Economic Commentary

January 29, 2003

Fed Holds Bank Rate at 1.25%, Sees Balanced Risks

The Federal Reserve left the benchmark U.S. interest rate unchanged at a 41-year low, saying the economy still needs low borrowing costs to accelerate the expansion. It held the overnight bank lending rate at 1.25 percent, the lowest since July 1961, and said the risks to the economy are balanced between slower growth and higher inflation in the weeks ahead. The vote to leave rates unchanged was unanimous. The Fed is counting on the dozen rate cuts they've approved since January 2001 to spur consistent growth. Unemployment stands at an eight-year high of 6 percent, stock prices are down a fourth year, consumer confidence is at a nine- year low and companies are reluctant to invest. The world's largest economy probably grew at just a 0.9 percent annual rate in last year's final quarter, down from 4.1 percent the previous three months. While Fed governors have said business investment is crucial to ensuring expansion, spending on factory equipment and software declined 5.1 percent in the U.S. in the third quarter of last year, and estimates are there was little pickup in the fourth quarter.

In their statement, Fed officials cited ``geopolitical risk,'' and ``oil price premiums'' as factors which have ``reportedly fostered continued restraint on spending and hiring by businesses,'' similar to comments in their September and November statements. Analysts interpret that phrase as a reference to the threat of war with Iraq. "As those risks lift, as most analysts expect, the accommodative stance of monetary policy, coupled with ongoing growth in productivity, will provide support to an improving economic climate over time,'' the Fed said in a statement accompanying its decision.

With inflation low -- consumer prices rose just 0.1 percent last month, and are up 2.4 percent over the past 12 months -- the Fed can leave interest rates alone until that spending picks up. Economists forecast a 2.8 percent increase in gross domestic product this year, according to the latest Blue Chip Economic Indicators survey. While faster than the 2.4 percent the economy likely grew in 2002, that would lag the 3 percent to 4 percent that Fed officials describe as the economy's potential growth rate. An economy running below potential is likely to show stable consumer prices and slow job creation. The Fed's discount rates remained unchanged with primary credit at 2.25 percent, or 1 percentage point above the overnight rate, and secondary credit at 2.75 percent, or 1.5 percentage points over the benchmark rate. The discount window is a direct loan facility banks for banks with short-term funding needs.

On January 9, the Fed changed the rate from a subsidized rate that was set at a half-percentage point below the overnight rate, to a penalty rate set one percentage point above the market rate. Primary rates are for banks the Fed determines to be financially healthy; the secondary rate is for banks that may be less financially sound and are having difficulties finding funds in the money markets. The Fed last reduced interest rates Nov. 6 with a larger-than- expected half percentage point cut in the overnight bank rate. It was the first reduction in 11 months and the latest in a dozen reductions that started January 2001. The FOMC meets again on March 18th.

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