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Fed to tie interest rate to job gains

The hope is to bring unemployment below 6.5%. Strategy marks a dramatic change in policy, made easier by low inflation lately.

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WASHINGTON — The Federal Reserve said it will continue aggressive measures to stimulate the economy and made a major policy shift to focus more directly on boosting the job market.

Fed policymakers said they would keep interest rates at historically low levels until unemployment drops below 6.5%.

It's likely to keep the Fed's short-term interest rates at historically low levels well into 2015.

The move marked the first time that Fed policymakers have tied themselves to an explicit unemployment goal. It appeared to end the long-running debate within the central bank over how aggressively to target the nation's lagging job market.

The jobless figure was 7.7% in November, and the Fed's new forecast doesn't see that dropping below 6.5% for about three years.

The decision was made easier by the slow pace of inflation, which remains below 2% on an annual basis. Critics of the Fed's policies have argued that efforts to stimulate the economy would lead to inflation, but so far, that has not happened, and Fed Chairman Ben S. Bernanke has argued that the risk is much smaller than the dangers posed by high unemployment.

"The conditions now prevailing in the job market represent an enormous waste of human and economic potential," Bernanke said Wednesday during a news conference after the central bank's last policy meeting of the year.

Under its new policy, the Fed would let its inflation outlook rise to 2.5% before taking action to curtail it — giving the nation's employers more time to create jobs.

The move to link interest rate policies directly to the jobless rate is meant to give the public and businesses greater confidence about how long interest rates will remain exceptionally low, and that by itself could act as a kind of stimulus to the economy.

The new push got a warm welcome from both economists and Wall Street.

Economist Bernard Baumohl at the Economic Outlook Group said the previous time frame for action was "self-defeating because it provided no incentive for employers to start spending any time soon to avoid higher interest rates. It just didn't create any sense of urgency to accelerate investments or increase the rate of hiring."

The Fed has kept its federal funds rate, which influences rates for credit cards, mortgages and business and other loans, near zero since December 2008. Unemployment has been near 8% or above since early 2009.

Bernanke and his colleagues also decided Wednesday to continue the controversial large-scale bond-buying programs in the new year. Specifically, the Fed will buy $40 billion of mortgage-backed securities and $45 billion of long-term Treasury bonds a month.

The purchases are intended to drive down long-term interest rates to spur spending, investment and lending, boosting economic activity as well as hiring.

The central bank launched the purchase of mortgage-backed securities in September to give a lift especially to the housing market, which Fed policymakers said Wednesday "has shown further signs of improvement." They said they would continue to buy bonds until the job market "improved substantially."

The Fed, which has a dual mandate to maximize employment and keep inflation in check, also forecast a somewhat stronger growth for next year.

Its policy statement Wednesday noted a slowing in U.S. business investment and "significant downside risks" in the global economy, but made no mention

of the so-called fiscal cliff, the automatic federal budget cuts and tax hikes scheduled to take effect beginning Jan. 1.

In a 75-minute news conference, however, Bernanke said it was clearly evident that concerns about the fiscal impasse already had hurt the economy, weakening business investments and consumer confidence.

He said that whatever the Fed did, it was not enough to offset the full effects of a U.S. economy failing to resolve fiscal issues. But he was cautiously optimistic: "I actually believe that Congress will come up with a solution, and I certainly hope they will."

For years, the Fed didn't give any indication of its future interest-rate path and only in recent years signaled what it might do by using somewhat vague language. In June 2011, the Fed said that it would keep rates exceptionally low for an "extended period." In August 2011, policymakers said no change was likely until at least mid-2013. And that date has since been extended twice, to late 2014 and then mid-2015.

In explaining the Fed committee's decision, Bernanke said the change didn't imply that the central bank had altered the period when it expects to raise short-term interest rates. By both the previous time frame and the new unemployment threshold, based on its forecast, the Fed would make its shift in 2015.

"By using the thresholds which tie rates to economic conditions, we're more transparent about what's going to determine our policy in the future," Bernanke said. And that, he said, would enable businesses to assess and react more quickly to potential changes in the Fed policy.

The Fed would consider other labor market indicators, besides the jobless and inflation rates, before making a change in interest rate policy, Bernanke said. Those would include measures of people involuntarily working part time and those without work for six months or longer.

Analysts are much more divided, however, on whether the Fed's continuing bond purchases were good for the economy.

If the Fed were to buy $85billion worth of bonds every month next year, by essentially printing money, the central bank would add $1trillion to its assets on top of about $2 trillion expanded to its balance sheet since the recession.

Many analysts fear that such expansion in the financial system will spark higher inflation down the road.

"They're doing something that's never been done before and they don't fully know the consequences," said Paul Edelstein, director of financial economics at IHS Global Insight. "How is the Fed going to get out of this situation? How will it sell into the market without disrupting the market?"

Although the Fed's bond buying will put more downward pressure on mortgage rates, which could help the housing market and the broader economy, Edelstein pointed out that home-loan rates already are at historic lows, leaving little room for further declines.

The Fed on Wednesday slightly upgraded its forecast for the jobless rate while leaving its broader projections for economic growth and inflation little changed.

In its quarterly update, the Fed said the unemployment rate would be 7.4% to 7.7% at the end of 2013, down from its previous September forecast of 7.6% to 7.9%.

The Fed projected that the economy would grow 2.3% to 3% in 2013, compared with its September projection of 2.5% to 3%. Growth in 2014 would be 3% to 3.5%, compared with a September forecast of 3% to 3.8%.

Inflation is expected to remain at 2% or less continuously through 2015.

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