

Fed Should Not Shut Door on Accommodative Policy

Desmond Lachman

Australian Financial Review

September 19, 2008

A dangerous myth is making the rounds in policymaking and financial market circles. It is the idea that the Federal Reserve has been overly accommodative in responding to the ongoing US housing market and credit market busts, which now raises the specter of rising inflation. The danger of this myth is that it could inhibit the Federal Reserve from forcefully responding to the present financial market meltdown with further interest rate cuts. Underscoring the risk of an overly tight monetary policy stance was the Fed's decision this week to keep interest rates on hold at the very same time that it was forced to provide AIG, the behemoth insurance company, with a US\$85 billion bridge loan to prevent the disorderly unwinding of its assets.

Proponents of the idea that US monetary policy is too loose primarily focus their argument on the unprecedented rapidity with which the Fed has cut the federal funds rate from 5¼ percent to 2 percent between August 2007 and March 2008. They are also quick to note that the federal funds rate now is considerably below the current 5½ percent inflation rate, which they fear could stoke inflationary expectations.

Those who believe that monetary policy is too loose make the additional argument that the Federal Reserve has been overly generous in opening its discount window wide open to both the commercial banks and the investment banks. As evidence of that largesse, they emphasize that the Federal Reserve has accepted over U.S.\$500 billion in mortgage-backed securities as collateral for repurchase operations.

There can of course be no denying that the federal funds rate is now significantly negative in real terms. However, before jumping to the conclusion that monetary policy is too lax, it would seem that a broader set of questions needs to be addressed. Has the reduction in the federal funds rate led to any meaningful reduction in the pertinent longer-term interest rates at which most households and corporations borrow? Might not the unwinding of AIG and Lehman in a fragile financial system lead to the further rationing of credit to households and corporations? And might not the very severity of the housing and credit bust dictate the need for a highly accommodative monetary policy?

A crucial point that the Fed's critics overlook is the fact that the Fed's efforts over the past year to reduce borrowing costs to final users has been largely offset by the intensification of the credit crisis. As a result, the interest rates paid today by households and corporations are in general no lower than they were last August when the Fed began cutting the federal funds rate. And in the case of mortgage loans they are appreciably higher.

In addition to not getting a break from lower interest rates at a time of economic weakness, households and corporations are now being squeezed by the virtual freezing of the securitization market and by a major reduction in credit availability. Private bank mortgage lending has all but dried up, while the Federal Reserve reports that around 60 percent of all banks have been significantly tightening their non-mortgage lending standards. In the wake of the Lehman fiasco

and the unwinding of AIG, one has to expect that this tightening will intensify in the months ahead.

The net upshot is that over the past year total bank lending has fallen by around 7 percent. This constitutes the fastest pace of credit contraction over the past forty years and stands in marked contrast to the double digit percentage rate of credit expansion in recent years. Such a pace of decline, coupled with the marked deceleration in the broad monetary aggregates, would hardly seem to be suggestive of an overly accommodative monetary policy stance.

A disturbing aspect of the ongoing credit crunch is that it is occurring at a time that the Federal Reserve correctly notes that the downside risks to the economy have increased. Of particular concern is the rising tide of home foreclosures, which underlines how far falling home prices are from finding a bottom and the continued stresses in the financial sector, as exemplified most recently by the Fannie and Freddie crisis.

Further clouding the immediate economic outlook is the fading of the tax rebate program that provided the economy with much needed support in the second quarter, and the growing evidence that Europe and Japan now appear to be on the brink of recession, which will put a damper on US export growth prospects.

In recent weeks, in response to slower global economic growth, international oil and food prices have declined by over 30 percent, which should ease inflationary expectations in the period ahead. Given the still very real downside risks to the economy, the Fed would be well-advised to ignore its critics and stand ready to cut interest rates as needed to keep the international financial system afloat.