

Applying the Concept: The Fed after Alan Greenspan

Monetary policy under Alan Greenspan has been exemplary. Since the early 1990s, growth has been higher and inflation lower than before he took the helm at the Fed in 1987. Moreover, both growth and inflation are more stable than ever before. It is hard to imagine things getting much better. So it is with anxiety that people look forward to the end of Mr. Greenspan's term as Chairman of the Federal Reserve Board on January 31, 2006, less than two months before his 80th birthday.* Who will succeed Alan Greenspan? Will the next head of the Fed be as able?

Fortunately, there are many able people who would do an excellent job. The primary reason for this is that the debate over the conduct of monetary policy has been depoliticized. While monetary economists and central bankers may differ in their support for various political causes, they all agree that central bankers should focus their energy on delivering low, stable inflation. Not only are central banks independent of political influence as a matter of law, they are independent of politics as a matter of best practice.

To be effective, the next Chairman of the Fed must meet certain critical qualifications, and this fact narrows the field of possible acceptable candidates significantly. The head of a central bank serves four constituencies: politicians, financial markets, academics, and the public at large. Here is how any a viable candidate must relate to those different groups in order to be successful in the job:

Politicians: While central banks must be independent from politicians in both law and in practice, since the president nominates the Fed Chair and he or she is confirmed by the Senate, people holding the post usually belong to the political party in power at the time of their nomination. The need for political support is hard to overstate. Politicians are accomplished at using words to sway public opinion. What they say matters, and if they attack the central bank, it can be devastating.

* Chairman Greenspan may serve beyond the date on which his formal term expires if a replacement has not yet been nominated by the President and confirmed by the Senate.

The financial system: Greenspan's replacement must be well-regarded by those who run the financial system. There is always the risk that financial markets lose faith and flee to high-quality, low-risk investments, slowing the flow of resources from those who save to those who have profitable investment opportunities. This is what happened briefly in the fall of 1998, when Long Term Capital Management's meltdown (see Chapter 9, page 222) and the Russian bond default (see Chapter 6, page 136) threatened to send the world's financial systems into a tailspin. At that time, Chairman Greenspan and his colleagues at the Fed took advantage of the relationship they had with financial market participants and were able to allay fears and set things straight. Diffusing the inevitable crises of the future requires that financial markets participants continue to trust the head of the Fed.

Academics: Not to put too fine a point on it, but if academics begin to criticize the monetary policy via quotes in the financial press, they can produce more than just noise. Today academics tend to provide intellectual support for policymakers, but they can also supply rhetorical ammunition for their critics. Since their arguments are based on the logic of decades of research by hundreds of well-respected economists, they can be very effective. The next Chair must have credentials and a reputation that are respected by the academic community.

The public: Finally, the Fed Chairman's ultimate constituency is the public. In the short-term, since the vast majority of people know little about the technical operation of monetary policy, the public tends to fall behind candidates who are solidly backed by the other groups already mentioned. But over the long haul, the public does see the results of the Fed's work: inflation, employment, and real growth. That's why even though most Americans can't tell you exactly what Alan Greenspan does, they know who he is. And with low, stable inflation, and high, stable growth, they generally know he is ensuring the economic stability that every central banker strives to deliver.
