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First Trust

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Economic Commentary

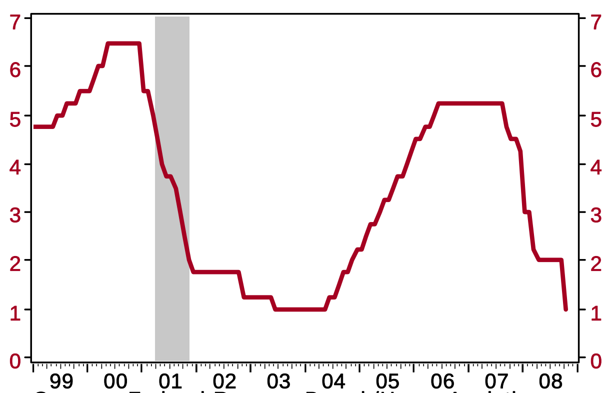
Fed Cuts Rates to 1%

In its renewed fight against a drop in the velocity of money, also known as the credit crunch, the Federal Reserve cut both the federal funds rate and discount rate by 50 basis points today. The funds rate is now 1.00%, matching the 2003-04 low, which was the lowest since 1958. The discount rate is now 1.25%. The votes on the changes in interest rates were unanimous.

The statement that accompanied these actions was bearish on the economy and dismissive of inflation risk. In addition, the Fed's formal balance of risk (sometimes referred to as the "bias") is now clearly toward fighting slow growth rather than inflation.

Target Federal Funds Rate

%



Source: Federal Reserve Board /Haver Analytics

Regarding economic growth (or the lack thereof) today's Fed's statement was more pointed than the one that accompanied the "emergency" rate cut of 50 basis points on October 8. The Fed noted a decline in consumer spending, weakness in both industrial production and business spending on equipment, and "slowing economic activity in many countries," which will impede US exports.

Regarding inflation, the Fed essentially said declines in energy and other commodity prices, plus weaker economic growth, mean inflation is not a problem. Notable by their absence were the references in prior Fed statements to inflation having been high or the inflation outlook being "highly uncertain."

We believe the slowdown in monetary velocity is only temporary and that inflation is a much more serious problem than the Fed currently thinks it is. If the Fed does not take the rate cuts back quickly once real GDP re-accelerates next year, inflation will return with a vengeance.

Text of the Federal Reserve's Statement:

The Federal Open Market Committee decided today to lower its target for the federal funds rate 50 basis points to 1 percent.

The pace of economic activity appears to have slowed markedly, owing importantly to a decline in consumer expenditures. Business equipment spending and industrial production have weakened in recent months, and slowing economic activity in many foreign economies is damping the prospects for U.S. exports. Moreover, the intensification of financial market turmoil is likely to exert additional restraint on spending, partly by further reducing the ability of households and businesses to obtain credit.

In light of the declines in the prices of energy and other commodities and the weaker prospects for economic activity, the Committee expects inflation to moderate in coming quarters to levels consistent with price stability.

Recent policy actions, including today's rate reduction, coordinated interest rate cuts by central banks, extraordinary liquidity measures, and official steps to strengthen financial systems, should help over time to improve credit conditions and promote a return to moderate economic growth. Nevertheless, downside risks to growth remain. The Committee will monitor economic and financial developments carefully and will act as needed to promote sustainable economic growth and price stability.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; Timothy F. Geithner, Vice Chairman; Elizabeth A. Duke; Richard W. Fisher; Donald L. Kohn; Randall S. Kroszner; Sandra Pianalto; Charles I. Plosser; Gary H. Stern; and Kevin M. Warsh.

In a related action, the Board of Governors unanimously approved a 50-basis-point decrease in the discount rate to 1-1/4 percent. In taking this action, the Board approved the requests submitted by the Boards of Directors of the Federal Reserve Banks of Boston, New York, Cleveland, and San Francisco.

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