The Case of the Futile Federal Reserve

Not since the Savings and Loan crisis of the 1990s has the U.S. banking system faced such dark times. A number of factors, working in concert, have driven the financial system to the brink and have the potential to send a systemic shock throughout the economy. Couple this with what is now an impotent Federal Reserve and we are faced with what could be the most significant financial crisis since the Great Depression.

The problems began with the overly accommodative monetary policy in the wake of the 2001 recession and the uncertainty following 9/11. Whilst monetary policy accommodation was exactly what the economy needed to promote growth in trying times, the length of the Fed’s loose policy helped fuel an unsustainable rise in real estate prices from 2002 to 2006. During this time, millions of Americans seeking the “American dream” of homeownership purchased properties that they would not have been able to afford during normal times but that favourable interest rates and bank lending standards made possible. In addition, speculators in the real estate markets drove up prices of some properties only to “flip” them for a quick profit. When the Fed began removing its accommodative policy and rates began to rise again, many who had bought homes were gradually squeezed from the markets. As a result, banks faced the prospect of foreclosing on thousands of properties where the outstanding mortgages were higher than the value of the property. In response, in the summer of 2007, banks began tightening their lending standards, prompting a credit crisis that further compounded an already tenuous situation.

In an effort to ease the credit crunch and boost confidence, the Federal Reserve began cutting interest rates along with other policy action to boost liquidity in August and September of 2007. The Fed’s rate cuts continued into 2008 with the most recent twenty-five basis point cut in the federal funds rate to 2% on April 30th. But the Fed’s actions—low rates for too long—are what started the mess by creating a moral hazard for banks to loan money, with little regard for fundamental valuation for real estate, whilst the money was cheap. In panicking and cutting rates so aggressively now, the Fed has done nothing but compound the situation whilst bailing out the equity markets with a protective “Bernanke put.” After all, the rate cuts now will not help those already in foreclosure or those who cannot afford their homes anymore—homes for which they overpaid and

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A Division of Global Financial Analysts, Inc.
PO Box 6895
Myrtle Beach, SC 29572
www.ThinkingOutsideTheBoxe.com

the values of which have dropped considerably—and that will ultimately go into foreclosure.

The banks must work the problem out on their own. Many banks have already started taking massive write-offs for bad mortgages. This, in itself, is financial hocus pocus—the writedowns damage profits now but some of the loans written off will still be collected. When they are collected in part or in full, the banks' profits will be higher than anticipated. Pay no attention to what the man behind the curtain is doing…

But the problems don't stop just with the banks. Many investment banks have become embroiled in the mess through derivatives and collateralized debt obligations. This has been like a vast Ponzi scheme where the investors left holding the bag are out billions. Witness the case of Bear Stearns whose plays in the real estate/mortgage markets brought about its collapse only to be bought by JP Morgan for cents on the dollar. The justification for the deal and the Fed's involvement was that the collapse of Bear Stearns could have had a systemic impact on the banking system and prompted a run on other banks.

Where does this leave us now? We may yet see a run on the banks (such as the run on Northern Rock in the U.K.), all factors considered, though there is ample liquidity in the system now…or so we are told. And if the banks and politicians have their way, the taxpayers will subsidize a massive bailout of banks and homeowners that will make the S&L bailout look like a picnic. This is abjectly wrong and will only promote further moral hazard in the future. The homeowners who made bad investment decisions and the banks that enabled this should not be rewarded for poor investment decisions. Rather, the banks and the homeowners should work together to find a solution, other than foreclosure, to the problem.

The Fed needs to now take away the punch bowl by ending rate cuts and taking back some of the policy accommodation instituted in the last eight months. The economic slowdown currently underway was inevitable. The Fed's cuts could not stop this. But as a result of policy accommodation, real rates are effectively 0% given the dangerous rise in inflation of late. With energy prices still rising and now fueling a dangerous rise in other consumer prices, namely for food, continued policy accommodation will prompt spiraling inflation, a weaker dollar, higher commodity prices as investors seek more favourable returns than on bonds or equities—factors which will retard long-term economic activity.

In addition to removing policy accommodation, the Fed should raise the reserve requirements of banks. Had this policy tool been used in the past (the last time the Fed used this was to cut the reserve requirement), bank capital ratios would be higher now—negating the need to shore up balance sheets with additional capital from foreign investors such as the Saudis. Banks would also have been more judicious in their lending habits, particularly in a period of low rates.

But despite the failings of the Fed, abolishing this institution, as some have suggested, is not a prudent or financially responsible action. The Fed provides a stable force in the banking system, overseeing regulation of banks and providing emergency liquidity to ensure properly functioning financial markets. Removing the Fed from the financial markets leaves regulation and oversight to either another government department or to the industry itself, leaves interest rates to be determined completely by banks and the markets, and forces banks to borrow overnight solely from each other. It should be easy to see how tempting it would be for the banking industry, in the absence of the Fed, to control interest rates in such a way as to negatively impact consumers and the broader economy. No, the simple fact is that we still need the Fed, no matter how misguided its actions or its shortcomings from time to time.

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