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Fed Casts About for Endgame on Easy-Money Policy

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Federal Reserve officials, mindful of a still-fragile economy, are laboring to devise a strategy to avoid another round of market turmoil when they pull back on one of their signature easy-money programs in the months ahead.

Central-bank officials have been debating for months when to start paring the $85 billion-a-month bond-purchase program. They were surprised during the summer when their discussions and public pronouncements on the potential timing rocked markets, pushing interest rates higher and stock prices down.

Minutes of the Oct. 29-30 policy meeting, released Wednesday, showed officials continued to look toward ending the bond-buying program "in coming months." But they spent hours game-planning how to handle unexpected developments and tailoring a message to the public to soften the impact of the program's end.

Investors responded Wednesday with new disappointment. The Dow Jones Industrial Average fell 66.21 points, or 0.4%, to 15900.82. The Dow had crossed the 16000 mark during intraday trading for the second time this week, but turned negative following the release of minutes from the Fed's Oct. 29-30 policy meeting. Bond yields rose to a two-month high, with the 10-year Treasury notes climbing 0.083 percentage point to 2.795%.

The Fed's next policy meeting is Dec. 17-18. The decision on whether to act then on cutting back on bond purchases will depend largely on the strength or weakness of economic data over the next few weeks.

Fed officials are hoping their policies will play out like this: The economy will improve enough in the months ahead to justify pulling back on the program, which has been in place since last year and has boosted the central bank's bondholdings to more than $3.5 trillion. After the program ends, they will continue to hold short-term interest rates near zero as the unemployment rate—which was 7.3% last month—slowly declines over the next few years.

Mr. Bernanke said Tuesday that one can think of the bond-buying program "as the first stage of the booster rocket to move our economy forward." Like a booster rocket, the analogy suggests, the program will eventually be discarded after it provides initial lift to the economy.

Some recent data suggest the economy might be following the hoped-for script. The Commerce Department on Wednesday reported stronger-than-expected sales by retailers in October, despite turmoil in Washington over fiscal policy. Business hiring was also surprisingly strong last month.

"There are some nascent signs that the economy may be doing better," New York Fed President William Dudley said Wednesday, pointing to the October jobs report showing a pickup in hiring and overall
economic growth up 2.8% in the third quarter.

But uncertainties abound, including whether inflation will keep falling—which could prompt Fed officials to keep their easy-money policies in place longer. The Labor Department reported Wednesday that consumer prices fell in October, thanks to a drop in oil prices, and were up just 1% from a year earlier. That year-over-year inflation reading is the smallest 12-month increase since 2009, when commodities prices collapsed with the global economy.

Fed officials spent much of their October meeting exploring possible developments and how to react.

"Policy makers are really ambivalent on what to do next," said Joseph Lavorgna, chief U.S. economist with Deutsche Bank.

One scenario getting increased attention at the Fed: What if the job market doesn't improve according to plan and the bond program becomes ineffective for addressing the economy's woes? The minutes showed their solution might be to replace the program with some other form of monetary stimulus. That could include a stronger commitment to keep short-term interest rates low far into the future, a communications strategy known as "forward guidance."

Top Fed officials have been signaling in recent weeks that their emphasis is shifting away from the controversial bond-buying program and toward these verbal commitments to keep rates down.

In a speech Tuesday, Mr. Bernanke laid out several reasons the Fed could eventually lose its patience with the bond-buying program, in part because of its uncertainty about the effectiveness of the program.

Bond-buying programs have "drawbacks not associated with forward rate guidance, including the risk of impairing the functioning of securities markets and the extra complexities for the Fed of operating with a much larger balance sheet," Mr. Bernanke said. For now, he added, he sees those problems as "manageable."

The message about the Fed's commitment to low rates appears to be sinking in. In September, as traders in the Eurodollar futures markets worried that the Fed was wavering on its low rate commitment, three-month borrowing rates were expected to reach 0.85% by December 2014. Expected borrowing rates have since sunk to 0.36% as the Fed has repeated its low-rate message.

Fed officials at their October meeting left the bond-buying program unchanged and discussions about amplifying or altering their low-rate strategy didn't get very far.

They left unchanged their promise to not raise short-term rates at least until the jobless rate falls below 6.5% as long as inflation isn't expected to rise above 2.5%, paired with additional assurances that even after the jobless rate falls below 6.5% the Fed will move slowly to raise rates.

The Fed has been debating tweaks to this commitment for months. One idea is to lower the unemployment threshold to 6% or lower, from the current 6.5% benchmark, which would carry an implication of low rates for even longer than currently planned. Just "a couple" of officials at the meeting supported the idea. Some officials worried it "might raise concerns about the durability of the [Fed's] commitment to the thresholds."

"A few" officials at the meeting favored adding a lower bound on the Fed's tolerance for inflation. The Fed has said it will raise rates if inflation looks like it is moving above 2.5%, but hasn't said what it will do if inflation gets too low. Its target is 2%.

Officials revived another idea to reduce the Fed's payments of 0.25% to banks that keep money on reserve at the central bank. Some Fed officials want to reduce the interest rate to give banks more incentive to lend.

The idea has gone nowhere in years of discussions—in part because officials don't think it will do...
much—but the minutes showed officials believed it "could be worth considering at some stage."

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