

Fed's bold moves: Band-Aid or breakthrough?

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Faced with the threat of a massive economic meltdown last week, the Federal Reserve rode to the rescue with unprecedented remedies. It didn't just slash interest rates, it offered emergency loans to securities firms, agreed to take mortgage debt as collateral, and brokered a fire sale of collapsing Wall Street giant Bear Stearns.

Now that the Fed has calmed the economy's troubled waters, investors and economists are left wondering whether the fix will prove to be a Band-Aid or a breakthrough.

Even optimists admit the economy seems to be in an early-stage recession with job losses spreading and spending curtailed as the credit crunch tightens. The question now is how deep the downturn will be and how long it will last.

"It's too soon to say whether we've turned a corner on a sustained basis, but this week's developments pulled us back from the edge," said Gary Schlossberg, senior economist at San Francisco's Wells Capital Management. "We're not out of the woods yet by any means. The fact the Fed and the government have shown willingness to move aggressively (helped) calm the markets; it may limit the turbulence going forward."

Many Wall Street experts say they are encouraged by the Fed's drastic actions and by the government's allowing Fannie Mae and Freddie Mac - the government-chartered lending agencies - to raise billions more to channel into buying mortgages. Most important, investors may have recovered some heart. But there are still huge challenges ahead.

Liquidity dries up

Simply put, much of Wall Street has become gun-shy about lending money as the infection has spread from the defaults of risky, subprime loans that lie at the heart of the economic problems. That crisis of confidence brought Bear Stearns to the brink of bankruptcy. It also has hammered consumers applying for mortgages and businesses seeking loans. Precious little liquidity is available.

Even though the Fed has chopped a whopping three percentage points off its key federal funds rate since September,

that has not translated into lower rates for mortgages, car loans and other forms of credit.

"If no one is lending, who cares what the rate is?" said Steve Cochrane, senior economist at Moody's Economy.com in West Chester, Pa. "Even a zero or very-low-interest (federal funds) rate means nothing if there's no lending going on. That's part of what forced the Fed's hand to move in these other directions to become the lender of last resort, and to a wider range of financial institutions."

"What you and I care about is the end borrowing rate, the rate we're going to be paying," said James Wilcox, a professor of financial institutions at the Haas School of Business at UC Berkeley. "So far it hasn't gone down because the financial system isn't working right now. That's short-circuiting some of the interest-rate cuts."

Housing at the epicenter

It all comes down to where it started: the housing market. The wounds are no longer confined to subprime mortgages, but have spread to all segments of real estate with buyers and sellers in a virtual stalemate, and prices plummeting. Until that changes, the economy cannot recover.

"The housing market is the epicenter of the crisis today," said John Lonski, chief economist at Moody's Investor Service in New York. "Stabilizing housing and moderating home-price deflation would go far to enhance investor confidence and modify the supply of liquidity. As home prices slump, so does wealth in general. That reduces consumer spending."

But the housing market is nowhere near a correction yet. The most cheerful estimate is that it will bottom out late this year. Some say it could take years to recover.

"There is no sign that prices have leveled off anywhere," Cochrane said. "Home prices have to get down to a point where buyers truly think they're a bargain given the cost of financing and the long-term outlook for price appreciation."

For a textbook correction, the faster housing prices plunge, the faster they'll hit bottom and be ready to turn around. But the faster they fall, the broader the pain - for homeowners forced into foreclosures, for their neighbors as their home values drop, for Wall Street investors as billions of dollars in mortgage-backed securities go up in smoke.

For that reason, some experts think the government should take even more steps to soften the fall.

"The simple idea would be to give home buyers a tax credit," Lonski said. "Say a home buyer would be allowed to subtract 5 or 10 percent of the purchase price of a home from her tax liability. That incentive would boost capital spending."

Meanwhile, the Fed's interest-rate cuts may help stem the foreclosure tide - which in turn could slow home price devaluation. That's because many homeowners get into trouble when their adjustable-rate mortgages reset to unaffordable levels. ARMs are linked to the federal funds rate, so lower rates there translate into more-manageable monthly mortgage payments and potentially fewer foreclosures.

Pop goes the bubble

Not everyone thinks the government should try to cushion the blow.

"To my mind, the best thing that could happen would be for the (housing) bubble to deflate more quickly," said Dean Baker, co-director of the Center for Economic and Policy Research in Washington. "Instead they're coming up with crazy schemes to get more money to Fannie Mae and Freddie Mac to expand lending. That will keep (home) prices inflated."

Baker said he felt the Fed overstepped its bounds by opening its discount lending window to securities traders. If (Fed chief Ben) Bernanke can do that, "Can he just lend me money?" Baker joked. "If he can, maybe I'll call him up and get a low-interest loan."

Another naysayer on government intervention is Peter Schiff, president of Euro Pacific Capital, a Darien, Conn., retail brokerage, and author of "Crash Proof: How to Profit From the Coming Economic Collapse," a 2007 book that predicted economic carnage.

"We would not have this mess if the Fed had not brought interest rates down (in the early 2000s) to postpone the pain from the dot-com collapse," Schiff said. "That created a bigger bubble in housing. Now it's trying to find ways to postpone the pain again."

Schiff's view is that the Fed is debasing the dollar's value - and that that will lead directly to rampant inflation.

"We didn't have a severe recession in 2001-2002," he said. "Now we're paying the price in spades."

But other experts say being too laissez-faire carries its own set of harsh consequences.

Christopher Thornberg, founding partner of Beacon Economics, said a mind-set that preceded the Great Depression was: " 'Let's allow a little Darwinian action to cure the industry of its ills.' In the process of that purge, you basically destroyed the U.S. economy."

Help the rich, not the poor?

This week's actions stirred controversy among those who feel the government will do whatever it takes to prop up rich folks on Wall Street, while exerting less effort for poor folks on Main Street - the people losing their homes to foreclosures.

"We've already seen the Nader-ists call this a bailout of the rich," Thornberg said. "We're going to continue to hear that, but I would make the fundamental argument here, bailout or no bailout, you just can't allow a wholesale panic to cripple the banking industry."

Peter Morici, a business professor at the University of Maryland and former chief economist of the U.S. Trade Commission, begged to disagree.

Treasury Secretary "Henry Paulson is running around the country telling people that if they're upside down in their mortgage but can still afford to pay it, then they have an obligation to pay," he said. "But on the other hand, we let

these guys in New York walk away with gigantic severance packages while Bernanke lends them money to stay afloat. That's not fair.

"The policies place a heavy burden on those least able to bear it and let the rich bankers off scot-free," Morici continued. "This kind of stuff caused the French Revolution. They should be thankful people don't work on farms anymore because then they would all have access to a pitchfork."

Morici thinks the Fed should have extracted some concessions from Wall Street in exchange for its assistance, such as agreeing to issue simple, easy-to-analyze mortgage-backed bonds rather than the complex instruments whose failures triggered the current crisis.

Bernanke should "take bankers to the woodshed, go up there with a hickory stick and straighten them out," Morici said.

Even Lonski from Moody's, who was bullish on the Fed's actions, cautioned that its results were fragile.

"Whatever we gained in confidence this past week can be lost in a hurry if we have new evidence of a worsening of home sales and home price deflation, and signs of even bigger job losses and further cutbacks in business and consumer spending," he said.

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