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FED SHADOW

# Is Ben Bernanke a Phillips Head?

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**Does the Fed chair mean it when he says that maximum employment and price stability are compatible?**

We continue to believe that **Ben Bernanke** will raise the **fed funds rate** higher -- and keep it higher longer -- than the market expects (though the **consensus** is now closer in line with our view than it has been for two years). Our view arises in part because we think that Bernanke is more cognizant than he is willing to admit in public of **inflationary risks** arising from the Fed's having stayed so accommodative for so long. But even setting that supposition aside, we think that Bernanke and the **Fed staff** are sufficiently wedded to macroeconomic concepts of inflation -- the present day embodiments of the **Phillips Curve** -- that will move them to make the next round of policy decisions correctly, if only for the wrong reasons (see "Accidentally on Purpose" January 11, 2006). But supposing that getting the funds rate promptly up to 5.25% or 5.5% is sufficient to quell inflationary pressures (which we would see confirmed in a decline in **gold** and **commodity prices**, and a rally in the **dollar** on **forex** markets), then the question would become: what next? If such macroeconomic indicators as a low **unemployment rate** were the wrong reasons that nevertheless got the Fed to a correct funds rate higher than the market now expects, then what's to cause the Fed to stop there, or stop at all until they cause the unemployment rate (and **the economy**) to roll over? Our sense is that the near-historic **risk premium** in **equities** won't unwind until markets have an answer to this critical question: just how much does Ben Bernanke believe in the Phillips Curve?

Bernanke's first two public appearances as Fed chairman seem to muddy the waters on this issue. On the one hand, his testimony mid-month before the **Senate Financial Services Committee** would seem to be straight from a **Phillips Curve/output gap/demand management/IS-LM curve framework**, which posits a **tradeoff** between economic **growth** and **price stability**. Bernanke testified,

> "...the risk exists that, with aggregate demand exhibiting considerable momentum, output could overshoot its sustainable path, leading ultimately -- in the absence of countervailing monetary policy action -- to further upward pressure on inflation. In these circumstances, the FOMC judged that some further firming of monetary policy may be necessary, an assessment with which I concur."

On the other hand, Bernanke's speech at **Princeton** last Friday -- offered as a manifesto of sorts, setting out his priorities as Fed chair -- would seem to be a repudiation of just this kind of analysis. It would seem to be impossible to square the concerns Bernanke expressed in his Senate testimony with his statement on Friday that "price stability and maximum employment are almost entirely complementary," or his critique of past Fed policy errors based on the Phillips Curve:

> "In the decade following the publication of his [Phillips's] paper, his empirical finding was sometimes interpreted (including, for example, by members of the Kennedy and Johnson Administrations) as showing that policymakers could choose (permanently) lower unemployment if they were willing to accept (permanently) higher inflation in exchange... these ideas likely provided part of the intellectual rationale that made the authorities willing to allow inflation to rise throughout the 1960s and in the early 1970s."

This seeming paradox -- embracing the Phillips Curve on the one hand and repudiating it on the other -- is, in part, a matter of **political positioning** for the new Fed chair. By distancing himself in Friday's speech from the failed policies of the Fed in the '60s and '70s, Bernanke is declaring that he will operate within the policy framework of his immediate predecessors **Paul Volcker** and **Alan Greenspan**, and repudiate as they did the notion that policymakers can buy prosperity through inflation. This is all about reassuring markets that Bernanke will be an agent of **institutional continuity**, especially for those who fear that Bernanke is **"Helicopter Ben,"** cynically appointed by the **Bush administration** to keep the good times rolling with **easy money**. Bernanke is saying that price stability will be Job One, and that it will be the instrument through which he will execute the Fed's statutory mandates to pursue **full employment** and **moderate interest rates**.

That's all to the good, as far as it goes. Yet all it says about Bernanke's views on the tradeoff between employment and inflation -- the Phillips Curve -- is that a central bank cannot forever exploit that tradeoff as a means of **job creation**. The reason why not, as Bernanke explains it, is that **expectations** will quickly adjust to account for inflationary policies -- **employers** won't create jobs based on apparent growth in demand that is only **nominal**, not **real**.

Yet Bernanke's statement that "price stability and maximum employment are almost entirely complementary" is probably a vast exaggeration of his position. Or, at best, it's a tautology -- in which "maximum" is defined as that level of employment that makes the statement true. What is that maximum? Bernanke's not saying, but in a 2004 speech, Bernanke noted that in the '60s and the '70s, when policymakers were mistakenly trying to exploit the Phillips Curve, "estimates of the rate of unemployment that could be sustained without igniting inflation were typically unrealistically low, with a long-term unemployment rate of 4 percent or less often being characterized as a modest and easily attainable objective." If 4% is to be talked about in this somewhat mocking tone, what must Bernanke think of today's level of 4.7%? Surely he must be seeing unemployment moving toward a level that is not "entirely complementary" with price stability.

We are unaware of any robust rationale why, *if* the Phillips Curve cannot be exploited to create jobs via inflation, as Bernanke admits, *then* high levels of employment or other **resource utilization** nevertheless ought to imply an inflationary threat. As we see it, any argument about expectations must cut both ways. One can't simultaneously believe that inflation expectations defeat Fed-stimulated job creation, and at the same time interpret high levels of job creation as evidence of expectations revealing that the Fed has been too stimulative. Bernanke himself, when he explores these ideas in free form, admits that "the Phillips curve is fairly flat" -- which is tantalizingly close to admitting that it doesn't exist, while preserving the appearance of staying faithful to the **neo-Keynesian catechism**.

Yet Phillips Curve rationales continue to dominate the modeling process within the Fed, and so far, Bernanke's policy framework as Fed chair. So we continue to expect that the Bernanke Fed will do the right thing for the wrong reason -- that is, fight embedded inflationary impulses by raising interest rates, at least within the general realm of **"normal,"** as long as economic growth continues to be robust (as we expect it will). When rates start approaching levels from which the next hike moves them beyond "normal," Bernanke will have to think long and hard about just

how much he really believes in the Phillips Curve before he takes steps that are are designed to slow the economy and cost jobs. If at that time leading indicators of inflation such as gold and commodity prices have already visibly come down -- even if lagging ones such as the **Consumer Price Index** continue to rise -- then further rate hikes would mean inflicting harm to the economy for no reason whatsoever. We don't blame equity investors for being cautious until Bernanke comes to that **Rubicon** -- and decides whether to cross it or drown in it.

**Bottom line:** Markets and Ben Bernanke are still on their first date, and statements from Bernanke now should be understood more as trying to create a good first impression than reveal anything substantive about current policy directions. It's constructive to see that the first impression he most wishes to create is one of institutional continuity in favor of price stability as the Fed's chief mission. But this leaves unresolved urgent questions about the Fed's use of flawed models to achieve that otherwise noble objective. For the moment, those false models -- which treat economic growth as an inflation threat -- happen to be pointing the Fed in the correct hawkish direction. But we expect that equities will continue to bear a heavy risk premium until markets see Bernanke not only do the right ting for the wrong reasons -- but then, afterwards, when it becomes the wrong thing, *stop* doing it. Right now **stocks** are priced, largely, as though Bernanke will screw it up, with the equity risk premium close to historic highs -- so there's little harm in betting that things will turn out well, even though they may not. But they may. Bernanke's Phillips Curve orientation will indeed lead him into error, but he is a smart and imaginative man who may allow any number of other considerations to color his decisions when crunch time arrives. In a 2004 speech he admitted that the **oil shocks** of the 1970s may have been triggered by prior Fed inflationary errors -- so perhaps there's even a chance that he'll consider the evidence from commodities markets this time around. This is a good time to be a Fed-watcher. TM