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Fed to Buy Extra $600 Billion of Treasuries to Boost Growth

By Scott Lanman - Nov 3, 2010

The Federal Reserve will buy an additional $600 billion of Treasuries through June, expanding record stimulus and risking its credibility in a bid to reduce unemployment and avert deflation.

Policy makers, setting a pace of about $75 billion of purchases a month, "will adjust the program as needed," the Fed's Open Market Committee said today in a statement in Washington. The central bank left unchanged its pledge to keep interest rates low for an "extended period" after Chairman Ben S. Bernanke said it could be modified in some way.

While Bernanke's near-zero rates and $1.7 trillion in asset purchases helped end the recession, the Fed said progress has been "disappointingly slow" in bringing down joblessness close to a 26-year high. The risk is that the move doesn't work or fuels inflation and asset bubbles, said Paul Ballew, a former Fed economist and a senior vice president at Nationwide Mutual Insurance Co. in Columbus, Ohio.

"The Fed has been dissatisfied with the pace of recovery," former Richmond Fed President J. Alfred Broaddus said. "The long-term mandate is to conduct monetary policy consistent with full employment and stable prices. We are a long way from that."

The FOMC kept its benchmark interest rate target for overnight interbank loans at zero to 0.25 percent, where it has been since December 2008. New York Fed President William Dudley, who serves as FOMC vice chairman, said Oct. 1 that purchases of $500 billion would be about equivalent to reducing the rate by 0.5 to 0.75 percentage point.

Boost Growth

Bernanke, in an opinion article for the Washington Post released late today, said the purchases should boost economic growth through lower borrowing costs and higher stock prices and that concerns about the strategy are "overstated."

"This approach eased financial conditions in the past and, so far, looks to be effective again," he said.

The Standard & Poor's 500 index rose 0.4 percent to 1,197.96 at the 4 p.m. close of trading in New York. The dollar weakened 0.7 percent against the euro to $1.4139 after touching a nine-month low of $1.4179.

Central bankers acted a day after Americans voted in midterm elections to hand control of the House to Republicans and slim down Democrats' Senate majority, intensifying political gridlock on fiscal issues and putting more of the burden for sustaining growth on the Fed. The FOMC's schedule of eight meetings in 2010 was announced in June 2009.

Asset Purchases

Fifty-three of 56 economists surveyed by Bloomberg News last week predicted the central bank would announce asset purchases today, with 29 forecasting a pledge to buy $500 billion or more.

"They did a little bit more -- that suggests they want to add an exclamation point to what they're doing," Broaddus said in a Bloomberg Television interview.

Including Treasury purchases from reinvesting proceeds of mortgage payments, the Fed will buy a total of $850 billion to $900 billion of securities through June, or about $110 billion per month, the New York Fed said in an accompanying statement.

The Treasury 30-year bond fell the most in almost two months after the New York Fed said in a separate statement that 86 percent of its purchases will target bonds coming due in 2 ½ to 10 years.

"Only a small fraction of the buying will be beyond the 10-year note," said Paul Zemsky, the New York-based head of asset allocation for ING Investment Management, which oversees $550 billion.

Temporarily Relaxed

Assets will have an average duration of five to six years, and the central bank temporarily relaxed a 35 percent per-issue limit on its securities holdings "to provide operational flexibility" and buy the "most attractive securities on a relative-value basis," the New York Fed said.

Central bankers in the world's largest economy are struggling to bring down a jobless rate that has persisted at 9.5 percent or higher for 14 months. U.S. payrolls have declined for four straight months as employees hired for the census were fired and state and local governments eliminated positions to balance budgets.

The Fed's preferred gauge for consumer prices, which excludes food and energy, rose 1.2 percent in September from a year earlier, the slowest pace since 2001. Fed policy makers have a long-run goal of 1.7 percent to 2 percent inflation they see as consistent with achieving

legislative mandates for maximum employment and stable prices.

Employment Growth Slow

"The pace of recovery in output and employment continues to be slow," the FOMC said. "Currently, the unemployment rate is elevated, and measures of underlying inflation are somewhat low, relative to levels that the committee judges to be consistent, over the longer run, with its dual mandate."

Bernanke, 56, a former Princeton University economist who studied the Great Depression, pressed forward with the move even after five of 18 policy makers went public with objections or doubts.

The one of the five who has a vote this year, Kansas City Fed President Thomas Hoenig, today cast his seventh straight dissent, the most at consecutive regular policy sessions since 1955. Hoenig was concerned that the "continued high level of monetary accommodation" may "destabilize the economy" by increasing long-term inflation expectations over time, the FOMC statement said.

U.S. real gross domestic product, which is adjusted for inflation, grew at a 2 percent annual pace in the third quarter, faster than the 1.7 percent rate between April and June yet still below what central bank officials believe is needed to reduce unemployment.

Economic Projections

Economists in a Bloomberg News survey last month forecast the unemployment rate will average 9.3 percent next year. Fed governors and regional presidents presented updated economic projections at this week's meeting and will publish them in minutes to be released Nov. 24.

Xerox Corp., the Norwalk, Connecticut-based printer and business-services provider, said Oct. 21 it would cut 2,500 jobs in the next 12 months. "I'm still cautious on the economy, particularly in the large enterprise portion of the economy," Xerox Chief Executive Officer Ursula Burns said on a conference call.

At Bentonville, Arkansas-based Wal-Mart Stores Inc., sales at U.S. locations open at least a year have declined for five consecutive quarters. Target Corp., based in Minneapolis, said last month that it would lower prices on more than 1,000 toys to attract shoppers.

'Bottom Line'

"The bottom line is that fundamental problems remain in the economy that monetary policy isn't going to fix," Ballew said. "Risks remain out there that overly aggressive monetary policy can cause unintended consequences."

Still, the economy has shown some signs of a pickup. Retail sales increased more than forecast in September, and manufacturing expanded in October at the fastest pace in five months.

Stocks have climbed and the dollar weakened in anticipation of further Fed easing. Since Bernanke said Aug. 27 the Fed "will do all that it can" to keep the recovery going, the Standard & Poor's 500 Index has gained 14 percent, and the dollar declined 8 percent against a basket of six currencies.

Bond traders' inflation expectations for the next five years, measured by the breakeven rate between nominal and inflation-indexed bonds, rose to 1.47 percent today from 1.44 percent yesterday and are up from 1.19 percent on Aug. 26.

Some Prices Gaining

Some measures of prices are gaining. Global food costs rose 26 percent in October from a year earlier, the fastest pace since 2008, according to the United Nations Food and Agriculture Organization. Gold futures traded in New York reached a record $1,388.10 an ounce on Oct. 14 and are up 23 percent this year.

The Fed's decision is the biggest in a marathon week of worldwide central bank meetings. Australia and India yesterday raised interest rates to cool inflation. Tomorrow, the Bank of England may leave the door open to more aid to the U.K. economy while the European Central Bank holds the line against price increases. The Bank of Japan on Nov. 5 may accelerate stimulus for its economy.

Bernanke's renewal of asset purchases completes a full U- turn this year. In February, the Fed raised the discount rate, charged on direct loans to commercial banks, to 0.75 percent from 0.50 percent. In March, it ended purchases of mortgage- backed debt begun during the financial crisis. Bernanke testified before Congress in March and July on how the Fed would pare back record stimulus.

Recovery Slowing

Then, with the recovery slowing, the Fed in August decided to halt the shrinking of its balance sheet by reinvesting maturing mortgages into new Treasuries, setting a $2 trillion floor on asset holdings. The next month, the Fed said it was prepared to ease policy if needed and said for the first time that too-low inflation, in addition to sluggish growth, would warrant taking action.

Bernanke and other Fed policy makers have since signaled the likelihood of printing money to start a new round of securities buying. "There would appear -- all else being equal -- to be a case for further action," Bernanke said Oct. 15 at a Boston Fed conference. "The risk of deflation is higher than desirable."

At the same time, "nonconventional policies have costs and limitations that must be taken into account in judging whether and how aggressively they should be used," he said. One risk is that the public becomes less confident in the Fed's ability to pare back stimulus and expects inflation above the central bank's desired level, a concern Bernanke said would be "unjustified."

Not Sure of Impact

Not all Fed officials are so sure of the impact. Philadelphia Fed President Charles Plosser said Sept. 29 that he doesn't see how additional asset purchases will help employment in the near term, and Narayana Kocherlakota of Minneapolis has said a new round would probably have a "more muted effect" than prior purchases.

St. Louis Fed President James Bullard in July warned of a rising risk of Japanese-style deflation in the U.S. and called for purchases of Treasuries as a response to any negative shock. Japan's economy has stagnated since the bursting of a stock- market and real-estate bubble in the early 1990s.

Consumer prices in Japan have fallen for seven of the past 10 years, and gross domestic product, unadjusted for changes in prices, was the smallest since 1991 last year. The country was overtaken by China as the world's No. 2 economy in the second quarter.

Quantitative Easing

The Bank of Japan started quantitative easing in 2001, pumping trillions of yen into the economy over five years through injecting funds into bank reserves. The funds sat static at commercial lenders' accounts at the central bank and failed to spark business investment and consumption.

The Fed purchases announced today will add to the $981 billion of excess deposits that banks held at the central bank as of Oct. 20. Plosser said Oct. 22 that the funds are failing to spur growth now and are "kindling" for money creation and inflation in the future.

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