

Chairman Bernanke's press conference <http://www.ustream.tv/federalreserve> provided a number of interesting insights regarding the Fed's view on monetary policy.

Bernanke made it clear Fed members were more concerned about recent inflationary developments than they were a year ago. He said part of the recent rise in core inflation was related to temporary factors. However, he noted that since Fed members had marked up their projections for core inflation, which means they were clearly concerned that some of the rise could be due to longer term factors.

The Fed Chairman also noted that recent employment growth, while slower than the Fed expected, was faster than a year ago. Hence, in balancing the Fed's dual mandates for maintaining price stability and maximum employment, the Fed was more concerned about inflation and less concerned about unemployment than it was a year ago.

Bernanke also reiterated his belief that excess capacity would hold inflation down and that longer-term inflation expectations remained low and relatively stable. He seemed to suggest that if inflation expectations were to increase, the Fed might be more concerned than they were at the current time.

My take is that inflation is currently contained and will remain contained. The reason for this is current dollar spending has been roughly 4% annually for the past two years. The economy probably has the potential to increase output by at least 2%-3%, even with the barriers imposed by the massive cost of health care and financial reform legislation. This means the underlying rate for inflation should be in the 1%-2% vicinity. Hence, I agree with the Fed's view that the recent increase in inflation is due to special, temporary factors.

However, with bank reserves now increasing at a more rapid pace, I would expect the pace of current dollar spending to accelerate later this year and into 2012. Once current dollar spending establishes a faster pace, the underlying pressures for inflation will increase. If the current increase in bank reserves continues, inflation will be well above the Fed's 2% target by late next year and into 2013.

With respect to the economy, Bernanke suggested that since they can't fully explain the current slowdown there is a high degree of uncertainty over the extent to which it will continue. Moreover, he said that his own forecast for growth was less than the Fed's consensus forecast.

Bernanke also explained his interpretation of what an "extended period of time" means for how long interest rates will remain low. He said the extended period referred to two or three Fed meetings. Since the Fed meets roughly every other month, this amounts to four or five months.

In commenting on the situation with Greece, Bernanke indicated US money market funds have relatively little direct exposure to Greece and the other lesser countries with serious debt issues. However, he noted that US money market funds have extensive exposure to French and German banks, so there would be significant problems for the US if these banks were to have problems.

(A recent Wall Street Journal article indicated US money market funds have \$1 trillion in exposure to French and German banks holding large positions in Greek debt. Europe's solution to the debt problems of its weaker nations has been to loan Greece the funds pay interest on its debt, thereby bailing out its banks. This is a temporary solution that increases the potential for serious financial problems for all of Europe. US money market funds should be reducing their exposure to French and German banks to compensate for the added risk. If they do not, US investors should shift to funds that avoid exposure to Europe.)

Bernanke also noted that if the Fed wanted to provide more monetary stimulus it could always reduce the interest rate it pays banks to keep their reserves at the Fed. (This indicates that the Fed realizes that by paying interest on bank deposits and encouraging banks to keep deposits with the central bank, it

reduces monetary stimulus. It also indicates that in late 2008 the Fed's move to pay interest to banks reduced monetary stimulus at the same time the Fed was using all types of exotic and experimental moves to increase such stimulus. This raises the question of whether the explosive rise in the Fed's balance sheet and other moves (such as QE2) would have been necessary if the Fed hadn't also been acting to reduce monetary stimulus at the same time it was attempting to get more money into the economy.)