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Markets Need Liquidity Shot That Will Last

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At every turn in this credit crisis Federal Reserve officials waited for someone else to act — for consumers or housing or financial firms to come crawling up the steps of the Federal Reserve hat in hand, begging for relief.

Some, such as AIG, were given help while Lehman was told to go away for good. Concern over a potential run on money market mutual funds this past week resulted in the U.S. Treasury stepping up with a bailout plan aimed at restoring confidence in the financial system. But the Federal Reserve never intended to bail out stockholders.

Chairman Bernanke said in his Aug. 31, 2007, talk that "it is not the responsibility of the Federal Reserve . . . to protect lenders and investors from the consequences of their financial decisions."

Bear Stearns and Lehman Bros. stockholders learned that he meant it. Management of these investment banks, as well as some commercial banks, gamed the system by taking on risks that common sense dictated against. But the potential fees and wealth gains overrode any sense of responsibility and judgment that management and directors had.

Federal Reserve actions over the past year confirm Bernanke's August 2007 position.

Fed officials did decrease the funds rate from 5.25% in September 2007 to the current 2%. But the Fed only followed — no effort was made to get in front of the slowing economy.

Instead the Fed chose to wait until the economic and financial pain increased to a high level before making the decision to lower rates.

Then the Fed would repeat the process of reaching a peak in financial pain before lowering rates.

Fed officials went through that process and backed off on Sept. 18, Oct. 31 and Dec. 11 in 2007. In 2008 the Fed replayed the tape on Jan. 22, Jan. 30, March 18 and April 30 before the funds rate reached 2%.

The Fed set up facilities along the way to help promote orderly functional financial markets such as the Primary Dealer Credit Facility, Term Securities Lending Facility and Term Auction Facility as smoke poured from melting financial entities. The PDCF affects reserves, but the Fed has acted to offset that.

But the Fed was never proactive in setting up these facilities — it waited until the cries for assistance were heard by everyone. The $180 billion swap setup is another example of the Fed waiting and waiting and then providing temporary liquidity.

U.S. homeowners have been hit with an inflation-adjusted loss in housing value of $4 trillion to $5 trillion from its peak, to date, using the Case-Shiller housing price index. Market value of the S&P 500, inflation-adjusted, is down approximately $2 trillion from one year ago. That is a loss of $6 trillion or more from household balance sheets.

Commodity prices are deflating. Europe, the U.K. and Japan are in recession. The Japanese have grown accustomed to being in recession.

There is no longer an inflation issue — it is a deflation issue. The overall CPI will disinflate over the coming year. Credit went from easy to tight in August 2007.

Monetary policy would typically offset that by becoming loose. That did not occur for two reasons: (1) the commodity price bubble and inflation issues, and 2) the Fed probably thought there were too many excesses left in the system, and both lenders and investors needed to pay.

Currently we have tight money in addition to tight credit. The average percent change in Fed bank credit over the past 15 years is nearly 7%. The average change in this measure since August 2007 is about 3%. That is tight money.

The Fed may have planned to wait to pump in permanent new additions until housing hit a trough. Greenspan followed that script in the early 1990s, pumping in permanent liquidity after the housing trough with a result of strong equity gains. Pumping in permanent liquidity goes a long way toward offsetting tight credit; that is its purpose.

But the Fed needs to act now. Pump in permanent new additions — do not wait until the housing trough. The Treasury bill under 1% tells them to act now. Markets need an infusion of permanent liquidity from the Federal Reserve.

Message to the Federal Reserve: Don’t follow the bonehead actions of the Bank of Japan in the 1990s.

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