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Fed makes sizable cut

Half-point trim shows fears for economy, sends stocks soaring

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The Federal Reserve thrilled Wall Street but chilled some economists Tuesday by boldly slashing a key interest rate to jump-start investment and reduce the possibility of a recession.

The Fed cut the rate banks charge each other for overnight loans by a half-point, twice as much as many economists had expected, to 4.75%. It was the first cut in the federal funds rate since June 2003, and it was aimed at preventing a more severe housing downturn.

"The tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally," the policy-making Federal Open Market Committee said in a statement. "Today's action is intended to help forestall some of the adverse effects on the broader economy that might otherwise arise."

The Dow Jones industrial average responded by roaring up 335.97, or 2.5%, to close at 13,739.39, its biggest increase in nearly five years. The Standard & Poor's 500 index gained 43.13, or 2.9%, to 1519.78. The Nasdaq Composite Index finished up 70.00, or 2.7%, at 2651.66.

By cutting the rate, the Fed wants to make it more attractive for businesses and consumers to borrow, and therefore to spend and stimulate the economy. The impact may be slow in coming, however, said Greg McBride, senior financial analyst for Bankrate .com in New York City.

Traditionally, the prime rate used by banks as a benchmark for many loans is linked to the federal funds rate. Several big national banks immediately cut their prime rate.

Many credit cards rates, some auto loans and some mortgage loans are tied to the prime, but the impact for individuals in the short term could be muted. McBride said that for a person with a \$5,000 credit card balance, a half-point cut in the interest rate would translate to a savings of \$25 a year, or slightly more than \$2 a month. And because of the way many credit card agreements are written, the decrease may not come for up to three months, he said.

Mortgage rates already have fallen, partially in anticipation of the Fed's action, McBride said.

Homeowners with revolving home equity lines of credit will be helped most, because their loans "follow the prime rate," said Harold Bloch, president of Priority Mortgage Corp., a mortgage banker in Brookfield. That might spell

better news for remodeling companies than for real estate brokers and lenders, he said.

Inflationary impact

These benefits, however, must be balanced against the possible inflationary impact of lower rates, which shows up in the behavior of the dollar, said Bruce Bittles, chief economist for Milwaukee's Robert W. Baird & Co.

After the rate cut was announced, the greenback swooned, falling to a record low against the euro and losing ground to the British pound and Canadian dollar. Not only was the cut seen as an indication that the U.S. economy was weakening at a time when other nations were doing better, but with lower rates, overseas investors will earn less on dollar deposits.

The size of the half-point rate cut was "a complete fake-out," said Bittles. While Wall Street had been hoping the rate would be cut from 5.25% to 4.75%, many investors had expected only a cut to 5%.

The bolder move gave the Fed "credibility in terms that they are willing to do what ever is necessary to prevent the economy from slipping into recession," said Bittles. It was the first half-point change in the rate - either up or down - since 2002, when it was also slashed that much.

For more than a year, the Fed has left its key rate at 5.25%. It didn't move the rate at its last meeting, on Aug. 7, despite financial turbulence, credit problems and a deepening housing slump. Its decision in early August 2006 to stop boosting rates ended a string of 17 straight increases, the longest string of Fed increases on record.

"It really looks like they are indicating that the economy is doing a little bit worse than people thought," said Brian Jacobsen, professor of economics at Wisconsin Lutheran College in Wauwatosa. "It is pretty clear they are not that concerned about inflation."

With a cheaper dollar, U.S. imports become more expensive, potentially driving up not only their prices but those that can be charged by domestic producers as well.

However, the Fed, led by Chairman Ben S. Bernanke, apparently believed it was more important to help the credit and financial markets recover from the fall-out from the subprime mortgage problems today than it was to worry about possible inflation tomorrow.

"The Fed, in our view, is belatedly recognizing the risks inherent in the mortgage meltdown - which will get worse - rather than playing fast and loose with inflation; that's yesterday's enemy," Ian Shepherdson, chief U.S. economist for High Frequency Economics Ltd., Valhalla, N.Y., wrote in a note distributed to investors and journalists. "The risk of this ease (in rates) is trivial compared to the risks of not acting boldly to limit the damage done. If the economy turns out to be strong they can always reverse it."

'Rewarding bad behavior'

Tuesday's action does mean the Fed is less likely to cut rates when it next meets Oct. 30 and 31, said Bittles.

"Now that they have done so much here, they certainly can take a wait-and-see approach," he said.

But by helping the mortgage industry in an effort to get the larger economy going, the Fed is in danger of being seen as rewarding bad behavior, said James L. Kochan, a senior strategist for Wells Fargo Funds Management Group in Menomonee Falls. The large increase in mortgage defaults came about because of a weakening of underwriting standards by brokers eager to collect commissions and financiers who wanted to create securities that could be sold for fees.

The Fed "had to balance their concerns about rewarding bad behavior versus what they see happening to the economy," Kochan said. "Clearly they are more concerned about the potential for economic weakness than they are concerned about being criticized for rewarding bad behavior."

In any event, the Fed was acknowledging that the economy was in worse shape than many thought, Kochan said. While soft, the economic data released in recent days have not pointed to the widespread decrease in employment and output needed to place the country in a recession.

"This suggests that the anecdotal evidence they were given by business around the U.S. has been very disturbing," he said.

JSOnline.com For the statement issued by the Federal Reserve board explaining the rate cut, go to [JSOnline.com/links](#) Joanne Cleaver of the Journal Sentinel staff contributed to this story.

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