



Market Flash

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FEDERAL RESERVE SURPRISES WITH LARGER-THAN-EXPECTED RATE CUT

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When was the last time a central bank delivered a larger rate cut than financial markets and economists were expecting? On Tuesday September 18, 2007, the Federal Reserve lowered its benchmark Funds rate by 50 basis points. Most economists polled by Bloomberg were looking for just a 25 basis point cut, and the futures markets were only pricing a 50% chance of a half-point move.

In addition to the Funds rate, the Fed also lowered the Discount rate, the rate it charges banks to borrow money for a very short time (usually overnight), by 50 basis points. This keeps the difference between the two key financing rates for the banking system unchanged.

Equally surprising was the Federal Open Market Committee (FOMC) policy statement, which read much more neutral than the one published as part of the discount rate cut on August 17. On the economic growth risks, the Fed now comments: "... *the tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally.*" This suggests that we need to see stronger evidence that the financial markets crisis is impacting the real economy for further action.

The Fed clearly based the decision to cut rates on the risks emanating from financial market disruption, and not the crisis in the housing market: "*Today's action is intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets.*" The big surprise was the fact that the statement continued to cite inflation risks: "... *some inflation risks remain, and it [the Committee] will continue to monitor inflation developments carefully.*"

Finally, the forward-looking strategy part of the FOMC statement sounded much more neutral than the August 17 release. Here was September 18th's key policy bias: "*The Committee will continue to assess the effects of these [developments in financial markets] and other developments on economic prospects and will act as needed to foster price stability and sustainable economic growth.*" This suggests an equal weighting between the Fed's dual policy goals of price stability and economic growth. The August 17 statement was clearly more focused on the economic growth risks: "*The Committee is monitoring the situation and is prepared to act as needed to mitigate the adverse effects on the economy arising from the disruptions in financial markets.*"

The Bottom Line: The Fed abandoned its policy of small steps and delivered a significant monetary stimulus that should bolster investor confidence (the stock market has reacted very positively); lower financing cost for Commercial Paper (CP) issuers; soften the impact of interest-rate resets on mortgage borrowers; and help stabilize housing demand through lower mortgage rates. The risk is that in a few weeks the transparency problems that have besieged the asset-backed market may still cause significant market dislocations, requiring further Fed action. ■

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