The New York Times, July 31, 2011

What's With All the Bernanke Bashing?

By N. GREGORY MANKIW

POOR Ben Bernanke.

He left a comfortable professorship at Princeton to run the Federal Reserve — and this is what he gets.

Mr. Bernanke has worked tirelessly to shepherd the economy through the worst financial crisis since the Great Depression, and yet, for all his efforts, seems vastly underappreciated.

CNBC recently asked people, "Do you have confidence in the way Ben Bernanke is handling the economy?" Ninety-five percent of the respondents said no.

Yes, the CNBC survey was hardly scientific. Nonetheless, it reflected the deep unease that many Americans feel about our central bank and its policies. Critics on both the left and right see much to dislike in how Mr. Bernanke and his Fed colleagues have been doing their jobs.

Let's review the complaints.

Critics on the left look at the depth of the recent recession and the meager economic recovery we are experiencing and argue that the Fed should have done more. They fear that the United States might slip into a long malaise akin to Japan's lost decade, in which unemployment remains high and the risks of deflation deter people from borrowing, investing and returning the economy to its potential.

Critics on the right, meanwhile, worry that the Fed has increased the nation's monetary base at a historically unprecedented pace while keeping interest rates near zero — an approach that they say will eventually ignite inflation. Some in this camp have gone so far as to propose repealing the Fed's dual mandate of simultaneously maintaining price stability — that is, holding inflation at bay — while maximizing sustainable employment.

Better, these people say, to replace those twin goals with a single-minded focus on inflation.

Yet Mr. Bernanke's record shows that the fears of both sides have been exaggerated.

Mr. Bernanke became the Fed chairman in February 2006. Since then, the inflation measure favored by the Fed — the price index for personal consumption, excluding food and energy — has averaged 1.9 percent, annualized. A broader price index that includes food and energy has averaged 2.1 percent.

Either way, the outcome is remarkably close to the Fed's unofficial inflation target of 2 percent. So, despite the economic turmoil of the last five years, the Fed has kept inflation on track.

Of course, this record could come undone in future years. Yet the signals in the financial markets are reassuring. The interest rate on a 10-year Treasury bond, for instance, is now about 2.8 percent. A 10-year inflation-protected Treasury bond yields about 0.4 percent.

The difference between those yields, the so-called "break-even inflation rate," is the inflation rate at which the two bonds earn the same return. That figure is now a bit over 2 percent, a sign that the market does not expect inflation in the coming decade to differ much from that experienced over the last five years. Inflation expectations are anchored at close to their target rate.

Could the Fed have done substantially more to avoid the recession and promote recovery? Probably not. The Fed used its main weapon against recession — cuts in short-term interest rates — aggressively as the depth of the downturn became apparent. And it turned to various unconventional weapons as well, including two rounds of quantitative easing — essentially buying bonds — in an attempt to lower long-term interest rates.

A few economists have argued, with some logic, that the employment picture would be brighter if the Fed raised its target for inflation above 2 percent. They say higher expected inflation would lower real interest rates, thus encouraging borrowing. That, in turn, would expand the aggregate demand for goods and services. With more demand for their products, companies would increase hiring.

Even if that were true, a higher inflation target is a political nonstarter. Economists are divided about whether a higher target makes sense, and the public would likely oppose a more rapidly rising cost of living. If Chairman Bernanke ever suggested increasing inflation to, say, 4 percent, he would quickly return to being Professor Bernanke.

What the Fed could do, however, is codify its projected price path of 2 percent. That is, the Fed could announce that, hereafter, it would aim for a price level that rises 2 percent a year. And it would promise to pursue policies to get back to the target price path if shocks to the economy ever pushed the actual price level away from it.

Such an announcement could help mollify critics on both the left and right. If we started to see the Japanese-style deflation that the left fears, the Fed would maintain a loose monetary policy and even allow a bit of extra inflation to make up for past tracking errors. If we faced the high inflation that worries the right, the Fed would be committed to raising interest rates aggressively to bring inflation back on target.

MORE important, an announced target path for inflation would add more certainty to the economy. Americans planning their retirement would have a better sense about the cost of living a decade or two hence. Companies borrowing in the bond market could more accurately pin down the real cost of financing their investment projects.

Mr. Bernanke cannot remove all of the uncertainty that households and businesses face, but he can eliminate one small piece of it. Less uncertainty would, other things being equal, encourage spending and promote more rapid recovery. It might even raise Mr. Bernanke’s approval ratings a bit.