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How a Rogue Trader in France May Have Moved the Fed

A ROGUE TRADER AT SOCIÉTÉ GÉNÉRALE MAY BE BEHIND THE FEDERAL RESERVE'S SURPRISING DECISION this week to make the biggest one-day reduction in interest rates on record. Jerome Kerviel, a 31-year-old trader, has been blamed for causing $7.2 billion in losses, wiping out almost the entire annual profit at the second-largest French bank. He was on the run from police as of press time yesterday.

Société Générale found out about the fraudulent trades Saturday and was busy unwinding its enormous positions on Monday, possibly explaining the panicked sell-off in the European and Asian markets on a day when no important news was announced. The markets tumbled to historic lows.

The Fed chairman, Ben Bernanke, reacting to Monday's devastating market losses, held an emergency meeting of the Federal Open Market Committee and announced a three-quarters of a percentage cut to its key interest rate before the market opened

Tuesday morning. The decision to cut rates in response to Monday's turmoil has angered some on Wall Street, who say it is outside the Fed's dual mandate to control inflation and spur economic growth.

"What Mr. Bernanke did was overreact and panic," the chief investment strategist at Raymond James, Jeffrey Saut, said.

"He clearly responded to Monday's sell-off and tried to bail out the stock market," an equity strategist for Miller Tabak + Co., Peter Boockvar, said.

On Monday, when the American markets were closed in honor of Martin Luther King Jr. Day, stock indices around the world plunged on the idea that America was headed into a recession and concerns that bond insurers were facing ratings downgrades and large write-offs.

Exacerbating Monday's sell-off, trading experts said, was the decision by Société Générale to unwind the enormous positions that Mr. Kerviel had amassed, a firesale of equity derivatives reportedly valued at as much as $74 billion. While the American markets were closed during the global stock slide, the futures market was indicating that Tuesday would be a bleak day for American stocks, with the Dow Jones futures index falling 546 points, or 4.5%.

Prompted by the European and Asian meltdown and concern that Tuesday would result in a stock crash, the Fed hastily called a meeting Monday evening, where it decided to reduce the benchmark overnight lending rate to 3.5% from 4.25%. It announced the move before the markets opened Tuesday.

Despite the rate cut, the Dow fell 464 points, or about 5%, as soon as the markets opened, as trades that were already in the pipeline were executed. After a tumultuous day, the markets had rebounded, with the Dow down just 128 points, or about 1%.

Even though the markets didn't crash Tuesday, critics were frustrated by the rate cut, which they said interrupted the market's natural cycle. "What Mr. Bernanke did was panic and cut rates in front of the opening, and never let the markets cleanse themselves on the downside," Mr. Saut said. "All the Fed is doing is putting off the inevitable. As sure as night follows day we are going to have a recession, and the longer they massage it and keep it from happening, the worse it will be."

Some on Wall Street are arguing that the economy is now too vast — it is estimated at $14 trillion and has seen an explosion in complicated financial instruments and global players — for Mr. Bernanke and the Fed to effectively manage market forces.

"Mr. Bernanke is too academic in his experience, he doesn't have the Rolodex and command that a real banker has," a managing director at Institutional Risk Analytics, Christopher Whalen, said. "What we need right now is leadership from the Street who says we know this asset class is taking some bullets, and here is how we fix it."

There is a division emerging between Wall Street pros critical of the Fed chairman and economists who say he is just doing his job. "I think people are looking for scapegoats in a very difficult situation," a professor of economics at New York University who is co-author of several publications with Mr. Bernanke, Mark Gertler, said. "He was put in an extremely trying situation, hit with oil price shocks, a housing correction, and the subprime crisis all at the same time."

Mr. Gertler warns that the Fed cannot prevent a slowdown, only soften its blow, and that Wall Street's expectations may be too high. "There is a slowdown coming for factors that are beyond the control of the Fed; what the Fed can do is moderate the pace of the slowdown."

Still, many on Wall Street say that Mr. Bernanke was tricked into a historic rate cut that was based on a stampede mentality of frightened traders rather than actual economic information.

"There was no other reason for him to cut rates on Tuesday — the FOMC was scheduled to meet next week and there was no new economic data that had come out," Mr. Boockvar said.

"His temptation to cut rates is driven by market forces, not what is right for the economy," a managing director at Westwood Capital, Daniel Alpert, said of Mr. Bernanke. The Federal Reserve did not return calls for comment.

In a statement, the French bank denied its operations caused Monday's worldwide panic, saying it had limited its trades to about 10% of trading volumes to minimize the impact on the markets.

"It's not possible that our covering operations contributed to the market's fall," the head of asset management at Société Générale, Philippe Collas, said.

In response to news of the fraud, the bank's chairman and CEO, Daniel Bouton, offered to resign; the board rejected the idea. It has announced plans to raise $8.1 billion in new capital to shore up its balance sheet.