

Fed Cuts Rates by Quarter Point

By GREG IP
October 31, 2007 2:41 p.m.

The Federal Reserve cut its target for short-term interest rates a quarter of a percentage point but sought in its accompanying statement to dispel expectations of more rate cuts.

As markets had widely expected, the Fed cut the target for the federal funds rate, charged on overnight loans between banks, to 4.5% from 4.75%, on the heels of a half-point cut last September.

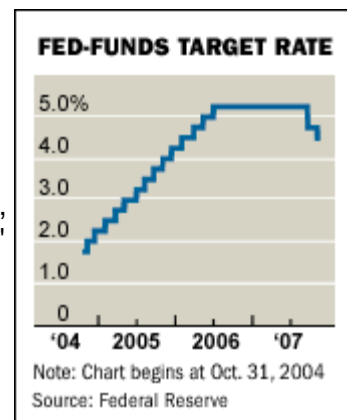
The two moves together, the Fed said in its accompanying statement, "help forestall some of the adverse effects on the broader economy that might otherwise arise" from the summer credit crunch that drove up interest rates paid by many homeowners, corporations and banks.

But the statement, in an apparent attempt to rein in market expectations of more cuts, said it now saw the risks of weaker growth and higher inflation as "roughly [in] balance."

Stocks and bonds sold off on the news. The Dow Jones Industrial Average, up over 80 points before the Fed's afternoon announcement, initially fell into negative territory. Long-term bond prices, which move in the opposite direction of yields, fell. The statement appears to sharply reduce the odds the Fed will cut rates again at its December meeting, as markets had expected.

The statement also reflected continuing concern about inflation. "Readings on core inflation have improved modestly this year, but recent increases in energy and commodity prices, among other factors, may put renewed upward pressure on inflation...Some inflation risks remain, it will continue to monitor inflation developments carefully."

For the first time this year, the vote by the 10 voting members of the Federal Open Market Committee (seven regional bank presidents participate but do not vote), wasn't unanimous. Federal Reserve Bank of Kansas City Thomas Hoenig dissented, saying he would have preferred no cut.



and

Moreover, only six of the Fed's 12 reserve banks requested the parallel decrease in the less important discount rate, charged on direct Fed loans to banks, to 5% from 5.25%.

Those signals suggest the decision to cut rates may have been close. It may have been driven in part by a desire not to disappoint markets. With futures markets assigning a 92% probability Wednesday morning to a cut, a failure to deliver would have been the biggest surprise in the 13 years for which comparable data is available, according to Bianco Research LLC, a Chicago financial research firm. That would likely have led to sharp declines in stock prices and a possible resurgence of risk aversion in debt markets.

But while avoiding that fallout may have helped tilt the Fed towards a cut, economic and strategic considerations were almost certainly more important. While the Fed expects the economy to emerge from its housing-induced slow period by the middle of next year, the risks around that forecast are of weaker, not stronger growth. Economists on average put the odds of recession in the next 12 months at 34%.

Mr. Bernanke and other Fed officials say "risk management" - a phrase coined by previous Fed Chairman Alan Greenspan - requires them to base interest rate decisions not just on the likeliest forecast, but on less likely but potentially far more damaging outcomes. Thus, a rate cut could be justified on the possibility that housing activity and prices fall even further than currently envisioned, causing more loss of wealth and more mortgage delinquencies and market turmoil. For the Fed, cutting now may avoid having to cut even more later.

Moreover, the risks of such a move appear acceptable: inflation, by the Fed's preferred measure, has been below 2%, the upper end of what most officials consider acceptable, and with unemployment rising from 4.4% in April to 4.7% in September (October's figure is released Friday).

Some officials have also argued that 4.75% is too high an interest rate at the current inflation rates and with long-term economic growth under 3%. They may have argued the Fed was going to ease eventually and it might as well do so now.

Still, the move is not costless. The Fed's rate cuts since the credit crunch have hastened a selloff in the dollar and a resulting run-up in commodity prices that could later on feed through to inflation, although Mr. Bernanke has played down that risk.

While the economy has so far held up well under the pressure of plunging home construction and eroding real estate wealth, the Fed, like other economists, expects those pressures to eventually take a toll. But it does not think this is the precursor to even slower growth or recession, but rather a temporary adjustment period while the excess of unsold new homes is worked down and the pool of potential homeowners shrinks to match the tightened terms of credit. Thus, it does not seem to think a string of rate cuts will be necessary as occurred in 2001 when the collapsing tech investment boom dragged the economy into recession.

Courtesy of JB Goodwin