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## Gentle Ben

Gentle and unflappable despite attempts by some Senators to have him buy into faulty economic policy analyses, the Chairman of the Board of Governors of the Federal Reserve began his two day appearance before Congress (the Senate Banking Committee today, tomorrow before the House Financial Services Committee). The last year in office for this Chairman has been one of growth, moderate success against inflation, improved communications and growth in his reputation as a competent central banker.

The Fed's monetary policy report features a slightly slower growth forecast (band) and an inflation band that is no worse than last year. We print today's projection and those of February 2006

Economic projections of Federal Reserve Governors and Reserve Bank presidents for 2007 and 2008

Percent

| Indicator | Memo 2006 actual | 2007 Range | 2007 Central tendency | 2008 Range | 2008 Central tendency |
|---|---|---|---|---|---|
| *Change, fourth quarter to fourth quarter*[1] | | | | | |
| Nominal GDP | 5.9 | 4¾–5½ | 5–5½ | 4¾–5½ | 4¾–5¼ |
| Real GDP | 3.4 | 2¼–3¼ | 2½–3 | 2½–3¼ | 2¾–3 |
| PCE price index excluding food and energy | 2.3 | 2–2¼ | 2–2¼ | 1½–2¼ | 1¾–2 |
| *Average level, fourth quarter* | | | | | |
| Civilian unemployment rate | 4.5 | 4½–4¾ | 4½–4¾ | 4½–5 | 4½–4¾ |

1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.

Economic projections of Federal Reserve Governors and Reserve Bank presidents for 2006 and 2007

Percent

| Indicator | Memo 2005 actual | 2006 Range | 2006 Central tendency | 2007 Range | 2007 Central tendency |
|---|---|---|---|---|---|
| *Change, fourth quarter to fourth quarter*[1] | | | | | |
| Nominal GDP | 6.2 | 5¼–6½ | 5½–6 | 5–6 | 5–5¾ |
| Real GDP | 3.1 | 3¼–4 | About 3½ | 3–4 | 3–3½ |
| PCE price index excluding food and energy | 1.9 | 1¾–2½ | About 2 | 1¾–2 | 1¾–2 |
| *Average level, fourth quarter* | | | | | |
| Civilian unemployment rate | 5.0 | 4½–5 | 4¾–5 | 4½–5 | 4¾–5 |

1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.

**What's interesting?** First, the forecast made last year was reasonably on the mark. Growth had been forecast between 3.75% and 4% and actually came in at 3.4%, 35 basis points below the forecast range. Inflation had been forecast between 1.75% and 2.5% and came in at 2.3%. Not as good as hoped for but not as bad as many feared. Basis points of inflation count for something, and 30 basis points above the central tendency forecast for last year was enough to worry some members of the Board. Fearing that inflation would lose its anchor, the FOMC continued to raise interest rates from its January level of 4.5% until June when it hit 5.25%, where it has stayed. Unemployment reached the bottom of the forecast range for 2006 at 4.5%.

Compared to Wall Street forecasters, this was a very good forecast and it may account for the rather moderate monetary policy during 2006, in spite of the three, quarter point raises. "Moderate" in this sense was the fact that the Fed communicated its intentions quite well to the market, and when the increases came the market has already taken them into account. There were essentially no big shocks in financial markets.

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The slowing of the economy during 2006 was of concern to some markets. For a time, the bond market had a forecast of rates that would drop as we entered 2007. Today's report reaffirms, however, the continued concern that inflation will break away from its anchor and a small likelihood that rates will decline shortly.

The Chairman did mention that there is some possibility that growth will slow markedly in the future, largely in response to untoward effects that could arise from the decline in housing activity. However, at this juncture, consumers continue to spend, even if the value of their housing assets may have been diminished somewhat. Put another way, even if expectations of further gains in housing have not been realized, little impact on spending has been noted. Further, exports are expected to continue to grow on the back of healthy growth in the world economy. Business spending has been solid, while the budget deficit has narrowed. There may be trouble brewing somewhere, but the Fed's central forecast is for generally stable growth and falling inflation.

The Senate Finance Committee was notably partisan in its Q&A, with Democrats posturing over the apparent growth of income inequality in the U.S. and loud concerns that manufacturing employment was being "globalized" with an attendant loss of 'high wage jobs.' The Chrysler announcement today of a plan to trim 13,000 jobs added fuel to their righteous concern for their constituents. As is well known, the inequality story is complex, and that makes it difficult to answer all the charges levied by some Senators. Bernanke could easily have tripped on the poisoned chalice offered him, but he adroitly and exceptionally declined the offer, and calmly walked through the fire. What is apparent, perhaps stimulated by his Omaha speech that dealt with the issues of inequality and educational achievement, is that Bernanke now has some ***gravitas*** in front of the Congress. Congress recognizes that he is learned and thoughtful and careful to delineate his areas of responsibility. He manages to submerge his usually, thoughtful academic analysis of difficult issues and he carefully deigns to step into the maelstrom of tax policy, exchange rate policy or other favored purchases of posturing Senators. He clearly has won their respect and he is careful not to go down the road blazed by his predecessor. Greenspan's long tenure in the public arena gave him considerable weight and his success in dealing with the various "crises" of his reign gave him an eminence that few Congressmen could attack. Greenspan's excursions put the Fed's independence at some risk. Bernanke is clearly less dramatic, but in some ways, therefore, more protective of the Fed's independence by staying out of the political fray. Given the longing of some Congressmen to force the Fed to pay attention to their more parochial interests, Gentle Ben has wisely stayed out of that circus and the Fed is better off for his caution. The recent turf battles in Japan between the MOF and certain politicians and the Bank of Japan underscores how important it is for a Central Bank to stay out of the political arena. It gains credibility for actions it may have to take in the future, and Bernanke is not likely to risk that independence by trying to be a political sage.

Where is the Fed going from here? The two handed economist has the floor. There are risks to the upside on inflation and risks to the downside from a wavering of demand. That said, the economy is performing more than adequately to meet the Fed's dual mandate. Sometimes doing nothing is just about right and that is where the Fed is headed, baring a major course change in the economy or a financial crisis that would force the Fed to concern itself about financial stability. In that light, the recent bankruptcies in the sub-prime lending market point to the obvious. In the search for return, risk seeking lenders can lend to that part of the income spectrum that is highly vulnerable to marginal economic setbacks, even when the credit histories of such borrowers make them suspect to more conventional lending institutions. Because financial diversification has allowed a 'slice and dice' approach to collateralized mortgage obligations, there always seemed to be a party going on during the ecstatic stages of the recent housing boom. All parties end sometime and the hangovers show up. Will the upsets cause a major financial infarct? Not likely, but no one can be totally sure where all the bodies are buried. At this stage, some trouble, but no major worries for the Fed. They are alert but not panicked in the least.

The Fed's forward policy is based on a central-forecast that with growth slowing to below or just around and assumed 2.75-3.0% growth trend, despite what appears to be a full resource utilization condition, prices should moderate over the medium term. While this might lead some to think unemployment will rise, the Chairman noted that the Fed expects labor force participation rates of women to moderate and the total labor supply to grow less sharply. That allows the economy to absorb the willing supply of workers at a slower growth rate and a slower rate of job creation.

Clearly, there are conditions that can trash this forecast, but the Fed has to have a model of the economy stretching out more than a year or more, and this is their central belief. It can change, but only when the evidence changes sharply. In the meantime, Gentle Ben is forecasting a rather stable and steady environment for a very moderate monetary policy.

The equity market seemed to like the "no surprises" tone of the report and in a world of a flat yield curve, low real rates of interest and growth here and abroad, equities are the asset du jour. Something will change, but right now, on the basis of the evidence, if it is not Goldilocks, it certainly seemed like a nice Valentine's Day for the market.

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Percent

Change, fourth quarter to fourth quarter1

Nominal GDP ......................................................................... 5.9 4¾ –5½ 5 – 5½ 4¾ –5½ 4¾ – 5¼

Real GDP ................................................................................. 3.4 2¼ –3¼ 2½ – 3 2½ – 3¼ 2¾ –3

PCE price index excluding food and energy .......................... 2.3 2 –2¼ 2 – 2¼ 1½ –2¼ 1¾ –2

Average level, fourth quarter

Civilian unemployment rate ................................................... 4.5 4½ –4¾ 4½ – 4¾ 4½ – 5 4½ – 4¾

1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.

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