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The Federal Reserve is charged by Congress to accomplish several goals within the banking system. Its two most visible goals are to promote price stability in the United States and encourage job creation at the same time. These somewhat contradictory goals make it necessary for the Fed to intervene regularly in the credit markets.

Balancing Act

When the economy is sluggish, the Fed cuts interest rates to stimulate spending. Nearly 70 percent of the U.S. economy is based on consumer spending, so the reality is that Americans have to keep spending, or the U.S. economy and international economies enter a recession.

Conversely, when the economy is expanding robustly and jobs are being created, the Fed will raise interest rates to "remove the punch bowl from the party." Eventually, rates get high enough to discourage spending and encourage saving. Consumer spending declines, the economy trends toward recession, and the threat of inflation fades away.

This ebb and flow of short-term interest rates orchestrated by the Fed is of keen interest to real estate owners and other business decision makers. Job growth is a key determinant of a healthy housing market and an indicator of commercial real estate absorption rates. When the Fed raises interest rates, employment growth slows, job creation follows suit, and absorption of commercial real estate falls. When the Fed cuts rates, employment generally rises.

While the consequences of Fed rate changes are well known, there is often a 12- to 18-month lag between the time the Fed initiates a change in interest rate policy and when the economy responds. Consequently, the Fed cuts that began in September 2007 will not have much effect on the U.S. economy until summer 2009.

Hikes and Cuts Revisited

A review of past Fed interest rate changes is helpful to understand the scope of the current rate-cutting regime. How much does the Fed usually reduce interest rates in a rate-cutting

Table 1. Federal Reserve Rate Cuts Since 1990

	Time From First Cut to Last Cut	Rate Moves	Change (Percent)	50 Basis Point Moves	75 Basis Point Moves	Rate Range
1990–92	26 months	19 cuts	5.25	3	0	8.25–3.00
1995–98	45 months	5 cuts	1.25	0	0	6.00–4.75
2001–03	30 months	13 cuts	5.50	9	0	6.50–1.00
2007–Present	6 months	7 cuts	3.25	2	2	5.25–2.00

Sources: Real Estate Center at Texas A&M University and The Federal Reserve Bank of St. Louis

Table 2. Federal Reserve Rate Hikes Since 1990

	Time From First Hike to Last Hike	Rate Moves	Change (Percent)	50 Basis Point Moves	75 Basis Point Moves	Rate Range
1999–2000	11 months	7 hikes	1.75	1	0	4.75–6.50
1994–95	12 months	7 hikes	3.00	3	1	3.00–6.00
2004–06	24 months	17 hikes	4.25	0	0	1.00–5.25

Sources: Real Estate Center at Texas A&M University and The Federal Reserve Bank of St. Louis regime? How fast does it cut rates? How long do these periods last? How do the rate cuts affect the job market and the stock market?

Since 1990, the Fed has engineered four rate-cutting episodes (Table 1) and three rate-hiking events (Table 2).

These two tables offer interesting items for consideration. First, the duration of a rate-hike regime is much shorter than a rate-cutting effort. The average length of time from the first rate hike to the last rate hike is about 16 months. Rate-cutting efforts last a lot longer, with average time between the first and last rate cut about 34 months.

Increasing interest rates is not a pleasant undertaking for the Fed, because the economy slows and people lose their jobs. When it decides to move rates up, the increases happen quickly.

Rate-cutting events take longer because the Fed wants to lower rates enough to keep the economy from tanking but does not want to overdo the cuts and cause rampant inflation. Some economists feel that the U.S. housing bubble was caused by the Fed dropping interest rates too low (to 1 percent) and leaving them there for too long.

If the Fed replicated the 1990–92 and the 2001–03 rate cuts (5.25 percent and 5.5 percent) in 2008, the fed funds rate would be reduced to zero. Do not expect the Fed to cut interest rates further in 2008, because inflation is increasing well above the Fed's comfort zone.

Table 3. Fed Moves During Election Years and Immediately After

	1984–85	1988–89	1992–93	1996–97	2000–01	2004–05
January		Cut		Cut		
February		Cut			**Hike**	
March	**Hike**	**Hike**			**Hike**	
April			Cut			
May		**2 Hikes**			**Hike 50 bps**	
June		**Hike**	Cut 50 bps			**Hike**
July	**2 Hikes**	**2 Hikes**				
August		**Hike**				**Hike**
September	2 Cuts		Cut			**Hike**
October	2 Cuts					
November	2 Cuts	**Hike**				**Hike**
December	3 Cuts	**2 Hikes**			Cut 50 bps	**Hike**
January	**Hike**	**Hike**			Cut 50 bps	
February	**Hike**	**3 Hikes**			Cut 50 bps	**Hike**
March	**Hike**			**Hike**	Cut 50 bps	**Hike**

* bps = basis points; 50 basis points = .5 percent

Sources: Real Estate Center at Texas A&M University and The Federal Reserve Bank of St. Louis

Election-Year Action

A popular myth in the world of Fed watching is that Fed officials do not like to make major moves in a presidential election year. The idea is that the Fed is supposed to be independent of the federal government and does not want to appear to be influencing election results. History tells a different story.

The Fed can be extremely active throughout election years and in the first four months after an election (Table 3). This is reassuring because it means it will not make massive changes in the first half of the year and then exit the global stage until after the election.

What can we learn from the past? A famous business tycoon said, "If history repeated itself, then librarians would be rich."

Indeed, history can never repeat itself because circumstances are always changing. But history can provide guidelines on what to expect in the future. It offers a context within which to gauge how significant current problems are compared with previous cycles in the economy.

The Fed is aggressively cutting interest rates now because of the crisis in the banking system brought on by the subprime market meltdown. By cutting rates, the Fed is helping banks shore up their balance sheets, which have been devastated by poor mortgage investments. Wall Street brokerage firms are now a part of the banking system and are likely to be much more heavily regulated by the government in the future.

If the Fed sees the U.S. economy slumping toward recession as it did in 1990 and 2001, it could cut interest rates by as much as 500 basis points. Because the fed funds rate was only 5.25 percent when the rate-cutting regime began, the rate could be close to zero when officials finish.

Fed officials have said the rate cuts and other actions taken to help the banks through the current calamity should be targeted and temporary. This means that the minute Fed officials feel the banking system has been salvaged, they will begin increasing interest rates. They do not want the world to get the idea that the Fed no longer cares about inflation and is willing to make cheap money available indefinitely, which is what happened in 2003 and 2004. Cheap interest rates encourage speculative behavior that leads to investment bubbles. They do not want to start that process over again.

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THE TAKEAWAY

The Federal Reserve raises and lowers interest rates to banks as a means of staving off recession and inflation. In the wake of the subprime mortgage crisis, rate cuts are being used to help banks shore up their balance sheets. Once Fed officials feel the banking system has been salvaged, expect rates to turn upward.

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