COMMENT
Respect for a master banker's reading of the tea leaves
By KENNETH ROGOFF
24 August 2005
Financial Times
London Ed1
Page 15
English

As Alan Greenspan's fifth and final term as Federal Reserve chairman comes to a close in January next year, more and more people are asking the question: "What were the secrets of his extraordinary success and can he pass them on to his successor?" This is not a small question given the Fed chairman's legendary reputation for obfuscation. (According to Andrea Mitchell, his wife, Mr Greenspan had to propose three times before she understood him.)

There are, indeed, huge stakes for the global economy as the world's most important financial position changes hands. Many financial analysts warn that, at a minimum, there will be a prolonged period of market volatility. However, if one looks at how the science of monetary policy has evolved over the past two decades, there is cause for optimism. In particular, although many people believe that monetary stabilisation policy has been more central than ever under Mr Greenspan, his greatest success may have come from making it less so.

Let us get one thing straight. Alan Greenspan is the Michael Jordan/Lance Armstrong/Garry Kasparov of modern-day central bankers. It may be a long time before we see another individual as adept in all phases of the job. He has certainly been a crisis manager extraordinaire. Though the main job of a modern central bank is to preserve growth and maintain price stability, its ability to print money also makes it the lender of last resort.

Mr Greenspan's deft handling of the October 1987 stock market crash - only months after he took office - was bold and brilliant. He poured liquidity with abandon into a financial system that might otherwise have seized and collapsed. The Fed probably lost a big chunk of change, but hundreds of billions of dollars were saved. The Greenspan team executed a similar strategy in the wake of the September 11 2001 terrorist attacks. With seconds on the clock, and the game on the line, there is no doubt who you want handling the ball in a global financial crisis.

He has been no less successful in the day to day routine of monetary policy. When Mr Greenspan came to the Fed, he took charge of a great team of economists and made them better. They are a key source of ideas and credibility, helping to make Mr Greenspan the Oracle of Delphi for financial markets. Any analyst who disagrees with one in five things Mr Greenspan says is considered a contrarian. The enormous prestige and respect he has brought to the job has, in turn, been a huge tool in recruitment and retention of top talent.

And yet, there is a curious disconnection between what most academics see as the limits of monetary policy and the popular conception of Mr Greenspan's wide-sweeping power.

Consider that the most recent Nobel prize in economics went to a pair of researchers, Finn Kydland and Edward Prescott, who argued that monetary policy plays only a relatively minor role in driving business cycles. Only a few years back, the Nobel prize went to Robert Lucas for his elegant theory in which activist monetary policy only adds unwanted noise to the economy. Does this claim not ring patently false? Doesn't everyone now agree that activism has been the hallmark of the hyper-successful Greenspan Fed? Is the main complaint about the ECB and the Bank of Japan not that they are too passive?

In fact, theory and practice have converged more than meets the eye. Newer theories, following up the Nobel laureates' early work, have resuscitated an important role for monetary policy, albeit a narrower one than Keynes' postwar followers once imagined. In addition, the Greenspan Fed is not nearly as activist as it seems. Yes, the Fed moves its instrument (the short term interest rate) around a lot but its goals - particularly low inflation and smoothly functioning financial markets - have remained relatively stable (True, Mr Greenspan has apparently resisted adapting one of the many variants of formal inflation targeting.) By and large, Fed policy is aimed at maintaining a stable inflation rate, except in the face of clearly discernable big shocks. Market data guides the Fed over time to the appropriate level of inflation-neutral interest rates, rather than vice-versa. The gravity with which markets treat Mr Greenspan's comments should be taken as a sign of deep respect for the Fed's reading of the tea leaves, not a view that it can bend the economy to its whim. Some of Mr Greenspan's most influential calls have come precisely from explaining how changing trends in productivity and globalisation were affecting the interest rates required to maintain price stability. Granted, his job (and every other central bankers') has been made easier by continuing good news on global productivity trends. His successor will face a much tougher challenge if and when there is ever a 1970s-style productivity slowdown.

The salient effects of the Fed's stabilising strategy, and similar ones followed by most other leading central banks around the world, have been stunning. The risk premium on long-term interest rates is down sharply, helping fuel sustained growth and expansion. (Let us set aside the thorny problem of the concomitant global housing bubble for another day.) Less well known but no less important is the fact that the volatility of global output growth has been falling steadily since the mid-1980s. Financial market deepening has also been a factor in lowering volatility by helping spread risk to those who can best handle it. But financial market deepening, in turn, owes much to today's more stable monetary policies. One only has to look at countries such as Mexico and Brazil, which still lag in financial intermediation, to realise what lasting damage a history of exotic monetary policies can inflict. Also thanks to the Fed's extraordinary success in stabilising inflation expectations, the US economy has been able to shrug off (so far) the recent round of oil price hikes. In the old days, the Fed would have been forced to jack up interest rates sharply to prevent a wage-price spiral.

Paradoxically, then, the Greenspan Fed has succeeded by reducing the role of monetary policy, rather than by enhancing it. Factoring in the superb staff and generally strong team in place on the federal open market committee, there is no reason to fear the post-Greenspan world. Certainly, there remains much room for debate on the fine points of how to respond to asset bubbles, not to mention productivity or terms of trade shocks. Whether the next Fed chairman will succeed in continuing to refine Mr Greenspan's eclectic approach to include more formal inflation targeting remains to be seen. Who knows, maybe Mr Greenspan himself has already proposed such a mechanism, and we just did not understand it.

The writer is professor of economics at Harvard University. He is a former chief economist at the International Monetary Fund.