THE FED CAN BRING THE HORSE TO WATER ...

Why Federal Reserve action by itself won't pull up the economy

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These are the most perilous economic times the Federal Reserve has ever faced. It's worth a look back over the Fed's responses over the last few years, to gain perspective as the central bank and the nation's banks move into the future...

When the Fed looked the original global financial meltdown in the face in 1929, it was young. Without the wealth of economic understanding we have today, the fledgling organization failed to fully grasp its predicament. Now, with a chairman whose Ph.D. dissertation was on the Great Depression, the Fed more quickly grasped the problem ... even if it failed to solve it.

Some saw it coming--from two directions

Many economic and banking commentators, the Fed included, recognized the onset of the global credit crisis in 2007 and 2008. The subprime loan market--and especially the trillions in credit default swaps issued against weak mortgage-backed securities, and other collateralized debt obligations--created a perfect financial storm. Many thought the crisis severe enough to easily tip global economies into recession.

At the same time, rapidly growing BRIC economies--Brazil, Russia, India, and China--were creating tight commodities markets. Oil and gasoline prices were rising rapidly, and with them prices in the energy sector and energy-intensive industries.

The Fed was confronted with inflation pressures it had not witnessed for a generation. Some Fed governors were calling for a tightening of monetary policy to nip a supply-driven inflation in the bud.

Meanwhile, others recognized a looming global financial crisis, which would command a loosening of the money supply to assure that banks had sufficient liquidity, so credit markets did not freeze up.

This monetary policy stalemate resulted in inaction by the Fed as it waited to see which crisis would come to a head first.

By the time credit markets froze almost completely in 2007 and 2008, and equity markets took a dramatic plunge, the die was cast. There was little the Fed could do but reassure the markets.

Looking back at "Quantitative Easing"

This is not to say the Fed did not try. In 2008 and 2009, it tried the typical loose monetary policy all Feds employ when necessary.

Called "quantitative easing," the policy is designed to encourage banks to lend, not hoard cash as a response to uncertainty. Banks are required by the Fed to hold a minimum of cash reserves as a share of all deposits. The rest they would rather lend out, as it is the spread between returns on loans and other assets and the interest they pay out that allows banks to make a profit.

The Fed can influence bank money-management tactics. It can push down the yield on bonds and the interest paid on banks' excess cash reserves held at the Fed. And, the Fed can further encourage banks to lend more aggressively by allowing them to have easy and cheap access to its discount window, should aggressive lending cause banks' reserves to fall short of the regulatory limit once in a while.

A low discount rate and open market operations designed to sell bonds and make banks too flush with cash are classic quantitative easing, labeled QE1.

In normal times, this policy works. Banks seek risk-adjusted returns by engaging in more lending. However, during deep recessions, prime borrowers choose not to build or invest, even though the interest rate may be very attractive. And, while a deep recession creates many potential subprime borrowers, banks have a hard time scratching out a reasonable return and cannot afford the risk of aggressive lending in a bad economic climate.

The Fed may bring the horse to water, but it would be irresponsible for the horse to drink.

Along comes a new twist--Operation Twist

As the Fed tried ever harder to make QE work, loose monetary policy and little loan demand forced interest rates so low that they became irrelevant. A commercial borrower does not hold off on a possible 3.5% loan to see if rates will go down to 3%. When rates are in the 3% range, and borrowing still does not resume, the economy falls into a classic liquidity trap in which rates become irrelevant--at least until consumer confidence resumes.

The Fed cannot be left as the emperor with no clothes, though.

Understanding that the definition of irrationality is to do the same thing and expect different results, it had to try something new. It invented QE2, also called Operation Twist, in which it sold short-term bonds and used the proceeds to buy long-term bonds, thereby raising the price of the short-term securities and lowering long-term interest rates and yields. The idea was to lower long-term capital borrowing costs even further to spur economic investment.

The problem with QE2, though, was that it drove some banks deeper into the red.

With little mortgage market activity, and with long-term interest rates driven further down, banks could not make much money on the few commercial loan applications out there. Nor could they risk buying long-term bonds at low rates, especially because the value of these long-term bonds would drop substantially once the recession ended and normal inflation and interest rates returned.

A third round commences--QE3

Not surprisingly, banks began to hoard cash and seek out short-term lending possibilities with ever-declining returns and profits. The Fed then realized that little could save bank profitability but a recovery of consumer confidence, led by a rebound in housing prices. Certainly, Congress was not helping in the recovery, so the Fed tried QE3 as a way to lower mortgage rates and stimulate housing purchases.

The central bank again began selling short-term bonds and buying mortgage-backed securities. It also harbored hope that a further decline in yields on long-term capital instruments would force money out of fixed-income securities and into the stock market. If the resulting rise in stock prices could increase portfolio wealth a trillion dollars or two, it was hoped that this wealth effect could spur a return of wealth-driven consumption and consumer confidence.

At least one Fed governor was skeptical of QE3. Most of the others had abandoned their concern that too much loose money would spur inflation. Indeed, inflation is unlikely when there is such incredible slack in the economy.

But, again, the Fed policy seems destined to fail. If the public does not want to buy homes at a 3.5% mortgage rate, it is unlikely that a 3% interest rate will be transformational. Instead, people are waiting to be convinced the housing market has bottomed out before they will come out of the woodwork.

Where are things headed?

Meanwhile, the Fed seems to have lost its focus on bank profitability. FDIC has created a very efficient bank restructuring program, and a sufficient number of well-run banks have led the Fed to believe its depressing effect on bank profits will not be catastrophic. After all, the Fed was forced out of the stimulus and bank solvency game with its first massive injection of monetary policy. Now, it is in the consumer and market confidence game like it has never been before.

It is likely that only time will heal these economic wounds. Things will improve when the economy realizes it has been down so long that anything feels like up.

About the author

In addition to his position on the bank's board, Colin Read teaches money and banking at the State University of New York College at Plattsburgh. He is also contributor to Bloomberg.com and has published eight books on global finance with MacMillan Palgrave Press.