

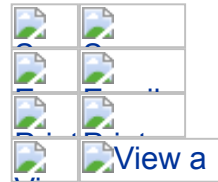
Fed hikes key rate



June 30, 1999: 5:15 p.m. ET

FOMC signals against another rate rise soon, but economists are wary

NEW YORK (CNNfn) - The Federal Reserve Wednesday raised a key short-term interest rate a quarter percentage point, but signaled it was not leaning toward boosting rates again anytime soon, sparking a sharp rally in U.S. markets.



The expected rise in the federal funds rate to 5 percent was overshadowed by the U.S. central bank's decision to soften its tightening bias toward a neutral stance, leading investors to believe a second rate hike is not imminent.

Typically, a higher fed funds rate -- the rate at which banks borrow from each other overnight -- means higher rates for things such as mortgage loans, credit cards and savings accounts.

Banks wasted no time in responding to the Fed action with rate increases of their own. Bank of America (BAC) and Bank One (ONE) each raised their prime rate, a baseline interest rate for business lending, to 8 percent from 7-3/4 percent, effective Thursday. Other banks were expected to follow suit.

A rising federal funds rate historically also has stunted corporate earnings growth and, therefore, stock prices.

But U.S. markets took heart in the shift to a neutral bias. The Dow Jones industrial average surged by as much as 200 points on the Fed's announcement before giving back some of the surge to close higher by 155.45 to 10,970.80. Likewise, the benchmark 30-year Treasury bond soared 1-1/8 of a point, pushing the yield down to 5.97 percent.



But economists cautioned that the neutral stance hardly ruled out a subsequent rate tightening, particularly given the Fed adopted a similar stance during its last string of rate hikes in March 1994 -- and boosted rates again less than one month later.

"I think the bond markets are getting a head fake here because [the Fed] explicitly said that they are going to be on guard," said David Orr, chief economist at First Union Corp. "It's more of a

technical change regarding the intermediate period between meetings.

"I still think there's a better than 50-50 chance they will raise rates again."

"I think they have sent a message that I'm surprised that they wanted to send to the market," agreed Alan Levenson, chief economist at T. Rowe Price Associates, who also predicted an additional quarter-point rate hike later this year. "I think the markets are seeing the neutral directive and they are saying, 'Well, they're done,' which I think is wrong."

In a related action Wednesday, the central bank maintained its discount rate, or the rate at which the Fed lends money to banks, at 4.50 percent.

A long-expected move

The quarter-point rate increase was widely anticipated by economists and investors. It comes amid growing concern that the white-hot U.S. economy will be unable to suppress inflationary factors for much longer.

The closely watched fed funds rate has been 4.75 percent since last November, when the Fed enacted the last of three successive rate cuts in the wake of the global financial crisis.

But in a written [statement](#) Wednesday, the Fed said, "Much of the financial strain has eased, foreign economies have firmed, and economic activity in the United States has moved forward at a brisk pace."

"I think you can take today as a shot across the bow," said Bill Hornbarger, a market analyst at A.G. Edwards. Federal Reserve Chairman Alan Greenspan "said the words 'modest pre-emptive tightening' and that's what he did today. He followed through on his promise."

But the shift in stance still caught many economists off-guard. With global economies stabilizing and the U.S. economy growing at what many economists believe is an unsustainable pace, members of the Federal Open Market Committee -- including Greenspan -- [expressed concern](#) in recent weeks that a pre-emptive strike against inflation might be necessary.

The central bank noted Wednesday that while labor markets had tightened recently, strong growth in labor productivity had suppressed inflationary pressures.

But economists said the Fed will maintain a close watch on the gap between consumer spending and consumer income growth. Both have been rising at rapid clips, but if spending begins to outpace income growth, many believe the Fed will react quickly.

"It just really puts an intense focus on all of the economic indicators going forward," said Stephen Slifer, chief U.S. economist at Lehman Brothers, who believes the Fed will not move on rates again this year. "I suspect that the reaction to those numbers is going to be enhanced from what it used to be."

That includes the June employment report due out on Friday from the U.S. Labor Department.

What also might alter the Fed's thinking, Slifer said, is an overly exuberant reaction by U.S. financial markets.

"If somehow the stock and bond markets combined decide the Fed is done, then we're off to the races again and we're not going to get that slower growth and these guys are going to be back," he said. ■



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