

FED SHADOW

## Bernanke's Conundrum

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Donald Luskin

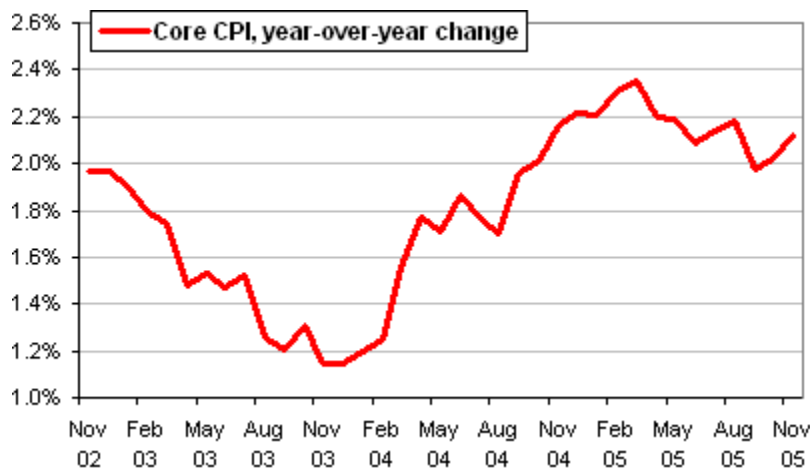
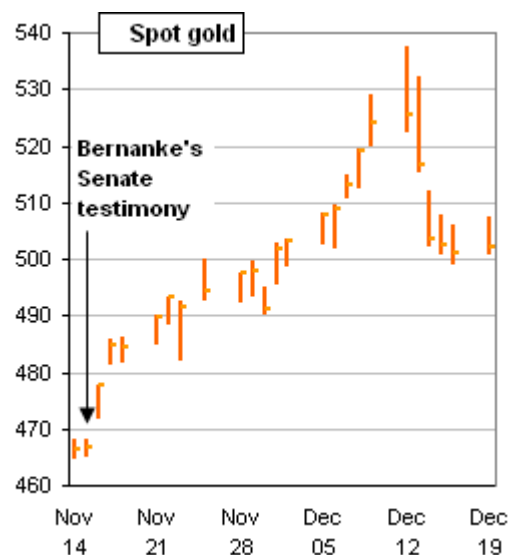
**As the new Fed chairman takes office, his deepest beliefs will pull him in opposite policy directions.**

As we've been predicting all year, the **fed funds rate** will close 2005 at 4.25%. We have no doubt it will be **hiked** to 4.50% on January 31, 2005, at **Alan Greenspan's** last **FOMC** meeting - the date of which he moved specifically so that he could personally ensure that this hike would take place. That, in turn, leaves us in little doubt that the funds rate will be hiked to 4.75% on March 28, the first FOMC meeting that **Ben S. Bernanke** will chair. Bernanke's desire to signal **institutional continuity** and his **anti-inflation credentials** -- standing as he does in the shadow of an inflation-fighting giant, now more than 18 years long -- assures that. But where he goes from there is more problematic. The state of the **economy**, the **expectations** signals from markets, and Bernanke's own **policy legacy** from his days as a **Fed governor** are likely to come together into a mix of contradictory pressures that will challenge Bernanke's core convictions. Markets always test new Fed chairs, just as water always tests new boats. Will this new Fed chair spring a leak?

As Bernanke prepares for the May 10, 2006 FOMC meeting -- his second as chair -- the economic environment is likely to be quite **strong**. For more than two and half years we've consistently stood against the conventional wisdom, confident that the **expansion** would keep advancing without a perennially forecasted "**soft spot**." We have no reason to change that view now, especially as we head into the period of most intense **post-Katrina reconstruction**. We expect to see the next couple quarters of **GDP** running at levels comparable to that of the third quarter of this year, and for the **unemployment rate** to drift below 5%. On the face of it, that alone should be enough to move the Fed to keep on hiking rates -- to 5%, and beyond. The **Fed staff** is committed to **policy models** based in the **neo-Keynesian/Phillips Curve/output gap/IS-LM framework**, which treats **full employment** and a rapid **growth** as evidence of -- if not the downright cause of -- inflation. This framework has already inserted itself into the policy process as of last week's FOMC statement, in which "increases in resource utilization" were cited as having "the potential to add to inflation pressures."

Bernanke, like any successful academic monetary economist, is steeped in that framework, and surely it will strongly influence his viewpoint. That said, he probably sat on the Ph.D. dissertation committees of many of the Fed staffers whose policy models will be urging him to hike rate, so he knows their models better than they do and will bring some nuance to their interpretation. For one thing, Bernanke is not fully confident of the predictive value of the neo-Keynesian model when the economy is thought to be running **at or above capacity**. Second, he is realistic enough to realize that value of the output gap isn't published every day in the newspaper, so that policy-makers never really know whether it has closed or not. Third, he subscribes to his own version of Alan Greenspan's **New Economy theory**, believing that high rates of **productivity growth** expand the non-inflationary capacity of the economy.

Further cutting against a potential knee-jerk reaction of hike rates in the face of a rapidly growing economy is the importance to Bernanke of the role of expectations. In his November 15 **confirmation testimony** before the **Senate Banking Committee**, he scarcely mentioned the word "inflation" without including it as part of the phrase "inflation and inflation expectations" -- as though the two were inseparable. Indeed, to some extent they are inseparable. If it weren't for expectations, **excess liquidity** would have no **transmission mechanism** of human action that could lead to **higher prices**, and thus measurable inflation. Presently, relying on **consumer surveys** and **Treasury yields**, Bernanke sees inflation expectations as "low and stable." Of course in our analytic model, we see just the opposite. Expectations embodied in **inflation-sensitive spot market commodities** -- especially **gold** -- are flashing warning signals of an intensity not seen in more than two decades. At a spot price 50% above its 10-year moving average, gold's **price momentum** is forecasting a **core CPI** rate of 5.5% one year from today, based on robust regression of historical data. It's too heroic, even for us, to actually forecast a result that extreme. But that's what the model says -- and if nothing else, it serves as a clear *directional* indicator of future inflation, strongly suggesting to us a core rate of at least 3% a year in the future. Bernanke is aware of what gold and other commodities are saying -- in fact, he's aware that gold's latest **break-out move** began the very day of his recent Senate testimony. But he relegates such things to a merely subsidiary role in his analytic toolkit. The potentially good news here is that Bernanke may end up downplaying the falsely sanguine expectations signals from Treasury markets. His own pet theory of the "**global savings glut**" suggests that the Treasury market is swamped by worldwide economic forces that could easily distort price signals.



Another thread in Bernanke's thinking this spring will be the memories of policy decisions he himself participated in, back in 2002 and 2003 when the threat of **monetary deflation** was perceived so sharply by the Fed. In a famous November 2002 speech, Bernanke wrote of the Fed running its "**printing press**" and making "**helicopter drops of money**", as credible policy tools of last resort to combat

deflation once the Fed was "**out of bullets**" when interest rates had hit zero. Those words -- the colorfulness of which Bernanke now regrets -- formed the intellectual backdrop for the "**considerable period**" of **hyper-accommodativeness**, for which Bernanke consistently served as public apologist by assuring markets that "**slack resources**" in the economy made inflationary consequences of such policies minimal. Yet for all that, Bernanke knows full well what Alan Greenspan admitted in his **Jackson Hole** speech last August: that the Fed in 2002

and 2003 deliberately set out to create a mild inflation in the name of "**risk control**," seeing it as the price of an **insurance policy** against what Greenspan characterized as the unlikely but potentially catastrophic outbreak of runaway deflation. So the inflation that we are experiencing today -- remember, core CPI is now running at almost twice its level of two years ago -- is the very phenomenon that the Fed itself willingly created. With the threat of deflation no longer a concern, Bernanke surely knows that his duty now is to contain the cost of that inflationary insurance policy to a tolerable 3% core CPI, not an intolerable 5%.

**Bottom line:** For Ben Bernanke to get it right next year, he will have to take appropriate steps to rein in the inflationary impulses that the Fed deliberately set in motion in late 2002 and early 2003. By our analysis, the Fed's alarm about deflation came too late -- the risk, which we identified as early as 1997, had already passed. As a result, we see the Fed as having spent more than two years treating a non-existent disease -- and so the inflationary pressures that they deliberately unleashed are likely to be stronger than they expect. Gold and other inflation-sensitive commodities are signaling that a fed funds rate next spring of lower than 4.75% -- currently the market's expectation embodied in **futures prices** -- will not be enough. Bernanke will be tugged in many different directions next year. A strong economy will move the neo-Keynesian in him to hike rates past 4.75%, which in our view would be to do the right thing for the wrong reasons. At the same time, rapid productivity growth and continued false expectations signals from the Treasury markets could cause Bernanke to be less aggressive than he otherwise might be. But given his need to both create institutional continuity and establish his own inflation-fighting credentials -- and cognizant of his own role in deliberately creating the bump in inflation already showing up in published statistics -- we think Bernanke will come down on the side of **hawkishness**. We expect to see a fed funds rate of at least 5% by summer, 2006. **TM**