The Journal Gazette
FORT WAYNE, INDIANA • LOCALLY OWNED SINCE 1863

Fed chief doubt erodes message

Bond purchases, interest rates being weighed

Craig Torres and Caroline Salas Gage – September 17, 2013

WASHINGTON – Federal Reserve officials will gather in their Washington board room this week to decide on policies that will unfold over the next two to three years without knowing who will lead the institution during that time.

Sunday's announcement that Lawrence Summers has withdrawn his name from Obama's list of candidates to succeed Fed Chairman Ben S. Bernanke threatens to weaken the central bank's policy message by leaving the succession unsettled just as it considers scaling back record accommodation.

Policymakers will decide today and Wednesday whether the economy is strong enough to begin tapering $85 billion in monthly bond purchases. As they do, they will use so-called forward guidance to convince investors they can keep interest rates low for as long as it takes to bring down unemployment so long as prices remain in check.

"The biggest problem with this period of indecision about Bernanke's successor is that it does have an effect on the Fed's ability to conduct monetary policy," said Ward McCarthy, chief financial economist at Jefferies in New York and a former Richmond Fed economist. "The market rightfully questions forward guidance, and that reduces the effectiveness of monetary policy."

At this week's meeting, officials will probably lower their estimates for growth for this year and next for the third consecutive time. To keep bond yields from rising and threatening growth, officials will need to emphasize their message that the benchmark interest rate is likely to remain low.

Ten-year Treasury yields have jumped almost 1 percentage point since May 21, the day before Bernanke said the central bank could "take a step down in our pace of purchases," in the "next few meetings."

The rise in yields in turn has pushed up interest rates on home loans, threatening to sap a housing revival that has helped drive the economic expansion.

In July, Obama mentioned three possible nominees for the chairmanship: Summers, 58, Fed Vice Chairman Janet Yellen, 67, and Donald Kohn, 70, a former Fed vice chairman who is now a senior fellow at the Brookings Institution.

With Summers out of the picture, investors are betting that Yellen is now the top contender for the job, according to Brian Jacobsen, chief portfolio strategist at Wells Fargo Advantage Funds in Menomonee Falls, Wis.

Summers, who served as Treasury Secretary under President Bill Clinton and was Obama’s top economic adviser in his first term, would have tightened Fed policy more than Yellen, according to a Bloomberg Global Poll last week.

“Markets were priced for the likelihood of a Summers nomination, primarily for the notion that he might raise interest rates sooner than perhaps other candidates, including Janet Yellen,” Tony Crescenzi, a portfolio manager and strategist at Newport Beach, Calif.-based Pacific Investment Management Co., which manages the world’s biggest bond fund, said in an email.

Yellen isn’t necessarily the “de facto nominee,” said Mark Calabria, a former top aide on the Senate Banking Committee and now director of financial regulation studies at the Cato Institute in Washington.

Twenty senators, including 19 Democrats and one independent, signed a letter of support for Yellen in July. If nominated and confirmed, she’d be the first woman to be chairman of the Fed.

More than four years after the recession ended, unemployment stood at 7.3 percent in August, and the annual inflation rate has been at least a half percentage point below the Fed’s 2 percent target since December.

Policymakers have pledged they won’t consider raising the federal funds rate, now near zero, as long as unemployment is 6.5 percent or higher. In July, they discussed lowering that unemployment rate threshold even more before any decision on raising borrowing costs, according to minutes of the meeting.

The Fed’s balance sheet has exploded to a record $3.66 trillion as it has bought up hundreds of billions of mortgage-backed securities and U.S. Treasury bonds to try and keep long-term interest rates low.

Policymakers, including Kansas City Fed President Esther George, are concerned the Fed risks creating asset-price bubbles and unmooring inflation expectations.

In June, 15 of 19 Fed officials said it would be appropriate to keep the benchmark lending rate near zero until 2015 or later.