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Fed Cuts Short-Term Rates by 0.25 Point

First Cut Since January '96 Is a Pre-Emptive Strike To Stave Off Recession

by Jacob M. Schlesinger and David Wessel

WASHINGTON -- The Federal Reserve cut interest rates for the first time since January 1996 in a pre-emptive strike against recession that reflects a sudden reversal in the central bank's outlook for the economy and new worries about a credit crunch.

The Fed trimmed its key short - term interest rate by 1/4 percentage point to 5.25%, saying it sought to "cushion the effects on prospective growth in the United States of increasing weakness in foreign economies" and offset what it termed "less accommodative financial conditions domestically."

The Dow Jones Industrial Average dropped immediately following the Fed 's announcement at about 2:15 p.m., and closed at 8080.52, down 28.32. But bond prices jumped; the benchmark 30-year Treasury bond rose 23/32, or $7.1875 for a bond with $1,000 face value.

The widely anticipated rate cut, already reflected in mortgage rates and other market-set rates, won't have much immediate effect on consumer-loan rates. But if commercial banks follow the Fed and cut their prime lending rates, that will mean lower interest charges on some credit-card loans and many home-equity loans.

Among some traders and other Fed watchers there was disappointment that the Fed didn't, as some expected, cut rates by 1/2 percentage point. The U.S. Chamber of Commerce, for instance, described the move as "underwhelming in its modesty." But a few months ago, a rate cut looked very unlikely.

Just last June, Federal Reserve Chairman Alan Greenspan declared the state of the U.S. economy to be "as impressive as any I have witnessed in my near half-century of daily observation of the American economy." With the unemployment rate at a low 4.5%, Mr. Greenspan's colleagues at the Fed were far more worried about an outbreak of inflation than about recession. The last time the Fed cut rates with unemployment this low was 30 years ago, and inflation took off soon thereafter.

What darkened Mr. Greenspan's crystal ball? Early signs of financial stress in the U.S., triggered largely by Russia's Aug. 17 default on its foreign debt and the resulting fear in financial markets of risky – and even not-so-risky-loans and investments of all sorts.

Fed officials worry that the seeds of a potentially strangling credit crunch have been planted in an otherwise healthy American economy. Though there's scant evidence of a slowdown in growth, yesterday's move, perhaps the first of a series, was an attempt to kill the weed before it takes root.

As Mr. Greenspan put it last week, global financial turmoil has produced "a general pulling back for risk-taking," which is showing itself in lower stock prices, higher yields on bonds of riskier companies and hints that banks – an important source of finance to companies too small for public offerings – are growing more reluctant to lend.

In preparation for yesterday's meeting, the Fed conducted a special survey of senior bank lending officers; it hadn't planned such a survey until November. Results aren't yet public, but the survey apparently found some hints that bankers, too, were beginning to pull back. "Banks are also reportedly becoming more cautious and more-expensive lenders to companies," Mr. Greenspan said last week.

"Banks are examining their exposures more carefully," and aren't as "free-wheeling" as they were," says David Bozynski, treasurer of Federal-Mogul Corp. When the Southfield, Mich., auto-parts maker borrowed more than $1 billion earlier this month, it had to pay 2.25 percentage points above the benchmark widely used by banks. Earlier this year, Federal-Mogul was able to borrow at 2 points above the benchmark.

"I'm hearing from my members that financial institutions are beginning to tighten their lending standards," says Barry Rogstad, president of the American Business Conference, a group of midsized, fast-growing companies.

Fed fears that another rude shock to the financial system would produce even more reluctance to lend among bankers and bond buyers contributed to its decision last week to broker the $3.5-billion rescue of Long-Term Capital Management LP, the spectacularly leveraged hedge fund.

Because growth has slowed so much outside of the U.S., hurting U.S. exports, and because of signs of credit tightening here at home, Wall Street analysts are marking down their forecasts for economic growth next year, and Fed staff economists have done the same.

Morgan Guaranty Trust Co. projects that the U.S. economy, which grew at an eye-popping 3.6% adjusted for inflation over the past year, will grow only about 1% over the next 12 months. Goldman Sachs & Co. figures that stock and bond markets now put the odds of a recession in the next 12 months at a substantial 40%.

There are only few fresh indications that the economy may soon slow, and some analysts think that the Fed is making a mistake. After all, only a few months back, Mr. Greenspan was fretting about bankers being too lax.

"If the Fed eases now," says Roseanne Cahn, an economist with Credit Suisse First Boston Corp., "there's a risk that they will foster the next financial bubble, which is likely to be followed by a bigger crash later."

But such concerns were outweighed by the tightening of credit conditions, which could make it difficult for businesses to finance the investment boom that has sustained the economy for years.

Most obvious is that the stock market's appetite for initial public offerings of shares has almost dried up, the latest casualty being Goldman Sachs & Co.'s celebrated planned offering.

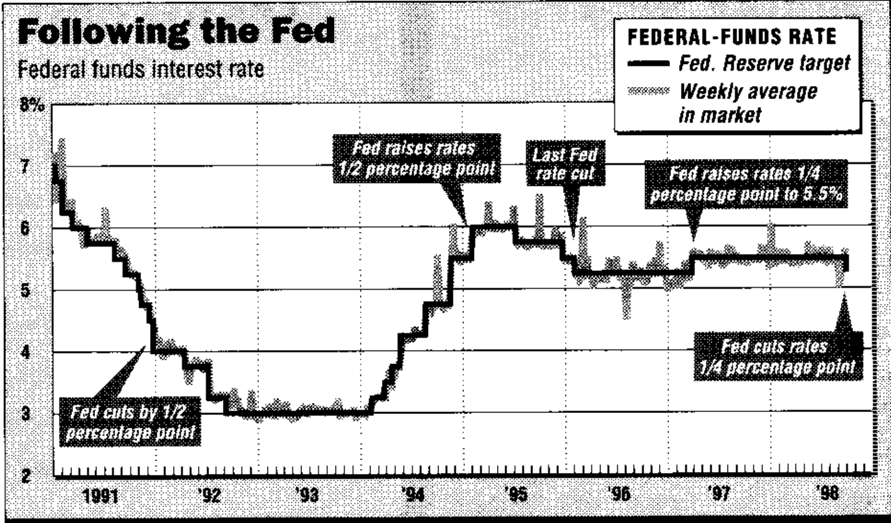
The end to the initial-public-offering boom "is forcing us to slow our expansion, and to cut expenses more," says Gene McGreven, chairman of PetNet Pharmaceutical Services LLC, a two-year-old, Norcross, Ga., maker of cancer diagnostics. "We would normally be making plans now to do an IPO six to nine months from now, but that would be a waste of time and effort," he says.

Bond-market borrowing also has been hurt in the past six weeks. In the last half of 1997 and the first half of 1998, riskier companies sold an average of $589 million in high-yield bonds per day; since the beginning of August, they've been selling only about $162 million per day, he says, according to Moody's Investors Services. And even though yields on Treasury bonds are down, the rate that the bond market demands from junk-bond issuers has jumped to 10.5%, the highest level since early 1995.

Bond issuance by blue-chip companies has also fallen, to $213 million per day from $714 million per day in the year ended July 31. And the spread -- the difference between the rates that the U.S. Treasury pays to borrow money and the rates that companies pay -- has widened, too, a measure that Mr. Greenspan and others at the Fed track closely as a gauge of credit conditions in the economy.

Ford Motor Co., which has a solid A rating, last week had to pay 1.45 percentage points above Treasurys to borrow $1.5 billion for 30 years. That's about a third more than the premium Ford probably would have paid earlier this year, says Moody's chief economist, John Lonski. "There appears to be an unusual and unwarranted risk aversion among lenders," he says. "That's what happens with a credit crunch: tight standards are applied quite often without regard to the underlying creditworthiness of the borrower."

Shortly after the Fed announcement, the Bank of Canada cut its short - term rates by 1/4 percentage point to 5.75%, prompting major Canadian banks to trim their prime lending rates by the same amount. The Canadian central bank raised the rate to 6% at the end of August in an effort to stabilize the sinking Canadian dollar.


Following the Fed
Federal funds interest rate
FEDERAL-FUNDS RATE
Fed. Reserve target
Weekly average in market
8%
7
6
5
4
3
2
Fed raises rates 1/2 percentage point
Last Fed rate cut
Fed raises rates 1/4 percentage point to 5.5%
Fed cuts rates 1/4 percentage point
Fed cuts by 1/2 percentage point
1991
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