The Fed's New Deep Bench

The Federal Reserve's
Ben Bernanke: *It doesn't take a great deal of imagination to see 4 percent-plus growth later this year and into 2004.*

Several new Federal Reserve policymakers are making surprisingly important contributions to the inside debate. TIE *interviews one of the leaders, Governor Ben Bernanke.*

TIE: ***Let's start out with the U.S. economy. There seem to be two views: One says that if you pull back the tarp—the tarp being geopolitical uncertainties post-Iraq—you have a pretty favorable picture. It's not perfect, but a 4 percent-plus potential growth rate is not unexpected given low interest rates and likely fiscal stimulus. The other view, as offered by firms such as Goldman Sachs, is that once you pull back the tarp, this economy is still pretty ugly, with a lot of problems in the world. This view says that the corporate CEO crowd was faking it, that geopolitical uncertainties are not the real reasons we're not taking risks. Some drag is coming from the state and local deficits. We have problems on Federal debt, not to mention other long-term concerns in a post-bubble economy. Where do you see things going post-Iraq?***

BERNANKE: First of all, I don't think that it is quite so clean as pulling the tarp back. There are plenty of geopolitical scenarios with various residual issues, such as terrorism, rebuilding Iraq, and other ongoing con-

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cerns. The experiment's never going to be that clean. Having said that, I would fall into the former camp, viewing the economy as fundamentally strong. Some of the positives are strong productivity growth, basically good financial conditions, a resilient and flexible structure, and technological leadership. If you look back at the last couple of years, the economy was hit not only by a big decline in stock prices and major problems in a number of sectors, but also by September 11 and a variety of other shocks including the accounting scandals, and despite that we had nearly 3 percent growth last year. I think that it's a safe bet we'll have 3 percent growth this year even with all that's going on. Also, there's a very good chance that after almost three years of not investing and not hiring, and squeezing more and more output out of more or less the same amount of capital and labor, firms are going to have to increase hiring and investment. Put all those things together with a reduction in geopolitical uncertainty and it doesn't take a great deal of imagination to see 4 percent-plus growth later this year and into 2004. The negative possibilities are continued nagging problems from the world situation. The more amorphous possibility is a kind of ongoing self-confirming pessimism such that people are afraid to invest because people are afraid to invest. But again, when you compare the United States to other major industrial countries, it's very hard to point to deep-seated financial and structural problems in this economy. It seems like an economy that has had some setbacks but is basically in remarkably good shape considering the events of the last few years.

TIE: ***So far the consumer has been the hero, holding things up impressively. The corporate decision-making community has held back. CEOs haven't really appreciated the degree to which inflation has come down. Is there a problem with the convergence of real and nominal rates now, given that the corporate community has not really experienced an environment in which they didn't have a 3–4 percent inflationary cushion? Is there going to be a problem with pricing power in a price-stable world, and is the convergence of real and nominal interest rates going to complicate the ability of the non-consumer part of the economy to take off?***

BERNANKE: It's remarkable that households have gotten used to a price-stable world, yet sophisticated CEOs haven't figured out money illusion yet. Profits are still being driven by very slow increases in unit costs, weak nominal wage increases, and strong productivity increases, even if revenues are growing slowly. Real profitability is ultimately what matters. I remember twenty-five years ago there was a great deal of academic literature on why inflation seemed to be so bad for the stock market. At the time the view was that people didn't understand the difference between real and nominal interest rates; high inflation was bad for the stock market because people were comparing stock returns to high nominal interest rates, and with nominal interest rates high, people wanted to hold bonds instead of stocks. So high inflation is bad for stocks and low inflation is bad for stocks. Ultimately people get used to the inflation environment, and we're better off in a world where prices are more or less stable so you can use dollar measures to compare prices across space and over time. It's also a better environment when firms see they have to make profits by cutting costs, increasing market share, and making better products, rather than trying to take advantage of a sloppy price environment by raising prices and taking advantage of that margin. In some sense it's a more disciplined environment, and a source of greater efficiency and productivity. One aspect of the invisible hand is that all the individual players in the market think of it as a pretty hard master but for society as a whole it's a beneficent force.

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TIE: ***How do you define price stability? You've written a lot in this area. Federal Reserve Chairman Alan Greenspan has defined it over the years as a condition where businesses and individuals can plan their investments without taking into account increases in the***

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overall price level, and long-term interest rates no longer factor in higher price expectations. How do you define a price-stable environment?

BERNANKE: That's one useful way to define it, and it's probably good enough for practical purposes when you're starting at a higher inflation rate and moving down toward stability. Now that we are at a very low inflation rate, it would be useful to get a quantitative measure of price stability just to provide information to the market about where we're going from here. A number I've used—it's not the only possibility—is between 1 and 2 percent on the price index for core personal consumption expenditures. One advantage of doing that is to get a floor of perhaps 1 percent. It's important to send a signal that by price stability we don't mean zero measured inflation. There are a couple of reasons why you want to have that floor. One is the upper bias in the measurement of inflation in all our existing price indices. But the other, which I've mentioned in some of my speeches, is that because there are some problems for monetary policy and capital markets that arise in a deflationary environment, it's good to have a bit of a buffer between your effective measure of price stability and the zero level. To some extent it's a technical issue, and the Fed staff's analysis might be useful there as well. But it would probably help the marketplace understand a little better about what the Fed's intentions are and also provide some assurance that we are prepared to guard against zero or negative inflation.

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TIE: ***Because there are lags in the preparation of price index information, you only recognize price stability after the fact. But to set policy, you must be forward-looking. How do you handle the information?***

BERNANKE: Monetary policy is made on a forecast basis. The staff provide the Federal Open Market Committee with regular forecasts, using financial market data, futures prices, econometric models, and those sorts of things. They try to provide near-term and longer-term estimates of not only inflation but economic slack, along with other kinds of indicators of the economy. It's essential to look as far ahead as possible, although in practice seeing beyond a few quarters is very difficult. You can get a sense of the trajectory of the economy by looking at the next few quarters, and you clearly want a policy in place that provides a trajectory in the direction of full employment and price stability. If your best estimates from your model or forecast are such that you're veering away in one way or another from that stated path, then clearly you need to rethink your policy path.

TIE: ***The Chairman has had this resilient view about the economy in part because the productivity numbers have been so outstanding. Is there some notion of what the potential of the economy is? We've heard anywhere from 3.5 to 4.2 percent annual GDP growth once all the slack is taken out. It seems as if it would be important to know how long the economy can run above potential, taking up the slack, and how long the economy may be in a recovery phase if it needs one.***

BERNANKE: Roughly speaking, the growth potential is the growth rate of the labor force—which is about 1 percent per year—plus the growth rate of productivity. Lately, trend productivity appears to be running somewhere above 2 percent. Thus, currently it looks as though growth potential is something above 3 percent. But making monetary policy, we don't have to project that out yet indefinitely; we just have to ask how much of the recent productivity gains are sustainable for a year or two. Looking forward for the next couple of years, since we've been at below potential for at least two and a half years, of course there's the catch-up as well, suggesting that there could be a period of 4 percent-plus growth as we move back toward the sustainable growth path.

TIE: ***As a policymaker, you're watching the employment situation. At what point do you think that the jobless situation becomes an important policymaking indicator for you?***

BERNANKE: The unemployment rate by itself is a rather poor indicator of whether the economy is at its potential.

TIE: ***If you'd operated over the last few years on the old assumptions about the rate of unemployment conducive to a climate of price stability, the Fed would have made some huge mistakes.***

BERNANKE: One of the great accomplishments of the Fed in the latter part of the 1990s was to allow the unemployment rate to reach new lows which policymakers were able to do without inflationary consequences.

TIE: ***True, and the Fed leadership, in particular the leadership of Chairman Greenspan and William McDonough of the New York Fed, deserves a lot of credit.***

BERNANKE: That was a significant accomplishment. I have no target or lower band for the unemployment rate. One of the reasons for looking at inflation as a policy guide is not only because you're interested in inflation per se, but because inflation and forecasts of inflation act sort of as a thermostat, making them a more sensitive indicator of building pressure on potential than the unemployment rate itself, which for demographic and many other structural reasons shifts around. The attainable unemployment rate can shift around considerably, and we wouldn't want to set a minimum on the unemployment rate that the economy would be able to achieve. We obviously want as much sustainable employment as possible. For that reason, inflation and other indicators are probably more reliable measures of when the economy is approaching its full potential.

TIE: ***The Fed's performance has been impressive given all the changes that have gone on. The result was a higher standard of living. But thinking globally, we've got so many weak situations in the world. China and its satellites have practically a zero marginal cost of labor; labor to them is like oil to Saudi Arabia. They can pump as much as they want. China is clearly producing a lot of tradable goods, along with deflationary pressures. Today, developed country corporations use China as a manufacturing base. It's shocking to see how even Mexico now is under assault from China. In theory such a shock is just one big relative price adjustment as long as central banks maintain the band. But that's one of the worries. The Fed has had to carry that entire burden. Other major central banks don't seem to be focused on this situation. The Bank of Japan clearly has let things slip away, the same with the European Central Bank. Does it worry you that it looks like the Fed is having to be the global central bank?***

BERNANKE: You are taking together several different issues here. One of them has to do with the emergence of low labor cost producers like China, which of course have the potential to be a major player in the world economy. This goes back to David Ricardo and comparative advantage and all the debates about trade. The usual answer is that it's costly in the short run for those sectors that are affected, but in general in the long or medium run it enriches everybody. And there's a lot of evidence for that. In particular it's interesting that for the United States, a large current account deficit has often been associated with a low unemployment rate. But I think the development of China is actually a big positive for us from an economic point of view. There are long-run political issues associated with the fact that China is still a one-party state and as North Korea illustrates there are very complex geopolitical issues in that region of the world as well. But from an economic point of view, China is a bright spot. It's going to be not only a major producer of goods but also

From an economic point of view, China is a bright spot. It's going to be not only a major producer of goods but also a major market for us and for other economies.

a major market for us and for other economies. The real problem which you also alluded to is that among the major industrial countries, the United States is by far the one with the most growth potential right now. Japan seems very quiescent, the European Union has substantial structural problems in their labor markets and some product markets as well. We're seeing some strength in Canada and East Asia, but many of the emerging markets in areas such as Latin America are also having significant problems. And to a greater extent than we would like, the United States is forced to be the engine of growth, and it's very difficult to reduce your current account deficit when there's no one out there to buy.

TIE: ***Is this a long-term problem because of demographic constraints?***

BERNANKE: Well, Chairman Greenspan in his recent testimony talked about the oncoming problems for our fiscal balances posed by retiring baby boomers. Those are quite real and serious, but other industrial countries, notably Japan and to some extent the European countries, in many cases face worse problems.

TIE: ***At least the United States will benefit from a baby boom in the early 1990s.***

BERNANKE: We have better native population growth and we have a better flow of immigrants in any case. So that's a longer-run consideration. In a sense we need China and Latin America and other emerging markets where there are massive numbers of young people to develop economically and become major trading partners and sources of growth for the world economy.

TIE: ***That's true. Shifting a little, there has been a lot of debate about whether the U.S. economy needs fiscal stimulus. Some think there is a need for an insurance policy of fiscal stimulus despite the risk of an expanding deficit. Do you have any thoughts on this point? The Chairman is basically not in favor of a big stimulus package, but at the same time seems supportive of some elements of the fiscal package.***

BERNANKE: I guess it depends on how optimistic you are about the ability of the Congress to act relatively quickly. There's a good chance that a fiscal stimulus this year would be helpful—immediate and real fiscal stimulus. Obviously a lot is already in the pipeline. There are several scenarios where it would be helpful. One is where there's still nagging geopolitical uncertainty. Suppose things drag on, and you pick up the tarp and there's still a great deal of weakness. But even under the more optimistic scenarios, where the economy is basically healthy and starts moving again, we still have slack in the economy until the latter part of 2004 into 2005. It's a bit premature to rule out additional fiscal stimulus in 2003 or the beginning of 2004. On the other hand, the Chairman is correct that the distant future is getting nearer and nearer as each year passes and we now have only seven or eight years before the first waves of baby boomers begin to retire and the social security trust fund must pay out significant amounts.

TIE: ***The baby boomer retirement used to seem like a long time away.***

BERNANKE: Thinking about that time frame, in principle some additional insurance might be useful for next year. But it would be most useful if it didn't lead to deficits as far as the eye can see.

TIE: ***Can we go back to the international scene for a minute? Some people have argued that there's no way out for Japan precisely because the Japanese are still a very wealthy country. Even though their house may be on fire, it's still a comfortable, big house. Their new central bank head, Toshihiko Fukui, is a career bureaucrat whose appointment has been interpreted as maintaining the status quo with no dramatic switch to a policy of inflation targeting. What can we look for from Japan?***

BERNANKE: Well, as I said in my speech on deflation last November, the Japanese deflation is not a technical problem; it's a political issue. There's no technical barrier to creating inflation. It's really a matter of creating enough money so that the value of money declines and prices begin to rise. At this point, as you say, Japan is a rich country and not in crisis. A truly comprehensive solution to Japan's problems would involve a lot more than just raising prices. It would involve restructuring and probably downsizing the banking system considerably. It would involve restructuring and probably bankrupting many corporations that are inefficient or technically insolvent. It would probably involve considerable reform of government finances. There's no question that it would cause a great deal of pain and inconvenience at a minimum for many. A comprehensive solution would require a great deal of political consensus and will. I can sit comfortably here in Washington and say they ought to do it, but it's of course up to the Japanese themselves to decide what path they want to take.

TIE: ***On another subject, a Dutch company, Royal Ahold, has allegedly seen some irregularities in its books. What are the chances of a European Enron? How well has the U.S. corporate system adjusted to the new realities of the post-Enron era? Are we about to see accounting irregularities unfold in Europe and the rest of the world, or is the situation with Ahold just an anomaly?***

BERNANKE: I don't have much of a sense about the European situation. The American firms are certainly aware that they are living in a new world and they doing the best they can to adjust both to the law and also to the spirit of the new environment. That is one of the intangibles that is really hard to judge—the extent to which investment and risk-taking have been depressed by the conservative corporate environment since Enron and WorldCom. Clearly, we want the best of both worlds. We want accountability and transparency and we also want firms to be willing to take measured risks. I'm sure that at some point we'll strike the right balance, but whether or not we've reached that point yet is a little hard to tell.

The economic forces of globalization are absolutely overwhelmingly strong, and likely enduring.

TIE: ***Do you worry about the end of democracy in Latin America blamed essentially on policy failures in recent years, including failures of imagination on the part of the international community?***

BERNANKE: I think democracy is holding up all right considering some of the economic stresses Latin America has endured. What's under a certain amount of siege is the so-called Washington consensus model or the IMF model of development. I suspect, however, that what originally drove many of these countries to adopt pro-capitalist-type reforms was simply the lack of a good alternative. As we find that there are not good command-and-control alternatives, there may at some point be a return to pro-market-type reforms, albeit with certain modifications or adjustments for specific countries or specific social situations. We'll know in about another cycle as far as the economic-type reforms that are being used. But in some cases, democracy presents a challenge because of the inability to control the fiscal purse. Fiscal indiscipline is making it difficult for some countries to get growth going. So there has definitely been a setback for the Washington consensus as far as economic development is concerned. But Brazil and even Argentina are doing a real good job of maintaining democratic institutions.

TIE: ***Will we look back five or ten years from now and say that globalization was strong in the 1990s but in the beginning of the twenty-first century saw a significant backlash? Certainly the events of September 11 have contributed to this sense that maybe not all the world wants to own a Lexus—they'd rather sit under the olive tree. Do you have any final thoughts on the global future of capitalism? Is it conceivable the United States becomes more of an island in that regard? Is the globalization of recent decades irreversible?***

BERNANKE: Well, the western capitalist vision is one in which the government's role is to make the environment safe for contracting and trade. Markets then have to create the trading. Under that paradigm, the economic forces of globalization are absolutely overwhelmingly strong, and likely enduring—I mean there was international trade in the fifth century when they moved goods by caravan trails. Under any circumstances there will be a great deal of international trade and globalization. But clearly we need at least a moderate degree of international political and military security order so that we can achieve the maximum benefits of globalization. My additional prediction would be that unless madmen and terrorism and recidivist movements are at the controls, then to a certain extent globalism will be pretty much unstoppable. But only a major trend toward political and social fragmentation would obviously create significant problems. It's remarkable the extent to which terrorists' threats—even when they're not realized—have a big effect on peoples' activities, and even very small statistical probabilities have a very big effect on peoples' willingness to travel or shop or invest.

TIE: ***Thank you very much.*** ◆