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The Cult of Alan Greenspan: Why the Fed Needs a Policy Framework

Stephen G. Cecchetti¹

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During a debate of Republican Presidential aspirants on 2 December, it fell to Senator John McCain of Arizona to summarize many people's feelings about Alan Greenspan, Chairman of the Federal Reserve Board. In the midst of the proceedings, Senator McCain said: "I would not only reappoint Mr. Greenspan, but if Mr. Greenspan should die, God forbid, I would do like they did in the movie *Weekend at Bernie's*. I would prop him up and put a pair of dark glasses on him." In this 1989 film, two young hustlers, far down on the corporate ladder, win an invitation to their boss' sumptuous beach house for the weekend... only to find him dead upon arrival. Not to ruin the fun, they place him in a chair with sunglasses, and the party goes on as none of the other guests are the wiser. When Mr. Greenspan does finally depart, hopefully under his own power, we need to find some way for the party to go on. The solution is to make monetary policy less dependent on the skills and acumen of the Chairman.

Greenspan took over the helm of the Federal Reserve in August of 1987, and over the past 12+ years, his record has been truly spectacular. Over this entire period, growth has exceeded 3 percent per year on average, well above the rate of the previous decade. During the past three years alone, real GDP has increased by a phenomenal 4 percent, on average. Meanwhile, inflation has fallen substantially, from a range of between 4 and 5 percent in the late 1980s to just over 2 percent today. These accomplishments are all the more remarkable when one recalls the fact that this has not been a particularly tranquil period in the financial history of the world. Indeed, the "Greenspan era" has been punctuated by crises. First came the U.S. stock market crash of October 1987, then the Mexican crisis of 1994, followed by the Asian crisis of 1997, finally the Russian default and the difficulties with Long Term Capital in the fall of last year. Overall, the 1990s have been a difficult period for monetary policy, and the results have been spectacular. Our appreciation of Alan Greenspan and his colleagues is well deserved.

¹Cecchetti is Professor of Economics, Ohio State University, as well as the former Director of Research at the Federal Reserve Bank of New York, and Associate Economist of the Federal Reserve's Federal Open Market Committee.

But Mr. Greenspan will be 74 years old this coming March, and he will not be with us forever. As Mr. McCain's remark suggests, our panic is over what will happen when he leaves. Isn't there some way we can keep this Chairman around indefinitely? The answer is clearly no, and so we should be thinking about what we will do next.

U.S. monetary policy is made by the Federal Open Market Committee (FOMC), which is composed of twelve voting and seven nonvoting, and they do provide a check on the Mr. Greenspan's policy prescriptions. But it is commonly, and I think correctly, believed that the Chairman's views dominate the proceedings. The fact that policy is perceived to be so reliant on the abilities of one individual is a failure of the institution. The problem is that we do not have well-articulated policy objectives, with an accompanying strategy or framework. What we have is a magician. As a result, we all live in fear of what will happen when the magician is replaced by a mere mortal.

As part of the recent transformation of central banking around the world, thought has gone into how to insure stability of monetary systems. New policy-making procedures have been put into place expressly to guard against a broad array for pitfalls, and we in the U.S. can draw lessons from experience in other parts of the world. Two recent examples come to mind. The most prominent is the new European Central Bank (ECB), created in July 1998. The ECB has a high degree of independence and autonomy from the European political system, and so it was clearly important to restrict the scope of its influence and create mechanisms for accountability. The second example is the Bank of England (BoE), one of the oldest central banks in the world, was granted independence only in the last two years.

What is striking about both the ECB and the BoE is that they were both given very clear mandates. No one wanted to create an independent institution as powerful as the a central bank, without constraining their actions by dictating that their primary objective is price stability. In the case of the ECB, the Maastricht treaty stated the Banks goals clearly. These were further enunciated in the policy strategy agreed to by the Governing Council on 13 October 1998, where they stated that "Price stability shall be defined as the year-on-year increase in the Harmonized Index of Consumer Prices for the euro area of below 2%". The BoE's writ is very similar. In his May 1997 letter to Governor Eddie George, Chancellor Gordon Brown instructs the Bank to adopt an inflation target, which was set by the government to be 2 1/2% annually, as measured by the retail price index, excluding home mortgage interest payments.

The specificity of the policy framework at both the ECB and the Bank of England provides a certain insurance against exactly the problem that we in the U.S. currently

face. That is, the existence of clear objectives make ultimate policy outcomes less reliant who is actually in charge of operational policy. The monetary policy makers themselves are left to be the technicians of the system, worrying about the mechanics of achieving the goals they are given rather than arguing about the goals themselves.

What does all of this have to do with Alan Greenspan and the Federal Reserve? Well, the problem is that the FOMC does not have a well-articulated, publicly stated, objectives, much less a clear policy framework. One could even argue that there is no agreement among that the members of the FOMC themselves about the objectives of policy. The Humphrey-Hawkins Act does specify a long list of objectives, and the FOMC directive does state the Committee's long-run goals as price stability and sustainable economic growth. But nowhere are either price stability or sustainable growth given clear definitions. As a result, the comments of the FOMC members, both on their own and as summarized in the minutes of their meetings, suggest wide disagreement about whether consumer price (CPI) inflation should be forced below 2% or allowed to rise to 3%, or whether potential growth is 2 1/2%, 3%, or 3 1/2%, for example.

Two reactions to all of this are possible. The first is that we should leave well-enough alone. The FOMC has been doing just fine, thank you very much. But to the extent that monetary policy performance has relied on the prescience of this Chairman, we might want to change things before he departs. What we need to do is to purchase some insurance for the post-Greenspan era. Clear, publicly announced policy objectives and a detailed framework — be it the inflation targeting procedure like that of the Bank of England, the more complex strategy of the European Central Bank, or some third possibility — would provide exactly this insurance. This would focus the FOMC's deliberations of on the technical aspects of how they should go about achieving the agreed upon goals. My own preference is that we should adopt a medium term inflation target that specifies average CPI inflation of 2 percent over the next three to five years. To reduce uncertainties even further, I would require that the Federal Reserve make public its estimates of the sustainable growth rate in GDP.

But in the end, exactly what the objectives are is much less important than that they be clearly publicly announced. If we can get to this point, the Senator McCain will not need to prop up Alan Greenspan and we can all let him rest in peace.