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Fed launches bold $1.2T effort to revive economy

WASHINGTON – March 19, 2009 – With the country sinking deeper into recession, the Federal Reserve launched a bold $1.2 trillion effort Wednesday to lower rates on mortgages and other consumer debt, spur spending and revive the economy.

To do so, the Fed will spend up to $300 billion to buy long-term government bonds and an additional $750 billion in mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac.

Fed Chairman Ben Bernanke and his colleagues wrapped a two-day meeting by leaving a key short-term bank lending rate at a record low of between zero and 0.25 percent. Economists predict the Fed will hold the rate in that zone for the rest of this year and for most - if not all - of next year.

The decision to hold rates near zero was widely expected. But the Fed's plan to buy government bonds and the sheer amount - $1.2 trillion - of the extra money to be pumped into the U.S. economy was a surprise.

"The Fed is clearly ready, willing and able to be the ATM for the credit markets," said Terry Connelly, dean of Golden Gate University's Ageno School of Business in San Francisco.

Wall Street was buoyed. The Dow Jones industrial average, which had been down earlier in the day, rose 90.88, or 1.2 percent, to 7,486.58. Broader indicators also gained.

And government bond prices soared. Heralding a coming drop in mortgage rates, the yield on the benchmark 10-year Treasury note dropped to 2.50 percent from 3.01 percent - the biggest daily drop in percentage points since 1981.

The dollar, meanwhile, fell against other major currencies. In part, that signaled concern that the Fed's intervention might spur inflation over the long run.

If the credit and financial markets can be stabilized, the recession could end this year, setting the stage for a recovery next year, Bernanke has said in recent weeks. The Fed chief and his colleagues again pledged to use all available tools to make that happen, and economists expect further steps in the months ahead.

Since the Fed last met in late January, "the economy continues to contract," Fed policymakers observed in a statement they issued Wednesday.

"Job losses, declining equity and housing wealth and tight credit conditions have weighed on consumer sentiment and spending," they said.

The Fed's announcement that it will spend up to $300 billion over the next six months to buy long-term government bonds was something that in January it had hinted it would do. But some officials had seemed to back off from the idea in recent weeks.

Such action is designed to boost Treasury prices and drive down their rates, as it did Wednesday. Rates on other kinds of debt are likely to fall as well.

"This is going to help everybody," said Sung Won Sohn, economist at the Martin Smith School of Business at California State University. "This might help the Fed put Humpty Dumpty back together again."

The last time the Fed set out to influence long-term interest rates was during the 1960s.

The Fed's decision to buy an additional $750 billion in mortgage-backed securities guaranteed by Fannie and Freddie comes on top of $500 billion in such securities it's already buying. It also will double its purchases of Fannie and Freddie debt to $200 billion.

Since the initial Fannie-Freddie program was announced late last year, mortgage rates have fallen. Rates on 30-year mortgages now average 5.03 percent, down from 6.13 percent a year ago, according to Freddie

Mac. The Fed's decision to expand the program could further reduce rates, analysts said.

"This is not only going to keep mortgage rates low for a long period of time," said Greg McBride, a senior financial analyst at Bankrate.com. "The mere announcement may produce a honeymoon effect and bring mortgage rates down to even lower levels in the coming days."

The goal behind all the Fed's moves is to spur lending. More lending would boost spending by consumers and businesses, which would revive the economy.

The Fed also said it would consider expanding another $1 trillion program that's being rolled out this week. That program aims to boost the availability of consumer loans for autos, education and credit cards, as well as for small businesses.

Where does the Fed get all the money? It prints it.

The Fed's series of radical programs to lend or buy debt has swollen its balance sheet to nearly $2 trillion - from just under $900 billion in September. Sohn believes the Fed's balance sheet could grow to $5 trillion over the next two years.

The Fed has said it's mindful of the risks of pumping more money into the economy, bailing out financial institutions and leaving a key rate near zero for too long. There's the potential to plant the seeds for higher inflation, put ever-more taxpayer money at risk and encourage "moral hazard." That's when companies make high-stakes gambles knowing the government stands ready to rescue them.

Across the Atlantic, the Bank of England last week began buying government bonds from financial institutions as it turned to new ways to help revive Britain's moribund economy. The Bank of England, like the Fed, already had lowered its key interest rate to a record low of 0.5 percent.

Finance leaders from top economies have discussed coordinating actions from their governments and central banks to provide a more potent punch against the global financial crisis.

The Fed is taking the new steps as the U.S. economy sinks deeper into recession. Businesses are facing weaker sales prospects as customers in the United States and abroad cut back, the policymakers said.

Still, the Fed said it hoped its actions, the government's bank rescue effort and President Barack Obama's $787 billion stimulus of increased government spending and tax cuts eventually will help revive the economy.

"Although the near-term economic outlook is weak, the committee anticipates that policy actions .... will contribute to a gradual resumption of sustainable economic growth," the Fed said.

But even in this best-case scenario, the nation's unemployment rate - now at quarter-century peak of 8.1 percent - will keep climbing. Some economists think it will hit 10 percent by the end of this year.

The recession, which began in December 2007, already has snatched a net total of 4.4 million jobs and has left 12.5 million searching for work.

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