The New York Times
nytimes.com

**March 9, 2008**

## Downturn Tests the Fed's Ability to Avert a Crisis

**By VIKAS BAJAJ**

In the last seven months, policy makers have cut interest rates, injected money into the banking system and approved a fiscal stimulus package in an effort to keep the economy from slipping into a recession. Often, the moves seemed to work at first, only to be overtaken by more bad news.

The failure of any of the usual fiscal and monetary policy tools so far raises questions about what the Federal Reserve and federal government can do in the near term to counter the forces that have battered housing prices and pushed down the stock market and are now causing a hiring slowdown.

"There are times when there is only so much the Fed can do," said Barry Ritholtz, chief executive of FusionIQ, an investment firm in New York. "It can smooth out the business cycle a little bit, but last I checked, we haven't done away with the business cycle."

One of the main problems now is a deepening crisis of confidence that is compounding the ill effects from the housing downturn. As lenders and businesses become more cautious about whom they lend to and hire, they are slowing an already weakened economy. If the housing boom was a manifestation of irrational exuberance, some say it has swung too far in the other direction, to irrational despondency.

"Banks went from giving money away like drunken sailors to not lending to the most credit-worthy borrowers," Mr. Ritholtz, who writes the popular economics blog The Big Picture, said. The latest signs of panic in the markets came last week. Banks began calling in loans they had made to hedge funds, mortgage companies and others, forcing them to sell billions of bonds. The moves prompted concern about securities backed by Fannie Mae and Freddie Mac, the large government chartered buyers of mortgages that many investors believe have the implicit backing of the federal government.

When big investors are forced to quickly dump billions of dollars in securities, trading can seize up, especially when buyers are scarce, as they are now. Just a few weeks earlier, a similar bout of forced selling drove down the prices of municipal bonds issued by states and cities.

In mid-January, the Fed moved to arrest the crisis in the financial system after markets plunged around the world and a French bank announced a big trading loss; markets in the United States were closed because of a holiday. The Fed cut interest rates three-quarters of a point and cut them another half-point a week later at a scheduled meeting. With the exception of a few days, the market rallied those two weeks, and investors even drove down mortgage interest rates, sending millions of homeowners shopping for new loans.

But the relief was short-lived. Mortgage interest rates headed back up almost immediately, and by early February the stock market was falling again after reports showed a drop in employment and a slackening in the service sector.

"The Fed rate cuts aren't doing anything for my clients except confuse them," Steve Walsh, a mortgage broker in the Phoenix area, wrote in an e-mail message at the end of January. Fed officials would say that mortgage rates would be higher still had they done nothing. But given the shortcomings of the response so far, the Fed and members of Congress are working on more aggressive tactics.

The Fed is expected to cut rates further when its policy-making committee meets next week. It will also increase the money it lends to banks in periodic auctions to $100 billion, from $30 billion. Fed officials have been meeting with aides to Representative Barney Frank, Democrat from Massachusetts, who is chairman of the House Financial Services Committee and has argued for more government intervention. The Fed supports some of the ideas Mr. Frank has been discussing, including having onerous mortgages refinanced and guaranteed through the Federal Housing Administration. But the central bank, at least so far, opposes the purchase of troubled loans by the federal government, an idea suggested by Mr. Frank and other Democrats.

Much of the focus will remain on housing, because policy makers and analysts think banks and investors will not regain confidence until the real estate market stabilizes. Uncertainty about how far home prices will fall has made banks less willing to lend and consumers reluctant to buy.

Banks are also unwilling to lend because they are worried they will not be paid back. Nearly 7.9 percent of home loans were in foreclosure or past due at the end of last year, and most economists expect that more borrowers will encounter trouble.

Some lenders are also trying to preserve their capital because they expect to have more losses. Last week, Citibank said it would reduce its holdings of home loans by 20 percent. “Lenders can’t lend in this environment because they fear they are not going to get paid back,” said

Daniel Alpert, a managing director at Westwood Capital, an investment bank in New York. “And guys who own homes have no value left to hock.”

The interest rate on 30-year fixed mortgages is back above 6 percent, still historically low, after falling below 5.5 percent in December. Banks are demanding bigger down payments and cutting off home equity lines of credit to borrowers, especially those who live in states where home prices are falling fastest.

Mr. Alpert and others see a parallel between the credit problems today in the United States and the economic crisis in Japan in the 1990s. In both cases, reckless lending and a bubble in real estate contributed to enormous losses and tightening of loans.

There are significant differences, however. American banks have been quick to recognize losses, and policy makers have moved to contain the damage and protect the broader economy. In Japan, many lenders did not write off bad loans and the central bank was much slower to respond. The 1990s is broadly seen as a “lost decade” for that country.

Mr. Alpert, who bought troubled loans from Japanese banks for pennies on the dollar, said that while American financial institutions are moving fast, policy makers should encourage or even force them to write down and restructure bad mortgages faster so they can get back to lending.

“If you fail to clean up the problem and take aggressive action, you are going to have years and years of stagnation as Japan did,” he said. There are signs that the logjam in some markets is loosening as bargain hunters move in to take advantage of the turmoil. When enough investors step in to buy beaten-down securities, it can restore confidence and make banks willing to lend more freely. In the municipal bond market, for instance, prices rose steadily last week as retail investors and mutual funds bought bonds that distressed hedge funds were selling at deep discounts, said Douglas

A. Dachille, the chief executive of First Principles Capital Management, a firm that specializes in bonds. Prices on one index compiled by The Bond Buyer, a trade publication, rose 5.7 percent last week after falling 6.2 percent in the last week of February.

That “problem was solved,” Mr. Dachille said Friday. “By the end of this week, the muni market is functioning well again.”