

BLOOMBERG, MAY 7, 2002:

Fed Holds Overnight Rate Steady, Helping Businesses, Consumers

by John Cranford

Washington, May 7 (Bloomberg) -- Federal Reserve policy makers gave the economic recovery an intended boost by leaving the benchmark U.S. lending rate at a 40-year low, making it easier for consumers to buy more cars and houses and for companies to invest.

Central bankers left the overnight bank lending rate at 1.75 percent and said the economy is just getting back on its feet after a recession that started in March of last year. It was the third time in a row the Fed's policy-setting Open Market Committee has held rates steady after 11 reductions last year.

"Economic activity has been receiving considerable upward impetus from a marked swing in inventory investment," the Fed said in a statement announcing its decision. "Nonetheless, the degree of the strengthening in final demand over coming quarters, an essential element in sustained economic expansion, is still uncertain."

Low rates mean that banks will be able to boost profits because they won't have to lower what they charge for loans to attract borrowers. Consumers, who pushed car and home sales to records in recent months, are likely to keep taking out loans for those purchases. Companies, which took advantage of falling rates to sell a record \$820 billion in bonds last year to refinance debt, may match that performance this year.

"Fed policy has made it easier" for consumers, banks and businesses, Neal Soss, chief economist at Credit Suisse First Boston Inc. in New York, said before today's announcement. "It's appropriate that it persist for a while."

'Uncertain' Recovery

Fed Chairman Alan Greenspan told Congress three weeks ago that the economy's recovery is "uncertain" until companies start hiring and he cautioned weak job growth may restrain consumer spending, which accounts for two-thirds of the economy.

The economy has added jobs in only one month since July, and the unemployment rate rose to a 7 1/2-year high of 6 percent last month, raising concerns about the fragility of the rebound.

Fed officials have said in recent speeches that they see little sign of a pickup in inflation. And today's report that worker productivity surged in the first quarter at the fastest pace in almost two decades suggests inflation isn't likely to become a problem. That will give the Fed room to hold rates steady until the rebound is secure.

Central bankers today retained their assessment that the risks to the economy are balanced between weakness and inflation, a neutral stance that suggests rate increases may not be imminent.

Meeting Expectations

Today's decision matched the expectations of all 62 economists surveyed by Bloomberg News. Few expected the Fed to signal that a rate increase was likely next month. Twenty-one of the 22 firms that deal directly with the Fed said they didn't foresee a rate increase before August, and five said central bankers probably would wait until September or November.

All signs indicate a recovery began late last year. Gross domestic product expanded at a 5.8 percent annual rate in the first quarter, the fastest in more than two years. Growth is expected to slow to about a 3 percent to 3.5 percent rate for the balance of the year, according to the most recent consensus forecast from the Blue Chip Economic Indicators survey.

Manufacturing has increased for three straight months. Consumer confidence has risen from lows after the September terrorist attacks. Housing and cars have been bright spots as a result of incentives such as zero-percent borrowing costs.

Treasury Yields

The yield on the benchmark 10-year Treasury note, to which many fixed-rate residential mortgages are tied, has fallen almost a quarter percentage point since Greenspan's congressional testimony on April 17. The yield on the two-year note, a benchmark for other lending, is also a quarter-point lower.

In turn, the average rate on a 30-year fixed mortgage fell to 6.78 percent last week from 6.99 the week of April 12, according to Freddie Mac, the No. 2 buyer of U.S. mortgages. And the average rate on a one-year adjustable loan was down a quarter point to 4.75 percent, the lowest in seven years.

Low rates have elevated home resales, which are expected by the National Association of Realtors to be close this year to last year's record 5.3 million.

Bank of America Corp., Wells Fargo & Co. and National City Corp. all reported higher quarterly earnings last month on the strength of a rise in mortgage lending and the low rates at which they were able to borrow. Last year, banks benefited from an average spread of 4.1 percentage points between what they charged for loans and what they had to pay, according to Keefe, Bruyette & Woods Inc. The Standard & Poor's index of bank shares is up 9 percent this year.

Auto Loans

Reduced borrowing costs made it possible for General Motors Corp. and other automakers to offer zero-interest loans, which boosted car sales to a record annual sales rate of 21.3 million last October. That helped total car sales last year rise to 17.2 million, the second-most ever. And in April sales increased to a 17.3 million pace.

Signs of an improving economy attracted a surge of people to the labor force last month. The number of employed workers, plus those who are seeking jobs, rose to a record 142.6 million, a sign people were job-hunting more aggressively than companies were hiring. So far this year, 256,000 people have joined the labor force as the total number of available jobs shrank.

That's had the beneficial effect of raising productivity, the amount of goods and services produced per hour of work, which grew in the first quarter at an 8.6 percent annual rate, following a 5.5 percent increase in the final three months of last year.

Productivity Gains

Productivity gains came as companies squeezed more from existing workers rather than hiring new ones. That helped reduce labor costs, taking the pressure off companies to raise prices as they coped with falling demand during the recession.

Greenspan has said consumer spending is dependent on job growth. "Perhaps most central to the outlook for consumer spending will be developments in the labor market," he told Congress last month. His view of the labor market may have worsened with the April report.

Even with a gain of 43,000 positions in April, the economy has lost 86,000 jobs so far this year on top of more than a million shed last year. Until demand picks up from consumers and businesses, and companies start hiring, Greenspan and other central bankers have said the recovery may have trouble taking hold.

"The Fed wants to see some serious job creation for a couple months in a row before they'd be eager to move rates in the other direction," Nancy Roman, managing director at the G-7 Group, a Washington consulting firm, said before the announcement.

Investor Expectations

That's reflected in federal funds futures contracts, an indication of where investors expect the overnight rate is headed.

The implied yield on the July fed funds futures has fallen to 1.79 percent from a recent high of 2.23 percent on April 1. That's just above the current target and a sign investors have concluded there won't be a rate increase at the June meeting. The September futures has a yield of 1.96 percent, suggesting a quarter-percentage-point increase is more likely in August.

The Fed's decision to hold rates steady follows the most aggressive series of rate reductions in Greenspan's 14-year tenure as Fed chairman. Beginning with an emergency rate cut Jan. 3, 2001, central bankers last year lowered the target rate for overnight loans between banks by a total of 4 3/4 percentage points last year to combat the economy's weakness.

The overnight rate is now lower than it has been on average in any month since July 1961. It averaged almost 5 percent during the decade-long record U.S. expansion from 1991-2000.