

# Research

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## US: How can the Fed avoid a 'credit run'?

- Liquidity provisions by Fed and other central banks have, so far, failed to calm markets. Instead, financial markets remain stressed and dislocated. Hence, it is no wonder many are calling for Fed cuts, to restore 'normality' in the markets.
- In many ways this crisis is a close parallel to the 1998 LTCM credit crisis. But the lesson learned by the Fed back then was that Fed cuts worked in the short term – but contributed to the notion of a 'Greenspan put' in the longer run.
- We think there are other interesting venues that the Fed could explore before cutting rates. One way to deal with the situation is to widen the list of assets eligible as collateral in the discount window. This would broaden the channel through which the Fed is able to provide liquidity to the financial system.
- The signal and the effect of such type of action will in our opinion be just as strong as a rate cut, as it effectively shows that the Fed is willing to deliver liquidity on all assets it takes, to restore the well functioning of markets. Of course if this doesn't work, rate cuts will be on the agenda. But the Fed will not tread down this road lightly.

### A wide(r) open discount window

#### *The crisis is broadening and deepening*

The present credit market crisis now competes with the 1998 Long Term Capital Management crisis for being the worst on record. The chaos and fear in financial markets has worsened in recent days and nobody knows if it will become even worse.

The central banks have tried calming the situation by using the standard tool for solving a liquidity crisis: pouring liquidity into the money market. So far, it seems like the operation has failed. Markets have not calmed down and financial instability is spreading, now hitting carry trades, emerging markets and commodity markets. Pun-

ditions and commentators are now calling for the Fed to take more serious measures and cut the Fed funds rate. Such a rate cut would of course be a powerful psychological signal to the markets, showing that the Fed is prepared to do what it takes to restore confidence in the financial system.

#### *Why the Fed won't like to cut rates*

However, so far the Fed has been reluctant to reach for the rate weapon. And we think they will continue to be so. Here is why.

For many investors the distress and market dislocation in the fall of 1998 after the Long Term Capital Management/Russian debt crisis is the closest parallel to the present situation.

Back then the LTCM's huge distressed portfolio of positions had its tentacles into all major markets sending financial prices a long way off their perceived "normal" trading range. This crisis raged for a while, but ended as the Fed cut rates three times through the fall of 1998 from 5.5% to 4.75% and as a consortium of banks overtook the LTCM. One of these rate cuts was even an inter-meeting cut implemented between FOMC meetings. The market seems to think that the Fed should and will do the same now to provide comfort.

The present dislocation of money markets and credit markets has the same feel to it as the 1998 crisis. In that sense we agree that the LTCM debacle in 1998 is the correct case to study. However, the market may be drawing conclusions too early. Thinking that the Fed will act in the same way is not necessarily obvious. This is for two reasons:

1. The 1998-episode is not generally perceived as a success by Economists at the Fed. Sure, the cuts calmed the market. But the economy was never really hurt by the market turmoil. On the contrary US growth accelerated from late 1998 through 1999, forcing the fed to hike rates already again in spring 1999. So, it isn't really obvious that the rate cuts in late 1998 were a good idea. Moreover, the Fed policy enacted in late 1998 contributed to the idea of a "Greenspan put option". The market perceived it as if the central bank would always come to its rescue when in distress by using rate policy to boost the economy. This idea of a "Greenspan put" arguably contributed to the build-up of the equity bubble in the following two years, by giving some investors a false sense of security.
2. It is a misunderstanding that the Fed cuts in the fall of 1998 were enacted just to help the market. In late 1998, the Asian crisis was still sending shock waves through the world economy. The US ISM index - the most important gauge for the US industrial cycle - was falling. It was already below the important 50-level signalling a manufacturing recession, when the credit crisis struck in the fall of 1998. Clearly, the perception was that the US was already facing a slowdown that might develop into something nasty, even if the

LTCM credit crisis hadn't occurred. Seeing the rate cuts in fall 1998 as a pure market saving operation is therefore wrong. They were adopted in the context of widespread cyclical pessimism (which later turned out to be misplaced).

Turning to the situation today the 1998-case should therefore not be seen as an argument for Fed doing short term rate cuts - on the contrary.

Despite the housing slowdown, US economic data point to quite solid growth right now. This is the case, not only for the ISM (at 53.8 corresponding to strong expansion levels) but also for GDP and labour market data. Had it not been for the market turmoil, the Fed would surely not be thinking of rate cuts now. This is a crucial difference from the 1998 situation.

But more importantly, the lesson learned from the 1998 turmoil is that a financial confidence crisis should preferably be dealt with through liquidity provisions instead of rate cuts. The notion of a "Greenspan put" smacks of moral hazard problems, as the central bank is seen as providing some kind of guarantee to investors. Would Bernanke really like the markets to talk about a "Bernanke put" after this? Would he like to take the chance of seeing a rate cut leading to even more extreme risk taking or leverage 1-2 years down the road? If anything tainted Greenspan's legacy it was his handling of policy and financial markets in the 1998-2000 period. And Greenspan's mistake was to be seen too much as "the markets man". Surely this is not something a thoughtful academic Fed chairman would like to replicate? So Bernanke is rightly fearful of the long-term cost of being seen as the saviour of the day (something Greenspan clearly was not).

#### *Is there another way out for the Fed?*

So what to do then? Surely, the Fed can't stay sidelined much longer, and liquidity operations have failed to do the trick. We think there are other interesting venues that the Fed could explore before reaching for the big gun. This crisis is first and foremost taking place in the credit market, more specifically in the market for risk on financial counterparts. Everybody is fearful of everybody else in the financial system going bust. And this fear is almost turning into a self-fulfilling prophecy. In the old days this would be considered a bank run. And bank runs were dealt with through provisions of liquidity to the needy and worthy - i.e. banks that could de-

liver safe collateral. However this crisis might better be described as a 'credit run'. It is a breakdown in the market for credit between financial institutions and in liquidity in complex products. These products are not directly exchangeable for money at the central bank, and the central bank cannot provide the safety against the storm for the credit market to the same extent it can for the banks.

One obvious way to deal with this is to change this. The Fed could extend its list of assets eligible as collateral in the discount window. Indeed we think the Fed could take an unconventional step like this as a next step in the attempt to restore market calm and financial stability. Of course taking more risky assets as collateral, would require bigger hair cuts (i.e. you cannot borrow corresponding to face value of the asset). But potentially this is just the right medicine for the current crisis. For example, the confidence

that a credit paper can always be used to provide just some measure of liquidity will provide a lot of confidence in the market. Obviously, there are issues of moral hazard in this kind of action too, but in our opinion they will be considerably smaller than with a rate cut. Especially if the Fed chose to make the widened list temporary. Moreover, the Fed has actually the authority to widen the list of counterparties for the discount window as it sees fit.

The signal and the effect of this action will in our opinion be just as strong as a rate cut, as it effectively shows that the Fed will deliver liquidity on all assets it takes to restore well-functioning markets.

If this doesn't work, rate cuts will be on the agenda. But the Fed will not tread down this road lightly.

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