SHORTLY after the Federal Reserve hinted in May that it might start to ease its monetary stimulus, rich-country bond yields shot up; emerging-market currencies and stockmarkets cratered. Was it all for nothing? On September 18th, at the end of a closely watched meeting, the Federal Open Market Committee, the Fed’s policy-setting body, chose not to “taper”. Instead, it said it would keep buying $85 billion a month of Treasury and mortgage bonds with newly created money (the policy of “quantitative easing”, or QE).

Although the Fed had never actually promised to act in September, all the signals pointed in that direction. QE would stop, it had said when the latest bout of bond-buying began last September, when the labour-market outlook had improved “substantially”. Since then, the unemployment rate has dropped to 7.3% from 8.1% and private employment has risen by 2.3m, or 2%. In June Ben Bernanke, the Fed chairman, said the Fed would probably start to taper by year-end, and stop QE when unemployment hit 7%, which it expected by mid-2014.

So what has now held it back? First, the pace of job growth has recently flagged; the drop in unemployment has been flattered by the number of people no longer looking for work. The labour-market participation rate sank to 63.2% in August, a 35-year low.
Second, fiscal policy continues to work at cross-purposes to monetary policy. Higher taxes and spending cuts have subtracted at least a full percentage point from growth this year. The prospect that spending caps may be lifted when the new fiscal year begins on October 1st has melted away. With Republicans in Congress and Barack Obama unable to agree on how to fund the government or raise the Treasury’s statutory debt ceiling, the risk of a government shutdown loomed large in the minds of Fed officials.

But the third and most important restraint on the Fed was the unexpected effect on financial markets of a prospective change in monetary stance. The central bank had always emphasised that tapering did not mean tightening. Provided asset purchases remained above zero, the Fed’s balance-sheet would keep growing and monetary policy would still be loosening. Separately, the Fed never wavered from its pledge to keep the federal-funds rate near zero at least until unemployment had fallen to 6.5%.

Nonetheless, investors radically repriced their expectations of Fed policy and fled positions predicated on a policy of QE ever after. Bond yields have risen by slightly less than a percentage point since May, mortgage rates by slightly more. Mr Bernanke fretted that this “rapid tightening of financial conditions in recent months could have the effect of slowing growth”, a problem that would be “exacerbated if conditions tighten further”.

The euphoric market response to the FOMC’s decision this week would seem to vindicate that judgment. But it leaves wide open the question of when the Fed will taper. The FOMC trimmed its projections for growth this year and next by about a quarter of a percentage point from its June forecast, to 2.2% in 2013 and 3% in 2014 (see chart). It also changed its unemployment projections, which it now expects to hit 7% early in 2014 and 6.5% later that same year.

Mr Bernanke was at pains this week to stress that the 7% unemployment target for ending QE and 6.5% threshold for raising rates have never been automatic triggers. It all depends on what else is happening in the economy. It is entirely sensible for the Fed not to be slavishly bound by its guidance, but that raises questions over how useful such guidance is. Most Fed officials expect to raise rates by 2015, for example, but Mr Bernanke said rates are unlikely to rise if inflation is below its 2% target, which the Fed’s new projections suggest could be the case until 2016.

The start of tapering could conceivably come at the end of October if data reassure the Fed that the economy has brushed off higher bond yields and if a fiscal train wreck has been avoided. But there are no clear signposts, which will irk investors.
Their frustration pales next to that of the Fed itself, which has blown its balance-sheet up to $3.6 trillion and held rates at zero since 2008 but achieved underwhelming results in return. On September 17th the federal Census Bureau reported that real household incomes in America, which had fallen by 8% between 2007 and 2011, did not fall further in 2012. That this counts as good news is telling.

Income inequality, meanwhile, is worsening on some measures. Emmanuel Saez at the University of California, Berkeley, reckons the top 10% grabbed its largest share of total incomes since 1917 last year. This is partly due to QE, which has been very good for the stockmarket and thus the wealthy. QE works in part by boosting household wealth and thus spending and jobs, but the effects have not yet filtered through strongly to the wider economy. The taps will be open a while longer yet.

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