Ben Bernanke at the Federal Reserve: What Can We Expect?

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Ben Bernanke at the Federal Reserve
What Can we expect?

1. Who is Ben Bernanke?
   *Personality matters. Fed Policy is run by committee.*

2. Bernanke’s approach to monetary policy.
   - Foundations: New Keynesian macro theory.
   - His signature proposal: Inflation targeting.
   - His views on asset prices, world savings, a/o key issues.

3. Challenges: Dealing with the Unexpected.
   - Setting Interest Rates - the Fed Funds target.
   - The Slowdown in Real Estate: How will the Fed respond?
   - Potential problems: The Dollar. Bank lending.
Who is Ben Bernanke?
A personal perspective.
Ben Bernanke’s Monetary Policy

• How will he run the Federal Reserve?
  Easy to answer: Read his writings!
  – On New Keynesian macroeconomic theory.
  – On inflation targeting.
  – On many other issues - usually find a publication.

• Do the academic writings matter?
  – Yes, for credibility. And in New Keynesian theory
    
    \textit{Credibility is crucial.}
New Keynesian Macro Theory

1. Inflation is economically harmful.
   - *Fed’s top priority: keep inflation low and stable.*

2. Money affects real output and employment.
   - There is a short run trade-off between stable employment and stable prices; a.k.a. the “Phillips curve”.
   - *Fed must be sensitive to business cycles.*

3. Households/firms respond to **expected** inflation.
   - If low inflation is expected, the Fed can more easily respond to cycles & keep interest rates more stable.
   - *Fed must maintain credibility (that inflation will stay low).*
Perspectives on Monetary Policy (2):

**Inflation Targeting**

- Bernanke’s proposal on how the Fed *should* operate.
  - Message: A specific target helps stabilize inflation at low “cost”.
- Will the Fed adopt an official inflation target?
  - All Fed governors have an informal target. Growing support.
    Newest Fed Gov. Mishkin is a coauthor of *Inflation Targeting.*
- What exactly is the target? Several measures of inflation:
  - **CPI** (consumer price index) or **PCE** (personal consumption expend. deflator)?
  - **Headline** (all items) or **Core** (excluding food & energy)?
  - **Answer:** Core PCE. Ben’s comfort zone: 1-2% growth.
Recent Inflation Data

Core CPI: +2.6% (Dec.06). Up 0.1%.
Core PCE: +2.2% (Dec.06). Constant.
Key Non-monetary Issues

Clues how Bernanke would respond to economic problems

- **Asset prices:**
  - Ignore bubbles and crashes, but do respond to the effects on inflation and employment.
  - Recognize the Fed’s crisis-management responsibility.
- **The U.S. current account deficit:**
  - Driven primarily by a “glut” of world savings.
- **Fiscal policy:**
  - Preference for the Fed to stay silent.
What Could Go Wrong?

• The real challenge: Dealing with the Unexpected!
  
  *How would the Bernanke Fed respond?*

• The “Slowdown” in Real Estate
  – No direct response [unless it triggers a banking crisis or mass unemployment]
  – Problem: Core-PCE includes rental cost! Rising > 3%.

• Potential for bank lending problems [if beyond sub-prime]
  – Recognize the ‘Credit Channel’ - respond to employment effects.
  – Worst case: Fed *will* serve as ‘Lender of Last Resort.’

• Potential for a U.S. dollar/current account crisis
  – Benign view of imbalances - inclined to let the markets work.
  – Key Issues: Rising import prices vs. employment effects.
Conclude: What Can We Expect?
5.25% Fed Funds rate target - “Paused, with Upward Bias”

Federal Reserve Projections
(Percentage changes - 4th quarter to 4th quarter.)

<table>
<thead>
<tr>
<th>Key Data</th>
<th>Actual 2006</th>
<th>Expect 2007</th>
<th>Expect 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation Core PCE</td>
<td>2.3</td>
<td>2.0-2.25</td>
<td>1.75-2.0</td>
</tr>
<tr>
<td>Real GDP</td>
<td>3.4</td>
<td>2.5-3.0</td>
<td>2.75-3.0</td>
</tr>
<tr>
<td>Unempl. Rate</td>
<td>4.5</td>
<td>4.5-4.75</td>
<td>4.5-4.75</td>
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</tbody>
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The Fed Funds Rate

Jan-01 Jan-02 Jan-03 Jan-04 Jan-05 Jan-06 Jan-07