Fed Clears Way For Future Rise In Interest Rates

Federal-Funds Target Left At 1%, but Central Bank Changes Phrase on Timing

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WASHINGTON -- The Federal Reserve has freed its hands for a future increase in interest rates.

The central bank left its short-term interest rate target at a 45-year low of 1%. But the bigger action was in its language, which it uses in addition to rate changes to guide the markets and economy. In an important tactical move, its policy panel dropped the commitment it first made five months ago to keep interest rates low for "a considerable period."

Instead, the Federal Open Market Committee said after its first two-day meeting of this year that it can be "patient" in raising rates because inflation is low and the economy still hasn't fully recovered.

Investors interpreted the omission of "considerable period" as a signal that the Fed is closer to raising interest rates than many thought. The 10-year Treasury bond yield leapt to 4.17% from 4.08% Tuesday. Futures trading on the Chicago Board of Trade suggests traders have moved up the month when they think the Fed will start raising rates to June from August.
The prospect of higher interest rates damped the relative attraction of stocks, which compete with interest-bearing investments. The Dow Jones Industrial Average, up almost 50 points earlier in the day, plunged after the Fed's announcement, closing down 141.55 points at 10468.37. The dollar rallied against the euro, since higher rates would improve the return on dollar-denominated loans.

The announcement doesn't seem to suggest an interest-rate increase is imminent. Rather, it appears the central bank wants the freedom to raise rates if the economy continues to improve, without worrying about violating a perceived commitment to keep them down.

"This is tactical," said Richard Berner, chief U.S. economist at Morgan Stanley. "It serves as a reminder that monetary policy will not stay on hold forever."

The rest of the statement suggested the Fed's economic outlook hasn't changed significantly since it last met in early December. "Output is expanding briskly," it said. While "new hiring remains subdued, other indicators suggest an improvement in the labor market."

Meanwhile, excluding food and energy prices, inflation is "muted and expected to remain low." It said upside and downside risks to economic growth were "roughly equal," while the risk of "an unwelcome fall in inflation" was "almost equal" to the risk of an increase.

Economic reports suggested the expansion may have slowed in December though it doesn't appear to be in trouble. New-home sales fell 5.1% in December from November to a seasonally adjusted annual rate of 1.06 million units, while new orders for durable goods -- those meant to last at least three years -- were unchanged in December from November.

Fed officials feel underlying inflation, at about 1%, is already at the bottom of their preferred range, and with businesses operating with a lot of spare capacity and unemployment high, there is little prospect that inflation will rise from that level. Still, in recent months they have grown more confident that the economic expansion is unfolding as expected.

'Better Alignment'

Some officials think upward pressure on consumer prices and wages could develop before the end of 2005, and they would like to start raising rates "well in advance of that point, rather than slamming on the brakes in the middle of 2005," said Michael Prell, an economic consultant in Arlington, Va. "This gets the market into better alignment with their thinking."

The FOMC, made up of seven governors in Washington and 12 regional bank presidents, of whom five vote, agreed unanimously to leave the federal-funds rate at 1%. The rate, charged on overnight loans between banks, has stood there since last June after 13 successive cuts beginning in January 2001.

With its shift in language, the Fed has exited from an unusual experiment with verbal monetary policy born of last year's brush with deflation, or generally falling prices.

Last summer, markets assumed the Fed would quickly raise interest rates to snuff out inflationary pressure, as in...
prior recoveries. In fact, with inflation so low and deflation still a risk, the Fed was prepared to wait much longer.

But as long as markets believed otherwise, long-term interest rates would be pushed up, undermining the recovery. To alter their expectations, the Fed began saying in August that rates could stay low for a "considerable period," departing from its historic practice of letting the markets decide for themselves what it would do.

The commitment was almost immediately controversial inside and outside the Fed. Some policy makers thought it dangerous to constrain their future actions, when inflation could surge unexpectedly. Some Wall Street analysts meanwhile thought the Fed had encouraged rampant speculation in the stock and bond markets with an open-ended promise of cheap financing. Still, the commitment worked: It has held down long-term interest rates, such as on mortgages, supporting home sales and other interest-sensitive purchases at a critical juncture for the economy.

Some analysts saw little change with the alteration of the language. Daiwa Securities economist Michael Moran said, "The phrases 'considerable period' and 'patient' should be viewed as near-perfect substitutes," noting that Fed Chairman Alan Greenspan has used the word "patient" before.

But for the Fed, the difference is crucial. With the change, it is now freer to act solely on economic data, rather than on any perceived commitment to keep rates low.

**Lengthy Review**

The change in language appears to be the only result so far of a lengthy internal review of communications policy.

Prompted by a series of controversies last year, the Fed's Federal Open Market Committee in October formed a working group headed by Gov. Roger Ferguson to study how it speaks to the public. The entire FOMC spent most of Tuesday discussing the issue.

A Fed spokeswoman said Mr. Ferguson's group has completed its work. She said that while FOMC members aren't announcing any specific changes, "they decided to gradually adapt their statements as needed and in response to changing economic circumstances." She added that no decision has been made about releasing meeting minutes earlier.

Currently, there is a wait of about six weeks. Analysts had speculated the Fed might start releasing minutes before, rather than after, its next scheduled meeting.

In Wednesday's economic reports, the Commerce Department said new orders for durable goods such as cars and computers were flat in December, after falling 2.3% in November from October. Excluding defense and aircraft, capital goods orders -- a barometer of business spending -- slipped 0.4%.

The data may be distorted by statistical difficulties related to communications-equipment orders.
Other data show a manufacturing and technology rebound, and tech executives are relatively optimistic.

In a separate report, the department said while new-home sales fell in December, sales during the previous two months were revised higher.

Homebuilders had on average 4.3 months of supply of homes, up from a low of 3.5 months during August. Mortgage rates have declined in recent weeks, which could provide a new lift to sales in the new year. (See related article.)

— Jon E. Hilsenrath contributed to this article.

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The Fed's Statement

Following is the full text of the Federal Reserve's statement following its two-day monetary policy meeting Jan. 27 and 28:

The Federal Open Market Committee decided today to keep its target for the federal funds rate at 1 percent.

The Committee continues to believe that an accommodative stance of monetary policy, coupled with robust underlying growth in productivity, is providing important ongoing support to economic activity. The evidence accumulated over the intermeeting period confirms that output is expanding briskly. Although new hiring remains subdued, other indicators suggest an improvement in the labor market. Increases in core consumer prices are muted and expected to remain low.

The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. The probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation. With inflation quite low and resource use slack, the Committee believes that it can be patient in removing its policy accommodation.

Voting for the FOMC monetary policy action were: Alan Greenspan, Chairman; Timothy F. Geithner, Vice Chairman; Ben S. Bernanke; Susan S. Bies; Roger W. Ferguson, Jr.; Edward M. Gramlich; Thomas M. Hoenig; Donald L. Kohn; Cathy E. Minehan; Mark W. Olson; Sandra Pianalto; and William Poole.

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