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Markets in Disarray as Lending Locks Up

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Federal Intervention Fails to Stem Crisis of Confidence on Wall St.

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The flow of money through critical parts of the financial system all but stopped yesterday, prompting the stock market to plunge again as banks lost faith in one another and investors rushed to U.S. government securities to protect their savings.

Goldman Sachs and Morgan Stanley, the only major investment banks still standing amid the wreckage of Wall Street's old order, tottered.

In one of the most tumultuous days ever for financial markets, the Dow Jones industrial average fell 449 points, or 4 percent, and so much money fled into safe U.S. debt that buyers were at one point willing to accept interest rates for Treasury bills of only 0.2 percent, the lowest since World War II.

The financial toll continued to mount despite a series of escalating steps taken by the government in recent weeks. As one investment bank failed Sunday and another was taken over, the Federal Reserve loosened its lending to troubled institutions. Then, in its most dramatic step yet, the government on Tuesday took over the enormous insurance company American International Group and extended it an $85 billion emergency loan. None of these measures succeeded in stopping the accelerating troubles.

Investors "are worried there is a lot more out there," said Robert MacIntosh, chief economist for Eaton Vance Management in Boston. "What other firms are going to collapse?"

The seizure in the credit markets made it difficult for the corporate giants of American industry to raise money through the short-term debt they use to make their payroll and extend credit to customers. Ordinary Americans by the millions invest in that short-term debt, called commercial paper, through money-market mutual fund accounts.

Yesterday, those money-market mutual funds were trying to unload commercial paper on fears of further problems, making it hard for all but the best-rated companies to borrow the money they need. That, in turn, led banks to hoard cash, which sharply raised borrowing costs for ordinary Americans. At one point, the rate that banks charge each other for overnight loans reached 6.4 percent, about triple what it would be in normal times.

The panic in credit markets made for tough sledding for the two remaining independent investment banks, which fund themselves with short-term borrowing. Both companies' stocks experienced their steepest single-day drop ever: Goldman Sachs down 14 percent and Morgan Stanley down 24 percent.

Morgan Stanley's chief executive, John J. Mack, told employees yesterday that "there is no rational basis for the movements in our stock" and that "we're in the midst of a market controlled by fear and rumors, and short sellers are driving our stock down," according to a staff memo.

Government leaders scrambled to consider their options, with officials at the Treasury Department and Federal Reserve calling contacts in financial markets and counterparts around the world to weigh any further intervention. As of last night, neither agency had any public comment on the distress.

The Securities and Exchange Commission instituted new rules to combat the "naked short selling" of stocks, a way of betting on their declines without having borrowed actual shares first. The ban could make it harder for hedge funds to make big bets against the shares of troubled companies. Last night, SEC Chairman Christopher Cox announced that he was asking the commission to urgently consider new rules requiring hedge funds and other large investors to disclose their short positions.

The Treasury, in the meantime, auctioned $40 billion in new debt to put the Fed in a stronger position to make future emergency loans, like those extended in the AIG takeover and the rescue of the failing investment bank Bear Stearns in March. The Treasury also established a procedure allowing it to auction off more debt if the Fed requires.

"They're recognizing that they may need more capacity in the days ahead, or at least they want to have that capability to intervene further," said Peter Hooper, chief economist at Deutsche Bank Securities and a former Fed economist.

Throughout the past year, the Fed has been creative at using its authority and nearly $900 billion balance sheet to try to ease the impact of the crisis. The Fed, for example, can lend money to any individual, partnership or corporation under unusual and exigent circumstances. And even after a series of unconventional loans in recent months, the Fed still had $479 billion of Treasury securities it could tap for such actions in the future. But what further options the Fed has remains unclear.

Even as they tightened their lending, banks were evaluating what the future may hold and looking for pairings. At Washington Mutual, a major shareholder waived a clause that made it difficult for the troubled Seattle-based thrift to sell itself, opening the way for a buyer. And Wall Street was rife with rumors that other banks may find merger partners in the coming days.

The turbulence was widespread through U.S. and global markets. Crisis deepened in Russia, where the government halted trading in stocks for the second straight day because of steep declines. There, the global financial crisis is compounded by a reliance on petroleum wealth, which is threatened by the severe drop in the price of oil over the past few months. Asian financial markets tumbled in early trading today, with Japan's benchmark Nikkei 225 index down more than 3 percent and Hong Kong's Hang Seng index off more than 7 percent.

Oil prices did rise yesterday, however, by $6 a barrel, as investors looked for places other than the debt markets to place their money.

Even nations without the severe problems of Russia have been hit: Stocks fell Wednesday in almost every country with an exchange.

There were also discouraging signs for U.S. housing, whose ailing health initially set off the credit crisis and continues to bedevil the financial markets. Home construction starts fell 6.5 percent in August, to 895,000 units, the slowest building pace since January 1991, according to Commerce Department data. It was down 33.1 percent from August 2007.

"We're dealing with a level of construction we haven't seen in two decades," said Mike Larson, a housing analyst with Weiss Research in Jupiter, Fla.

But some of the most severe -- and surprising -- damage to the financial system involved money-market funds, one of the most widely held types of investment in America and a key component in the way corporations and investment banks finance their businesses. Managers of those funds, which control $3.6 trillion, fled for safe havens yesterday, which aggravated a vicious cycle in the credit markets.

Many of these funds, long seen as one of the safest places for ordinary investors and businesses to park their money, have decided to play it safe and put their holdings into Treasury bonds, which are fully backed by the U.S. government. Several funds have even incurred losses, though in most cases they have stepped forward to cover them.

Money-market funds traditionally have been the primary buyers of commercial paper from U.S. corporations. These loans help companies buy supplies, pay their employees and purchase raw goods for production.

Investment banks help the companies find buyers for their paper within the money-market world and also issue such loans for their own benefit. With the funds as buyers, short-term loans flowed freely for Wall Street and Main Street.

But this week, the commercial-paper market began to break down. As money-market funds rushed into Treasurys, corporations could not find buyers for their short-term loans. Some companies had to tap their backup lines of credit at banks. Banks, in turn, saw demand for their capital rise, one reason why some stopped lending to each other.

In an environment where banks are lending to each other only at high rates or not at all, Morgan Stanley and Goldman Sachs may be particularly vulnerable, Wall Street analysts say. Both firms borrow heavily from other banks and financial firms to minimize the amount of their own money they have to invest and maximize their profits.

If all of their lenders demand their money back at once -- effectively a run on the bank -- Goldman and Morgan would have difficulty surviving. There is a range of estimates for how much these firms have borrowed, but analysts say they are probably borrowing $25 to $30 for every dollar they invest.

Trading yesterday in the market for credit default swaps, a form of insurance against corporate failures, showed that the perceived risk of Goldman or Morgan failing to repay their debts had risen sharply and that the companies may have to pay higher rates on their debt in the future.

Staff writers Binyamin Appelbaum and Renae Merle and special correspondent Heather Landy in New York contributed to this report.

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