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News Analysis

Working Without a Standard Playbook, the Fed Plans Its Moves on Rates

By [SEWELL CHAN](#)

WASHINGTON — In raising the interest rate it charges banks for short-term loans, the [Federal Reserve](#) set the stage on Thursday for the day when the recovering economy will lead it to begin a broader campaign to tighten monetary policy.

The question now is how long it will be until that day arrives.

The Fed and its chairman, [Ben S. Bernanke](#), face a complex set of forces as they decide how and when to reverse the aggressive steps they took to contain the [financial crisis](#) and the ensuing damage to the economy.

With the financial system awash in money and economic growth picking up, inflationary forces are possible. But with unemployment hovering near double digits, with Mr. Bernanke under attack for his performance in the runup to the crisis and with Congress moving to pare back the central bank's powers, economic and political pressures are weighing against rapid interest rate increases.

How Mr. Bernanke manages the pivot to tighter policy will test his skills nearly as much as the near collapse of the banking system and the worst [recession](#) in generations.

Managing expectations, said Karen E. Dynan, who was a longtime Fed economist and is now co-director of economic studies at the [Brookings Institution](#), is one of the Fed's greatest challenges.

"No one knows what's going to happen as they start to withdraw this unconventional monetary policy," she said. "These linkages are not understood. It's critical right now for the Fed to be laying out its logic and persuading markets that its logic makes sense."

Given that unemployment is nearly 10 percent, she said, it is unusual that inflation expectations have not declined. Economic forecasters expect a core measure of inflation to average 2.39 percent a year from 2010 to 2019, an increase from 2.26 percent when the survey was last conducted, according to a quarterly survey of forecasters released last week by the Federal Reserve Bank of Philadelphia.

“People are worried about the size of the balance sheet,” Ms. Dynan said. “They’re worried that there’s a tipping point whereby the Fed’s balance sheet gets so large that it triggers inflation.”

Matthew J. Slaughter, an economist in the Tuck School of Business at Dartmouth, said that any number of narratives seemed plausible. “You can reasonably tell stories about high inflation emerging in the next few years — or persistently high unemployment,” he said. “It would be great to have strong economic recovery and modest inflation.”

Just as Mr. Bernanke had to improvise to create emergency programs to address the liquidity crisis threatening the capital markets, so too will he have to be nimble in unwinding them.

The termination of four emergency lending programs on Feb. 1, and the quarter percentage point increase in the discount rate the Fed charges banks, mean that the Fed is reducing the liquidity it opened in 2008 when credit markets froze.

But with considerable slack in the economy, the Fed says the benchmark interest rate it controls — the one that most influences rates paid by consumers and businesses — will stay near zero “for an extended period” of at least several months.

“It’s hard to see inflation picking up anytime soon, so there is time for the Fed to normalize,” said Kristin J. Forbes, an economist at the [M.I.T. Sloan School of Management](#).

After Mr. Bernanke presents his semiannual monetary policy report to Congress next week, the central bank will be looking ahead to March 31, its self-imposed deadline for ending its purchases of \$1.25 trillion of mortgage-backed securities and another \$175 billion in debts guaranteed by federally controlled housing entities like [Fannie Mae](#) and [Freddie Mac](#).

“The discount rate, from the Fed’s point of view, is not the punctuation point,” said Bruce C. Kasman, chief economist at [JPMorgan Chase](#). “The bigger event, in terms of market reaction and consequences, is the end of the mortgage purchases.”

Economists call those asset purchases, along with the Fed’s holding of interest rates near zero, [quantitative easing](#). It is one of the most extreme forms of monetary policy, and although the Fed has now outlined an exit strategy, there is no precedent to examine.

“There’s no playbook for this,” Mr. Slaughter said. “The Fed and other central banks — including the [European Central Bank](#), the [Bank of England](#), and the [Bank of Japan](#), though it has dealt with quantitative easing longer — have to figure out how to shrink their balance sheets and return to more traditional central banking.”

The Fed’s balance sheet reveals the depth of the challenge. As of Wednesday, the balance sheet stood at \$2.2 trillion. The assets included \$1.03 trillion in mortgage-backed securities and \$165.6 billion in debts guaranteed by housing entities. The Fed’s asset purchases have helped to cradle the housing market and keep mortgage interest rates down.

Short-term [Treasury bills](#), historically a mainstay of the balance sheet, now make up just a tiny fraction of the picture.

On the liabilities side, banks hold \$1.2 trillion in reserves at the Fed. When the time comes to tighten credit, Mr. Bernanke has indicated, the Fed will start with the interest rate on excess reserves — a policy tool Congress gave the Fed in October 2008.

Raising that rate would discourage banks from pulling out their reserves and increasing the money supply too quickly. It would also have the effect of lifting the benchmark Fed funds rate, the rate at which banks lend to each other overnight.

Compared with the enormous challenge posed by the balance sheet, the decision to raise the discount rate on loans made directly to banks, to three-quarters of a percentage point from half a percentage point, which was effective Friday, might seem insignificant. As of Wednesday there were \$14.2 billion in discount-window loans

on the balance sheet, down from a peak of \$110.7 billion in October 2008.

But even though the Fed had indicated that the discount-rate increase was coming, the timing took many by surprise. Mark W. Olson, a financial regulatory consultant and a former Fed governor, called it “eye-catching.”

“From inside the Fed, it may have been seen largely as technical, but outside the Fed, it is seen as more than that,” Mr. Olson said.

The apparent divide between those who were taken aback by the timing of the increase and those who were not “probably means that he found a decent balance,” Ms. Forbes said.

“If you perfectly telegraph when you’re going to do it, you might as well do it that day, since so much of interest rate and monetary policy is about expectations,” she said. “It doesn’t matter so much what it is, versus what was expected.”

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