

Analysis: Fed Tackles Financial Crisis

By JEANNINE AVERSA 08.10.07, 4:40 PM ET

WASHINGTON -

Facing a major test, the Federal Reserve on Friday pumped billions of dollars into the U.S. financial system after a global credit crunch sent Wall Street into a dive and shriveled the nest eggs of investors large and small.

Will it be enough or will Fed Chairman Ben Bernanke and his central bank colleagues have to dig deeper into their arsenal?

The Fed's action may have eased some investors' anxieties. The Dow Jones industrial average was down again Friday, but only a little - 31 points - by the end of a seesaw day.

The Federal Reserve has a range of tools to keep financial institutions' problems from morphing into a broader economic crisis. It can also use the power of words to try to calm investors.

So far, the Fed has chosen a little of both.

It ordered extra cash to be plowed into the system, hoping to help banks and other institutions get over the hump and carry out their business more smoothly.

The Fed also sought to send a reassuring message to Wall Street and Main Street that it is on top of an unsettling situation, pledging to provide "reserves as necessary" to help the markets safely make their way.

Bernanke and his colleagues had to walk a fine line to acknowledge a problem, discuss some relief but not say anything that might spook investors further.

"If they were to say it is a really big crisis and they are really concerned it could translate into an economic crisis, it would have the reverse effect on investors and send them into a bigger panic," said Victor Li, economics professor Villanova School of Business.

The Bernanke Fed can't ignore the market's pain. At the same time, it must be mindful of doing what is best for the economy in the long run.

The Fed, in a meeting on Tuesday, acknowledged that Wall Street turbulence, credit problems and a nationwide housing slump pose increasing threats to the economy. But it refrained from cutting rates and stuck to a forecast that the economy will weather the financial storm and grow gradually in coming months.

"It seems like Bernanke might be more willing than (former chairman) Alan Greenspan to let financial stress play out to ensure investors don't feel emboldened in the future and take on more risk. There is a sense that Bernanke buys into that argument more than Greenspan did," said Mark Zandi, chief economist at **Moody's** (nyse: [MCO](#) - news - people) Economy.com.

"We'll see if that is true in the next week or so. If markets remain unstable, it will be a test to see how closely the Bernanke Fed sticks to the Greenspan cookbook."

To make sure there's adequate money available, the Federal Reserve pushed \$38 billion in temporary reserves into the system on Friday - the biggest injection since the days following the Sept. 11, 2001, terror attacks. On Thursday, the Fed had put \$24 billion into the system.

Banks were also told that the Fed's discount window - where they can turn in an emergency for short-term loans - is available as a source of funding. After the 2001 terror attacks, the Fed used the discount window to extend billions of dollars worth of emergency loans to keep the financial system functioning.

Financial markets in the United States and around the globe have been shaken by fears about

spreading credit problems that started with home mortgages. Investors are worried that these problems will infect the larger financial system and possibly hurt the U.S. economy.

If the turmoil persists, the Fed probably will dig deeper into its toolbox.

Besides, injecting cash into the financial system as it did on Thursday and Friday, the Fed could lower the discount rate on loans to banks. That would encourage increased lending to people and businesses. The Fed has done this before in times of economic or financial crisis.

The central bank's most potent weapon, though, would be to lower the federal funds rate, now at 5.25 percent. That rate is the interest banks charge each other on overnight loans.

Cutting that rate would influence other important lending rates throughout the economy. Most notably, it would lead to a corresponding reduction in commercial banks' prime interest rate - now at 8.25 percent - for certain credit cards, home equity lines of credit and other loans.

Bernanke, an economist and former academic, took the Federal Reserve helm in February 2006. He succeeded Greenspan, who in his 18 1/2-year run seemed to some to have a sixth sense about Wall Street's psyche.

Some economists suggest that if credit conditions seriously worsen, the Fed might cut rates before its next scheduled meeting on Sept. 18. Others think a rate cut any time soon would be a mistake because the economy is still fundamentally in good shape. It is growing and businesses are hiring.

The White House, meanwhile, also sought to calm markets by saying it is monitoring the situation.

"I can assure you that there are many of the president's advisers who are keeping a very close eye on all the market activity and making sure that policies are put in place to keep our economy strong and growing," spokeswoman Dana Perino told reporters in Kennebunkport, Maine, where President Bush is spending the weekend.

Sen. Charles Schumer, D-N.Y., welcomed the Fed's action but said he remained "concerned by the potential of this contagion to spread more broadly."

Financial concern about the credit crunch swept through Europe and into the United States on Thursday. That prompted the Europeans to pump \$130 billion into their financial system. The Fed moved to add an extra \$24 billion in temporary reserves to the U.S. banking system.

The current meltdown in the housing and mortgage markets has caused new home foreclosures to climb to record highs and has forced some lenders out of business. Problems first sprouted in the market for higher-risk or "subprime" mortgages, which are held by people with poor credit or low incomes. But some problems have spilled over to more creditworthy borrowers. That has led to tighter lending standards, making credit harder to get for people and businesses.

The free flow of credit is important to the smooth functioning of the national economy. Increasingly restrictive lending conditions can put a damper on people's ability to buy big-ticket items such as homes, cars and appliances. And it can crimp businesses' capital investment and hiring.

EDITOR'S NOTE - Jeannine Aversa is an economics writer for The Associated Press.

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