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meltdown
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NEWS

WRAPUP 1-Fed may boost rates while economy still weak -Kohn

Wed Sep 30, 2009 3:47pm EDT

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By **Mark Felsenthal**

WASHINGTON, Sept 30 (Reuters) - The Federal Reserve may need to begin to pull back its extensive support for the weak U.S. economy before it has healed enough to substantially lower the jobless rate and get factories working again, Fed Vice Chairman Donald Kohn said on Wednesday.

"Tightening (monetary policy) while there's still slack in the economy is something that we have to do every time," he told a monetary policy conference at the Cato Institute.

Kohn said the Fed -- the U.S. central bank -- would base its actions on its forecast for the path of the economy, and would not wait for clear evidence the recovery has taken hold:

"It's incumbent upon us to ... be forward-looking in our story. Yes, there's slack, but it's going away. Yes, people are still unemployed, but people are being put

back to work. And the alternative of not tightening and not beginning this process is to create a destabilizing round of inflation. ... If we can't tell that story we shouldn't be tightening."

EXIT BEFORE WARNING SIGNS

The Fed has begun to move gradually toward removing its extensive support for the economy during a devastating financial crisis. At its latest policy-setting meeting, it said it would phase out by March a program to buy mortgage-backed securities that had been aimed at bolstering housing markets.

Most analysts do not expect the Fed to begin to raise benchmark interbank lending rates from near zero until the middle of next year but analysts are watching what it plans to do shrink a balance sheet that has ballooned to over \$2.3 trillion as a result of aggressive actions to stem the crisis.

Kohn said that while the recovery will likely be sluggish, the Fed would act before warning lights flash on spending or inflation.

"We must begin to withdraw (monetary policy) accommodation well before aggregate spending threatens to press against potential supply, and well before inflation as well as inflation expectations rise above levels consistent with price stability," he said.

Kohn and another senior Fed official cautioned that the recovery remains fragile.

Atlanta Fed President Dennis Lockhart said he wants to see more evidence that the private sector can thrive without government support before kicking away the crutches.

"I do not think that time has yet come, and ... I think it may well be some time before a comprehensive exit need be under way," Lockhart told the University of South Alabama's economic forum in Mobile, Alabama.

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