

# Fed cuts discount rate

**The central bank, citing tough market conditions, cuts the symbolic rate half a percentage point.**

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NEW YORK (CNNMoney.com) -- The Federal Reserve, reacting to concerns about the subprime lending crisis that's rocked financial markets in recent weeks, Friday cut its so-called discount rate half a percentage point, to 5.75 percent.

The discount rate, the rate the Federal Reserve charges qualified lenders, mainly banks, for temporary loans, is largely symbolic. The central bank did not change its more closely watched federal funds rate, which affects credit cards, home equity lines of credit, car loans and other consumer loan rates. That rate remains at 5.25 percent. But one economist suggested that the Fed's discount rate cut has more than token significance. David Wyss, chief economist with Standard & Poor's, said the cut could help convince banks it was okay to keep lending to companies or consumers that actually are creditworthy.

"This is an important move. It's not just a symbolic action. The Fed is telling banks that the discount window is open. Take what you need," Wyss said.

Wall Street cheered the cut. The [Dow Jones industrial average surged 300 points](#) at the open and finished the day up about 230 points, or 1.8 percent.

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The Nasdaq composite closed up 2.2 percent while the S&P 500 gained nearly 2.5 percent. Stock futures were trading lower before the open after another wild day Thursday but surged following the Fed's announcement.

"The Fed is trying to maintain some stability in the market. They can't control the financial markets, which are being driven by emotion right now. But this move was a good option that will bring some relief to the market," said Oscar Gonzalez, an economist with John Hancock Financial Services.

The Fed last met Aug. 7 and decided to leave both the federal funds and discount rates unchanged. One economist said if the Fed changed course on Friday and cut the federal funds rate, that actually may have spooked Wall Street.

"The Fed wanted to ensure liquidity to the markets but they don't want to send a message that they are panicking. It was only a week and a half ago that they said the outlook for the economy was for moderate growth," said Kenneth Kim, an economist with Stone & McCarthy Research Associates, an economic and bond research firm based in Princeton. "To suddenly turn around and cut the fed funds rate would have made them look foolish."

Nonetheless, stocks have plunged further since the Fed's last meeting due to fears that some financial institutions and hedge funds were in serious trouble because of the mortgage meltdown.

Mortgage lender [Countrywide Financial](#) ([Charts](#), [Fortune 500](#)), for example, announced Thursday that it needed to tap an \$11.5 billion line of credit because of liquidity problems. That came a day after an analyst at Merrill Lynch suggested that Countrywide might need to declare bankruptcy.

"The credit crunch is both real and driven by fear but primarily fear. Nobody knows who is exposed to these subprime loans. Uncertainty is the problem," said Zach Pandl, an economist with Lehman Brothers.

With this in mind, several market observers felt that Fed chairman Ben Bernanke needed to acknowledge the risk that the subprime mortgage crisis could hurt the broader economy.

### [Read the Fed's statement](#)

In a statement, the Fed said it took the move to "promote the restoration of orderly conditions in financial markets."

In another statement, the central bank indicated that "financial market conditions have deteriorated, and tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward."

The Fed added that "although recent data suggest that the economy has continued to expand at a moderate pace, the Federal Open Market Committee judges that the downside risks to growth have increased appreciably" and that the Fed was prepared to take more action if necessary.

The Fed, as well as other central banks around the world, had responded to the market turmoil by pumping more cash in to the banking system over the past week.

But many market observers felt the Fed would also need to lower rates to restore investor confidence, citing the example of former Fed chair Alan Greenspan.

Under Greenspan's stewardship, the Fed cut the federal funds rate at an emergency meeting in 1998 as a result of the Asian financial crisis and also lowered rates at two unplanned meetings in early 2001 due to an economic slump and again that year after the Sept. 11 terrorist attacks.

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While Greenspan was praised at the time for these rate cuts, some have since criticized him for helping to create a low interest-rate environment that fostered a culture of "easy money" where consumers who had poor credit histories were able to take out the types of exotic mortgage loans that are now defaulting.

One money manager said the Fed should not go ahead and cut rates to bail out consumers who took out loans they never should have - and the banks that made the loans and hedge funds that invested in them.

"The Fed is putting its fingers in the cracks of the dike," said Matthew Smith, president and chief investment officer of Smith Affiliated Capital, an investment advisory firm based in New York. "There is nothing the Fed can do. They are just prolonging the inevitable. The Fed has to get the speculators out of the market."

Wyss did not buy this argument though.

"If you enjoy cutting off your nose every time you have a cold, then not cutting rates would be a good strategy. There are a lot of people who have this puritanical view that everyone should be punished," he quipped. "But the Fed's job is to worry about the whole economy. It has to make sure that the rest of the economy doesn't suffer. What the Fed did today has nothing to do with bailing out banks. If (banks) were going to lose money on a bad mortgage (they) will still lose money."

### Mortgage Meltdown 2007

With that in mind, the central bank's next scheduled meeting is Sept. 18. According to federal funds futures listed on the Chicago Board of Trade, investors are betting that it is all but certain the Fed will cut the federal funds rate by at least a quarter of a percentage point.

Lehman's Pandl expects a quarter-point rate cut in September and another one after the Fed's two-day meeting in late October. That would bring the fed funds rate down to 4.75 percent.

But Pandl does not think the Fed will need to act before September since Friday's move may be enough to reassure Wall Street that it has things under control.

"This is a good sign that the Fed is addressing the problems in the market. This buys them a little time. It's the appropriate action," he said.

Smith, however, thinks a rate cut would be a mistake since it's far from clear that inflation won't later become a problem.

"The Fed is in a bind. Weakening the dollar could boost inflation," Smith said. "The problem is if the Fed cuts rates it could put the dollar into a bigger tailspin. Oil prices would go up. Gold prices would go up."

And even more worrisome, Smith said, is that U.S. Treasury bonds could become less attractive to foreign central banks if the dollar falls further. If global investors stop buying Treasuries, or dump bonds they already own, that could drive long-term rates higher since bond yields rise when bond prices fall. ■