

March, 2010

On High Wires & Juggling

In February, the Federal Reserve increased the rate it charges banks to borrow money from the Fed. This is the basic interest rate, the 'discount rate', one of two the Fed actually controls by itself. Until this financial crisis, banks viewed it as the last resort when they needed to borrow. The loans have always been kept secret, because a bank would only go to the discount window (shh!) if it was unable to borrow conventionally from other banks in the open marketplace. Banks had eagerly borrowed money from each other until that day the primary instruments they were trading, sub-prime mortgage pools, got their new name: toxic assets. Suddenly, trading ceased, the banking system seized up, near-panic set in, and as they say, the rest is history, a history that is still in the making.

The banks couldn't trust each other anymore, so the Fed was the only remaining resource. One Fed effort to keep the banking system operating was to reduce the rate at the discount window to 0%, where it stayed for some time. Banks could borrow for no cost. The goals were simple enough: save the banking system by making it as easy as possible for banks to stay in business . . . and hope that they will start feeling brave enough to make loans. As we all know, the loans have not happened.

The Fed has now increased the rate for the first time since the crisis started. What does that mean to us down here on Main Street? Quite a lot actually. The first ray of sun breaks through the clouds after one of the worst hurricanes in our financial history. This rate increase pushes the banks away from the discount window, where the emergency transfusions were, and encourages them to go to the marketplace for their money. If the machinery gets unstuck, businesses of all kinds and sizes will feel invited to take a deep breath, take out a loan, get back in the game. For the investor, the yield on money market accounts will slowly rise. The markets will get some make-up on that black eye and those bruises and may even begin to look alluring once more.

On the other hand, some analysts believe the market has already adjusted all it's going to in response to the new interest rate, believing for some months that it was coming. Which may explain why the markets are so sluggish now, a little increase today, a little decrease tomorrow. The big Q on the street (for which no immediate A has come forth) is: OK, what happens next? Where does the economy go from here?

The Fed is doing one of those high-wire acts that also involves juggling—you've seen those? It wants the banks to work with each other in the interest of economic recovery, especially through job creation. But--and most emphatically--it doesn't want to do anything that might ignite inflation. Moreover, as I wrote last time, deficits remain a serious problem; therefore, any increase in borrowing costs is problematic. Ooo, I can't look!

For the markets, interest rate increases are critical chiefly in terms of how quickly they come and how high they rise—slower and lower are better. Two other factors may weigh as heavily: the impact of foreign failures—Dubai, Greece and who's next—and the nature and effectiveness of any regulation of the financial industry. Think 'bubbles', and I don't mean the Clown. Somewhere another one is expanding even as you're reading this newsletter. Crackerjacks, anyone? Cotton candy?