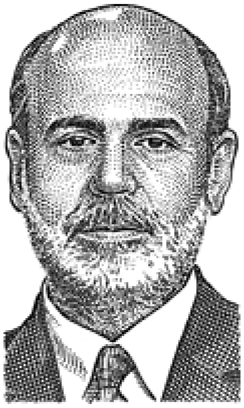
COMMENTARY



Ben Bernanke

The Accidental Inflation Hawk

By MARC SUMERLIN
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There are no Gentlemen C's in central banking. The costs of monetary policy mistakes are so large that you tend to be right or wrong. With this in mind, Ben Bernanke deserves an A for his first year as chairman of the Federal Reserve. The Bernanke Fed hasn't always been graceful or elegant, but it has been mostly right.

Mr. Bernanke started off with a stumble last April, testifying awkwardly that he might choose to stop raising rates even if inflation were at risk of accelerating. This statement, combined with his past fretting about deflation, led markets to question his fortitude on preventing inflation. Long-term inflation expectations promptly rose by 20 basis points. The chairman regained his footing with a hawkish speech two weeks later and two more rate hikes on the Federal Funds rate in May and June, bringing the rate to 5.25%. The hike in June wasn't an obvious one given the fragility in global financial markets, which had lost $5 trillion in value over the preceding seven weeks, due in part to diminished confidence in the new Fed chairman. But markets digested the last rate hike with only a bit of consternation and no more genuine turmoil.

At this point, it would have been tempting to go for another rate hike in August. A legitimate strategy for a new chairman is to build up inflation-fighting capital early in his term so that he can spend it when needed. In fact, a risk-weighted analysis of Mr. Bernanke's personal survival would have argued for hiking in August and cutting later if needed. But Mr. Bernanke appears to make fact-based decisions rather than strategy-based decisions. In this, the facts were slightly on the side of a pause. A seasoned chairman with ample credibility would surely have taken a break to see how the lagged impact of past rate increases was working.

By the August FOMC meeting, it was clear that the housing sector had rolled over. It was also clear from the size of the housing bubble, from an examination of historic corrections, and from collecting anecdotes, that the housing slide was going to be with us for years not months. In effect, the desired growth slowdown had been accomplished, likely with the move to a 5% federal-funds rate in May. Mr. Bernanke had gone one further, but a modest overshoot is almost always needed from a practical standpoint.

Still, the decision to pause was not obvious. While economic growth was decelerating, there were no signs at that point that inflation was coming under control. In fact, wages were accelerating according to the available data, which usually gives a central bank more room to tighten. What is most amazing in retrospect is that the first Fed chairman ever to advocate inflation targeting was pausing as inflation was high and possibly accelerating. A key critique of inflation targeting -- one to which I still subscribe -- is that the target could in practice lessen the Fed's ability to look far down the road. But in this case, Mr. Bernanke was not a slave to the latest figures and bet that inflation would subside. So while a belief in inflation targeting has not added value to the decision-making process, it hasn't done any harm so far.

At the time, many bond market participants were not impressed with the pause and started to question Mr. Bernanke's resilience again. The behind-the-back whispers were perceptible. Then a curious and unpredictable thing happened. Inflation stopped accelerating. After four months of hot data, prices started to behave better. Spot oil prices plunged after a gratefully mundane hurricane season, taking some pressure off headline inflation. I'm not sure if Mr. Bernanke is also a skilled weather forecaster, but he may be the first person to simultaneously predict the weather and the economy accurately. It's still not clear why prices outside of energy stopped accelerating -- the tightness of the labor markets and other facts in early August pointed to continued inflation trouble. But whether Mr. Bernanke was lucky or not is now beside the point for workers and investors who benefited from his call. Global equities started another long rally that more than made up for the springtime losses.

The upcoming December FOMC meeting will mark the fourth straight gathering without a change in monetary policy. That is proof in and of itself that Mr. Bernanke's decision to pause was reasonable. It is not, however, proof that Fed policy is correctly calibrated going forward.

Since the August pause, the housing and domestic auto industries have fallen into recession, and importantly, wage gains have been revised down. The bond market, the stock market and the currency markets are all betting that the Fed's next rate move will be down, even though the Fed tries to tell markets at every chance that a hike is more likely. The disconnect with the bond market is so large that Mr. Bernanke could wrap up his first full year with as much as a 100-basis-point inversion in the yield curve. Yet the tightening of policy relative to reality has created a stance sufficiently hawkish to rebuild inflation-fighting capital -- a welcome strategic development. In a sense, Mr. Bernanke has become an accidental hawk. This fortuitously earned capital is especially timely with the economy below its long-run sustainable growth rate. After all, a central banker never knows when he will need to cash in some chips.

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