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Fed Watch

US

Houston, April 30, 2012
Economic Analysis

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The Fed is not the Borg

- Bernanke's old policy recommendations went unused for practical reasons, not conservatism
- Most organizations subject to frictions in decision-making, not just the Fed
- The Federal Reserve may have a lot of problems, but the Fedborg is not one of them

The Great Chairmanship Decision-making Debate

Recently Federal Reserve Chairman Ben Bernanke has been subject to a new strand of criticism that argues he has been absorbed by the "groupthink" of the FOMC and the design of the committee itself is such that Bernanke's shyness has become damaging to decision-making. Paul Krugman and Laurence Ball argue that Bernanke's position today on monetary policy tools to combat the problem of the zero bound are less aggressive than his position before he joined the Federal Reserve. In many ways, this criticism of the Fed is unfair. First, most organizations, be it a central bank or a car wash, are subject to pathologies of control loss. Second, some of the measures Bernanke advocated years ago are simply not practical from an applied standpoint. They may be only useful in desperate situations, which is not the current expectation of US deflation prospects. In other words, the criticism from Krugman and Ball is criticism that envisages the world as a frictionless plane. What happened to Bernanke – and would happen to Ball and Krugman as well in similar conditions – is that the world is a messy place that makes some strategies unfeasible for practical or operational reasons.

First, the Federal Reserve is not the only organization in the world where new members must reshape their behavior to norms of conduct and hew to ceremonial centers of organizational power. Economists too often consider organizations as black boxes. In contrast, their colleagues across the yard at business schools invest considerable amount of time conceiving of organizations as collections of routines, processes and ceremonies that constitute an institution. Furthermore, maintaining a perception in the public that the Federal Reserve is a credible fighter of inflation requires careful management of what is said to the public and how the organization responds to innovations in inflation. As such, there is a reason for the powerful conforming pressures of a Fed chairmanship. Moreover, some of Ball's textual analysis of speeches may be picking up the communication strategy, but not the true beliefs of Bernanke. Another possibility is that Bernanke's mentioning of the options was by itself a strategy to move us away from a tail risk scenario. This could have been part of a communications strategy to convince markets that the Fed had plenty of ammunition, much like a sign on your door saying "Beware of Dog." Diplomatic skills are certainly part of the toolkit when running a many-headed organization such as the Federal Reserve.

Sometimes organizations are modeled as a collection of problems and solutions. The key part of management is to match problems with solutions effectively, but the organization as a construct will keep generating both problems and solutions. Specifically, Bernanke once considered four solutions to the problem of the zero bound that were not subsequently used since 2008: depreciation of the currency, an inflation target or price level target, money-financed fiscal expansion and targets for long-term rates. The reason for not using these potential monetary tools is quite simple: they are not practical. Setting a target for the price-level gap makes sense in theory, but in an applied setting PCE inflation (and GDP, for that matter) is subject to sizeable statistical revision. Thus, the central bank may commit to a particular price level gap and then find it is way beyond it, with clearly unsettling consequences. Depreciation of the US dollar would rock the world financial system and anger major trading partners, thus making this strategy more relevant for small open economies and not the world's reserve currency. A target for long-term rates is something that hedge funds dream about: given a pledge to purchase unlimited amounts of bonds at a certain yield, the $2.13tr in hedge fund assets would clobber this target. As for a money-financed fiscal expansion, this is a measure left to truly desperate situations. Thus it is not the case that Bernanke was consumed by the Fedborg. It is simply the case that these measures will not work. Krugman and Ball are pushing pieces around a map, whereas Bernanke is in the trenches.

Bottom line: Monetary policy in an imperfect world

The criticisms of Krugman and Ball fail to convince us. This is because from an applied standpoint either these more aggressive policies that Bernanke supposedly ignored will not work or are only useful in extreme circumstances. Hard-won inflation credibility is just that: hard-won, with high levels of uncertainly in returning it once it has been lost. As such, the careful deliberations, communication, routines and ceremonies of the Federal Reserve serve a purpose. The Federal Reserve is not a panel discussion at an academic conference; it is a linchpin of the financial system and an institution of capitalism. Moreover, the amount of change in monetary policy over the past few years is remarkable in terms of what the post-crisis environment will resemble. The manipulation of bank reserves will become a method of regulating the leverage of the banking system, as work by new appointee Jeremy Stein suggests. The creation of a clear inflation target for the Federal Reserve is a huge boost to the management of inflation expectations and will likely outlast all criticisms of Bernanke.