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Sep 17, 12:01 AM

Fed holds key interest rate steady

Decision to stay 45-year low seen as sign of confidence

FLORIDA TODAY Staff and Wire Reports

The Federal Reserve kept a key interest rate at a 45-year low on Tuesday and repeated its pledge to keep rates at rock-bottom levels for a "considerable period."

The action triggered a broad rally on Wall Street, as investors were bolstered by the Fed's assurances that the central bank is determined to hold rates down for as long as it takes to engineer a sustained economic rebound.

The Dow Jones industrial average closed the day up 118.53 points at 9,567.34, with the broader market showing strong gains as well.

"Fed officials are saying that, despite an improved economic outlook, they are not going to be raising interest rates any time soon, so the markets can relax," said Sung Won Sohn, chief economist at Wells Fargo in Minneapolis.

Many analysts predicted that the Fed will keep rates at the current level for as long as a year, in part because of lingering worries that inflation has fallen to such low levels that the bigger risk right now is a destabilizing fall in prices, rather than any threat of higher inflation.

Currently, low rates are "providing important ongoing support to economic activity," the Fed said.

Holding the funds rate steady means that commercial banks' prime lending rate for many short-term consumer and business loans will remain at 4 percent, the lowest level since 1959. Any changes to the funds rate affects the prime lending rate.

Maintaining a climate of near-rock-bottom short-term borrowing costs may make consumers and businesses feel more inclined to step up spending and investment, which would spur economic growth.

David Scott, executive director for the Dr. Phillips Institute for the Study of American Business Activity in Orlando, said the Fed's decision Tuesday reinforces the position that it's "still highly concerned about the

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slow place of overall economic recovery."

Job growth is the No. 1 thing on economists' minds.

"When the economy is perking along, the U.S. will add about 250,000 payroll jobs a month," Scott said.

"By contrast, the data for Aug. 2003 show that 93,000 seasonally adjusted payroll jobs were shed, and payroll losses, not gains, have extended on for seven consecutive months now."

The Fed last changed rates in June when it pushed its target for the federal funds rate, the interest that banks charge each other on overnight loans, down by a quarter-point to 1 percent. It was the Fed's 13th rate cut since early 2000 and brought its key policy lever to the lowest level since July 1958.

At the following meeting on Aug. 12, the Fed left rates unchanged but said for the first time that it was prepared to leave rates at low levels "for a considerable period," language it repeated in Tuesday's statement.

Analysts said the central bank was achieving success in correcting botched signals earlier this year when Fed worries about the remote threat of deflation misled bond investors into thinking the central bank was prepared to cut rates even faster and to employ unconventional methods such as direct purchases of long-term bonds in an effort to raise rates.

Treasury's benchmark 10-year note fell to a more than four-decade low of 3.1 percent in mid-June before jumping to 4.6 percent in August, raising concerns that a too-rapid rise in long-term rates could abort the current recovery.

However, the central bank's assurances in August and this month that it will keep rates low for a considerable period seemed to be convincing bond traders. In recent days, the 10-year Treasury note has retreated and is trading below 4.3 percent.

The central bank specifically stated Tuesday that it was concerned about recent "weakening" in the labor market.

Businesses cut payrolls for a seventh consecutive month in August, bringing total job losses to nearly a half-million. For the last two weeks, initial claims for unemployment benefits have climbed back above the 400,000 mark.

President Bush, who will be running for re-election next year, pushed through a third round of tax cuts this summer in an effort to counter Democratic attacks that his record on job growth is the worst of any president since Herbert Hoover.

By specifically mentioning the poor jobs performance, the central bank is sending a message that it too is worried about the economy's inability

to generate strong enough growth to put a dent in unemployment, analysts said.

"Even though the Fed tries to be independent of the political situation, Fed officials know that they will be in the hot seat next year along with the administration if they can't start bringing the unemployment rate down," said David Jones, head of DJM Advisors, a Denver-based economic consulting firm.

"Chairman Greenspan got one President Bush mad at him so he would prefer to stay on good terms with the current president," said Diane Swonk, chief economist at Bank One in Chicago.

Bush's father blamed Greenspan's interest rate policies for dampening economic growth in 1992, the year he lost the White House to Bill Clinton.

Some analysts are forecasting a significant rebound of growth starting this quarter, with gross domestic product growth rates above 4 percent both this quarter and the fourth quarter, which would be the strongest back-to-back GDP rates since 1999.

But productivity growth has been so strong that it will take growth above 4 percent for several quarters to make a sizable dent in the unemployment rate, which currently stands at 6.1 percent.

The National Association for Business Economics predicted Monday that a sizable rebound in economic growth would finally halt the wave of layoffs later this year, but it also predicted that unemployment would only be slightly improved at around 5.8 percent by the end of next year.

Staff writer Wayne T. Price contributed to this story.

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