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Fed holds the line on interest rates

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The Federal Reserve held interest rates steady on Wednesday and raised the possibility they could be cut in the months ahead, igniting a rally on Wall Street where investors are thirsting for a reduction.

Fed Chairman Ben Bernanke and his central bank colleagues left an important interest rate unchanged at 5.25 percent, the sixth straight meeting without budging the rate. The decision was unanimous.

On Wall Street, stocks rose sharply. The Dow Jones industrials closed up 159.42 points at 12,447.52 in the index's biggest one-day gain since July 24.

The Fed's decision means that commercial banks' prime interest rate -- for certain credit cards, home equity lines of credit and other loans-- stays at 8.25 percent. The Fed has left rates alone since August, giving borrowers time to catch their breath after two years of steadily rising rates.

In an important change, Fed policymakers got rid of language from previous policy statements that suggested their next move could be a rate increase. Instead, the Fed is now widening its options and raising the possibility that rates also could go down.

Investors are betting the Fed will cut rates later this year to guard against any undue economic weakness. Many economists predict the central bank will probably start cutting rates early next year.

"The needle has shifted a little more to the center. I think they are more open to easing rates than they would have been several months back," said Lynn Reaser, chief economist at Bank of America's Investment Strategies Group. "They are moving away from the notion there could only be a rate increase."

The Fed is still sticking to its forecast that inflation should recede over time and that the economy -- despite strains from the housing slump and troubles facing lenders and borrowers of risky mortgages -- should log moderate growth over the coming quarters.

That being said, the Fed did slightly downgrade its assessment of current economic conditions, saying recent barometers "have been mixed." In contrast, at its previous meeting in late January, the Fed said recent indicators "suggested somewhat firmer economic growth."

Similarly, the Fed on Wednesday talked about the ongoing "adjustment" taking place in the housing sector. The Fed didn't mention any "tentative signs of stabilization," as it had in January, a view that led some to hope that the painful housing slump could be improving somewhat.

The economy has been feeling the strain of the housing slump. Economic growth in the final quarter of last year clocked in at a 2.2 percent pace, a sluggish performance that is expected to continue in coming months.

Investment in home building in the fourth quarter was slashed by 19.1 percent on an annualized basis, the steepest decline in 15 years.

Even with lackluster economic growth, however, the jobs market remains in good shape. The unemployment rate dropped to 4.5 percent in February and workers got fatter paychecks even as bad winter weather sent a chill through U.S. job growth.

Inflation, meanwhile, is still running above the Fed's 1 percent to 2 percent comfort zone. An inflation gauge closely watched by the Fed that excludes volatile energy and food, was up 2.3 percent for the 12 months ending in January.

After citing some inflation improvements in its last statement, the Fed this time noted that underlying inflation readings have been "somewhat elevated" recently.

Fed policymakers continued to make clear that the biggest risk to the economy is inflation.

The "predominant policy concern remains the risk that inflation will fail to moderate as expected," Fed policymakers said.

To fend off inflation, the Fed steadily boosted interest rates for two years, the longest stretch in its history. But since last summer, it has left rates alone. The Fed's goal is to slow the economy sufficiently to thwart inflation but not so much as to cripple economic activity.

Fed policymakers' meeting on Wednesday is their first since a worldwide stock market meltdown on Feb. 27, when the Dow Jones industrials suffered a 416-point plunge.

Fears about risky mortgages, economic slowdowns in two global powerhouses -- the United States and China -- and the possibility of a U.S. recession this year raised by former Fed chief Alan Greenspan, were factors in the market nosedive.

One day after the stock swoon, Bernanke -- tackling his first financial crisis -- sought to calm jittery investors. The Fed chief said nothing had altered the Fed's outlook for moderate growth in the economy this year.

"The Fed may not have blinked in the face of subprime mortgage problems but it seems ... that its eyelids are fluttering" as it takes into account the prospects of an economic slowdown, said Terry Connelly, dean of Golden Gate University's Ageno School of Business.

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