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The Fed Engages as Economy Wavers

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The Federal Reserve Board is now center stage in economic policy as it performs triage on the financial markets today and faces building inflation pressures tomorrow. At best, the overall U.S. economy has entered a period of slow growth; or it may be teetering on the edge of recession if one is not already at hand. Two major sectors of the economy—housing and financial markets—are in severe recession, and it is unclear whether other elements of the economy, especially business investment and the health care and net trade sectors, will be sufficient to stave off an overall contraction.

While the underlying fundamentals of the economy strongly suggest a recovery and a return to robust growth, the length and depth of this period of weakness is unclear and will depend significantly on the actions of the Federal Reserve in the days and weeks ahead.

Bear Stearns: Buyout, Not Bailout. The Fed is to be commended for showing initiative in recent months in taking aggressive, timely, and innovative actions to keep financial markets operating in very difficult circumstances. A good example is the Fed's husbanding over the weekend of the sale of the investment firm Bear Stearns to J.P. Morgan. In this event, the Fed properly used it powers to fold an investment bank whose weakness posed a potential risk to the financial system.

Bear Stearns faced two choices going into the weekend: a takeover or bankruptcy. Bankruptcy would have led to great disruption for Bear's customers and financial markets generally. A takeover, in this case by J.P. Morgan with support by the Fed and the Treasury Department, preserved services for Bear's customers and helped calm the markets. In neither case, however, has there been any sort of material bailout, as Bear's stockholders are left with almost nothing.

Fed Innovations Target Liquidity. In a further innovation, this past weekend the Fed established a new Primary Dealer Credit Facility. This will allow the Fed to offer liquidity assistance directly to certain major investment banks that were previously ineligible. The move signals the Fed's ability and determination to support these investment banks as long as they remain economically viable, thus averting a potential panic in the financial system.

The shift in roles with the creation of the new Primary Dealer Credit Facility is important. In more normal times, the Fed would, with changes in the Fed Funds rate, content itself with ensuring that the financial system has sufficient liquidity to work through its troubles. More recently, the Fed has ensured that specific troubled markets, such as those for commercial paper or mortgage-backed securities, had sufficient liquidity. The new Credit Facility expands the scope of firms in temporary distress that may be supported through Fed injections of liquidity.

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The combination of the new Facility and the Bear Stearns purchase constitute a potent one–two policy punch. The Facility means the Fed will not stand by while an investment banks risk failure due to liquidity constraints as long as the company remains viable. The Bear Stearns example means the Fed will act aggressively to fold such companies with little or no remaining net worth so as to preserve orderly markets.

Wanted: White Knights. The great uncertainty over the next few days will be whether those firms that find themselves in similar straits as Bear Stearns can, with the Fed's help, find similar White Knights in time. As it happens, many of these firms will be reporting earnings in the coming week, which should cast a penetrating light on their financial conditions.

Whether the Fed will be able to husband such takeovers in the future—as it did with Bear Sterns—will depend in part on whether there are sufficient pools of unencumbered private capital held by willing investors. There is plenty of capital "on the sidelines" earning low returns, but the question will be whether the owners want, or can be persuaded by the Fed to acquire, significant portions of these troubled companies. If so, then the turmoil among the financial institutions will pass; painfully for some, but it will pass—and with it the threat to the economy. If not…

The Risk of Building Inflation Pressures. In the months ahead, the Fed has a second task before it in constraining building inflationary pressures. This task may prove at least as difficult as navigating the present turmoil; once again, recession hangs in the balance. Many of the actions by the Fed and other central banks across the globe involved transactions in which financial assets held by a bank or other firm were exchanged for a cash loan over a specified period. These transactions provide liquidity precisely where it is needed and to whom it is needed. They also have the advantage of automatically withdrawing liquidity again upon expiration.

In contrast, the Fed has also aggressively reduced the Federal Funds rate. This likely has helped financial markets in a general way, and likely gave a dollop of extra energy to the rest of the economy. But the low Funds rate has also created a serious risk of rapidly rising inflation and inflationary expectations. Before long, the world's central banks will need to act aggressively, and sooner than they would otherwise choose, to drain this excess liquidity with some urgency. This will be a very dicey business, because if the central banks, and especially the Fed, act too slowly, then higher inflation will take hold; but if they act too aggressively, they will trigger a classic recession sometime in 2009.

Congress's Role Comes Later. The missing player in the present turmoil is the United States Congress. Citizens ought to be grateful that Congress is in recess. If Congress were in session, it would likely feel the ever-present need to "do something." At this point, any action taken by Congress would be *at best* harmless. This is a time to let the professionals at the Federal Reserve and the other regulatory agencies do their jobs. There will be plenty of time in the months and years ahead for Congress to review what occurred and, hopefully, to review the financial regulatory apparatus and rectify any shortcomings with respect to transparency and safety while improving the competitiveness of U.S. financial markets.

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