

# 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

*Credibility is crucial.*

## New Keynesian Macro Theory

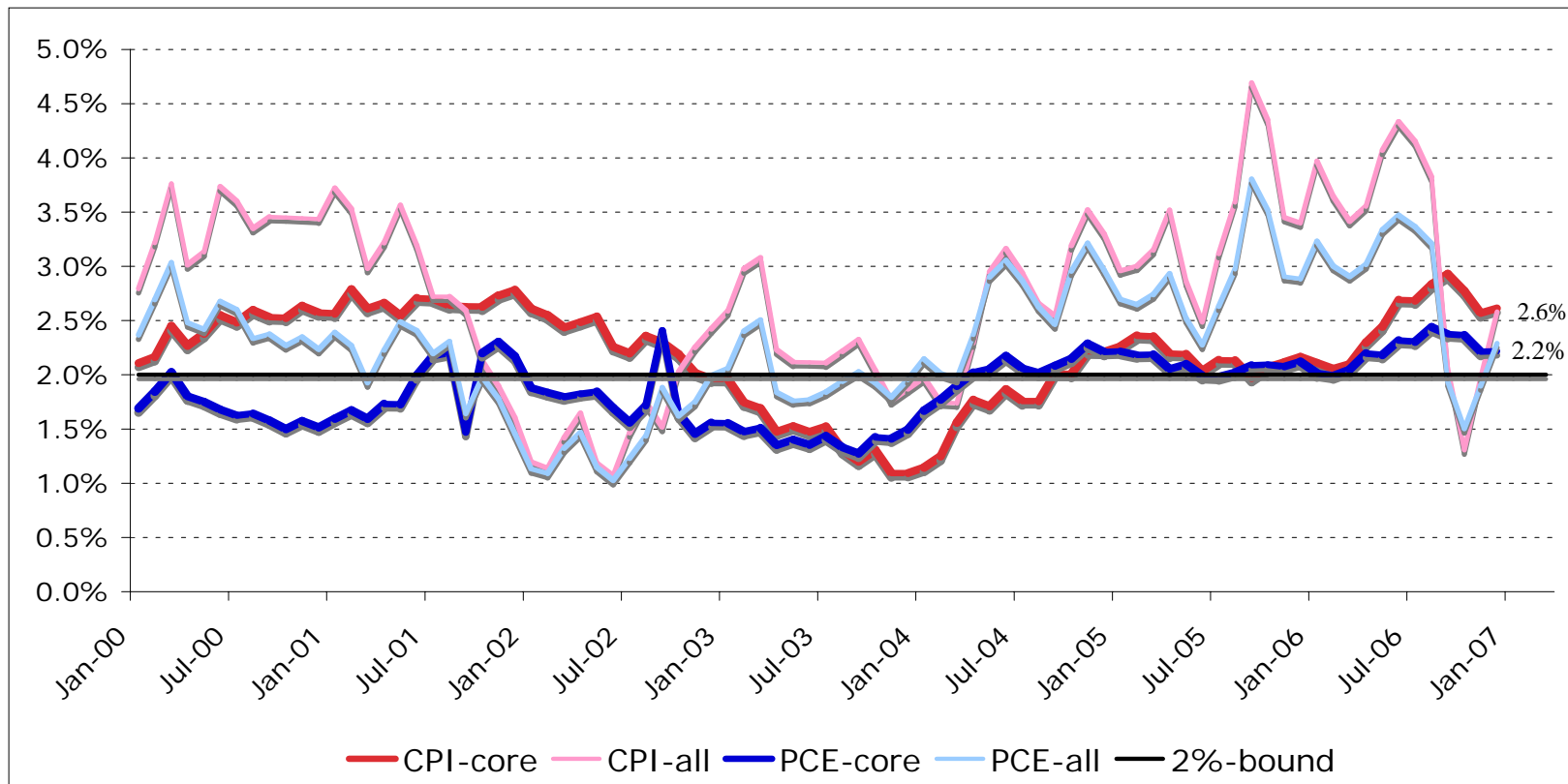
1. Inflation is economically harmful.
  - *Fed's top priority: keep inflation low and stable.*
2. Money affects real output and employment.
  - There is a short run trade-off between stable employment and stable prices; a.k.a. the “Phillips curve”.
  - *Fed must be sensitive to business cycles.*
3. Households/firms 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).*

## Inflation Targeting

- Bernanke's proposal on how the Fed *should* operate.
  - Detailed in a Princeton Univ. book:  
*“Inflation Targeting: Lessons from the International Experience.”*
  - Message: A specific target helps stabilize inflation at low “cost”.
- Will the Fed adopt an official inflation target?
  - Open question. Objections based on the Federal Reserve Act.
  - 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.



Perspectives on Monetary Policy (3):

## Key Non-monetary Issues

*Clues how Bernanke would respond to economic problems*

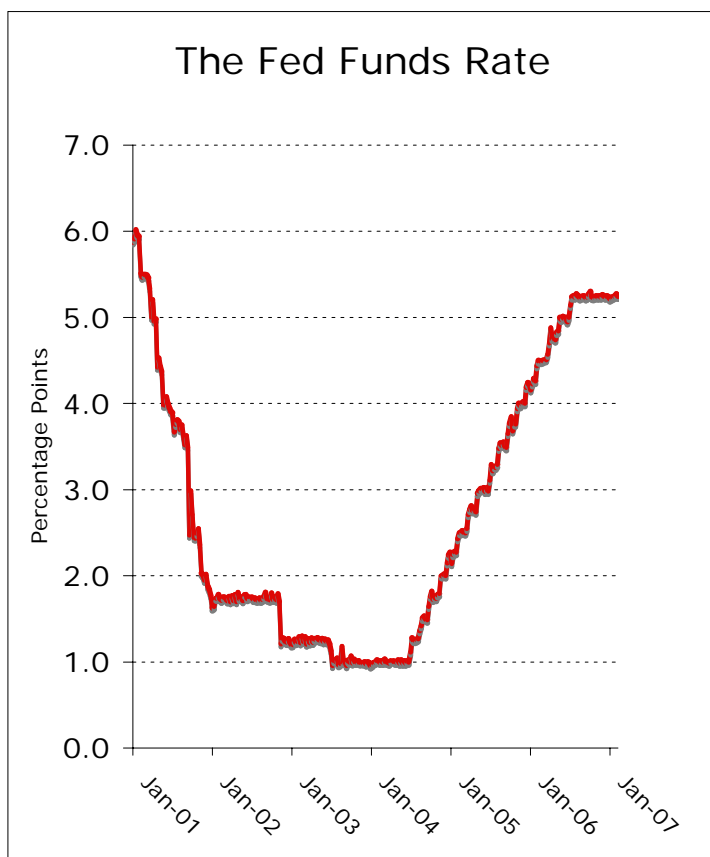
- **Asset prices:**
  - Ignore bubbles and crashes, but do respond to the effects on inflation and employment.
  - Recognize the Fed's crisis-management responsibility.
- **The U.S. current account deficit:**
  - Driven primarily by a “glut” of world savings.
- **Fiscal policy:**
  - Preference for the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

Key Data	Actual 2006	Expect 2007	Expect 2008
Inflation Core PCE	2.3	2.0-2.25	1.75-2.0
Real GDP	3.4	2.5-3.0	2.75-3.0
Unempl. Rate	4.5	4.5-4.75	4.5-4.75