



## Liquidity Boost Rallies Wall Street

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August 17, 2007--America's Federal Reserve found a way to inject much-needed liquidity into the credit-strapped financial system without sacrificing the dollar or the inflation fight. The Fed cut its discount rate Friday, which rallied U.S. equities and avoided the more drastic move of slashing the federal funds target rate.

The Federal Reserve Board announced early Friday that it was cutting its discount rate by 50 basis points, to 5.75%, from 6.25%. Banks use the so-called discount window to borrow money directly from the Fed, rather than from each other, which is the more common way that they obtain short-term financing. The Fed also lengthened the period of borrowing at the discount window to a 30-day term, renewable by the borrower, from the previous overnight limit.

"The move is intended to free up liquidity support for the commercial paper market," said Sam Stovall, chief investment strategist at Standard & Poor's. Companies issue commercial paper in return for short-term financing.

In recent weeks, commercial paper investors have backed off from issuers with even a whiff of mortgage contagion. The lack of buyers leaves companies that often use paper issues, like Countrywide Financial, unable to raise short-term funding. (See: ["Countrywide Starving For Cash"](#)) Shares of Countrywide jumped 13.1%, or \$2.48, to \$21.43, on Friday.

The Fed's unusual step will inject liquidity into the U.S. banking system by making it cheaper to use out-of-favor securities to borrow money. The Federal Reserve accepts home mortgages and related assets as collateral through the discount window. Lenders have become increasingly reluctant in recent months to accept mortgage-backed securities as collateral in private trades because of declining values.

"It's a smart move," said Alan B. Lancz, director of investment research firm LanczGlobal.com, since the discount rate cut boosts liquidity without the more drastic step of reducing the target on federal funds rate, which would have cut interest rates throughout the economy. A fed funds rate cut would provide liquidity but also encourage inflation and weaken the dollar. (See: ["Bernanke Won't Ride To The Rescue"](#))

The discount rate is set directly by the Federal Reserve Board, while the federal funds target is established by the Federal Open Market Committee, which includes the 12 presidents of the regional Federal Reserve Banks, although only five can vote at any time. The FOMC issued a statement of its own on Friday, saying "the downside risks to growth have increased appreciably." The panel said it is prepared to "act as needed to mitigate the adverse effects on the economy arising from the disruptions in financial markets."

Stovall said the Fed's move sent a message to investors that the Fed will do whatever it can to alleviate the lending freeze. The Dow Jones industrial closed up 1.8%, or 233.30, at 13,079.08.

The Fed's move lifted the financial and mortgage sectors, which were feeling the brunt of credit strains. Lehman Brothers closed up 6.1%, or \$3.36, at \$58.11, and Merrill Lynch added 6.9%, or

\$4.91, to \$76.04. Thornburg Mortgage jumped 21.5%, or \$2.66, to \$15.04 and Anworth Mortgage Asset climbed 19.7%, or 80 cents, to \$4.86.