“To the Bunkers!”: Central banks slash rates in emergency “midnight” meeting

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Stocks fell sharply across Europe and Asia on Wednesday following another down day on Wall Street where the Dow Jones lost 508 points and the S&P 500 slipped below the 1,000 mark for the first time since 2003. Japan’s benchmark index, the Nikkei, lost nearly 10 percent while shares in London at one point slumped more than 7 percent. Trading was suspended in Indonesia and Russia where stocks fell 10 percent each on opening.

According to Bloomberg News: “The Federal Reserve, European Central Bank, Bank of England, Bank of Canada and Sweden’s Riksbank cut interest rates in an emergency coordinated bid to ease the economic effects of the financial crisis.”

The move by the Fed’s Open Market Committee (FOMC) brings the Fed’s Fund rate down to 1.5 percent, 500 basis points below the current rate of inflation.

Following yesterday’s 508 point bloodbath, President George Bush tried to calm jittery investors about the turmoil in the markets. He said, “I know that the days are dim right now for a lot of folks. But I firmly believe tomorrow is going to be brighter.”

Just hang in there.

The present crisis, which has its roots in the unsupervised expansion of credit in the United States, has spread from subprime mortgages and toxic securities, to the entire global financial system, where it has roiled equities markets and is now threatening to do incalculable damage to the US and European banking systems.

Yesterday, Fed chairman Ben Bernanke announced plans to pump an estimated $1 trillion of short-term loans (commercial paper) into the financial system to head off a growing liquidity squeeze. Unlike, Treasury Secretary Paulson’s $700 billion bailout, which was opposed by over 200 economists, Bernanke’s plan targets the source of the problem and could actually succeed. (ed: Commercial paper is a low-cost source of cash for companies to meet short-term financial needs. It’s cheaper than tapping a line of credit at a bank) The Fed will start providing businesses and financial institutions with the short-term credit they need to maintain normal day-to-day operations. The Fed is invoking emergency powers under its “unusual and exigent circumstances” clause in order to avert an even larger shock to the financial system beyond the wreckage in the stock market and hundreds of bank closures that are expected into 2010. Providing unsecured loans directly to businesses is controversial, but necessary. If these corporations and financial institutions fail just because they cannot roll over their short term debt, the overall damage to the economic system could be devastating

In yesterday's speech, Fed chairman Bernanke gave a gloomy summary of present economic conditions:

"Economic activity had shown signs of decelerating even before the recent upsurge in financial-market tensions. As has been the case for some time, the housing market continues to be a primary source of weakness in the real economy as well as in the financial markets. However, the slowdown in economic activity has spread outside the housing sector. Private payrolls have continued to contract, and the declines in employment, together with earlier increases in food and energy prices, have eroded the purchasing power of households. This sluggishness of real incomes, together with tighter credit and declining household wealth, is now showing through more clearly to consumer spending. Indeed, since May, real consumer outlays have contracted significantly. Meanwhile, in the business sector, worsening sales prospects and a heightened sense of uncertainty have begun to weigh more heavily on investment spending as well."

The US is caught in a deflationary downdraft that could have catastrophic long term effects. That's why Bernanke has pulled out all the stops and doubled the Fed's loans (via auction facilities) to banks to $900 billion while allowing financial institutions to use mortgage-backed securities and other dodgy structured investments as collateral. The Fed has also started paying interest on reserve balances held at the central bank. This helps to push down the overnight lending rate below the Fed Funds rate which helps to reliquify the banks.

John Ryding, chief economist of RDQ Economics LLC in New York, called the practice, "stealth easing", another attempt to flood the markets with credit and get the economy moving. Will it work?

Bernanke has a good idea of the nearly-insurmountable challenges in front of him. Apart from the faltering banking system, the collapse in real estate, and the unwinding of trillions of dollars of counterparty bets via derivatives contracts; Bernanke faces the sudden capitulation in consumer spending. The US consumer is tapped out on credit card debt, student loans, car loans and home mortgages. Retail spending is falling and likely to get worse. Bernanke's plan to recapitalize the banking system ignores the larger issue that less people will be applying for loans and that less credit will be flowing through the system. Slower growth is inevitable. The sudden change in spending patterns is evident everywhere. Personal savings are increasing, home equity withdrawals are down (to nearly zero) and the new reality of "living within one's means" is becoming the prevailing ethos. America is hunkering down.

"Big discounts fail to lure shoppers," reports the Wall Street Journal . Restaurants are empty. Shopping malls are not even attracting strollers and gawkers – let alone people with money to spend. Auto lots are so quiet the salesmen take turns pretending to be customers – just to keep their skills at-the-ready. Even the private jet business is in a tailspin." (The Daily Reckoning)

Personal consumption is down, unemployment is rising, manufacturing is slowing, and commodities have taken a record plunge in the last few weeks. The telltale signs of deflation are everywhere.

According to economist Asha Bangalore at Northern Trust:

"The July-August data point to a possible drop in consumer spending during the third quarter. If the forecast is accurate, it would be the first quarterly decline since fourth quarter of 1991. Given the importance of consumer spending in GDP, a drop in consumer spending in the third quarter raises the probability of a contraction in real GDP in the third quarter."

9 out of 10 Americans now believe the country is headed in the "wrong direction" economically, while, according to CNN/Opinion Research Corp. poll, which surveyed more than 1,000 Americans over the weekend, a majority of people now "believe another economic depression is likely" and that we will experience "25% unemployment rate, widespread bank failures and millions of Americans homeless and unable to feed their families."

The good news is that inflationary pressures have eased. The bad news is…well…everything else.

From the Fed's 7 AM, October 8, 2008, Press Release, "Joint Statement by Central Banks":

"Incoming economic data suggest that the pace of economic activity has slowed markedly in recent months. Moreover, the intensification of financial market turmoil is likely to exert additional restraint on spending, partly by further reducing the ability of households and businesses to obtain credit. Inflation has been high, but the Committee believes that the decline in energy and other commodity prices and the weaker prospects for economic activity have reduced the upside risks to inflation."

The United States is headed into another Great Depression and has probably dragged the rest of the world along with it. The global financial system will look very different by the time we reach the other end of the tunnel.