



New Fed Head Bernanke: Inflation Is Key

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Ben S. Bernanke is a superb choice to replace Alan Greenspan as chairman of the Federal Reserve, but he will have to demonstrate to financial markets that he is as much an anti-inflation hawk as his highly regarded predecessor, according to faculty members in Wharton's finance department and private-sector economists.

These observers also say that Bernanke -- a former professor accustomed to discussing economics and monetary policy with students and others -- will speak more plainly in explaining Fed actions than Greenspan, whose cryptic, oracular comments became his trademark. Also, Bernanke is likely to establish and publicly disclose the Fed's specific target, or target range, for the inflation rate -- a policy that Greenspan eschewed but one that is becoming more common among central bankers worldwide.



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"I was thrilled [at Bernanke's nomination by President Bush] because he's a friend and I was just greatly relieved for the country; he was the best choice," says professor [Andrew B. Abel](#), co-author with Bernanke of a textbook titled *Macroeconomics*. Abel calls Bernanke, who taught at Stanford University and served as chairman of Princeton University's economics department, "a very judicious, careful, thoughtful kind of person who is capable of moving an institution in ways that benefit stakeholders as he sees fit. But he will do that in a consultative, deliberate way." Bernanke will need such talents to work with the Federal Open Market Committee, the group of officials that sets interest rates.

"I was definitely pleased," says professor [Jeremy J. Siegel](#), a longtime Fed watcher. "He seemed to be the favorite choice among economists and, I think, those in the market." Professor [Franklin Allen](#) says he had been hoping Bush would nominate Bernanke, calling him the "best candidate."

John Silvia, chief economist for Wachovia Bank and member of an informal advisory group for the Federal Reserve Bank of Philadelphia, praised the nomination because Bernanke already has had experience at the Fed as a governor, a post he held prior to being named chairman of the President's Council of Economic Advisers in June 2005. "I think he's like a top executive officer in a company going back to the same company he was working for before," says Silvia. Another reason Silvia likes Bernanke is that the nominee is "far less political than a number of other people that were mentioned on the shortlist."

Inheriting 'Near-Ideal' Numbers

In their weekly report on U.S. financial markets, published October 28, Standard & Poor's economists David Wyss and Beth Ann Bovino noted that Bernanke "inherits an economy that is in very good condition, with growth stable in the 3.5% range, inflation (excluding food and energy) at 2%, and an unemployment rate at 5.1%. These are near-ideal numbers for the central bank, and the new chairman's job will be to keep the economy in its current box, not to change conditions."

Assuming the U.S. Senate confirms Bernanke -- and it is widely expected that it will -- he would assume office on February 1, 2006, a day after Greenspan's term expires. The timing of Bernanke's ascension to the chairman's post is critical because he will have to decide at that time whether he feels the Fed should

continue the campaign of quarter-point rate increases that it began last year to head off any nascent inflation.

Since June 2004, the Fed has raised its target for the federal-funds rate, the interest that banks charge one another for overnight loans, from 1% to 3.75%. If the Fed continues to raise rates one-quarter point during the remaining three policy meetings of Greenspan's term, the rate would stand at 4.5% when Bernanke takes over. The question for Bernanke at that stage would be whether the Fed should raise rates again at its March 28 meeting, the first policy gathering at which Bernanke would be in charge.

Professor [Richard Marston](#) says the Fed should forego any action in January and give the FOMC under Bernanke a chance to raise rates in March if it feels a hike is necessary. "If Greenspan were going to be at the Fed another year, the Fed would probably raise rates in November, possibly in December, then once in the spring, then perhaps pause at 4.5% to see how the economy is responding," suggests Marston. "The final rise to 4.5% is not guaranteed, but is most likely at this stage. The economy is resilient. Even oil at \$60 a barrel cannot bring it to its knees."

But Marston says Bernanke's appointment makes the timing of further rate hikes awkward. "Bernanke needs to establish his inflation credentials. He is a fine economist and knows that the more conservative a reputation a central banker has, the more successful that central banker will be. If I were at the Fed, I would argue that it should hold up any action at the last Fed meeting in January under Greenspan. Pass the champagne and cake and applaud this great central banker. Then, let Bernanke begin his tenure with perhaps a final interest rate hike in March. The markets will get a clear message, then the Fed can proceed from there under the new leadership."

Siegel and Silvia agree that Bernanke needs to establish that he will be as diligent in fighting inflation as Greenspan and Greenspan's predecessor, Paul Volcker.

There is a consensus that the Fed is getting close to ending its string of rate increases, according to Siegel. The Fed raised rates November 1 to 4%, and Siegel believes there will be another quarter-point hike at the December meeting. "But whether there is a January increase is in the balance," Siegel says. "When that meeting comes it's going to be a transition point. It will be near the end of tightening -- if not at the end -- and Greenspan will have to judge whether the economy warrants a pause or even a decrease if the economy weakens significantly. Bernanke has to show his anti-inflation bona fides. I think if Greenspan holds off on a rate hike in January, and Bernanke later does an increase, it would show the Fed is really anti-inflationary. But the problem with that is if the economy is weakening, it would look awkward. The market wouldn't call for it."

By January 31, Bernanke and other economists will know a lot more about the success of the Christmas shopping season and how consumer spending has been affected by high oil prices. If 2005 turns out to have a particularly weak Christmas, Greenspan should hold off on raising rates January 31, Siegel says. If the economy is strong and Christmas sales are robust, Greenspan is likely to raise rates. Bernanke would then have six more weeks to analyze economic data prior to the Fed's March meeting.

Wachovia's Silvia says if the economy "is relatively unchanged between the January and March meetings, Bernanke will likely "go ahead with a 25-basis point increase to demonstrate his bona fides. If the bond market gets any sense that he's easy [on inflation], the bond market will sell off quickly."

For their part, Wyss and Bovino of S&P say they expect Greenspan, before he leaves office, to get the fed funds rate to neutral -- a rate that neither stimulates nor curtails economic growth -- which they believe to be near 4.5%. This could be accomplished with quarter-point hikes at the next three FOMC meetings, or Greenspan could decide "to punctuate the end of the tightening with a half-point hike in December, and then hold in January," they write. "That might be an easier entry for the new chairman, who could then just continue to do nothing for the rest of the year, barring a major crisis. More importantly, he would

have the maneuvering room to turn in either direction if a new shock hits the economy.”

Abel declines to predict what Greenspan or Bernanke might do about rates in the months to come. And while Abel agrees that Bernanke “needs to establish his inflation-fighting credentials,” he feels there will be no rush for him to do so. “Every central banker needs to do that, but Ben does come in with a history of inflation targeting,” Abel notes. “So I don’t think he needs to establish [his inflation-fighting commitment] right out of the chute” with an immediate rate hike.

Targeting Inflation

Bernanke has stated in the past his preference that the Fed announce a specific target, or target range, for inflation. Indeed, he is co-author of *Inflation Targeting: Lessons from the International Experience*, which argues that the openness of inflation targeting makes it easier for the financial markets, business people and citizens to understand the goals and effects of monetary policy. Inflation targeting is a relatively new idea. Greenspan never publicly announced a target rate. The experts interviewed by Knowledge@Wharton agree that Bernanke is likely to be more plainspoken than Greenspan.

Bernanke’s preference for targets “speaks partly to the difference in their styles as well as substance,” Abel says. “In recent years, many central banks around the world have moved in the direction of greater transparency so that people and capital markets can better understand what they’re up to. Targeting is an example of greater transparency. But it is more than that: It is a commitment to keeping your eye focused on inflation.”

Abel says that “Greenspan is legendary for his circumlocutions” but predicts Bernanke will not take that approach. “Ben has made a career out of studying monetary policy and then explaining it clearly. He’s written textbooks, and when you write textbooks, your goal is to explain things clearly, not cloak them in mystery. In his congressional testimony it will be really interesting to see how plainspoken he is. I think his natural tendencies will make him that way unless confidentiality requires him to be [circumspect].”

Siegel is in favor of inflation targeting. “Under Greenspan I can understand why it wasn’t necessary, but under a new Fed chairman who has not been tested, having a target would be useful.”

Professor [Marshall E. Blume](#) says it may not matter much if the Fed announces a specific target or not -- so long as the markets believe that the Fed has a goal. Greenspan has had such enormous credibility as an inflation hawk that he did not feel it necessary to disclose a specific target.

No Surprises

“One of the worst things that can happen to financial markets is surprises,” says Blume. “To the extent that people know what’s going to happen, they are more willing to invest and bear risk. The general view was that Greenspan had a target of 1% to 2% for the core inflation rate, but he never really said it. Now, if the Fed says our target is 1% to 2% for the core rate [which excludes volatile energy and food prices], the market will adjust and investments will flow into sectors of the economy that are the most competitive. I’m not sure [targeting] matters as long as people believe there is a goal. With Greenspan, people believed there was a goal.”

Blume says an inflation target is in large measure a political decision. “You can make your inflation target whatever you want. The reason it’s a political decision is that the rate of inflation, in some circumstances, is related to the growth rate of GDP. To maintain a fixed inflation rate in an environment where we’re running large deficits, one might have to incur a recession.”

A recession is exactly what occurred after Volcker became Fed chairman in 1979. To combat double-digit inflation, the Fed under Volcker raised interest rates sharply. That policy brought on a severe

recession in 1981 and 1982, but inflation was finally licked.

“Volcker was an inflation killer,” recalls Blume. “But if the body politic hadn’t been willing to suffer that recession, he couldn’t have brought inflation down. Think of the potential hazards in the U.S. right now. We’re running a large budget deficit and a large trade deficit. As long as foreigners are willing to hold U.S. dollars, it doesn’t matter too much, but at some point they may decide they hold too many dollars and in order for them to keep holding American dollars, they would have to have high real interest rates.”

Professor [Skander Van den Heuvel](#) says transparency by central bankers is generally a good policy but warns that Bernanke will still have to be cautious about what he says and how he says it. “I think the Fed chairman has to be very careful. The first president of the European Central Bank [Wim Duisenberg] made statements that were not phrased very carefully and the press took them and ran with them. That didn’t seem to help the ECB at its early stages.”

Aside from inflation, any number of shocks to the world or domestic economies could sooner or later test Bernanke’s mettle -- something akin to the Asian currency crisis of the late 1990s or the 1987 U.S. stock market crash that Greenspan had to contend with just a few months after he became Fed chairman. But Abel believes Bernanke has the ability to rise to the occasion. “Everyone has had a presumption that it’s harder than easier [to succeed Greenspan]. It’s true that Greenspan has been a terrific Fed chair for 18 years and that he’s a hard act to follow. But Greenspan was following Paul Volcker, who was regarded as a hard act to follow and who really had big shoes to fill. But Greenspan filled them fine. I think it may be daunting to follow someone as successful as Greenspan, but I don’t think that will stand in Ben’s way. A few years from now his name will be as much a household word as Greenspan’s.”

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