

# INVESTMENT UPDATE

Alan Greenspan will soon be gone. OK, maybe not gone, but gone from the public eye. Gone from the seat of power. Gone from the perch (some would say “pedestal”) from which he has directed the Nation’s monetary policy for nearly two decades. Gone to play tennis and take leisurely baths ‘til his heart’s content.

The “Maestro” has achieved celebrity status, which has made him both wildly popular and a lightning rod for those critical of the Fed and its current policies. But, love him or not, few would argue that he established himself as the most powerful Chairman of the Federal Reserve System this country has ever known. Let’s take a look back at the Greenspan years and take a glimpse of what the future may hold for the Chairman-Elect, Ben Bernanke.

It’s been more than eighteen years since President Reagan appointed Greenspan to take over as Fed Chairman from Paul Volcker. Volcker and Greenspan shared the experience of working for Republican Presidents, and both had formal education and training as economists. But the similarities didn’t extend much further. Greenspan’s profile—bookish, intel-

lectual and—gasp—artsy (he attended Julliard to further his saxophone tutelage) seemed so much smaller next to the powerful physical presence of his cigar-chomping line-backer-sized predecessor. Early in their respective careers, Greenspan seemed to be more of a “pure monetarist” next to the pragmatic Volcker. Volcker, after all, was a major architect of the 1970 Bretton Woods Agreement that modernized the US dollar and weaned the US off the gold standard; Greenspan was critical of this major shift in the US monetary system and lamented the inconvertibility of paper money back into gold.

US monetary policy has always had two goals that are not always compatible: Price stability and economic growth. When Volcker took over the Fed in 1979, inflation had been running out of control for most of the decade and, out of necessity, breaking the back of inflation became his single

purpose. In fact, Volcker purposely put the US economy into a recession in 1979 in order to end the inflationary cycle. His approach was straightforward, and reflected the monetary principles popularized by Milton Friedman and others—to control inflation, policymakers must limit the amount of dollars in circulation. Thus, the Fed’s main economic barometer during the Volcker era became “M1,” the funds in the nation’s checking accounts.

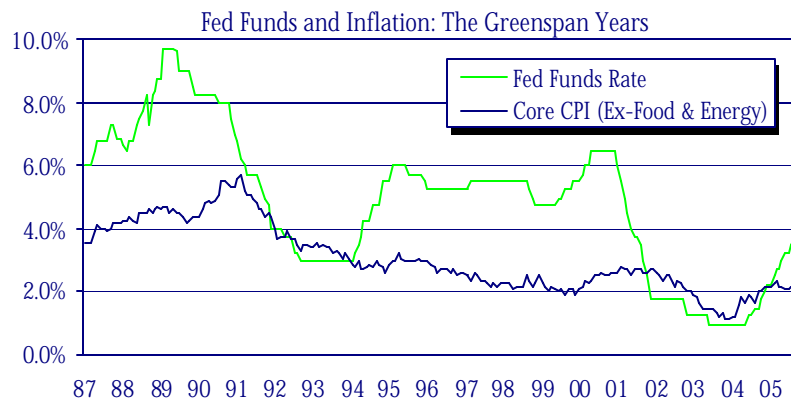
Greenspan got off to a rocky start in his first few months as Chairman. After taking the reins in August of ’87, the Fed’s Open Market Committee (FOMC) voted to hike the overnight funds rate by 50 basis points (0.50%) in order to raise borrowing costs and help slow some of the excesses of the LBO-fueled 1987 stock market (and, some would say, to demonstrate that he was as tough on inflation as his predecessor). The equity markets reacted badly, and after

stumbling for a number of weeks, finally collapsed on Black Monday. On October 19<sup>th</sup>, 1987 the Dow dropped by 23%, the largest one-day percentage decline in the history of the US stock market.

In the wake of the ’87 crash and over the next few years, Greenspan established himself as a thoughtful and decisive leader. He acted quickly

to provide liquidity in the wake of the October ’87 crash, as he would 14 years later after the 9/11 attacks. In between, he won the respect of his colleagues by digging deeply into data that few others, even professional economists, cared to study. He, alone among his Fed colleagues, predicted that increases in US productivity could lead to a sustained period of exceptional economic growth with little labor market inflation in the 90’s.

Greenspan presided over significant changes in monetary practice. Early in his tenure, the monetary rule so dear to the orthodoxy—monetary growth determines inflation—became untenable. Deregulation of the financial markets had led to broad outflow of funds from checking accounts, and into non-bank money market and brokerage accounts. Not only the accurate measurement of “money supply” but the very definition of what constituted liquid consumer



funds became vague to the point of uselessness. Gradually, monetary policy became less about controlling the *amount* of money and more focused on the *price* of money. Thus, the emergence of targeting the Fed funds rate, the price at which banks lend overnight funds to each other.

This, perhaps more than any other factor, has brought the wrath of many of monetarism's old guard upon Greenspan over the years. James Grant, professional curmudgeon and publisher of *Grant's Interest Rate Observer*, has called Greenspan "an aging price controller" and "a de facto central planner." For old-school monetarists such as Grant, the best monetary policy is one that places tight controls on the US Treasury's printing presses and lets the market determine the rate of interest, based on the supply and demand for credit. They decry the idea of monetary fine-tuning, believing that a more-or-less passive form of monetary policy will provide steady economic growth and low inflation.

What's more, the hard-line monetarists have a hard time dealing with the "cult of personality" that surrounds Greenspan, and his outsized personal impact on US policy. They see no reason why the Fed Chairman would opine (in front of Congress or otherwise) on topics outside of US monetary policy, or arrange bail-outs of hedge funds and banks, or (as Greenspan did in February 2004) admonish consumers for failing to use adjustable rate mortgages which "might have saved [them] tens of thousands of dollars....during the past decade." They are hoping that the next Fed Chairman will maintain a lower profile and keep his focus squarely on US monetary policy.

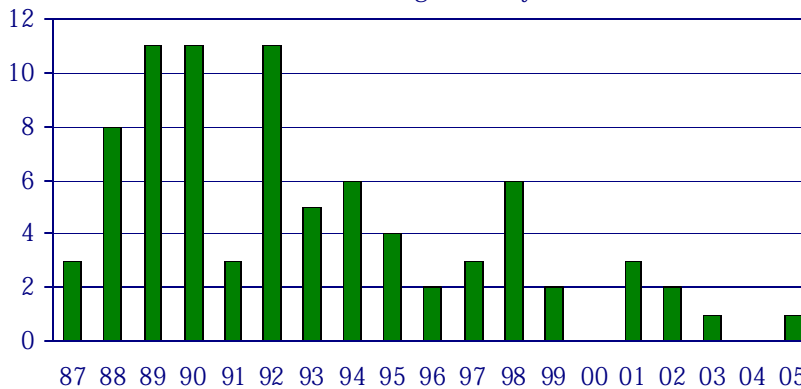
Which brings us to Ben Bernanke, the man who will take over as Chairman on February 1, 2006. He is well-known in academic circles as a brilliant economist, and has, in a relatively short time period, established himself in Washington for his work with the Fed and the Council of Economic Advisors (CEA).

The Chairman-Elect gives away nothing in the brain department to his predecessor: As a South Carolina sixth grader, Bernanke won the state spelling bee, went on to teach himself calculus in high school (his school didn't offer it) and scored 1590 out of 1600 on his SATs, the highest of any student in the state that year. Undergraduate economics work at Harvard and a PhD from MIT followed. In his own words, he thought he would be "an academic lifer" but at-

tracted attention from public policy makers for his study of the root causes of the Great Depression (adding to the seminal research of Friedman and Anna Schwartz).

Bernanke's work for the Government began fairly recently, officially starting when he was named one of seven Fed Governors in August of 2002. He served on the Fed until June of this year when President Bush brought him over to head the President's Council of Economic Advisors. During his three years on the Fed, Bernanke made his mark as a vocal supporter of explicit inflation targets, in opposition to Chairman Greenspan. Yet his work was well received by his colleagues, and even Greenspan used one of Bernanke's pet concepts, the "global savings glut," earlier this year to describe the most likely explanation for ultra-strong worldwide demand for US securities.

FOMC Dissenting Votes, by Year



In his nomination speech, Bernanke provided some comfort to Greenspan fans when he said his plan is "to maintain continuity with the policies and policy strategies established during the Greenspan Years." This was not at all surprising for a man who never dissented while on the FOMC.

But, like Greenspan in his early years, Bernanke will have to prove himself to his colleagues. As the chart on this page shows, Greenspan enjoyed remarkable autonomy in the past few years on the Fed, with few dissenting votes. As much as Bernanke would like to see this trend continue, it ain't going to happen. The other voting members of the Fed's Open Market Committee will be jockeying for position, and testing the new Chairman's leadership. Think of it as "Fed Hazing."

Add to this the fact that Dr. Bernanke is inheriting the job at a fairly difficult time. While inflation is nowhere near the issue it was in the early 90's (much less the early 80's), there is a whiff of old-fashioned energy-induced inflation in the air. Inflation targets or not, Bernanke will want to establish his own price stability credentials, and is likely to err on the side of too much monetary restraint than risk an acceleration in inflation in his first few months on the job.

And, after all, isn't that what maintaining the continuity of the "Greenspan years" is all about?

