

The Other Side of the Street December 7, 2008

This is too important to leave in the body – this issue is huge and will be perhaps the most important story of 2009. The bottom line is that interest rates are absurdly low relative to risk and the U.S. government can't force others to finance its problems.

November 30 2008 FT Fears are rising over the ability of governments to raise the vast amounts of debt they need to pay for economic stimulus packages and bank bail-outs. Faced with the prospect of governments around the world issuing more than €2,000bn (\$2,535bn) of bonds in the next year, bankers are warning of potential problems in meeting funding needs. Roger Brown, global head of rates research at UBS, said: "Governments are already running into problems, which does not bode well so early after the recapitalisations and extra funding needs have been announced. **We do have to ask whether there will be enough investors to buy the bonds, or at the very least over whether this will push yields substantially higher to attract them.** "Given the volumes involved investors may decide to wait and see if yields rise. There is no need to rush to buy the first issues as plenty more are coming." The rush of bond issues comes against a background of record low yields in some countries because of recession and fears of deflation. Last week, 10-year bonds in both the US and the UK fell to 50-year lows. However, faced with contracting economies, lower tax receipts, and rising benefit payments, **countries could face higher debt-servicing costs as overall debt levels rise.** The UK and Italy may face the greatest difficulties. The UK is expected to issue £10bn (\$15.3bn) of bonds in December. In the past, monthly volumes have averaged about £2bn a month. The government is also expected to issue £60bn in the remainder of the financial year to the end of March – more than it would previously issue in an entire year. In Italy, bond issuance could rise to €220bn next year, with €100bn in redemptions in the first half of the year – about €20bn higher than usual – putting the government under even more pressure to raise money. **Even in the US and Germany, which have the most liquid bond markets in the world, there have been some warning signs. In Germany, a bond auction failed in November, something virtually unheard of until this year, while in the US some analysts say yields could start to rise because of about \$1,000bn in bonds in the pipeline next year. It is significant that problems have emerged in auctions for shorter-dated securities, which are usually the easiest to sell.** Towards the end of November, the UK and Italy were forced to pay higher yields to attract investors in bond auctions for four and three-year paper, respectively, compared with similar existing debt. The Italians also scaled back the amount of bonds on offer. **Concerns mount on ability to fund state debt** <http://www.ft.com/cms/s/0/eb690be2-bf0f-11dd-ae63-0000779fd18c.html>

Comments

Nov 30 - This Pearl Harbor Day plus 67 years finds me in Michigan. Accordingly, these notes will be out effective December 5. As I am typing this paragraph it is November 30 and the week is a blank canvas. Should the week end up, particularly with a rally Friday, one might expect the coast to be fairly clear for a year end jam job. One thing is for sure, the adults will be gone as of December expirations, which is December 19. The last two weeks will be a good time to enjoy the holidays as NOTHING worth watching will happen on Wall Street. However, the Grinch Dog will be looking at all the January gifts piling up. At this point, my best guess would be that ALGT will be jammed like the momentum darling it is. This will leave an

unbelievable shorting opportunity in the mid-high 50s. (it is now at 43). A short at such prices will return a minimum of 50% next year. And who says I don't give presents ☺

December 2 evening – well, 2/5ths into the week, we have a huge drop followed by a remarkable 250 point jam job in the last 45 minutes today. So, what do we know? Answer – not much. However, I have a few observations

- The idea that there was in some way more “consumer spending” this last weekend and in fact it would be the highest of all time, flies in the face of anecdotal evidence as well as simple logic. Ask yourselves if you were out and about, how crowded were places you saw. I've asked friends in multiple large cities as well as observing myself and I would say the volume of people out last Friday was at best half of what I have seen. OK, so what about the “statistics”. Well, they are based on a survey of 3000 people and I have to believe the sample was either tainted in some way or questions asked differently. Further, CNBC featured numerous shopping arbitragers who claimed they were buying the bargains to resell them on E-Bay. How this impacts spending nationally I do not know. However, I do know that during the recently deceased Real Estate boom there were tens of millions of new RE “investors” who simply saw \$\$ signs instead of reality. So . . . was the “increased spending” lots of wanna be resellers who instead of actually being buyers are now competition with the stores that in essence gave away the stuff in the first place? Impossible to know, but a good question to ponder.
- Next, the sole consensus I can see from the pundits is that it is poison to be short right now. I have yet to find anyone who is stating anything contrary (and to a large extent I somewhat share this view due to the seasonality). However, once things become the thinking of the group, the one thing likely to happen is NOT what is expected. So . . . I wonder where the short squeeze is going to come from. Are there really large amounts of untapped wealth just dying to jump into the market in the last 29 days of the worst year in anyone currently tradings professional career? Isn't it more likely that those still sitting on huge chunks of money are doing so because they have been risk adverse? Does this crowd suddenly decide they can't wait another 29 days for further clarity in economics? . . . So, is this feared short squeeze actually tremendous wishing and hoping from the tens of thousands who will be fired at year end? Once again I do not know, but I am becoming more reluctant to sit on the sidelines out of fear.
- More on the short squeezers . . . so if in fact some stock has been beaten into the ground this year, is it not full of wishers and hoppers who might finally throw in the towel for tax reasons particularly if they sold commodities and huge gains to offset? And while on the tax idea, let's say you have been working a great short all year. Do you now say let me cover just before year end so I can trigger a big tax gain?
- Well what about the quant funds? Today's last 45 minute jam job sure looked like the momo quant guys of old. Is this the start of the Santa rally? Maybe, but

more likely anyone trying to trade momentum has been crushed. If you are down 60% but somehow still have investors, do you try to get back 10% at year end or do you simply sit it out until January and thus be ready to “out perform in the new year?” Once again, questions and not answers

- This can go on many more paragraphs, so I will simply summarize that I can think of lots of reasons why we keep going down and very few why we will have a huge rally in the next 3 weeks. Maybe I’m the sucker in this. We will see. However, I am willing to not only sit on some shorts of garbage that will go bankrupt (think JRCC) but also to short into these no volume rallies. Will I be burnt toast? May well be, but if I continue to take the unpopular side of the trade I think it will work out in the long run. Time will tell . . .

Now Dec 9 – not sure what I said above, but I do this real time. There remains nothing to read from the action – manipulation all across the board. It actually is a pretty great time to trade as the pitches are very fat. Longer term, expect the “strong dollar” and attendant run to safety to disappear with the Christmas trees. And as for the year ahead . . . ALGT will run to some absurd high at the end of this year. A good guess will be north of 50. As one of my final acts of this 2008. I will short it. I will not cover or think about covering until this time next year at which point it will trade at least 50% below the December 31 close. This is as easy a trade as they come.

Stock Notes

- When market historians look back at the year 2008, they will most likely call it the "Year of the Bubble", with so many markets reaching not only all-time highs, but price levels thought to be nearly impossible. Who would have thought Wheat would trade above \$20 per bushel or Oil nearly reaching \$150 per barrel! I know I never expected to see Platinum top \$2000 per ounce. However, these prices were reached in 2008 as the speculative fervor for all things "commodities" reached their apex this summer. Now it appears that the financial markets are entering the bubble phase, especially the U.S. government interest rate markets. Treasury Bond futures made new contract highs on Tuesday, as traders reacted to a speech by Federal Reserve Chairman Ben Bernanke that the Fed may consider the purchase of longer-dated treasury and agency debt. This action could be put on the table if the Fed feels it cannot lower short-term rates any further. With the fed target currently at 1%, this scenario does have some legitimacy. The idea that the Fed may be buying the long end of the yield curve is causing many traders to re-think how the slope of the yield curve will play out. Previously, many analysts thought the yield curve would steepen (long-term yields rising faster than short-term yields), which would benefit banks, who would profit from borrowing at lower short-term rates and lend at higher long term rates. However, with short-term rates approaching zero and the Fed seemingly inclined to help stimulate growth, a flattening of the curve is now thought likely, forcing traders to buy back long dated Treasuries and causing Bond yields to plummet. As long as the equity market s remain volatile and financial uncertainly

remains in the news headlines, investors will still look towards Treasuries, despite relatively low yields -- at least until the "bubble" bursts!

Notes

- Fyi, another steel industry update: ArcelorMittal is combining the production of three Indiana/Illinois plants into one (Indiana Harbor) by January 2009. With all of that production at one location, it will be running at only 60% of capacity. The Burns Harbor plant is ArcelorMittal's most efficient, highest quality and lowest cost facility in North America. The volume produced there is down 80-85% from only three months ago. There are almost no orders coming in at all. They have announced the "potential" for an indefinite layoff of 2400 workers. They are saying it might last up to a year. As you might guess, the Big 3 are not taking any deliveries, choosing instead to run off their inventories and wind down production. Steel production has often been a good predictor of an economic downturn. It makes a lot of sense. Unfortunately, nobody working in a steel mill or supplying one has ever seen a downturn as swift or as steep.
- According to the theory given to us by Keynes, the government has to make up for the spending private citizens are no longer doing. Americans used to 'take out' as much as \$200 billion per quarter from their home equity. Now, they have nothing to take out. So, that's \$800 billion per year that needs to be replaced right there. And, instead of taking out, they have to put back in...that's what a 'balance sheet recession' is all about. They have to pay off debt and build up savings. Our own guess is that that figure – the amount that used to be spent, but must now be used to repair finances – will rise to about 10% of GDP – or about \$1.4 trillion per year. In other words, the feds will have to spend an extra \$2.2 trillion per year. For comparison and reference, the *Times* is reporting a \$1 trillion figure. And economists argue that \$750 billion of federal spending would achieve the equivalent of \$1 trillion in additional output, thanks to the 'multiplier effect.' But today's *Times*' editorial goes on to say something uncharacteristically smart: **“fighting today’s crises the government is teeing up the next one. To finance the bailouts, the Treasury is borrowing money and the Fed is printing it. That bodes ill for a heavily indebted nation, presaging higher interest rates and higher prices – perhaps sharply higher.”**
- So financial strength is going to be very important in 2009. I also think it will be crucial to stay in needed industries and industries that have a clear and bright long-term future, as opposed to businesses that can grind to a practical halt.”
- **Last week, including the last five trading days, was the best the stock market had seen in 75 years.** After sinking to an 11-year low on Nov. 20, the S&P 500 boomed for the mother of all bear market rallies... From Friday to Friday, the S&P jumped 19%. The Dow followed close behind, up almost 17%. If you can call this period a “week” (since traders took Thursday off), it's the best since the Great Depression. It's also the first five-day winning streak for both the Dow and S&P 500 since July 2007. **[Followed by a complete collapse on December 1, maybe the government can mandate 3.5 day**

trading weeks, things seem to work better when volume is light and stocks can be easily manipulated.]

- The ISM Manufacturing Index showed manufacturing activity is the weakest in 26 years.

Web links

Credit

[After this was made public GM went up nearly 10%. Thus “THE BOTTOM is IN” and it is great news that a company is weeks away from running out of money unless the government vies them \$4B. For those of you playing the home edition, GM’s equity is worth NOTHING. Simply a question as to when it reaches that figure] Dec. 2 (Bloomberg)
-- **General Motors Corp. said it will run out of money to pay its bills this month unless Congress gives it access to \$4 billion immediately and is seeking \$18 billion total as a worsening economy forces the automaker to use more cash.** GM asked for \$12 billion in loans and an additional credit line of \$6 billion, as it tries to shrink U.S. employment by 34 percent, close plants and emphasize only four of eight current U.S. brands, according to a statement today on its Web site. The Detroit-based company also is trying to cut debt in half and win new concessions from the United Auto Workers union. “Our plan is part of an urgent request for federal funding to help the auto industry weather a major crisis” GM Chief Executive Officer [Rick Wagoner](#) said on a conference call. The request “demonstrates in detail why GM needs federal funding not just for the company, but to be beneficial to the U.S. economy.”

Ford Motor Co. today asked [Congress](#) for a credit line of as much as \$9 billion, saying it expects to break even or be profitable before taxes in 2011 and may not need to use the aid. Chrysler LLC sought \$7 billion in loans, saying that without “an immediate working capital bridge” it may lack funding to get through next year’s first quarter.

The automakers’ \$34 billion in requests exceed the \$25 billion in aid lawmakers have been considering for them. The companies must persuade a divided Congress their plans to shrink are severe enough to ensure repayment of the loans.

The company proposals came the same day as GM said November U.S. sales tumbled 41 percent from a year earlier, Ford reported a 31 percent drop and Chrysler posted a 47 percent decline.

‘Lifeline’

“We hope that we can work something out” with the automakers, Senate Majority Leader [Harry Reid](#), a Nevada Democrat, told reporters. “We don’t want to throw them a lifeline if the lifeline doesn’t get them to the shore.”

Reid agreed to hold a second lame-duck session to consider the requests next week. Lawmakers already have set hearings for Dec. 4 and 5.

Lawmakers are split on whether aid for the automakers should come from a \$700 billion bank-rescue fund or Energy Department loans approved in September.

“Our expectation is that they go and duly genuflect and appear to be repentant,” said [Eric Noble](#), president of Car Lab, an Orange, California-based consulting firm for automakers including GM, Chrysler and Toyota Motor Corp.

Ford said it doesn't anticipate a 2009 “liquidity crisis,” barring a competitor's bankruptcy or more severe economic slump.

Selling Jets, Cutting Pay

GM, which along with Ford and Chrysler was criticized for using corporate jets to get to Washington last month, said in a statement it will halt travel on such aircraft starting Jan. 1 and is pursuing the sale of four planes.

Ford plans to sell five jets and would pay Chief Executive Alan Mulally a \$1 annual salary if the loan is used. GM's Wagoner and Chrysler CEO [Robert Nardelli](#) also would be paid \$1 a year under their companies' requests.

Wagoner will drive to this week's hearings in company vehicles such as a gasoline-electric Malibu sedan, said [Tony Cervone](#), a GM spokesman. The automaker said pay for its top five executives will be reduced.

House Majority Leader [Steny Hoyer](#), a Maryland Democrat, said in a statement he hopes the automaker plans and hearings will lead to increased public confidence in the industry's viability “and that Congress will be able to take action next week.”

Without the loans, GM said, its cash on hand will fall below the \$11 billion it needs to pay monthly bills.

Debt Target

GM is seeking to reduce total debt of \$62 billion, including obligations related to a union retiree health-care fund, to about \$30 billion, according to the plan. The company had \$43.3 billion in debt at the end of September, not including borrowings associated with the retiree plan.

The automaker intends to focus most of its future product development and marketing on the Chevrolet, Cadillac, Buick and GMC brands. Pontiac will become a niche brand with few models, and GM said it will consider options for Saab and Saturn. The company already said it is seeking a buyer for its Hummer unit.

Chrysler called its request a “bridge loan” to cover immediate expenses. The Auburn Hills, Michigan-based company, owned by Cerberus Capital Management LP, said it expects an operating profit next year, while using up \$2 billion in cash. Chrysler forecast U.S. auto sales of 11.1 million vehicles for the year, which would be down from 16.1 million in 2007.

Merger, Alliances

A merger or alliances with other automakers might generate \$3.5 billion to \$9 billion in annual savings and is “fundamental” to its plan, Chrysler said, adding that it could remain a viable standalone company. Its plan assumes being awarded \$6 billion in government loans for upgrading plants to produce more fuel-efficient vehicles.

Chrysler also forecast building 500,000 electric-drive vehicles in 2013, after producing the first model in 2010.

Ford’s proposal includes investing about \$14 billion in the next seven years to improve vehicle fuel efficiency. Mileage will rise 14 percent for its fleet of 2009 models from 2005, and 36 percent for 2015 models, the company said. Ford plans to have a group of gasoline-electric and all-electric vehicles by 2012.

The second-largest U.S. automaker in its statement also calls for focusing on its namesake brand through efforts such as exploring the sale of its Volvo unit.

“There is very little in the way of new initiatives” in the proposal, Credit Suisse Securities analyst [Christopher Ceraso](#) said in a note. “Most of the document submitted to the Congress is an outline of the company’s existing plan.” He rates Ford shares “neutral.”

The company reiterated that it’s canceling management bonuses worldwide in 2009, and for all employees in North America. Ford also said it’s in talks with the [United Auto Workers](#) on further labor-cost reductions.

Union Meeting

The UAW called an emergency meeting for tomorrow to consider concessions that make it less costly to cut jobs, people familiar with that session said.

Ford, which isn’t as desperate for financial aid as GM and Chrysler, said that as of Sept. 30 it had \$19 billion in [cash](#) and \$11 billion in available credit lines. The company is taking steps such as reducing capital spending to improve its cash position by \$14 billion to \$17 billion through 2010.

The automaker also said the number of U.S. Ford dealers by the end of this year will be down 14 percent from 2005 “to increase efficiency and promote mutual profitability.”

The auto companies must show that their plans will enable them to repay the proposed U.S. loans, White House spokeswoman [Dana Perino](#) said today.

“We are sticking to our guns in that these companies need to prove they are viable,” Perino told reporters traveling to Greensboro, North Carolina, with President George W. Bush. **GM Seeks \$4 Billion to Survive ‘08, \$18 Billion Total**
http://www.bloomberg.com/apps/news?pid=email_en&refer=home&sid=aE2hbcBROd7s

- Dec. 2 (Bloomberg) -- [HSBC Holdings Plc](#) raised its Hong Kong mortgage rates by the most in a decade to maintain profitability on home loans. HSBC, the bank with the most

branches in [Hong Kong](#), will charge 1.5 percentage point below its so-called best rate for mortgages above HK\$1.5 million (\$194,000), spokeswoman Louisa Leung said. The discount narrowed from 2 percentage points and will bring HSBC's home loan rates in the city to about 3.5 percent, according to calculations by Bloomberg. The increase, HSBC's second in a month and the biggest since Asia's 1998 financial crisis, aims to maintain margins as banks in Hong Kong typically follow rate cuts by the U.S. Federal Reserve because of the local currency peg, [Wong Leung-sing](#), an associate director at Centaline Property Agency Ltd., said today. Mortgage loans in Hong Kong are charged at a discount to the benchmark cost, or the so-called best lending rate. "HSBC is taking the lead in raising mortgage rates as Hong Kong banks will have to cut their best rates in line with the Fed, as otherwise they will not be making any profit," Wong said. "Other Hong Kong banks will follow HSBC because they all face the same problem." HSBC overtook BOC Hong Kong (Holdings) Ltd. as the city's biggest mortgage lender in June, Wong said. In October, HSBC had a 27 percent share of Hong Kong's mortgage market by the number of loans made, compared with 20 percent for BOC Hong Kong, according to Centaline. **HSBC Increases Hong Kong Mortgage Rates by the Most in a Decade**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=agGYxFiIDEZk&refer=home>

Commercial Real Estate

Commodities

- The dollar is doomed. Anybody who understands the laws of economy recognizes this eventual outcome. The U.S. Treasury is printing money at a record pace. A few hundred billion dollars to help out the banks, \$50 billion-\$75 billion earmarked for the auto industry, a couple hundred billion to guarantee the good folks in the insurance business can afford their annual retreats, several trillion in new spending promised by the president elect, and on and on. Pretty soon, we're talking about real money. Ultimately, all of this new money will lead to inflation. The dollar will decline in value. And the primary beneficiaries of this decline will be gold and silver. Right now, though, a stronger force is at work causing the dollar to rally. Investors need liquidity, and they're selling everything to get it. They're selling stocks, corporate bonds, commodities, and precious metals. Then, they're buying dollars with the proceeds. So for now, the dramatically increasing supply of dollars is being offset by a temporary increase in demand. Economics is taking a back seat to the need for liquidity. The dollar is up 15% in just the past 10 weeks. That's extraordinary. Most currencies don't move 15% in a year. And the dollar accomplished this feat in the face of an endlessly increasing new supply. Like I said... extraordinary.
- Dec. 2 (Bloomberg) -- [Royal Dutch Shell Plc](#) and Anglo American Plc have delayed plans to develop a A\$5 billion (\$3.2 billion) project in Australia to convert coal into clean fuels, citing higher costs. The partners will extend studies into the proposed plant rather than move forward toward development, Roger Bounds, project director at the [Monash Energy Holdings Ltd.](#) venture, said in an e-mail. They still believe coal-to-liquids provides a "long-term" opportunity for the brown coal resources in Australia's Victoria state, he said. The decision makes the Monash Energy plan the latest low- emissions

energy project to be slowed or scrapped even as Resources Minister [Martin Ferguson](#) promotes their development to increase energy supplies while cutting greenhouse pollution. Santos Ltd. and General Electric Co. last year canceled a low- emissions power venture in Queensland, while BP Plc and Rio Tinto Group in May dropped a plan to build a carbon capture power plant. “This is a commercial decision of the joint venture,” Ferguson said in an e-mailed statement. “The project is still at pre-feasibility stage and at that stage of any project it is not uncommon for the study period to be extended.” **Shell, Anglo to Delay A\$5 Billion Clean Fuels Project**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a913fWSezn8E&refer=home>

Currency

Diversification

Derivatives

Housing

- More bad news on the housing front: **New home sales have fallen to their lowest level since 1991.** Sales of new houses fell 5.3% in October, to an annual rate of 433,000, the lowest level in 17 years, said the Commerce Dept. last week. The median sale price fell 7% from the same time last year, to \$218,000. That’s a four-year low.

Housing Finance

Macro Economic

Dec. 3 (Bloomberg) -- China’s sovereign wealth fund said it wouldn’t “dare” invest in foreign financial firms after losing \$6 billion on stakes in [Morgan Stanley](#) and Blackstone Group LP.

“I don’t dare to invest in financial institutions now,” [Lou Jiwei](#), chairman of [China Investment Corp.](#), said today at a conference in Hong Kong. “The policies of the developed nations on these institutions are not clear. Until they are clear, I don’t dare to invest in them. What if they go bust? I will lose everything.”

Western banks have turned to state-owned investment funds in Asia and the Middle East for money as they seek to shore up capital eroded by almost \$1 trillion in writedowns and losses triggered by the collapse of the U.S. subprime mortgage market.

CIC, with \$200 billion, invested \$5 billion last year for 9.9 percent of [Morgan Stanley](#) and \$3 billion in [Blackstone](#), the world’s largest private-equity firm. Both New York-based companies have lost more than three-quarters of their market values since the investments were made.

China Development Bank, which funds the nation's public works, spent 2.2 billion euros (\$2.8 billion) for 3.1 percent of Barclays Plc in July 2007 and bought another 136 million pound (\$202 million) stake in June. The combined holding, which was diluted to 2.97 percent after Barclays' latest round of fundraising in November, is now worth \$582 million.

Morgan Stanley gained 6.1 percent in New York yesterday, taking this year's drop to 77 percent. Blackstone fell 4 percent, extending its loss to 76 percent in the period.

'Doomed to Fail'

"Chinese institutions' investments in U.S. and European counterparts are doomed to fail," said [Li Jing](#), a Shenzhen-based analyst at Ping An Securities Co. "CIC should definitely avoid investments in financials as the credit crisis is nowhere near the bottom and they have no experience whatsoever in managing these companies."

The U.S. Treasury has committed \$700 billion to rescue financial firms after a global credit seizure forced the sale of Bear Stearns Cos., a government rescue of American International Group Inc. and the collapse of Lehman Brothers Holdings Inc. this year. The British government is spending 50 billion pounds buying stakes in Royal Bank of Scotland Group Plc, Lloyds TSB Group Plc and HBOS Plc.

China, which primarily invests its \$1.8 trillion [currency reserves](#) in low-yielding U.S. government debt, set up CIC last year to put about \$200 billion into assets with higher rates of return, such as stocks and corporate bonds.

'Undervalued' Companies

"Now is also an opportunity for us. Some companies are undervalued and we can invest in them," Lou said, adding that the fund plans to buy in non-financial industries overseas.

The Chinese government announced a 4 trillion yuan (\$582 billion) stimulus plan in November to spur expansion in the world's fourth-largest economy.

That may not be enough to prevent Asia from slipping into a recession, according to [Stephen Roach](#), chairman of Morgan Stanley Asia Ltd.

"American consumption, to be quite blunt about it, is toast, and when the consumption bubble goes that's a big problem for this region," Roach said at the conference. "There is no country in this region that is not either slowing or in recession right now because the world's biggest end market for its exports is in serious trouble."

China can't save the global economy from financial crisis because the world's most populous nation has its own problems, Lou said.

"Because of the reduced consumption and credit in the developed nations, China needs to boost its domestic demand to sustain growth, which is difficult and requires a lot of reforms to do," he

said. **CIC Won't 'Dare' Invest in Financial Firms, Lou Says**

http://www.bloomberg.com/apps/news?pid=email_en&refer=home&sid=aIYdewrRwOXc

- **[This is so frighteningly stupid that I almost did not put it in. however, it is important that all of you keep in mind that no matter how absurd a concept, Wall Street will simply spit it out and hope it sounds good. I do not have time to go through all the economics but I will simply say that the BRIC economies are a blip on the global economic radar, are extremely dependent on U.S. and EU spending and that there is not a chance in hell they can make up for the trillions in gaps].** Dec. 1 (Bloomberg) -- The best hope to keep the global economy growing may be people like Wei Yufang. A peasant who farms a small plot beside the mud-brown Huaihe River in central China, Wei has a modest dream: to buy an air conditioner to give her family relief from the dusty heat that each summer envelops Xiaogang (Little Hill) village in Anhui province. With economies from the U.S. to Japan in recession, Wei and the other 2.8 billion people in Brazil, Russia, India and China may provide the consumer demand needed to counter the slump. **Jim O'Neill**, the Goldman Sachs Group Inc. economist who in 2001 coined the acronym BRIC from the initials of the four big emerging economies, says the faster growth investors have come to expect from these countries will survive this crisis. O'Neill, who is based in London, says the citizens of the BRIC nations are poised to spend more. **"The BRIC consumer is going to rescue the world," he says.** China's leaders are doing their part. The massive 4 trillion yuan (\$586 billion) stimulus plan they unveiled on Nov. 9 signaled their intent to spur domestic consumption to help pick up the slack left as developed economies buy fewer Chinese exports. The first-ever meeting of finance ministers from the BRIC nations, a few days earlier in Sao Paulo, charted a newly assertive role. "The crisis revealed weakness in risk management, regulation and supervision in the financial sectors of some advanced economies," the ministers said in a statement. **It also showed the resilience of the BRIC economies, they said. ["resilience" is the current in vogue WS word. It is utterly meaningless as applied "in this space" (my favorite empty headed WS lingo)]** 'Global Solutions' "This is a global crisis and demands global solutions," says Brazilian President **Luiz Ignacio Lula da Silva**. "The participation of the developing world is essential." Chinese President **Hu Jintao** said at a summit in Washington on Nov. 15: "Steady and relatively fast growth in China is in itself an important contribution to international financial stability." **Economic leadership from these nations wasn't part of the mix in 1997 and 1998, when currency devaluations and excessive debt threw Asia and then Russia into crisis. Back then, the world looked mostly to the U.S. to spark a rebound. [Sure glad things are going so well in Russia they have closed their equity markets multiple days the past month . . . and ignore the Korean currency crisis behind the curtain]** China's two-year stimulus program calls for spending on housing, roads, railways and airports; tax deductions for businesses that invest in new equipment; and subsidies for farmers. **While Chinese consumers, as a group, still don't overshadow their American counterparts in total spending, their outlays are growing. China's retail sales jumped 22 percent in October. Consumer purchases in the U.S., by contrast, dropped in the third quarter for the first time in seven years. "Since October 2007, the Chinese shopper alone has been contributing more to global GDP growth than the American consumer," O'Neill, 51, says. [How this can**

be said with a striahg face is amazing. Yes, the Chinese consumer has spent 122 dollars instead of 100 at the same time the U.S. consumer has spent 16 billion 900 million instead of 17 billion. An exaggeration, but you get the point I hope] The BRIC economies are performing better overall than O'Neill forecast when he unveiled the term in a November 2001 report. He predicted they would account for 10 percent of global economic output by 2010. Already, they comprise more than 15 percent. 'Hit the Hardest' **Forecasters at Merrill Lynch & Co. share the enthusiasm. "Can BRICs help stabilize the global economy?" Merrill's global economics team asked in an October report. "We think so." [You can now see how the investment banking industry imploded. Knowledge without thought. Ability to spit out facts, but no understanding of what they mean.]** This doesn't mean that the downdrafts being felt by the BRIC nations don't hurt. "A year ago everyone was so optimistic about emerging markets," says **Marc Faber**, who manages \$300 million in Hong Kong. "Now the global economy is going into a severe recession and it is the most volatile economies -- the emerging markets--that are being hit the hardest," says Faber, publisher of the Gloom, Boom and Doom Report. The BRIC countries' stock markets have seen big swings. The benchmark index in Shanghai has been down as much as 70 percent from its high, while Moscow's stock market has fallen as much as 75 percent from its peak. **The question is whether a deeper collapse is coming -- or a turnaround. Mark Mobius, the Singapore-based money manager, says BRIC markets are a buying opportunity. "We're like children in a candy shop," says Mobius, 71, who oversees \$30 billion in emerging-market equities at Templeton Asset Management Ltd. [oh good another buying opportunity!!!!] The obstacles the BRIC nations have to negotiate include the cutoff of capital as U.S. and European banks refuse to lend. Japan and Germany are in recessions, recent economic data show, while the U.K. and U.S. economies are also shrinking. That means lower demand for products from China, services from India and energy and metals from Russia and Brazil. [let's see -- no customers and no financing, those shouldn't cause any problems]** China's booming economy, which expanded by 9.9 percent a year for three decades, may slow to 7.3 percent in 2009, says China International Capital Corp., a Beijing investment bank. Growth in India may drop to 6.5 percent in 2009, from 9 percent in the year ended in March 2008, according to CLSA Asia-Pacific Markets, part of the French bank Credit Agricole SA. **Plunging Oil Price Growth in Russia, the world's second-largest oil producer, after Saudi Arabia, may drop to 3 percent in 2009, according to Arkady Dvorkovich, an adviser to President Dmitry Medvedev. Growth topped 8 percent in 2007, according to the Russian government.** "The oil price is the main transmission route of the crisis to Russia," says **Vladimir Osakovsky**, senior economist in Moscow for Italy's UniCredit SpA. Crude oil is down 63 percent from its July record, trading at about \$54 a barrel in London at the end of last week. The government has raised interest rates and spent foreign currency reserves to try to halt a slide in the value of the ruble. The Russian currency lost 3 percent against the euro last week. Investors have pulled \$190 billion out of the country since August, according to French bank BNP Paribas SA. **BRIC bulls like O'Neill say the four countries are much better prepared for this global economic crisis than they were for the turmoil of a decade ago. Banking systems are stronger and international trade has expanded. Most important, the governments of the BRIC nations have accumulated some of the world's largest financial reserves.**

Currency Reserves The four BRIC nations combined held 41 percent of total global foreign exchange reserves as of early November. Russia's reserves are the third biggest, after China's and Japan's, though the government used about 20 percent of its hoard from August to mid-November to support the ruble. China's \$1.9 trillion [stockpile](#) helped make possible the giant November stimulus, targeted to the spending habits of citizens such as Wei Yufang. China's Communist government has already given people like Wei a push up the economic ladder. Changes in land ownership rules mean Wei, 41, can rent out some of her plot to another farmer, who grows grapes. She also plans to seek a bank loan against her landholding. "My family's already feeling richer," Wei says. Investors worldwide should hope the feeling lasts. **BRIC Shoppers Will 'Rescue World'**

Goldman Sachs Says

http://www.bloomberg.com/apps/news?pid=20601170&refer=home&sid=aajYkzL_xTWY

- Dec. 1 (Bloomberg) -- The U.S. once exported jobs. Now, it is exporting unemployment. America's deepening [recession](#), which has cost 1.2 million jobs so far this year, is taking a heavy toll overseas. Shrinking consumer demand for imports and less need for outsourcing by U.S. companies are idling workers at Germany's [Porsche SE](#) and Chinese businesses that make toys for [Mattel Inc.](#) **Economists say worldwide unemployment may increase to a two-decade high as trade and investment ties that have developed during 20 years of globalization magnify the impact of the U.S. contraction. Without buoyant economies elsewhere in the world to act as buffers, a longer, deeper slump in the labor market is likely.** "In the same way that we were supporting economic activity when we were growing rapidly, the recession in the U.S. is going to be a drag on the global economy and is going to reduce employment in our trading partners," says [Lewis Alexander](#), chief economist at Citigroup Inc. in New York. That would bring job losses for 2008 to 1.5 million. "Millions" more may follow in 2009 "if we do not act swiftly and act boldly," President-elect Barack Obama said at a Nov. 24 press conference. He aims to create 2.5 million new jobs in his first two years in office. **Worldwide, the jobless rate may rise above 7 percent by 2010 after remaining between 5 percent and 7 percent for two decades,** says [Kathleen Stephansen](#), chief global economist for Credit Suisse Holdings USA Inc. in New York. Euro Region [Unemployment](#) in the 15-nation euro region rose to 7.7 percent in October from a low of 7.2 percent in February. It will reach 8.3 percent next year, the International Monetary Fund forecasts. Also feeling the fallout from the U.S. downturn are manufacturers in low-cost countries such as China, where American companies have turned for manufacturing. **"China's economy has acutely felt the impact of the financial crisis,"** Yin Weimin, head of the Ministry of Human Resources and Social Security, said on Nov 20. **"Some enterprises, particularly labor-intensive small and medium-size enterprises, have gone bankrupt or partially shut down their production capacity and, as a result, many people have lost their jobs."** "U.S. multinationals are facing harder times and scaling back production in the rest of the world, and at the same time there's a straightforward contraction of imports into the U.S.," says [Marco Annunziata](#), chief economist at Unicredit MIB in London. "All this means more job losses, as we're seeing a slowdown in U.S. growth that will impact everywhere." **Not since the 1930s have unemployment and economic decline been more closely linked across international borders, says Nobel laureate**

economist Robert Solow, 84, a professor at the Massachusetts Institute of Technology in Cambridge. “Normally, business cycles are not in synch around the world, and that helps keep them relatively mild,” he says. Now, “there’s a lot more synchronization, and that contributes to the likely depth of the recession.” **America Exports Unemployment as Slump Shrinks Consumer Demand**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=a0XWoWq6J5k8&refer=home>

- November 28 2008 FT **The French government’s plan to shore up the capital position of France’s six main retail banks is being blocked by the European Commission, which insists they must reduce their lending in return for state support.** Christine Lagarde, French finance minister, on Friday spoke to Neelie Kroes, EU competition commissioner, to persuade her to lift her veto on France’s €10.5bn (\$13.3bn) support package but Ms Kroes is sticking to her view that banks cannot use state aid to increase their lending books. “We have to apply the same criteria to everyone . . . support should be sufficient to offset the negative impact of the current financial crisis and no more,” said one official. **The French government reacted furiously to the Commission’s argument. One senior official described it as “ridiculous” and “stupid” because it would exacerbate the credit crunch** – the very thing Paris said it was trying to avert when it decided last month to inject capital into all its large high-street banks. France – unlike the UK, Germany or Italy – intended to recapitalise all its lenders at the same time to ensure they did not tighten credit to business and households. **Paris argued that without state support, and in view of the frozen interbank lending markets, banks would have shored up their capital positions by reducing loans, with catastrophic consequences for the real economy.** However, France’s six high-street banks were fundamentally sound but were under pressure from the markets to bolster their balance sheets, officials said. They added that EU leaders and the Commission endorsed this preventative recapitalisation approach in October. The French plan is one of a number of banking aid measures notified to Brussels but still not approved. The Austrian, Spanish and Hungarian framework schemes are still awaiting a green light. However, it has also already approved some schemes with a recapitalisation element. Germany’s framework scheme included recapitalisation proposals, for example, although beneficiaries would have to give behavioural commitments and maintain high solvency ratios. Separately, it emerged that the French plan to underpin credit insurance for risky companies may also run into state aid issues. **Brussels blocks French bank bail-out**
<http://www.ft.com/cms/s/0/7e7f0ec6-bd72-11dd-bba1-0000779fd18c.html>
- Nov 30 FT **Japan’s economy is unlikely to respond to a planned fiscal stimulus but will have to endure higher unemployment and possibly a return to deflation and shrinking output,** according to Kaoru Yosano, economy minister. In an interview with the Financial Times, Mr Yosano said there could be no quick fixes through fiscal spending. He painted a gloomy economic picture, saying that companies were preparing to cut thousands of non-permanent jobs at the end of the year when fixed-term contracts expired. **“I cannot tell you it will be a bright next day. The time for endurance has come,” [wow, an honest politician]** he said. “We are moving to the next phase of shrinking consumption – some call it deflation – production going down and prices going down.” October industrial output fell 3.1 per cent month on month and is projected to fall

6.2 per cent in November. Richard Jerram, economist at Macquarie Securities, said the decline was unprecedented. Data in November showed Japan sank into recession when the economy shrank 0.1 per cent in the three months to September 30. Economists said Japan's labour market had become very flexible, with more than a third of workers in non-regular employment. As a result, the jobless rate, which peaked at 5.5 per cent in the previous recession, could rise steeply from its present 4.1 per cent, they said. Japan, whose financial system has been relatively sheltered from the credit squeeze, has come under international pressure to try to stimulate domestic demand through government spending. Mr Yosano, a fiscal hawk, played down the likely impact of a planned ¥5,000bn (\$52.3bn) package, saying that most of it was credit guarantees rather than genuine new money. **Japanese stimulus will fail, warns minister**

<http://www.ft.com/cms/s/0/df583330-bf0c-11dd-ae63-0000779fd18c.html>

Retail

- Dec. 1 (Bloomberg) -- [General Motors Corp.](#), [Ford Motor Co.](#) and Chrysler LLC union leaders will meet Dec. 3 in an emergency session in Detroit as the companies seek concessions from the United Auto Workers to win \$25 billion in government loans with plans due to be submitted to Congress tomorrow. Participants will be asked to reopen a 2007 labor agreement to consider concessions, said one person familiar with the purpose of the forum, who asked not be named because the details are private. Two delegates from each UAW local are invited, according to a copy of a letter obtained by Bloomberg News from a person planning to attend. GM, which has said it may run out of [cash](#) to pay its bills this year, **wants to stop paying union workers when plants are closed and there no other work, [that not paying people who had to be laid off because there is no work is considered to be a concession says it all. Unions RUINED the domestic auto industry. Case closed.]** people familiar with GM's plans said. All the automakers are expected to ask the union for similar concessions as part of getting government aid, two union officials said today. UAW spokesman [Roger Kerson](#) had no immediate comment on the meeting. GM also aims to change how it pays for a union retiree health care fund as part of a broader cost cutting plan designed to win government aid, people familiar said. **GM, Ford, Chrysler UAW Leaders Call Emergency Meeting**
http://www.bloomberg.com/apps/news?pid=20601087&sid=ak_P1YizFrDo&refer=home
- Investors "may see (the weekend's data) as supportive of some stability in the consumer, but we believe that is not the case," said Richard Hastings, a consumer strategist with Global Hunter Securities, Hastings. He expects about 1 million U.S. jobs to be lost during the holiday period of November, December and January, with retail sales falling 6 percent to 8 percent in that time. "That would put this cycle on track to compete with 1974 as one of the worst layoff cycles during a holiday season," he said.

Retirement

Risk

Savings Rate

Tech

The Fed

Chairman Ben S. Bernanke

At the Greater Austin Chamber of Commerce, Austin, Texas

December 1, 2008

Federal Reserve Policies in the Financial Crisis

It is a privilege for me to be here in Texas, and I would like to thank the Austin Chamber for hosting this luncheon. The Texas economy is strong and diversified, accounting for more than a trillion dollars of output last year. However, our nation, and Texas too, is being tested by economic and financial challenges. Those challenges and the Federal Reserve's policy responses are the topic of my remarks today.

Federal Reserve Policies during the Crisis

As you know, this extraordinary period of financial turbulence is now well into its second year. Triggered by the contraction of the U.S. housing market that began in 2006 and the associated rise in delinquencies on subprime mortgages, the crisis has become global and is now affecting a wide range of financial institutions, asset classes, and markets. Constraints on credit availability and slumping asset values have in turn helped to generate a substantial slowing in economic activity.

The Federal Reserve's strategy for dealing with the financial crisis and its economic consequences has had three components. First, to offset to the extent possible the effects of the crisis on credit conditions and the broader economy, the Federal Open Market Committee (FOMC) has aggressively eased monetary policy. The easing campaign began in September 2007, shortly after the turbulence began, with a cut of 50 basis points in the target for the federal funds rate. The cumulative reductions in the target rate reached 100 basis points--that is, a full percentage point--by the end of 2007. As indications of economic weakness proliferated, the Committee continued to respond, reducing the target rate by an additional 225 basis points by the spring of this year. By way of historical comparison, this policy response stands out as exceptionally rapid and proactive. In taking these actions, we aimed not only to cushion the direct effects of the financial turbulence on the economy, but also to reduce the risk of a so-called adverse feedback loop in which economic weakness exacerbates financial stress, which, in turn, leads to further economic damage. Unfortunately, despite the support provided by monetary policy, the intensification of the financial turbulence this fall has led to a further deterioration in the economic outlook. The Committee again responded by cutting the target for the federal funds

rate an additional 100 basis points in October. Half of that reduction came as part of an unprecedented coordinated interest rate cut by six major central banks on October 8.

The Committee's rapid monetary easing was not without risks. Some observers expressed concern at the time that these policies would stoke inflation, and, indeed, inflation reached high levels earlier this year, mostly as the result of a surge in the prices of oil and other commodities. Throughout this period, the Committee remained closely attuned to inflation developments. Because control of inflation requires that the public's longer-term inflation expectations remain well anchored, we paid particularly close attention to indicators of those expectations, as inferred, for example, from financial markets and from surveys of households and businesses. However, the Committee maintained the view that the rapid rise in commodity prices primarily reflected sharply increased demand for raw materials in emerging market economies, in combination with constraints on the supply of these materials, rather than general inflationary pressures. We expected that, at some point, global economic growth and the associated growth in the demand for commodities would moderate, which would result in a leveling out of commodity prices, consistent with the predictions of futures markets. As you know, commodity prices peaked during the summer and, rather than leveling out, have actually fallen dramatically with the weakening in global economic activity. As a consequence, overall inflation appears set to decline significantly over the next year toward levels consistent with price stability.

Although monetary easing likely offset some part of the economic effects of the financial turmoil, that offset has been incomplete, as widening credit spreads and more restrictive lending standards have contributed to tight overall financial conditions. In particular, many traditional funding sources for financial institutions and markets have dried up, and banks and other lenders have found their ability to securitize mortgages, auto loans, credit card receivables, student loans, and other forms of credit greatly curtailed. Consequently, the second component of the Federal Reserve's strategy has been to support the functioning of credit markets and to reduce financial strains by providing liquidity to the private sector--that is, by lending cash or its equivalent secured with relatively illiquid assets.

To ensure that adequate liquidity is available, consistent with the central bank's traditional role as the liquidity provider of last resort, the Federal Reserve has taken a number of extraordinary steps. For instance, to provide banks and other depositories easier access to liquidity, we narrowed the spread of the primary credit rate (the rate at which banks borrow from the Fed's discount window) over the target federal funds rate from 100 basis points to 25 basis points; extended the term for which banks can borrow from the discount window to up to 90 days; and developed a program, called the Term Auction Facility, under which predetermined amounts of credit are auctioned to depository institutions for terms of up to 84 days. These innovations resulted in large increases in the amount of Federal Reserve credit extended to the banking system. Following the funding crises faced by Bear Stearns and other institutions this past spring, we also expanded our liquidity programs to include primary dealers in the government securities market. It should be emphasized that the loans that we make to banks and primary dealers through our standing facilities are both overcollateralized and made with recourse to the borrowing firm, which serves to minimize the Federal Reserve's exposure to credit risk. To further improve funding conditions, the Federal Reserve has also recently introduced facilities to

purchase highly rated commercial paper at a term of three months and to provide backup liquidity for money market mutual funds.

In our globalized financial markets, the provision of dollar liquidity has international as well as domestic aspects. To improve dollar funding conditions in important foreign markets, the Federal Reserve has approved bilateral currency swap agreements with 14 foreign central banks. Swap facilities allow each of the central banks involved to borrow foreign currency from the other; in this case, foreign central banks such as the Bank of Japan, the European Central Bank, the Bank of England, and the Swiss National Bank have borrowed dollars from the Federal Reserve to re-lend to banks in their jurisdictions. Because short-term funding markets are interconnected, the provision of dollar liquidity in major foreign markets eases conditions in dollar funding markets globally, including here in the United States. Importantly, these swap arrangements pose essentially no credit risk because our counterparties are the foreign central banks themselves, which take responsibility for the extension of dollar credit within their jurisdictions.

Judging the effectiveness of the Federal Reserve's liquidity programs is difficult. Obviously, they have not yet returned private credit markets to normal functioning. But I am confident that market functioning would have been more seriously impaired in the absence of our actions. My reading of the evidence and the reports we have received is that these programs have been helpful in lowering spreads in certain short-term funding markets, enabling financial and nonfinancial businesses to obtain credit that would have been costly or difficult to obtain elsewhere, and allowing a more orderly process of asset sales and the necessary deleveraging by financial institutions. Ultimately, however, market participants themselves must address the fundamental sources of financial strains by raising new capital, restructuring balance sheets, and improving risk management. This process is likely to take some time. The Federal Reserve's various liquidity measures should help facilitate that process indirectly by boosting investor confidence and by reducing the risk of severe disruption during the period of adjustment. Once financial conditions become more normal, the extraordinary provision of liquidity by the Federal Reserve will no longer be needed, and financial institutions will again look to private counterparties, and not central banks, as a source of ongoing funding.

Consistent with the historical mission of the Federal Reserve, the third component of our policy response has been to use all our available tools to promote financial stability, which is essential for healthy economic growth. At times, this has required working to preserve the stability of systemically critical financial institutions, so as to avoid further costly disruptions to both the financial system and the broader economy during this extraordinary period. In particular, the Federal Reserve collaborated with the Treasury to facilitate the acquisition of the investment bank Bear Stearns by JPMorgan Chase and to stabilize the large insurer, American International Group (AIG). We worked with the Treasury and the Federal Deposit Insurance Corporation (FDIC) to put together a package of guarantees, liquidity access, and capital for Citigroup. Other efforts include our support of the actions by the Federal Housing Finance Agency and the Treasury to place the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac into conservatorship and our work with the FDIC and other bank regulators to assist in the resolution of troubled depositories, such as Wachovia. In each case, we judged that the failure of the institution in question would have posed substantial risks to the financial system and thus to the economy.

The Federal Reserve has worked to promote financial stability through other means as well, such as strengthening the financial infrastructure. For example, the Federal Reserve Bank of New York has led cooperative efforts to improve the clearing and settlement procedures for credit default swaps and other over-the-counter derivatives. In addition, the Federal Reserve is collaborating with the Securities and Exchange Commission and the Commodity Futures Trading Commission to facilitate the development of central counterparties for the trading of credit default swaps. Properly managed, central counterparties can mitigate the counterparty risk that has proved a source of contagion in the past year.

The Federal Reserve's efforts in conjunction with other agencies to prevent the failure of systemically important firms have been controversial at times. One view holds that intervening to prevent the failure of a financial firm is counterproductive, because it leads to erosion of market discipline and creates moral hazard. As a general matter, I agree that preserving market discipline is extremely important, and, accordingly, the government should intervene in markets only in exceptional circumstances. However, in my view, the failure of a major financial institution at a time when financial markets are already quite fragile poses too great a threat to financial and economic stability to be ignored. In such cases, intervention is necessary to protect the public interest. The problems of moral hazard and the existence of institutions that are "too big to fail" must certainly be addressed, but the right way to do this is through regulatory changes, improvements in the financial infrastructure, and other measures that will prevent a situation like this from recurring. Going forward, reforming the system to enhance stability and to address the problem of "too big to fail" should be a top priority for lawmakers and regulators.

In particular, recent events have revealed a serious weakness of our system: the absence of well-defined procedures and authorities for dealing with the potential failure of a systemically important nonbank financial institution. In the case of federally insured depository institutions, the FDIC has the necessary authority to resolve failing firms; indeed, in situations in which the failure of a firm is judged to pose a systemic risk, the FDIC's powers are quite broad and flexible. No comparable framework exists for nondepository financial institutions. The Federal Reserve is authorized to lend to nondepositories under unusual and exigent circumstances, but such loans must be backed by collateral sufficient to provide reasonable assurance that they will be repaid; if such collateral is not available, the Fed cannot lend. And until recently, the Treasury also did not have the authority to inject capital to prevent the disorderly failure of systemically significant private institutions.

In the absence of an appropriate, comprehensive legal or regulatory framework, the Federal Reserve and the Treasury dealt with the cases of Bear Stearns and AIG using the tools available. To avoid the failure of Bear Stearns, we facilitated the purchase of Bear Stearns by JPMorgan Chase by means of a Federal Reserve loan, backed by assets of Bear Stearns and a partial guarantee from JPMorgan. In the case of AIG, we judged that emergency Federal Reserve credit would be adequately secured by AIG's assets. However, neither route proved feasible in the case of the investment bank Lehman Brothers. No buyer for the firm was forthcoming, and the available collateral fell well short of the amount needed to secure a Federal Reserve loan sufficient to pay off the firm's counterparties and continue operations. The firm's failure was thus unavoidable, given the legal constraints, and the Federal Reserve and the Treasury had no choice but to try instead to mitigate the fallout from that event.

Fortunately, we now have tools to address any similar situation that might arise in the future. The intensification of the financial crisis this fall made clear that a comprehensive approach involving the fiscal authorities was needed to address more effectively the problems of the financial system. On that basis, the Administration, with the support of the Federal Reserve, asked the Congress for a new program aimed at stabilizing our financial markets. The resulting legislation, the Emergency Economic Stabilization Act (EESA), provides the necessary authorizations and resources to strengthen the financial system and, in particular, to deal with the potential failure of a systemically important firm. Notably, funds provided under the act facilitated the recent government actions to stabilize Citigroup. More broadly, the act allows the Treasury to recapitalize and stabilize our banking system by purchasing preferred stock in financial institutions. The Capital Purchase Program is voluntary and designed to encourage participation by a broad range of institutions while maintaining the ability of participating institutions to raise private capital. Up to \$250 billion has been committed to this program. In addition to measures being implemented by the Treasury, the FDIC has announced programs to guarantee selected liabilities of FDIC-insured depository institutions and their holding companies. With time, these measures should help strengthen the banking system, allowing credit to flow more freely to support economic growth.

Collectively, the Treasury, the FDIC, and the Federal Reserve are now much better equipped to address potential systemic risks quickly and effectively, and we are firmly committed to doing so. However, measures such as the Capital Purchase Program and the FDIC guarantee are temporary. In the longer term, the development of a statutory framework for resolving systemically critical nonbank financial institutions in ways that do not destabilize the financial system as a whole must be another key priority.

Economic Outlook

Despite the efforts of the Federal Reserve and other policymakers, the U.S. economy remains under considerable stress. Economic activity was weakening even before the intensification of the financial crisis this fall. The sharp falloff in consumer spending during the summer was particularly striking. According to the latest estimates, real gross domestic product (GDP) declined at an annual rate of 0.5 percent in the third quarter, with personal consumption falling at an annual rate of 3.7 percent.

However, economic activity appears to have downshifted further in the wake of the deterioration in financial conditions in September. Employment losses, which had been averaging about 100,000 per month for much of the year, accelerated to more than 250,000 per month, on average, in September and October, and the unemployment rate jumped to 6.5 percent in October. Moreover, recent increases in the number of new claims for unemployment insurance suggest that labor market conditions worsened further in November. Housing markets remain weak, with low demand and the increased number of distressed properties on the market contributing to further declines in house prices and ongoing reductions in new construction. In reaction to worse economic prospects and tightening credit conditions, households have continued to retrench, putting consumer spending on a pace to post another sharp decline in the fourth quarter. In particular, sales of light motor vehicles fell to an annual rate of 10-1/2 million units in October, the lowest level since 1983, and November sales reports are downbeat.

Business activity also slowed in recent months. Excluding the effects of the hurricanes and the Boeing strike on production, manufacturing output fell 2 percent over the months of September and October, orders and shipments of nondefense capital goods fell markedly in October, and most survey measures of business conditions are at or close to record lows.

Amid the bad news, there have been some positives. The pronounced declines in the prices for crude oil and other commodities have helped to reverse what had been a significant drag on household purchasing power through much of the year. And there have been a few tentative signs of stabilization in financial markets. For instance, short-term funding costs for banks and commercial paper issuers have come down recently, and issuance of investment-grade bonds by nonfinancial corporations appears to have held up well. Banks have recently issued bonds backed by the FDIC guarantee. That said, investor concerns about credit quality have increased further, and risk aversion remains intense. As a result, in almost all credit markets, spreads remain wider, maturities shorter, and availability more constrained than was the case before the intensification of the crisis this fall.

The likely duration of the financial turmoil is difficult to judge, and thus the uncertainty surrounding the economic outlook is unusually large. But even if the functioning of financial markets continues to improve, economic conditions will probably remain weak for a time. In particular, household spending likely will continue to be depressed by the declines to date in household wealth, cumulating job losses, weak consumer confidence, and a lack of credit availability.

The global economy has also slowed. Many industrial countries were affected by the financial crisis from the beginning, but the latest economic data point to a more noticeable weakening of conditions. And emerging market economies, which were little affected at first, are slowing now as well. One implication of these developments is that exports are not likely to be as great a source of strength for U.S. economic activity in coming quarters as they had been earlier this year.

At the same time, the increase in economic slack and the declines in commodity prices and import prices have alleviated upward pressures on consumer prices. Moreover, inflation expectations appear to have eased slightly. These developments should bring inflation down to levels consistent with price stability.

Although the near-term outlook for the economy is weak, a number of factors are likely over time to promote the return of solid gains in economic activity and employment in the context of low and stable inflation. Among those factors are the stimulus provided by monetary policy and possible fiscal actions, the eventual stabilization in housing markets as the correction runs its course, and the underlying strengths and recuperative powers of our economy. The time needed for economic recovery, however, will depend greatly on the pace at which financial and credit markets return to more-normal functioning.

The Outlook for Policy

Going forward, our nation's economic policy must vigorously address the substantial risks to financial stability and economic growth that we face. I will conclude my remarks by discussing

the policy options of the Federal Reserve, focusing on the three aspects of policy that I laid out earlier: interest rate policy, liquidity policy, and policies to stabilize the financial system.

Regarding interest rate policy, although further reductions from the current federal funds rate target of 1 percent are certainly feasible, at this point the scope for using conventional interest rate policies to support the economy is obviously limited. Indeed, the actual federal funds rate has been trading consistently below the Committee's 1 percent target in recent weeks, reflecting the large quantity of reserves that our lending activities have put into the system. In principle, our ability to pay interest on excess reserves at a rate equal to the funds rate target, as we have been doing, should keep the actual rate near the target, because banks should have no incentive to lend overnight funds at a rate lower than what they can receive from the Federal Reserve. In practice, however, several factors have served to depress the market rate below the target. One such factor is the presence in the market of large suppliers of funds, notably the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, which are not eligible to receive interest on reserves and are thus willing to lend overnight federal funds at rates below the target.¹ We will continue to explore ways to keep the effective federal funds rate closer to the target.

Although conventional interest rate policy is constrained by the fact that nominal interest rates cannot fall below zero, the second arrow in the Federal Reserve's quiver--the provision of liquidity--remains effective. Indeed, there are several means by which the Fed could influence financial conditions through the use of its balance sheet, beyond expanding our lending to financial institutions. First, the Fed could purchase longer-term Treasury or agency securities on the open market in substantial quantities. This approach might influence the yields on these securities, thus helping to spur aggregate demand. Indeed, last week the Fed announced plans to purchase up to \$100 billion in GSE debt and up to \$500 billion in GSE mortgage-backed securities over the next few quarters. It is encouraging that the announcement of that action was met by a fall in mortgage interest rates.

Second, the Federal Reserve can provide backstop liquidity not only to financial institutions but also directly to certain financial markets, as we have recently done for the commercial paper market. Such programs are promising because they sidestep banks and primary dealers to provide liquidity directly to borrowers or investors in key credit markets. In this spirit, the Federal Reserve and the Treasury jointly announced last week a facility that will lend against asset-backed securities collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration. The Federal Reserve's credit risk exposure in this facility will be minimized because the collateral will be subject to a "haircut" and because the Treasury is providing \$20 billion of EESA capital as supplementary loss protection. Each of these approaches has the potential to improve the functioning of financial markets and to stimulate the economy.

Expanding the provision of liquidity leads also to further expansion of the balance sheet of the Federal Reserve. To avoid inflation in the long run and to allow short-term interest rates ultimately to return to normal levels, the Fed's balance sheet will eventually have to be brought back to a more sustainable level. The FOMC will ensure that that is done in a timely way. However, that is an issue for the future; for now, the goal of policy must be to support financial markets and the economy.

Finally, working together with the Treasury, the FDIC, and other agencies, we must take all steps necessary to minimize systemic risk. The capital injections into the banking system under the EESA, the FDIC's guarantee program, and the provision of liquidity by the Federal Reserve have already served to greatly reduce the risk that a systemically important financial institution will fail. We at the Federal Reserve and our colleagues at other federal agencies will carefully monitor the conditions of all key financial institutions and stand ready to act as needed to preserve their viability in this difficult financial environment.

I have not discussed the international response to the crisis today, but policymakers abroad as well as those in the United States have taken a series of extraordinary steps to address an extraordinary situation. These steps include strong fiscal and monetary actions as well as measures to stabilize key financial institutions and markets and to strengthen the financial infrastructure. I am not suggesting the way forward will be easy. But I believe that the policy responses taken here and by our international partners, together with the underlying vitality and resilience of the American economy, will help to restore confidence to our financial system and place our economy back on the path to vigorous growth.

Footnotes

1. Banks have an incentive to borrow from the GSEs and then redeposit the funds at the Federal Reserve; as a result, banks earn a sure profit equal to the difference between the rate they pay the GSEs and the rate they receive on excess reserves. However, thus far, this type of arbitrage has not been occurring on a sufficient scale, perhaps because banks have not yet fully adjusted their reserve-management practices to take advantage of this opportunity. [Return to text](#)

Wall Street

- Dec. 2 (Bloomberg) -- Investment banks may reduce compensation for commodity traders as much as 75 percent as prices of oil and copper fall the most in at least two decades. The best paid metals and energy traders may earn \$1 million to \$1.5 million in salary, bonus and related pay this year, down from \$5 million to \$8 million in 2007, according to estimates by London-based recruitment company [Kennedy Associates](#). Bonuses at Goldman Sachs Group Inc. and Morgan Stanley, the biggest oil-trading banks on Wall Street, may fall 60 percent, according to Armstrong International, another London-based recruiter. **“At the end of the day, the commodity industry is not bullet-proof,” said Jason Kennedy, 38, chief executive officer of Kennedy Associates, whose clients include Merrill Lynch & Co. “It’s following the trend.” Banks and hedge funds that piled into [those are the key words “a bunch of us piled in” the infamous herd, trade against them and make a fortune, let them manage your money and enjoy your retirement years as a Wal-Mart greeter]** raw materials as crude, copper and gold rallied for seven straight years, cut jobs during the second half as the Reuters/Jefferies [CRB Index](#) tracking prices of grains, fuels and metals declined, heading for its biggest annual drop ever. Goldman Sachs dismissed 10 percent of its employees in November, including cuts in commodities. Zurich-based UBS AG,

Switzerland's biggest bank, said in October it will end over-the-counter trading in industrial metals and energy. **“The manic scramble in commodities in 2007 and early 2008 has calmed down,”** said Shaun Springer, 52, chief executive officer of Napier Scott Executive Search Ltd., which has recruited for banks since 1992. **“It has moved from a frenzy to nigh on dormant.”** ‘Best Career Options’ Nuon NV, the second-biggest Dutch utility, hired Gregor McDonald from Dresdner Kleinwort Group as its head of natural gas trading. Matthew Nicholas and Erik Hokmark joined Swiss utility Energie Ovest Suisse from Lehman Brothers. **“For the first time in the past five years utilities and producers are seen as the best career options due to their commitment to the markets coupled with the more aggressive compensation structures that they have adopted,”** said Elliot Pickering, a consultant at London-based Human Capital Search, which specializes in recruitment for metals and energy markets. **“We are certainly attracting high calibre candidates from investment banks and hedge funds,”** Pierre Lorinet, the chief financial officer at Trafigura, said in an e-mailed statement. E.ON earned three times as much from buying and selling energy in the third quarter as it did in the first six months of the year. Dusseldorf, Abu Dhabi **“We have seen increased interest from individuals in the financial sector looking to come over to us, and it’s possible there could be some correlation with the current situation,”** Dusseldorf-based E.ON Energy Trading AG Chief Commercial Officer Gareth Griffiths said in an e-mailed response to questions. According to Gardner Chief Executive Officer Michael Laznicka, **“there’s no way that some of these managers can sustain their current performances and survive.”** **Commodity Pay Falls Faster Than Oil as Goldman, Funds Retrench**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=adZqKzItx6e8&refer=home>

- November 29 2008 FT – **your investment dollars at work** - The titans of Wall Street have taken a battering in the financial markets recently, **but they are eating well and drinking more**, according to the people who run Manhattan’s “power” dining spots. At the 21 Club, a longtime redoubt of corporate chieftains and big names, **alcohol sales are up 9 per cent from last year**, and businessmen can be seen drinking \$14-a-glass cocktails as early as 3pm on a weekday. **“Where people used to have one vodka on the rocks, now it’s a second one or maybe a third,”** says Roger Rice, the floor manager. **“I don’t know what to attribute it to. Maybe it’s the last year of the expense account.”** Others say their customers are drinking more to drown their sorrows. **“People want to feel a little numb because it’s numbing out there,”** says Steve Millington, general manager at Michael’s, the restaurant of choice for publishing and media executives. He reports that alcohol sales are up a fifth from last year. **“At dinner, hard liquor sales are up, cocktails and martinis.”** The increase in alcohol sales is clear, says Mr Millington, because overall customer levels are on a par with last year. **“There’s a scent of fear,”** he says. Times are good at Delmonico’s, the 181-year-old fine dining restaurant, says Dennis Turcinovic, managing partner. **“It’s scary to say, but our business is up 6 to 7 per cent,”** he says. **“Alcohol sales...help a lot, they’re about 15 per cent up this year. The bar’s busy all day.** I’ve had to hire extra barmaids.” There are few signs that people are saving money on food either. Wine sales remain strong, especially at dinner, except for one noticeable change. **“When times are fantastic, the host does not lead, he lets his guests lead in choosing the wine,”** says Mr Bruno. However, in the current climate, dinner hosts are turning to him to ask for wine recommendations, a clear sign that restraint is in order, according to Mr Bruno. Yet not everyone has suffered in the

economic downturn. Mr Bruno produced two empty bottles of 1947 Petrus, consumed recently by a Chinese customer who called ahead to order the wines. The price? A mere \$12,000 each. **Wall Street drowns its sorrows** <http://www.ft.com/cms/s/0/693de752-bdaa-11dd-bba1-0000779fd18c.html>

Don't Fight The Fed

I Disagree . . . and why

Article of the week:

Best of the Dog