The Federal Reserve

Plan B

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With or without the bail-out bill, the Fed has its work cut out

WITH strains intensifying in the money markets, the Federal Reserve still faces the burden of averting a serious recession. This was true whether or not America's House of Representatives approved the proposed $700 billion mortgage-rescue bill to create the Troubled Asset Relief Programme (TARP).

As *The Economist* went to press, the House had not yet voted again on a bill, after its rebellion on September 29th. The bill would permit the treasury secretary to acquire mortgage-related assets either in auctions or direct purchases, and if they are short of capital, to put equity into weakened institutions. (Half the money would be available now; the other half subject to congressional approval). Participating firms would have to give the government some form of equity or debt interest and accept limits on executive pay. A five-member oversight board and an inspector-general would monitor the programme. To win approval in the Senate on October 1st, the bill was amended to increase the limits on federal deposit insurance (see article).

But even if the House approves it, the plan will not deal with the immediate economic threat, which is a collapse of confidence in the financial system. Money-market funds and banks are deeply suspicious about whom they can entrust their money to. That could stifle the supply of credit and cause more banks to fail.

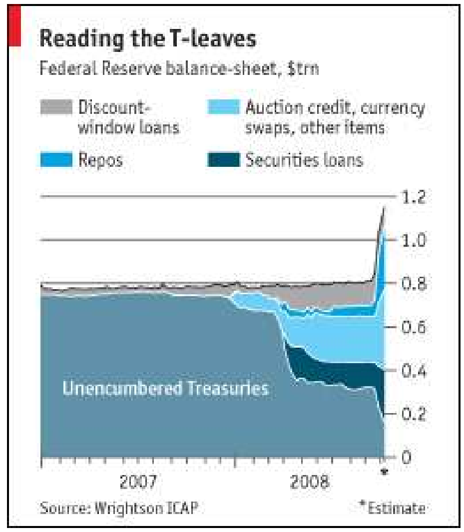
The most obvious way for the Fed to help is to lower the federal funds rate target, which sets the cost of borrowing, from its level of 2%. Markets expect a half-point cut by year-end. Lower interest rates would boost confidence, and that effect would be multiplied if the Fed acted in concert with other central banks. But the money markets are so dysfunctional that the benefits of a lower fed funds rate might be lost on most borrowers. And the European Central Bank (ECB) may not go along while it is focused on the risk of inflation, says Julian Callow, of Barclays Capital.

So although a rate cut remains on the table, the Fed will continue for the moment to rely on the growing use of its balance-sheet to counter the credit crunch. It has created many lending programmes since August 2007 to help banks finance holdings of illiquid assets and so avoid fire sales. But its balance-sheet is running up against constraints.

When the Fed makes loans, it deposits the proceeds in the accounts it holds for its customers—the banks themselves. Until now it has not paid interest on those deposits, which means banks lend their excess reserves to other banks. All else being equal, that would push the fed funds rate below the Fed's target, which is why it sterilises those excess reserves by selling some of the Treasuries in its portfolio.

So far, so conventional. At the end of July last year, the Fed had $760 billion of unencumbered Treasuries, or 87% of its assets. But the Fed's lending commitments have soared: $29 billion to back the assets of Bear Stearns, a failed investment bank; $85 billion in support of American International Group, an insurer; eventually $300 billion in discount-window credit auctioned to banks; and a vast $620 billion "swap" line which foreign central banks use to lend dollars to their own banks. It has also pledged to swap $200 billion of its Treasuries with investment banks. By October 1st Wrightson ICAP, a money-market research firm, reckoned the Fed had just $158 billion of unencumbered Treasuries left (see chart).

The Treasury has helped the Fed out by issuing additional debt exclusively for its use. This helps soak up the excess reserves created by the Fed's numerous loan programmes, which has caused its balance-sheet to balloon to $1.2 trillion. But the Treasury has congressional limits on how much debt it may issue. In search of a permanent way round the problem, the Fed has asked Congress to let it pay interest on bank reserves. It could then expand its balance-sheet indefinitely without driving the fed funds rate to zero; a bank will not lend out excess reserves at 0.25% if it can earn 1.75% at the Fed. The new bill would raise the debt ceiling and permit the Fed to pay interest on reserves immediately.



But even unlimited Fed liquidity may not fix the money markets. The Fed's torrent of cash pushed the fed funds rate down to 1% this week, from a high of 6% in the wake of Lehman's failure. But few borrowers benefited: some creditworthy firms paid 5% on overnight commercial paper this week and European banks paid 11% for overnight dollar funds from the ECB on September 30th. This partly reflects a temporary quarter-end scramble for funds. Burned on Lehman debt, many money-market mutual funds have also stopped buying commercial paper. Banks have picked up some of the slack, but many are reluctant to lend because their capital bases are already suffering from loan losses, and they are uneasy about the ability of many customers to roll over the paper. More lending by the Fed cannot create capital or trust; it is counting on the $700 billion bail-out plan for that.

If the plan fails to pass, the Fed could conceivably create one itself for mortgage assets, argues Michael Feroli, economist at JPMorgan Chase. The template is its September 19th announcement that it would finance banks' purchases of asset-backed commercial paper from money-market funds. The Fed, not the banks, bears the risk of any default on the paper. The risk here would be political: the Fed would be taking upon itself to intervene in the markets. But perhaps that is just what Congress would prefer: all the benefits of a rescue plan without the voters' retribution.