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The Fed shocks the markets – not once but twice

Its rate cut surprised some, but so did last week's later gesture to banks

SUMMING IT UP

William Rutherford

The Federal Reserve last week shocked the markets with an underwhelming 25-basis-point Fed funds rate cut and, more importantly, a 25-basis-point discount rate cut. The markets immediately plummeted, closing down 294 points on the day, shocked because of the seemingly cavalier approach to the problems in the credit markets that caused credit markets to nearly seize up.

In its announcement, the Fed acknowledged "economic growth was slowing" and cited "deterioration in financial market conditions." Of interest was that the only dissenting vote was that of the newest member of the Federal Reserve board, the head of the Federal Reserve Bank in Boston. It would appear he's not yet been "institutionalized."

In the weeks between its November and December meetings, the Fed engaged in a round of hawkish statements indicating that its rate cuts, begun in September, were on hold.

But a negative market reaction met each of the Fed's statements. Then, about two weeks before the December meeting, the Fed speakers adopted a new line about rate cuts and seemed to embrace further cuts. This led to hope in the markets that the Fed would cut rates by 50 basis points and get ahead of the problems in the financial sector. Bank after bank announced new write-offs, sometimes bigger ones than they'd previously announced.

Financial problems spread into Europe. In the United States, even governments announced problems. The state of Florida's investment pool stopped withdrawals after a large write-down of the value of holdings. Local governments and schools borrowed to meet paydays.

Finally an accommodation was reached between the Fed and the markets: A consensus of a rate cut of 25 basis points, with a hope of 50 basis points, and a thought that the Fed would cut the discount rate (the rate at which the Fed loans to banks) by 50 basis points and make a strong statement. But with such ambiguity in that consensus, the stage was set for disappointment.

The scenario was reminiscent of 2000, when the Fed failed to take necessary action in December and the markets tumbled, giving up all of the year's gains. The Fed was forced to make a dramatic inter-meeting rate cut of 50 basis points in early January 2001 as the error of its ways sank in.

Not surprisingly, former Fed chairman Alan Greenspan interjected himself into the fray with an op-ed in which he found the genesis for the housing problems in the fall of the Berlin Wall, a theme he's returned to time and time again to deflect any responsibility for the housing problem. Still, he had to admit, the low interest rates during his tenure and the adjustable-rate mortgages he championed led to the rise in home prices and the mispricing of risk.

Early Wednesday last week, having assimilated the market reaction to it decision, the Fed, in concert with central banks around the world, announced action to ease tight credit conditions in world financial markets. No doubt this plan had been in the works for some time, but the announcement may have been accelerated by the Fed's fumble. The move was made in concert with the European Central Bank, the Bank of England, the Bank of Canada and the Swiss National Bank. No doubt other banks will join in.

The Fed said it would hold a series of auctions that would provide term funds to banks against a wide variety of collateral to secure the loans. The loans would be at the discount window. The plan would create a new "term auction facility" and initially lend $40 billion, and potentially far more, in auctions starting this week. Rates would be far below the rate charged on direct loans from the Fed to banks at the discount window.

The Fed also created reciprocal "swap lines" with the European Central Bank and the Swiss National Bank. These swap lines allow these European banks to make dollar loans in their own jurisdictions to put downward pressure on interbank dollar rates, principally the London Interbank Offering Rate. The

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inability of banks to make loans in anything other than their own currency had created problems in funding. All of these actions demonstrated the central banks were working together to pump liquidity in financial systems. The LIBOR immediately responded by dropping 17 basis points.

A spokesman for the ECB said the action was "designed to address elevated pressures in short-term funding markets." A Bank of England spokesman called the actions a "response to pressures in interbank markets."

This had a cathartic effect: European markets jumped, and the U.S. markets opened higher.

The advantages of the plan are several: The term "auction facility" avoids the stigma of the discount window, which banks were reluctant to access because of the message it sends to other bankers. Furthermore, the rates charged are expected to be below market rates. While one can expect criticism of lending to bankers at below market rates, the Fed will counter that market rates will converge with the auction facility rates, which certainly indicates the Fed expects interest rates to decline further.

All this is designed to increase liquidity in global credit markets. It's further recognition of the interconnected nature of world financial markets, and it marks a turning point for central bank cooperation. Indeed, out of the housing mess may come some good in the form of new kinds of cooperation between central banks.

The Federal Reserve deserves an "A" for creativity in its effort to solve the credit market problems, but it will probably get an "F" for how it handled the announcement. Instead of saying "more news is on the way," it let the markets plummet and then said, "Oh, by the way ..." More will be said about the process.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a four-star rating from Morningstar. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com.