Fed ties rates to joblessness; 6.5% is target

By Binyamin Appelbaum
December 13, 2012 – *The New York Times*

The Federal Reserve made it plain on Wednesday that job creation had become its primary focus, announcing that it planned to continue suppressing interest rates so long as the unemployment rate remained above 6.5 percent.

It was the first time the nation's central bank had publicized such a specific economic objective, underscoring the depth of its concern about the persistence of what the Fed chairman, Ben S. Bernanke, called "a waste of human and economic potential."

To help reduce unemployment, the Fed said it would also continue monthly purchases of $85 billion in Treasury securities and mortgage-backed securities until job market conditions improved, extending a policy announced in September.

But the Fed released new economic projections showing that most of its senior officials did not expect to reach the goal of 6.5 percent unemployment until the end of 2015, raising questions of why it was not moving to expand its economic stimulus campaign.

At a news conference after a two-day meeting of the bank's top policy committee, Mr. Bernanke suggested that the Fed was approaching the limits of its ability to help the unemployed.

"If we could wave a magic wand and get unemployment down to 5 percent tomorrow, obviously we would do that," he said when asked if the Fed could do more. "But there are constraints in terms of the dynamics of the economy, in terms of the power of these tools and in terms that we do need to take into account other costs and risks that might be associated with a large expansion of our balance sheet," referring to the monthly purchases of securities.

The changes announced Wednesday continue a shift that began in September, when the Fed announced that it would buy mortgage bonds until the job market generally improved.

As it did in September, the Fed sought to make clear on Wednesday that it was not responding to new evidence of economic problems, but increasing its efforts to address existing problems that have restrained growth for more than three years.

In focusing on job creation, the Fed is breaking with its long history of treating the inflation rate as the primary focus of a central bank. But the Fed is charged by Congress with both controlling inflation and minimizing unemployment. And over the last year, a group of officials led by Charles L. Evans, president of the Federal Reserve Bank of Chicago, convinced their colleagues that the Fed was falling short on the unemployment front.

The unemployment rate in November was 7.7 percent — it has not been below 6.5 percent since September 2008 — and inflation is below the 2 percent annual rate that the Fed considers healthiest.

"Imagine that inflation was running at 5 percent against our inflation objective of 2 percent," Mr. Evans said in a September 2011 speech first describing the proposal. "Is there a doubt that any central banker worth their salt would be reacting strongly to fight this high inflation rate? No, there isn't any doubt. They would be acting as if their hair was on fire. We should be similarly energized about improving conditions in the labor market."

That argument was easier to win because inflation is under control, and the Fed expects the pace of price increases to remain at or below 2 percent through 2015. But in perhaps the clearest indication of the Fed's philosophical shift, the Federal Open Market Committee said Wednesday that it would not relent in its focus on unemployment unless the medium-term outlook for inflation rose above 2.5 percent.

The change was supported by 11 of the committee's 12 members. The only dissent came

from Jeffrey M. Lacker, president of the Federal Reserve Bank of Richmond, who has repeatedly called for the Fed to do less. He believes the policies are ineffective and could inhibit the central bank's ability to control inflation.

The Fed has held short-term interest rates near zero since December 2008, and it said in September that it intended to do so until at least mid-2015. The forecast was intended to reduce borrowing costs by persuading investors that interest rates would remain low for longer than they might have expected.

Mr. Bernanke said Wednesday that the shift to economic targets was not significant in the short term because the Fed still expected its goals to be reached no sooner than mid-2015. He said the bank chose 6.5 percent as its target because analyses showed that full-throttle stimulus beyond that level of unemployment could result in higher inflation.

Stock prices jumped after the Fed released its policy statement at midday, then began falling during Mr. Bernanke's news conference about two hours later as he insisted that the Fed was not significantly increasing its efforts to bolster the economy. The Standard & Poor's 500-stock index rose 0.04 percent on the day.

Some of Mr. Bernanke's colleagues, and some outside economists, argue that telling investors how the economic situation must change in order to warrant a shift in policy might be more convincing, and more potent, than publishing an estimated endpoint.

"The accommodation switch has been turned on," wrote Michael Gapen, senior United States economist at Barclays. He added that the new guidelines "could very well overcome some of the previous confusion surrounding date-based policy rate guidance."

The Fed's asset purchases are intended to reinforce the impact of its interest rate policies in a manner akin to removing seats from a game of musical chairs. Would-be investors in Treasuries and mortgage bonds are forced to compete for the remaining supply by accepting lower interest rates — that is, they are forced to pay up front a larger share of the money they are entitled to receive as the bond matures, lowering costs for borrowers.

The Fed announced in September that it would expand its holdings of mortgage-backed securities by about $40 billion a month. Those purchases joined the bank's earlier commitment to buy about $45 billion in Treasury securities each month through the end of December, which has now been extended indefinitely. But instead of financing the purchases by selling short-term Treasuries, the Fed will credit banks that sell the bonds with new reserves, essentially creating money, as it now does in purchasing mortgage bonds.

It decided not to increase the scale of purchases, however, in part because it did not want to undermine the private market by soaking up too much of the available supply — one of the constraints Mr. Bernanke referenced on Wednesday.

The forecasts published Wednesday show that Fed officials expect the economy to expand 2.3 percent to 3 percent in 2013, slightly below the September forecast of 2.5 percent to 3 percent. Fed officials have repeatedly overestimated the health of the economy and the pace of the recovery, and the latest changes, while relatively small, continue that pattern.

The forecasts remain optimistic in at least one respect: they assume that Congress and the White House will reach a deal to avert scheduled tax increases and spending cuts next year. If that does not happen, Fed officials agree that the impact of the bank's stimulus campaign will be trivial in comparison to the consequences, and the economy will most likely return to recession.