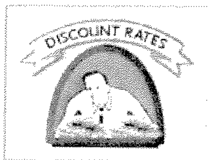
The Federal Reserve Lowers Interest Rates by 0.25%... What Does This Mean For YOU?

In order to answer this question, it is helpful to understand the **four major interest rates** that are affected by the Fed:

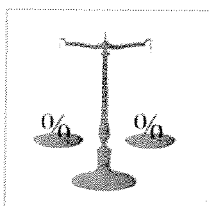


Discount Rate (currently 5%) - the interest rate that banks pay when they borrow money directly from the Fed. The rate has been largely symbolic in the past because hardly any banks take the Fed up on their offer these days!

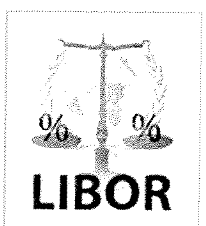
You see, banks prefer to get short term financing by:

- Issuing "commercial paper" – these are short term IOUs of typically one to ninety days that are sold on the open market to Wall Street investors. Interest rates on these short term loans are often better than the discount rate offered by the Fed
- Borrowing money from other financial institutions using the Fed Funds Rate as illustrated below. In most cases, this rate is also better than the discount rate offered by the Fed

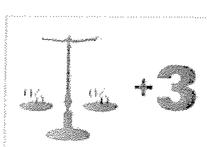
Nonetheless, many banks in today's "credit crunch" environment have actually taken advantage of this opportunity to borrow from the Fed in recent weeks.



Fed Funds Rate (currently 4.5%) - the interest rate that banks pay when they borrow money from each other here in the US. This rate is also determined by the Fed because banks in the US are part of the Federal Reserve System. You see, the Fed's main role is to maintain "monetary stability" by keeping a close eye on the flow of money throughout the economy. One way they do this is by regulating the interest rates that banks charge each other for short term funds.



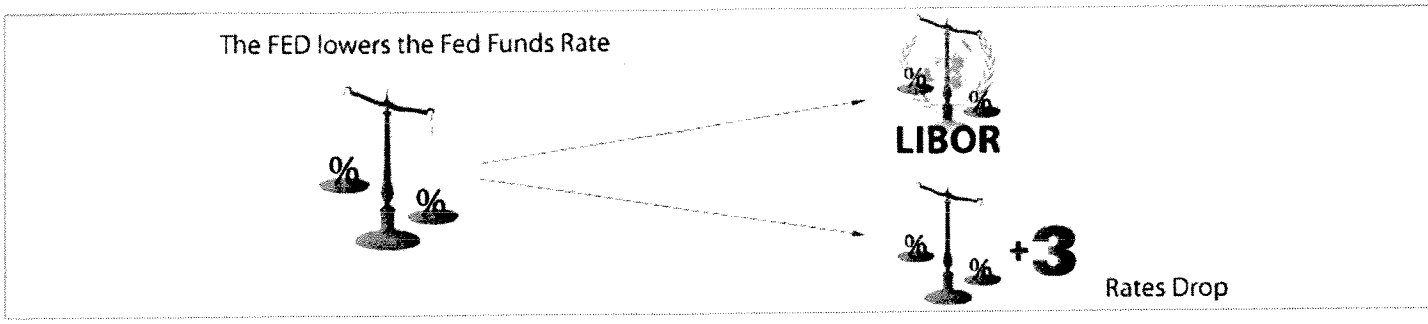
LIBOR Rate (One Month LIBOR is currently 4.86%) – the London Interbank Offered Rate (LIBOR) is the interest rate that banks pay when they borrow money from other banks anywhere in the world (primarily in the international wholesale money market based in London). There are various types of LIBOR rates including the 1 week LIBOR, 1 month LIBOR, 6 month LIBOR, and 1 year LIBOR; these are the rates banks would pay if they want to borrow funds for 1 week, 1 month, 6 months, etc. Although the LIBOR rates are determined by the financial markets at any given time, they are very closely related to the Fed in that LIBOR most often changes when the market anticipates that the Fed will change their Fed Funds Rate. LIBOR is the base rate that is used on most adjustable rate mortgages (ARMs) in the US and large corporate / commercial loans. The reason LIBOR is used most often for US adjustable rate mortgages is because LIBOR is really the most accurate measure of a bank's cost of borrowing funds since most banks do business internationally these days.



Prime Rate (currently 7.5%) – the Fed Funds Rate + 3; this is the base rate that is used for most consumer loans such as credit cards and home equity lines of credit, as well as most small business loans. Like the LIBOR, the Prime Rate is also tied to the Fed Funds Rate.

In response to the economic slowdown that has occurred and due to the current credit crisis, the Fed lowered the discount rate and Fed Funds rate by 0.5% on September 18, 2007 and again by another 0.25% on October 31, 2007. Does this mean that more rate cuts are on the way or should we expect that the Fed will sit tight now that they have taken some action?

This largely depends on whether inflation remains under control.



You see, as the Fed lowers the Fed Funds Rate, the business and consumer-based interest rates of LIBOR and Prime will also go down as illustrated above. The Fed would be reluctant to continue lowering rates if they feel that businesses and consumers would start borrowing and spending so much money that inflation will go up significantly.

Remember, the Fed's main goal is to "maintain monetary stability" by keeping a close eye on the flow of funds in the US economy. It would be reckless of them to artificially encourage too much borrowing and spending as this would only artificially drive up asset prices and cause money to lose its purchasing power. This phenomenon is known as "inflation." The good news, however, is that inflation seems to be under control based on some of the latest economic reports.

How does the Fed affect mortgage rates?

Well, if you have a home equity line of credit based on Prime or short term ARMs based on LIBOR, you should see an immediate reduction in your interest rate in the coming weeks. However, if you are considering a fixed rate loan or longer term ARM with a fixed period of 3, 5, 7 or 10 years, rates on those types of loans are not directly related to the Fed. Instead, these rates are closely tied to the Mortgage Backed Securities that trade on the bond market. For more on how this process works, please reference the article entitled, Saga of the US Mortgage Industry.