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First Trust

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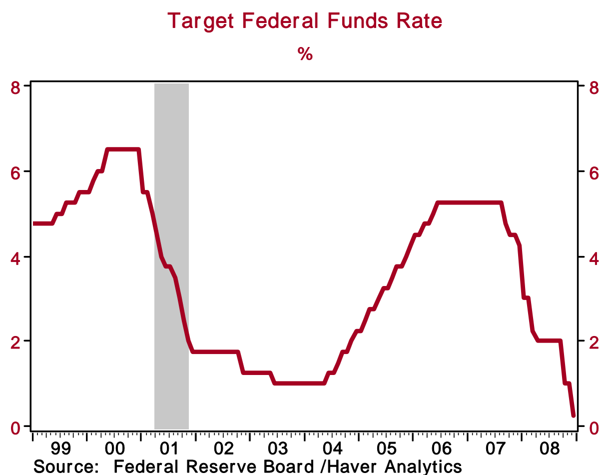
Economic Commentary

The Fed Goes Nuclear

Today the Federal Reserve declared all out war on the recent, but severe, drop in the velocity of money that has driven the US into recession and, at the same time, generated the fastest declines in monthly consumer prices since the 1930s. The declaration of war includes three major lines of attack.

First, the Fed reduced the target federal funds rate (previously 1%) to a range between 0% and 0.25%, essentially adopting a Japanese-style zero interest rate policy.



Second, it committed to maintaining this unprecedented low interest-rate range, saying that weak economic conditions "warrant exceptionally low levels of the federal funds rate for some time."

Third, it said it will continue to use its already expanded balance sheet to support credit markets, what some call "quantitative easing." In addition to signaling that it will hold interest rates down, the Fed said it will buy agency debt and mortgage-backed securities, along with longer-term Treasury securities. All of this is reminiscent of the early 2000s when the Fed said it would hold short-term rates down for a "considerable period," which was a strategy to pull long-term rates down.

The Fed's statement was very bearish on the economy and signaled that the Fed expects inflation to go below a level consistent with price stability.

While all of this may appear appropriate in the heat of battle, this idea that the Fed should attempt to drive down long-term interest rates to stimulate the economy is flawed. The last time the Fed did this was in the early 2000s when it drove short-term interest rates down to 1%, and convinced markets that these rates would stay low for a long time. This in turn brought down long-term interest rates, which is what the Fed wanted.

Those low interest rates, as everyone knows, were a key catalyst beneath an over-bought and over-leveraged housing market. They also drove the value of the dollar down, while igniting inflationary pressures and pushing oil prices near $150/barrel, which virtually killed the auto industry. Apparently, this is all behind us now and the Fed is using the same strategy all over again.

This strategy of driving interest rates down below 25 basis points is likely to push money market fund yields to very near zero. As a result, we expect to see a huge shift toward holding cash in certificates of deposit. If banks pay depositors 25 or 50 basis points for money, they can earn a large spread on any borrowing. As a result, financial stocks soared today, giving a boost to the entire market.

The market obviously liked the Fed's move, but it needs to realize that the Fed is throwing high-octane fuel on the fire. There will be a price to pay in the long run. For some reason, people only think about the cost of borrowing when the Fed cuts rates. But there is also a cost to lending, and the lower the Fed drives interest rates, the less incentive there is to lend.

This is especially true when mark-to-market accounting can undermine the value of assets. When risks rise, lenders want to earn higher rates not lower rates. Money does not grow on trees. It is printed by the Fed, added to the banking system and then used to make investments.

If rates are held artificially low while risks remain high, the financial system will not utilize money efficiently. Will anyone, other than the government, lend money to General Motors today at 75 basis points less than yesterday? The answer is no.

So, while we expect the Fed's actions to help offset the decline in velocity in the near-term, it is the longer-term that is becoming more of a risk. Once the economy shows clear signs of reviving, the Fed must act quickly to remove this monetary stimulus.

Text of the Federal Reserve's Statement:

The Federal Open Market Committee decided today to establish a target range for the federal funds rate of 0 to 1/4 percent.

Since *the Committee's last meeting, labor market conditions have deteriorated, and the available data indicate that consumer spending, business investment, and industrial production have declined. Financial markets remain quite strained and credit conditions tight. Overall, the outlook for economic activity has weakened further.*

Meanwhile, inflationary pressures have diminished appreciably. In light of the declines in the prices of energy and other commodities and the weaker prospects for economic activity, the Committee expects inflation to moderate further in coming quarters.

The Federal Reserve will employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability. In particular, the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.

The focus of the Committee's policy going forward will be to support the functioning of financial markets and stimulate the economy through open market operations and other measures that sustain the size of the Federal Reserve's balance sheet at a high level. As previously announced, over the next few quarters the Federal Reserve will purchase large quantities of agency debt and mortgage-backed securities to provide support to the mortgage and housing markets, and it stands ready to expand its purchases of agency debt and mortgage-backed securities as conditions warrant. The Committee is also evaluating the potential benefits of purchasing longer-term Treasury securities. Early next year, the Federal Reserve will also implement the Term Asset-Backed Securities Loan Facility to facilitate the extension of credit to households and small businesses. The Federal Reserve will continue to consider ways of using its balance sheet to further support credit markets and economic activity.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; Christine M. Cumming; Elizabeth A. Duke; Richard W. Fisher; Donald L. Kohn; Randall S. Kroszner; Sandra Pianalto; Charles I. Plosser; Gary H. Stern; and Kevin M. Warsh.

In a related action, the Board of Governors unanimously approved a 75-basis-point decrease in the discount rate to 1/2 percent. In taking this action, the Board approved the requests submitted by the Boards of Directors of the Federal Reserve Banks of New York, Cleveland, Richmond, Atlanta, Minneapolis, and San Francisco. The Board also established interest rates on required and excess reserve balances of 1/4 percent.

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