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# Days Before Housing Bust, Fed Doubted Need to Act

By: Binyamin Appelbaum – January 18, 2013

WASHINGTON — When Federal Reserve policy makers convened in August 2007, one of the nation's largest subprime mortgage lenders had just filed for bankruptcy, and another was struggling to find the money it needed to survive.

Officials decided not to cut interest rates. The Fed did not even mention housing in a statement announcing its decision. The economy was growing, and a transcript of the meeting that the Fed published on Friday shows officials were deeply skeptical that problems rooted in housing foreclosures could cause a broader crisis.

"My own bet is the financial market upset is not going to change fundamentally what's going on in the real economy," William Poole, president of the Federal Reserve Bank of St. Louis, told his colleagues at the meeting.

That was on a Tuesday. By Thursday, the European Central Bank was offering emergency loans to continental banks, the Fed was following suit, and an alarmed Mr. Poole had persuaded the board of the St. Louis Fed to support a reduction in the interest rate on such loans. The somnolent Fed was lurching into action.

"The market is not operating in a normal way," the Fed chairman, Ben S. Bernanke, told colleagues on a hastily convened conference call the next morning. Mr. Bernanke, a former college professor and a student of financial crises, was typically understated as he explained that the Fed was pumping money into the financial system because private investors were fleeing. "It's a question of market functioning, not a question of bailing anybody out," he said. "That's really where we are right now."

More than five years later, the Fed continues to prop up the financial system, and the transcripts of the 2007 meetings, released after a standard five-year delay, provide fresh insight into the decisions made at the outset of its great intervention.

They show that Mr. Bernanke and his colleagues continued to wrestle with misgivings about the need for action, because at the time there was little evidence of a broader economic downturn. Several officials worried that the economy would instead overheat, causing inflation to rise. By December, as the Fed began to act with consistent force, the economy was already in recession.

Officials lacked clear information, relying on anecdotes like a reported conversation with a Wal-Mart executive who said Mexican immigrants were sending less money home. They were also limited by economic models that could not simulate the problems that seemed to be unfolding.

“This may be a situation in which you will have to resolve your ambivalence quickly,” Timothy F. Geithner, then president of the Federal Reserve Bank of New York, warned in September. “You may not be able to resolve it.”

They questioned, too, the Fed’s ability to stimulate the economy, an issue that is still at the center of the debate about its policies.

“There’s no guarantee whatsoever that this thing will do what we’re trying to do,” Donald Kohn, then the Fed’s vice chairman, said at a meeting later in August. As the Fed debated a strategy to encourage bank lending, he said, “I just think it’s worth giving it a try under the circumstances.”

But eventually, Mr. Bernanke and his colleagues concluded that they could see the future, that they did not like what they saw and that it was time to act.

“At the time of our last meeting, I held out hope that the financial turmoil would gradually ebb and the economy might escape without serious damage,” Janet L. Yellen, then president of the Federal Reserve Bank of San Francisco, said in December. “Subsequent developments have severely shaken that belief. The possibilities of a credit crunch developing and of the economy slipping into a recession seem all too real.”

The Fed’s eventual response, which it expanded significantly in 2008 and 2009, is now widely credited with preventing an even more catastrophic financial crisis and a deeper recession. It is not clear that quicker or stronger action in the fall of 2007 would have made a big difference. Critics focus instead on the Fed’s earlier failure to keep banks healthy and to prevent abusive mortgage lending, and on its later role in allowing the collapse of the investment bank Lehman Brothers.

“The outcome would have been different only if the Fed and others had reacted back in 2004, 2005, 2006” to curtail subprime mortgage lending, Mr. Poole, now a senior fellow at the libertarian Cato Institute, said on Friday in an interview on CNBC.

The transcripts show that the Fed entered 2007 still deeply complacent about the housing market. Officials knew that people were losing their homes. They knew that subprime lenders were blinking out of business with each passing week. But they did not understand the implications for the rest of the nation.

“The impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained,” Mr. Bernanke said in March.

Officials said at the time that they took particular comfort in the health of the largest banks. Even as the housing market deteriorated, the Fed approved acquisitions by some of the banks with the largest exposure to subprime mortgages, like Citigroup, Bank of America and the Cleveland-based National City.

By the early August meeting, Fed officials had moved from denial to puzzlement. American Home Mortgage, a leading subprime lender, had filed for bankruptcy the previous day. Countrywide Financial, another lender, was looking for a lifeline. The investment bank Bear Stearns had liquidated a pair of mortgage-focused hedge funds.

“It is an interesting question why what looks like $100 billion or so of credit losses in the subprime market has been reflected in multiple trillions of dollars of losses in paper wealth,” Mr. Bernanke said at the meeting, referring to the decline of global financial markets.

Three days later, the Fed moved from puzzlement to action.

It acted again the next week. There was, Mr. Bernanke said on a conference call on Thursday, “a certain amount of panic, a certain amount of markets seizing up, with good credits not being able to be financed, and a good deal of concern that there is a potential for some downward spiral in the markets that could threaten or harm the economy.”

The Fed’s response was relatively modest. It cut the interest rate on loans from its discount window, at which banks borrow from the central bank, by half a percentage point to 5.75 percent, and let banks borrow for up to 30 days rather than reapply daily. Then it arranged for four large banks — Bank of America, Citigroup, JPMorgan Chase and Wachovia — to take what it called symbolic loans of $500 million.

Mr. Bernanke wanted to avoid cutting an interest rate that banks paid each other, according to the transcripts, because he did not want to give the impression that the Fed was engaged in the rescue of investors, banks or borrowers that made bad decisions.

“My own feeling is that we should try to resist a rate cut until it is really very clear from economic data and other information that it is needed,” he said. “I’d really prefer to avoid giving any impression of a bailout.”

But private sources of financing were drying up. The premium banks paid to borrow from other banks, without pledging collateral, widened to 0.85 percentage points in mid-September from 0.1 percentage points in mid-August.

In September, after the government announced that employment had declined in August, the first monthly fall in seven years, the Fed announced that it would reduce its benchmark interest rate for the first time since 2003. To punctuate the decision, it cut rates by half a percentage point rather than the more typical quarter-point cut. This time, it mentioned the housing crisis.

But the Fed’s biggest steps did not begin until December, when it created the Term Auction Facility, the first of several programs intended to pump money into the financial system, and arranged to put dollars into the European financial system in partnership with the European Central Bank.

By then the Fed had cut rates at three meetings in a row, but the disruption of financial markets was only getting worse, and the economy was showing strain.

The Fed’s own staff still forecast that the economy would avoid a recession.

“We came up with this projection unimpaired and on nothing stronger than many late nights of Diet Pepsi and vending-machine Twinkies,” David Stockton, a Fed economist, said as he presented the forecast in December.

Mr. Geithner said it was time to prepare for a crisis. “I don’t think the past four to six months have been kind to those who have argued that this was just a mild and transitory bump,” he said.

The economy might still grow, but it seemed increasingly likely “that we have a deep and protracted recession driven as much by financial headwinds as by other fundamentals,” Mr. Geithner said. “There are good arguments for the former, the more benign scenario, but we need to set policy in a way that reduces the probability of the latter.”