The Transition to a New Chairman

By Anthony M. Santomero

The prospect of a new Chairman at the helm of the Federal Reserve has always caused anxiety from Wall Street to Main Street. Here President Anthony Santomero shares his thoughts on the Fed's transition to a new Chairman, bidding farewell to the venerable Alan Greenspan and welcoming a new era under Chairman Ben Bernanke.

The Changing of the Guard

When Alan Greenspan was nominated to replace Paul Volcker as head of the Federal Reserve in June 1987, the world's financial markets collectively held their breath. Skepticism was rampant as to whether Greenspan would be able to do as good a job as Volcker.

A *New York Times* article expressed these concerns, saying:

"The markets had incredible confidence in Paul. Investors saw him as the one guy with the knowledge, guts and skill to stop inflation and hold the system together… Indeed, some economists are saying that one reason there is growing fear of an economic catastrophe is that the Reagan administration let Volcker go, replacing him with the less-experienced and less-well-known Alan Greenspan."

Barron's also opined on the transition, calling Volcker "a legend in his own time," and comparing him to Greenspan, who was "a relatively unknown quantity." Little did they know at the time, they were referring to the man who would come to be known as "the Maestro."

Federal Reserve Chairman Ben Bernanke, former Chairman Paul Volcker, and former Chairman Alan Greenspan at a reception in January 2006.

The Volcker Legacy

Before Greenspan, Paul Volcker earned quite a reputation — for himself and for the Federal Reserve as an institution. When he assumed office in 1979, Volcker also assumed the burden of double-digit inflation. It was the most sustained period of inflation post-WWII America had ever faced—rising at annual rates of over 10 percent and up to 14 or 15 percent in some months. As Fed Chairman, Volcker devised a strategy that would crush inflation and change the face of central banking.

Rather than follow the Fed's traditional practice of nudging interest rates up or down, he decided the Fed should focus on controlling the money supply and be committed to slowing monetary growth to beat inflation. To achieve its money growth targets, the Fed would have to allow interest rates to rise, and they rose dramatically. The fed funds rate reached 19 percent in 1981 and held fast despite the ensuing recession.

Chairman Bernanke and former Chairman Greenspan at the public swearing-in ceremony on February 6, 2006.

But the policy proved effective, and within three years, inflation had been tamed. By 1983, Volcker's policy succeeded in bringing the inflation rate down to around 4 percent, and the economy was on the path to a sustained expansion. Volcker was lauded as a genius, and his powerful policy changes earned the Fed an unprecedented level of credibility and prestige.

Greenspan's Tenure

At his confirmation hearing before the Senate Banking Committee, Greenspan spoke of the same Fed goals Volcker had advocated. He too recognized and argued forcefully that to create an environment for solid, sustained economic growth, it was absolutely crucial that the Fed focus on containing inflation.

As the expansion of the 1980s matured, the Chairman remained true to his words. However, only two months after he took office, Greenspan was faced with the biggest stock market crash since the Great Depression. On October 19, 1987—Black Monday—the Dow Jones Industrial Average plummeted nearly 23 percent, its greatest loss ever in percentage terms. Amid widespread fears of a recession, Greenspan acted quickly to provide liquidity to financial markets and calm investors. His quick response and competent leadership shaped his reputation and earned him high marks from his peers and the public. The Fed's actions under Greenspan helped secure public confidence in future price stability, though not without a period of recession as the new decade began.

It was during the expansion of the 1990s that Chairman Greenspan put his own unique stamp on the conduct of monetary policy. In the first half of the decade, the economy moved from recession to recovery, and the Fed removed the monetary accommodation it had provided. Then, mid-decade, the economy began to boom. Growth accelerated, and unemployment began falling to levels not seen in 30 years. The orthodox monetary policy prescription was to tighten. But Greenspan veered from the orthodox view. He believed that the rules of the game had changed. In a new era of accelerating productivity growth and increased competition, he believed it was possible to run the economy on all cylinders and close to full employment, without undue inflationary pressures. With the Fed ever-vigilant, the expansion went on to become the longest in U.S. history.

Still, Greenspan knew that all was not perfect. In 1996, he gave his famous "irrational exuberance" speech, alluding to concerns about a stock market bubble. When the bubble finally burst and the economy fell into recession, the Federal Reserve responded aggressively. Short-term rates were slashed nearly 5 percent in one year and brought down to a mere 1 percent by 2003. The U.S. financial markets had not seen rates so low in nearly 50 years.

Supported by strong monetary stimulus, the economy proved surprisingly resilient—indeed, more so than most had believed possible. Despite an unprecedented series of disturbances—the declining stock market, a terrorist attack on American soil, two wars, numerous financial scandals, skyrocketing oil prices, and even natural disasters—the economy recovered and again embarked on a path of sustainable expansion. Indeed, under Chairman Greenspan's leadership, the 21st century began with the Fed providing the economy with unprecedented monetary support during a difficult downturn and, at the same time, preserving public confidence in its commitment to long-term price stability.

Alan Greenspan served as Fed Chairman for more than 18 years. The second longest-serving Chairman in the history of the Fed, he was appointed or reappointed by four different Presidents. During his tenure, the U.S. economy achieved both strong growth and stable prices. Inside the Fed, Greenspan, like Volcker, exerted a powerful influence and fundamentally altered the way we think about policymaking.

Bernanke at the Helm

In February 2006, Ben Bernanke succeeded Alan Greenspan as Fed Chairman. Again, there is some apprehension because a relative unknown is following a celebrated success. Again, the incoming Chairman has stated publicly his commitment to pursuing the Fed's fundamental goals, in particular, preserving a stable price environment. If history is a guide, circumstances will

"The Fed's job is to take away the punch bowl just when the party really gets going."

— Former Chairman William McChesney Martin

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challenge the new Chairman to meet that commitment and offer him opportunities to put his own stamp on the conduct of monetary policy.

On a personal level, Chairman Bernanke has the talent and expertise to serve well as the head of the nation's central bank. He is an accomplished scholar in the field of monetary economics, a former Fed Governor and economic advisor to the President, and widely recognized as a deep thinker and clear communicator.

Beyond that, Ben Bernanke has the support of his colleagues on the FOMC in monetary policy matters. All seven Fed Governors and 12 Reserve Bank presidents participate in FOMC meetings, collectively assessing the economy, discussing policy alternatives, and ultimately selecting a policy action.

Among the most powerful allies Chairman Bernanke has in making effective monetary policy is one his predecessor helped to create: greater transparency. Greater openness about monetary policy decisions was a defining aspect of the Greenspan Fed, and it was an important means through which Greenspan built the Fed's reputation and influence.

Prior to 1994, there was no direct communication between the FOMC and the markets. Today, the FOMC issues press releases after each meeting, stating its near-term fed funds target, with an explanation of the action and an indication of the likely future course of policy. The release also summarizes the FOMC's outlook for growth and inflation.

This transparency in monetary policy only enhances its effectiveness. Indeed, the financial markets begin building anticipated policy actions into asset prices even *before* they are actually implemented. Thus, the response to Fed policy in the financial sector, and in the economy as a whole, is swifter, smoother, and stronger than it would otherwise be.

Our new Chairman is a strong supporter of transparency, and, as a Governor, he had often spoken in support of a more open Federal Reserve System. For instance, he has already indicated that he would like to see more consideration of an explicit inflation target. So, indications are that the Fed may well consider additional steps toward transparency under Chairman Bernanke.

The Chairman's Leadership

Looking back, Paul Volcker and Alan Greenspan came to the Fed Chairmanship with a strong sense of the Fed's mission, keen insight into the workings of the economy, and the confidence to act decisively in the face of challenging circumstances. During their tenures, they advanced the Fed's capabilities and instilled strong public confidence.

Sharing their strengths and building on their legacy, Ben Bernanke now leads the way as Fed Chairman. We will all be watching to see how the new leader of the Fed changes the System's approach to monetary policy and builds on its strong legacy.