

Strategy Matters

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The Fed cuts by 75bp

The Federal Reserve has cut its Fed funds and discount rates by 75 basis points today. The key Fed funds rate falls from 4.25% to 3.5%.

This is the first 75bp move in US interest rates since 1994 (when they were raised by that amount), and the first cut on this scale in over two decades. When taken with the fact that an FOMC meeting was scheduled for next week, so that the decision to make an inter-meeting move only brought forward the cut by eight days, this smacks of panic.

The FOMC's statement does little to counter this view. It refers to "a weakening of the economic outlook and increasing downside risks to growth" and makes specific reference to the recession in the housing market and the softening labour market. But there has been no new evidence in the last few days on these factors. If they were the reason for the rate cut, then it would have happened sooner – or it could have waited until next week.

Clearly, the reason that interest rates have been cut today is the real danger that US equity prices might have plunged on their opening (having been closed for the Martin Luther King holiday yesterday when markets slumped in the rest of the world). This might then have triggered another bout of selling in Asia on Wednesday with markets finding it difficult to find a bottom in the short-term.

It is not obvious, though, that this move will have anything other than a short-term impact on markets. Investors will be asking themselves whether it is good news because it shows the Federal Reserve is prepared to act aggressively, or bad news because it indicates that the Federal Reserve is very worried about the

economy. The next bad economic release, poor statement from a financial institution or downgrading of a bond insurer might make them lean towards the view that the rate cut does little to change the outlook.

This is because there are real reasons to doubt the effectiveness of interest rate cuts in the current cycle. Lower interest rates work best when there is a group within the economy looking to increase its borrowing. In 2001/02, rates cuts were effective because households were prepared to respond by borrowing more to invest in housing. It is not so easy to identify a group of willing borrowers in the present environment. Furthermore, even if there were potential borrowers, it is not so obvious that financial institutions have any appetite for increased lending.

It will be interesting to see if the Federal Reserve takes further action at next week's meeting. At this point, that seems unlikely. Certainly, there is unlikely to be any justification in the economic data for an additional move so soon. But it is possible that another bout of equity market selling could trigger one.

It will also be interesting to see how other central banks react. The Bank of Canada cut its key interest rate from 4.25% to 4% about 45 minutes after the Fed's move, but that was after a scheduled meeting and was widely expected.

What the European Central Bank does next could be crucial. In public, it has been leaning towards an increase in interest rates to counter inflation pressures. If it should cut interest rates in the near term, this would represent a big change of direction and markets may believe

that a co-ordinated easing of monetary policy significantly lowers the recession risk.

On balance, today's move is to be welcomed – despite the risk that it is seen as a panic reaction to equity market falls. It will help, a little, to reduce the possibility of a recession, especially if it is the start of concerted action from central banks. Remember, though, interest rates work with a lag of up to a year and the risk is that it is too late, and that a recession is already inevitable.

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