Credit crunch: Did the Fed do the right thing?

The US Federal Reserve cut short-term interest rates half a percentage point in mid-September to make it cheaper for banks to provide loans and keep the crisis in the subprime mortgage market from spreading to other sectors of the economy.

The cut was bigger than many market analysts had expected and was designed to have an immediate impact on interest rates for home loans, credit cards and business borrowing.

The credit crunch is the first major test for Fed Chairman Ben Bernanke and not all the experts agree on whether Bernanke has got it right.

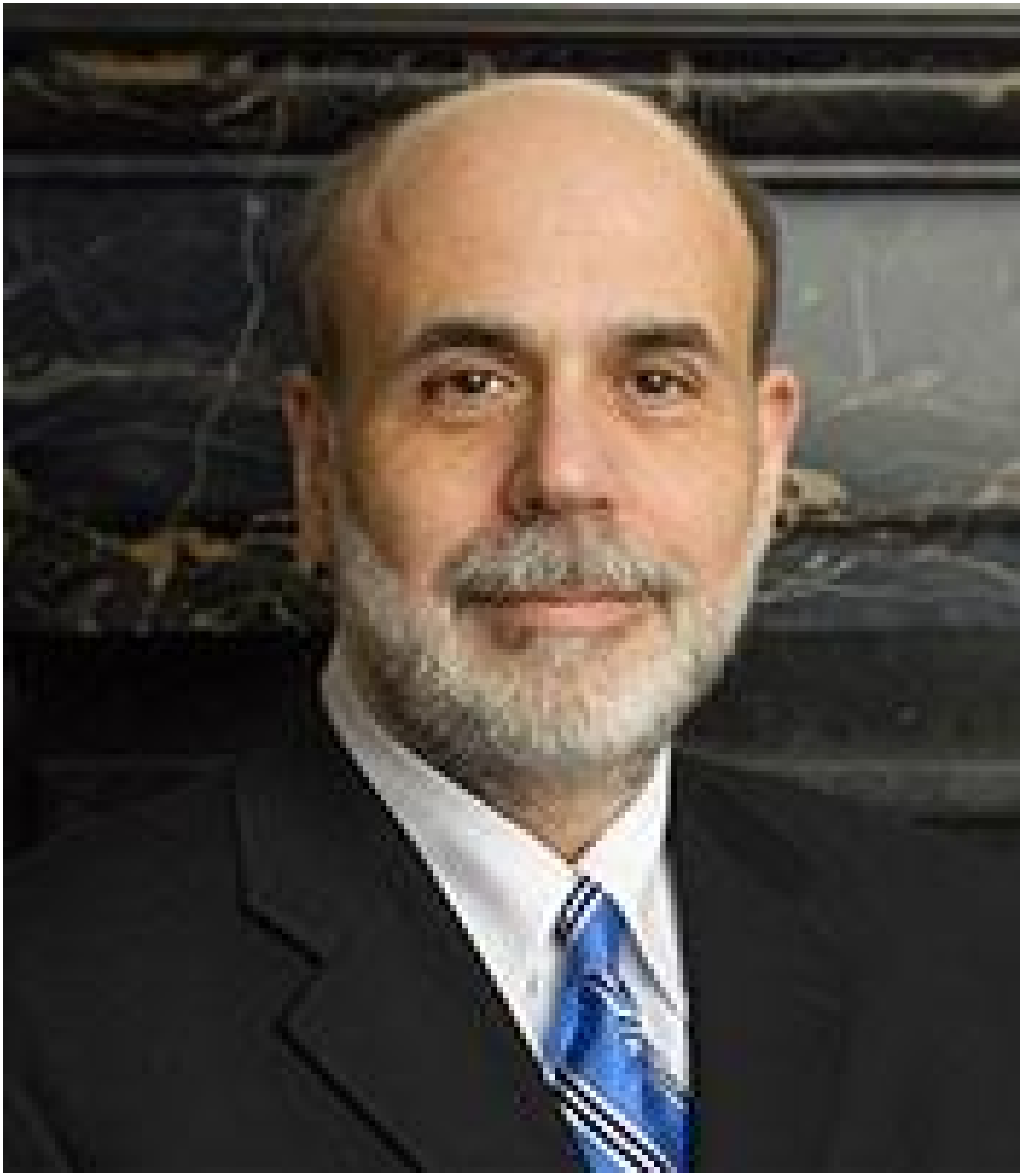
Steve Forbes, the billionaire publisher and a former US presidential candidate, called on the Fed to cut rates by one full percentage point to get banks and the economy past the immediate credit scare. He says Bernanke and the other Fed governors are too worried about being accused of bailing out the banks and borrowers that are responsible for the current problems.

“If our own central bank does what a central bank should do and gets over the hang-ups over who you help (and) who you hurt. Deal with the crisis, get on with it and adopt a stable monetary policy in the future,” he said.

Ilian Mihov, INSEAD professor of economics, thinks the Fed has been prudent and that making a more drastic cut in rates now could cause bigger economic problems.

“It’s much more symptomatic of problems in the economy so making sure that inflation is on track or in the right range is much more important and serious than to keep asset prices from bubbling or trying to address movements in asset prices,” Mihov said.

There has been a sharp rise in defaults and foreclosures on riskier subprime mortgages. Many mortgage lenders that offered low, teaser rates have adjusted those rates upwards making it difficult for some borrowers to meet their obligations. Many economists aren’t sure how much worse the crisis might get and whether it might infect the rest of the economy.



Bernanke took over at the Fed from the venerable Alan Greenspan. Just this week, Greenspan admitted that he hadn't expected the problems in the subprime market or the resulting credit crunch. He said the issue was difficult for banking regulators to curb.

Forbes thinks the Fed took the problem too lightly under Greenspan and that Bernanke's Fed has been too slow to act. Forbes watches gold and commodity prices and indeed oil and commodity prices surged after the rate cut. Forbes and some other economists expect additional rate cuts.

“Uncertainty is the great killer at a time like this,” Forbes said. “Thanks to securitization, everyone owns subprime mortgages even if they don’t know it. (If) you have a money market fund, some of that commercial paper may be backed by subprime paper.”

Mihov disagrees. He thinks the Fed has done the right thing. Mihov admits that he may have some bias. He was a student of Bernanke’s and thinks his former professor has done an “excellent job.” He believes that since the Fed has only one instrument of monetary control: interest rates as it has to watch inflation.

That position has its backers too, with some economists worried that lowering rates too far, too fast could put more pressure on an already weak dollar and could provide even more fuel for rising oil prices.

In its statement released along with the rate cut, the Fed governors didn’t indicate where rates were headed. It noted some risks of inflation but uncertainty about the economic outlook.

“Economic growth was moderate during the first half of the year, but the tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally,” the Fed said in a statement.

Only a small percentage of mortgages in the US are subprime, but the housing boom was a major contributor to growth in household incomes in recent years and any slowdown threatens consumer spending. There was a knock-on impact as well as banks became wary about loaning to all but the best borrowers. That’s wreaked havoc with banks and businesses around the world.

“The financial sector has a very important role in matching lenders and borrowers, so if the Fed sees there is a process of disintermediation, which means lenders put their money in banks, but banks do not lend to borrowers, so the intermediaries do not fulfill their function, then the Fed knows this a very serious problem and the real economy will suffer,” Mihov said.

Forbes is more critical. He told the Singapore Press Club shortly before the Fed meeting that Bernanke should stop acting like Hamlet and start acting like a central banker. “It will be felt. It shouldn’t be a disaster but it will have a little bit of impact. But the key thing is, the sooner the Fed gets its act together, the better we are all going to be."

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