Fed moves to restore balance

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The Federal Reserve action on Friday tries to maintain a distinction between its two core responsibilities: to keep markets functioning and manage the macroeconomy.

The changes to the discount rate – the interest rate charged to commercial banks and other depository institutions on loans they receive from their regional Federal Reserve Bank's lending facility, known as the the discount window – are designed to tackle the liquidity drought and get financial markets working properly.

The new statement meanwhile signals that the Fed stands ready to cut interest rates if necessary to deal with the spill-over effects of the liquidity crunch on the real economy.

The objective is to restore the flow of funds through the financial system, though not at any particular level of prices, and thus limit the damage to the real economy.

Its new policy stance encouraged speculation that the European Central Bank might have to back away from its inclination to raise rates in September.

Up to this point the Fed had concentrated its efforts to pump liquidity into the money markets in the overnight federal funds market, where interest rates spiked above the target rate of 5.25 per cent last week.

Repeated intervention brought the fed funds rate back down again and in recent days the Fed has kept the effective rate below 5.25 per cent, which some traders dubbed "stealth easing".

But while the Fed succeeded in restoring liquidity to the overnight money market, this liquidity did not flow through the financial system.

Three-month lending rates remained high and the asset-backed commercial paper market, and the jumbo (large loan) mortgage market remained dysfunctional.

The Fed is determined to reliquify these markets – partly because it sees part of its mission as keeping markets working, and partly because it believes the longer markets stay closed the bigger the risk that this will affect the flow of credit to households and businesses. Moving aggressively on the discount window front may help get these markets working, by ensuring a steady supply of finance to banks.

The Fed has not changed the list of securities eligible for these operations. But by reducing the penalty rate on discount window lending from 100 basis points over the federal funds rate to 50 basis points, and allowing banks to obtain 30-day loans rather than overnight money, it ensures that banks encountering difficulties securing finance against mortgage and other collateral have easy access to liquidity.

The Fed sees this as part of its classic role as a lender of last resort, first laid out more than a century ago by Walter Bagehot.

Not all economists, though, agree with the decision to reduce the interest penalty for institutions caught holding less liquid securities.

All depository institutions are eligible to borrow from the discount window, allowing funds to flow directly to a much wider range of banks than participate in the overnight federal funds market.

The Fed hopes its discount window steps will jump start the commercial paper, jumbo mortgage and other asset-backed markets. But the US central bank put in a powerful backstop by changing the policy statement to make clear that interest rate cuts – if not yet decided – were certainly on the table.

Its new statement says the “downside risks to growth have increased appreciably” that the committee “is monitoring the situation and is prepared to act as needed to mitigate the adverse effects on the economy arising from the disruptions in financial markets”.

In effect, the Fed was marking to market its statement of August 7 in the light of market deterioration since then, and making clear that the committee did not share the hardline views of Bill Poole, the president of the St Louis Fed, who told Bloomberg on Wednesday an emergency inter-meeting rate cut would be a “calamity.”

In doing so it was sending a signal that it would do whatever as necessary to stop markets seizing up and prevent the financial crisis turning into an economic crisis.

A Fed rate cut in September or earlier is still not certain, and will depend in large part on how markets behave between now and then. However, the new statement gives the Fed the flexibility to cut rates at any point.

Additional reporting by Ralph Atkins

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