

Suite 502

1150 Seventeenth Street, N.W., Washington, D.C. 20036

Telephone: (202) 777-3000 Facsimile: (202) 777-3010

## ECONOMIC NEWS UPDATE

IRWIN M. STELZER

20 February 2007

### **Transparency Comes to the Fed as Bernanke “Hits One Out Of the Park”**

In days gone by, when share price movements were recorded on ticker tape, those bits of paper that were at times showered from skyscrapers on heroes being honored in New York City’s so-called ticker-tape parades. Were it not improper, and had paper tape not been made obsolete by electronic reporting, Ben Bernanke would be sitting in an open-top limousine, showered with ticker tape by adoring traders after last week’s appearances before Congress.

“He hit it out of the park,” said one trader, resorting to one of the sports analogies popular on the still-macho trading floor of the New York Stock Exchange. Here’s why. “Real activity ... expanded at a solid pace in 2006....The US economy appears to be making a transition ... to a more sustainable average pace of growth.... The weakness in housing market activity ...[does] not seem to have spilled over to any significant extent to other sectors of the economy.... Consumer spending has continued to expand at a solid

rate.... Inflation pressures appear to have abated.... The business sector remains in excellent financial condition.... Overall, the US economy seems likely to expand at a moderate pace this year and next, with growth strengthening somewhat as the drag from housing diminishes.” It just doesn’t get any better than the Fed chairman’s statement from the point of view of investors. No surprise, then, that the bulls are routing the bears, despite weak retail sales, industrial production, and employment figures released on the final day of Bernanke’s testimony.

That economic glow is in odd contrast with the national political gloom. The economy seems about as good as it can get. But the political life of America is a mess: the Democratic Congress is battling the White House over Iraq policy, is investigating the administration’s handling of the reconstruction of Iraq and New Orleans, and is launching multiple investigations of, among others, the pharmaceutical, oil, and health care industries.

Perhaps Americans have decided that what goes on in Washington is full of sound and fury, signifying merely that the great machine that is the US economy is impervious to the self-important posturings of the politicians who think they are guiding it. They have also decided that Ben Bernanke can indeed fill the large shoes left empty when Alan Greenspan departed the scene.

With reason. His policy of raising and then freezing interest rates seems to have set the economy on a glide path to a soft landing, despite the weakness in the housing sector. Better still, there are signs that the housing market is stabilizing. Sales of new and exiting homes are no longer plummeting, mortgage applications are up, homebuyers' sentiment has improved, and the National Association of Homebuilders activity index, although still recording builder gloom, has climbed to its highest level since June. In the fourth quarter of 2006, house prices in 71 local markets rose, while prices in 73 markets fell. Average prices fell by a relatively moderate 2.7% during all of 2006. David Lereah, chief economist of the National Association of Realtors, thinks the bottom of the housing market was reached in the fourth quarter of 2006. Given the still-high level of unsold inventory, that might be a bit optimistic. But if mortgage rates stay low, and Bernanke's prediction of an uptick in real incomes proves correct, we may at least be close to the point where new construction will pick up.

More important than the upbeat tone of the chairman's remarks are the clues he sprinkled around of the rules that will guide him as he sets monetary policy. Bernanke expects real (after adjusting for inflation) GDP to increase

between 2.5% and 3.0% this year and 2.75% and 3.0% in 2008. It seems clear that he thinks growth in that range is about what the economy can sustain without triggering inflation. So, if growth falls below, say 3%, he might be inclined to lower interest rates, and to raise them if growth tops that level.

Second, he suggests that he is willing to live with an inflation rate of 2%, but no more, using the Fed's preferred measure of inflation (Personal Consumption Expenditures). So watch that indicator, and assume that Bernanke will get an itchy trigger finger if inflation persistently tops 2%, especially if the economy is pressing on capacity at that time.

Third, Bernanke's statement suggests that he believes that the level of unemployment at which there are neither too many jobs chasing workers, nor too many workers chasing jobs, is somewhere between 4.75% and 5.0%. (For the jargon-prone, that's the NAIRU, the noninflationary rate of unemployment).

This is carrying transparency to levels that probably sent nervous chills down the spine of his Delphic predecessor. Some critics feel Bernanke has gone too far, and given hostages to fortune. After all, decimal places were invented to prove that economists have a sense of humor, and it is not impossible that one end or another of those ranges will be pierced as a result of transitory events to which the data-driven Fed will not want to react by adjusting interest rates. But congress is happy: one member said it is a relief to have a chairman who does not speak in tongues.

Before buying a ticket for a spin around the dance floor with Rosy Scenario, do take notice of two things.

First, the Fed chairman warned that the economy is operating at a high rate relative to its capacity, that tight labor markets and rising compensation might cut into profit margins, and that oil and other commodity prices are difficult to predict.

Second, the longer term problems that the economy faces are unsolved. The federal deficit remains high despite the high level of economic activity; the economy remains subject to an "oil shock", which its supplier-countries are quite capable of orchestrating; the ageing population will put strains on the pensions and health care programs; the continuing trade deficit and some row with China might cause a run on the dollar.

But that's for later, a period that will not be confronted until after a new president moves into the White House in January of 2009.



## **THE SUNDAY TIMES**

A version of this Update appeared in  
The Sunday Times (London)