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TRENDMACRO LIVE!

On the March FOMC

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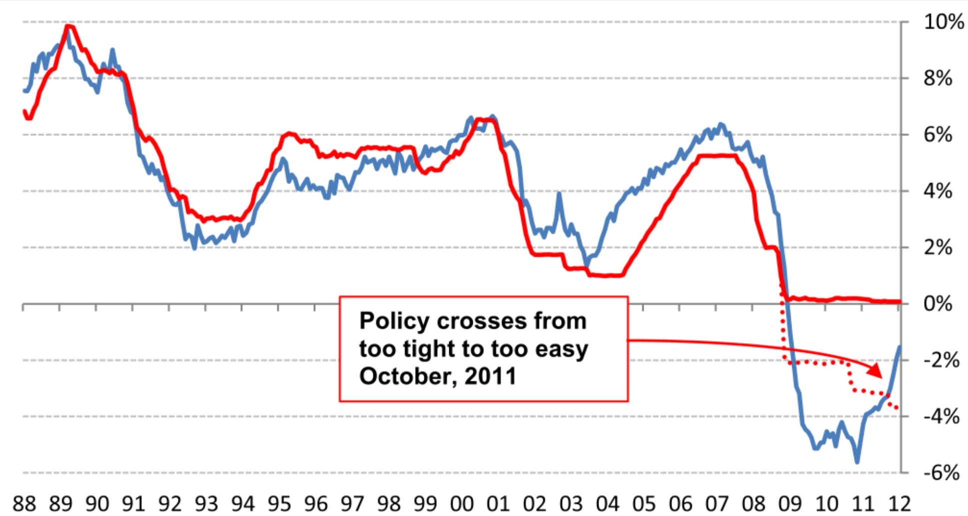
Donald Luskin

Bernanke emerges as a hawkish bulwark on the FOMC: if not for him, we'd have QE3 now.

The FOMC stood pat today, despite last week's highly visible trial balloon hinting at a sterilized version of QE3. There were no surprises in the committee's statement -- some slight language tweaks toward the optimistic, but still that recurring reference to "significant downside risks." *But a lot is going on under the surface.*

- Standing pat today reflects a victory -- at least for now -- by a politically weakened Ben Bernanke in a battle to rein in two highly influential FOMC members who are adamant doves: Vice Chair Janet Yellen, and New York Fed president William Dudley.
- If Yellen and Dudley had their way, we think we'd already have seen QE3, probably a trillion dollars of it.
- The Fed is now objectively easy, as measured by the modified version of the Taylor Rule we know is favored by the FOMC, including Bernanke (please see the chart below).
- Conventional wisdom holds that the Fed has been easy for more than three years, with a zero interest rate policy and several rounds

Fed funds rate — Taylor Rule ··· Funds rate adjusted for QE
Rule rate = 2.07 + 1.28 x 12-mo core PCE inflation - 1.95 x (UE - CBO natural rate)



Source: TrendMacro calculations per Rudebusch 2009

Update to strategic view

US FED, US MACRO: The Fed went from years of being too tight to being too easy, crossing over in October 2011 as unemployment fell and inflation rose. That was the same month the stock market bottomed, so it would seem to be a good thing to have relieved a long period of error with some degree of error in the opposite and compensating direction. But an error is an error. If the Fed persists in staying too easy for too long -- and it seems it is locked in until 2014 -- it will make real an inflationary outcome that so far has been merely a risk. Bernanke, the inflation-targeter, appreciates this. But he is politically weak in this election year, and faces stiff opposition from interventionists Yellen and Dudley. Ironically, Bernanke has emerged as the least dovish among the FOMC's influential members.

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of QE. But according to the Rule, the Fed was too *tight* until October 2011 -- the same month the stock market bottomed, beginning a slow-motion melt-up to new recovery highs. So this crossover would seem to be a good thing, relieving a long period of error with some degree of error in the opposite and compensating direction.

- This critical transformation of policy posture was not due to "Operation Twist" (see "On the September FOMC" September 21, 2011), though it did begin one month prior. It had a relatively small policy impact in terms of the Rule.
- It was the result of ongoing drifts higher in inflation and lower in unemployment. The Fed *didn't* change much, but the world *did*, and the net effect was easier policy.
- Despite that, the Fed got even easier in January by extending its commitment to ultra-low interest rates through the end of 2014 (see "On the January FOMC" January 25, 2012). And new easing options such as sterilized QE3 continue to be bruited.
- We are now at the juncture we have been warning about repeatedly (see, among others, "Gold is a Hold" December 20, 2010). This is a classic central bank error -- responding too late to a changing economic environment. Probably all the worse now because the Fed has pre-committed to ultra-low interest rates through 2014. *Tardy response is pretty much locked in.*

It's teetering on the verge of getting proactively worse, with additional easing programs. But it's not Bernanke who is pushing them -- he's holding them back. Bernanke is hardly the most hawkish FOMC member (Richmond Fed president Jeffrey Lacker dissented again today, objecting to the commitment to low rates through 2014). But still, it is deliciously ironic that Ben Bernanke, famous for his "helicopter" speech, is now a hawkish bulwark against the other two members whose voices really count on the FOMC -- Yellen and Dudley. Among the three, he's the least dovish.

- Yellen and Dudley are deeply committed and strongly insistent on more easing in the face of stubbornly high unemployment. Both are, by inclination, interventionists. Like most who believe that government intervention can fine-tune the economy, when one of their programs fails to deliver the promised results, their first reaction is to try it again bigger.
- Both are Democrats (Yellen was Clinton's Chair of the Council of Economic Advisors).
- It is an election year.
- Bernanke, on the other hand, is not an interventionist by nature -- despite the many interventions he was forced to undertake in the financial crisis in 2008 and 2009. As he said in 2006 in his first speech as Chairman of the Fed, he doesn't believe that a central bank can do much to promote employment other than to promote a healthy economic backdrop by assuring stable prices.
- Bernanke's focus on stable prices is famously pointed at deflation, with two episodes of it experienced during Bernanke's time at the Fed -- in 2002, and again in 2008-9. After those episodes, he is still inclined toward the dovish, believing the US price *level* should be

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higher. But he is mindful of the reality that the *rate* of inflation has recovered to, or above, his target: year-on-year headline PCE inflation is 2.4%, and core is 1.9%. The Fed's explicit target is 2.0%.

Today's divide on the FOMC -- Yellen and Dudley the insistent stimulus advocates, Bernanke the insistent inflation-targeter -- symbolizes the present contradictory state of the two elements of the Fed's dual mandate from Congress. It calls for both "maximum employment" and "stable prices" -- yet employment is still below maximum, while inflation is already at target, and making the employment situation better (or trying to) will (arguably) make inflation worse. How to resolve the contradiction, philosophically, politically and in policy?

- **Philosophically,** January's first-ever annual "statement of longer-run goals and policy strategy" from the FOMC says that when the two objectives are out of whack as they are now, the Fed "follows a balanced approach in promoting them, taking into account the magnitude of the deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate."
- This compromise presently favors the doves, as unemployment is more out of whack than inflation is. If you want to "split the difference," you would be willing to tolerate some amount of higher inflation for some amount of lower unemployment.
- That said, the whole exercise is based on a false premise *that everyone agrees is false*. In the annual goals statement, the FOMC agreed by consensus that "inflation rate over the longer run is primarily determined by monetary policy" while the "level of employment is largely determined by nonmonetary factors."
- **Politically,** the dual mandate exists and must be dealt with. And despite the seeming intellectual buy-in by highly trained economists Yellen and Dudley, the fatal conceit that intervention can be effective -- must be effective! -- runs deep.
- It is an election year.
- And it is an election year in which Bernanke has been weakened, politically, by the seeming universal need by all Republican presidential primary candidates to declare either than they will fire him or not reappoint him. With that in the background, and with the worst of the financial crisis in the past and little need for continuity, a re-elected Obama wouldn't necessarily reappoint him either -- so Yellen and Dudley, both credible candidates to replace Bernanke, are especially motivated to assert themselves in the president's interests.
- Bernanke was attempting to erode Yellen's and Dudley's case -- by taking their argument public -- when he shocked markets in his congressional testimony two weeks ago, saying the "decline in the unemployment rate over the past year has been somewhat more rapid than might have been expected" (see "When Bernanke Talks, People Sell" March 1, 2012).
- **In policy,** all Bernanke can do is compromise. Thus we have seen over the last six months "Operation Twist" and the commitment to

further extend the period of ultra-low interest rates (again, see "On the January FOMC"), and now hints of sterilized QE3. Both moves surprised us because we've been operating on the assumption that Bernanke has more personal control of policy than it turns out he actually does. We now see that what control Bernanke possesses has in fact kept those surprises from being even bigger.

Bottom line

The Fed went from years of being too tight to being too easy, crossing over in October 2011 as unemployment fell and inflation rose. That was the same month the stock market bottomed, so it would seem to be a good thing to have relieved a long period of error with some degree of error in the opposite and compensating direction. But an error is an error. If the Fed persists in staying too easy for too long -- and it seems it is locked in until 2014 -- it will make real an inflationary outcome that so far has been merely a risk. Bernanke, the inflation-targeter, appreciates this. But he is politically weak in this election year, and faces stiff opposition from interventionists Yellen and Dudley. Ironically, Bernanke has emerged as the least dovish among the FOMC's influential members.