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Fed Views Recession as Near an End

By EDMUND L. ANDREWS

WASHINGTON — Almost exactly two years after it embarked on what was the biggest financial rescue in American history, the Federal Reserve said on Wednesday that the recession is ending and that it would take a step back toward normal policy.

Though the central bank stopped well short of declaring victory, policy makers issued their most upbeat assessment in more than a year by saying that the downturn appears to have hit bottom and that consumer spending, financial markets and inventory-building by corporations all continued to stabilize.

“Economic activity is leveling out,” the Fed’s policy-making committee said Wednesday after a two-day meeting, adding that inflation would remain “subdued for some time.”

The central bank cautioned that the recovery would be slow and that unemployment was likely to remain high for the next year. It reiterated that it would keep its benchmark short-term interest rate at virtually zero for an extended period.

But it also announced that it would wrap up its program to buy $300 billion worth of Treasury bonds by the end of October. The program was one of several tools invoked to drive down long-term interest rates and indirectly reduce the cost of home mortgages and corporate borrowing.

The move signaled that policy makers were confident enough to remove one of their emergency props for the financial markets.

“In a way, it’s more of a thumbs-up than if they had said they were continuing the Treasury-buying,” said Edward McKelvey, an economist at Goldman Sachs. “They’re saying that things are going according to plan,

and that the policy is O.K."

Stock prices, which were already up from Tuesday, ticked up again after the Fed announcement. The Dow Jones industrial average ended the day up 120.16 points, or 1.30 percent, at 9,361.61.

Fed officials made it clear they were still more worried about unemployment than a resurgence of inflation. As they have said for months, they will use "all available tools" to support the economy and will keep the benchmark federal funds rate at "exceptionally low levels" for the foreseeable future. Many analysts predict that the Fed will not raise the federal funds rate, which is the overnight rate at which banks lend reserves to each other, until late next year.

The latest assessment comes two years after the Fed, in August 2007, began the first of its emergency lending programs to banks when credit markets seized up in response to the crisis in the subprime lending market.

The central bank is not yet throttling back its biggest emergency credit programs. The Fed is barely halfway through its plan to buy $1.25 trillion in mortgage-backed securities, a program that directly affects home mortgage rates and has had a much more noticeable effect than the Treasury bond program.

Analysts said the Federal Reserve had entered a wait-and-see period, continuing to supply the economy with cheap money but not expanding or extending the emergency programs beyond what policy makers have already announced.

The government's preliminary estimates show that the economy's downturn slowed markedly in recent months, shrinking only 1 percent in the second quarter compared with 6.4 percent in the first. The rate of job losses has slowed sharply as well, though the nation still lost 247,000 jobs in July.

The most recent forecasts by Fed policy makers say that the economy will begin an unusually slow recovery in the second half of this year and pick up speed only gradually in 2010. Even if all goes according to plan, the Fed envisions that unemployment will climb from its already high level of 9.4 percent and average as much as 9.8 percent through the end of 2010.

Rising productivity rates in the United States are giving the Fed more maneuvering room to keep borrowing

costs low without aggravating inflation. The productivity of workers, the amount produced per hour of work, shot up at an annual rate of more than 6 percent in the second quarter and has been climbing throughout the recession.

That is unusual for an economic downturn, but it means that wages have more room to climb before employers start to raise prices for their goods and services.

The Fed's decision to end its program of buying Treasury bonds appears to have reflected both practical and philosophical concerns among some policy makers.

According to minutes of the Fed's previous policy meeting in June, some policy makers worried that the central bank's heavy purchases of new Treasury debt would be seen by investors as simply financing the federal government's huge deficits. That, they feared, would erode the Fed's credibility and heighten inflation expectations.

"Some of those who are less disposed to additional Treasury purchases worry about the perception in the markets that they are motivated by a desire to help the Treasury finance a mountain of debt," wrote Laurence H. Meyer, chief economist at Macroeconomic Advisers, and a former Fed governor, in a note to clients last week.

By contrast, Mr. Meyer said, most policy makers seem to agree that the mortgage-security program strikes at the heart of the economy's biggest problem — the housing market.

On a practical level, analysts said, the Treasury-buying program never packed as much punch in the markets.

At $300 billion, the Treasury purchases are only one-quarter as big as the mortgage program, and they have equaled only about one-third of the new issuance of Treasury securities, according to Ira Jersey, an interest-rate analyst at Royal Bank of Canada Capital Markets. By contrast, the Fed purchases of government-guaranteed mortgage securities equaled more than 100 percent of new issuance in that market.

Though mortgage rates have edged up in recent weeks, along with other long-term interest rates, the spread between mortgage rates and risk-free Treasury rates has narrowed by almost half since last November.

“The program to buy Treasuries wasn’t as effective as some of the other programs, like the mortgage-security program, so ending it made sense,” Mr. Jersey said.

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