



## The New Fed Chairman and the New Fed

Wall Street economists and commentators have a new topic: to opine upon the likely policies of the Fed under its new chairman to be, Professor Ben S. Bernanke. Bernanke will have great power, but what he does with it is the issue. “The measure of a man is what he does with power.”<sup>1</sup>

Wall Street also likes to say, ‘markets will test him,’ but that is not a helpful forecast because truly none of know for sure what the next crisis will be nor whether the crisis is one that the Fed can address. What we think we know are some of the problems that currently afflict the economy and not all of them lie within the power of the Fed to cure. (e.g. the energy shock). The nature, timing and magnitudes of the next shocks will affect how we measure and assess the new Chairman’s capabilities. What he will do at the time, we can only guess, but fortunately Bernanke’s past thinking offers some signposts.

He has been a gifted scholar, well respected among monetary economists. He comes from a school (M.I.T.) that has often been seen as a well-spring of activist monetary policy, yet his own research on inflation targeting suggests that he believes “less may be more.” He has been an active proponent of more transparency in Central Bank communications which in turn suggests that he believes that well-informed markets make the Fed’s job easier and the economy’s adjustments less abrupt. He has not been afraid to stake out new ground such as his timely but thoughtful remarks on the dangers of deflation or his recent view that the American current account deficit was more a product of a world savings “glut” than the simplistic view that Americans saved too little. At the same time, his short tenure as the Chairman of the Council of Economic Advisors suggests he is more comfortable working from the “inside” on policy matters than in articulating Administration policy views in a public setting. That would be consistent with a view that he is comfortable with a Fed that vigorously examines and debates policy from within, but then speaks very clearly and predictably to markets leaving less doubt perhaps than in the past as to future policy changes.

In this regard, two observations seem pertinent. Greenspan’s dominating presence did not deter Bernanke from exploring alternative ideas and alternative formats of presentation. He is likely to respect that during his own tenure which will give more scope to his colleagues. Nor is he likely to dominate the Fed at the outset as did Greenspan. He is comfortable with his ability to understand alternative opinions and to reach a reasoned judgment between such alternatives. That is the mark of a confident and ever-inquiring mind, not of a dogmatic and doctrinaire policy maker. It suggests that the Fed is likely to become an even more deliberative body. Markets will have to adjust to a diversity of opinion from within, and will need, therefore, to be guided by even more transparent policy statements.

The likely role of diversity at the “new” Fed suggests that the remaining two appointments on the Federal Reserve Board are likely to tell us more than they would have during the Greenspan era. It

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<sup>1</sup> Pittacus, who also said, “power shows the man.”



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is bound to be a more collegial Fed at the outset, which will magnify the impact of the two new appointees. Markets need to see who these appointees are and to assess their policy views.

Bernanke's recommendations on these appointments will undoubtedly be solicited, but as an 'insider' this past year, he is also likely not to try and enforce his views of the appropriate appointment. If the Administration thinks it needs to shape future Fed policy, the opportunity is at hand. How much weight the new appointments will carry is a big unknown. Bernanke's comfort level with his own achievement is likely to produce a congenial but thoughtful debate on policy within the Fed, but we will "only know it when we see it." Still, diversity of view is a virtue at the Fed when it provides opportunities to avoid monumental error. At the end of the day, however, history suggests that the Fed Chairmanship offers the opportunity for a convincing Chairman to carry more than his formal weight. Bernanke will start as a first among equals and only time will tell if he carries the weight that his predecessors once did.

It is hard to overstress the importance of error avoidance in a Fed Chairman. If Bernanke's own work is a signpost to his future belief structure, it suggests to us that reading the tea leaves of current economic behavior is a much harder job than many policy advocates have been willing to admit. At the same time, his original work on the Great Depression as well as the lessons he drew from the Japanese experience with deflation suggest that he is more than causally familiar with the need to avoid major directional errors in monetary policy. His work on inflation targeting suggests and informs this view because an inflation targeting approach is one that distances itself from frequent and decisive changes in monetary policy. It emphasizes "rules" rather than "authorities," and it implicitly is a much more 'modest' statement of what monetary policy makers know at any given time and what they could accomplish by sudden and unexpected shifts in policy.

Bernanke's appointment comes after two extremely strong Chairmen, whose views on many public policy issues were widely known before their appointment and who had to face a "crisis" early in their tenure. Volker set out to break the Great Inflation and is applauded for his resolute attack--in spite of the economic and short term political consequences. Some forget that the Fed continued to tighten **despite** many cries for Volcker's political scalp. History has dealt him a better hand than did contemporaneous policy commentators. Greenspan was scarcely Chairman when he faced the October 1987 stock market collapse. He answered with an unswerving dedication to maintaining liquidity and the economy largely avoided an economic decline that had often been the result of a sharp market break. His long tenure has scarcely been marred by recession, although some of his critics have allowed that he has been swapping one bubble for another precisely to avoid such an outcome while the "imbalances" remain as the central legacy for his successor. What characterizes the Greenspan era was his willingness to make a pronounced policy shift once he felt he understood the data. We see that as a less likely outcome under Bernanke. We expect a more "measured" responses.

Sensitive to monetary history as he is, it is most likely that Bernanke will move modestly and with early warning to allow markets to become fully comfortable with his policy prescriptions and more importantly with his policy process. What should create confidence for the market is becoming accustomed to the synthesis that Bernanke is likely to build and the early warning character of transparent policy announcements through which such policies are conveyed. This was a very solid appointment indeed.



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Meanwhile, the second market day after the appointment seems to have led to divergent evaluations by equity and bond market participants. What has been the “take” of the average investor? Equities experienced a huge rally the first day (with the Dow up 169 points) and after declining some 68 points early on Tuesday, rallied to finish off only .07 percent. Similar behavior was seen in the other principal indices. Bond yields rose with the 10 year Government rising from 4.39 to 4.53 over the two day period. Clearly, the uncertainty surrounding the departure of Greenspan was lifted, but the Bond market is not so sure that Bernanke will be a dove on inflation as some commentators remarked early in the appointment cycle. The Deflation bogeyman of 2002 is history, and our read of Bernanke is that he is going to be as committed an inflation fighter as was Greenspan. Did the Bond Market read it right? It would not be the first time.