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Fed Gears Up for Stimulus

Eyes Gradual Bond Buying of Several Hundred Billion Dollars; Doubts Linger

By **JON HILSENRATH** And **JONATHAN CHENG**

The Federal Reserve is close to embarking on another round of monetary stimulus next week, against the backdrop of a weak economy and low inflation—and despite doubts about the wisdom and efficacy of the policy among economists and some of the Fed's own decision makers.

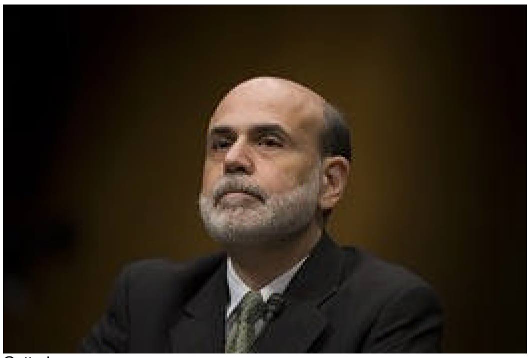
The central bank is likely to unveil a program of U.S. Treasury bond purchases worth a few hundred billion dollars over several months, a measured approach in contrast to purchases of nearly $2 trillion it unveiled during the financial crisis. The announcement is expected to be made at the conclusion of a two-day meeting of its policy-making committee next Wednesday.

The Fed's aim is to drive up the prices of long-term bonds, which in turn would push down long-term interest rates. It hopes that would spur more investment and spending and liven up the recovery. But officials want to avoid the "shock and awe" style used during the crisis in favor of an approach that allows them to adjust their policy, and possibly add to their purchases, over time as the recovery unfolds.

Fed Chairman Ben Bernanke's push to restart the bond-buying program—a form of monetary stimulus known as quantitative easing—has been greeted with deep skepticism among some of his colleagues.

In some of his strongest words yet, Thomas Hoenig, president of the Federal Reserve Bank of Kansas City, said Monday that more expansive monetary policy was a "bargain with the devil."

In the next few months, internal opposition to Mr. Bernanke's approach could intensify as presidents of three regional Fed banks who have expressed skepticism about the plan—Narayana Kocherlakota of Minneapolis, Richard Fisher of Dallas and Charles Plosser of Philadelphia—take voting positions on the Fed's policy-making body. There are 12 regional Fed banks, and five voting seats on the Federal Open Market Committee rotate among them every year, with New York always keeping one.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Investors already expect Fed action. Stock prices have rallied since Mr. Bernanke broached the idea of bond buying in late August. But investors and analysts are divided on whether the gambit will work.

In normal times, the Fed reduces short-term interest rates when it wants to spur growth. But the central bank already cut short-term rates to near zero in 2008, so it is turning to an unconventional measure.

Some Fed officials argue the economy is going through long-term changes that the central bank can't rush, and worry a large bond-buying program might only stoke future inflation or a new asset bubble.

But the view likely to prevail at the Nov. 2-3 meeting is that the economy is falling short on two fronts: Unemployment, at 9.6%, means the Fed is falling short of its legal mandate to maximize employment. Inflation, which is running a bit above 1% so far this year, is below the Fed's informal objective of about 2%, and runs the risk of falling even lower. With so much unused capacity and spare labor, many officials contend, the Fed is unlikely to stoke a worrisome amount of inflation.

Though details remain to be being sorted out internally, the broad outlines have taken shape.

Unlike in March 2009, when the Fed laid out a program to buy $1.75 trillion worth of Treasury and mortgage bonds over six to nine months, officials this time want flexibility as they assess if the program is working.

Mr. Bernanke has used the analogy of a golfer with a new putter: Unsure how it will work, he finds best strategy is to tap lightly at first and keep tapping until the golfer figures out how best to use the putter.

The Fed could leave open the possibility of more purchases in the future, particularly if inflation is projected to remain below 2% and the unemployment outlook remains high, which is currently the expectation of many officials. Or it could halt the program if the economy or inflation surprisingly take off, officials have said.

Fed officials will update their forecasts for growth, unemployment and inflation through 2013 at the upcoming meeting.

Some investors are on edge about how the Fed will proceed. On the one hand, the Dow Jones Industrial Average has risen 12% since Mr. Bernanke began hinting about buying more bonds two months ago, a welcome rise inside the Fed.

But commodities prices are also soaring, with copper, gold and oil prices rising 16%, 8.1% and 13% respectively. That could portend more inflation than the Fed wants. At the same time, the dollar has slid nearly 10% against the euro; that could help U.S. exports, but it creates tensions with trading partners. A sharp drop in the dollar could give Fed officials pause.

The main aim of a bond buying program would be to drive down long-term interest rates by pushing up the price of Treasury bonds and thus driving down their yields. From nearly 4% in April, the yield on the 10-year Treasury note has already tumbled to about 2.6%, in part because investors expect the Fed to be in the market buying bonds. Mortgage rates, closely tied to the 10-year note yield, have fallen to their lowest levels in more than four decades.

Some investors say the Fed doesn't have much margin for error next week. Too modest a move could disappoint those who say the economy needs aggressive Fed action, but an overly muscular approach could prompt concerns the Fed is overreacting. "There is room on either side for a negative surprise," said Mike Ryan, chief investment officer for UBS Wealth Management Americas.

A Wall Street Journal survey of private sector economists in early October found that the Fed is expected to purchase about $250 billion of Treasury bonds per quarter and continue until mid-2011, amounting to about $750 billion in all.

New York Fed president William Dudley put forward one key benchmark in a speech earlier this month. He noted that $500 billion worth of purchases had the same impact on the economy as a reduction of the federal funds rate by one-half to three-quarters of a percentage point.

In speeches this week, Mr. Dudley repeated he found the economy's weak state "unacceptable" and said "further Fed action was likely to be warranted."

The bond-buying program is likely to focus on Treasury bonds with maturities mostly between 2-years and 10-years, according to interviews with some officials. The Fed could buy even longer-term bonds, though some officials are reluctant to do that aggressively because it could expose them to long-term losses without much added benefit.

—Mark Gongloff contributed to this article.