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Fed Cuts Rates by Half Point To Counter Freeze-Up in Markets

By GREG IP, September 18, 2007, wsj.com

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The Federal Reserve cut short-term interest rates for the first time in four years to counter a freeze-up in financial markets that threatens to deepen the housing slump and drag the down the entire economy.

The Fed cut its key target for the federal funds rate, charged on overnight loans between banks, by half a percentage point, more than most economists had expected, to 4.75%.

The action, which sparked a huge rally in stocks, marked an aggressive attempt by the Fed and its Chairman, Ben Bernanke, to forestall a potentially serious economic slowdown that just a month ago seemed only a remote possibility.

"Economic growth was moderate during the first half of the year, but the tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally," the Fed said in a statement accompanying its decision, approved by all 10 voting policy makers. The cut is meant to "forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and to promote moderate growth over time."

Importantly, the statement gave no explicit hint about what

the Fed's next move would be. In fact, it said "that some inflation risks remain," suggesting that another cut is far from a foregone conclusion. Rather than state a clear focus on either the risk of higher inflation or of weaker growth, the Fed said, "Developments in financial markets ... have increased the uncertainty surrounding the economic outlook. The [Fed] will continue to assess the effects of these and other developments on economic prospects and will act as needed."

The Fed also cut the discount rate, charged on direct Fed loans to commercial banks, by the same amount, to 5.25%. The Fed's "discount window" is ordinarily used very little but since August the Fed has sought to encourage banks to use the discount window, with easier terms, to ease the shortage of cash in financial markets.

Tuesday's decision was the most important since Mr. Bernanke took office in February of last year. Until early August, the economy had been evolving largely as he had expected. The housing downturn that began last year had shown signs of bottoming out, paving the way for the economy to return to normal growth of a bit below 3% next year, and inflation to remain comfortably low at about 2%.

That forecast when off track when losses linked to mounting delinquencies of subprime mortgages suddenly erupted in numerous unexpected markets and regions in August. Skittish investors began charging higher rates to lend to all but the highest-quality borrowers. As a result, numerous prospective home buyers face sharply higher mortgage rates, or are unable to get a mortgage at all.

Investors are recoiling from buying commercial paper backed by mortgages, trade receivables and other assets. Banks have become nervous about lending to each other.

In recent weeks, market stress has begun to ease. Stock prices have rebounded. Money-market interest rates, while still unusually high relative to the federal funds-rate, have dropped a bit.

In spite of that improvement, the outlook is still

treacherous. Recent data show the economy had already slowed more than expected before the market turmoil hit: payroll employment shrank in August, and retail sales weakened a bit.

The biggest risk emanates from housing. With many potential buyers locked out of the market, sales are likely to fall further in the months ahead. Rising inventories of unsold new homes will likely push prices down further, pinching consumer wealth and making it harder to finance purchases by borrowing against home equity. A survey of homebuilders released yesterday found confidence at its lowest level matching a record low set in January, 1991.

In spite of that, the evidence of broader economic stress remains relatively sparse. "Most businesses that are in decent shape can get credit," said Martin Regalia, chief economist of the U.S. Chamber of Commerce. "Their business, if they're not in housing, is still relatively good." Businesses would like a rate cut, he said, but aren't clamoring for one the way Wall Street has.

Moreover, the risk of higher inflation remains. Recent data suggest the economy has less ability to grow rapidly without running into capacity constraints than in the 1990s. The dollar has declined steadily this year, and commodity prices have jumped, which could put upward pressure on inflation.

Tuesday's rate cut was the first since June, 2003, when the central bank, then under Chairman Alan Greenspan, cut the rate to 1%, at the time the 13th in a series of cuts beginning in early 2001 designed to counter a recession induced by collapsing stock prices and technology investment.

Those rate cuts are now being blamed by some for creating a housing bubble whose bursting is behind the economy's current troubles. The debate has grown fiercer with the release Monday of Mr. Greenspan's memoir and numerous interviews he has given to promote it.

Mr. Greenspan has defended those actions, while also issuing a gloomy forecast of the challenge Mr. Bernanke

faces. He has argued that the mounting inventories of newly built homes raises the risk of "far bigger price declines," while also warning inflation faces long-term upward pressures as the cost-reducing impetus from globalization wanes.

Text of Fed Statement

September 18, 2007 2:49 p.m.

Below is the text of the Federal Open Market Committee's statement from its meeting Sept. 18, 2007.

The Federal Open Market Committee decided today to lower its target for the federal funds rate 50 basis points to 4-3/4%.

Economic growth was moderate during the first half of the year, but the tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally. 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 and to promote moderate growth over time.

Readings on core inflation have improved modestly this year. However, the Committee judges that some inflation risks remain, and it will continue to monitor inflation developments carefully.

Developments in financial markets since the Committee's last regular meeting have increased the uncertainty surrounding the economic outlook. The Committee will continue to assess the effects of these and other developments on economic prospects and will act as needed to foster price stability and sustainable economic growth.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; Timothy F. Geithner, Vice Chairman; Charles L. Evans; Thomas M. Hoenig; Donald L. Kohn; Randall S. Kroszner; Frederic S. Mishkin; William Poole; Eric Rosengren; and Kevin M. Warsh.

In a related action, the Board of Governors unanimously approved a 50-basis-point decrease in the discount rate to 5-1/4%. In taking this action, the Board approved the requests submitted by the Boards of Directors of the Federal Reserve Banks of Boston, New York, Cleveland,

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