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Analysis: Fed's Bold Moves Have Risks

By JEANNINE AVERSA – 22 hours ago

WASHINGTON (AP) — There's a risk in Federal Reserve Chairman Ben Bernanke's bold moves of late.

If recent history is any guide, the euphoria that met the Fed's three-quarter-point reduction to a key interest rate Tuesday could be short-lived. With a string of urgent and aggressive actions, the Fed itself could end up feeding the panicky mind-set that it so desperately wants to calm.

Even inside the Fed there was disagreement about just how much the key interest rate — its most potent tool in dealing with economic trouble — should be lowered.

Two Fed members dissented, preferring a smaller cut, while Bernanke and seven others prevailed with a more powerful three-quarter-point one. Cuts of this size are pretty infrequent. Bernanke, in an emergency session in January, ordered one — making for the single-biggest reduction in more than two decades.

Wall Street was ebullient Tuesday — soaring 420 points — even as it had hoped for greater relief — a rare reduction of one percentage point. Yet, one wonders just how long the good feeling will last. Wall Street has been largely engulfed in turmoil since last year — swinging wildly at times between relief and panic.

In a bid to revive a sagging economy, the Fed dropped its key rate to 2.25 percent. In turn, the prime lendng rate for millions of consumers and businesses fell by a corresponding amount, to 5.25 percent. Both are the lowest since late 2004. It held the door open to the possibility that rates would fall even lower in the months ahead.

The Fed's action was the latest in a series of extraordinary moves — many in just the past few days and weeks — that the Fed has resorted to as it seeks to prevent a financial catastrophe that could plunge the country into a deep and painful recession.

Yet, it raises the question: can the Fed in its very efforts to contain spreading credit and financial crises, end up also spreading fear?

"I think it is true that Federal Reserve actions coming closely one after the other in the last few weeks — while no doubt are helpful for the economy — they carry with them a risk that people will perceive them as involving some slight desperation," said Marvin Goodfriend, economics professor at the Carnegie Mellon University.

The Fed's words — not just its actions — matter a lot and can color how people view the economy and their own financial fortunes.

On Tuesday, the Fed was blunt in its assessment that the country's economic health has worsened. "The outlook for economic activity has weakened further," the Fed said. "Financial markets remain under considerable stress and the tightening of credit conditions and the deepening of the housing contraction are likely to weigh on economic growth over the next few quarters."

Such words can make people more nervous. The Fed walks a fine line between trying to give the public an accurate picture of what is going on and at the same time not spooking them — or investors.

"Saying nothing could also trigger a panic as well" and undermine the Fed's credibility, said Victor Li, an economics professor at the Villanova School of Business. "People would be more nervous if the Fed sat back and did nothing."

Still, the Fed's rate-cutting campaign, which started in September, and turned much more forceful in January, hasn't put people into a better frame of mind where they are more willing to spend. Instead, they have hunkered down, adding to the economy's problems. "Maybe the public is saying, the Fed can't really do much about the impending recession," Li said.

The Fed's lifelines — through interest rate cuts and other moves — probably won't pull the country back from the brink of its first recession since 2001. Many believe the country has slipped into recession.

With jobs harder to come by, most people probably will feel skittish for a while. Employers slashed 63,000 jobs in February, the most in five years. It was the second month in a row of nationwide job losses. The unemployment rate, now at 4.8 percent, is expected to rise to around 5.5 percent later this year.

And, many believe the market's volatility will persist for some time, too.

"Volatility is to be expected. You'll have good new one day, bad news another day. The market is trying to find a stable point in being buffeted by good and bad revelations of matters involving credit," Goodfriend said.

Just a week ago, Wall Street soared by nearly 417 points — the biggest rally since 2002 — when the Fed unveiled a new and innovative way to deal with the worsening credit crunch, — letting big Wall Street firms borrow up to $200 billion in ultra-safe and much-in-demand Treasury securities and pledge harder-to-sell mortgage securities as collateral. The euphoria, however, was short-lived, and investors fell back into a nervous funk.

A few days later, the Fed, in a rare use of authority dating back to the Depression-era days of the 1930s, backed a rescue package of venerable investment bank Bear Stearns, which teetered on the brink of collapse. Wall Street, however, tumbled by nearly 195 points as the Fed's action stoked concerns about the severity of credit troubles and whether other big financial firms might falter.

Two days after that — on Sunday — the Fed took more bold actions — including backing JP Morgan's takeover of Bear Stearns and guaranteeing up to $30 billion in troubled mortgages and other assets that brought about Bear Stearns' downfall. Critics contend it's akin to a government bailout.

The Fed also Sunday agreed to let big investment houses get emergency loans directly from the central bank for the first time. The new lending facility — similar to one that's been available to commercial banks for years — started Monday and will continue for at least six months. The following morning, stocks around the world fell sharply. Investors remained skittish in the United States, although the Dow Jones managed to finish the day up slightly.

The panicky mind-set that has swept over investors since last summer has made credit become harder and harder to get. Financial institutions, which racked up huge losses due to soured investments in mortgage-linked securities, became increasingly wary of lending and hoarded cash.

"The menacing beast is not a recession but the credit crisis," said Greg McBride, senior financial analyst at Bankrate.com. "Recessions happen and we'll get through them particularly with the Fed's rate cuts and the government's stimulus (of tax rebates and tax breaks). But without properly functioning credit markets, the economy can't grow. It is like starving a fire of oxygen."