The Bernanke-Greenspan Difference: Monetary Policy Report

In a calm, dispassionate and thoroughly professional presentation, Chairman Bernanke presented his first **Monetary Policy Report to the Congress** (the mid year update). It was a straightforward exposition of what we think the consensus at the FOMC believes. The crosscurrents are a forecast of slower growth with some allowance for a higher than average rate of inflation, measured by core personal consumption expenditures. The Chairman took a risk management approach but laid out a central scenario that has core inflation as measured by the core price index for personal consumption expenditures in 2006 at 2 ¼ to 2 ½ percent and 2 to 2 ¼ percent in 2007. There was some indication that the latter numbers could stretch well into 2008. Bernanke (or the FOMC as a whole, more on this below) expects real growth to moderate and come well in line with potential growth (not explicitly enumerated).

> **"The FOMC projections, which now anticipate slightly lower growth in real output and higher core inflation than expected in our February report, mirror the somewhat more adverse circumstances facing our economy, which have resulted from the recent steep run-up in energy costs and higher-than-expected inflation more generally."**

Growth, in this view, will slow from the above trend 5.6% rate of QI 2006, but remain around the estimated potential growth rate (which we infer from his remarks to be some 2.75/3.00 %). Historically, that would still be a respectable achievement, but it means moderation of real growth to be sure. Perhaps most surprising was the Chairman's willingness to accept inflation rates going forward for the immediate term above the oft-supposed limit of 2%. The data will do the talking but the trend behavior of inflation will be important the longer time passes. He is aware that current core and top line measures are not consistent.

Equity and bond markets rallied, but perhaps the rallies were based more on hope than a certainty that the FOMC is through with its dis-accomodation cycle. A careful parsing of Bernanke's remarks reveals no such certainty, and his oral Q and A cannot be stuffed into such a simple mold. In fact, what we saw was a true professional economist, not a political pontificator, practicing his profession with the care and deliberateness that the market will come to respect. Markets want the Fed to be perfectly clear---well beyond its current knowledge base---and Bernanke is neither foolish enough to provide what he cannot nor political enough to tantalize without guaranteeing. This is not the Greenspan era and the best thing for market players to do is to take him at his word. He thinks the economy is slowing, and **if it does, the Fed will be more moderate in its response than it will be if in fact growth does not slow and inflation continues to rise.** That is not a commitment. It is a conditional forecast.

What markets should realize is that they are implicitly making two forecasts: first, how will the data points come out and secondly, how will those data points be "read" by the FOMC. What Bernanke gave the market is the FOMC's best judgment of where the economy is at present and its most likely course. But "most likely" is not certainty and the data can turn out quite differently than what is now his (or the FOMC's) best judgment. If the data do turn out differently, he and his colleagues will be forced back to the table and to choose the most propitious course. Market players are well advised to keep in mind what he said earlier in the year.

> **"Given this reality [bond prices, like other asset prices, incorporate a great deal of information], policymakers are well advised to follow two principles familiar to navigators throughout the ages: First, determine your position frequently. Second, use as many guides or landmarks as are possible."**

This was advice to his fellow policy makers. Traders would be well advised to follow the same advice.

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Bernanke is not from Pittsburgh, and the Fat Lady has not yet sung!

One other small point that may become increasingly important as Bernanke's control of the Fed becomes clearer. This speech was undoubtedly written before the 8:30 AM numbers came out. He may well have seen them the night before, but the larger inflation number (core CPI up 0.3%) and the smaller housing starts number (down 5.3%) amplify the central message of his text: slower growth and still rising inflation. They are not inconsistent numbers because adjustment of different macro variables (prices and expenditures) takes place at different rates. The inconsistency arises only when we try to go from these numbers to a simple formulation about the expectations of economic agents. The argument about whether core or top line inflation numbers are the more relevant begs the central issue: how will households and business change their **expectations of inflation** as a result of these data points. Bernanke doesn't know that; no one knows that. If he believes, as a recent staff study at the Fed concludes, survey data are the best predictor of actual inflation numbers, then he is going to be less moved by these two data points than some in the markets now think.

Finally, there could well be a difference between what Bernanke thinks and what the central tendency is at the FOMC. If this were a Greenspan Fed, we would need to know what Greenspan thought since his views were more than that of a first among equals. Bernanke is not a Greenspan…the data will indeed do the real talking and judgments about the data are likely to be much more collective than the market has come to expect.