In a speech in his hometown of Dillon, South Carolina, Fed Chairman Ben Bernanke recently promised that the Fed would “forcefully deploy all the tools at our disposal” in responding to the ongoing financial crisis.

This is excellent news, since the tools at the Fed’s disposal are awesome, and if deployed forcefully enough, could almost certainly end the acute stage of our present financial panic.

The Fed has already shown remarkable boldness in responding to the crisis; if not for that boldness, financial markets and the world economy would be in much worse trouble than they are now.

And yet, the crisis continues. This appears to be because the Fed’s principal mode of intervention, the expansion of its balance sheet by well over $1 trillion, has mainly involved supplying perfectly riskless assets in exchange for nearly riskless ones. This has not cured the disease, because the fundamental problem is a colossal collapse in investors’ willingness to hold risky assets.

In ordinary recessions, a sharp cut in the riskless interest rate has the effect of making riskless assets deeply unattractive (who wants to hold onto an asset that pays little or no interest?). And ordinarily, markets retain some confidence in the long-term value of the risky assets, so that as the riskless ones are made sufficiently undesirable, investors become willing to bear the risk in exchange for higher expected yields.

But this is no ordinary recession, as everyone knows by now. Short term interest rates have already been cut to zero, and yet the demand for the lowest-risk assets is unabated. The price of risky assets seems to plumb new lows every few weeks, profoundly undermining confidence in their long-term value. In this environment, suddenly a zero percent nominal rate of interest looks good. We are in what Keynes called a “liquidity trap.”

It seems increasingly clear that the only monetary action that offers any reasonable hope of helping to escape that trap is for the Fed to support, on a massive scale, the kinds of market interventions that can affect the price of risky assets, not just riskless ones.
There seems to be some sentiment that the Fed does not have the authority to intervene deliberately and with forethought in markets for risky assets. It is hard to tell where that view originates; certainly not from the plain language of the Federal Reserve Act, whose Section 13(3) gives the Fed virtually unlimited powers to deal with “unusual and exigent circumstances.” (A reasonable interpretation of the language of the crucial passage is that the Fed can buy whatever assets it wants, in exchange for whatever collateral it deems sufficient.)

The Fed has invoked this clause of its charter sparingly (as is appropriate); but aside from the Great Depression, it is hard to imagine circumstances more exigent than the ones we face. These extraordinary powers were granted to the Fed at its founding because the authors of the Federal Reserve Act had fresh memories their own crisis: The Panic of 1907, in which J.P. Morgan came to the rescue of the financial system by acting as a sort of private-sector “lender of last resort.”

Fortunately, the Fed’s recent actions indicate that it has a full appreciation of these powers; the Board approved the taking on of an enormous portfolio of risky assets during the negotiations over the fate of Bear Sterns, and has taken on an even more massive and risky challenge in trying to unwind the tangled operations of AIG.

Unfortunately, however, the most promising vehicle for further action to stem the crisis, the Term Asset Lending Facility, has (at least initially) been restricted to financing investments only in the safest, AAA rated, securities. If the private sector investors who will be participating in the TALF were given the authority to make investments in risky assets, TALF investments could spark a turnaround in the market’s appetite for risk.

The structure of the TALF has been cleverly designed to induce private-sector investors to reveal their best guesses about which assets will pay off and which will not, which is the key question that has blocked rational resolution of the problems in the markets for “toxic assets.” (An inability to achieve clarity on prices for those assets is what has made it so difficult for markets and regulators to make sensible judgments about which banks are solvent and which ones are insolvent. Hence, resolution of this problem would also clear the way for a rational resolution of the problems in the banking sector, which is desperately needed).

Once any initial kinks are worked out in the first offering from the TALF, the later stages of the program should expand the range of assets eligible for purchase, thereby helping to re-establish rational pricing for the toxic assets
for which no meaningful prices currently exist.

Alternatively, the Public-Private Investment Bank contemplated in Secretary Geithner’s February 7th speech may prove to be the primary vehicle for the purchases of toxic assets, though since the TALF is much closer to operational status it seems that it would be wiser to use it as the vehicle for such purposes than to await the construction of yet another novel entity.

However it is done, very substantial funding from the Fed will be required to make intervention in the market for risky assets effective. Fortunately, Chairman Bernanke’s promise to use “forcefully use every tool at our disposal” suggests that he and the Fed’s staff understand that extraordinary times require the use of the Fed’s extraordinary powers, which were granted to it for just such circumstances by people who had lived through a similar crisis.

The question of how to systematize the new rules of the game, and what further actions are required, is one that can be postponed to a date when the worst stage of the Global Panic of 2008-2009 has subsided.