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THE FED EASES AGAIN IN THE WAKE OF MARKET TURBULENCE

Last Wednesday, the Fed again cut short-term interest rates. But this time, they only lowered their Fed funds target by $\frac{1}{4}$ of a percentage point (25 basis points), half the $\frac{1}{2}$ percentage point cut they installed in September. As a result of September and yesterday's cuts, their funds rate target now stands at 4.5%, a full 75 basis points below the 5.25% that prevailed for over a year. In addition to the cuts, the press release announcing the cut also contained a statement, in essence, stating that the downside risk to economic growth and the risk of higher inflation were, in their view, roughly in balance. This "balance of risks" statement had not appeared in the Fed press releases for a while. Furthermore, the press release also noted that the Fed stands ready, as the economy unfolds, to make any necessary adjustments to policy in pursuit of their objectives of maximum sustainable growth and price stability.

Why did the Fed cut rates again? Well, this cut, as with the September cuts, represented an effort to buttress economic growth, which, in the Fed's view, is now at risk of faltering in the wake of the housing slump and from the financial seizure that arose from the sub-prime mortgage market meltdown. Despite the fact that economic momentum is holding up quite well recently (with yesterday's advance report showing Q3 real GDP came at an annual rate of 3.9%) and



despite a declining housing market, the Fed has become increasingly worried about the state of the economy in the last two months. Their concerns about economic malaise taking hold have counterbalanced, at least to some degree, their ongoing worry about inflation rising. Moreover, with inflation still showing signs of moderating, they have increasingly focused their attention on the slower pace of the economy suggested by recent economic data. So, to a large degree, the rate cuts of recent months represent the Fed taking out “insurance” against the economy slowing too much, perhaps even falling into recession.

Those rate cuts represented an abrupt about-face for the Fed. Up until mid-August, the Fed maintained that inflation moving higher was their major policy risk, not the strength of the economy. Indeed, they continued to point to tight labor market conditions (as evidenced by a low unemployment) as possibly pushing wages and inflation higher. Also, in the previous quarter, the economy grew considerably above trend, with real GDP growing at an annual rate of 3.8% that quarter. Economic growth, if sustained near that above-trend rate in subsequent quarters, could pose the risk of further tightening labor market conditions (pushing the unemployment rate down) and creating the potential for wages and inflation to move higher to unacceptable rates. Hence, at their August meeting, they maintained their funds target at 5.25%, the same rate that was in place since June 2006.

Then the meltdown in the sub-prime mortgage market hit. With that meltdown, liquidity in key financial markets (for example, the asset-backed commercial paper market) dried up. Transactions of sub-prime related paper (including CDOs and SIVs) came to a screeching halt as market players became increasingly concerned about the risk sub-prime related investments posed to their balance sheets and capital positions. With few transactions, pricing of sub-prime investments became virtually impossible. Poor liquidity conditions on those markets led to still worse liquidity conditions. By the middle of August, the Fed became extremely concerned about the fierce tightening of liquidity conditions in financial markets. At that time they, and other central banks around the world, started to inject sizable amounts of liquidity into financial markets via open market transactions and direct loans in an attempt to calm markets and improve liquidity. Nonetheless, despite these

conditions, major financial markets (equity markets, high-yield corporate bond markets) continued to decline and be more volatile. Even after the Fed lowered the discount rate for loans from the Fed and made such loans available to a wider range of financial institutions, markets continued to correct and showed increased volatility. Finally, it was only after the Fed recognized the potential downside risks to the economy from this financial market turbulence and rate cuts on September 18th that markets started to rebound and become less volatile.

So, what will the Fed do the next time they meet in December? Some interpreted the “balance of risks” statement in the press release as meaning that Fed was finished cutting for now. However, that statement, together with Fed’s explicit (usually simply implicit) mention that future policy action is data dependent, probably means that the Fed signaled a reluctance to cut further, but will do so if the unfolding economic data suggests that policy adjustments are necessary. The bottom line then is that, as usual, much will depend on what the incoming data shows. If the Fed sees signs of further economic weakness, they may again cut rates to take out still more “insurance” against the economy faltering. However, they would probably not ease again if they see the economy holding up well and, with that, a greater risk of inflation moving higher (not an unlikely prospect given recent soaring energy prices and a very weak dollar). In fact, if these latter circumstances were to prevail into early 2008, the Fed may, at that time, start hiking rates again, perhaps reversing out (or more) the cuts they have put in place recently. Under those conditions, the Fed’s main concern would again be inflation getting out of control, not the economy faltering.

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