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Economic Front: How Policy Makers Regrouped to Defend The Financial System --- Rate Cut Caps Week Spent Trying to Lessen Harm To the Global Markets --- Weighing Bailouts, Tax Cuts

By Greg Ip and Jim VandeHei
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WASHINGTON -- At 7:30 a.m. yesterday, Alan Greenspan convened FederalReserve Board members in Washington, and the central bank's regional bank presidents joined in by speaker phone. After observing two minutes of silence, the group took just 20 minutes to agree on slashing the Fed's two main benchmark rates by half a percentage point. The early-morning move capped a week of hectic scrambling by the world's economic generals to try to ensure that the terrorists who destroyed the World Trade Center didn't do the same to the world economy. From Washington to Frankfurt to Tokyo, central bankers and finance ministers have been pulling little-used levers and bending usually strict rules in order to keep money moving globally, banks lending and ATMs full of cash. The Fed boosted by 200-fold the amount of money it lends directly to private banks, while telling them it would turn a sympathetic eye to restrictions on loans to brokerage firms.

The Fed also yesterday morning took the unusual step of giving the European Central Bank advance word of its rate cut, according to a European official, allowing the ECB enough time to match the move later in the day. That marked a new level of global coordination. When central banks around the world cut rates during the 1998 financial crisis, the moves were spread out over three months.

Officials stress that their goal in the frantic activity of the week wasn't to keep the stock market afloat. Officials at the Securities and Exchange Commission, for instance, quickly and firmly rejected proposals that they try to limit traders from selling stocks short yesterday. Instead, the aim of the policy makers in general has been to do whatever they could to get the nation's financial markets operating smoothly, and to avoid excessive damage to the economy in the process.

It's too soon to say how successful their effort has been. Stock prices fell sharply, but there were no obvious glitches in trading yesterday. Now, the emphasis shifts from preventing a near-term market meltdown to containing broader economic fallout. The chief fear, of course, is a recession, often defined as two consecutive quarters of declining gross domestic product. If it's too late to stop a recession, the goal is to make it as short and shallow as possible.

Along those lines, the Fed made clear in its statement yesterday that it is ready to cut interest rates even further. Already, the federal-funds target, at 3% after yesterday's cut, is at its lowest level since 1994, while the discount rate, cut to 2.5%, is at its lowest level since 1959. In the White House, President Bush met just as the markets were closing yesterday afternoon with his economic team to weigh other actions for keeping the economy and crucial sectors afloat. His group of conservative advisers -- who came to Washington earlier this year intending to limit the federal government's role in the economy -- are now contemplating whether and how to bail out industries from airlines to insurance and hotels, and whether to back a capital-gains tax cut or tax incentives for business investment. Yesterday's internal discussions devoted nearly an hour to airlines alone, and top Bush aides will meet in Washington today with a group of industry chief executives.

Missouri Republican Rep. Roy Blunt, a close Bush ally, said he expects an airline aid package by week's end. The president and Congress "want to show financial markets that government is paying attention" to the economic fallout, he said.

The managers of the global economy have elaborate contingency plans for such events, some of them written in anticipation of the Y2K crisis that never emerged. But events, as always, didn't stick to the script. For starters, key players -- notably Fed Chairman Greenspan and Treasury Secretary Paul O'Neill -- were overseas when the hijacked airplanes hit their targets. And at one point, the Fed's European counterparts fretted that they might not be able to immediately supply badly needed dollars to their European commercial banks, because technical "**swap**" agreements among central banks had lapsed some years earlier. The swaps were quickly reactivated.

Mr. Greenspan was on a Washington-bound flight from Switzerland, where he had been attending an international meeting of central bankers. The pilot came on and announced to the passengers that American airspace had been closed and that the flight was returning to Zurich. With the airplane's phone lines into the U.S. jammed, the Fed chairman was unable to make contact with anybody back in Washington until the plane landed. Three of the four other Fed governors were also out of Washington on Tuesday -- Laurence Meyer was in China for bilateral economic meetings, Edward Gramlich was giving a speech on Social Security in Arizona, and Edward Kelley was on vacation.

Back in Switzerland, Mr. Greenspan linked up with New York Fed President William McDonough -- the **Federal Reserve** system's main contact for financial markets -- who had also attended the European meetings. The two got on a military tanker plane, which traveled to Washington via England. Mr. Greenspan was back at his desk by 1 p.m. Wednesday. Mr. McDonough was able to get back to New York by hitching a ride on a government plane carrying New York Democratic Sens. Hillary Rodham Clinton and Charles Schumer.

Mr. O'Neill had been at his Tokyo hotel less than half an hour when he saw the news on CNN. He canceled meetings scheduled for the next day with Japanese Prime Minister Junichiro Koizumi and Japan's finance minister and central-bank governor. He and aides were able to get on a military cargo plane with canvas seats attached to metal bars, a far cry from the business-class comforts he had enjoyed on the way to Japan. After refueling in the air, the plane landed at Andrews Air Force base near Washington around 5 p.m. Wednesday.

One top economic player who was in town was Lawrence Lindsey, the president's chief economic adviser. But with the White House under threat, Mr. Lindsey shifted with about 70 other White House staffers to the nearby Washington offices of DaimlerChrysler AG. After more than an hour there, he was brought to the White House bunker. The president's comments that day were written in the DaimlerChrysler offices.

In the absence of many of the top men, their deputies swung into action. Their war plan called for assembling an emergency response team, dubbed the working group and made up of officials from the Fed, the Treasury, the SEC and the Commodity Futures Trading Commission, with White House officials weighing in. The group gathered by phone almost immediately, and it has met two to three times each day since, for about a half hour each time.

Joining the discussions for the Fed was Roger Ferguson, the level-headed 49-year-old vice chairman of the central bank and the only Fed board member in town Tuesday morning. He was well-suited for the crisis. With a Ph.D. in economics from Harvard University, Mr. Ferguson, is known for his intimate knowledge of the banking system's critical plumbing. Before joining the Fed in 1997, he was a partner at McKinsey & Co. specializing in financial institutions, and he won plaudits as a Fed official for his chairing of a committee of the world's central banks preparing for Y2K.

The SEC team included Annette Nazareth, Mr. Ferguson's wife, and head of market regulation for the SEC. It became an inside joke among working group members that Mr. Ferguson and Ms. Nazareth were on most of the calls together. "Fortunately the relations have been good between the Fed and SEC," Ms. Nazareth said. Frequent conversations about the crisis occurred at home, too. During a call to Mr. Ferguson at home one night last week, an official asked him a question about the SEC. "I have the director of market regulation right here," he said, handing the phone to his wife.

On Tuesday, Mr. Ferguson convened as many of the regional bank presidents as he could on a conference call, and once it was over, issued a key statement: "The **Federal Reserve** System is open and operating. The discount window is available to meet liquidity needs."

The wording was similar to a statement Mr. Greenspan issued in the wake of the 1987 market crash, just a few weeks after he had taken the helm at the Fed. The discount window is a last-resort source of money for banks that has fallen into disuse as banks found they could borrow more easily in the markets and as going to the discount window came to be considered a sign of weakness. Indeed, the prior week, discount-window borrowing from the Fed stood at less than $200 million. But last week, with the money markets crippled and the Fed's open invitation blunting the stigma, bank borrowing from the discount window exploded to $45.6 billion.

In the meantime, the New York Fed, under the watchful eye of Sandra Krieger, an economist responsible for money-market operations, was busy ensuring that banks and investment dealers unable to raise essential funds in the barely functioning money markets had all the financing they needed. The Fed routinely makes overnight loans collateralized with government bonds to a network of 25 banks and securities dealers, but such injections of cash seldom top a few billion dollars at a time. Wednesday, with those players unable to locate funds clogged in the payment system or to borrow in the markets, the Fed injected $38.25 billion, more than double the previous record. To ease the way, it eased the collateral rules for its loans. By Friday, the injection had reached an astounding $81.25 billion, exceeding what it had done during the Y2K scare.

Meanwhile, the New York Fed had to deal with the chaos surrounding its own offices on Liberty Street just a few blocks from the destroyed World Trade Center. Beginning Wednesday, some of its staff began moving to an operations center in East Rutherford, N.J., which also has a backup trading desk. That afternoon, the National Guard ordered out most of the remaining staff amid concern that another nearby building might collapse.

The concern proved unfounded, but by Thursday the Fed was conducting its open-market operations from East Rutherford. A protective force was left behind to keep watch over the huge hoard of gold the New York Fed stores deep beneath its headquarters on behalf of foreign central banks. At the Fed's regional banks based in Atlanta and Richmond -- offices that supervise banks in their areas and distribute bank notes -- law-enforcement officials issued warnings that they may have been the potential targets of a terrorist attack, although the officials cautioned that the credibility of the information's source was questionable. Nonetheless, both offices warned their employees over the weekend and beefed up security. Concern was especially acute in Richmond, where the **Federal Reserve** Bank building is among the city's most prominent and was designed by the same architects who designed the World Trade Center.

Throughout the week, Fed officials popped up everywhere doing their part to get the markets going again. At a meeting Thursday afternoon on how to reopen the markets, Mr. McDonough reminded the bankers and executives in attendance that they were expected to keep credit flowing to brokerage firms who were good credit risks but cash-constrained by the disaster. They had heard the same message during the 1998 debt-markets crisis and over Y2K. The Fed also quietly notified banks that it would be "very understanding" of their lending to securities-dealer affiliates, a practice normally limited by Depression-era laws to avoid risky loans within a single financial entity.

Even before yesterday's emergency rate cut, it was obvious to Fed officials that the economic recovery they had all hoped to see start soon was going to be compromised -- just how much, nobody knew. Consumer confidence, already under pressure, was bound to slide further, and plunging business investment, the primary source of the economy's weakness, could suffer more as businesses factored an added risk premium into their plans. Even before Monday's announcement, five of the Fed's regional banks had voted, either at scheduled meetings or by teleconference, to request a half-point rate cut.

Almost as important as the Fed's actions at home were its efforts to limit the damage of the crisis abroad. The European Central Bank in particular had a dilemma: how to help European banks who borrow and lend heavily in the New York money markets but now were struggling to finance those positions? Banks in the U.S. were unwilling or unable to lend them dollars, partly because of difficulties in arranging the required collateral. And if foreign central banks wanted to get the dollars in the open market, they risked destabilizing exchange rates.

Two alternatives were considered. The first was for the Fed to temporarily lend dollars to the European central banks, which they could in turn lend to commercial banks; in return the Fed would receive euros. But such formal "**swap**" agreements between U.S. and European central banks had lapsed years earlier and there were concerns that legal issues would slow their speedy reinstatement amid Wednesday's turmoil. So as an alternative, the Bank for International Settlements in Basel, the central banks' central bank, began arranging to borrow from U.S. commercial banks, who would waive the usual demands for collateral given the BIS's reputation as the most creditworthy of borrowers.

In the end, the BIS scheme proved unnecessary. Early Thursday, the Fed announced it had reached a **swap** arrangement of up to $50 billion with the ECB. Friday, it announced a $30 billion **swap** agreement with the Bank of England and expanded an existing **swap** line with the Bank of Canada to $10 billion from $2 billion.

Meanwhile, the central banks and finance ministers also acted on the political front. The night of the bombing, Canadian Finance Minister Paul Martin spoke by phone with Secretary O'Neill in Tokyo. The Canadians drafted a G-7 statement and then sent it to the Italians. The Italians took it to the European ministers, who were meeting in Brussels on Wednesday. There was some debate within the G-7 about the wording, particularly the phrase, "We will monitor economic developments and financial markets closely and stand ready to take further action as necessary."

Some of the central bankers wondered exactly what further action the group was willing to pursue, particularly on the fiscal front. In the end, however, the G-7 language stayed in the statement, which said, "We are committed to ensuring that this tragedy will not be compounded by disruption to the global economy. Our central banks have indicated that they will provide liquidity to ensure that financial markets operate in an orderly fashion."

After a week of sifting mainly through the human tragedy, and the national security aspects of the attacks, President Bush yesterday turned his attention to the economic fallout. He met for 20 minutes in the Oval Office with Mr. Lindsey and Glenn Hubbard, chairman of the Council of Economic Advisers, reviewing that day's market activity. They stressed the positive aspects of the day, despite the sharp price drop, noting that the decline wasn't any worse than the decline in overseas markets during the past week -- just that it was compressed into a single day. And they marveled at the orderly nature of trading, with a patched-up exchange handling record volume.

The group then moved to the larger nearby Roosevelt Room, where still more aides joined in a discussion of the ailing airline industry. Mr. Lindsey presented Mr. Bush with a range of options and the discussion, slated to last 40 minutes, stretched to nearly an hour.

Bush aides are split over how much to help the airlines, with many of advisers wary about giving extra aid to an industry that, through mismanagement, had created substantial problems for itself before this crisis. While House Republican leaders are sympathetic -- and they consider Mr. Lindsey their best ally in the administration -- some in the cabinet are skeptical. "Looking at their balance sheets, quite a few have had economic problems in spite of the fact that last year was the best in the airline business for some time," Mr. O'Neill said in one of a whirlwind of television interviews from New York yesterday, part of a confidence-building visit to Wall Street. During the day, the treasury secretary stood at the podium for the opening of the New York Stock Exchange, toured with a face mask the still-sooty American Stock Exchange, and went to the Nasdaq for the market's 4 p.m. closing.

The internal debate over airlines reflects the broader complex questions facing the administration in the coming days and weeks. A number of industries are seeking help, large and small, to mitigate the effects of the disaster. Commerce Department officials yesterday were canvassing U.S. companies to determine which ones are being hit the hardest. Commerce Secretary Donald Evans spoke yesterday to the chief executives of Southwest Airlines, Morgan Stanley and Bank of America, according to an administration official. He is working closely with the U.S. Chamber of Commerce, which has been asked by officials to survey companies, a senior administration official said, and find out who needs help. Thomas Donohue, president of the U.S. Chamber, says he has created a "clearinghouse" so U.S. businesses can tell the White House how the terrorist bombings are affecting their companies and how security measures being considered could undermine the economy.

The Big Three auto makers, for instance, have been working closely with Mr. Evans and other administration officials to unclog truck traffic coming and going from Canada, according to a senior White House aide. Mr. Donohue weighed in on their behalf. DaimlerChrysler in particular has 600 trucks moving parts through the Canadian border every day, and aggressively lobbied the administration to speed up security checks at the border. A top industry lobbyist said Mr. Evans "responded very, very quickly" and the U.S. Customs Service and the National Guard steered more personnel and resources to alleviate the problem. The auto makers continue to press the administration to keep the traffic flowing. Mr. Evans says he will visit the border later this week to make sure traffic flow has improved.

Several legislators have also talked about aiding insurance companies, although Mr. O'Neill suggested that he is hesitant to help companies that "are now being asked to fulfill their contractual obligations -- that's what they ought to do, that's what free markets are all about."

Some officials, though, are open to creating some form of government coverage for terrorist acts. And Mr. Lindsey, in an interview, defends more broadly an activist approach in these unusual times. "We all hope we can return to a state where intervention is not necessary, but we've had a major catastrophe, and one of the roles of government is to help ameliorate catastrophes," he says.

David Wessel, Jacob M. Schlesinger, Michael Schroeder and Michael M. Phillips in Washington, Christopher Rhoads in Berlin and G. Thomas Sims in Frankfurt contributed to this article.

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