



## FLASH REPORT

### *Greenspan versus Bernanke*

The global financial markets are bracing for an almost unprecedented change in leadership: the retirement of Alan Greenspan as Chairman of the Federal Reserve. The full Senate will almost certainly approve his proposed replacement, Benjamin Bernanke. While changes occur at all central banks, Greenspan's 18-year tenure, unique syntax and frequent public comments defined the institution. Bernanke's job performance will inevitably be benchmarked to that of Mr. Greenspan's.

There is surprisingly wide divergence on Greenspan's legacy. The majority of market observers think of him as a hero. They point to years of low inflation and a generally robust economy and allot Greenspan much of the credit. Yet a vocal minority believes Greenspan has been a disaster. These commentators point to "bubbles" in the equity market during the late 1990s and the potential bubble in the housing markets as dereliction of duty if not gross incompetence. There are also criticisms that Greenspan politicized the Fed. Given that Greenspan dominated public perception of the institution, evaluating Bernanke depends on one's opinion of Greenspan's performance.

A review of Bernanke's recent speeches and articles, reveals a difference between the two men: the importance of expectations theory. Developed in the 1970s, two leading proponents of this theory (Finn Kydland and Edward Prescott) were awarded the 2004 Nobel Prize in Economics. Grossly oversimplified, this body of research suggests that markets adapt to economic policies. The adaptation either rewards or frustrates policy makers. Whether the market aids or thwarts a policy is largely dependent on the market's opinion on the level of commitment to the policy by its creators.

Implicit in expectations theory is that the market needs to understand the policy in order to evaluate the level of commitment. Bernanke suggests increasing the level of transparency to improve implementation of the desired policy. In one speech Bernanke states; "...taking the 'right' policy action... is a necessary but not sufficient condition for getting the desired economic response." While Greenspan has done much to increase the transparency of the Fed, he does not appear to appreciate expectations

theory to the degree Bernanke does. One possible reason is that expectations theory was developed after Greenspan was well established in his career, indeed, after he became Chairman of the Federal Reserve.

Four areas provide a contrast between Greenspan and Bernanke. We focus on what we believe are the easiest issues first, concentrating on the more difficult ones later.

**STYLE.** Greenspan is often criticized for being obtuse, with a penchant for sentences more akin to James Joyce than John Keynes. But this argument only gets half a mark. Wall Street economists and portfolio managers have learned to decipher "Greenspeak" just fine. So have the reporters that cover the Fed. The complaints about the syntax, though justified, are really a form of subtle mockery. Bernanke's speeches and writings are more direct. We do not know whether Bernanke's clarity is a conscious nod to expectations theory or simply personal style. Regardless of why, we expect shorter, more direct speeches and testimony in the future.

**TRANSPARENCY OF THE FED.** The Greenspan Fed has been as clear in its message as it has been opaque in its delivery. It is easy to forget that until 1990, the Fed didn't announce policy changes. Formal announcements on target interest rates didn't occur until 1995. Greenspan probably has not been given adequate credit for these and other changes in operations.

Yet the Federal Reserve is behind most other developed nations' central banks when it comes to policy targets and providing a rationale for decisions. For example on November 3rd, the European Central Bank provided a 10-paragraph explanation of the decision to leave rates unchanged, immediately followed by a question and answer session with bank president Jean-Claude Trichet. In contrast, the Federal Reserve is officially silent for several days after an announcement of policy, and the statements of policy can be unnecessarily cryptic. Bernanke, with his belief in well-announced inflation targets, is likely to move the Fed closer to the European model of central bank disclosure.

**RESPECT FOR THE INSTITUTION.** There are several areas for criticism of Greenspan. In many ways, he became the voice of economic, not just monetary

policy. There was no separation between the man and the institution; we say that “Greenspan” not “The Fed” raised interest rates. While it may have been impossible for him to maintain this separation, it appeared that Greenspan enjoyed the spotlight.

The most significant criticism of Greenspan is that he cast doubt on the independence of the Federal Reserve. In the developed world we take this independence for granted. The perception of independence of a central bank is vital to its success as an inflation fighter. Anything that calls this independence into question does great harm to the institution.

For example, Greenspan was criticized for comments made on tax policy, especially his endorsement of the tax cuts proposed by the Bush administration in 2001. This was a reversal from the Greenspan of the 1990s that lauded Bill Clinton for reducing the budget deficit. He is often criticized for favoring the economic policies of the current administration.

Bernanke served for four months as Chairman of President Bush’s Counsel of Economic Advisors. His appointment to that post is puzzling. It seems strange that the President would move him from the Federal Reserve to the White House, only to move him back a few months later. Bernanke’s tenure, however brief, as a member of the administration cannot help but call into question his relationship with the White House. This tension was evident during his confirmation hearings as Congressional Democrats pressed him on independence. For his part, Bernanke declined to answer questions regarding tax policy and budget cuts. Central bank independence and the absence of any appearance of the Fed yielding to political pressure are vital to the concept of consistency which Bernanke values so highly.

**CONDUCT OF POLICY.** Given the success of anti-inflation policies initiated by Paul Volker in the late 1970s, it is hard to imagine that any central banker would reverse course. Yet some believe that Bernanke is softer on inflation than Greenspan or Volker. One reason is the comments Bernanke made in 2002-2003. At the time, the Federal Reserve was aggressively cutting interest rates due to fears of deflation. Several of Bernanke’s speeches suggested that monetary policy could fight deflation in a way that some considered reckless.

Bernanke has also uttered several controversial statements. The first was stating that the nation could solve its underlying budget deficit by creating inflation, effectively repaying the debt with devalued dollars. This fact is obvious but unspoken, especially given the extent to which foreign assets finance the deficit. In a more recent statement, Bernanke suggested that a cause of the United States’ persistent trade deficit is a savings glut overseas, particularly from Asia. This view is contrary, though not completely contradictory, to the orthodox view that the US trade deficit is due to the low domestic savings rate.

Glut or not, foreign purchases of Treasury bonds have kept long US interest rates low, despite multiple

increases in short term rates by the Fed. Ironically, Greenspan referred to the low long term interest rates as a “conundrum” earlier this year. Greenspan undoubtedly realized the potential political complications regarding this issue and chose not to speak. Greenspan has been aware of the political ramifications of his actions. However, several early Bush administration officials (John Snow for example) were less politically savvy and were less effective because of it. Bernanke will need to gain some of Greenspan’s tact on sensitive political issues.

Bernanke’s critics see a man who might take the easy way out, or to find fanciful explanations when more sober analysis is required. Some accuse him of trying to deflect blame from the current administration. Others suggest he shows a lack of tact. It is likely that Bernanke will try to prove his inflation fighting bona fides early in his term and limit his speaking on controversial subjects.

**INFLATION TARGETING.** This is the most esoteric but clearest example of Bernanke’s belief in transparency in policy. Inflation targeting means that the Fed sets a desired level of inflation and commits to engaging in a policy to maintain that level. This is monetary policy disclosed and explained for the world to see. No more semantic parsing of terms. No more fretting about the inclusion of phrases such as “measured pace.” Most developed world central banks employ some form of inflation targeting.

In practice this would be much more complicated. In several speeches, Bernanke has attempted to bridge the gap between strict rule-based and purely discretionary monetary policies. He labeled this compromise “constrained discretion.” Greenspan has always publicly advocated a discretionary based policy. However, the net effect of his actions suggests that Greenspan has a de facto inflation target. Academics will continue to debate whether an announced policy is superior to a discretionary one. However, given the amount of time Bernanke has devoted to this issue in his professional life, it seems certain that he will move the Fed in this direction.

How different will the Bernanke Fed be? Not very much at first. Bernanke will almost certainly continue to talk tough on inflation during his first year. Communication from the Fed will get clearer, both on policy goals and how they will be implemented. Our belief is that Bernanke will stay the course on most items until he feels comfortable in the role and believes that the markets are comfortable with him. Then look for changes, especially with regard to inflation targeting. The wild card remains: what will happen if a crisis hits, especially a crisis early in Bernanke’s term? Hopefully Bernanke will have learned Greenspan’s art of playing politics. We just hope he will play less frequently. ♦