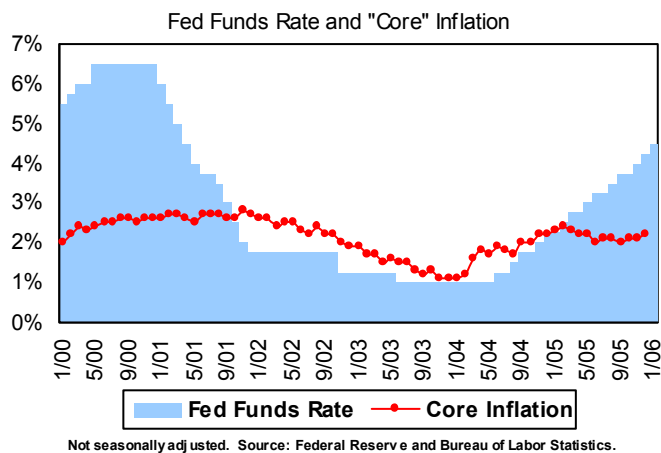




The Maestro's Finale

When the Federal Open Market Committee (FOMC) raised its target rate by 25 basis points to 4.50% on January 31, it was hardly news. After all, the latest rate increase was very widely expected. What was still newsworthy was that the meeting marked Alan Greenspan's last day as the chairman of the Board of Governors of the Federal Reserve System. After 18 years of being the nation's top central banker, he hands the helm over to Ben Bernanke this month.



Greenspan's illustrious career

There is no doubt that he will be long remembered for his accomplishments. During his tenure as the Fed chairman, Greenspan and his Board of Governors successfully tamed price inflation and kept recessions mild. At the same time, the Federal Reserve increased policy transparency by communicating more clearly to the financial markets about its future intents.

In addition, Chairman Greenspan amply demonstrated his crisis management capability. His initial test came two months after his ascension to the chairmanship at the Fed. On October 17, 1987 (Black Monday), the Dow Jones Industrial Average suffered one of its largest one-day declines. Greenspan managed to keep the U.S. economy on a relatively even keel during this crisis and subsequent ones, including the Asian financial crisis in 1997; the collapse of a giant hedge fund, Long-Term Capital Management, in 1998; the tech stock meltdown in 2000; and the terrorist attacks in 2001. His deft handling of the economy and these crises won him a title of "the Maestro."

Chairman Greenspan was also credited for spawning a cottage industry of economists decoding his words, because his comments were often opaque—largely due to his fondness for complex sentence structures, though sometimes his opacity might have been intentional.

Transitions at the Federal Reserve

As the year 2005 drew to a close, it became increasingly evident that the Fed's tightening was approaching completion. The chart on this page shows the history of the Fed Funds rate target and the "core" inflation.¹

The chart suggests that the Fed Funds rate has reached a more "normal" level in relation to the core inflation rate. The real interest rate (i.e., nominal rate adjusted for inflation) is currently around 2%. The real interest rate of 2.0 to 2.5% is generally considered to be "neutral"—neither stimulative nor restrictive. Assuming stable inflation, the Fed can leave the nominal rate around the current level without worrying about the economy overheating or stalling.

As the Federal Reserve shifts monetary policy from tightening to holding steady, an important transition also takes place with its leadership. Even though Chairman Bernanke will likely operate the Fed almost exactly as Alan Greenspan did in coming months, these two leaders have quite different styles.

It is a well-known fact that Greenspan had enormous influence over the FOMC. This led to some observers dubbing the rest of the FOMC as the "Maestro's choir."

Ben Bernanke's quite different leadership style emerged during his confirmation hearings. When questioned about his support of inflation targeting (the establishment of a numerical goal for price inflation), Bernanke stated that he would institute such an approach only when a consensus among FOMC members is achieved. These words strongly suggest that he is a consensus builder and will treat other members more like his equals, actively seeking their input.

¹ There is more than one way to calculate "core" inflation, but here I used 12-month percentage changes of the Consumer Price Index (CPI), not adjusted for seasonal factors and excluding food and energy items.

This, of course, is entirely consistent with Bernanke's career to date. Before being elected a Fed governor in 2002, he had been a college professor for 27 years. This is why some Fed watchers refer to him as the "Professor." The Bernanke Fed is expected to be more collegiate in style. (Other FOMC members, while keeping their choir gowns on, may start acting more like university dons...)

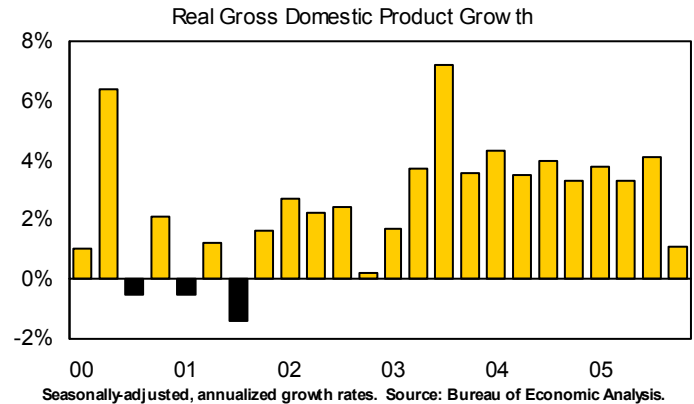
The Professor's dilemma

When I met Ben Bernanke last summer, he was the chairman of the Council of Economic Advisors at the White House, and was no longer a Fed governor. He was plain-speaking but articulate, reinforcing his image of the "Professor" in my mind. Besides being a first-rate academic economist, he is a superb communicator.

Bernanke currently enjoys broad support as a new Fed chairman, but his assignment comes with great responsibility and some daunting challenges. The biggest challenge, of course, is how to establish his credibility as someone tough on inflation while keeping the economy from sliding into a recession.

Again, based on his previous comments about inflation targeting, he is a hawk (intolerant of rapid inflation) advocating a core inflation target of 1 to 2%, measured by the Personal Consumer Expenditure price index. However, the bond market so far has perceived him as a dove.

This is why many analysts believe that another rate hike at his first FOMC meeting on March 28 is all but guaranteed. There's no better way, they argue, to prove his stance on inflation than through the concrete action of raising rates. (I am in this camp, as the forecast below indicates.)



The economy is currently sending mixed signals. The real GDP growth rate in the fourth quarter of 2005 was a mere 1.1% (see the above chart), down from 4.1% in the third quarter, suggesting that the economy is now cooling. Employment data, on the other hand, show that the economy has significant momentum. At the same time, price inflation is on a relatively high level, though it has subsided a little from last summer.

So it's a tough call. And whether Chairman Bernanke decides to raise the interest rate or not in March, he must be able to cite compelling reasons to back up his decision. Fortunately, his audience can now understand the Fed chairman without relying on some economists interpreting his words.

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Economic Forecast – February 2006

UNITED STATES	2003	2004	2005	2006
Real GDP Growth (%)	2.7	4.2	3.5	3.3
Unemployment (%)	6.0	5.5	5.1	4.9
CPI Change (%)	2.3	2.7	3.4	2.7
Federal Funds (%)	1.1	1.3	3.2	4.7
Housing Starts (millions)	1.85	1.95	2.07	1.92
Car/Lt. Truck Sales (millions)	16.6	16.9	16.9	16.7

Bold: Actual.

The information in this report is based on data available as of January 31, 2006, and has been obtained from sources believed to be reliable, but its accuracy, completeness, and interpretation are not guaranteed. We do not think it should necessarily be relied upon as the sole source of information and opinion.