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Few Expect a Panacea in a Rate Cut by the Fed

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By EDMUND L. ANDREWS
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WASHINGTON, Sept. 2 — Would cheaper money relieve the anxiety in financial markets about shoddy mortgages and declining home prices?

Even as the chairman of the Federal Reserve vowed on Friday to act “as needed” to keep the economy from sliding into recession, some analysts and even some policy makers caution that the central bank’s main tool may be ill-suited to the problem it faces.

Like horses that rear up at the sight of a rattlesnake, investors who financed commercial lending have become spooked as the housing bubble turned to a bust and foreclosure rates on subprime mortgages began to skyrocket.

Money for subprime mortgages, for people with weak credit, has already evaporated. And the paralysis has spread to more traditional home loans, business loans and corporate borrowing for billion-dollar leveraged buyouts.

But the Fed’s main weapon for restoring confidence — reducing its benchmark federal funds rate on overnight loans between banks to 5 percent or less, from 5.25 percent now — would have little effect on fears about credit quality.

“The reason there isn’t a market for these credits is that people don’t know what price they should be trading at,” said Edward E. Leamer, professor of management at the University of California, Los Angeles, who presented a paper during the weekend at the Federal Reserve’s symposium in Jackson Hole, Wyo. “That’s not going to be affected by a small change in the federal funds rate.”

The meltdown in credit markets permeated discussions at Jackson Hole. In late-night chats over Cognac, European central bankers and American hedge fund managers swapped stories about collapsing “conduits,” “special investment vehicles” and “SIV-lites” — entities that banks and private equity funds use to bundle and sell loans as securities.

The talk was not idle.

Over the next six weeks, more than $1 trillion worth of commercial debt is set to come due and will need to be refinanced, more than five times as much as came due since the disruption began one month ago.

Fed officials say most of that $1 trillion in maturing debt has nothing to do with subprime loans and any other kind of mortgages. It includes credit card debt, car loans and business loans.

One official compared the load of maturing debt to a pig in a python: a bulge that would be take time to digest, but could eventually be absorbed without huge problems.

Much of the digesting will be by big banks, which provided backup credit lines for their mortgage lenders.

But David Hale, a longtime Fed watcher, noted that at least two German banks needed to be rescued last month because of their exposure to American mortgages. Chances are very high that there will be more, Mr. Hale said.

Ben S. Bernanke, the Fed chairman, said on Friday that the central bank was ready to act if the turmoil in credit markets threatened to undermine the overall economy.

On Wall Street, investors welcomed Mr. Bernanke's remarks as a signal that the Fed would probably lower rates at its policy meeting on Sept. 18. Many economists and hedge fund managers said the move would indeed shore up confidence.

More important, supporters of a lower fed funds rate say it could prevent the huge looming losses from bad mortgages from expanding into even bigger losses on all kinds of loans.

"It would be a very powerful signal," said Lewis Alexander, chief economist at Citigroup. "A critical determinant of housing prices is employment. If you think employment is going to weaken, your assumption for housing and for the ripple effects through the economy will be very different."

But economists are still debating whether the Fed created the housing bubble, and thus set the stage for the current bust, when it slashed interest rates to cushion the shock of a bursting stock market bubble.

John B. Taylor, a former under secretary of the Treasury under President George W. Bush, argued over the weekend that the Fed "would have avoided much of the housing boom" if it had followed a more traditional monetary policy between 2001 and 2006.

But other experts attributed the real estate frenzy to other factors, in particular to an explosion of exotic mortgages that allowed people with low incomes and weak credit to buy houses with no money down and deceptively low initial payments.

"It's too easy to blame the Fed," said Robert J. Shiller of Yale, who sounded early alarms about both the stock market and housing bubbles. Mr. Shiller blamed mass psychology for the bubble, an almost ubiquitous conviction that housing prices would simply keep climbing at double-digit rates.

Mr. Bernanke took pains on Friday to warn that the Fed did not want to bail out either home buyers or investors who had made bad investments. Fed officials have long cringed at the idea of a "Greenspan put," the idea that former chairman Alan Greenspan could be counted on to rescue financial markets in times of turmoil by cutting rates.

Mr. Bernanke also made it clear he now worries that the downturn in housing and mortgage lending could pose a danger to the broader economy. Until recently, he had described the decline in residential real estate as a necessary "adjustment" to speculative excesses in one sector of the economy.

"Housing prices should not have a special role in the conduct of monetary policy," said Frederic S. Mishkin, a Fed governor, in a speech at the Jackson Hole conference. "On the

other hand, central banks should be actively prepared to deal with situations as they arise. You want to be prepared."

Reducing the fed funds rate would not necessarily rescue people who took on far more debt than they could afford. Rather, Fed officials appear to hope that the move would stimulate consumption and send a reassuring signal to investors that the Fed is prepared to prevent a full recession.

But the last few years suggest that the overnight fed funds rate has a weak relationship to housing.

Long-term interest rates, which determine mortgage rates, rose slightly before the central bank began raising the overnight rate in June 2004. But long-term rates and mortgage rates soon declined and stayed low throughout the time that the Fed quintupled its overnight rate to 5.25 percent.

The housing market began spiraling down in 2006, but primarily because houses had appreciated so much faster than household incomes and had become increasingly unaffordable.

But given the collapse of confidence in the credit quality for subprime and near-prime mortgages, which accounted for about one-quarter of mortgage originations as recently as May, few forecasters expect a quick recovery — and certainly not because of a slightly lower overnight lending rate.

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