

Opinion article published in The Washington Post on November 4, 2010:

Aiding the economy: What the Fed did and why

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Two years have passed since the worst financial crisis since the 1930s dealt a body blow to the world economy. Working with policymakers at home and abroad, the Federal Reserve responded with strong and creative measures to help stabilize the financial system and the economy. Among the Fed's responses was a dramatic easing of monetary policy--reducing short-term interest rates nearly to zero. The Fed also purchased more than a trillion dollars' worth of Treasury securities and U.S.-backed mortgage-related securities, which helped reduce longer-term interest rates, such as those for mortgages and corporate bonds. These steps helped end the economic free fall and set the stage for a resumption of economic growth in mid-2009.

Notwithstanding the progress that has been made, when the Fed's monetary policymaking committee--the Federal Open Market Committee (FOMC)--met this week to review the economic situation, we could hardly be satisfied. The Federal Reserve's objectives--its dual mandate, set by Congress--are to promote a high level of employment and low, stable inflation. Unfortunately, the job market remains quite weak; the national unemployment rate is nearly 10 percent, a large number of people can find only part-time work, and a substantial fraction of the unemployed have been out of work six months or longer. The heavy costs of unemployment include intense strains on family finances, more foreclosures and the loss of job skills.

Today, most measures of underlying inflation are running somewhat below 2 percent, or a bit lower than the rate most Fed policymakers see as being most consistent with healthy economic growth in the long run. Although low inflation is generally good, inflation that is too low can pose risks to the economy--especially when the economy is struggling. In the most

extreme case, very low inflation can morph into deflation (falling prices and wages), which can contribute to long periods of economic stagnation.

Even absent such risks, low and falling inflation indicate that the economy has considerable spare capacity, implying that there is scope for monetary policy to support further gains in employment without risking economic overheating. The FOMC decided this week that, with unemployment high and inflation very low, further support to the economy is needed. With short-term interest rates already about as low as they can go, the FOMC agreed to deliver that support by purchasing additional longer-term securities, as it did in 2008 and 2009. The FOMC intends to buy an additional \$600 billion of longer-term Treasury securities by mid-2011 and will continue to reinvest repayments of principal on its holdings of securities, as it has been doing since August.

This approach eased financial conditions in the past and, so far, looks to be effective again. Stock prices rose and long-term interest rates fell when investors began to anticipate this additional action. Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion.

While they have been used successfully in the United States and elsewhere, purchases of longer-term securities are a less familiar monetary policy tool than cutting short-term interest rates. That is one reason the FOMC has been cautious, balancing the costs and benefits before

acting. We will review the purchase program regularly to ensure it is working as intended and to assess whether adjustments are needed as economic conditions change.

Although asset purchases are relatively unfamiliar as a tool of monetary policy, some concerns about this approach are overstated. Critics have, for example, worried that it will lead to excessive increases in the money supply and ultimately to significant increases in inflation.

Our earlier use of this policy approach had little effect on the amount of currency in circulation or on other broad measures of the money supply, such as bank deposits. Nor did it result in higher inflation. We have made all necessary preparations, and we are confident that we have the tools to unwind these policies at the appropriate time. The Fed is committed to both parts of its dual mandate and will take all measures necessary to keep inflation low and stable.

The Federal Reserve cannot solve all the economy's problems on its own. That will take time and the combined efforts of many parties, including the central bank, Congress, the administration, regulators and the private sector. But the Federal Reserve has a particular obligation to help promote increased employment and sustain price stability. Steps taken this week should help us fulfill that obligation.

The writer is chairman of the Federal Reserve Board of Governors.