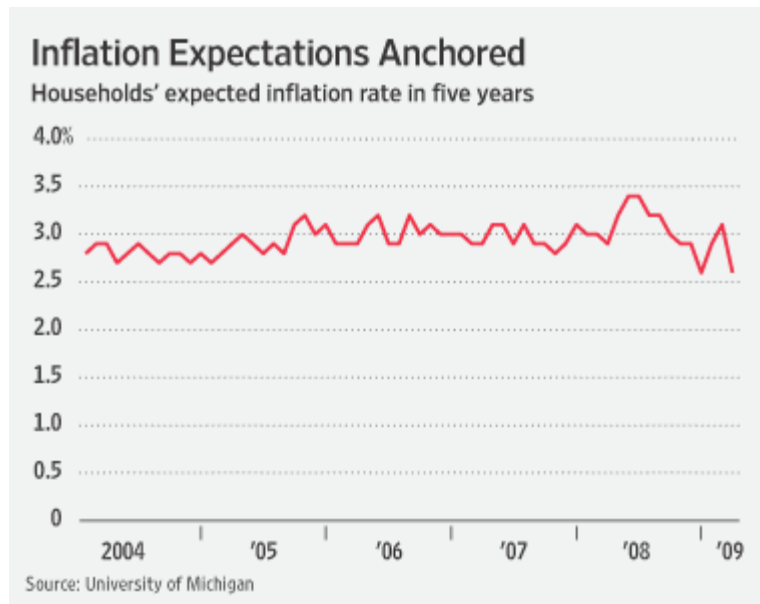


By JON HILSENATH

During the past eight months, the Federal Reserve has pumped more than \$800 billion of cash into the nation's financial system, an action that in normal times could lead to an ugly inflation surge.

Fed Chairman Ben Bernanke is confident that isn't going to happen this time around. To quiet skeptics and reassure markets, he and his lieutenants have been going out of their way the past few days to explain why inflation isn't in the outlook and to lay out the tools they have in hand to fight it.

The focus on inflation isn't just coming from the Fed. In a report this month, Goldman Sachs economists sought to knock down what they described as a wave of "inflation hype" they had been hearing from clients and bond-market traders.



The focus on the issue comes with the Fed's next policy meeting, set for next week. With so many programs already in train, the central bank looks unlikely to take dramatic new actions at the meeting. Assessing signs of improvement in the economy, contingency planning and deliberations on long-term exit strategies are likely to be important parts of the discussions.

Inflation might seem like a distant worry today. Last week, the Labor Department reported that consumer prices in March fell year over year for the first time in 54 years. Rising unemployment and idle factory floors mean businesses have little incentive or capacity to raise wages or the prices they charge customers. There's a risk, in fact, that if the economy weakens much more, the opposite of inflation -- deflation -- could become a serious threat.

That's why the Fed's goal for now is to get inflation higher, not lower. It has effectively been printing money as part of its rescue efforts. When it buys mortgage-backed securities or makes commercial-paper loans, as it has been doing, it electronically credits its counterparty banks with cash in return, which pumps new cash into the financial system.

At some point when the economy recovers from recession, the Fed is going to have to withdraw this money and raise interest rates. Because the Fed is still ramping up many of its programs, the amount of money it will have to withdraw some day is sure to be even higher than today's astronomic levels.

If the Fed is too slow to mop up, the economy could theoretically overheat and lead to an inflation comeback. If investors don't believe the Fed is up to the task, long-term interest rates could rise in advance of such an event, undermining a recovery before it even happens.

"We are thinking carefully about these issues," Mr. Bernanke said in a speech in Atlanta last week. "Indeed, they have occupied a significant portion of recent [Federal Open Market Committee] meetings."

One worry is that the Fed has pumped so much money into the economy, and done it in so many unconventional ways, that it is going to be operationally hard to reverse course when the time comes.

"We have a number of tools we can use to absorb [cash in the financial system] and raise interest rates when the time comes," Fed Vice Chairman Donald Kohn said in a speech over the weekend.

One part of the Fed's strategy is that many of its programs were designed to run off naturally as the markets they are meant to assist improve. For example, its holdings of short-term commercial paper have declined to \$250 billion from \$350 billion in January as the private market has come back to life.

Programs like the Fed's commercial-paper-lending effort were designed to have unattractive terms as markets heal, giving investors an incentive to wean themselves off the central bank.

The central bank also could someday sell some of its longer-term holdings, such as Treasury bonds or mortgage-backed securities. The act would pull cash out of the financial system and push up interest rates in those markets, which could help the Fed temper growth if the economy begins to overheat. It also could lend its holdings of long-term securities to private investors and take cash in return -- something known as a "reverse repo" -- which would pull cash out of the financial system.

It has other approaches for both draining cash from the financial system and pushing up interest rates as needed. It pays banks interest on the cash they keep on reserve at the central bank. The Fed could push up those rates -- now near zero -- when the time is right. That would give banks a disincentive to lend the money in other ways.

Getting the plumbing right is part of the challenge. A bigger challenge is deciding when to turn the water off.

Right now the moment looks far off. Despite recent signs of improvement in consumer spending, housing and stock markets, the economy is still burdened by slack. The unemployment rate, at 8.5% in April, was three percentage points above its 20-year average. It could take months or even years of above-trend economic growth to get the jobless rate back to its longer-run trend. That gives the Fed "oodles of time to unwind its balance sheet," says Goldman Sachs.

But Paul Kasriel, chief economist of Northern Trust of Chicago, isn't so sure the central bank will get it right. He's not worried about what the Fed has done to date. He's worried the Fed will take too long to make the decision to unwind it.

"The Fed is going to want to make sure that the economy has started on a sustained growth path, and of course there will be a lot of uncertainty about that," Mr. Kasriel says. The real risk, he says, is that the Fed overstays its accommodative policies, "for fear of choking off a recovery."

By 2011, despite all the Fed's efforts to prepare itself, Mr. Kasriel sees inflation on the rise.