It was only 10 years ago, in January 2008, that the Fed shocked markets with a 75 basis-point rate cut that was announced between formal meetings. It was the steepest single-day rate cut ever, and was just the first in a series of extraordinary measures by the Fed to avert an economic implosion. The state of the economy was so precarious that the Fed was forced to embark on a profound re-examination of long-held macroeconomic assumptions. In these weeks of particularly volatile trading, with Janet Yellen leaving her post as Fed Chairman, and investors’ expectations for higher rates on the rise, we believe it is worth understanding how today’s rate discussions fit into the broader context of monetary policy.

BACKGROUND:

In the six weeks between December 10, 2007 and January 22, 2008, the S&P 500 Index (“S&P”) fell 13.5%, from 1,516 points to 1,310 points. Over 10% of that decline occurred between January 1 and January 22. Globally, most other stock markets were also plummeting, and in the US the decline continued until March 6, 2009, when the S&P bottomed at 683, a fall of 54% from its December 2007 peak.

Harbingers of recession had already began to appear. In the financial sector, JPMorgan, Wells Fargo, and other major banks were announcing significant losses in their consumer credit divisions. In fact, these losses actually accelerated as the year progressed. Also in January, Citigroup cut its dividends to investors by 41%, a move that had been predicted several months previously and strenuously denied. The significance of the world’s largest bank admitting that it was cash-strapped was clear. And at the end of January, the Philadelphia Fed reported that 23 states were in recession, 7 additional states exhibited zero growth, and despite total positive growth, home values were plunging in Florida and California.

Yet in the wake of this and other evidence, many prominent economists continued to suggest that a recession could be avoided. This included Fed chairman Benjamin Bernanke who, up until the 75 bps rate cut in January of 2008, had resisted aggressive monetary policy intervention by the Fed.

EVENTS OF JANUARY 22 & 23, 2008:

US markets were closed on Monday January 21 for Martin Luther King Jr. Day. But overseas, markets were open and declining quickly. A Fed meeting was scheduled for the following week, but Bernanke determined the economic situation was too precarious to wait until then, and he organized an impromptu conference call of FOMC officials. It was during this call that the Fed agreed on its policy shift.

An hour before markets opened on Tuesday, the Fed announced its historic one-day rate cut: a 75 basis-point move in the overnight rate from 4.25% to 3.50%. The Fed also hinted that more cuts could be announced at the following week’s meeting.

The markets were surprised by the unusual announcement. The last cut between meetings had been in response to the September 11th attacks of 2001. While Europe and Asia had been continuing their free fall before US markets opened, markets clawed back some losses following the announcement. Stocks on the whole ended the day down 1% and continued to crater in the weeks and months ahead.

Reactions to the Fed decision were mixed. On the hill, slow-moving talks on tax cuts for businesses suddenly had more urgency. Yet there was no consensus about the potential for recession.

Some economists spoke with foreboding about macroeconomic trends; others were more optimistic. Martin
Feldstein hedged himself when he said that a recession was not a sure thing, because he also noted that the economy “could slip into recession and the recession could be a long, deep, and severe one.” Meanwhile, Bruce Bartlett wrote in the New York Times that “the enactment of stimulus plans is a fairly accurate indicator that we have hit the bottom of the business cycle, meaning the economy will improve, even if the government does nothing.” In a debate with other Democratic presidential contenders, President Obama suggested that “we could be sliding into an extraordinary recession.”

Paul Krugman of the New York Times (and others, such as author and commentator Barry Ritholtz) had no such doubts. In his blog for the Times, Krugman questioned whether the Fed had enough ammunition to fight the inevitable recession. He noted that the prior two recessions ended with “jobless recoveries” that felt more like a continuation of the recession for many people. He addressed the level of interest rate cuts that might be needed to alleviate symptoms of the recession, noting that it took 6.5% of Fed Funds rate cuts to respond to the recession of 1990-1991 and 5.5% of cuts to respond to the 2001 recession. In the summer of 2007, the Fed Funds rate stood at 5.5%. When he wrote his blog on January 23, 2008, the rate was 3.5%. With the poor outlook for the market, he deemed there was reason to worry.

The Fed cut rates an additional 50 bps just one week after the surprise 75 bps cut. At the end of January 2008, the Fed Funds rate was 3.0%. By the end of that year, the target rate was 0.25%.

The implications of Krugman’s analysis proved correct: negative interest rates or something just as drastic had to be considered. Even dropping the Fed Funds rate to zero, which amounts to free money, was not enough.

A program of “quantitative easing” (“QE”) – which eventually became a series of 3 separate, somewhat consecutive programs, was undertaken in the hopes of kickstarting the moribund US economy, with the Fed purchasing government and other bonds in order to further lower interest rates and increase monetary supply.

**SOME OBSERVATIONS:**

At the time, despite the shock of an unusually deep, between-meetings cut, prevailing opinions considered the threat to be just an ordinary recession. The aggressive, unanticipated action by the Fed seemed to suggest that at least some believed the situation was more serious than usual. Ultimately, a series of highly unusual and unprecedented steps were taken to prevent recession, depression, and deflation, which, for the most part, have been successful. While the US was able to skirt depression and deflation, a recession – the Great Recession – was certainly not avoided.

The effects of monetary policy lag behind market conditions. Because of this delay between changes in Fed policy and its lasting effect on the economy, it’s possible to conclude that the Fed may have been more successful in avoiding the deep recession had they acted sooner. This conclusion is supported by the fact that credit conditions continued to tighten and housing continued its downward spiral following the Fed’s decision in January of 2008.

**EVALUATING ULTIMATE SUCCESS:**

Ultimately, the novel monetary policies begun in January of 2008 have been so successful that the worries and anxieties of the Great Recession have now been largely forgotten, if not entirely erased from our collective memory. The US has mostly avoided a “lost generation” scenario of the type that plagued Japan in the late 1980s and 90s. But, in the process, the conventional wisdom that the modern US economy functioned far more smoothly than in the past was questioned, if not abandoned entirely.

**In past 10 years, a “new normal” has evolved with:**

- A longer but less exuberant expansion
- Tamed inflation with occasional concerns about deflation
Slower, if somewhat steady, job creation
Weaker wage growth
Increasing income polarization
Continued concern about how to distribute financial risk across institutions and across geographic regions

In our view, the “new normal” will require major revisions to textbook versions of how financial markets work. Desktop models which assumed the existence of efficient markets showed limited ability to anticipate the severity of the downturn. While there is heightened interest in trying to predict “black swan” scenarios, it remains to be seen whether the newer methods of analysis turn out to be any more predictive.

ANALYSIS AFTER THE FACT:
Six years later, on February 21, 2014, Binyamin Appelbaum published an article in the New York Times on how the Fed board members – apart from Bernanke and Yellen - continued to misread the crisis. His conclusions were based on minutes and other information that had just been released:

Lehman filed for bankruptcy on September 15, 2008: the day before the Fed’s regularly scheduled meeting.
Stock and housing prices continued to collapse, while unemployment was climbing.
The day after Lehman’s bankruptcy filing, the Fed held its regularly scheduled meeting. Most Fed officials continued to believe that the US economy would continue to grow despite a deep financial crisis that was only accelerating.
Rather than be concerned with the uniqueness and extent of the financial fallout, officials “fretted repeatedly about overstimulating the economy only to realize time and again that they needed to redouble their efforts to contain the crisis.”

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Supporting his point, Appelbaum noted that the transcript for the September 16, 2008 meeting mentioned “inflation” 129 times and “recession” 5 times, strongly suggesting misplaced concerns. He found that while Bernanke was “clearsighted” about the crisis, other Fed officials were not. Governor James Bullard, for instance, wanted “to wait for some time to assess the impact of the Lehman bankruptcy filing, if any, on the economy.” And while Bernanke did acknowledge that an economic downturn was clear, even he did not favor cutting rates further at that point. Others took a more detached approach despite the Lehman collapse, reasoning that allowing Lehman to fail would help restore a sense of accountability on Wall Street.

Yellen, six weeks after Lehman’s bankruptcy, argued that “given the seriousness of the situation, I believe that we should put as much stimulus into the system as we can as soon as we can.”

But this stimulus effort still took time. By early October 2008, the Fed finally reached out to central banks to cut rates in a coordinated move due to, in Bernanke’s words, “an extraordinary situation.”

Given the variety – even conventionality – of informed, professional opinions on the Fed’s board in 2008 and the following years, it is clear that who is in charge makes a difference. In that regard, we were fortunate to have Bernanke and Yellen. But even the most able leaders are not clairvoyants. Ultimately, while the Fed’s decisions are influential, the lag of their effects demand that in order to more accurately direct the economy's trajectory, we believe Powell must look past market noise and make heavy-handed decisions if he deems them appropriate for the time.
ENDNOTES

4 Ibid.
5 Bartlett, Bruce. “Maybe Too Little, Always Too Late.” *The New York Times*.
6 Ibid.
8 Ibid.
10 Ibid.

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