

Viewpoints

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Why Bernanke Is Right to Be Worried

By Mohamed El-Erian
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Chairman Bernanke's congressional testimony on Wednesday warrants careful attention by market participants – this at a time when policy measures play an unusually large role in determining both absolute and relative values in many markets.

In his prepared written remarks, Mr Bernanke correctly points to the ongoing healing in critical elements of the financial markets, including inter-bank and commercial paper transactions. He also notes the improved functioning of the corporate credit market which has enabled many companies to raise needed and precautionary capital.

Yet, the most interesting aspects of his testimony are elsewhere. They relate to his more nuanced outlook about the economy and his attempt to place fiscal issues in their proper place.

Mr Bernanke acknowledges that, despite the "green shoots", there are still question marks over which components of demand will kick into gear once the cyclical inventory pick-up runs its course, as it will inevitably do so over the next few months. Indeed, the chairman notes that "businesses remain very cautious and continue to reduce their workforces and capital investments".

Concerns about a sustainable recovery are not limited to the dynamics of the immediate cyclical recovery. Mr Bernanke also notes that "even after a recovery gets under way, the rate of growth of real economic activity is likely to remain below its longer-run potential for a while, implying that the current slack in resource utilisation will increase further".

Yet he stops short of addressing what, increasingly, will be on many people's minds going forward. Specifically, the longer-term question goes well beyond the notion of a prolonged period of below-potential growth. The level of potential growth itself is likely to decline. Indeed, this is a central element of what we, at PIMCO, call the "new normal".

When it comes to fiscal issues, the chairman is not timid about worrying about longer-term questions – and rightly so. He is explicit about the need for greater clarity on how fiscal sustainability will be restored after this period of emergency policy actions.

Mr Bernanke states that "even as we take steps to address the recession and threats to financial stability, maintaining the confidence of the financial markets requires that we, as a nation, begin planning now for the restoration of fiscal balance. Prompt attention to

Viewpoints

June 2009

questions of fiscal sustainability is particularly critical because of the coming budgetary and economic challenges associated with the retirement of the baby-boom generation and continued increases in medical costs.”

He does not stop here. He goes on to warn that ”near-term challenges must not be allowed to hinder timely consideration of the steps needed to address fiscal imbalances. Unless we demonstrate a strong commitment to fiscal sustainability in the longer term, we will have neither financial stability nor healthy economic growth.”

These are strong words, and appropriately so given the worrisome fiscal outlook facing the US. By necessity, Mr Bernanke will increasingly be in the business of countering monetisation and inflation concerns.

Indeed, the markets have already fired a couple of clear warning shots in the last couple of weeks, as illustrated by recent moves in US bonds and the dollar.

The chairman’s challenges on this count are neither easy nor amenable to quick solutions. Moreover, as markets increasingly look into the underlying factors, as inevitably they will, they will recognise the difficulty that the government faces in credibly committing to the needed primary fiscal adjustment in the absence of high economic growth.

The bottom line is that we should come away from Mr Bernanke’s testimony with at least two conclusions: the chairman seems more cautious about the growth outlook when compared with other recent public statements; and he wants to push fiscal sustainability issues clearly away from the Fed’s domain and back where they belong, with Congress and the administration. He is correct on both counts. He would have been justified on Wednesday in being even more forceful; and he mostly probably will be in the next few months.

The writer, chief executive officer and co-chief investment officer of PIMCO, is author of [“When Markets Collide: Investment Strategies for the Age of Global Economic Change”](#) (McGraw Hill). 2008 FT/Goldman Sachs business book of the year.

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