Fed Cuts Benchmark Rate to Near Zero

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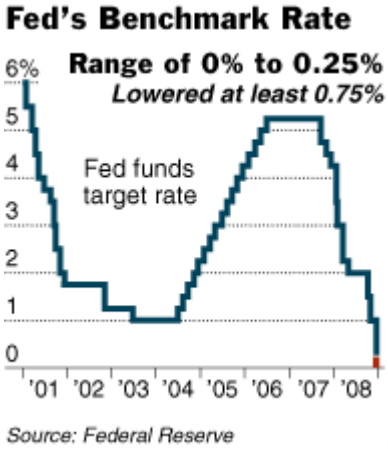
The Federal Reserve entered a new era on Tuesday, setting its benchmark interest rate so low that it will have to reach for new and untested tools in fighting both the recession and downward pressure on consumer prices.



Going further than analysts anticipated, the central bank cut its target for the overnight federal funds rate to a range of 0 to 0.25 percent, a record low, virtually bringing the United States to the zero-rate policies that Japan used for six years in its own fight against deflation. The rate had previously been 1 percent, and a cut of a half-point had been widely expected.

The move, which affects the rate at which banks lend their reserves to one another, was to a large degree symbolic. Demand for interbank loans has been so low that the actual Fed funds rate has been far below the previous target for a month and hovered at barely 0.1 percent in the last several days.

In its statement announcing the cut, the Fed's Open Market Committee made it clear that it still had ammunition with which to stimulate the economy and referred the wide array of new lending programs that essentially allow it to pump money directly into financial institutions.

"The Federal Reserve will employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability," it said. Among those tools, it cited the continuing purchase of agency debt and mortgage-backed securities and the "potential benefits of purchasing longer-term Treasury securities."

With its move, the central bank implicitly acknowledged that recession is more severe than officials had thought at their last meeting in October. "The committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time," it said.

A raft of new data on Tuesday offered fresh evidence that the central bank faces little danger that its easy-money policies will stoke inflation. Indeed, the data reinforced the impression that the much more immediate risk is deflation — a widespread and disruptive decline in consumer prices.

The federal government reported on Tuesday that the consumer price index fell 1.7 percent in November, the steepest monthly drop since the government began tracking prices in 1947. The decline was largely driven by the recent plunge in energy prices, but even the so-called core inflation rate, which excludes the volatile food and energy sectors, was essentially zero.

With less than two weeks before Christmas, retailers from Saks Fifth Avenue to Wal-Mart have been slashing prices to draw in consumers, who have sharply reduced their spending over the last six months. On Tuesday, Banana Republic offered customers $50 off on any purchases that total $125. DKNY offered customers $50 off for any purchase totaling $250.

Ian Shepherdson, an analyst who follows the United States economy for High Frequency Economics, said falling energy prices were likely to bring the overall consumer price index to below zero in January.

Ben S. Bernanke, the chairman of the Federal Reserve, has already outlined a range of unorthodox new tools that the central bank can use to keep stimulating the economy once the federal funds rate effectively reaches zero.

Those techniques include buying vast amounts of longer-term Treasury bonds, mortgage-backed securities issued by government-sponsored companies like Fannie Mae and Freddie Mac and commercial debt issued by private companies and consumer lenders.

The Federal Reserve has already introduced a slew of lending programs in its effort to revive corporate and consumer lending. Later this month, the Fed will start purchasing $600 billion worth of securities that are backed by Fannie Mae, Freddie Mac and other government-sponsored entities. The Fed and the Treasury are also introducing a joint program to buy up securities backed by consumer debt like automobile loans.

All of the new tools amount to printing money in vast new quantities, and the Fed has already started the process. Since September, the Fed's balance sheet has ballooned from about $900 billion to more than $2 trillion as the central bank has created new money and lent it out through all its new programs. As soon as the Fed completes its plans to buy up mortgage-backed debt and consumer debt, the balance sheet will be up to about $3 trillion.

"At some point, and without knowing the timing, the Fed is going to have to destroy all that money it is creating," said Alan Blinder, a professor of economics at Princeton and a former vice chairman of the Federal Reserve, said the central bank. "Right now, the crisis is created by the huge demand by banks for hoarding cash. The Fed is providing cash, and the banks want to hoard it. When things start returning to normal, the banks will want to start lending it out. If that much money is left in the monetary base, it would be extremely inflationary."

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