Bernanke’s How-To on Rate Increase Lacks a When

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WASHINGTON — “At some point.” “At the appropriate time.” “When the time comes.”

On Wednesday, the Federal Reserve’s chairman, Ben S. Bernanke, outlined a strategy — but not a timetable — for scaling back the extraordinary measures it began taking in 2007 to prop up the economy as financial markets teetered on collapse.

The Federal Reserve has eased borrowing by lowering short-term interest rates to nearly zero and built up a $2.2 trillion balance sheet by scooping up assets like mortgage-backed securities and even vast sums of Treasury bonds and notes.

Eventually, to avoid inflation, both actions will have to be reined in. But Mr. Bernanke, in a 10-page statement, provided few hints as to how long that period will be.

“Although at present the U.S. economy continues to require the support of highly accommodative monetary policies, at some point the Federal Reserve will need to tighten financial conditions by raising short-term interest rates and reducing the quantity of bank reserves outstanding,” he wrote.

“We have spent considerable effort in developing the tools we will need to remove policy accommodation, and we are fully confident that at the appropriate time we will be able to do so effectively.”

Mr. Bernanke, however, did provide new details of a major concern: how, as the recovery proceeds, to gradually shrink the balance sheet, which along with a vast array of assets also includes $1.1 trillion that banks are holding with the Fed.

Mr. Bernanke suggested that a new policy tool — the interest rate on excess reserves, which the Fed began paying in October 2008 — would be a vital part of the Fed’s strategy.

Increasing that interest rate, he said, will have the effect of pushing up other short-term interest rates, including the benchmark fed funds rate — the rate at which banks lend to each other overnight.

It is even possible, Mr. Bernanke said, that the Fed “could for a time use the interest rate paid on reserves, in combination with targets for reserve quantities,” to communicate its policy stance to the markets. Since 1994, the fed funds rate has been the much-watched centerpiece of statements by the Federal Open Market Committee, the Fed’s crucial policy-making arm.

Representative Spencer Bachus of Alabama, the senior Republican on the House Financial Services Committee, which requested Mr. Bernanke’s statement, noted on Wednesday that many in Congress never approved of the Fed’s extraordinary actions in the first place.

“An intervention creates an artificial condition in which the system becomes increasingly dependent on government action,” he said in a statement. “As with any addiction, an altered state is created where the only choices are permanent addiction or a sometimes painful withdrawal.”

For days, economists have been trying to forecast what Mr. Bernanke would say about the sequence of steps and the combination of tools the Fed will use to tighten credit. On that subject, Mr. Bernanke offered only hints of his thinking.

"One possible sequence would involve the Federal Reserve continuing to test its tools for draining reserves on a limited basis, in order to further ensure preparedness and to give market participants a period of time to become familiar with their operation," he wrote.

"As the time for the removal of policy accommodation draws near, those operations could be scaled up to drain more significant volumes of reserve balances to provide tighter control over short-term interest rates. The actual firming of policy would then be implemented through an increase in the interest rate paid on reserves."

But Mr. Bernanke suggested that "if economic and financial developments were to require a more rapid exit from the current highly accommodative policy" — that is, if fears emerge about inflation — the Fed "could increase the interest rate paid on reserves at about the same time it commences significant draining operations."

Along with raising the interest rate on reserves, Mr. Bernanke discussed three other options for draining reserves. The first involves reverse repurchase agreements, in which the Fed would sell securities from its portfolio with an agreement to repurchase them at a later date.

The second involves term deposits — similar to certificates of deposit — to banks. That would convert part of the banks' reserves into deposits that could not be used for short-term liquidity needs and would not be counted as reserves.

A third tool involves redeeming or selling securities. That strategy could carry risk, as the Fed's large portfolio of mortgage-backed securities is helping to prop up the housing market and keep mortgage-interest rates low.

As part of its special lending programs to inject liquidity into the market, the Fed modified its discount window — the traditional program for direct lending to banks — to make terms more generous and to make nonbanks eligible for borrowing. That effort is winding down, and Mr. Bernanke said that "before long, we expect to consider a modest increase in the spread" between the discount rate — the rate at which the Fed directly lends to banks — and the fed funds rate. He emphasized that the change "should not be interpreted as signaling any change in the outlook for monetary policy."

Mr. Bernanke's statement elicited mixed views from economists.

Laurence J. Kotlikoff, an economist at Boston University, said that despite Mr. Bernanke's efforts to be reassuring, the prospect for serious inflation was real. "We could go from here to hyperinflation, basically overnight, because we've increased the basic supply of money by a factor of three," he said.

Mr. Kotlikoff also was skeptical about Mr. Bernanke's proposed solution. "The Fed printed more than $1 trillion in new money and then went out and handed it to the banks, and now they're trying to bribe those banks not to actually release it into the public stream — that's what these interest rates on reserves are," he said, adding, that that interest also amounted to a free subsidy to banks.

Ricardo Reis, an economist at Columbia University, was more sympathetic, describing Mr. Bernanke's actions as innovative and necessary.

“The Fed can now return to having a ‘boring’ balance sheet with mostly government securities as assets, and bank reserves and cash as liabilities,” he said. “The increase in reserves plus the payment of interest on reserves — two innovations of the past two years — are good things. They should remain.”

Mr. Bernanke did note that the balance sheet would shrink on its own, over time, as assets like mortgage-backed securities and debt guaranteed by Fannie Mae and Freddie Mac are prepaid or mature. “In the long run, the Federal Reserve anticipates that its balance sheet will shrink toward more historically normal levels and that most or all of its security holdings will be Treasury securities,” he wrote.