Chairman Ben S. Bernanke moved the Federal Reserve further into uncharted policy territory in combating joblessness by tying the bank's interest-rate outlook to unemployment and inflation, while committing to an even faster expansion of the central bank's balance sheet.

The actions on the eve of the Fed's centenary year underscore Bernanke's hallmark commitment to experimentation and forceful action, derived in part from his research showing too little monetary stimulus produced large economic costs for the U.S. in the 1930s and for Japan in the 1990s. He called the current state of the labor market, with unemployment at 7.7 percent, "an enormous waste of human and economic potential" and said the benefits of more bond buying outweigh the potential risks.

"Bernanke is pulling out all the stops to kick this economy back into a higher gear," said Chris Rupkey, chief financial economist at Bank of Tokyo-Mitsubishi UFJ Ltd. in New York. "They are buying everything in sight -- Treasuries, mortgage-backed securities -- and will keep rates low until everyone who wants a job has one.

Bonds fell yesterday on the prospect of higher inflation after policy makers boosted their main stimulus tool by adding $45 billion of monthly Treasury purchases to an existing program to buy $40 billion in mortgage debt a month. That decision puts the Fed's $2.86 trillion balance sheet on track to reach almost $4 trillion by the end of next year.

Rate Outlook

Central bankers for the first time linked their interest-rate outlook to economic thresholds, saying rates will stay low "at least as long" as unemployment remains above 6.5 percent and if the Fed projects inflation of no more than 2.5 percent one or two years in the future. Fed officials don't see joblessness falling near that goal until 2015.

The adoption of thresholds was urged in September 2011 by Charles Evans, president of the Chicago Fed, who said the central bank should "add very significant amounts of policy accommodation" to bring down unemployment, even at the risk of a temporary increase in inflation.

A year later, the idea was backed by President Narayana Kocherlakota of Minneapolis, who had earlier criticized the Fed's easing policies. Fed Vice Chairman Janet Yellen and the Boston Fed's Eric Rosengren last month backed the concept. In a Nov. 27 speech, Evans spelled out the numerical benchmarks that were adopted yesterday.

"The Fed is all in," said Diane Swonk, chief economist for Mesirow Financial Holdings Inc. in Chicago. "They are absolutely committed to averting the mistakes of the Japanese and of the Great Depression. They will not stop too soon. He is willing to take the risk of unintended consequences."

Budget Talks

U.S. stocks erased gains as optimism about the Fed's additional asset purchases faded and investors focused on the budget deadlock in Washington. The Standard & Poor's 500 Index closed up less than 0.1 percent at 1,428.48 in New York, after earlier climbing as much as 0.8 percent.

The additional Treasury purchases will follow the expiration at the end of this year of Operation Twist, in which the central bank each month has swapped about $45 billion of short-term Treasuries for an equal amount of long-term debt.

Bernanke, who lowered the benchmark interest rate almost to zero four years ago, yesterday said the Fed's "ability to provide additional accommodation is not unlimited," which is "an argument for being a little bit more aggressive now."

When he was a Princeton University professor, Bernanke presented a paper in January 2000 with the title "Japanese
Monetary Policy: A Case of Self-Induced Paralysis?" In it, he criticized monetary authorities’ unwillingness to experiment, “to try anything that isn’t absolutely guaranteed to work.”

'Rooseveltian Resolve'

In slumps, policy makers need “Rooseveltian resolve,” he wrote, which he described as a “willingness to be aggressive and to experiment -- in short, to do whatever was necessary to get the country moving again.”

Bernanke, who turns 59 today, shunned orthodoxy as the global credit crisis unfolded, giving out more than $2 trillion in emergency aid through six loan programs, currency swaps with other central banks and the rescues of Bear Stearns Cos. and American International Group Inc. (AIG)

The Fed has more than tripled the size of its balance sheet with three rounds of large-scale asset purchases intended to bring down long-term borrowing costs and stimulate purchases of homes and cars. Bernanke broke new ground with the latest round of so-called quantitative easing by setting no limit on the size or duration of the program.

The economic parameters for policy tightening replaced the Fed’s previous calendar-based guidance that rates would stay “exceptionally low” at least through the middle of 2015.

'Paradigm Changing'

"From a communications perspective, it is absolutely paradigm changing,” said Carl Tannenbaum, chief economist at Northern Trust Corp. in Chicago, where he worked at the central bank until July this year. “The Fed has put itself very squarely in the search for better economic growth.”

FOMC participants yesterday lowered their forecasts for growth next year. They now see the economy expanding 2.3 percent to 3 percent, compared with 2.5 percent to 3 percent in September. The average pace of growth for the decade through 2007 was 3 percent.

“A return to broad-based prosperity will require sustained improvement in the job market, which in turn requires stronger economic growth,” Bernanke said yesterday.

More than three years into the recovery, the 7.7 percent jobless rate remains higher than Fed officials' estimates for full employment, which range from 5.2 percent to 6 percent. Employers added 146,000 workers to payrolls in November, less than the monthly average of 151,000 this year and the 153,000 in 2011.

Some Tolerance

The search for stronger growth comes with an indication of some tolerance for inflation to exceed the Fed’s 2 percent goal after year-over-year readings have come in below that level past seven months through October.

Inflation expectations climbed after the Fed’s announcement. The break-even rate for five-year Treasury Inflation Protected Securities -- a yield differential between the inflation-linked debt and Treasuries -- rose to 2.1 percentage points from 2.07 points on Dec. 11. That’s a measure of the outlook for annual consumer prices over the life of the securities.

The yield on the 30-year Treasury bond yield rose five basis points, or 0.05 percentage point, to 2.89 percent at 5 p.m. New York time, according to Bloomberg Bond Trader prices. It touched 2.9 percent, the highest level since Nov. 7.

Price Acceleration

“There’s reason to be concerned” about inflation, said Marvin Goodfriend, a former adviser at the Richmond Fed. The Fed’s 6.5 percent unemployment objective is "aggressive," while using a projection for price acceleration over one to two years may not lead to policy tightening before inflation “becomes a problem,” he said.

“It’s likely that the Fed will have a balance sheet $2 trillion higher before it tries to reverse” its stimulus, said Goodfriend, a professor at Carnegie Mellon University’s Tepper School of Business in Pittsburgh.

Inflation has “remained tame and appears likely to run at or below” the Fed’s 2 percent goal, Bernanke said.
Bernanke said tying the outlook for interest rates to economic variables is a better way to communicate the policy outlook than using a time horizon because markets can “infer how our policy’s likely to evolve.”

**Data Adjustment**

“If information comes in which says the economy is stronger or weaker than we expected, that would in principle require a change in the date, but it doesn’t necessarily require a change in the thresholds, because that data adjustment can be made by markets just simply by looking at their own forecasts,” Bernanke said.

The thresholds will act as an “automatic stabilizer,” he said. If there is a “shock” to the economy, investors will push interest rates down on expectations it will take longer for the Fed to tighten policy, Bernanke said.

One such shock is already on the horizon as lawmakers and the Obama administration continue talks to avert more than $600 billion of automatic spending cuts and tax increases that threaten to throw the country into a recession.

The so-called fiscal cliff is a “major risk factor” that is harming investment and hiring decisions by causing “uncertainty” or “pessimism,” Bernanke said. The Fed “doesn’t have the tools” to offset that event, he said.

Bernanke “is really on guard” against criticism that “he had done too little,” said Stephen Oliner, a resident scholar at the American Enterprise Institute in Washington and a former senior adviser at the Fed Board in Washington.

“The way the economy has evolved and inflation has evolved suggests that there is really nothing here that says the Fed has been too aggressive,” he said. “They are getting feedback that says, ‘Keep going.’”

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