ECONOMY

Fed Closes Chapter on Easy Money

Benefit of Bond-Buying Experiment Remains Unclear as Central Bank’s Focus Returns to Interest Rates

WSJ’s Jon Hilsenrath and Emma Moody and Meg McClellan of J.P. Morgan discuss the Federal Reserve’s rate decision, including the end of the Fed’s bond-buying program. Photo: Getty.

By JON HILSENRATH

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The Federal Reserve said it would end its long-running bond-purchase program, concluding a historic experiment that stirred disagreement among policy makers, economists and investors about its impact even though the central bank said it helped accomplish its goal of reducing unemployment.

The move and the Fed’s accompanying assessment of current conditions were a vote of confidence in the U.S. economy, which many economists peg to have grown at an annual pace near 3% or more in the third quarter. That’s a much better performance than in Japan or Europe and a hopeful sign for the world economy when growth in China appears to be flagging.

“There has been a substantial improvement in the outlook for the labor market since the inception of [the] current asset-purchase program,” the Fed said in its policy statement, released Wednesday after a two-day policy meeting. “Moreover, the [Fed] continues to see sufficient underlying strength in the broader economy to support ongoing progress toward maximum employment in a context of price stability.”

The program ends with mixed reviews. While it clearly didn’t cause the inflation
outbreak some predicted, it also didn’t clearly lead to a surge of economic output or hiring.

If all goes as they expect, officials will now turn their attention in the months ahead to discussions about when to start raising interest rates and how to signal those moves to the public before they happen. For now the central bank stuck to an assurance that it will keep short-term interest rates near zero for a “considerable time.” Many investors and Fed officials expect no rate increases until the middle of next year.

Plenty could go wrong and drive the Fed to tear up its plans. Twice before officials declared they would stop printing new money to buy bonds, only to restart the process when growth, hiring and inflation appeared to sag. One official, Minneapolis Fed President Narayana Kocherlakota, dissented from the Fed statement Wednesday because he wanted to keep the bond program going.

Underscoring its own uncertainty, the Fed’s official rate assurance included a new qualifier about the economic outlook: If the job market improves more quickly than expected or inflation rises, rate hikes could come sooner, and it could wait longer if the job market or inflation slow.

The inflation and employment backdrop now is subtly pulling the central bank in two directions. Officials noted “solid job gains” and said labor-market slack is “gradually diminishing,” signs of economic vigor that might spur early rate increases. Since July the Fed had been saying it saw “significant” slack, a phrase it struck this time around.

But Fed officials also noted falling energy prices and downward pressure on market expectations of inflation, signs of low inflation that give them leeway to wait before raising rates. Inflation has been running below the Fed’s 2% target for more than two years.

The moves left investors weighing the prospect of less support to markets by the central bank. But they showed little immediate alarm about the end of the program. The Dow Jones Industrial Average finished the day down 31.44 points, or 0.18%, to 16974.31. Yields on 10-year Treasury notes rose 0.041 percentage point to 2.325%.

While Fed officials consider their next steps, economists and market participants are writing postmortems on whether the bond program worked.

Debate of late has gotten heated. In exchanges online earlier this month, Paul
Krugman, a Nobel Prize-winning economist and columnist, accused critics of the bond program of whining and being unreasonable and unwilling to admit mistakes assessing its risks. Cliff Asness, a hedge-fund manager and one of those critics, likened Mr. Krugman to a skunk. Mr. Krugman shot back that Mr. Asness was accusing him of “being a big meanie.”

The bond-buying program, known as quantitative easing, is controversial in part because it involves many unknowns. In normal times, the Fed tries to modulate the swings of economic upturns and downturns by raising or lowering short-term interest rates. When it pushed rates to near zero in December 2008, officials were left scrambling to find other ways to stimulate financial markets and economic activity in response to the downturn and they’ve leaned heavily on bond purchases.

The Fed—seeking to lower interest rates and push investors into risky assets, and in turn spur borrowing, spending, investment, growth and hiring—launched the latest round of bond purchases in September 2012, when it said it would buy $40 billion a month of mortgage bonds and keep going until it saw substantial improvement in the job market. It expanded the purchases in December 2012 by saying it would also buy $45 billion a month in Treasury bonds, for a total of $85 billion monthly. It has been phasing out the program gradually since January.

WSJ’s Simon Constable, Emma Moody, and J.P. Morgan’s Meg McClellan discuss the Fed’s decision to wind down its bond-buying and when interest rates are likely to rise. Photo: Getty.

The program was pioneered by former Fed Chairman Ben Bernanke. He started pulling it back early this year and his successor, Janet Yellen, has followed through on his plan to end it.

The central bank’s holdings of securities, loans and other assets have increased from
$2.825 trillion when the program started to $4.482 trillion. The Fed has said it plans to maintain this level of holdings until after it starts raising short-term interest rates. Eventually, officials expect to reduce the holdings gradually by letting securities mature without reinvesting the proceeds.

Critics of the Fed for years have argued the strategy risked stoking inflation, devaluation of the dollar and market distortions.

The worst fears about bond buying haven’t come to pass. Inflation, as measured by the Commerce Department’s personal consumption expenditure price index, has been unchanged at 1.5% since September 2012. The dollar, as measured by the Fed’s broad dollar index, is up 6.7% in value compared to the world’s other currencies. Meantime, the price of gold, which some investors believe should rise when inflation fears pick up, has fallen from $1730.60 per ounce to $1229.20, a 29% decline.

“I guess I was wrong thinking that we would recover faster than we did,” Peter Wallison, co-director of the American Enterprise Institute’s financial studies program, said in an interview.

Mr. Wallison was one of several prominent scholars, along with Mr. Asness and other market participants, who wrote an open letter to Mr. Bernanke in 2010 warning him that he risked causing inflation and debasing the currency with an earlier bond-buying program. Mr. Wallison said new financial regulation, caused by the Dodd-Frank law, had choked off credit and prevented the inflation he feared back then.

Yet clear demonstrations of QE’s benefits are elusive. Though the jobless rate has declined from 8.1% before the latest program was launched to 5.9% in September, this is in part due to people leaving the work force and the ranks of those counted as unemployed. Job growth was 2.2 million in the 12 months before the Fed launched the latest round of bond buying and 2.6 million in the past 12 months, but it is hard to prove the faster growth has come even indirectly from the Fed’s efforts.

“It is a mistake to think that the Fed was a major driver of either bond prices, stock prices or the economy over the last four years,” said James Hamilton, a professor at the University of California at San Diego, who has studied the effects of bond purchases. “There has been some exaggeration of what this meant, both from the doomsayers as well as some of the Fed’s defenders.”

While the Fed is backing away from bond purchases, other central banks are embracing them. The Bank of Japan last year ramped up an asset-purchase campaign that goes beyond bonds and into stocks and real estate investment trusts...
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and vowed to keep at it until inflation rises to 2%. Meantime, the European Central Bank has started buying financial assets and its president, Mario Draghi, has said the ECB would expand the effort if needed to fight deflation.

Fed officials say they are prepared to use bond buying again, but disagree about the circumstances that would warrant it. In addition to Mr. Kocherlakota, who called for continuing bond purchases at the latest meeting, St. Louis Fed President James Bullard said before the Fed meeting the central bank should consider continuing the purchases in light of falling inflation expectations.

John Williams, the San Francisco Fed president, said he would have no reservations about returning to bond purchases, but only if the economy is clearly taking a turn for the worse. For now, he and most other officials don’t think it will be needed.

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