



The MacLellan Group

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Ben Bernanke & the FED

President Bush's nominated Ben Bernanke, to replace Alan Greenspan as Fed Chairman yesterday. This announcement received mixed reviews from financial markets, due to the perception that Mr. Bernanke is an inflation dove. The equity markets rallied yesterday while the bond market sank.

Two items should be noted in regards to this market reaction. First, if taken at face value, the bond market's decline suggests that fixed income investors are concerned about the outlook for inflation and want the Fed to continue tightening monetary policy. This is clearly the opposite of current conventional wisdom. Second, the conclusion that Mr. Bernanke is an inflation dove is likely premature.

Mr. Bernanke joined the Federal Reserve Board in 2002 when deflation was a major concern. He has also completed extensive research into the link between deflation and the Great Depression. As a result, he supported aggressive Fed action in fighting deflation. But, being a deflation hawk does not make him an inflation dove.

The concern that perhaps should be focused upon is that in 2002, when he gave his most ardent speeches about deflation and supported very aggressive Fed action, deflation was no longer a problem. The Fed had already slashed rates to the point of creating the inflation that many are worried about today. This highlights a common Fed mistake of focusing on the wrong indicators of inflation like unemployment, economic growth and capacity. As a result, the Fed tends to overshoot when it tightens or eases. The Fed is always fighting the previous monetary experience. Based on his writings and speeches, Mr. Bernanke will not likely alter this pattern.

The path of the federal funds rate over the past six years highlights this issue. Starting at 4.75% in mid-1999, the Fed lifted rates to 6.5% because its models predicted rising inflation due to low unemployment. The recession and deflation that followed caused the Fed to cut interest rates to 1.0%. The Fed overshoot on both sides.

If Chairman Greenspan hikes rates at each of his remaining three meetings, and Mr. Bernanke follows with a rate hike to establish his credentials as an inflation fighter, the funds rate will complete a round trip to 4.75%. If the Fed had never moved rates at all in the past six years it is likely that the 2001 recession and worrisome deflation would have been avoided. Inflation would not be rising today and oil prices would be lower.

However, because the Fed staff has institutionalized a Keynesian-based Phillips Curve approach to managing monetary policy, the Fed will continue to make these kinds of mistakes in the future. Although Mr. Bernanke seems to lean toward a supply-side view on fiscal policy and advocates inflation targeting, the available evidence suggests that he has no material disagreement with the conventional wisdom of the Fed staff. While movement toward inflation targeting would be a positive, instituting a price rule based on forward looking indicators such as the dollar, commodities and the yield curve would be a much more accurate forecasting standard. The expectation should be for low for any serious progress in a change in forecasting models in the near future. Nonetheless, Mr. Bernanke will likely do just fine.

Mr. Douglas MacLellan holds significant expertise in developing and financing businesses in emerging markets and industries, particularly in the pharmaceutical telecommunications, software and media industries. Over the past fifteen years, Mr. MacLellan has helped to develop and finance businesses in Bulgaria, Cambodia, Canada, Chile, China, Hungary, India, Korea, Madagascar, Russia and the United States. Mr. MacLellan is currently a member of the Board of Directors and Chairman of the audit committees of two publicly listed companies.

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