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Fed Rate Cut Halts Market Free Fall, But Recession Fears Are Mounting

Foreign Shares' Tumble Prompts Bernanke Call; Biggest Trim in 20 Years

By Greg Ip

Ben Bernanke blinked.

The Federal Reserve chairman, who normally tries to avoid reacting directly to financial markets, saw global markets in free fall, and yesterday abruptly orchestrated the single deepest cut in the Fed's main interest-rate target in more than two decades.

The move shored up confidence, at least for the moment. U.S. and many global markets quickly rebounded from huge losses in response to the three-quarter percentage-point cut in the target for the federal-funds rate, to 3.5%.

Ben Bernanke

But in a sign that risks to the U.S. and global economy remain strong, the Fed hinted another rate cut next week is likely. The central bank's moves may be too late to stop the U.S. from entering recession, as many economists now forecast, but it may make one milder and shorter.

By acting so explicitly in response to market developments—just a week before a scheduled meeting to decide on rates—the Fed is running a risk. Investors may view the steps as panicky, undermining the goal of the rate cuts. And investors may come to judge the Fed's success narrowly, by how the stock market, rather than the economy as a whole, performs.

Still, Fed officials agreed on the emergency move during a videoconference call convened hastily Monday evening by Mr. Bernanke. It came after Mr. Bernanke spent Monday in the office, despite the national holiday, watching the fallout as Asian and European markets plummeted and consulting with aides. Futures markets Monday were predicting a 4% plunge Tuesday in U.S. stocks.

His main concern: Investor fears of an economic catastrophe could become

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Stocks Show Classic Bear Signals, And This Time, Impact Is Global

By E.S. Browning And Joanna Slater

A classic bear market starts with a period of exuberance. Then a downturn hits one part of the market, and gradually, the losses spread even to strong companies. A prolonged grind begins.

It happened in the 1970s, when an oil embargo helped puncture the "nifty fifty" big-company stocks, and again in 2001, when the bursting of the Internet bubble caused a broad decline. Now, investors shaken by two days of severe volatility fear another bear market—only this time, it would fully span the globe.

Even as some world-wide markets recovered yesterday on the back of the Federal Reserve's interest-rate cut, the losses have put some markets already in bear territory by the traditional definition of a 20% drop from a high.

The Russell 2000 small-stock index, bank-stock indexes and the Dow Jones Transportation Average already are down more than 20% from last year's highs. So are benchmark indexes from Switzerland to Taiwan to Chile.

The Nasdaq Composite Index fell 2.04% yesterday and now is 19.8% off last year's high. The Dow Jones Industrial Average is 15.5% below last October's record. Indexes in India and China are getting close to the 20% mark.

Some investors don't think a lengthy bear market is upon us. They believe the worst may be over as the Fed moves aggressively to prop up the U.S. economy. Yesterday, markets around the world bounced back, with

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More on the Credit Crunch

NEW MACHINE

In South, Democrats' Tactics

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Congress may seek to nomic-stimulus efforts. House isn't ruling out of a proposed $145 bil- Democrats have dis- ng a two-part bill in nal stimulus policies gered by negative fac- easing unemployment. considering a second d include longer-term ures, like infrastructure aid to states. A3, A23 *nd Republican contenders are stepping hasis on economic issues moil in financial markets.*

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dropped out of the race after the former nator finished a dis- Saturday's South ublican primary. A2

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House isn't satisfied tion it's getting about ps operating in Paki- rea, a top official said. he administration rts to curb U.S. aid to le warning Mushar- romote democracy.

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Fed Rate Cut Halts Stock Market Free Fall

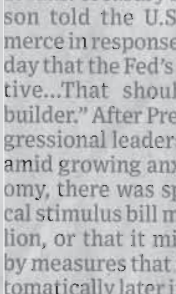
Continued from Page One

self-fulfilling. Another big drop in U.S. stocks, on top of a 15% decline since last October, would represent a hit to household wealth on top of eroding home values. Falling asset prices could force banks to take more write-downs, further eroding capital and constricting credit. Mr. Bernanke believed the Fed should try to short-circuit the negative psychology, and that it stood a better chance by acting right away instead of waiting a week. It was the first time the Fed has cut rates between meetings since the aftermath of the terrorist attacks of Sept. 11, 2001.

The Dow Jones Industrial Average, down as much as 464 points early in the morning, later recovered to close down 128.11 points, or 1%. European markets, which were falling steeply for a second straight day, reversed course and closed higher on the Fed's action.

"Appreciable downside risks to growth remain," the Fed said in a statement, vowing to "act in a timely manner as needed to address those risks." Futures markets see a high likelihood of another half-point cut, to 3%, at the meeting scheduled for next Tuesday and Wednesday, and see the Fed bringing its target as low as 2% by year end.

"The sense was that we were facing a meltdown," said former Fed governor Laurence Meyer, now at forecasting firm Macroeconomic Advisers LLC. "That was the reason for trying to get out in front rather than trying to sit out on the sidelines." The move would be "pointless" if it merely shifted a scheduled rate cut ahead by a week, he added. The aim, he predicted, is to get the rate lower by month's end than it otherwise would have been. He predicted a half-point cut next week.



Donald Kohn

Mr. Bernanke's rate cut is a telling sign of the urgency with which policy makers are responding to the risk of recession. The Bush administration is pushing for a fiscal stimulus package of $145 billion composed primarily of temporary tax breaks. Treasury Secretary Henry Paulson told the U.S. Chamber of Commerce in response to a question yesterday that the Fed's rate cut is "constructive...That should be a confidence builder." After President Bush met congressional leaders at the White House amid growing anxiety about the economy, there was speculation that a fiscal stimulus bill might exceed $145 billion, or that it might be accompanied by measures that would take effect automatically later in the year if the economy weakens.

The odds of recession are rising, and some economists believe the U.S. already has entered one, or is about to do so. "The best forecast now, based on guesstimates of first-quarter data, is that we're not in a recession right now," said Robert Gordon, a Northwestern University economist who sits on the academic National Bureau of Economic Research committee that officially dates recessions. But he says odds favor a recession starting late this quarter or next quarter. Merrill Lynch yesterday predicted that the economy will contract in each of the first three quarters of the year.

Today's economy shows some signs that are common to most recessions: Stock prices are falling; long-term interest rates are dropping below the level of short-term rates; housing construction is declining; and the unemployment rate is up sharply.

But some usual indicators aren't flashing recession. Employers haven't trimmed employee work weeks, as they commonly do when demand trails off; initial claims for unemployment insurance have been dropping recently, and inventories aren't unusually high, which makes it less urgent for manufacturers to scale back production. "There is no clear evidence" a recession has begun, said Victor Zarnowitz, a scholar at the Conference Board who is also a member of the NBER committee, "but it bears watching very, very closely."

Consumers are feeling the pinch of weaker job growth and higher energy prices. Darion Hammie of Inglewood, Calif., who makes about $50,000 as logistics coordinator for a freight-forwarding company, has been cutting back on everything from Christmas toys to organic groceries. Her wages are rising, but rent on her two-bedroom house has risen $200 to $1,400 a month from last year. Filling her Ford Explorer costs $80, up from $40 or $50 a few years ago. So she has largely abandoned Whole Foods for less-expensive supermarkets, and enrolled her children in the lunch program at school. "I have to make choices that I never thought I would have to make," she says.

Businesses are also cutting back in response to tighter lending conditions and weaker demand. Dan Imbrogno, president of Ohio Screw Products Inc., a manufacturer in Elyria, Ohio, started noticing a slowdown in inquiries a few months ago in September, which accelerated in the past month. His company, which makes hydraulic fittings as well as screws and bolts, took delivery of a computerized metal-cutting machine last fall that cost more than $100,000 and was planning to get a second machine early this year. He has now canceled the order.

The Fed move marks a radical shift for Mr. Bernanke. Since August, the Fed has cut its target for the federal-funds rate—at which banks lend to each other overnight—three times by a full percentage point. But at no time was it willing to say it was more worried about the weakening economy than inflation, a reflection of the stubbornness of price pressures emanating in particular from energy costs.

But by earlier this month, weakening employment, retail sales and manufacturing activity convinced Mr. Bernanke the risks to the economy were paramount. In a Jan. 10 speech he promised "substantive" action, widely read as a promise to cut rates further. Many in the markets expected a cut shortly at that time. Some Fed officials saw merit in the idea.

Mr. Bernanke thought it better to act at next week's scheduled meeting. But market events forced his hand. Last week, bond insurers faced the threat of rating downgrades that would force banks to take on billions of dollars of added default risk, and then came the global stock-market plunge on Monday.

The Fed itself and markets were closed for the Martin Luther King Jr. holiday, but Mr. Bernanke—who comes into the office seven days a week—was at his desk. After consulting with Federal Reserve Bank of New York President Timothy Geithner and Vice Chairman Donald Kohn, he convened a videoconference call of the Federal Open Market Committee. Since economic fundamentals justified a significant rate cut, the main issue was convincing the committee that it should be done now. All but one of the participants, William Poole, president of the Federal Reserve Bank of St. Louis, voted for the move. He didn't believe conditions justified moving before the meeting, the Fed said. Another member, Fed governor Frederic Mishkin, was on a skiing trip and unable to get to a secure Fed facility in time for the session.

The timing may resurrect accusations that the Fed is too quick to bail out investors at the expense of low inflation and prudent behavior. And by setting aside the longstanding preference of moving only at meetings, the FOMC risks looking desperate. Vincent Reinhart, a former top staffer at the Fed who is now a scholar at the American Enterprise Institute, said the Fed may have put itself in "harm's way" by basing its action so explicitly on market developments.

"If markets go down after you've acted, do you jeopardize some of your credibility? I think they did," Mr. Reinhart says. If market panic resumes, "You are then faced with the question, what is plan B?"

But former Fed governor Lyle Gramley, who now follows the Fed for Stanford Washington Group, says the risk of not acting was larger. "You have a credibility problem whenever things don't go right," he said. "You have a much larger credibility problem twiddling your thumbs, doing nothing, when the economy is going down the tubes."

Before announcing the rate cut Tuesday, the Fed notified its counterparts in Japan, Britain, Canada and the European Central Bank. By the end of the day, only the Bank of Canada had followed suit, lowering its short-term rate a quarter of a percentage point at a scheduled meeting, as expected. But the governor of the Bank of England suggested rate cuts in the U.K. are likely, and markets anticipate the European Central Bank—despite its tough rhetoric about inflation worries—will follow later this year. (Please see related story on page A22.)

The Fed said it acted because of a "weakening of the economic outlook and increasing downside risks to growth. Broader financial market conditions have continued to deteriorate and credit has tightened further for some businesses and households. Moreover, incoming information indicates a deepening of the housing contraction as well as some softening in labor markets." It also said it expects "inflation to moderate in coming quarters" though it will "monitor inflation developments carefully."

Stanford economist Robert Hall, chairman of the seven-member NBER committee that dates recession, said colleagues on the usually dormant panel have begun to discuss the numbers by email. "The crystallizing event was the weak employment numbers at the beginning of the month," Mr. Hall said. It would not announce a starting date for any recession until well after one has started, he said.

Typically, lower interest rates begin to help revive a sagging economy by spurring purchases and construction of homes. But the deflating real-estate boom has left an unprecedented share of homes standing unsold and vacant, says Columbia Business School economist Christopher Mayer, suggesting the moves may have less effect than usual. "No matter how much the Fed cuts interest rates we are not going to see an appreciable pickup in home construction for a couple of years," he says.

Lou Barnes, president of Boulder West Inc., a Lafayette, Colo., mortgage bank, said the cuts will help only those home buyers who qualify for prime mortgages of $417,000 or less. Banks that used to originate mortgages for less-than-perfect credits or for amounts above $417,000 are reluctant to do so because they can't sell them to investors and have little room left on their own balance sheets for them. (Mortgage giants Fannie Mae and Freddie Mac can't buy mortgages above $417,000.)

Still, lower short-term rates will produce benefits that grow with time. Because banks usually borrow for shorter terms than they lend, the reduction in short-term rates will make lending more profitable and thus appealing. Major banks yesterday lowered their prime lending rates to 6.5% from 7.25%, which will deliver savings to anyone with a prime-linked loan, such as on a home-equity line of credit.

Stanford's Mr. Hall said while fiscal stimulus plans will take too long to influence the economy significantly, by contrast, "the Fed can turn on a dime as it did this morning. Claims that it's lost its grip on the economy are misplaced."

The current month is proving to be a critical test of Mr. Bernanke's leadership. He became chairman in February 2006, intending to be more collegial than his predecessor, Alan Greenspan. He made sure fellow FOMC members had their say before he settled on the course for interest rates, tried to stay out of the limelight and to avoid explicit clues on interest rates. While that style worked in his first year on the job, it has been criticized since the crisis erupted in August for encouraging Fed officials to air multiple, often disparate, views when the markets most want clarity. Officials have since been advised to hedge their remarks more carefully, people close to the Fed say.

Mr. Bernanke also tried to focus the market's attention more on explicit forecasts than verbal clues. In October, the Fed released the first of expanded quarterly economic projections which helped quantify the inflation rate the Fed is aiming for. But like most of the Fed's projections lately, that forecast was made obsolete within days by the intensifying credit crunch and housing slump.

Wall Street has been quick to vilify Mr. Bernanke for being slow and indecisive. "A number of our clients believe Bernanke has lost it and they are uncertain as to what the Fed is up to," ISI Group, a New York brokerage firm, wrote in a morning report. Greg Peters, head of credit strategy at Morgan Stanley, said, "I think the Fed definitely has lost a decent amount of credibility...they have been behind the curve and reacted to the market and that doesn't engender a lot of confidence."

But Mr. Bernanke's defenders note he has plenty of company: Most Wall Street economists have also had to mark down growth expectations and mark up expected Fed easing as the outlook has deteriorated since August. Investors also wrongly thought the worst had passed in October when they pushed stocks to their last, all-time high.

Moreover, even as Mr. Bernanke battles the risk of recession, inflation has not faded from view. "You have the underlying inflation rate moving in the wrong direction," noted Al Broaddus, former president of the Richmond Fed. If the Fed is going to be flexible in the face of risks to growth, "it needs to move back in the other direction as soon as the balance is shifting back towards inflation risk. And it's not easy to do that."

Yesterday's move came closer to the day of a scheduled meeting than any between-meetings move since the Fed began announcing rate changes in 1994. The Fed last cut the target for the federal-funds rate in one move by as much as three-quarters of a point back in 1982, when it was lowered a full point. Prior to 1994, however, the Fed publicized only the less-important discount rate, charged on the Fed's direct loans to banks. It cut that rate a full percentage point in 1991.

—Sudeep Reddy, Timothy Aeppel, Conor Dougherty and Justin Lahart contributed to this article.

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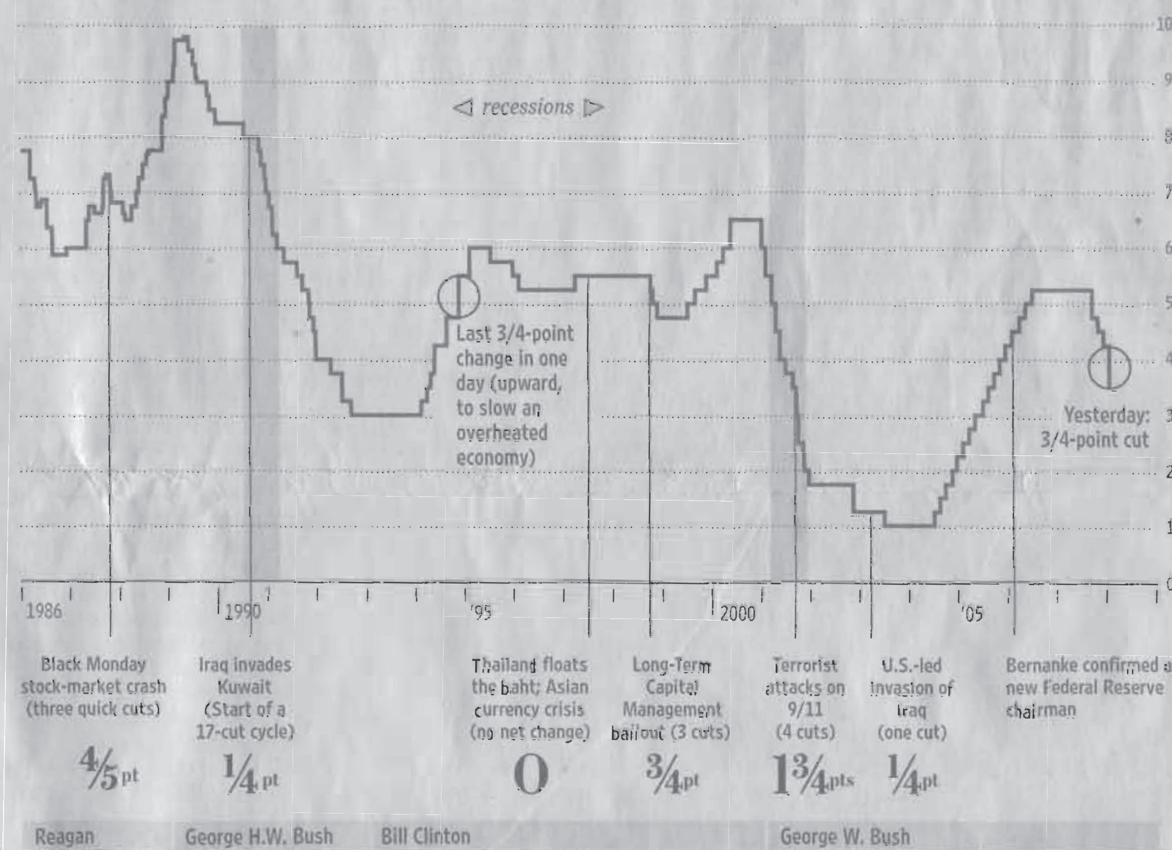
ONLINE TODAY: Read the Fed's statement and economists' reactions to the announcement, at **WSJ.com/Economics**.

Crisis Control at the Fed

The Fed often cuts rates in response to unexpected shocks, such as war, terrorist attacks, and stock market plunges.



Sources: Thomson Datastream (Fed rate target); Dow Jones Newswires and WSJ news reports (crises and dates)