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# The Chairman of the Board

*Departing Federal Reserve chief  
Alan Greenspan did it his way*

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BY IRWIN M. STELZER

**A**t midnight on January 31 Alan Greenspan will hop into bed for his first worry-free sleep in almost two decades. So he told me during a recent visit to London at the invitation of Chancellor of the Exchequer Gordon Brown, who credits Greenspan with persuading him to grant the Bank of England independence from political pressures. Greenspan came to deliver a lecture and be made a Freeman of the City of London (which entitles him to herd sheep across London Bridge, be drunk and disorderly without being arrested, and be hanged, should it come to that, with a silken rope). “I have only just realized that I have been on 24-hour call for 18 years,” said the 13th chairman in the 92-year history of the Federal Reserve. He will leave the chair of the world’s most important central bank four months shy of being its longest-serving chairman, a distinction held by Truman-appointee William McChesney Martin. A bit of legislative juggling would have allowed Greenspan to beat Martin’s record, but he doesn’t approve of such legerdemain, and politely declined the offer to enhance his entry in the history books of the Federal Reserve Board.

That entry, of course, will need little artificial enhancement. Greenspan’s critics may disagree—more on that below—but there is little doubt that he exits the Fed to applause from his fellow central bankers, politicians of most stripes, the financial community, and, unusually for a central banker, the public, among whom “he enjoys almost rock-star status,” according to the *Economist*. I am certain that the “almost” will not cut too deep, since Greenspan is inured to critics who rank him not only below rock stars, but below his illustrious predecessor, Paul Volcker, revered

for slaying the inflation dragon and undoing some of the damage inflicted on the economy by Jimmy Carter.

Indeed, Ravi Batra, professor of economics at Southern Methodist University and a Greenspan critic, contends that “the real impact of Greenspan’s influence [was to] unwittingly effect . . . a global crash and spread economic misery on our planet.” Greenspan, in Batra’s view, leaves in his wake millions without health insurance, mountains of consumer debt, and a record number of personal bankruptcies. Less strident critics complain that Greenspan has handed his successor, Ben Bernanke, a poison’d chalice. By their reckoning, he has kept interest rates too low for too long, and pumped so much liquidity into the economy that Bernanke will have to be adroit to avoid a recession—if it is indeed possible to do so. Nobel laureate Joseph Stiglitz says Greenspan, by supporting President Bush’s tax cuts (as did Bernanke), leaves in his wake a country “with huge instabilities, . . . ill-equipped to face any kind of shock.”

The reasoning of Greenspan’s critics goes something like this: Greenspan has allowed asset bubbles to form first in stocks, then in real estate, by keeping interest rates so low that, in the case of houses, consumers refinanced their mortgages and used the released equity to shop until they dropped. Except that they didn’t drop: They kept on shopping, buying so many imported television sets, cars, sneakers, and T-shirts that our trade deficit ballooned to an allegedly unsustainable 6 percent plus of GDP. We send foreigners pictures of our presidents printed on green paper, and they send us their manufactured products. Then, not having much use for dollars in Beijing, Tokyo, Mexico City, and Riyadh, the foreigners use their dollars to buy the flood of Treasury IOUs issued to cover our federal deficit—the second of the financial “twin towers” that, critics say, will tumble down just as their Trade Center counterparts did. Those foreign purchases of our bonds and notes kept long-term interest rates low (low interest rates are the flip side of high bond prices), throwing gasoline on the bonfire of consumer spending.

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All of this because Greenspan hesitated to raise interest rates to deflate house prices. Never mind that economists cannot agree that there has been a house-price bubble. After all, the underlying fundamentals dictate a robust market. Demand from baby boomers for second homes, immigrants for starter houses, and increasingly wealthy Americans for bigger homes resulted in the completion of almost 30 million housing units during Greenspan's tenure. This demand pressed on a supply limited by local planning restrictions. Little wonder that prices headed upward.

The critics ignore the fact that the trade imbalance might be due, in part, to the massive savings surpluses in such countries as China, where consumers, acutely aware that the Communist regime provides no social safety net or health insurance, save some 50 percent of their incomes. Add to that the sluggishness of the major continental European economies, and the consequent low level of demand for imports from America, and you have an explanation of the trade deficit that locates the villain of the piece abroad, rather than in the boardroom of the Fed.

Greenspan's detractors also stumble over the hard fact that he has racked up three notable successes. The one of which he claims to be most proud is weaning the Fed off its excessive devotion to economic models. These constructs, he contends, project past relationships into the future and are useful only when those relationships hold. But in a dynamic economy they often do not, witness what has come to be called the productivity revolution, and globalization.

Greenspan intuited—well, more than intuited: determined from the multiple sources of information that he manages to tap and then integrate—that the American economy was experiencing a productivity revolution, with workers producing more and more goods in each working hour. This made nonsense of arguments that interest rates must be raised as soon as labor markets tighten, lest wages be bid up, and trigger a round of inflation. What Greenspan saw far before others was that employers were finally reaping the benefit of investment in Internet and other technology, enabling workers to produce more each hour, allowing compensation to rise without driving up labor costs or prices. Raise compensation, but raise output even more, and costs and prices need not rise.

Greenspan also saw that models based on data from pre-globalization days were not particularly useful forecasting tools. Globalization has tripled the potential supply of what Larry Lindsey, a former Fed governor and architect of the Bush tax cuts, calls “undifferentiated labor.” Triple the supply of anything and, other things being equal, its price will come down. That is what has happened

to wages of undifferentiated labor, in which category Lindsey includes not only the unskilled, but also many workers with skills that are replicated by their competitors in India and elsewhere. For Greenspan that meant that tightness in the U.S. labor market no longer would trigger inflation.

No model can capture such changes. Ruptures in the historic relation between labor input and product output—what we broadly call productivity—and globalization of markets are too recent to be reflected fully in historic data. But economic models are based on the assumption that historic relationships hold, and would have forced a rise in interest rates at the first sign of a tightening of the labor market. Greenspan captured what was going on in American factories and markets far more accurately than did the standard econometric models, leaving him free to avoid triggering a slowdown by raising rates, and the Fed with a legacy of skepticism about mechanistic models that should inform monetary policy long after the chairman has repaired to the speaking circuit.

His second success is less obvious but equally important: He preserved the political independence of the institution he headed. It is easy to forget that his first act as chairman was to raise interest rates, to the obvious displeasure of the man who appointed him, Ronald Reagan, a president dedicated to the rapid economic growth needed to produce the promised “morning in America.” Greenspan also made George H.W. Bush unhappy by, in the then-president's view, adopting policies that prolonged a mild recession just long enough to allow Bill Clinton to contend that it would take a Democrat to restore prosperity. And the incumbent resident of the White House cannot have been pleased with Greenspan's criticism of the profligacy of the federal government.

Add to independence from presidential pressure the chairman's masterful defanging of his congressional critics at his many appearances before the House and Senate committees to which he is obliged by law to report. It is no exaggeration to say that Greenspan's reasoned and precise answers to those who at times urged him to loosen, or to tighten, more than he was inclined to do, showed respect for their views, but an unwillingness to change course to satisfy the political requirements of his critics. At times, watching Greenspan's performances, I was reminded of a lawyer-friend who once accused me of using the language with such precision that it had ceased to be a means of communication. But precision is not obscurantism: Jokes about Greenspan's use of the language to confuse are just that, jokes, enjoyed immensely by their object, but based more on the hearers' unfamiliarity with precise expression than the speaker's lack of clarity. There is nothing difficult to understand about “irrational exuberance,” or “globalization is changing many of our economic guide-

posts,” or “the more flexible an economy the greater its ability to self-correct after inevitable, often unanticipated, disturbances.”

Greenspan’s third triumph was as a crisis manager. Two months after he was sworn into office, Greenspan was confronted with a stock market crash. During his tenure (a term he prefers to the word I originally planned to use, “reign”), he confronted a collapse of the Mexican peso (December 1994), and of Asian currencies (July 1997), and of the Russian ruble (October 1994 and August 1998). He prevented those crises and the near-collapse of Long Term Capital Management (September 1998), its investments managed by model-building Nobel laureate economists, from destabilizing the entire world financial system. And he saw Wall Street through the fraught period following the 9/11 terrorist attacks.

“At crucial points,” Greenspan said in a 2004 speech, “simple rules will be inadequate.” That’s a bit of wisdom I am sure he passed on to his successor, perhaps with a caution or two about the moral hazard that successful bailouts do create—the perception on the part of investors that they are walking on a one-way street to profits and prosperity, with governments ready to absorb any losses their failed investments might generate. As the *Economist* put it, “Investors’ exaggerated faith in his ability to protect them has undoubtedly encouraged them to take ever bigger risks and pushed share and houses prices higher.”

The rapid and unhesitating injection of liquidity into the system, and the successful overall management of these crises, enabled the economy to right itself quickly, and to resume what proved to be the two longest expansions on record. Only two very short and very mild recessions (compared with four long and deep ones in the preceding 18 years) blemish an otherwise perfect record that saw the American economy grow at a quite satisfactory average rate of slightly over 3 percent during Greenspan’s tenure. This compares with 2.05 percent in Japan, 2.25 percent in France, 2.18 percent in Germany, 2.44 percent in Great Britain, 1.67 percent in Italy, and, no surprise, 6.58 percent in low-tax Ireland. Perhaps more important, while major continental European countries seem unable to bring down double-digit unemployment, the American economy is close to full employment. During Greenspan’s tenure the unemployment rate declined from above 6 percent to below 5 percent, as some 30 million new jobs were created.

Alan Greenspan would be the first to credit much of the success of his years in the Fed chair to the dynamism, flexibility, and entrepreneurial nature of the American economy. He has always attributed our economy’s ability to bounce back from near-disaster, and to grow, to the

nation’s free market system. And he has fought against policies that would introduce rigidity into the economy—unnecessary regulations, protectionism, taxes that discourage risk-taking and hard work. And, it should be added, what he considers the rigidity of inflation targeting.

It is this that will distinguish Bernanke, an advocate of targeting, from Greenspan, whose approach was characterized by Princeton economists Alan Blinder and Ricardo Reis as “maximum tactical flexibility . . . and not much in the way of explanation.” Bernanke has said that at some point people will have to get over the fact that he is not Alan Greenspan, just as they had to get over the fact that Greenspan was not Volcker. (On the day on which Greenspan’s nomination was announced, bond markets had their biggest plunge in five years.) Greenspan preferred the flexibility that refusing to set an explicit inflation target gave him—license to deploy his vaunted judgment, informed by myriad contacts in the business and financial community and by masses of data that he deemed most relevant. An explicit target, thinks Greenspan, will force the Fed to raise or lower interest rates when such moves might do more harm than good. Bernanke prefers greater specificity, and an inflation target of 1 percent to 2 percent, not very different from the informal comfort range used by Greenspan, but more binding on the Fed to act. However, as former Fed governor Edward Gramlich has told the press, Bernanke is unlikely to try to impose his views about targeting if his colleagues oppose the idea.

It is too early to determine whether Greenspan has left a mess for his successor to clean up, or a golden inheritance on which he can build. Bernanke is calmly confident that, come what may, he can handle the job. Good thing, if Bank of England Governor Mervyn King is right that “it is rather unlikely . . . [that] the next ten years [will] be as nice as the past ten.”

My own view is that it is impossible to get monetary policy just right, and that when it comes to raising interest rates, any Fed chairman has to decide between too little, too late, and too much, too soon. Do the latter and risk recession and deflation, both so difficult to reverse that Bernanke regards deflation as the economy’s enemy number one. Raise rates too little and too late, as Greenspan is accused of having done, and you risk a bit of inflation and, it seems, unsustainable increases in the price of assets such as homes and shares. That seems to me the less damaging of the two possible errors, being less likely to throw thousands out of work, and more easily reversible. So, if the departing chairman has erred, he has chosen the best of the available errors. More likely, the performance of the economy suggests that the honors he wears so lightly are well deserved. ♦