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Fed Seeks Balance as Investors Clamor for Action

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WASHINGTON, Aug. 21 — Wall Street thinks the Federal Reserve is running short of time.

After another day of restless anxiety in the world's credit markets, most lenders and investors remained fearful of all but the very safest Treasury securities, and new figures showed that the rate of foreclosures in the housing market in July was almost double that of a year ago.

Analysts now say that the central bank's move last Friday to restore confidence by encouraging banks to borrow directly from the Fed at a lower cost has had only limited impact so far and that the Fed will need to take more drastic action by cutting its benchmark interest rate soon if it fails to see more progress.

"I would calibrate it in days, not weeks," said Richard Berner, chief United States economist at Morgan Stanley. "If the money markets are still in disarray a few days from now, I would think the Fed is going to have to take additional steps."

But the central bank's chairman, Ben S. Bernanke, and most other Fed policy makers are extremely reluctant to have the Fed jump to the rescue with an interest rate cut simply to relieve the woes of investors on Wall Street or to bail out hedge funds and others that many blame for the current problems caused by excessive investment in risky mortgages. Instead, the Fed is much more closely watching for clues to whether the housing market itself and consumer spending are weakening before deciding that it needs to cut interest rates.

That means an imminent reduction in the Fed's key policy tool, the federal funds rate on overnight loans between banks, is still far from a sure bet.

The big issue facing the Fed — whether or not to cut the federal funds rate by a quarter point or even half a point from its current level of 5.25 percent and when to do so if it decides a cut is warranted — poses major risks for Mr. Bernanke. Since taking over the Fed in February 2006, Mr. Bernanke's hallmark has been a cool patience and willingness to stick with his economic game plan even when it clashed with the expectations on Wall Street.

But Mr. Bernanke does not have the luxury of time. Lessons from the last big credit crunch, which came after Russia's financial meltdown in August 1998, show that timid action has little effect, while a quick and decisive follow-up move can make a major difference.

On the other hand, any sign that the central bank has itself become overly nervous about the situation by moving precipitously could compound the anxiety that has paralyzed investors about everything from mortgages to commercial bonds.

The Federal Reserve rarely changes its benchmark interest rate between its official policy meetings, and only

when it faces an unexpected shock. The last time it did so was a week after the terrorist attacks of Sept. 11, 2001. The Fed's next meeting is not scheduled to occur until Sept. 18.

But the Fed is under time pressure in part because it pointedly raised expectations of a broader rate cut last Friday when it declared that it was "prepared to act as needed" to help the economy weather disruptions in the markets.

The Fed's first move — to entice banks into borrowing through its so-called "discount window" — has done almost nothing to jumpstart lending, many analysts now say.

"It's not clear that the discount window was a viable option," said Laurence H. Meyer, a former Fed governor who is now vice chairman at Macroeconomic Advisers. "It just doesn't seem like it is going to be a very effective tool in adding liquidity."

Fed officials and top Treasury officials continued on Tuesday to talk by telephone with major banks, encouraging them to borrow from the discount window and repeating that there was no stigma associated with such loans. Traditionally, banks have only resorted to the Fed's discount window when they had no other place to borrow money.

In a separate move, the Federal Reserve Bank of New York cut in half the fee it charges banks to borrow Treasury securities. Fed officials described the move as "purely technical," though it dovetailed with investors' rush to find safety in Treasury bills.

Senator Christopher J. Dodd, Democrat of Connecticut and chairman of the banking committee, met with Mr. Bernanke and Treasury Secretary Henry M. Paulson Jr. on Tuesday morning. He said the Fed chairman told him that he would use "all available tools" to head off a surge in mortgage foreclosures.

If Wall Street regains even a small part of its past willingness to finance mortgages and commercial loans, Fed policy makers could gain enough breathing room to postpone a decision until their next scheduled policy meeting.

Fed officials would probably prefer to wait until their Sept. 18 meeting, by which time they will have more information on whether the fear in financial markets has in fact translated to problems in the real economy.

Indeed, there were signs Tuesday of an internal debate about the need to cut rates at all.

Jeffrey M. Lacker, president of the Federal Reserve Bank of Richmond, said in a speech to risk managers in North Carolina on Tuesday that turmoil in financial markets was not a reason in itself to reduce rates.

"Interest rate policy needs to be guided by the outlook for real spending and inflation," Mr. Lacker said, adding that many of the market's problems are simply a reaction to previous "misjudgments" about the exotic mortgages.

There were hints on Tuesday that such fears, stemming in large part from the meltdown in mortgage markets, were ebbing slightly. The stock market was relatively tranquil for the second day on Tuesday and while investors continued to cling to short-term Treasury bills, a sign of risk aversion, rates moved up later in the day, suggesting that some of those anxieties were easing. And prices of credit swaps tied to Countrywide Financial, the giant but

struggling mortgage lender, declined slightly.

But Fed officials had little cause for cheer. Banc of America Securities downgraded the stocks of two major homebuilders — Toll Brothers and Hovnanian Enterprises — because of the growing number of customers canceling contracts for new homes.

And RealtyTrac, a publisher of databases on foreclosures, said on Tuesday that the number of foreclosure filings jumped 9 percent in July, to 179,599, and was 93 percent higher than in July 2006.

More than half of those threatened foreclosures were in California, Florida, Michigan, Ohio and Georgia, RealtyTrac reported. But 43 states experienced an increase in such filings compared with one year ago.

Though many big pending leverage buyouts have run into problems with financing, Fed officials have long been skeptical about the economic impact of such difficulties.

The real issue for policy makers is whether companies are investing less in new equipment and construction, or whether consumer spending is being seriously undermined.

To that end, Mr. Bernanke appears to be paying especially close attention to the health of the housing market. Fed officials have recently acknowledged that the downturn in housing over the last 18 months has been deeper and more protracted than they expected, and the Fed was clearly startled by the recent panic associated with subprime mortgages and other exotic home loans.

Until two weeks ago, Fed officials had steadfastly contended that they saw little spillover from woes in the housing market to the broader economy. And while they had acknowledged acute problems among people with weak credit who took out subprime loans, officials contended that subprime mortgages were a small part of all home loans.

But Fed officials now concede that problems in the mortgage market are broader than they once thought, with problems surfacing in so-called “Alt-A” mortgages, from interest-only loans to “no-doc” loans in which borrowers do not need to document their incomes. Fears about the hidden risks in mortgages have now prompted many investors to back away even from conventional mortgages.

Fed officials were pleasantly surprised earlier this year that the plunge in home building, which began more than a year ago, has not led to higher unemployment or lower consumer spending. But they repeatedly cautioned that uncertainties about housing still posed the biggest risk to their forecast for a “soft landing.”

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