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Fed Trims Rates As Growth Slows

U.S. Cuts Target for Lending To 5.5% in 'Forceful Response'

By Mitchell Martin
International Herald Tribune

NEW YORK — The U.S. central bank cut short-term interest rates Wednesday, saying that eroding confidence among consumers and businesses had prompted a "rapid and forceful response."

The Federal Reserve Board said that it was cutting its target on federal funds, the overnight interbank loan rate that forms a floor for the U.S. credit markets, to 5.5 percent from the 6 percent level set in January.

The central bank's Federal Open Market Committee said that it remained more concerned about economic weakness than the risk that its rate cuts would kindle inflationary pressures. It also cut its emergency discount rate to 5 percent from 5.5 percent.

"This is the shot in the arm that the economy needs, and I don't think it is the last one," said Alan Skrainka, chief market strategist of Edward D. Jones & Co., a brokerage house based in St. Louis, Missouri.

Stock prices were mixed after the news, while bond prices rose. (Page 12)

Takanobu Igarashi, chief economist at Sanwa Bank New York, told clients Wednesday that the Fed had "no time to lose" in trying to reinvigorate the economy. "If demand cools further, there could be an abrupt, all-encompassing correction of the various imbalances in the U.S. economy," he wrote.

Mr. Skrainka said that the economy had weakened precipitously in November and December, the result of previous interest-rate increases, a loss of \$5 trillion in the value of U.S. stocks from their March peak and a tripling of energy prices.

Underlining the economic weakness was the government's report Wednesday that fourth-quarter growth in gross domestic product was a lower-than-expected 1.4 percent and data on Tuesday that showed consumer confidence at its lowest level in four years. Testifying to the Senate Budget Committee last week, Alan Greenspan, the Federal Reserve Board chairman, said that growth had slowed further in January to "very close to zero."

Separately, the Chicago branch of the National Association of Purchasing Management said that its monthly index of manufacturing in the Midwest fell to 40.2 in January, the lowest since November 1982. Mr. Skrainka said that the manufacturing sector, which accounts for about a fifth of the U.S. economy, already was in recession.

The index was 45.2 in December. A level below 50 indicates contraction in manufacturing.

A bit of good news was in a third report, which said sales of new homes jumped 13.4 percent in November.

Since 1998, the Fed has been relatively active in its monetary policy. From early 1996 until March 1997, the fed funds target was 5.25 percent. The central bank then raised it to 5.5 percent, after Mr. Greenspan told Congress that there were signs of inflationary pressures in the economy, even though prices were not actually rising at a worrying pace.

The 5.5 percent rate remained in effect until October 1998, when the financial crisis that had begun in Asia the year before led Russia to default on some of its bonds. It also led to the near-collapse of Long-Term Capital Man-

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agement LP, a huge hedge fund that was rescued by major banks and financial firms in an action facilitated by the New York Federal Reserve Bank.

The Fed brought the fed funds target down to 4.75 percent in November 1998, executing quarter-point cuts in three successive months. Once the global turmoil subsided, it rescinded those reductions, raising the fed funds target back to 5.5 percent by November 1999.

It did not, however, stop there. The fed funds target was raised to 5.75 percent in February 2000, 6 percent in March and 6.5 percent after an unusual half-point increase at the May 16 Federal Open Market Committee meeting. Those actions roughly coincided with the stock-market peak in March. Mr. Greenspan, in testimony to Congress in February and a presentation in Boston the following month, explained that the central bank was worried that demand for goods and services from American consumers and companies was greater than the ability of the domestic economy to provide them.

Normally, this situation would lead to sharply rising prices, but Mr. Greenspan said that two factors were acting as "safety valves" to limit inflation: the willingness of foreign investors to pour roughly a billion dollars a day into the American economy and new workers' entering the labor force as jobs became plentiful in the booming economy. The first effect allowed the United States to pay for imports to satisfy the demand for goods and services, while the second kept wage pressures moderate. Mr. Greenspan said that neither could be expected to last indefinitely.

Mr. Greenspan cited what is known as the wealth effect for stimulating the strong demand in the U.S. economy: As investors saw the value of their holdings in the stock market rise, they felt increasingly affluent and willing to spend their money instead of saving it.

This optimism had its basis in the remarkable expansion of the economy, which the Fed chairman has said reflects in part technological advances that allow companies to increase profits more quickly than they raise prices. Mr. Greenspan added, however, that it was not day-to-day gains in efficiency that could justify the soaring prices of stocks but long-term gains in what he called structural productivity.

Late last year, the central bank abruptly reversed course, saying at a Dec. 19 meeting that economic weakness rather than inflationary pressures were its main concern. The high short-term rates had slowed economic growth from 4.8 percent and 5.6 percent rates in the first two quarters to 2.2 percent in the third quarter and 1.4 percent in the final three months of 2000. As well, stock investors had a poor year, especially those investing in the high-tech issues that dominate the Nasdaq index, which fell 39 percent for the year and 44 percent from the March peak.
