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FED SHADOW

FOMC Preview: In Praise of Ben Bernanke

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Donald Luskin

QE2 complete -- the Fed's just right. No QE3 unless unemployment rises or inflation falls.

Today's FOMC statement and Bernanke's subsequent press conference will make it official that QE2 has been completed, and that there will be no QE3 unless unemployment rises and/or core inflation falls. There's nothing tactically important or market-moving in that, but let's take a brief moment to appreciate how generally positive it is *strategically*.

- QE2 *worked*. Nothing spectacular, but since it began, inflation has stopped falling and started rising and unemployment is lower. Monetary policy effects always lag, so QE2 will likely *continue* to work (see "Will the World End when QE2 Does?" April 4, 2011).
- As a result, the version of the Taylor Rule we know Bernanke uses has gone from calling for a negative 6.62% funds rate to a negative 5.03% funds rate (please see the chart below).
- The Fed's accumulated long-term asset purchases can be modeled as a "funds rate-equivalent" of negative 3.15%. This brings the gap between the Taylor Rule and the funds rate to less than 2% -- indicating the Fed is still slightly tight. If we say that the natural rate of unemployment has risen from the 4.8% assumed in the Taylor Rule to 5.8%, then the gap closes and Fed policy is just 7 basis

Update to strategic view

US FED: QE2 is complete, and there will be no QE3 unless unemployment rises and/or core inflation falls. Based on the version of the Taylor Rule that Bernanke uses, Fed policy is exactly right -- not too loose, not too tight.

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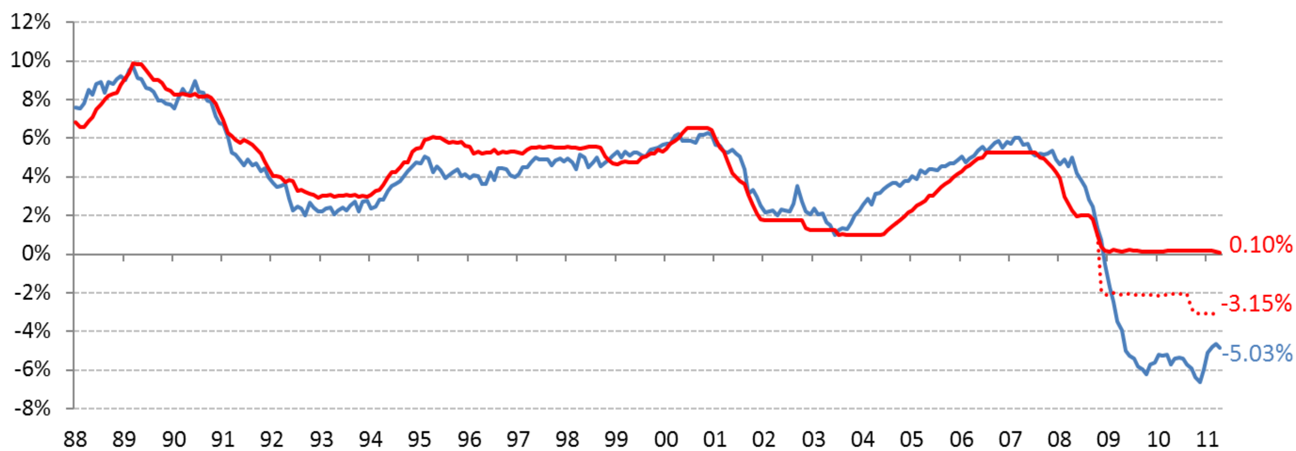
Rule-based funds rate **Actual funds rate** **QE-adjusted "funds rate-equivalent"**

Rule = 2.07 + 1.28 x 12-mo core PCE inflation - 1.95 x (UE - CBO natural rate)



Source: BEA, BLS, Federal Reserve, TrendMacro calculations per Rudebusch (2009) and Chung *et al* (2011) points from perfect.

- John Taylor, who conceived the Taylor Rule in a seminal 1993 paper, argues that his rule is now calling for a funds rate of positive 1%, and vehemently disagrees that it ever called for a rate of negative 6%. Among other reasons, it is because Taylor is looking at GDP *growth*, which is now close to trend. He ignores that the GDP *level* is far below trend -- a fact captured by using the unemployment gap in the model, as Bernanke does. This is the first post-war business cycle in which this distinction is important. We've never before had only trend growth in the presence of such a large output gap following a recession trough.
- Be that as it may, Bernanke calls the shots, not Taylor. So we can be highly confident that the Fed will simply let QE2 come to completion, and make no commitments as to future QE ventures.
- It doesn't even take the Taylor Rule to predict that. Bernanke has said as much, loud and clear, at his post-FOMC press conference in April (see "On the April FOMC" April 27, 2011). We expect markets will not be watching *today's* press conference with as much apprehension as they did last month's. The path is clear.

Bernanke is to be congratulated for creating such a transparent policy environment. At the same time, he has corralled his unruly team of regional presidents who, a year ago, were espousing such ridiculous and dissonant policy ideas as to give the market the impression that the Fed was intellectually rudderless (see "When PhD's Attack" August 25, 2010). The transparency and intellectual coherency Bernanke has brought to the Fed has played a large part in the reduction in market volatility over the last year. For instance, the present stock market correction -- in the face of a daunting panoply of global risk factors and intense pessimism -- is the second longest-lasting in this bull market, but only of average depth (see "The Post-Osama Slow-Motion Drip-Down" June 10, 2011).

QE2 has played a part in this, too. Many rationales have been given for it, many purposes ascribed to it, and many mechanisms by which it might operate have been described. But it is clear to us that, whatever else it has done, it has succeeded in creating an enormous cushion of liquidity in the world financial system. This facilitates useful risk-*taking* when sentiment is positive (see "Risk-On Hearts QE2" October 14, 2010). And now, when sentiment is negative, it is facilitating useful risk-*bearing*.

It's fashionable to hate Ben Bernanke nowadays, especially among certain Republican presidential aspirants who ought to be focusing on growth (see "Chaos in Athens, Progress in Washington" June 20, 2011). Nevertheless, as QE2 comes to completion, we think Bernanke has pretty much gotten things just right.

Bottom line

QE2 is complete, and there will be no QE3 unless unemployment rises and/or core inflation falls. Based on the version of the Taylor Rule that Bernanke uses, Fed policy is exactly right -- not too loose, not too tight.

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