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Fed Keeps Interest Rates at 5.25 Percent

By JEANNINE AVERSA 01.31.07, 4:42 PM ET

Pointing to a revved-up economy and encouraging news on inflation, the Federal Reserve held interest rates steady on Wednesday and extended a half-year breather for U.S. borrowers. Wall Street surged in response.

Fed Chairman Ben Bernanke and his central bank colleagues left an important interest rate unchanged at 5.25 percent, the fifth straight meeting without budging the rate. The decision was unanimous.

On Wall Street, stocks rose sharply. The Dow Jones industrials gained 98.38 points to close at 12,621.69 in preliminary data.

That means commercial banks' prime interest rate - for certain credit cards, home equity lines of credit and other loans - stays at 8.25 percent, once again giving a break to borrowers who until last summer had endured the pain of two-plus years of rate increases.

Fed policymakers delivered a more positive assessment of the economy than in December, recognizing improvements in economic growth, inflation and even the troubled housing sector.

"Overall, the economy seems likely to expand at a moderate pace over coming quarters," they said.

The Fed also observed that core inflation, which excludes energy and food prices, has "improved modestly in recent months." That was an upgrade from December when policymakers fretted about "elevated" readings on underlying inflation.

They continued to note that inflation risks remain, keeping open the possibility of a rate increase. Still, with the Fed's fairly upbeat assessment, many economists believe rates are likely to remain where they are for much of this year.

"I think they are taking a slightly softer stance on inflation. They are not as concerned about inflation as they were last year," said Victor Li, associate professor of economics at Villanova School of Business. "I think right now they are taking a wait-and-see approach."

The Fed's announcement came hours after the government reported that the economy snapped out of a sluggish spell and grew at a 3.5 percent pace in the final quarter of last year as consumers ratcheted up spending.

The report also showed that underlying inflation ebbed during the quarter.

The fresh snapshot of business activity, released by the Commerce Department, underscored the resilience of the economy. It has managed to keep moving despite the ill effects of the residential real-estate bust and an ailing automotive sector.

President Bush pointed to the economic figures as evidence that his policies are working. The president, in a New York speech, also sought to calm fears about an economy that is constantly changing.

"By and large, our dynamic and innovative economy has helped Americans live better and more comfortable lives," Bush said. "Yet the same dynamism that is driving economic growth ... also can be unsettling for people. For many Americans, change means having to find a new job, or to deal with a new boss after a merger or to go back to school to learn new skills for a new career."

An AP-Ipsos poll in early January found that 55 percent of people disapproved of the president's handling of the economy, while 43 percent approved.

Democrats, in control of Congress for the first time in a dozen years, argue that the White House hasn't paid attention to widening economic inequality that they say is making it harder for the middle class to succeed. "Middle class families are not struggling to get by, but they are struggling to get ahead," said Sen. Charles Schumer, D-N.Y.

The economy opened 2006 on a strong note, growing at a 5.6 percent pace, the fastest spurt in 2 1/2 years. But it lost steam during the spring and late summer. It grew at a 2.6 percent pace in the second quarter and then a weaker 2 percent pace in the third quarter. The fourth quarter's rebound ended the year on a positive note.

"The economy has clearly caught its second wind," said Bernard Baumohl, managing director of the Economic Outlook Group.

For all of 2006, the economy increased by 3.4 percent. That was an improvement from a 3.2 percent showing in 2005.

That's even more impressive considering the economy was hit by the housing slump. Investment in home building for all of last year was slashed by 4.2 percent, the most in 15 years.

An inflation gauge tied to the report showed that core prices - excluding food and energy - rose at a rate of 2.1 percent in the final quarter of last year, down from a 2.2 percent pace in the third quarter.

To fend off inflation, the Fed had steadily boosted interest rates for two years, the longest stretch in its history.

But since last summer, it has left rates alone. Economists believe the Fed is on course to achieve its goal of slowing the economy sufficiently to thwart inflation but not so much as seriously hurt economic activity.

"The Fed almost seemed to be on the verge of declaring victory," said Joel Naroff, president of Naroff Economic Advisors.

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