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The Right Choice For The Fed

Bernanke, an expert on inflation targeting, is likely to keep a cool head in a crisis

President George W. Bush has likely just made his most important appointment, that of Ben S. Bernanke to succeed retiring Federal Reserve Chairman Alan Greenspan. I think Bernanke is an excellent choice because he combines a deep understanding of monetary theory with broad policy experience. The next Fed chair will need both traits to maintain the board's record of low inflation and to deal with future financial crises.

The triumph over inflation in the last 25 years has been one of the great successes of economic policy. Back in 1980-81, the broad inflation rate exceeded 10%. Fed Chair Paul A. Volcker, backed by President Ronald Reagan, committed to using contractionary monetary policy to bring inflation down. The main instrument was high interest rates: Volcker boosted the federal funds rate to a dizzying 19% in 1981, and held fast to high rates despite the 1981-82 recession. This policy proved remarkably successful, and inflation receded to 3% by 1983. Most important, the Fed established a strong reputation for raising rates when inflation threatened and lowering rates only when inflation was tame.

IN ADDITION TO RESPONDING to inflation, the Fed tends to raise rates when the economy is strong and lower them in weak spells. It does this not in reaction to overall growth but rather to the labor market; rates rise when employment growth is high and the unemployment rate is low. But unlike the central bank's necessary response to inflation, it is unclear whether this part of Fed policy is useful.

The Fed was a monetary policy innovator in the 1980s, but many other central banks have since surpassed it in the use of sophisticated techniques. Beginning with New Zealand in 1989, a number of central banks successfully designed and followed formal rules for inflation targeting. Examples include Canada, Britain, Australia, and Sweden. The less formal U.S. procedure shares some features of these rules, notably the tendency to raise rates when inflation is high. However, despite increases in transparency, the U.S. system remains opaque and relies more on the judgment and credibility of its chair -- since 1987, Greenspan.

The occasion of a new chairman is a good time to consider a shift to a more formalized procedure, particularly since credibility will be more of an issue when the office holder is no longer a policy icon. Thus it is fortunate that Bernanke, well schooled in policy through his position as chair of the White House's Council of Economic Advisers and previous stint on the Fed's Board of Governors, is also one of the main contributors to research on inflation targeting.

A crucial question is how Bernanke would function in a global crisis -- specifically, whether he could maintain the confidence of U.S. and world financial markets. Although I lack inside information on this trait, I can offer a firsthand account of Bernanke's performance during a more localized predicament. Back in 1983, only four years after receiving his PhD in economics from the Massachusetts Institute of Technology, Bernanke gave a seminar at the University of Chicago's prestigious Money & Banking Workshop, founded by Milton Friedman. The workshop that year was headed by economist Robert Lucas, and I was second-in-command. Although Lucas was 12 years away from his Nobel prize, everyone knew that he would get one eventually, and he had an almost godlike reputation.

I was seated next to Lucas during that seminar and noticed that he was mumbling in an increasingly annoyed manner every time a seminar participant -- an equally brilliant economist Lucas could never stomach -- interjected. Finally, Lucas stood up, exclaiming for all to hear "I can't take this any more," and stormed out. Due to my proximity, only I realized that he was reacting to the other economist who so vexed him. Everyone else -- including Bernanke -- thought the revered Lucas was responding with disgust to Bernanke and his paper. Most senior professors would have broken down, but not the young Bernanke. He continued without pause and completed the 90-minute seminar with aplomb. Only at the end did he coolly ask: "What's up with Bob?"

I know that this incident was only an academic seminar, but I think that the coolness Bernanke showed under this Chicago fire has only increased over the years. So, I was greatly pleased that Bush chose him to be Fed chair. Sometimes even Washington makes the right choice.

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