Fed May Revise Zero-Rate Vow as Bond-Buying Need Fades

By Joshua Zumbrun - Dec 13, 2011

The Federal Reserve will probably revise its pledge to keep interest rates close to zero through mid-2013 as the need for large scale asset purchases diminishes, according to economists in a Bloomberg News survey.

The Fed will alter the interest rate commitment before June, according to 64 percent of economists surveyed, with 51 percent saying the central bank will abandon the option of a third round of buying bonds, or so-called QE3.

Chairman Ben S. Bernanke and his policy-making colleagues plan to meet today to discuss the outlook for an economy that has strengthened since their November meeting, lowering the jobless rate to 8.6 percent from 9.1 percent. Altering the low-rate commitment would give central bankers the flexibility to adjust monetary policy without resorting to a third round of large-scale bond purchases, also known as quantitative easing.

“The base case is that QE3 probably will not unfold,” said Sam Bullard, senior economist at Wells Fargo Securities in Charlotte, North Carolina. “We’ve got some momentum here. The data that’s been coming in has been stronger than expected and prior months’ data have been revised up.”

Before the Fed’s November gathering, 69 percent of economists in a Bloomberg News survey said they believed the Fed would begin more purchases, as did 16 of the 21 primary dealers of U.S. government securities in a survey last month.

The Federal Open Market Committee is set to release a statement at around 2:15 p.m. Washington time, following its last scheduled meeting of the year.

Target Rate

The Fed reduced its target interest rate to a range of zero to 0.25 percent in December 2008. In August the FOMC said economic conditions would probably warrant leaving rates near zero through at least mid-2013, replacing an earlier pledge to keep them there for a “considerable period.”

The central bank purchased $2.3 trillion of bonds in two rounds from December 2008 to June 2011. In September it announced it would buy $400 billion of longer-term government securities and sell $400 billion of short-term debt in order to lengthen the average maturity of securities on its balance sheet.

The yield on the 10-year Treasury fell to a record low 1.72 percent on Sept. 22, the day after the central bank announced the maturity-lengthening program known as...
Operation Twist. The yield was 2.01 percent late yesterday in New York.

A plurality of 44 percent of economists expect the central bank to wait until their Jan. 25-26 meeting to revise their pledge to hold interest rates near zero through mid-2013. Fifty-one percent say the central bank will use that meeting to unveil a “broader overhaul” of their strategy for communicating with the public about policy, including the path of interest rates.

‘Full Scope’

While policy makers in their statement today may hint at such changes, they probably won’t provide “a complete sense of the full scope of the new communications strategy until January,” said Robert Dye, chief economist at Comerica Inc. in Dallas. Bernanke is scheduled to hold a news conference after the meeting next month.

By holding interest rates near zero, the central bank has helped push down mortgage rates to record lows. The national average for a 30-year fixed-rate mortgage was 3.99 percent as of Dec. 8, according to a Freddie Mac index. The index touched a record low 3.94 percent on Oct. 6.

“Eventually the economy has to be weaned off of these steroids, and if we just keep throwing more and more stimulus at it, the economy will never find its own legs without risking some sort of inflation flare-up,” said Carl Riccadonna, senior U.S. economist at Deutsche Bank Securities Inc. in New York.

Home Purchases

Low interest rates aren’t prompting home purchases by consumers concerned about the outlook for the economy, said Robert I. Toll, chairman of Toll Brothers Inc., the largest U.S. luxury homebuilder.

“Our customers have the ability to buy,” Toll said. “They are aware of the tremendous affordability of homes and the record-low interest rates. However, a lack of confidence in the direction of the economy is perhaps the biggest impediment to releasing what we believe is significant pent-up demand.”

While tracking household spending, Fed policy makers are also watching the sovereign-debt crisis in Europe for signs that they need to shift policy. In a statement after their Nov. 1-2 meeting, Fed officials said “strains in global financial markets” were creating “significant downside risks.”

“Europe is the biggest, disruptive exogenous shock you could have,” said Paul Ballew, chief economist at Nationwide Mutual Insurance Co. in Columbus, Ohio.

Dollar Loans

Six central banks led by the Fed on Nov. 30 lowered the cost of emergency dollar funding with a 0.5 percentage-point cut in the premium banks pay to borrow dollars overnight. European banks will now pay about 0.6 percent to borrow dollars from central banks, cheaper than what U.S. banks would pay to borrow from the Fed’s discount window.
Most economists don’t expect the Fed to cut the so-called discount rate that U.S. banks pay on emergency borrowing, with 63 percent calling such a move unlikely, according to the Bloomberg survey. The discount rate was raised to 0.75 percent from 0.5 percent in February 2010 as financial markets improved following the financial crisis. Twenty-two percent of economists say the Fed will lower the rate back to 0.5 percent.

To contact the reporter on this story: Joshua Zumbrun in Washington at zumbrun@bloomberg.net;

To contact the editor responsible for this story: Christopher Wellisz at cwellisz@bloomberg.net