Monetary Policy AG

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While the Fed has a number of stated objectives with respect to monetary policy, the hallmark of the Greenspan Fed has been the pursuit of low and steady inflation. In January of next year the Fed is due to have a new chairman to direct monetary policy. He can pursue price stability or choose to emphasize another objective. It is because of this discretion that so much attention is focused on a change in chairman. When Greenspan leaves the Fed does he take his inflation fighting credibility with him or does the institution retain it no matter who becomes chairman? The answer to this question is unclear. What is clear is that an explicit institutional pre-commitment to longer term price stability as the dominant objective of monetary policy would enhance the credibility of the Fed and limit future monetary policy mistakes.

Not All Chairmen Are Equal. All the Fed can do over time is to provide price stability. In economist speak the Fed affects nominal as opposed to real variables over time. If the Fed produces price stability (zero inflation), it provides the best environment for maximum sustainable economic growth over the long term. So how do the chairmen of the last half century stack up with respect to price stability?

Chairman	Average annual inflation rate (CPI)	Range High	Range Low
Martin	2.25	7.9	-0.4
Burns	6.48	11.0	3.2
Miller	9.45	11.3	7.6
Volcker	5.82	13.5	1.6
Greenspan	3.04	5.4	1.6

Martin became chairman on April 2, 1951. In that year inflation was 7.9 percent. But for the next 13 years it never went above 3.3 percent or lower than minus 0.4 percent. However, near the end of his term he yielded to the hubris of the Johnson administration economists who believed they knew enough to trade off a little inflation for more economic growth.[1] While the Martin Fed kicked off the inflation of the 1970's, he nevertheless produced the lowest average inflation rate of any chairman in the last 50 years.

[1]Christina D. Romer and David H. Romer, "Choosing the Federal Reserve Chair: Lessons from History." Journal of Economic Perspectives, Volume 18 Number 1, winter 2004, pp. 137-138.

Burns took over as chairman on February 1, 1970, and managed to nearly triple the average inflation rate of his predecessor in his eight year tenure. Burns also yielded to political pressures arguing that the Fed's independence could be threatened or that more harmful fiscal policies could be imposed.[2] Money growth (M2) was in double digits much of the time and real interest rates often were negative. Wage and price controls, incomes policies, and cost push inflation were the ideas of the day. The Burns Fed sacrificed price stability in an attempt to boost employment. In the end it produced higher inflation and higher unemployment rates. The Burns Fed had used up the anti-inflation credibility of the Martin Fed.

Miller started his chairmanship on March 8, 1978, and ended it on August 6, 1979. In his short tenure he was merely along for the ride. Aggressive Fed action to reinstitute the primacy of price stability was needed. Money growth slowed but there was no credible commitment to end inflation. Inflation averaged 9.45 percent in 1978-79. This was the highest average rate for any chairman in the last half century. Miller simply reaped what Burns had sowed.

Volcker, as president of the Federal Reserve Bank of New York, served as vice-chairman of the FOMC prior to becoming chairman on August 6, 1979. While he was a participant in the disastrous Fed policy- making of the last half of the decade of the 70's, he quickly took control as chairman and moved aggressively to establish low inflation as the dominant objective of Fed policy. He announced the Fed was changing operating procedures to focus on containing money growth with the aim of restoring price stability. By 1983 the Volcker Fed had chopped the inflation rate from 13.5 percent to 3.2 percent. He did this with much less damage to the economy than many mainstream economist thought possible. When he handed off the chairmanship to Greenspan in 1987 the unemployment rate had fallen from almost 10 percent to less than 6 percent and the inflation rate had dropped to 3.6 percent from its double digit rate in 1980.

Greenspan took office on August 11, 1987. In October the stock market crashed and policy focused on stabilizing financial markets. The inflation rate rose for three consecutive years and peaked in1990 at 5.4 percent before trending downward to a low of 1.6 percent. The current rate is about 3 percent and rising. Volcker did the heavy lifting in bringing the rate of inflation down but Greenspan kept it low and stable for nearly two decades. Greenspan's record on inflation is second only to Martin's. Martin also served for nearly two decades. Judging by the relatively low inflation premiums in market interest rates, the Greenspan Fed has credibility with respect to controlling inflation. Whether that credibility will remain with the Fed or leave with Greenspan is an open question.

What Has The Future Chairman Learned? After 25 years of low and stable inflation that benefited the economy, the future chairman has surely learned the value of

[2] Henry W. Chappell Jr., Rob Roy McGregor, and Todd Vermilyea, Committee Decisions on Monetary Policy (The MIT Press: Cambridge, Mass.; London, England 2005) pp. 140-142.

low inflation if not price stability. Or has he? Martin provided nearly 20 years of low and stable inflation but the next two chairmen, Burns and Miller, did the opposite. Greenspan risked an inflation surge in his first three years.

The backgrounds and economic views of Fed Chairman have been studied in detail. Yet there is little in their backgrounds that would help in picking a successful chairman other than having a sensible or realistic view of economic policy and a belief that long term inflation has no benefits[3]. Prior to his chairmanship Burns would have met these qualifications.

The future chairman, if he has studied his predecessors, knows that they have been concerned over retaining Fed independence and that there is a political bias towards easy policy. For example, Fed governors are political appointees and generally prefer easier policies than Fed bank presidents and that democrats in the White House prefer easier policies than republicans living there.[4] The fact that no chairman in the last 50 years has achieved price stability (zero inflation on average) is evidence that the Fed has a persistent bias towards inflation. The future chairman also knows there are no policy procedures that he cannot change. He can attempt to trade off some inflation for more employment, if he so desires. He is bound by no rules and has no long term inflation target or constraint. A new chairman, either by accident or intent, could attempt to exploit the anti-inflationary credibility of his predecessor.

For example, when Martin handed off to Burns, 10-year treasury rates were in the area of 4 percent and inflation expectations were low. Not much different from the situation we have today. Bond investors failed to anticipate the magnitude of the Burns inflation until 1980, allowing the Fed to pursue easier policies than otherwise. In short, the Fed was able to create a monetary surprise because of the credibility of its earlier policies. Could a new chairman, if he were so inclined, do so today?

Preserving Credibility. The Greenspan Fed has a chance to lessen these uncertainties by adopting inflation targeting procedures. Such targeting would also improve market understanding of Fed procedures and render obsolete the confusing word games it currently uses to convey policy. Announcing a long term benchmark for inflation would be a start. Policy responses could be tied to it once experience is gained. Over time an explicit long term target of zero could be established with policy reactions tied to achieving that target on average over some multi-year period. The misleading wording of balancing the risk of inflation against risks to the economy should be eliminated. The Fed determines inflation not the real economy. If the Fed controls inflation the economy will take care of itself. Discretion would still be part of the policy process but at least it would be bounded. If a major financial disturbance or shock to the economy were to occur the Fed could temporarily suspend its inflation target. The central banks currently targeting inflation have not given up discretion in responding to a crisis.

[3] Romer and Romer, pp. 129-162.
[4] Chappell, et. al. p. 56

Of course, a new chairman may be able to change such a targeting procedure but the longer it stays in place the more difficult it becomes to do so. The only sure way to ensure price stability as the dominate objective of monetary policy is to ask Congress to make it so. Unfortunately champions of a price stability objective for the Fed, such as former Senator Connie Mack and former Representative Steve Neal, do not exist in today's Congress. There are risks in asking Congress to act. However, legislative bodies in other countries have passed sensible inflation targeting legislation.[5]

After AG. The most likely course for monetary policy after Alan Greenspan is more of the same. There is great inertia in the policy process and barring some major economic or financial market problems the new chairman is unlikely to make major changes, at least until he gains the confidence of his colleagues. Recent past growth in money (M2) is consistent with future low inflation but the low level of real interest rates may not be. Fortunately, the federal funds rate will likely exceed the inflation rate, a more traditional alignment, by the time that Greenspan departs and perhaps there will be no conundrum in the bond market if future inflation remains low.

Yet economic shocks and surprises do occur and political pressures can follow. A binding price stability objective for the Fed would lessen the chance of a Burns-Miller mistake no matter who becomes the next chairman and no matter what challenges he might face.

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[5] Bennett T. McCallum, "Inflation Targeting for the United States", Shadow Open Market Committee, May 3, 2003, pp. 7-8.