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The Greenspan Story: Goodbye, Mr. Big Chips

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Tomorrow is Alan Greenspan's last day at the Federal Reserve. To appreciate his monetary policy, one has to go back to the watershed event in 1980-81, when then Fed Chairman Paul Volcker faced an inflation rate above 10%. Mr. Volcker, supported in 1981-82 by President Ronald Reagan, committed to contractionary monetary policy as the way to reduce inflation. Unlike the mid-1970s, the Fed raised interest rates much more than the increase in inflation -- the Federal Funds rate reached 20% in 1981. This policy proved remarkably successful, and inflation receded to 3% by 1983. Most importantly, by sticking to high interest rates despite the 1982 recession, the Fed established a reputation for raising rates sharply when inflation threatened and lowering rates only when inflation was tame.

When Mr. Greenspan took over in August 1987, his main mission was to sustain the Fed's credibility. The success is clear, even at the challenging times of the 1987 stock-market crash and the Asian/Russian/Long-Term-Capital-Management financial crises of 1997-98. During the Greenspan era, the Fed adjusted the Funds rate in a nearly rule-like manner to achieve a low and stable inflation rate. Broad inflation above an implicit target range, now around 2%-3%, triggered increases in rates, and vice versa. This policy led to the tranquil inflation environment since 1987.

Aside from responding to inflation, the Greenspan Fed raised interest rates when the economy was strong and lowered rates when the economy was weak. These reactions were to the labor market, not real GDP. For example, the Funds rate rose from 3% in late 1993 to 6% in mid-1995 in response to strong employment growth and a falling unemployment rate. In the opposite direction, the weak labor market in the 2001-02 recession induced the Fed to lower the Funds rate from 6.5% in late 2000 to 1% in mid-2003. The benefits from this part of Fed policy are unclear -- we do not know whether the economy performs better because the Fed adjusts interest rates in response to strength or weakness in the labor market.

The general view, which I share, is that the achievement of low and stable inflation has enhanced real economic performance. Support for this proposition comes from broad international experience, which reveals that higher inflation retards economic growth. However, the data also show that inflation stability is less important for growth than many other factors, including strong property rights and rule of law, free markets, and efficient systems of schooling and health. Moreover, sound monetary policy does not guarantee high growth -- witness the low inflation and anemic growth in Switzerland from the 1970s through the 1990s.

The Volcker Fed was an innovator in monetary policy in the early 1980s, but many other central banks have since become more sophisticated. Beginning with New Zealand in 1989, several countries designed and implemented formal rules for inflation targeting. Early adopters were Canada, the U.K., Australia and Sweden, and the total is now around 20. The key feature of these systems is a transparent monetary policy that focuses on keeping inflation within a pre-announced range. Despite widespread success, a few major central banks remain as holdouts: the Greenspan Fed, the European Central Bank (which has an implicit inflation target), and the Bank of Japan (which may move to inflation targeting in its post-deflation environment).

U.S. monetary policy has become less secretive since the 1980s, though Mr. Greenspan usually seemed to be a reluctant supporter of transparency. Even now, policy remains somewhat opaque and heavily dependent on the judgment of the Fed chair. To be fair, the Fed's policy worked very well since 1987, and Mr. Greenspan's sound decisions deserve credit. However, the likely reason for the good results is that the interest-rate changes usually approximated those implied by a version of the "Taylor Rule," which dictates reactions of interest rates to inflation and real economic activity. The appointment of a new chairman, Ben Bernanke, is a good time to consider a more formalized structure, especially since credibility will be an issue when the chairman is not an icon. However, the Bernanke Fed will likely move gradually toward a more transparent and formal system.

We will learn something about future Fed policy from Mr. Greenspan's last FOMC meeting, on Tuesday, and Mr. Bernanke's first meeting, in late March. Three approaches provide similar guidance about the likely near-term course of the Federal Funds rate. First, the Chicago Board of Trade futures market predicts one-quarter-point rate increases at the next two meetings, then a flattening at 4.75%. Second, a model that I constructed predicts a near-term rise to 4.5% or 4.75%, followed by declines in 2007. Finally, we can infer bond-market expectations from the nearly flat yield curve, with five- and 10-year rates around 4.5%. The bond market apparently anticipates a Funds rate peak at not much above 4.5%, followed by declines to below 4% (along with restoration of the normal upward-sloping yield curve). Note that the model-based approach takes no account of the shift from Mr. Greenspan to Mr. Bernanke, whereas the two market-based analyses factor in this shift. Therefore, the similar projections -- with all three approaches signaling the end of rising interest rates -- indicate that markets anticipate a smooth

transition to Mr. Bernanke.

What can we learn from the strong performances of Messrs. Volcker and Greenspan about the characteristics of a successful policy maker? Neither chairman is a great economist from the standpoint of research contributions or mastery of economic theory. (Despite Mr. Greenspan's strengths, there is something akin to Peter Sellers's *Chance the Gardener* in the exaggerated popular view of his economic prowess.) Fortunately, setting interest rates to ensure low and stable inflation does not require much economic sophistication. More important qualities are abilities to commit to sound policy and to inspire mystical confidence by financial markets, particularly in crises. Messrs. Volcker and Greenspan get high marks here, and their lack of research credentials mattered little.

Many great economists have been mediocre or worse as policy makers or government advisers. The most prominent economist to serve as Fed Chairman was Arthur Burns, famous for empirical studies at the National Bureau of Economic Research. He proved to be a disaster when he went over to the dark side to back President Richard Nixon's outrageous price controls in 1971. (Nixon's self-description, "Now I am a Keynesian in economics," says a lot about Nixon and Keynesian economics.)

A different picture comes from Mervyn King, now Governor of the Bank of England, who was a prominent public-finance economist before leading the bank as chief economist to a transparent regime with inflation targeting. However, although highly successful, the Bank of England's monetary policy has not been obviously better than those of other inflation-targeting central banks, which were not led by major economists. At the pioneering Reserve Bank of New Zealand, the key figure was Don Brash, as much a politician as an economist. Mr. Bernanke resembles Mervyn King more than the other central bankers I have mentioned, combining policy skills with strong academic credentials. Despite my stress on policy skills over research ability, his important studies of inflation targeting may facilitate the coming changes at the Fed.

Although one can quarrel about the rankings of policy makers, there is no doubt that Alan Greenspan has done a great job in managing U.S. monetary policy for more than 18 years. So, the best way for me to conclude is to say: Thank you, Mr. Greenspan.

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