Fed pledges action until economy shows gains

By Editor Test Thu, Sep 13, 2012

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WASHINGTON — The Federal Reserve opened a new chapter on Thursday in its efforts to stimulate the economy, announcing simply that it plans to buy mortgage bonds, and potentially other assets, until unemployment declines substantially.

The Fed said that it would expand its holdings of mortgage-backed securities and potentially take other steps to encourage borrowing and financial risk-taking. But perhaps more significant was the basic change in its approach: For the first time, the Fed pledged to act until the economy improved, rather than creating another program with a fixed endpoint.

In announcing the new policy, the Fed sought to make clear that its decision reflected not only an increased concern about the health of the economy, but an increased determination to respond – in effect, an acknowledgment that its approach until now had been flawed.

The Fed also acknowledged its limits. "Monetary policy, particularly in the current circumstances, cannot cure all economic ills," the Fed chairman, Ben S. Bernanke, said at a news conference.

The Fed's policy-making committee said in a statement that its efforts would continue for "a considerable time after the economic recovery strengthens." Specifically, it said it would act until the outlook for the labor market improved "substantially," although it did not offer a numerical target.

In a separate statement, the Fed said its senior officials now expected the economy to expand from 1.7 to 2 percent this year, down from their June projection of growth of 1.9 to 2.4 percent. The officials continued to predict that the unemployment rate would not fall below 8 percent.

"The weak job market should concern every American," Mr. Bernanke said at the news conference. "The modest pace of growth continues to be inadequate to generate much improvement in the current rate of unemployment."

Fed officials predicted that growth would be somewhat faster in coming years, and that unemployment would decline somewhat more quickly, presumably reflecting the impact of the measures the Fed announced Thursday.

"The idea is to quicken the recovery, to help the economy begin to grow quickly enough to generate new jobs and reduce the unemployment rate," Mr. Bernanke said.

On Wall Street, traders welcomed the moves. The benchmark Standard & Poor's 500-share index was up 1.6 percent by the close of trading. The Dow Jones industrial average also ended with a gain of 1.6 percent, or about 200 points.

The Fed's plan went further than many investors had expected by providing an open-ended commitment. But stocks have been rising in recent weeks, partly in anticipation of the Fed taking more measures to support the economy.

"There weren't many more accommodative options the Fed could have gone with," said Dan Greenhaus, the chief global strategist at BTIG, an institutional broker.

In its measures, the Fed said it would add $23 billion of mortgage bonds to its portfolio by the end of September, a pace of $40 billion in purchases each month. It will then announce a new target at the end of this month, and every subsequent month, until the outlook for the labor market improves "substantially," as long as inflation remains in check. The statement did not further explain either standard.

The Fed's statement made clear, however, that it would continue to stimulate the economy even as the recovery strengthened, suggesting that it was now willing to tolerate somewhat higher inflation in the future to encourage growth in the present.

"A highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens," the Fed's policy-making committee said in its statement, issued at the end of its regular two-day meeting in Washington.

Asked what improvement in unemployment would satisfy the Fed, Mr. Bernanke said: "We are looking for ongoing, sustained improvement in the labor market. It is not a specific number we have in mind, but what we have seen the last six months, that isn't it."

The committee's statement said that the Fed now expected to hold short-term interest rates near zero at least through the middle of 2015, and that it would take other measures as necessary – including purchasing other kinds of assets. The projections of senior Fed officials showed, however, that almost all of them expect to start raising short-term rates before the end of 2015.

Eleven members of the committee voted for the action; Jeffrey Lacker, president of the Federal Reserve Bank of Richmond, dissented, as he as throughout the year.

The scale of the new effort is significantly smaller than the Fed's previous rounds of asset purchases. The Fed's most recent expansion of its portfolio added about $75 billion in securities each month. Its first round was even larger. It said Thursday that it would target a rate of about $40 billion a month during the current campaign, although unlike those earlier efforts, the volume is now subject to adjustment.

The Fed also said it would continue through the end of the year a program it announced in June to exchange short-term securities for longer-term securities, taking the total volume of purchases to roughly $85 billion a month.

The new purchases will be the first time in more than two years that the Fed has expanded its holdings of mortgage bonds. That decision reflects the Fed's view that the housing market still needs help, and that lower rates on mortgage loans could provide significant benefits for the broader economy.

The committee said in its statement that the new actions "should put downward pressure on longer-term interest rates, support mortgage markets and help to make broader financial conditions more accommodative."

The Fed had given unusually clear indications in recent weeks that it was ready to act. An account of its last meeting, published in mid-August, suggested action was imminent unless the economy showed "substantial and sustainable" improvement.

A few weeks later, Mr. Bernanke spoke of his "grave concern" about the high rate of unemployment and said that in his judgment, the likely benefits of additional action outweighed the potential costs. A number of longtime observers of the central bank said they could not recall a Fed chairman using stronger language.

Since then, the economy has shown little evidence of substantial improvement. The government estimated last week that employers added only 96,000 jobs in August, and other economic indicators have been similarly lackluster.

The political climate has complicated the Fed's efforts. Republicans including Mitt Romney, the party's presidential nominee, have argued against new action. Mr. Romney has promised to replace Mr. Bernanke, and Republicans are seeking to impose new limits on the Fed's management of monetary policy.

Fed officials insist that they do not consider politics in making their decisions, and history shows that the central bank often has acted during presidential campaigns – it has announced policy changes in September or October during 10 of the last 15 presidential election years, according to research by Credit Suisse.

Moreover, the political situation also has provided a motivation for the Fed to act. The nation's fiscal policy – including the tax increases and spending cuts scheduled to take effect next year – increasingly looms as the largest threat to growth, many experts say. Fed officials have said that it could tip the economy back into recession, and Mr. Bernanke has repeatedly urged Congress to dismantle this "fiscal cliff." Some Fed officials have argued that the central bank should seek to strengthen the economy as much as possible in the meantime to cushion the potential shock.

The Fed has struggled to define its role over the last three years. Its big and unprecedented actions helped to arrest the 2008 financial crisis, economists maintain. But as the economy has settled between crisis and prosperity, Fed officials have become divided over their ability and responsibility to do more.

Mr. Bernanke has presided over a gradual intensification of the central bank's stimulus campaign, but the central bank has repeatedly underestimated the depth of the nation's economic problems, and the unemployment rate has remained stubbornly high. The Fed has said its current policies will not reduce unemployment to normal levels for years to come.

There is broad disagreement among economists about the effects of the Fed’s expansion of its balance sheet. The Fed’s own research shows it may have raised economic output by 3 percent and created more than two million jobs. Most independent analyses have reached more modest conclusions, and some experts argue that there is little evidence of any meaningful economic impact.

Experts also disagree about the likely impact of additional purchases. Mr. Bernanke said last month in Jackson Hole, Wyo., that he was confident such a program would stimulate the economy. Significantly, he also said that he had concluded the likely benefits of such a program would outweigh the potential costs.

Many outside economists share Mr. Bernanke’s conclusion that the Fed retains considerable power to bolster the economy. However, some economists argue that the Fed has exhausted its power or that the costs now outweigh the benefits.