



**Maria Fiorini Ramirez, Inc.**

Global Economic Consulting Services

675 Third Avenue, 11th Floor, New York, NY, 10017

Tel. 212.416.5000

Fax. 212.385.1860

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### Fed's Options - Door Wide Open to Alleviate Pain

The events of the last 14 months have been quite disruptive for the financial system. Non-performing assets have been beleaguered by lack of demand from buyers and instead a desire to liquidate holdings. At the same time Fed policy has been extremely aggressive in trying to avoid failure in the financial system. This culminated with the historical event two days ago, which was the bailout of Bear Stearns, one of the top five investment banking firms and a primary dealer in the US. This was done by forcing a merger with JP Morgan Chase. This acquisition by Chase seems to have taken place without Bear having any alternatives, and leaves a lot of speculation now and in the years to come as to whether it was the right decision. The questions will remain whether the response was one that reflected undue panic or not. Time will have to pass in order to make that assessment.

One fact for sure was that the lack of liquidity and confidence that seemed to drive liquidity out of Bear and the financial markets in general. These latest set of circumstances may not be quite over yet. In my opinion, the Fed's bailout and the way it was announced, in a Sunday evening in New York and at the opening of the Asian markets, clearly showed a heightened concern that a downward spiraling of the stock markets and an unraveling of the counterparty risks in the financial markets globally was not acceptable.

Has the Fed used all its tools and is there anything else that it can do?

The Fed has been lowering interest rates and it has a little room left but not much. Today's additional 75 basis points cut in the Fed Funds rate bringing it to 2.25% was in line with expectation. The Fed has lowered the discount rate now to 2.50% still a penalty rate by 25 basis points. While they have little bit more room left, there is not much. The Fed has been expanding access to funds to the primary dealers and accepting a broader range of collateral from the financial community with the last move. The Fed has provided Term Auction Facility funds to inject liquidity directly into the markets and some other central banks have done the same, as the liquidity problem has been global. The bailout of Bear by taking \$30 billion of collateral out of the system is unprecedented. However, in light of the panic environment at the moment there seemed to be no other choices. So it is our view that the Fed has done as much as it can.

It has been our feeling that as we moved closer to the end of the quarter, more of the losses in balance sheets of financial institutions would be announced. The main problem is the size of impaired assets that the auditing firms are forcing write-downs on. I would certainly be in favor of adopting some temporary rules that would create an environment where monetary policy could be more successful in periods that are very unusual and we are in one of those periods now. The main problem is that many of these securities are not capable of being priced right now. It does not mean that they are worth nothing forever. And for those investors who do not mind holding them to maturity, there should be at least some balance between what the models value would imply as their value and the lack of any value that the markets seem to imply at this time have a big spread.



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Why is the issue of impairment important? It is because the Fed's ability to succeed in its implementation of so many tools rests on how effective they are in restoring liquidity in the markets. If assets are impaired they have to be written off and that absorbs capital that can be used in making loans or extending credit to the housing markets or small businesses. The pipeline of creating assets and securitizing them is not working and unless this ability to create credit and liquidity is restored, the chances of success diminish and the accounting and capital requirements presently work opposite from the Fed's goals. All we can hope for is a prompt and successful resolution soon so that the economy, the financial markets and investors can feel assured that their investments are well preserved.

Maria Fiorini Ramirez