The Fed flexes its monetary muscle

IT IS a sign of the times that a cut of three-quarters of a percentage point in interest rates may be considered modest. On Tuesday March 18th the Federal Reserve slashed its headline interest rate to 2.25%, down by two percentage points in some two months. And it looked poised to keep on cutting.

Equities markets soared on the news. The Dow Jones Industrial Average rocketed by 3.5%, or 420 points, its largest gain in more than five years. But the cut was smaller than markets had expected, and the Fed said it would “monitor inflation developments carefully”, signalling that it has not given up concerns over price stability. This caused the dollar to surge against the yen and the price of gold to waver after hitting a record high on Monday.

The drop in the Fed funds rate caps an exceptional period of central-bank activity as credit markets seized up. Over the weekend the Fed unexpectedly cut the discount rate it charges to commercial banks, and it opened this “discount window” to investment firms for the first time since the 1930s. After another cut, the discount rate sits at 2.5%.

The Fed also brokered a rescue of Bear Stearns, an investment bank struggling from its exposure to mortgage-related securities. The central bank assumed the risk for $30 billion in mortgage-related securities in order to entice JPMorgan Chase to buy Bear Stearns for a bargain $2 a share and assume its liabilities. All of this is on top of promising up to $400 billion in expanded liquidity facilities in the past month to keep money flowing through the system.
The Fed made clear it is most worried about economic weakness. But the statement accompanying its decision acknowledged “uncertainty about the inflation outlook has increased”. There are risks to this approach. The Fed’s aggressive rate cutting might stimulate inflation, which was 4% for the year to February. Core consumer prices, which exclude food and fuel, were flat in February but 2.3% higher than a year earlier. More worryingly, the spread between inflation-linked Treasury securities and ordinary ones is increasing. Inflation hawks on the open market committee dissented from the latest rate cut and may have succeeded in keeping it to three-quarters of a percentage point rather than the whole percentage point the markets expected.

But for all the Fed’s effort, and despite the rally in the markets, the crisis in American finance remains severe. There is still vast uncertainty about how much toxic debt remains, and who owns it. This has led banks to hoard money and call in loans.

The fear hitting American finance will not subside dramatically until the value of mortgage-related securities is clearer and the size of investment houses’ liabilities is known. That in part depends on stabilisation of the housing market. The newly announced, and unexpectedly modest, decline in housing starts last month should provide encouragement. Previous housing start data was revised upward, too.

But much of the positive news was in the volatile multi-family housing market. Single-family starts were down by 6.7% in February and by 60% from their cyclical high, a larger tumble than in the early 1990s. Housing permits, which project future building, fell by 7.8%, the largest drop this decade. All the signs point to continuing drops in home prices.

The big question now is whether fiscal policymakers will step in, perhaps with a rescue for the mortgage industry that George Bush has thus far resisted. Congress will be increasingly receptive to calls from the left to take the pressure off homeowners, particularly now that Americans have seen massive Fed action to shore up Wall Street. Mr Bush also seems to be coming around. He now says that the government might do more beyond the fiscal stimulus set to take full effect in May, should conditions warrant.