



Tough Love: Why the Federal Reserve Should NOT Cut Interest Rates

With the real estate bubble having burst and the financial system in a tizzy over the attending fallout in the mortgage markets, bankers, investors, homeowners, and CEOs are calling on the Federal Reserve's Federal Open Market Committee (FOMC) to cut the federal funds rate in an effort to avert a financial meltdown. However, the Federal Reserve should see through these self-serving calls and hold rates steady for the time being.

A cut in the federal funds rate, or several cuts as the futures markets are predicting, may well spur growth in GDP from the tepid rate of the first half of the year. With this, however, comes the risk of increasing inflationary pressures at a time when inflation is likely to remain above a comfortable level for maximum economic output. In addition, increased economic activity resulting from lower interest rates at a time of sustained higher energy prices could result in inflationary pressures spiraling out of control.

A cut in the federal funds rate would also likely result in a long-term strengthening in the dollar. With the dollar currently weak in the foreign exchange markets, consumers here in America may find domestic-made goods less expensive than imported foreign goods. Likewise, foreign trading partners would find American produced goods relatively less expensive than their own domestic goods. Thus, the weaker dollar may well lead to a shrinking of the current account deficit. Cutting rates and strengthening the dollar could lead to an increased current account deficit which could have adverse economic consequences.

Further, a cut in rates now may well lead to increased spending by consumers, many of whom have already spent beyond their means. Higher rates have reduced the proclivity of consumers to make purchases on credit and have prompted repayment of debt and increased savings. This increased savings comes at a time when America has become a nation of dissavers in recent years.

But more importantly, cutting rates now is not going to stem the much needed cooling of the housing market. Highly accommodative monetary policy that saw the federal funds rate cut to 1% was what



the economy needed in the aftermath of September 11, 2001 and likely helped to avert a potentially deep recession. However, the FOMC, as is so often the case, overshot on the downside by cutting rates so aggressively. The environment of virtually free money, credit, and mortgages from 2002 to 2004 created a moral hazard--mortgage companies and banks loaned money for real estate purchases to many individuals who otherwise would not have been able to afford such investments. At one point, exotic mortgages (reverse amortization for example) and interest only mortgages accounted for over half of those underwritten.

But cheap money could not last forever, and, ultimately, the time would come to pay the piper when rates began to rise. Little heed, evidently, was given by lenders to the ability to service the debt obligation when rates increased down the road. By then, the underwriters would have packaged and resold those loans to other investors. Consumers also failed to consider the consequences of when the music stopped and they were unable to pay for purchases made on credit that had been and were still beyond their means. The irrational exuberance that surrounded the noble desire to achieve the American dream of home ownership clouded some consumer's and lender's judgment.

But the blame for the current situation has to be shared by all parties. Consumers thirsted for the American dream but spent beyond their means with mortgages and credit cards. Lenders made the American dream sound possible with sales pitches that seemed too good to be true. Investors bought speculative properties and flipped them for quick gains with what was perceived to be no risk, driving up prices in some places and further fueling the exuberance. The FOMC failed to take the punch bowl away whilst the party was still going strong by opting for a measured removal of accommodative monetary policy in twenty-five basis point increments. Whereas their rate cuts had, at times been in fifty basis point increments, their reaction in removing accommodation was weak and timid.

Through all of this, did no one--lenders, consumers, investors, the Federal Reserve policymakers--recall the old adage, "If it seems too good to be true, it probably isn't true?"

But now that the party is over and everyone has a bad hangover, these same partygoers are turning to the Fed to bail them out of the problems that they have created. During the Greenspan era at the

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Fed, investors and financial market participants manifested in their minds the existence of a protective "Greenspan put"—the notion that the Fed would aggressively cut interest rates to avoid a steep decline in the markets. Indeed, the Fed cut rates in the early 1990s following the savings and loan crisis and again in the late 1990s following the Asian contagion and bailed out the markets following the collapse of Long-Term Capital Management.

The mandate of the Federal Reserve, however, is not to protect the markets from sharp declines. The mandate of the Fed is, as defined by the Federal Reserve Act, to "maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Whilst working to ensure the stability in the overall financial system is important, this should in no way imply that the Fed should bail investors out of bad investment decisions. Declines in markets (a.k.a. corrections) are a perfectly natural part of a well-functioning, orderly financial system and serve to adjust asset prices towards more fundamental valuations.

To be sure, the Fed should not cut interest rates now. Yes, credit conditions did deteriorate considerably in mid- to late August. The injection of over \$69 billion into the system coupled with a cut in the discount rate helped shore up confidence amongst lending institutions. But cutting the federal funds rate (leading to lower interest rates overall) will not stop the pain the real estate market is feeling and the further pain that is to come. To stop the default on loans and subsequent foreclosure on properties with adjustable rate mortgages would require a cut in rates to levels of 2003 and 2004 when the federal funds rate was still under 2.25%. However, consumers who are already stretched too thin and who are buried under mountains of mortgage and credit card debt would still not likely be able to satisfy their debt obligations. Additionally, such a dramatic cut in rates again would start a vicious cycle of loose policy all over, further compounding the situation.

But more importantly, doing so would send a signal to the financial markets that this Fed will bail them out when they get into trouble as a result of bad investment decisions. Thus, the Fed would be obligated to bail out the next hedge fund that goes bust, and the next one, and the next publicly-traded mortgage lender that goes



under, etc. Much like a spoiled child whose parents continue to bail him out of trouble without any consequences, the Fed would play this role well for unruly investors. And like the spoiled child, the investors would never learn their lessons. No, what we need is tough love from the Fed. Let the markets and investors sort this one out on their own. The Fed must hold rates steady. After all, the best lesson is a bought lesson, and it appears that investors and lenders may have bought and paid for this one to the tune of \$50-\$100 billion.