

Bernanke: Slowing economy will curb inflation in coming months

WASHINGTON -- July 20, 2006 -- Federal Reserve Board Chairman Ben Bernanke seemed nervous in his midyear appearance before Congress on Wednesday, but he delivered a soothing message.

A slowing economy would reduce inflation without a recession even in the face of record oil prices, he said.

Although Bernanke did not tip his hand on whether there would be another boost in interest rates at the Fed's next meeting Aug. 8, he left the clear impression that the central bank's tightening of monetary policy is either at or near an end after 17 straight interest-rate increases beginning in June 2004.

Financial markets loved his testimony, even if he wasn't terribly specific, and staged a broad "Bernanke rally," with the Dow Jones industrial average soaring by 212.19 points and the Standard & Poor's 500 index surging by 22.95 points.

Bernanke was candid in stating that he and his colleagues are in a tough spot in setting interest rates, not wanting to tighten too much or too little in a climate of uncertainty. That comment also played well on Wall Street.

The Fed chief had every reason to be on edge as he gave the Senate Banking Committee a semiannual economic assessment. Bernanke is still feeling his way as Alan Greenspan's successor, struggling to establish his credibility as the result of recent mixed messages. There was a slight quiver in his voice and a deep caution in his tone. Recent oil price increases had raised the stakes of this appearance.

Bernanke's most important comment was that while oil prices were still a major concern, the economy would cool down enough in coming months to bring about moderating inflation -- and apparently, without interest rates going much higher than they are now. Since 2004, the Fed has raised its key federal funds rate by a total of 4.25 percentage points, to 5.25 percent.

Bernanke said inflation remains a risk that would be watched closely and could prompt more interest-rate boosts. But he cited future market projections that energy prices, after a sharp rise, would likely be flat in the near term and expressed hope that they would not get out of line. Indeed, oil prices fell for the third day in a row after hitting a record high as a result of Middle East fighting.

Some economists interpreted Bernanke's remarks as suggesting that the central bank would not raise interest rates in August, while others said the Fed would boost them next month and then pause.

Still, others thought the economic situation was riskier than Bernanke suggested.

Nigel Gault, economist for consulting firm Global Insight, said one more increase in interest rates is expected, "but we still see clear and growing risks that the Fed will have to do more than that. The inflation figures will get worse before they get better, and the Fed may have to do more to keep inflationary expectations in check."

Fed projections call "for a gradual decline in inflation in coming quarters," Bernanke said, adding that inflation is expected to rise by 2.25 percent to 2.5 percent this year and edge lower to 2-2.25 percent in 2007.

Reporting on the central bank's economic forecasts, he said the economy would grow by 3.25-

3.5 percent this year and by 3-3.25 percent in 2007, he said.

"I don't see a recession as being very likely," he said in response to a question.

The once-red-hot housing market will be a major factor in the economy's slowing, he said. That market is in the process of softening because of higher mortgage interest rates and "reduced affordability," he said. Household spending is also down, partly because homeowners are not seeing larger increases in the equity value of their homes, Bernanke said.

The Fed chief earlier had roiled financial markets with remarks to a television reporter that Wall Street had not understood his congressional testimony that seemingly indicated the central bank was ready to take a pause from raising interest rates. He later apologized, saying the remarks reflected a lapse in judgment.

In what may be a crucial appearance by the new Fed chairman, Bernanke put on his educator's hat (he was once a college professor) to inform the financial markets that the economy is in a transition phase, with inflation on the rise and the economy slowing at the same time.

Some analysts have called this phase a mild form of stagflation, saying that it would require a delicate balancing act by the central bank.

"There are risks in both directions (higher inflation or steeper slowdown), if I may say so," he said. "Clearly we don't want to tighten too much to cause our economy to grow more slowly than its potential. We are very aware of that concern. We think about it. We look at it. We try to evaluate it."

On the other hand, he said, "The risk in the other direction is that we stop tightening too soon and inflation were to get higher and more persistent. Then we would be faced with a situation of having to address that later on with perhaps even more rate increases."

The U.S. economy grew at a rapid 5.6 percent annual pace in the first quarter, but has begun to slow down and is expected to grow at an annual rate of 3 percent or less in the second half of the year.

The chairman's testimony came on a day that the Labor Department announced that consumer prices in June rose by 0.2 percent, the smallest rise in fourth months. But the news is expected to be worse when July's consumer price index is announced, since oil prices surged to record levels because of the Middle East crisis.

The "core rate" of consumer inflation, excluding food and energy, went up by 0.3 percent in June, higher than the 0.2 percent that Wall Street had forecast.

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