



Daily Note: 22 January 2008

Panic? Or the right move?

WE SUGGEST: Fed move smacks of panic, may not save markets

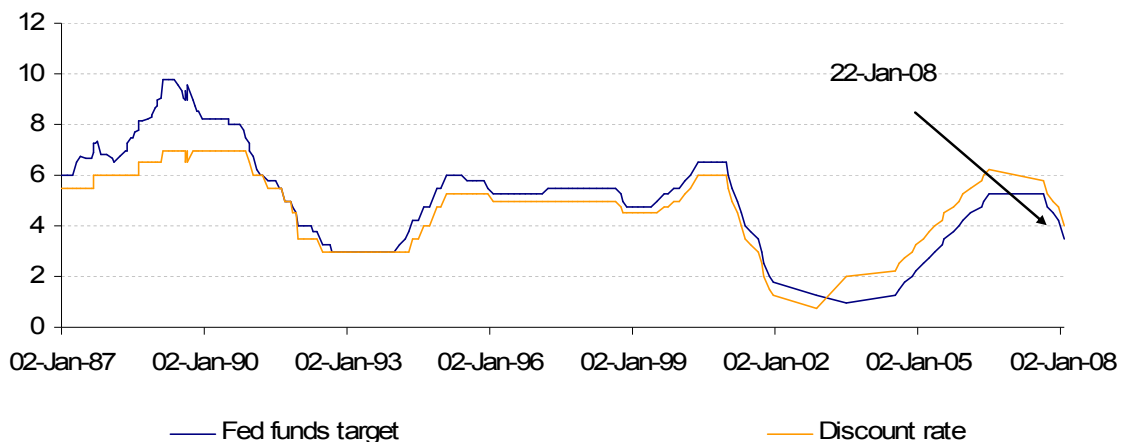
SUMMARY: The Fed has just implemented the biggest interest rate cut in 25 years. It highlights how much the Bernanke Fed differs from the Greenspan Fed in its modus operandi. But it might have been better to wait until next week's regular FOMC meeting. If the move is perceived as the Fed in panic, it could do more short-term harm than good.

The *Hitchhiker's Guide to the Galaxy* had a front page on which the words Don't Panic were written in large friendly letters. The Fed's action today in cutting interest rates (Fed Funds target and discount) by 75bps raises the question of whether central bankers should not have the same words prominently displayed in their board rooms.

Was the Fed's action right? Or did the FOMC panic? Ultimately, this question will only be answered a year or two down the line. However, a discussion of some of the pros and cons may still be helpful.

In favour of the cut was the desire to avoid a crash in US equity markets following the tumbles elsewhere in the world. Whether this was successful is unclear: European markets jumped for joy for about 15 minutes and then promptly began to fall again. US markets opened down and initially fell further. (That may well have changed by the time this reaches clients.) The move also shows that the Fed is taking current economic weakness seriously. Here, the move fits in with the MO outlined last year by Governor Frederic Mishkin. This is one, namely of larger, pre-emptive and (most likely) fewer moves, followed by gauging their effect, instead of the Greenspan Fed's 'measured approach' with an almost pre-set change up or down at every meeting. So far, so good.

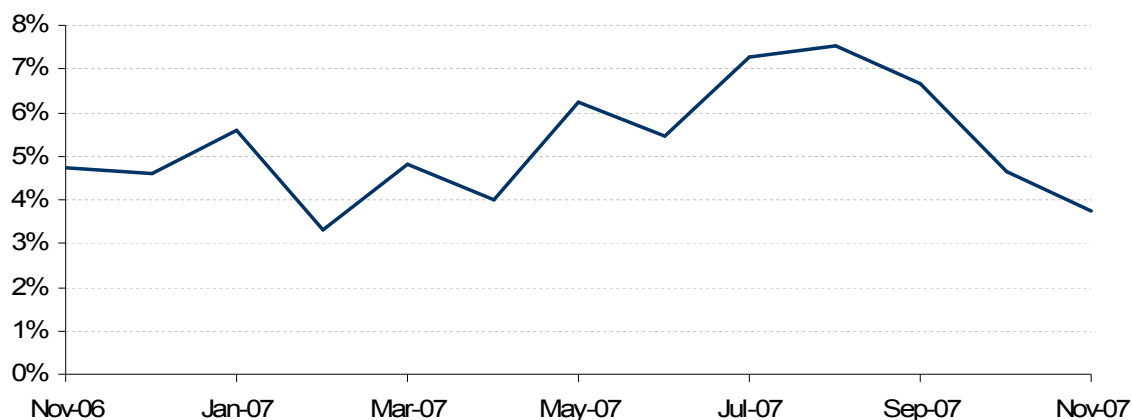
Fed funds target and discount rate, %



However, there are also arguments implying a panic reaction. An inter-meeting cut, let alone the largest change in interest rates in more than three years and the biggest cut in 25 years, coming less than a week before a regular FOMC meeting and obviously triggered by a stock market fall regardless of the statement's talk about "increasing downside risks to growth" – all this certainly smacks of panic.

Much more importantly, will it actually do the trick and save the US economy from a prolonged downturn? Here, the evidence is much less clear. The key imponderable is what will sway households. Will households take their proposed tax rebates and spend them? That would be helpful. Or will they pay down debt or in any other way save them? In that case, little or no effect. Equally, will households take advantage of lower interest rates and start borrowing again? (Maybe a prior question should be, 'Will banks, in desperate need to rebuild their margin, actually pass on the entire interest rate cut to borrowers?') Or will they remain traumatised by the collapsing housing market and the erosion of their balance sheets? As I pointed out in my *Daily Note* this morning, important as interest rates are, they are not the key determinant of credit growth. That role is reserved for credit demand. The development of consumer credit growth in the last six months – a period when interest rates were continually cut – rather argues against any silver bullet-effect from lower interest rates.

US consumer credit, three-month annualised change, %



The Fed was not wrong to cut interest rates. The US economy is facing a sharp slowdown, probably a recession (is it already in recession? Possibly). But the danger of a huge intra-meeting move is that if markets perceive it as a sign of panic, and that the Fed believes the US economy to be in worse straits than it actually is, the move may do more short-term harm than good. Certainly, for bonds, the yield on the 30-year bond is up by 7bps after the cut – a clear sign that markets were less than happy.

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