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Bernanke Takes the Helm: Critical Questions

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Inside the mind of the new Fed chair -- for better, and for worse.

We will be listening carefully to **Ben Bernanke's** confirmation hearings before the **Senate Banking Committee** in hopes of gaining a more complete understanding of the former **Princeton professor's** probable approach to managing **monetary policy** as **Fed chairman**. In his lengthy academic career and relatively brief stints as both **Fed governor** and **White House economic adviser**, Bernanke has left a long trail of writings. But his published record also leaves unanswered some critical questions that could well determine how the Bernanke era at the Fed will play out in terms of practical **policy decisions**, and the scope for **error** arising from those decisions.

First, it's clear that Bernanke, like virtually all academic economists, subscribes to a version of the conventional **Phillips Curve/output-gap neo-Keynesian inflation model** which views policy primarily as an exercise in managing the **economy's "slack"** relative to some estimate of its **growth potential**. To his credit, in a speech last spring while still at the Fed, Bernanke allowed that "measuring the output gap in real time can be quite a treacherous undertaking, particularly when the economy is near full employment," suggesting more policy flexibility might be called for during such times than a rigid interpretation of the model would find appropriate. Still, it's apparent that his core analytical outlook views the economy's degree of **"resource utilization"** as the primary determinant of inflation risk and the principal concern of policy. Thus, in a ***Wall Street Journal*** op-ed last summer he used the familiar neo-Keynesian formulation defining "full employment" as "the highest level of employment that can be sustained without creating inflationary pressure."

Missing from -- or, at best, only implicit in -- this **demand-management** focus is the principle that inflation and **deflation** are **monetary phenomena** arising from an imbalance of **dollar liquidity** relative to **liquidity demand**, as reflected first in **market-based indicators** including sensitive **commodity** prices **and foreign exchange rates**. This conceptual framework has led Bernanke to fall **behind the curve** in responding to the monetary forces present in recent Fed **policy cycles**. While still at Princeton in summer 2001, Bernanke expressed considerable skepticism about the advisability of the Fed's **easing campaign** begun in January that year. "I personally would have preferred if the Fed had been a little less aggressive," he said at the time. "I think there's a good chance we'll dodge the bullet this time." As we now know, a **recession** was already well underway by then. More than that, though, Bernanke appeared unmindful of the deflationary pressures set off by the previous several years of excessively **tight** Fed policy, as seen in the surging forex value of the dollar and collapse of commodities such as **gold**, the broad economic consequences of which were finally compelling a belated Fed ease.

Then in November 2002, as a Fed governor, Bernanke garnered praise for a speech in which he discussed the central bank's essentially unlimited capacity to combat deflationary forces including, if need be, by a "'helicopter drop' of money." While Bernanke's quotation of **Milton**

Friedman and that allusion to the role of **money** in achieving price stability might have been welcome in months past, our analysis was that Fed ease had already rooted out the deflationary impulses by the time he spoke, with gold trading around $325 -- up from as low as $275 early that year. The speech essentially marked the outset of the Fed's **hyper-accommodative** phase that would see it cut the **funds rate** to 1% the following June and committing to hold it there for a "considerable period" -- another deflation-fighting tactic suggested by Bernanke in the same speech. As evidence of the consequent decline in **dollar purchasing power** mounted, with gold trading around $375, in September 2003 Bernanke said in another speech that inflation "risks remain to the downside." He suggested that with **employers** able to meet demand through ongoing **productivity gains** rather than substantially increased **new hiring**, **labor markets** would remain soft, which he said should lead to some additional **disinflation**. "By my reckoning," Bernanke said, "inflation in 2004 might well be a bit lower than in the second half of 2003." As it turned out, reported inflation was bottoming about the time Bernanke gave that speech, with **core CPI** hitting 1.1% year-on-year. It had doubled by the end of '04.

Of course no monetary policy maker has ever had a perfect record -- the venerated **Alan Greenspan** certainly didn't. And there is an element of intrigue about Bernanke's thinking that leaves room for hope that a more innovative policymaking approach could take shape under his leadership, something beyond the neo-Keynesian framework he seems to feel most comfortable talking about. As has been widely reported, he is an advocate of **inflation targeting**, believing that an appropriate primary objective of **central bank** policy should be to stabilize prices in a range of 1 to 2% per year. Stating that as an objective, however, says nothing about how policy would actually be conducted to achieve it. The **government inflation indexes** are among the most deeply lagging data series in the statistical arsenal. Using such a backward-looking lens to guide policy decisions would potentially be a recipe for serious error, the equivalent of attempting to drive through an obstacle course using only the rear-view mirror.

Bernanke has talked about innovative techniques such as targeting **consensus inflation forecasts** formed in some kind of **"prediction market,"** if such a thing could be organized. In our view, markets for capturing consensus inflation forecasts already exist -- the gold market, as well as the markets for basic commodities and foreign currencies. Bernanke has disparaged the exclusive reliance on market price indicators to gauge inflation expectations, but there are at least some encouraging indications that his mind is not closed to the potential value of incorporating such tools in policymaking. How Ben Bernanke grapples with these issues will determine whether the next Fed chairman has a chance for a successful tenure, or will be entering office already prone to making all the same errors as his forbears.

Bottom Line: Gold has rallied back above $470 and the dollar has fallen on an apparent bet, based on some of his previous statements, that Bernanke will be softer on inflation than his legendary predecessor. That, however, is not our principal concern. For one thing, by the time Bernanke takes office, the target funds rate is likely to be at 4.5%. That would be close to equilibrium levels, leaving limited scope for near-term dollar softening. Of greater concern is the potential for significant overshoot in the early stages of Bernanke's chairmanship, as the lagging inflation indexes accelerate as a consequence the Fed's too-easy posture over the last two years. And his stated skepticism of output-gap tenets when the economy is near full employment will be put to the test -- when he's under the gun, we'll see whether or not he hews to the mistaken notion that price stability mandates that a central bank prescribe limits to growth. TM