3.7 percent annual rate this quarter and a 2.3 percent pace in the first quarter of 2009, marking the worst six-month period for the world economy since World War II.

Every day brings multiple announcements of job cuts across all branches of the private sector US economy. Such announcements over the past few days include 1,000 jobs at the insurance company Aetna, 2,500 jobs at hard-drive manufacturer Western Digital, 800 jobs at Caterpillar's Mossville, Illinois engine plant, and hundreds of layoffs at Ford's Flat Rock, Michigan plant, American Apparel in Los Angeles, Cooper Tire and Newell Rubbermaid.

The Fed's massive injection of liquidity into the financial markets does not address the underlying causes of this downward spiral. The crisis is not one of liquidity, but of solvency. Decades of rampant speculation and outright fraud based on cheap credit and an expansion of debt, facilitated by government deregulation of the banks and financial markets, have produced a vast edifice of paper values that is now collapsing.

There is a general erosion of confidence in the credit markets. The basic problem is not the cost of credit, but the fact that banks and other financial institutions refuse to lend to one another, to other businesses and to consumers because they have no confidence in the financial viability of prospective clients.

At the heart of this crisis is the internal decay of American capitalism, marked above all by the dismantling of large sections of its manufacturing base, and the decline in its global economic position. A longstanding crisis of profitability in industry has led to a separation of wealth accumulation by the financial elite from the productive process and a massive growth of financial parasitism. There is no genuine solution to this crisis within the framework of the capitalist market system—only ever more brutal attacks on the jobs and living standards of the working class, combined with a growth of militarism and war.

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