Payden & Rygel

Payden & Rygel Economic**Research**

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Highlights

- The Fed cut the discount rate, the rate at which banks can borrow directly from the Fed, by 50 basis points to 5.75%.
- Policymakers downgraded their outlook for the economy, noting that the "downside risks to growth have increased appreciably."
- The Fed left the door open to further action and the futures market is pricing in a 72% probability of a cut in September.

Fed Cuts Discount Rate

Today, the Federal Reserve reduced the discount rate by 50 basis points to 5.75% noting that "the downside risks to growth have increased appreciably." The Fed also announced it was extending the term of financing from the discount window to 30 days rather than the usual overnight loan. These measures to increase liquidity come on the heels of the Fed's decision to inject roughly $80 billion into the interbank market through open market operations over the past week. For the time being, the central bank has left the target for its benchmark policy rate, the federal funds rate, unchanged at 5.25%.

What is the Discount Rate?

The discount rate is the rate at which banks can borrow directly from the Fed so long as they have collateral to post for the loan. This differs from the fed funds rate which is the rate at which banks lend reserves to one another on an overnight basis. The Fed can set the discount rate at the level it deems appropriate, whereas the federal funds rate is a market determined rate, which the Fed can influence through open market operations.

The Fed said it will continue to accept a broad range collateral, including home mortgages and related assets. Banks, not the Fed, decide when to borrow from the discount window and they are free to lend the money out to other banks once they do so. Since 2003, the discount rate stood 1 percentage point above the federal funds rate, but today's action reduces that spread to 50 basis points. The reason the discount rate is above the federal funds rate is to encourage banks to obtain regular funding from market sources rather than from the discount window.

The Fed releases data on the funds borrowed from the discount window once a week on Thursday. According to the figures released yesterday, the average daily borrowing for the week ending August 15 was $11 million which was up from $1 million in the prior week. Although the Fed does not reveal who borrowed the funds, we do know that the amounts are small by historic standards. Over the last four years, weekly discount window borrowing has averaged just under $50 million. Thus, it seems unlikely that last week's borrowing from the discount window had anything to do with the current liquidity squeeze in the financial markets.

Fed's Next Move

The Fed left the door open to further action by saying that "the Committee is monitoring the situation and is prepared to act as needed to mitigate the adverse effects on the economy arising from the disruptions in financial markets." Should cuts in the discount rate and recent open market operations fail to stabilize the markets, the Fed would likely step in with a cut in its benchmark policy rate. At a minimum, today's action and accompanying statement would seem to imply that the Fed has adopted a neutral bias, meaning it sees the risks to economic growth and inflation as balanced. The stock market rallied on the news of the discount rate cut, but it seems unlikely that the recent bout of volatility is over. The fed funds futures are currently pricing a 72% probability of at least a 25 basis point cut in the fed funds rate by the September 18 Fed policy meeting.