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Fed policy on buying Treasury bonds stays on track

Interest rates are marching upward, making it more expensive to take out a mortgage or get a loan to expand a business, and diluting efforts by Congress and the Federal Reserve to strengthen the economy.

The rise is partly because of good news: The outlook for growth has improved, putting less pressure on investors to keep their money in ultra-safe bonds. When there's less demand for bonds, their interest rates - or yield - go up to attract more investors.

And the better economic outlook could allow the Fed to pull back sooner than expected on the extraordinary steps it's taking to keep rates low.

But bond investors are also spooked by the tax-cut deal between President Obama and congressional leaders, which if enacted would increase the budget deficit substantially over the next two years.

The climb in interest rates is confounding the Fed's efforts as it tries to bring down rates by buying $600 billion in Treasury bonds. The central bank affirmed that it would stay on course with those plans Tuesday after a policy meeting.

The interest rate the U.S. Treasury must pay to borrow money for a decade climbed 0.2 percentage points Tuesday - a significant one-day bounce - to 3.47 percent, and is up about 1.1 percentage points since Oct. 7. A wide range of other interest rates, including on corporate loans and home mortgages, usually move in tandem with government borrowing rates. Thirty-year fixed-rate mortgages averaged 4.62 percent last week, Freddie Mac said, up from 4.17 percent the week of Nov. 11, and the rise in Treasury bond rates is likely to push them up further.

If the higher rates persist, or rise further, it would both lean against economic growth and make it that much more expensive for the federal government to finance its debt.

Interest rates - both for Treasury bonds and for those paid by ordinary consumers and businesses - remain low by historical standards. But the speed with which they have risen is startling, particularly in the nine days since the White House and Congress reached a tentative agreement to leave Bush-era tax cuts in place for two more years for all Americans, implement a temporary reduction in payroll taxes and extend unemployment insurance benefits.

"The policy is definitely going to lead to more deficit spending," said Michael Dueker,

head economist at Russell Investments. "At a certain point, the trade-off gets to the point where higher rates take away the benefits of deficit spending, and we could be pretty close to that point now."

The Congressional Budget Office estimates that the proposal will increase the deficit by $858 billion over the next two years, which would mean the Treasury will have to issue that much in additional debt. The Senate debated the measure Tuesday.

At the Federal Reserve, officials have viewed the higher rates as mainly reflecting positive forces in the economy. Economic data since the Fed's Nov. 3 decision to enact a massive bond-purchase program has been generally solid, and the spike in interest rates Tuesday was fueled by a better-than-expected retail sales number that led analysts to raise expectations for fourth-quarter growth.

Meanwhile, the Fed drew intense criticism for its decision to buy bonds, which led analysts to conclude that the central bank will now be reluctant to expand the purchases beyond the announced $600 billion.

After its policy meeting Tuesday, the Fed embraced a policy of continuity, making clear that it intends to continue with the policy despite criticism and that officials at the central banks still view the economy as weak.

New information since the last meeting "confirms that the economic recovery is continuing, though at a rate that has been insufficient to bring down unemployment," the Federal Open Market Committee said. The Fed intends to continue buying $75 billion in Treasury bonds each month through June and to keep short-term interest rates near zero for an "extended period."

The Fed's final scheduled policy meeting of 2010 was notable more for the absence of fireworks than any changes. Most of the statement released following the meeting was identical, or nearly so, to the statement released in early November.

"To promote a stronger pace of economic recovery and to help insure that inflation, over time, is at levels consistent with its mandate, the Committee decided today to continue expanding its holdings of securities as announced in November," the release said.

Some analysts worry that part of the rise in interest rates is due to worries that the Fed is being feckless and will allow inflation or other negative side effects to emerge.

"Did these rates move higher because the economy is getting stronger - or because bond investors fear the Fed is about to err by continuing to pump too much money into an economy that is in the midst of accelerating?" said **Bernard Baumohl**, chief global economist of the Economic Outlook Group, a consultancy. "Our concern . . . is that it's the latter."

That, in turn, could trigger inflation, which would make bonds a less desirable investment and push rates up even higher.

Fed officials are taking some solace in the fact that measures of inflation expectations

seem to be little changed in recent weeks. The rates paid on bonds that are indexed to inflation and those that are not have risen in tandem. Over the coming five years, investors are expecting inflation to average 1.6 percent a year, based on the gap between those two rates.

That level is below the inflation rate of just under 2 percent that Fed officials aim for and is up from about 1.5 percent that investors predicted in the last week.