EconomicView

Payden&Rygel

Payden & Rygel Economic**Research**

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Highlights

- The Federal Reserve cut the federal funds rate 50 basis points to 4.75%--its first rate reduction in four years.
- Although the Fed downgraded its growth assessment, it stopped short of adopting an outright easing bias.
- According to the Taylor rule, the federal funds rate is still restrictive and thus further cuts will probably prove necessary.

Helicopter Ben Swoops In?

The Federal Open Market Committee (FOMC) voted unanimously to slash the federal funds rate by 50 basis points to 4.75% when it met today. The move, which was larger than most investors had anticipated, marked the first reduction in the Fed's benchmark interest rate since June 2003. The Fed said the cut was necessary to "forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets."

Although the Fed downgraded its growth assessment, it stopped short of adopting an outright easing bias by saying that "some inflation risks remain." The Fed is probably hoping that today's aggressive move will mitigate the need for another rate cut at its next policy meeting at the end of October. The Fed also probably wants to buy itself some time to assess the impact of the credit crunch on the real economy so it can more accurately gauge whether further rate cuts are necessary.

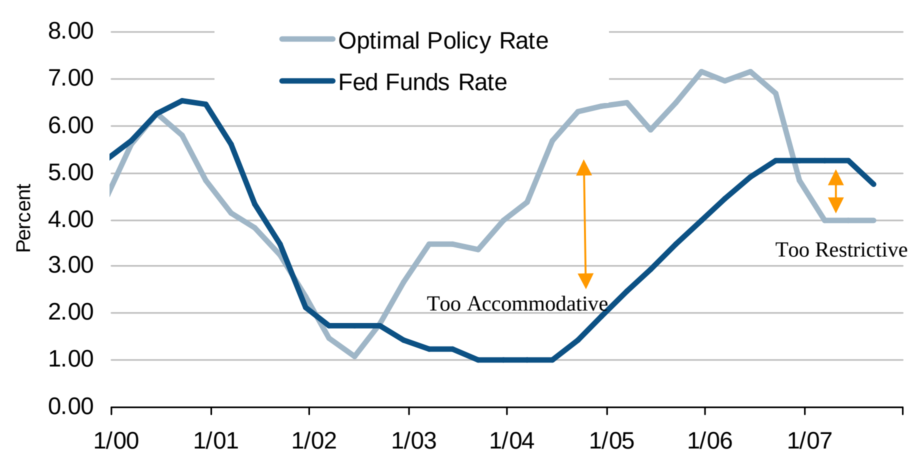
However, unless the economic data begin to come in stronger in the weeks ahead, there is a risk that the markets may interpret the larger-than-expected cut as a sign that the Fed is more nervous about the economic outlook than previously thought. That said, it is worth pointing out that 50 basis point moves were the rule, rather than the exception, in the last easing cycle, with nine of the 13 rate cuts done in 50 basis point increments.

According to the Taylor rule, a formula developed by Stanford economist John Taylor to estimate the optimal policy rate, the federal funds rate is still restrictive at 4.75%, given the US economy is growing below its long-term potential and inflation is within the Fed's 1-2% target zone. This suggests further rate cuts may be necessary to get the economy back on track.

In any case, the Fed also approved a 50 basis point reduction in the discount rate to 5.25% at the request of seven of its 12 regional banks. The discount rate is the rate charged on direct Fed loans to commercial banks. Borrowing from the discount window spiked to a daily average of $2.9 billion last week, up from a daily average of just $50 million for most of the last four years.

The Fed's decision sparked a rally in the stock market and led to a dramatic steepening in the Treasury yield curve as short-term bonds rallied while long-term bonds held their ground. The Standard & Poor's 500 stock index jumped 0.6% to 1,520 and the yield on two-year Treasuries tumbled 12 basis points to 3.96%.

Taylor Rule Suggests Policy Remains Restrictive



Source: The Federal Reserve, Payden & Rygel