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Fed Action: Expected, But Not Exciting

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Highlights

- The Federal Reserve slashed its benchmark overnight rate by three-quarters of percentage point to 2.25% following its March policy meeting this afternoon.
- The Fed has less room to maneuver in the months ahead when the economic data is likely to take a turn for the worse and the pain on Wall Street impacts Main Street.
- In the end, the Fed's actions are necessary but not sufficient to end what is essentially a banking crisis.
- A three-prong approach that addresses the issues of getting bad loans off banks' books while simultaneously restoring investor confidence and restarting the securitization process could shorten the period of adjustment.

The Federal Reserve slashed its benchmark overnight rate by three-quarters of a percentage point to 2.25% at its March policy meeting this afternoon. The Fed also reduced the discount rate for the second time in the last two days, bringing the rate banks pay to borrow from the Fed to 2.5%. The vote was eight to two with Richard Fisher of the Dallas Fed and Charles Plosser of the Philadelphia Fed favoring less aggressive action.

Today's decision came on the heels of the Fed's Sunday announcement that it was expanding borrowing at the discount window to non-bank primary dealers for the first time since the Great Depression under the Primary Dealers Credit Facility (PDCF). This is the Fed's latest innovation to target liquidity where it is needed most in the market. The Fed is betting that these actions will ease financial market stress and mitigate the downside risks to economic activity. Investors seemed to have given the Fed a vote of confidence with the Standard & Poor's 500 index bouncing 4% to close at 1,331 today.

My concern is that the Fed has already used up a significant amount of its traditional policy ammunition to ease strained financial markets. This leaves the central bank less room to maneuver in the months ahead when the economic data is likely to take a turn for the worse and Wall Street's pain impacts Main Street to an even greater degree. Interest rate cuts can play an important role in supporting consumer and business confidence in hard economic times. If the US economy has indeed entered a recession, as I believe it has, then the incoming data on economic growth and unemployment may deteriorate significantly in the coming months.

Although many market participants and some Fed officials continue to focus on the risk that higher food and energy costs will result in a pick up in inflation, Mr. Bernanke seems to be more concerned about a very different risk. In fact, the actions that the Fed has taken thus far are directly out of a playbook Mr. Bernanke laid out in a speech back in November 2002 titled, "Deflation: Making Sure 'It' Doesn't Happen Here." At the time, Mr. Bernanke said that "by moving decisively and early" the central bank could avoid the onset of deflation. Mr. Bernanke acknowledged that deflation was only a remote risk at the time, but that he preferred prevention to trying to cure "it" once the problem took hold. Today, the risk of deflation is even smaller than it was in 2002, but Mr. Bernanke is still following the same game plan.

The Fed has already employed some of the non-conventional policy tools that Mr. Bernanke mentioned in his 2002 speech. For example, the decision to extend borrowing at the discount window through the PDCF is right out of this playbook. In the end, however, the Fed's actions are necessary but not sufficient to end what is essentially a banking crisis. The Fed's term lending facilities are only a band-aid that will temporarily get bad assets off banks books. Other actions that the Fed may take if the financial markets fail to stabilize include purchasing Ginnie or Fannie Mae mortgage-backed securities. This might make sense given that the mortgage market is the epicenter of the current credit crisis. It may also relieve some of the pressure in the Treasury bill market in which the Fed conducts most of its open market operations.

Ultimately, banks are in need of a more permanent solution. A three-prong approach to this problem that addresses the issues of getting bad loans off banks' books while simultaneously restoring investor confidence and restarting the securitization process could shorten the period of adjustment and lessen the downside risks to the US economy. But that requires action from the Federal government, not the Federal Reserve.