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Decoding Bernanke
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CAMBRIDGE – Federal Reserve Chairman Ben Bernanke has been struggling to deliver a clear message about the future of Fed policy ever since his May 22 testimony to the US Congress. Indeed, two months later, financial-market participants remain confused about what his message means for the direction of US monetary policy and market interest rates.

Bernanke's formal statements about the Fed's two unconventional policies have been clear. First, the Fed is trying to give relatively specific guidance about the future path of the federal funds rate (the overnight rate at which commercial banks lend to each other). Second, the Fed is indicating the conditions that will cause it to start reducing its massive monthly bond-buying program and eventually bring it to an end. Bernanke has emphasized that these two policies are on separate tracks and will respond to different indicators of the economy's performance.

The Federal Open Market Committee (FOMC), comprising the Fed governors and the presidents of the regional Federal Reserve banks, has agreed that the federal funds rate will remain at its current near-zero level until the unemployment rate drops to 6.5% and can be expected to remain there or decline even further. With unemployment now at 7.6% and falling only slowly, the Fed may not be ready to raise the federal funds rate until 2015.

But there are caveats that make this forward guidance ambiguous – and therefore uninformative. The Fed warns that it might increase the federal funds rate if the anticipated annual inflation rate rises from its current level of a bit less than 2% to more than 2.5%. There is no clue, however, about how that "anticipated future inflation rate" will be determined. So the Fed could, in principle, decide to raise the federal funds rate even before the unemployment rate reaches 6.5%.

Moreover, the Fed recognizes that a substantial part of the decline in the unemployment rate in the past year reflects the large number of people who stopped looking for work (and who therefore are no longer counted as unemployed). So, if the unemployment rate is deemed to have fallen below 6.5% because of continuing declines in labor-force participation, or because firms increase the relative number of part-time workers (which would imply no increase in the aggregate number of hours worked), the Fed may not raise the federal funds rate.

As a result, it is not surprising that the market is confused about the likely path of the federal funds rate over the next 24 months. And that is important, because a rise in the federal funds rate will cause other, somewhat longer interest rates to increase as well.

The bigger policy uncertainty is about the more immediate prospect that the Fed may soon reduce its purchases of long-term assets – so-called quantitative easing. Bernanke continues to stress that shifts in the pace of bond buying will depend on how well the economy is doing. But he startled markets recently by saying that the FOMC's expected path of stronger growth could lead to a slower pace of buying later this year and an end to the asset purchases by mid-2014.

Bernanke justified his position by stating that quantitative easing is intended "primarily to increase the near-term momentum of the economy," suggesting that stronger momentum would justify less asset

buying. The reality, however, is that the economy's near-term momentum has actually been decreasing ever since quantitative easing began – and has decreased more rapidly as the size of the program has grown.

The pace of real GDP growth fell from 2.4% in 2010 to 2% in the next four quarters, and then to 1.7% in 2012. The first official estimate of GDP growth in the second quarter of 2013, to be released on July 31, is likely to be less than 1%, implying that annual GDP growth in the first half of this year was considerably slower than in 2012.

So what does this imply about the Fed's willingness to "taper" its pace of asset purchases? Ironically, it might help to rationalize the decision to begin tapering before the end of the year.

First, the lack of correlation between quantitative easing and GDP growth suggests that the pace of asset buying could be reduced without slowing the pace of growth. That is true even though, contrary to the assumption of Bernanke and some other FOMC members, interest rates will rise as the pace of purchases declines.

Second, if the extreme weakness in the second quarter is followed by a return to a sluggish growth rate of around 2% in the third quarter, the Fed could declare that it is observing the pick-up in growth that it has said is necessary to justify the beginning of tapering.

The policy of extremely low long-term rates is now doing more harm than good by driving lenders and investors to take inappropriate risks in order to achieve higher returns. Bernanke and the FOMC should recognize this and gradually bring the bond-buying program to an end during the next 12 months. They can take credit for what quantitative easing has achieved without holding its termination hostage to the economy's future performance.

It is significant that Bernanke will be stepping down at the beginning of 2014. He did a remarkably good job in dealing with dysfunctional financial markets during the crisis years of 2008 and 2009. When the financial markets were working again but the economy was still growing much too slowly, he turned to unconventional monetary policies to reduce long-term interest rates and accelerate the housing market's recovery. So, although the economy is now weaker than he or anyone else would like, he may want to complete his policy legacy by beginning the exit from unconventional policies before he leaves the Fed.

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