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FED SHADOW

Bernanke's Second Act

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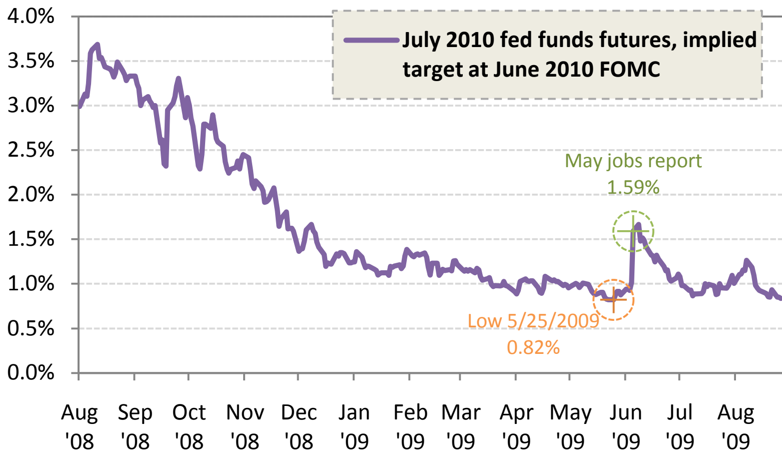
For good or for ill, the Fed's ultra-easy policy stance has a new lease on life.

Update to strategic view
US MACRO: Bernanke's nomination to a second term probably assures that his easy policy stance will be maintained for the foreseeable future. For now, that's appropriate. Inflation risk remains acute, as he will likely not recognize the time to reverse course.
[see Investment Strategy Dashboard]

As we predicted, Ben Bernanke has edged out rivals Larry Summers and Janet Yellen (see "America's Next Top Fed Model" July 27, 2009), and his reappointment as Fed chair likely ensures continuity of the policy stance that he has engineered. Conventional wisdom has it that Yellen or Summers would have made Bernanke's ultra-easy posture even easier, to accommodate the political priorities of the Obama administration. But as a novice central bank chair, either would have faced considerable pressure to establish anti-inflation *bona fides*, and may well have been more likely to begin unwinding the current ultra-accommodative policy more quickly. The markets seem to agree -- since Bernanke's reappointment, year-ahead tightening expectations reflected in the fed funds futures markets have fallen to within half a basis point of all-time lows, even as the macro news backdrop markedly improves.

The prospect of the Fed maintaining its current posture indefinitely under Bernanke should be a comfort to the consensus view that the bigger risk would be to begin the policy normalization process too early rather than too late. That view was reinforced last weekend at the Jackson Hole conference when Fed vice chairman Donald Kohn asserted that policymakers were still acting to guard against the possibility of inflation moving too low. And St. Louis Fed president James Bullard told the same gathering that the Fed's pledge to keep policy exceptionally easy for an "extended period" means that any policy shift in all likelihood will not begin when an



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upturn in economic indicators would ordinarily prompt action.

The Fed is comfortable conveying this outlook under its demand-based "output gap" model which holds that as long as economic growth is below "potential," the "slack" in the system will keep inflation under wraps. Today's *Wall Street Journal* expresses the conventional wisdom that while Bernanke will have to begin tightening policy eventually, "unemployment remains so high and capacity utilization so low that the economy is awash with spare capacity. It will take several quarters of above-trend growth before inflation becomes a problem." The likelihood, says the *Journal*, is that Bernanke "will keep monetary policy loose for a long time, confident inflation risks are overstated."

It's that confidence which, from our perspective, feeds the risk of the Fed extending its current posture beyond the point at which a wave of higher inflation would be the inevitable consequence. Yes, at this point, initiating a policy reversal would still be premature. Money demand remains elevated, and deflationary pressures have not yet been completely flushed from the system. That can be seen during the occasional spikes in risk aversion, when the safe-haven rush to cash brings with it a sharp rise in dollar forex and a sell-off in sensitive commodities such as gold.

But as markets continue to stabilize and confidence is restored, that extra increment of money demand will fade, and with it the major factor offsetting the Fed's copious liquidity posture. If by that time the Fed is not convinced that the slack in resource utilization has lessened enough to justify moving toward a tighter policy stance, the excess liquidity will become entrenched, bringing about a rising inflation environment.

We can't rule out the possibility that the Fed -- as much by accident as anything -- could get it right. The recent data clearly indicate that the recession trough has passed and the economy is now transitioning into a recovery of some form. At this point it's questionable how strong a recovery we will have, but at least some portion of the "slack" is being absorbed. If that continues and potentially accelerates, it's not inconceivable that even under its fallacious output gap model, the Fed *could* move into policy normalization mode more quickly than we now anticipate. But it's eminently unlikely that the deeply destabilized economy will emerge from this unique recession in an orderly fashion, one that will serve up exactly the data the Fed would need to respond appropriately.

At the same time, we think it's debatable whether the Fed would actually be entirely averse to seeing some moderate increase in inflation. The global economy was put through a deflationary wringer late last year and into early this year, eerily mirroring the deflation that ushered in the Great Depression. Without the Fed's aggressive liquidity-flooding response, a calamitous deflationary collapse of the economy and financial system was a live possibility. If ensuring against that eventuality requires accepting a higher inflation rate for some period of time, we think that it's a price the Fed is willing to pay. Bernanke will likely remain loath to acknowledge that, although at some point he may feel compelled to do so to avoid losing credibility. Of course, while the Fed may believe it has the tools to ensure that whatever inflation is produced will be restrained, in fact it has very little ability to exercise effective control. The Fed determines the supply of money, *not* the demand for money. In a rising inflation environment, money demand is likely to fall and velocity rise, meaning that whatever inflation rate the Fed might find tolerable, the actual result is likely to be higher.

BOTTOM LINE: Bernanke's nomination to a second term probably assures that his easy policy stance will be maintained for the foreseeable future. For now, that's appropriate. Inflation risk remains acute, as he will likely not recognize the time to reverse course.