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Fed Gets Aggressive After Months of Holding Back

By DAVID LEONHARDT

For much of the last year, there were three basic camps on what the Federal Reserve should be doing.

One focused on the risks of the Fed’s taking more action to help the economy. This camp — known as the hawks, because of their vigilance against inflation — worried that the Fed could be sowing the seeds of future inflation and that any further action might cause global investors to panic.

Another camp — the doves — argued instead that the Fed had not done enough: inflation remained near zero, and unemployment near a 30-year high.

In the middle were Ben Bernanke and other top Fed officials, who struggled to make up their minds about who was correct. For months, they came down closer to the hawks and did little to help the economy. On Wednesday, they effectively acknowledged that they had made the wrong choice.

The risks of inaction have turned out to be the real problem.

The recovery has not been as strong as the Fed forecast. Businesses became more cautious about hiring after the European debt crisis in the spring. State governments began cutting workers around the same time, and the flow of federal stimulus money began to slow. Since May, the economy has lost 400,000 jobs.

Now — six months later, with Congress unlikely to spend more — the Fed is getting more aggressive. (And, yes, the idea that the doves are the advocates for aggression is indeed a bit odd.) Having long ago reduced its benchmark short-term interest rate to zero, the Fed will again begin buying bonds, as it did last year, to reduce long-term interest rates, like those on mortgages. Lower rates typically lead to more borrowing and spending by households and businesses.

Of course, the risks of taking action have not gone away. The new policy could eventually cause inflation to spike. All else equal, a policy that encourages more spending will cause prices to rise. And if investors begin to think that a dollar tomorrow will be worth much less than one today, they may refuse to lend money at low interest rates, undercutting the whole point of the bond purchases. Separately, the Fed, like any bond buyer, could end up losing money on the purchases, worsening the federal budget deficit.

What's striking about the last six months, however, is how much more accurate the doves' diagnosis of the economy has looked than the hawks'.

Early this year, for example, Thomas Hoenig, president of the Kansas City Fed and probably the most prominent hawk, gave a speech in Washington warning about the risks of an overheated economy and inflation. Mr. Hoenig suggested that the kind of severe inflation that the United States experienced in the 1970s or even that Germany did in the 1920s was a real possibility.

When he gave the speech, annual inflation was 2.7 percent. Today, it's 1.1 percent.

The doves, on the other hand, pointed out that recoveries from financial crises tended to be weak because consumers and businesses were slow to resume spending. Around the world over the last century, the typical crisis caused the jobless rate to rise for almost five years, according to research by the economists Carmen Reinhart and Kenneth Rogoff. By that timetable, the unemployment rate would rise for a year and a half more.

Perhaps the clearest case for more action came from within the Fed itself. In June, an economist at the San Francisco Fed published a report analyzing how aggressive monetary policy should be, based on past policy and on the current levels of unemployment and inflation.

As a benchmark, it looked at the Fed's effective interest rate, taking into account the actual short-term rate as well as any bond purchases to reduce long-term rates. Because the short-term rate was zero and the Fed bought bonds in 2009, the report judged the effective interest rate to be below zero — about negative 2 percent.

And what *should* the effective rate have been, based on the economy's condition? Negative 5 percent, the analysis concluded. In other words, the Fed wasn't buying enough bonds.

All the while, global investors have continued to show no signs of panicking. If anything, as the economy weakened over the summer, investors became more willing to lend money to the United States, viewing its economy as a safer bet than most others.

After the Fed's announcement on Wednesday, many of the hawks who warned about inflation earlier this year repeated those warnings anew. The Cato Institute, citing a former vice president of the Dallas Fed, said the new program would "sink" the economy. Mr. Hoenig provided the lone vote inside the Fed against the bond purchases.

It's always possible that the critics are correct and that, this time, inflation really is just around the corner. But there is still no good evidence of it. The better question may be whether the Fed is still behind the curve.

Some economists are optimistic that it has finally found the right balance. Manoj Pradhan, a global economist at Morgan Stanley, pointed out that bond purchase programs lifted growth in Europe and the United States last year — and a broadly similar approach also helped end the Great Depression. "There are no guarantees," Mr. Pradhan said, "but the historical precedents certainly suggest it will work."

Others, though, wonder if the program is both too late and too little. "I'm a little disappointed," said Joseph Gagnon, a former Fed economist who has strongly argued for more action. The announced pace of bond purchases appears somewhat slower than Fed officials had recently been signaling, Mr. Gagnon added, which may explain why interest rates on 30-year bonds actually rose after the Fed announcement.

One thing seems undeniable: the Fed's task is harder than it would have been six months ago. Businesses and consumers may now wonder if any new signs of recovery are another false dawn. And although Mr. Bernanke quietly credits the stimulus program last year with being a big help, more stimulus spending seems very unlikely now.

Unfortunately, in monetary policy, as in many other things, there are no do-overs.

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