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The Greenspan Era: Lessons for the Future— A Summary of the Bank's 2005 Economic Symposium

By George A. Kahn

During Alan Greenspan's years at the helm of the Federal Reserve System, the global economy has undergone significant structural change and withstood a variety of financial and economic shocks. In addition to helping steer the global economy through such challenges, Chairman Greenspan has been at the center of discussions on monetary policy ideas and issues.

To honor Alan Greenspan's service, the Federal Reserve Bank of Kansas City sponsored an economic symposium to explore several of these ideas and issues that will continue to challenge central bankers for years to come. The symposium brought together a distinguished group of central bank officials and academic, policy, and business economists to discuss these important challenges and identify lessons for the future.

The Greenspan legacy

The symposium began with a look back at the issues, events, and ideas that defined the Greenspan era. Conference participants were universal in their praise for the manner in which Greenspan steered the

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THE GREENSPAN ERA: LESSONS FOR THE FUTURE

A Symposium Sponsored by the Federal Reserve Bank
of Kansas City
August 25-27, 2005

SESSION I

Chair
ROGER W. FERGUSON, JR. – Vice Chairman,
Board of Governors of the Federal Reserve System

Reflections on Central Banking

ALAN GREENSPAN – Chairman,
Board of Governors of the Federal Reserve System

Economic Performance in the Greenspan Era: The Evolution of Events and Ideas

ALAN S. BLINDER – Professor, Princeton University

RICARDO REIS – Professor, Princeton University

Discussants

ALLAN H. MELTZER – Professor,
Carnegie-Mellon University

JOHN B. TAYLOR – Professor, Stanford University
and Senior Fellow, Hoover Institution

Business Cycle Dynamics and Monetary Policy

ROBERT E. HALL – Professor, Stanford University

Discussants

CHARLES BEAN – Executive Director and Chief Economist, Bank of England

N. GREGORY MANKIW – Professor, Harvard University

Current Account Imbalances: How Will They End?

SEBASTIAN EDWARDS – Professor, University of California, Los Angeles

Discussants

BARRY EICHENGREEN – Professor, University of California, Berkeley

CATHERINE L. MANN – Senior Fellow, Institute for International Economics

Luncheon Address

ROBERT E. RUBIN – Director, Citigroup

SESSION II

Chair
MALCOLM D. KNIGHT – General Manager, Bank for International Settlements

Financial Markets, Financial Fragility, and Central Banking

RAGHURAM G. RAJAN – Economic Counsellor and Director of Research, International Monetary Fund

Discussants

DONALD L. KOHN – Governor, Board of Governors of the Federal Reserve System

HYUN SONG SHIN – Professor, London School of Economics

Central Bank Transparency and Communications Policy

MICHAEL WOODFORD – Professor, Columbia University

Discussant

TIFF MACKLEM – Deputy Governor, Bank of Canada

Monetary Policy Strategies: A Central Bank Panel

KAZUMASA IWATA – Deputy Governor, Bank of Japan

MERVYN A. KING – Governor, Bank of England

JEAN-CLAUDE TRICHET – President, European Central Bank

Federal Reserve System during his tenure as chairman. Despite a number of economic shocks—including the 1987 stock market collapse, the savings and loan crisis of the 1980s and early 1990s, the Mexican peso crisis, the Asian financial crisis, the Russian debt default, the bursting of the high-tech stock market bubble, and the 9/11 terrorist attacks—the U.S. economy experienced sustained economic growth interrupted by only two mild recessions. Over the same period, inflation fell gradually from roughly 4 percent to 2 percent—a level many would associate with price stability.

If participants were looking for a simple formula that explained the success of the Greenspan Fed, they were disappointed. Greenspan's approach to monetary policy was described as discretionary, flexible, and based on a deep understanding of economic data and business conditions. The Greenspan approach was also said to reject reliance on a single model of the economy with fixed economic relationships and parameters. In a dynamic economic environment with rapid technological change, financial deregulation and innovation, and increasing globalization, key economic relationships are constantly changing, rendering empirical models—that are based on the past—obsolete. There is no substitute for listening to a wide range of business and financial market contacts and using judgment in the conduct of monetary policy.

That is not to say there were no guiding principles for conducting monetary policy during the Greenspan era. In fact, one presentation identified eleven such principles (Blinder and Reis). One key principle that everyone agreed guided monetary policy in the Greenspan era—one so obvious that it was not included in the list of eleven principles—was the idea that achieving and maintaining price stability was central to attaining maximum sustainable growth. Another hallmark of the Greenspan era was reliance on what he himself has characterized as a "risk-management" approach to monetary policy. Under this approach, policymakers guard against low probability outcomes that might have outsized adverse effects on the economy. An example of the risk-management approach occurred in 2002-03 when the Federal Reserve eased monetary policy to prevent the unlikely, but potentially very costly, emergence of deflation.

There was considerable discussion about whether a risk-management approach was really that different from a flexible application of a policy rule, or from the use of a rule as a check on policymakers' judgment. A policy rule is a formula that policymakers can use to systematically set their policy instrument in response to economic conditions. Conference participants disagreed about the extent to which monetary policy in the Greenspan era could be characterized by a simple rule.

Some participants questioned the future reliability of rules based on unobservable variables that are not well defined (Hall). Typically, policy rules that have been advocated in the academic literature require estimates of the "neutral interest rate," the "natural rate of unemployment," or the "potential level of GDP." These "equilibrium" concepts are based on the idea that the business cycle can be separated from longer-run trend movements in the economy. But, increasingly, macroeconomists are questioning the view that the business cycle can be measured as a temporary departure from trend. An implication is that policymakers should rely only on rules with observable variables, and that the key variable should be inflation.

Challenges for the future

After reviewing the events and ideas associated with the Greenspan era, the discussion turned to challenges for the future. Three economic developments occurred during the Greenspan era that will continue to challenge policymakers in the years ahead. First, the U.S. current account has moved from relative balance to a record deficit. Second, financial market innovation and deregulation have distributed risk more broadly but potentially led to excessive risk taking by financial intermediaries. And third, asset price movements have become more important sources of economic fluctuations.

In the view of many symposium participants, the return to current account balance in the United States could be painful. Large current account deficits have been financed with capital inflows—much of which have come in the form of foreign central bank purchases of government securities. If this flow of capital were to stop suddenly, the dollar could depreciate and inflationary pressures might build. This

could lead the Federal Reserve to raise short-term interest rates which, in turn, could slow economic growth in the United States and possibly the rest of the world.

While there are no modern historical precedents for a large country such as the United States running very large and persistent current account deficits, there are numerous examples of current account reversals among smaller countries in both the industrial and developing world. And the experience of these countries—to the extent it is relevant—does not bode well for the United States. Previous episodes of current account rebalancing in both industrial and developing countries have been associated with a depreciation of the exchange rate and a temporary reduction in real GDP growth. Effects on inflation and interest rates have varied depending on the size of the country and whether it is industrialized (Edwards).

While the current account imbalance appears quite large, some participants thought a more orderly and less painful adjustment was possible. For example, with gradual and simultaneous adjustments in savings and investment in the United States and the rest of the world—and in the associated exchange rate movements—the required rebalancing of the current account need not be disruptive (Crockett). One key to an orderly adjustment process is for policymakers to resist protectionist trade measures and work toward further trade liberalization (Krueger, Redrado).

Another challenge facing policymakers is maintaining financial stability in a deregulated global economy with ongoing financial innovation. A driving force of financial innovation is technological progress, which has altered many aspects of financial transactions and spurred deregulation and institutional change (Rajan). Participants agreed that maintaining financial stability was an important policy objective but disagreed about whether financial markets had become riskier and about whether new forms of regulation were desirable.

While it was generally agreed that financial developments had allowed for greater diversification of risk, there was concern that financial intermediaries' size and appetite for risk could increase over the cycle. The increased ability of economies to bear risk might lead to greater risk-taking behavior. Financial institutions might act in ways that exacerbated real economic fluctuations, and, through their collec-

tive and sometimes herd-like behavior, increase the likelihood of realizing what would otherwise have been low-probability risks. To those concerned with excessive risk taking, "a risk-management approach to financial regulation [would] help stave off such states through the judicious operation of monetary policy and through macro-prudential and regulatory measures." However, such measures may not be enough. In addition, a case was made for "market friendly" policies that better align the incentives of financial managers with society's appetite for financial risk (Rajan).

Not all participants shared this view. Some participants saw financial deregulation and innovation as reducing risk and better allocating risks across the global economy. Technological change and financial market innovation have reduced transactions costs and led to the creation of new financial instruments. These new financial instruments have increased liquidity and allowed various types of risk to be divided among investors according to their risk tolerance. By reducing the price of risk and increasing liquidity, financial innovations have likely channeled savings into riskier investment projects, but they have not necessarily increased systemic risk. Finally, financial innovation may have contributed to the reduced volatility of output and inflation in many industrial economies over the last 20 years (Kohn).

This more sanguine view of recent financial developments does not imply that financial market regulation is obsolete. Rather, it suggests a need for ongoing review and modernization of regulatory structures, supplemented by the regulation of the marketplace itself. That said, some participants expressed skepticism about the desirability of regulating the incentive structures of financial managers.

A third challenge for the future was addressed by Chairman Greenspan himself. In his opening comments, Greenspan pointed to the growing importance of asset price movements in economic forecasts and policy resulting from the sharp increase in household net worth relative to disposable income since the mid-1990s. This increase has been driven, first, by a run-up in stock market prices, then by accelerating house prices. Greenspan cautioned that many investors seem to have grown complacent in their expectations of continued asset price

appreciation and in requiring less compensation for taking on risk. Greenspan noted that "history has not dealt kindly with the aftermath of protracted periods of low risk premiums."

Lessons learned

Participants drew a number of lessons from the Greenspan era that might help policymakers in their conduct of monetary policy in the future. One general area of agreement was that moves toward greater transparency that have been undertaken by a number of central banks including the Federal Reserve have helped make monetary policy more effective. Further steps toward transparency were seen as desirable, although participants disagreed about the kinds of steps that should be taken.

The importance of clear communication and transparency follows from the idea that forward-looking households and businesses form expectations about future monetary policy, and that these expectations influence their actions. Thus, policymakers influence the economy not just through the current setting of the overnight rate but also through their influence over the public's expectations of future policy. To the extent policymakers can respond systematically to the state of the economy and can credibly communicate this response to the public, smaller moves in the overnight rate might lead to a larger response of long-term interest rates and a bigger impact on output and inflation (Woodford).

While participants agreed on the importance of policy expectations, they disagreed on how best to influence expectations. One view was that central banks should commit to a policy rule, follow it systematically, communicate it in words and actions to the public, and issue statements about the expected future path of the policy instrument. Announcing a commitment to a future path for the policy instrument could prove highly useful in unusual situations, such as when there is a risk of deflation and nominal interest rates have already been reduced to near zero. The Federal Reserve's policy statements following the 2003 period when the federal funds rate fell to 1 percent were cited as an example of effective signaling of future policy (Woodford).

Signaling of future policy has also played a central role in the Bank of Japan's strategy to move from deflation to price stability. In particular, the Bank of Japan has committed to maintain its policy of quantitative easing until the economy achieves "stability above zero of the core consumer price index on a year-to-year basis"—although the numerical upper limit has not been announced (Iwata).

Other participants, while agreeing in principle with the desirability of systematic policy and instrument rules, placed relatively more emphasis on the need for transparency about policy objectives and advocated numerical targets for inflation. "Whilst the central bank must always be ready to take aggressive action if needed, a well-designed institutional framework, which undisputedly assigns the central bank the primary objective of price stability, and the adoption of a clear monetary policy strategy, which quantitatively defines price stability and does not pretend to fine-tune directly the business cycle, can make the latter type of policy activism unnecessary in many circumstances" (Trichet). In particular, the quantitative objective for inflation anchors inflation expectations and helps the public anticipate how the central bank will adjust overnight rates in response to macroeconomic conditions.

Participants also offered lessons of a more general nature. One set of lessons focused on broad principles that could be applied to many areas of policymaking. First, a successful policymaker "recognize[s] that economics tells you how to think, not what to think." Accordingly, policymakers should be skeptical that any economic model accurately describes how the economy responds to policy. Second, useful information often comes from sources other than econometric models and official data. Indeed, qualitative data from businesses can help policymakers identify trends before they show up in the data, as was the case when Chairman Greenspan detected an upturn in trend productivity growth well before the data proved it. And third, economic policy is best thought of "as an environment in which the decisions of households and firms are not marginally affected by the need to insure against future arbitrary or mischievous changes in government policy." Applied to monetary policy, this lesson means economic agents should not have to take inflation into account when they make decisions about the future. They should be able to plan on price stability (King).

Another broad set of lessons had a similar tone but focused more directly on central bankers. First, central bankers should be prepared to confront new risks at any time. These risks are the counterpart of rapid technological change, globalization, and rapid structural change. Second, as a result, central bankers should not depend on a single model of the economy but instead look for policies that are robust across a range of models. Finally, a credible commitment to price stability is essential for anchoring inflation expectations (Trichet).

Conclusion

At the conclusion of the symposium, Chairman Greenspan offered some thoughts about the future. He noted the aging of the population and described its profound effects on the economy and economic policy. He predicted the housing boom will "inevitably simmer down," that housing equity extraction will subside, and that consumers will increase their savings. With the resulting slower pace of consumer spending and reduced demand for imports, the current account deficit will decline. Whether the decline will be orderly or abrupt will depend on maintaining, if not increasing, the flexibility of economic institutions in the United States and abroad.

With respect to monetary policy, Greenspan expects continued refinement of the risk-management paradigm. However, he expressed skepticism about the usefulness of numerical inflation targets in the United States and the ability of central banks to successfully target asset prices. Greenspan concluded by saying, "Surely difficult challenges lie ahead for the Fed, some undoubtedly of our own making, and others that will be thrust on us by market or other forces… I have little doubt that my successors, and theirs, will continue to sustain the leadership of the American financial system in an ever-widening economy."