The Finance Round-Up: September 7th 2007

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(See also the Energy and Environment Round-Up for September 7th below.)

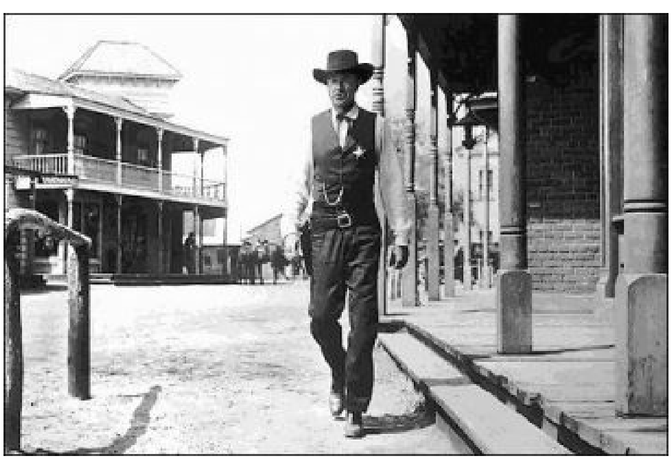
For all those who think that the world's central bankers have the developing credit crunch contained, look at the liquidity crisis in asset-backed commercial paper (ABCP), which is currently affecting Canada worst of all. ABCP is an impenetrable mish-mash of mortgages, credit card receivables, car loans and other miscellaneous debt that institutions were quite happy, until recently, to use as a convenient place to park short term cash. Within a month that has seen a severe attack of risk aversion, it has gone from safe to toxic, with the result that liquidity has dried up almost completely.

In Canada, banks are trying to put together a deal that converts $35 billion of non-bank short term paper, that could no longer be rolled over, into 5-year floating-rate notes, but the credit default swaps (which can be, and were, used as vehicles for naked speculation) are a huge problem. Does the deal remind anyone of the Argentine financial crisis - where short term bonds were converted to long term (and then later defaulted upon)?

Those who think the situation contained might also look to Europe at the increasing gap between base rates and three-month interbank lending rates (Libor). That gap is now at its widest for 20 years, reflecting uncertainty and distrust as to the risk exposure of other banks, and the hoarding of cash. Interbank lending is breaking down, despite the efforts of the ECB and the Fed to restore confidence.

Is there really nothing to worry about?

ABCP investors could lose half their money



The vast majority of about $35-billion of non-bank ABCP is backed by risky bets on credit default rates that are now so far underwater that investors could be looking at losses as high as 50 on the dollar, said Edward Devlin, Canadian portfolio manager for highly respected California-based bond fund manager Pacific Investment Management Co. LLC....

....**Commercial-paper markets around the globe have been struggling with fallout from the subprime mortgage crisis in the United States, but the situation is worst in Canada**.

"It's the one country where people couldn't get their money back," Mr. Devlin said. "There's a whole group of people who bought commercial paper [thinking it was liquid] and now they find they can't get their money back."

Credit bust bypasses banks

In a period of just weeks, the subprime time-bomb that had been ticking unnoticed for half a decade suddenly exploded into a systemwide liquidity crisis that then escalated into a credit crisis in the entire money market dominated by the non-bank financial system that threatens to do permanent damage to the global economy.

As an economist, Ben Bernanke no doubt understands that the credit market through debt securitization has in recent years escaped from the funding monopoly of the banking system into the non-bank financial system. As chairman of the US Federal Reserve, however, he must also be aware that the monetary tools at his disposal limit his ability to deal with the fast-emerging marketwide credit crisis in the non-bank financial system. The Fed can only intervene in the money market through the shrinking intermediary role of the banking system, which has been left merely as a market participant in the overblown credit market.

Thus the Fed is forced to fight a raging forest fire with a garden hose. One of the reasons the Fed shows reluctance in cutting the Fed Funds rate target may be the fear of exposing its incapacity in dealing with the credit crisis in the non-bank financial system at hand. What if the Fed fires its heavy artillery but the credit crisis persists, or even gets worse?

Mutual funds squeezed by credit crunch

The growing global credit crunch squeezed the life out of mutual fund performance in August, Morningstar Canada says.

Just 17 of the investment research firm's 42 fund indices delivered positive returns for the month, as the U.S. subprime mortgage debacle intensified and sparked a crisis in the asset-backed commercial paper (ABCP) market in Canada.

As is typical during times when investor confidence gets shaken, the firm said in a news release Wednesday, bonds outperformed stocks, high-quality bonds beat those of lower quality and large-cap stocks beat smaller ones.

> "Overall, the meltdown in the (ABCP) sector that began roiling markets in July continued to drive extreme levels of volatility throughout August among long-term fund categories," Morningstar Canada analyst Jordan Benincasa said in a news release Wednesday.

Investors flee money markets in August

> With the gyrations in stock markets last month triggered by global credit woes, investors typically would have been plunking cash into money market funds, Mr. Loach said. "It was definitely an anomaly."
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> Money market funds are typically used as a parking spot for cash, and have always been marketed by fund companies as a safe haven. August was the worst month for net redemptions in money market funds since investors withdrew $1.7-billion in April, 2003.
>
> But some fund companies invested in non-bank ABCP in its money market funds, and this short-term debt backed up by packages of credit card, car and mortgage loans have faced a liquidity crisis. Players in this market, such as Toronto-based Coventree Inc., have fallen victim to a global credit crunch and have been unable to fund repayment of notes that have come due.

Manage the damage

> The asset-backed commercial paper (ABCP) market has grown considerably since the Reichmanns stumbled and has become much more complex without becoming correspondingly more transparent. ABCP has become the key area for financing securitized bundles of mortgages, car loans, credit-card debt and other more elaborate leveraged instruments. Contagion from the subprime mortgage problems in the United States have entered Canada, and been exacerbated by the lack of effective insurance against default on such instruments....
>
> ....Many reputedly sophisticated investors who put funds in ABCP are angry, embarrassed and looking for anybody to blame but themselves. Ned Goodman's fledgling Dundee Bank of Canada raised $2-billion by offering generous deposit rates, then made the mistake of putting a bunch of that cash -- reportedly around $400-million -- into ABCP. "It's impossible to get $2-billion properly invested in a short period of time," Mr. Goodman recently self-exculpated. But doesn't that mean he shouldn't have been so aggressive in raising it? Mr. Goodman also tried to point the finger at the banks, which had allegedly reneged on liquidity backup for commercial paper, but that backup was heavily conditional, and part of due diligence is surely to know the conditions. Mr. Goodman also tried on a little conspiracy theory for size: that the big banks were trying to put innovative financiers such as Coventree Inc. (a prime issuer of non-bank ABCP) out of business. Coventree may be able to do that all by itself.
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> The root causes of this financial folly lay in flawed assumptions and over-convoluted financial instruments. Subprime mortgages -- under which the non-creditworthy were lured into mortgages with cheap initial rates -- always looked like insanity unless U.S.

domestic real estate continued to rise in value. How many times does this lesson have to be learned?

Financial institution problems open opportunities for banks

> The problems of Canadian financial institutions that hold asset-backed commercial paper could create opportunities for Canadian Western Bank, says president Larry Pollock.
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> An estimated $35 billion in Canadian-issued ABCP has ceased trading in the past month, leaving many institutions scrambling for cash.
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> But CWB never bought ABCP because it is packaged as a bewildering mix of mortgages, credit-card receivables, derivatives and other assets Pollock said, Thursday. "It is very difficult to understand what is backing it."
>
> Other institutions bought ABCP as short-term investments that could be sold easily and quickly. Suddenly, however, the ABCP market has dried up.
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> "It has become illiquid," Pollock said. "Nobody will buy it."
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> As a result, "there may be opportunities to acquire high quality assets that were not previously available, at reasonable prices," perhaps including residential and commercial mortgages, he said.

Class-action guys see profit in subprime mess

> Most people know the market for third-party asset-backed commercial paper in Canada is in trouble.
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> But not many people outside a small knot of senior lawyers and bankers appreciate just how tenuous the situation really is, despite the Aug. 16 rescue agreement putting a 60-day standstill on $35-billion worth of non-bank asset-backed commercial paper (ABCP) while lawyers figure out how to convert it to longer-term floating-rate notes.
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> There's a problem with the plan, backed by 10 large institutions including the Caisse de dépôt et placement du Québec. And it's not with the holders of the commercial paper, who overwhelmingly support the bailout. No, the elephant in the room is the credit default swaps, derivatives that riff off the commercial notes.
>
> To step back for a moment, the swaps are contracts between two parties who agree to exchange the risk of default on an underlying investment, say a BCE bond, which they may not even own. One side buys protection in case of default, and pays a monthly fee for the privilege.
>
> This kind of swap can be used by companies as an insurance policy to make sure they can pay their bondholders. But it can also be used as a vehicle for naked speculation on changes in the credit spread.

In Canada, special-purpose trusts have been set up in recent years just to hold baskets of credit default swaps.

Canadian Mutual Funds Had August Redemptions of C$1.55 Billion

Canadian mutual-fund sales had redemptions of about C$1.55 billion ($1.47 billion) in August after concerns that bonds would default prompted Canadian investors to sell money-market funds.

Redemptions exceeded sales by C$1.3 billion to C$1.8 billion, the Toronto-based Investment Funds Institute of Canada said today in a preliminary report. That compared with net sales of C$744 million in August 2006.

Investors shunned money-market funds last month after the market for asset-backed commercial paper issued by non-bank dealers seized up on concern the funds may have investments linked to U.S. subprime mortgages.

International Forecaster MidWeek Reading - Gold, Silver, Economy + More

These money market funds may no longer be safe. Liquidity has been hit in these funds in Britain and Canada as well. We are told that money market funds worth $3 trillion have probably $300 billion in CDOs and other garbage. If that wasn’t bad enough, we have a long line of hedge funds and banks ready to go upside down. This is still the beginning of the beginning....

....We suspect not only did MBS go toxic, so did many derivatives and it is being hidden from us. In addition, we have not even begun to see the fallout in the hedge fund industry and in pension and retirement plans. We also ask who is going to resurrect the $2.2 trillion commercial paper market?

Credit crunch deals blow to Canadian economy

Canada's booming housing market could feel the chill of the U.S. real-estate crash by year end, warned maverick Member of Parliament Garth Turner, a financial author and former Conservative MP and Cabinet minister, who joined the Liberals after being kicked out of the Tory caucus.

"As up to a million and a half U.S. homeowners walk away from their houses and mortgages, the result has been a credit crunch, a construction bust, sagging car sales and an expected American recession," Mr. Turner said in a release.

Credit crunch threat to Canadian growth

A continuing liquidity crunch in Canada's asset-backed commercial paper market is triggering a sharp contraction in the availability of credit, threatening to cut short the economy's robust growth.

The problems are striking, given that the Canadian authorities organised a highly unusual restructuring of ABCP paper last month – a move intended to bring an end to the liquidity squeeze and restore confidence.

Bankers globally will be closely watching developments, particularly as similar pressures are emerging in Europe and the US.

The Canadian crisis stems from issuers' inability in mid-August to roll over maturing issues as a result of turmoil in the US subprime market, investors' diminishing appetite for risk, and the failure of emergency liquidity provisions of some commercial paper issues....

....A group of issuers, investors and foreign banks struck a deal on August 16 to convert outstanding asset-backed commercial paper, which normally matures in one to three months, into five-year floating-rate notes.

The agreement has removed the immediate uncertainty about lenders' ability to renew these debts, but has raised uncertainty about how the market will function in future.

Credit squeeze puts brakes on rates

The actions on Thursday brought down overnight interbank interest rates, but three-month interbank rates in the UK, eurozone and the US stayed at the high levels reached on Wednesday.

This means banks are continuing to hoard money in case they need to lend to companies and financial vehicles that might have to draw on emergency credit lines if they cannot refinance their debts.

Banks and other financial institutions will attempt to refinance nearly $130bn of short-term European commercial paper next week, at a time when the appetite for such debt has significantly weakened. This will be the highest weekly refinancing since the credit market problems emerged in August, according to Dealogic.

In the US, the size of the commercial paper marked has declined 13.4 per cent in the past four weeks to $1,925bn, the Fed said. The amount of asset-backed commercial paper has fallen 18.3 per cent to $977bn.

The central banks' actions come as European policymakers, central bankers and regulators begin a series of scheduled meetings, in which the credit squeeze is expected to dominate discussions, starting with a gathering of central bank officials and others in Paris on Friday.

Liquidity crisis grows as Libor rates gap hits 20-year high

Pressure is mounting on the Bank of England to intervene in the credit crisis after money-market lending rates jumped to a 20-year record and economists warned that central banks have "not properly recognised the dangers" ahead.

Hedge fund Synapse Investment Management became the latest market casualty, shutting a €200m (£135m) fixed-income fund due to "severe illiquidity", as the gap between the Bank's base rate, 5.75pc, and the three-month inter-bank lending rate (Libor) reached 1.05 percentage points - its widest since the mid-1980s and a clear sign of the ongoing credit crunch. Libor is now 6.8pc, the highest it has been since 1998.

Patrick Perrett-Green, director of European derivatives and bond trading at Citi, said: "The reality is that central banks don't know how to deal with the current situation within the confines of their existing rule books... In short, things are a mess and unless central banks start to properly recognise the dangers, the situation could reach critical." He called for an urgent cut to interest rates.

[Barclays borrows £1.6bn from Bank of England]

Barclays has been forced to tap the Bank of England's emergency lending fund after a major error in the City's trading systems wreaked havoc on the money markets.

The bank borrowed up to £1.6bn from the central bank's standing facility after it failed to settle its positions on the open market. It is the second time in as many weeks it has had to turn to the lender of last resort.

The embarrassing move came on a chaotic day in which a major problem with the electronic settlement system, CREST, forced the Bank of England to take the extraordinary step of extending trading for almost an extra hour.

Clearing banks such as Barclays have to settle thousands of different trades at the end of every day in order to balance their books. Usually, any shortfall on their account can be made up by borrowing money on the open market, from other banks.

[Top US Economists Present Scary Scenarios For Us Economy]

US homes may lose as much as half their value in some US cities as the housing bust deepens, according to Yale University professor Robert Shiller. Meanwhile, Martin Feldstein of Harvard University says that experience suggests that the dramatic decline in residential construction provides an early warning of a coming recession. The likelihood of a recession is increased by what is happening in credit markets and in mortgage borrowing.

Banks' nerves jittery over subprime mess

> Hopes of a U.S. interest-rate cut have helped stock markets banish their subprime demons but they have done little to ease the fear in a key conduit for global finance -- the market for lending between banks.
>
> While money markets appear to have freed up somewhat in the United States, they remain strained in Toronto and London, perhaps reflecting anxiety that the Bank of Canada and the Bank of England are unlikely to follow the Fed with the hoped-for rate cuts....
>
> ...."**There is extreme uncertainty and distrust as to what other financial institutions' exposure is**," said Diana Choyleva, head of U.K. Service at Lombard Street Research in London.

Why Libor Defies Gravity

> Libor is an interest rate charged by banks for short-term loans to each other. It is set daily by a bank trade association in London. The loans can be in U.S. dollars, euros, British pounds or other currencies.
>
> U.S.-dollar Libor rates usually closely track the federal-funds rate, which is the overnight lending rate managed by the Federal Reserve. But the two rates are now parting ways, complicating matters for the Fed as it tries to manage the global credit crisis and pushing up many short-term interest rates for borrowers.
>
> For the first eight months of this year, the U.S.-dollar Libor rate for three-month loans between banks nudged between 5.34% and 5.36%. Yesterday, the rate hit 5.7%, marking the rate's fastest rise in several years. The Libor hasn't been this far above the base short-term rates set by central banks since the Enron and WorldCom collapses in 2001, according to the British Bankers' Association, which sets the rate.
>
> One reason the Libor is trading so high: Banks, many of them in Europe, have heavy commitments tied to struggling commercial-paper markets. They are reluctant to lend out dollars, and that is driving up short-term borrowing rates. Some are also worried that their counterparties in these trades, other banks, might be too weak to pay back the loans.

Sense of growing crisis over interbank deals

> In particular, the cost of borrowing funds in the three-month money markets – as illustrated by measures such as sterling Libor or Euribor – is continuing to rise, suggesting a frantic scramble for liquidity among financial groups.
>
> This trend is deeply unnerving for policymakers and investors alike, not least because it is occurring even though the European Central Bank and the US Federal Reserve have

taken repeated steps in recent weeks to calm down the money markets.

“**What is happening right now suggests that the moves by the Fed and ECB just haven’t worked as we hoped**,” admits one senior international policymaker.

Or as UniCredit analysts say: **“The interbank lending business has broken down almost completely . . . it is a global phenonema and not restricted to just the euro and dollar markets.**”

If this situation continues, it could potentially have very serious implications.

One of the most important functions of the money markets is to channel liquidity in the banking system to where it is most needed.

If these markets seize up for any lengthy period, there is a risk that individual institutions may discover they no longer have access to the funds they need.

Banks issue record amount of dollar debt

Banks are issuing record amounts of dollar-denominated debt as they fear more demands for cash from troubled structured investment vehicles, according to the latest figures.

Despite having to pay higher interest rates, financial institutions and investment-grade companies raised $53bn in dollar-denominated fixed income debt last month – the highest amount ever for August, according to Lehman Brothers.

The bulk of that $53bn, which was also the 10th highest month in volume terms since 1992 according to Lehman, was raised by financial institutions as they sought to shore up their balance sheets amid the threat of a fully-blown liquidity crisis. When floating rate notes are included, issuance for financial institutions and investment-grade companies rises to just under $77bn, according to Thomson Financial, also a record for the traditionally quiet month of August.

This was in sharp contrast to the high-yield market, which was in effect closed in August with only three deals in the US and not one in Europe.

The banks have increasingly needed large reserves of cash to provide credit lines to structured investment vehicles, or SIVs, which have been unable to fund themselves in the asset-backed commercial paper sector – short-term notes backed by collateral such as mortgages – because of a sharp rise in risk aversion.

Moody's Lowers Outlook on Commercial Paper Funds

Moody's Investors Service downgraded or placed on review for downgrade $14 billion of bonds sold by funds that rely on the commercial paper market for borrowing, known as structured investment vehicles.

Moody's stripped Cheyne Finance Plc, the unit of London- based hedge fund Cheyne

Capital Management Ltd., of some of its investment-grade ratings. One portion of the fund's debt was slashed 11 levels to Caa2 from A3, Moody's said.

``It seems clear that the situation has not yet stabilized and further rating actions could follow if the situation continues or deteriorates,'' Paul Mazataud, group managing director at Moody's in Paris, said in a conference call today.

Structured investment vehicles, or SIVs, sell commercial paper and medium-term notes, using the money to invest in longer- dated bonds including mortgage-backed debt. Losses on securities linked to U.S. subprime home loans has the roiled the market for commercial paper after investors refused to buy the funds' securities.

U.S. job cuts soar 85%

U.S. planned job cuts soared 85 per cent in August from July as mortgage lenders buckled, a U.S. consultancy said Wednesday.

Almost half of the month's 79,459 cuts came from financial firms, Chicago-based Challenger, Gray & Christmas, Inc. said in its monthly tally.

Cuts in the financial services sector hit a record as a barrage of mortgage and subprime lenders collapsed amid a sinking housing market. More ominous news landed Wednesday with an ADP report showing employment in the U.S. private sector rose by just 38,000 in August — the weakest showing in four years.

“What had been a relatively small number of job cuts [in July] suddenly turned into a deluge in August as financial institutions literally shut down operations overnight,” said John Challenger, the company's chief executive, in a report.

Danger: Steep drop ahead

Credit crises have always been painful and unpredictable. The current one is particularly hair-raising because it's occurring amid the first truly global bubble in asset pricing. It is also accompanied by a plethora of new and ingenious financial instruments. These are designed overtly to spread risk around and to sell fee-bearing products that are in great demand. Inadvertently (to be generous), they have been constructed to hide risk and confuse buyers....

....Investment bubbles and high animal spirits do not materialize out of thin air. They need extremely favorable economic fundamentals together with free and easy, cheap credit, and they need it for at least two or three years. Importantly, they also need serial pleasant surprises in such critical variables as global GNP growth. All of this has been provided.

These conditions always produce excess and are always extrapolated. Unfortunately, like almost all other investment factors, they eventually move back to normal.

As wonderfully favorable factors cool off, asset prices will be under broad pressure, and risky assets will be under extreme pressure. If the credit crisis gets out of control, this will happen quickly and painfully.

[Conduit Risks Are Hovering Over Citigroup]

Though few investors realize it, banks such as Citigroup Inc. could find themselves burdened by affiliated investment vehicles that issue tens of billions of dollars in short-term debt known as commercial paper.

The investment vehicles, known as "conduits" and SIVs, are designed to operate separately from the banks and off their balance sheets.

Citigroup, for example, owns about 25% of the market for SIVs, representing nearly $100 billion of assets under management. The largest Citigroup SIV is Centauri Corp., which had $21 billion in outstanding debt as of February 2007, according to a Citigroup research report. There is no mention of Centauri in its 2006 annual filing with the Securities and Exchange Commission.

Yet some investors worry that if vehicles such as Centauri stumble, either failing to sell commercial paper or suffering severe losses in the assets it holds, Citibank could wind up having to help by lending funds to keep the vehicle operating or even taking on some losses.

[Money Market Squeeze Is Getting Worse, Barclays's Bond Says]

``This suggests that the money market liquidity crisis is getting worse, not better,'' said Tim Bond, the London-based head of global asset allocation at Barclays Plc's securities unit. Barclays, the U.K.'s third-biggest bank, tapped the Bank of England's emergency overnight funds twice last month at the central bank's penalty rate of 6.75 percent, 1 percentage point higher than its benchmark rate.

The Bank of England today offered to provide additional cash to reduce ``unusually high'' overnight interest rates and said it shouldn't be expected to take action to reduce three- month borrowing costs. The European Central Bank said money market volatility has increased and it may act tomorrow to ``contribute to orderly conditions.''

The rate at which banks lend pounds to each other overnight declined to 5.91 percent from 6.11 percent today after the Bank of England's announcement, according to figures compiled by the British Bankers Association. The three-month rate was unchanged at 6.8 percent, the most since December 1998. The bank's goal is to keep the overnight rate close to its benchmark lending rate, currently 5.75 percent.

``Lowering the overnight rate will not encourage banks to lend out more term money,'' Bond said in a phone interview today. ``Central banks are putting money in the wrong maturities, they should be supplying three-month money.''

[ECB pledges further action if needed]

The European Central Bank announced on Wednesday that it is ready to intervene again to relieve tension in financial markets, the day before its governing council meets to discuss interest rate policy.

The ECB's pledge to launch a fresh liquidity-boosting operation on Thursday if necessary, followed sharp rises in overnight interest rates and an earlier attempt by the Bank of England to calm financial market pressures. Euro overnight interest rates had earlier hit 4.685 per cent, almost as high as on August 9 when the ECB injected an unprecended €94.8bn into money markets.

In a statement, the ECB said that volatility in the euro money market had increased that it was "closely monitoring" the situation. It went on: "Should this persist tomorrow, the ECB stands ready to contribute to orderly conditions in the euro money market."

Hold off on foreclosures, Fed urges

The U.S. Federal Reserve and other federal banking regulators are making an unusual plea to mortgage lenders to hold off foreclosing on struggling homeowners as the country tries to ride out the worst housing slump in 16 years.

The Fed and the U.S. Treasury Department yesterday asked financial companies that process mortgage payments to identify homeowners at risk of falling behind before they automatically "reset" their interest rates at high rates.

"We encourage servicers of securitized mortgages to reach out to financially stressed homeowners," said Randall Krozner, a Fed governor. "Keeping families in their homes is a matter of great importance to the Federal Reserve."

The call comes after both George W. Bush, the President, and Ben Bernanke, the Federal Reserve chairman, pledged last week to do what they could to help those homeowners who were lured into the then-booming housing market by "teaser" low-rate interest rates that rose sharply after several years.

About 1.3 million subprime mortgages will reset to higher monthly payments this year and another 1.2 million will reset next year.

Subprime Crisis Hits Municipal Bond Market

We can still remember when people were telling us that the subprime crisis was confined to U.S. housing — that it was not a big deal in the final analysis. Well, the final analysis is not in yet, but oh were they wrong.

Not only is the subprime crisis not confined to U.S. housing — it is rippling through the entire U.S. and world economy. The Federal Reserve, European Central Bank [ECB], and the Bank of Japan [BOJ] have injected liquidity . The ECB and BOJ have talked about deferring expected short-term interest rate increases. The People's Bank of China has been talking up the dollar in response the crisis.

Nobel laureate Mundell: Euro gains risk deflation

> The euro's steady appreciation against the dollar in the last several years threatens to devastate the European economy by tipping it into deflation, Nobel Prize laureate Robert Mundell said on Tuesday.
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> Speaking at a forum in New York organized by Brown Brothers Harriman, Mundell said the euro's march toward $1.40, which began gathering pace in 2005, threatens to lead the euro-zone down the path traveled by Japan after the 1985 Plaza Accord.
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> That's when Japan agreed to let the yen rise, with the dollar at one point slipping to as low as 80 yen from around 240. The move crippled Japan's export industry and sent the country into more than decade of deflation.
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> Mundell, who won the Nobel Prize for Economics in 1999 and is often credited as the intellectual father of the euro for his research on optimal currency zones, said the same could happen to Europe's economy.
>
> "The movement up in the euro toward $1.40 is devastating for the European economy," he said. "It creates the potential for deflation ... it's a hangover for the stock market."

Fed, Blamed for Asset-Price Inaction, Is Told `Tide Is Turning'

> Federal Reserve officials, wrestling with a housing recession that jeopardizes U.S. growth, got an earful from critics at a weekend retreat arguing they should use regulation and interest rates to prevent asset-price bubbles.
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> Otmar Issing, former chief economist at the European Central Bank, and Stanley Fischer, head of the Bank of Israel, were among guests at the Fed's summer symposium in Jackson Hole, Wyoming, to challenge the hands-off approach. Fed Governor Frederic Mishkin reiterated his view in a paper at the conference: Officials should only respond to the effects of asset prices on the outlook for economic growth and inflation.
>
> ``The position that `this isn't an issue for central banks' has lost some support,'' Issing said in an interview at the gathering, which ran from Aug. 30 to Sept. 1. ``The tide is turning.''

[OECD calls for US rate cut to ward off crisis]

> The OECD club of rich nations has called on the US Federal Reserve to cut interest rates to stave off a credit crunch, warning the sub-prime crisis could trigger a serious global downturn.
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> "Downside risks have become more ominous. What we had not forecast was the extent of the spread of this financial risk beyond the US," said chief economist Jean-Philippe Cotis. The OECD downgraded its US growth forecast for 2007 from 2.1pc to 1.9pc, and refused to rule out a full-blown recession.
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> "The housing sector is set to exert a longer and more potent than expected drag, and confidence has weakened in the US," Cotis said. "There may be a case for some easing in the US federal funds target rate. There's still the risk of a credit crunch."
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> The OECD was caught off guard by the credit turmoil, which has spread quickly from US sub-prime across the entire gamut of commercial paper and low-grade debt.

[Feldstein Warns of U.S. Recession, Urges Fed Rate Cut]

> Harvard University economist Martin Feldstein said the U.S. housing slump threatens a broader recession, and the Federal Reserve should lower interest rates.
>
> ``The economy could suffer a very serious downturn," Feldstein, head of the group that charts America's business cycles, told a Fed conference in Jackson Hole, Wyoming, yesterday. ``A sharp reduction in the interest rate, in addition to a vigorous lender-of-last-resort policy, would attenuate that very bad outcome."....
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> ....Feldstein outlined a ``triple threat" from housing: a ``sharp decline" in home prices and construction; higher borrowing costs and a ``freeze" in credit markets stemming from subprime-mortgage losses; and fewer home-equity loans and refinanced

> mortgages, leading to less consumer spending.

[Fed Gets `F' for Failures on Housing, Leamer Says]

> Federal Reserve policy makers underestimated the role that housing plays in triggering recessions and merit an `F' grade for their failure, said Ed Leamer, director of an economic forecasting group at UCLA.
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> ``Something's wrong here,'' Leamer wrote in a paper presented to a conference in Jackson Hole, Wyoming, attended by Chairman Ben S. Bernanke and other Fed officials. ``Housing is the most important sector in our economic recessions, and any attempt to control the business cycle needs to focus especially on residential investment.''
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> Housing is vulnerable to ``persistent'' trends that, once under way, are difficult to restrain, Leamer wrote. The Fed ought to have raised interest rates more aggressively to head off the ``bubble'' in home prices that grew from 2003 to 2005 and should have lowered rates by now, he said.
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> ``What I'm calling for is monetary policy which at this point in the cycle would be stimulative because you're trying to keep the housing sector from crashing'' even further, Leamer said in an interview before attending the economic symposium.

[Bernanke's Pledge Fails to Dispel Pessimism at Jackson Retreat]

> Federal Reserve Chairman Ben S. Bernanke's pledge to stop the credit-market rout from wrecking the economy failed to quell concern at the Fed's Wyoming summer retreat that the U.S. is heading for recession.
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> ``I came to Jackson Hole thinking there would be no recession, but I'm leaving thinking we could well have one,'' said Susan Wachter, a professor at the University of Pennsylvania's Wharton School, who co-wrote the first academic paper presented at the conference.

[Being the Fed Means Never Having To Say You’re Sorry]

> Everyone knows who the Federal Reserve Board is. They are the folks who told us that there was no housing bubble. Then they told us that there might be some problems with housing, but it would be restricted to the subprime market, and was no big deal. Last weekend at their annual meeting of central bankers in Jackson Hole, Wyoming, they seemed to agree that the housing market is somewhat of a problem. However, just like President Bush in Iraq, they were nonetheless confident that everything is under control.
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> Excuse me if I don’t share their confidence.

[Panic Speaks Louder Than Words]

> Paulson is of course confusing strength with crack up credit booms. We are now on the back side of that credit boom, otherwise known as the start of a credit bust. It is foolish to believe the Fed or anyone else can contain it.
>
> And as for the Beige Book where this post started: "outside of real estate, reports that the turmoil in financial markets had affected economic activity ... were limited" ... Sorry Ben Bernanke. No one buys it. If this was truly contained to real estate, we would not be seeing so much panic. And panic speaks louder than words.

[Candy to Stop America's Blubbering]

> At the first sign of nervousness on Wall Street -- relatively small falls in asset prices which might threaten oversized bonuses -- Bernanke was quick to offer cheap money from the Federal Reserve for banks that lacked the credit standing to borrow in the marketplace. All this is done in the name of financial sector stability, code words for bailing out greedy and incompetent financial market players.
>
> Next up was President Bush, kindly offering government-supported relief for vast numbers of sub-prime borrowers who are unable, or soon will be, to pay rising interest rates on their loans. This was presented not only as a way of helping distressed, lower-income home-owners but of preventing mortgage problems from having a knock-on effect on the wider economy. Of course, it is also another way of bailing out those who persuaded borrowers to take out unaffordable loans in the first place – Wall Street.
>
> Of course these bailout efforts were accompanied by suitably responsible-sounding messages about the need to avoid moral hazard, to let a few of the more dodgy players suffer the consequences of their greed and stupidity. But the mainstream message is bailout, bailout, bailout.

[The Predicted Financial Storm Has Arrived]

> We are at an end of an era, living through the worst financial panic in many decades. Now begins global financial instability. It is impossible to speculate how long today's turmoil will last-but there now exists an uncertainty and lack of confidence that has been unparalleled since the 1930s-and this ignorance and fear is itself a crucial factor. The moment of reckoning for bankers and bosses has arrived. What is very clear is that losses are massive and the entire developed world is now experiencing the worst economic crisis since 1945, one in which troubles in one nation compound those in others.

[Will Japan be next to feel the US crisis fallout?]

Japan's economy has slowed sharply over the summer and may now be on the brink of recession, dampening hopes that Asia will buttress world growth as America battles the sub-prime housing crisis.

In the latest grim data, Tokyo said wages had fallen for the past eight months in a row. The cumulative fall over the past year to July has been 1.9pc, evidence of how intractable deflation can become once lodged in an economy. Business investment fell 4.9pc, with the pace of decline gathering speed in recent months.

The seemingly endless string of weak data from Japan comes amid mounting concern in Washington that the US economy is starting to buckle, and possibly tipping into a severe slump.

Australian Central Bank to Buy Mortgage-Backed Debt

Australia's central bank said it will buy debt backed by home loans to add cash to the financial system, after the U.S. subprime credit rout eroded demand for asset-backed securities and drove up interest rates.

The rate banks charge each other for three-month loans fell 15 basis points from yesterday's 11-year high of 7.06 percent after the Reserve Bank of Australia said in a statement today it will buy top-rated bonds linked to mortgage payments. Asset-backed commercial paper and bank bills are also eligible for its money market operations.

The purchases will increase funds available to banks and support the market for asset-backed debt in Australia, where credit markets have been roiled by losses related to debt backed by loans to U.S. homeowners. National Australia Bank Ltd., the nation's largest lender, yesterday said an affiliate had been unable to refinance A$6 billion ($4.9 billion) of loans.

Batten Down the Hatches

If you thought August was a crazy month to be in the stock market, wait until you see September. That, at least, is one of the potential themes facing investors as the school bells ring in what is traditionally a more active season for stock market activity.

Not that August was a slow month in comparison with previous years. This time, it jolted investors with its sharp sell-off and impressive rebound, leaving many observers nervous about sounding the all-clear signal on volatility.

Tobias Levkovich, chief U.S. equity strategist at Citigroup, noted a couple of weeks ago that, as rough as August was, September is statistically the worst month for stock market performance. For that matter, October is no great shakes either. "Thus, getting out of August may not lead to the best of times," he cautioned clients.

In mid-August, major stock market indexes hit their low points for the year. Many of

> them dipped into what is widely considered bear market territory, or losses of 10% or more from peak to trough. It was an all-out retreat from risk that left many of the highest-flying sectors of the market the most bloodied.

[Countrywide Finds No. 1 Spot Isn't Easy]

> Countrywide's fate is still unfolding, so it's too early to attempt a definitive analysis of its problems. But its aggressive lending strategy of the past few years appears to have relied on a belief that rising real-estate values would keep turning risky mortgages into strong -- and highly profitable -- assets.
>
> That worked beautifully for a while. Then, home prices headed south. And Countrywide couldn't tidy up its portfolio fast enough to calm investors' anxieties that it was overextended.
>
> Now, Countrywide hopes that a $2 billion equity infusion from Bank of America will restore investors' faith in its operations and let it grow again. Maybe; maybe not. Despite its vast size, Countrywide still is at the mercy of investors' sentiment, which fluctuates daily. The company declined to comment.

[Critical Illness Causes 50% of Home Foreclosures]

> New figures show 25 people suffer a critical illness every four minutes in North America.
>
> Not only that, according to financial consultant Sam Harris, in the same four minutes, five North American families will have to file for bankruptcy caused by a family medical problem....
>
> ...."The main problem is, we all take our health for granted until it's gone and then it's too late," he said.
>
> The second problem, according to Harris, is that North Americans have to rethink their priorities.
>
> "For instance, people traditionally insure their homes, cars and boats. However, if you look at the statistics there is a 1 in 300 chance that your home will burn down in a North American city, yet almost a 1 in 2 chance you will get a critical illness!"

[Meet the Struggling Insured]

> Last week, the government announced that the number of Americans who have no health insurance rose to 47 million, or nearly 16 percent of the population, from 44.8 million.
>
> But even people who have coverage through their employers are struggling with health care costs.

According to a new study by Consumer Reports, 4 in 10 Americans can't depend on their health insurance.

"Of the people who had health insurance, some told us they postponed getting tests or treatment, going to doctor, or filling prescriptions because they couldn't afford it," says Consumer Reports senior editor Nancy Metcalf, the report's author. "They could not pay for their share of their health care over and above what insurance covered."

Respondents said they raided retirement accounts, borrowed from friends and family, or ran up credit cards to pay medical bills. Three percent of insured respondents said medical bills forced them to declare bankruptcy.

Stretching to make car payments?

When it comes to car payments, consumers are stretched to the limit. Buyers are paying more, extending loan terms and making smaller down payments, according to a recent study by the Consumer Bankers Association. Many buyers also wrap old loans -- for vehicles they haven't yet paid off -- into the terms of their new deals.

"They're stretching in a lot of cases and may be well advised to pick a more affordable model or keep their car a little longer," says Fritz Elmendorf, the vice president of communications for the bankers association. About 60% of buyers are opting for loan terms of more than five years, the study said.

"It's been steadily stretching for many years," says Elmendorf. And it's because buyers want to get a better-quality car and still keep their payments low.

"So many have gotten used to lease payments," Elmendorf says. "They're looking for the cheapest payment on the nicest vehicle they can get into."

Fuzzy Bush math

There will be lots of celebrating in Washington next month when the Treasury announces that the federal budget deficit for fiscal 2007, which ends September 30, will have dropped to a mere $158 billion, give or take a few bucks.

That will be $90 billion below the reported 2006 deficit and will be toasted by the White House and Treasury as a great accomplishment.

But I have a nasty little secret for you, folks. If you use realistic numbers rather than what I call WAAP - Washington Accepted Accounting Principles - the real federal deficit for the current fiscal year is more than 2-1/2 times the stated deficit.

Why am I inflicting this information on you? Because there's been so much joyous noise about the budget emanating from Washington, despite the subprime mess and market meltdowns (which don't bode particularly well for future tax collections), that my natural contrarianism makes me feel like bombing the buzz machine.

Is China quietly dumping US Treasuries?

> A sharp drop in foreign holdings of US Treasury bonds over the last five weeks has raised concerns that China is quietly withdrawing its funds from the United States, leaving the dollar increasingly vulnerable.
>
> Data released by the New York Federal Reserve shows that foreign central banks have cut their stash of US Treasuries by $48bn since late July, with falls of $32bn in the last two weeks alone.

Pension rule change welcomed

> About 60 eligible multi-employer pension plans – the sort common in construction trades and supermarkets – will be allowed to carry on for at least three years without being hassled for failing a controversial test of their financial health.
>
> The temporary concession, which became effective and available Sept. 1, will give the province's year-old expert pension commission time to recommend permanent rule changes. It should also reduce the risk of pensioners picketing during the provincial election campaign.
>
> Actuaries and labour leaders are welcoming the province's response to months of lobbying, saying it is regulatory over-kill to force this type of pension plan to meet the so-called solvency funding test.
>
> Ministry of finance officials replied to questions that the changes recognize the unique nature of multi-employer plans, which generally differ from single-company plans. They have no government-backed guarantees and can legally cut pensions and benefits earned to date if a shortfall becomes unmanageable with the negotiated level of contributions.
>
> Seventeen plans covering 494,000 current and former members of Ontario MEPPs last reported they would lack more than 20 per cent of the money they would need if they had to shut down immediately and pay all benefits earned to date.