

Suite 502 • 1150 17th Street NW • Washington, DC 20036

Telephone (202) 777-3000 • Facsimile: (202) 777-3010

ECONOMIC NEWS UPDATE

IRWIN M. STELZER

17 August 2007

Bernanke to the Rescue

Like the cavalry coming over the hill just as the Indians were about to overwhelm the wagon train, Ben Bernanke rode to the rescue of beleaguered investors. He opened the discount window, making it possible for those desperate for liquidity to show up, hand over some assets that no one seems willing to buy, and borrow cash against those assets. The Fed specifically listed “home mortgages and related assets” as acceptable collateral.

Bernanke once said that the way to end a liquidity problem is to hop into a helicopter, and shower the country with cash, leading to the nickname “Helicopter Ben”. Fortunately, he knows the difference between a professor’s joke and a Fed chairman’s policy. He knows, too, that he cannot bail out imprudent lenders and borrowers without creating moral hazard -- encouraging a repeat of such behavior. So he has made it possible for banks and other institutions to get their hands on sufficient cash to give them time to work out their problems, but only by

paying interest rates that are higher than those routinely charged overnight borrowers. Walter Bagehot must be smiling from on high, as his prescription is applied to ailing markets, “Lend freely against good collateral at a penalty rate.”

Bernanke also met the economy’s liquidity needs without lowering overall interest rates, which he doesn’t want to do, at least not quite yet. One commentator called it a surgical strike, as opposed to carpet bombing the entire economy. Another suggested that Bernanke had gone from Scrooge to rock star overnight.

Not only has Bernanke managed to hold to his anti-inflation stance by refusing to cut interest rates, but he has gone a long way towards eliminating the uncertainty that has been plaguing the markets. Given the complexity of the various asset-backed securities, and the lack of transparency, no one knew which securities were infected with the problems related to the collapse of the market for troubled subprime

mortgages. So they avoided the good as well as the bad and the ugly. Now holders of those pariah securities can use them as collateral at the discount window.

Even more important, he has abandoned the policy of restricting these loans to very short periods. The new liquidity will be available so long as it is needed. So two cheers for Bernanke and his colleagues on the Fed Board of Governors, who unanimously supported the opening of the discount window.

The third cheer has to be held until we see whether this move combines with other Fed policies to keep the economy on its current modest growth course. Wall Street is sighing with relief; Main Street is yet to be heard from. The Fed's critics have not been appeased by its latest move. They want Bernanke to cut interest rates to reverse what they see as a major slow-down in the economy. He is hesitating. The inflation rate remains a bit above the Fed's comfort range, the industrial sector remains strong, the jobs market is in good shape, and consumers' incomes are rising.

But last Friday the Fed noted that "the downside risks to growth have increased significantly". This has many Fed watchers believing that Bernanke is on the verge of striking a new balance between inflation-fighting and economy-stimulating, and will cut interest rates next month.

Meanwhile, Main Street's reaction is difficult to read. Consumer confidence dropped last month. This probably was due to a combination of the financial turmoil and continued problems in the housing markets. But the survey predated Bernanke's surprise move on Friday.

Even with confidence dropping last month, and the troubles in the housing market, consumers did not retire from the malls and shops to their couches and television sets. Retail sales continue to grow, especially at the shops of middle- and high-end merchants. Consumers have continued to snap up electronics gear, furniture, and clothing, more than offsetting their inclination to make their existing automobiles do a bit longer.

If the economy continues to grow, Bernanke will have done one of the things he has to do to earn that third cheer. The other is to complete the process of making it possible for the nation's financial institutions to use the breathing space he has given them to work their way out of their current difficulties. That might involve further injections of liquidity. Make no mistake: the Fed's spectacular move on Friday is no panacea. Warren Buffett, "the sage of Omaha", says "The hangover is commensurate with the binge." And lenders have indeed been on a binge that has produced a massive hangover. There are still lots of securities out there that are backed with assets of unknown value; lenders are still skittish, and not eager to finance new mortgages; many lenders are going to have to write down the value of assets they have on their books at values far above what they can fetch in the market.

After all, the problems in financial markets transcend the subprime mortgage market. There are some \$10 trillion of residential mortgages outstanding in America. Only 15% of those are subprime mortgages, and only some 12-13% of those mortgages are delinquent (payment overdue for more than 30 days), with even fewer, perhaps 5-6% in foreclosure. That is fewer than

1% of all residential mortgages. This tiny tail has been wagging the great big dog that is the US and world financial markets. If the banks avail themselves of the open discount window -- something they have historically been reluctant to do because such a move has been seen as the last stop on the way to the graveyard for a financial institution -- Wall Street traders might actually get to their seaside mansions for a weekend breather for the first time this summer.

A version of this Update appeared in The
Sunday Times (London)