As part of its transparency campaign, the Fed also published Wednesday a statement of its long-term goals, formalizing its longstanding commitment to maintain inflation at about 2 percent a year. The Fed also said that it was equally committed to minimizing unemployment, but that its exact goal would vary based on economic circumstances. It said the goal now was to reduce unemployment below 6 percent.

The new forecast showed that the Fed expects to hit its inflation target over the next three years, but to fall well short of its goals for unemployment. The Fed projected that unemployment would drop no lower than 8.2 percent this year, just slightly below the current rate of 8.5 percent, and no lower than 7.4 percent by the end of next year. By the end of 2014, the Fed still expects that at least 6.7 percent of people actively interested in working would not be able to find jobs.
Ben S. Bernanke laid the groundwork for a **third round of large-scale asset purchases** should unemployment remain higher than the Federal Reserve would like while inflation falls below a newly-established target.

The Federal Open Market Committee “recognizes the hardships imposed by high and persistent unemployment in an underperforming economy, and it is prepared to provide further monetary accommodation,” Bernanke said yesterday at a press conference in Washington.

**Stocks and Treasuries rallied after policy makers said the benchmark interest rate would stay low until at least late 2014**, pushing back a previous date of mid-2013. Fed officials also lowered their projections for economic expansion and inflation for this year and next.

“It was an unambiguous, aggressive statement,” said Julia Coronado, chief economist for North America at BNP Paribas in New York. “My expectation is that we are going to get quantitative easing three in April,” she said, referring to a third round of bond buying.

The U.S. central bank’s “two main tools” to boost growth are asset purchases and communications, and bond buying is “an option that is certainly on the table,” Bernanke said. “The unemployment level is elevated and the inflation outlook is subdued.”

Policy makers yesterday set a **long-term goal of 2 percent inflation**, and forecast that price increases would fall short of that target this year and next. The personal consumption expenditures price index (SPX) climbed 2.5 percent for the 12 months ending in November.
FIGURE 5.3 The Risk–Return Trade-Off
Adverse Selection: An Example

(A) ASSUMPTIONS

Safe Firm
- Firm must sell bond to finance project that costs $100.
- Project earns $125 for sure.

Risky Firm
- Firm must sell bond to finance project that costs $100.
- Project earns $150 with 2/3 probability, $0 with 1/3 probability.
- Firm defaults on bond if $0 earnings. Expected payment on bond is thus 2/3 of $150 = $100 promised payment.

Savers
- Will buy bonds for $100. If expected payment is at least $110.
Adverse Selection: An Example

(B) WITH SYMMETRIC INFORMATION

**Safe Firm**
- Sells bond that pays $110.
- Earns profit of $125 - $110 = $15.

---

**Risky Firm**
- Savers require promised payment of $165 to get expected payment of $110 (2/3 x $165 = $110).
- $165 exceeds highest possible earnings of $150, so firm abandons project.

---

Savers buy bond

No bond issued
The Business of Banking

Adverse Selection: An Example

(C) WITH ASYMMETRIC INFORMATION

**Savers**
- If both firms issue bonds, average probability of payment is 5/6 (average of 1 and 2/3).
- Savers require promised payment of $132 to get expected payment of $110 (5/6 x $132 = $110).

**Safe Firm**
$132 exceeds earnings of $125, so firm abandons project.

No bond issued

**Risky Firm**
Will issue bond: has 2/3 chance of earning $150 for profit of $150 - $132 = $18.

**Savers**
Require promised payment of $165 because probability of payment is 2/3.

No bond issued
(A) ASSUMPTIONS

Safe Firm
- Firm must sell bond to finance project that costs $100.
- Project earns $125 for sure.

Risky Firm
- Firm must sell bond to finance project that costs $100.
- Project earns $150 with 2/3 probability, $0 with 1/3 probability.
- Firm defaults on bond if $0 earnings. Expected payment on bond is thus 2/3 of promised payment.

Savers
- Will buy bonds for $100 if expected payment is at least $110.

(B) WITH SYMMETRIC INFORMATION

Safe Firm
- Sells bond that pays $110.
- Earns profit of $125−$110 = $15.

Risky Firm
- Savers require promised payment of $165 to get expected payment of $110 (2/3 × $165 = $110).
- $165 exceeds highest possible earnings of $150, so firm abandons project.

Savers buy bond

(C) WITH ASYMMETRIC INFORMATION

Safe Firm
- $132 exceeds earnings of $125, so firm abandons project.

Risky Firm
- Will issue bond: has 2/3 chance of earning $150 for profit of $150−$132 = $18.

Savers
- Require promised payment of $165 because probability of payment is 2/3.

No bond issued

FIGURE 7.2 Adverse Selection: An Example

Copyright © 2009, 2012 by Worth Publishers
Money, Banking, and Financial Markets Second Edition
FIGURE 7.3 Shareholder Rights and Stock Market Activity
<table>
<thead>
<tr>
<th>Point Range</th>
<th>Frequency</th>
<th>Comment:</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-2</td>
<td>11</td>
<td>Weakest</td>
</tr>
<tr>
<td>3-4</td>
<td>11</td>
<td>Weak</td>
</tr>
<tr>
<td>5-6</td>
<td>10</td>
<td>Getting Stronger</td>
</tr>
<tr>
<td>7-8</td>
<td>10</td>
<td>Good Job</td>
</tr>
<tr>
<td>9-10</td>
<td>4</td>
<td>Excellent!</td>
</tr>
</tbody>
</table>