Life After Greenspan

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During a debate in the 2000 presidential campaign, John McCain was asked what he would do if something happened to Alan Greenspan. He replied that he would prop him up in a chair, put sunglasses on him and hope no one noticed. That answer showed both Sen. McCain's quick wit and his understanding of the vital role that Mr. Greenspan plays in our economy.

In a little over a year, President Bush will have a tougher choice, since Mr. Greenspan's term as a governor will expire. The law prohibits the president from appointing him to another term. So the still-hearty chairman will depart after nearly 19 years as the world's pre-eminent central banker. Sen. McCain's erudite answer points out the reason that the president will search for someone with qualities most like Chairman Greenspan.

Intellectually, Mr. Greenspan combines the right mix of academic and real-world understanding of the economy and the role of monetary policy. Although any university would have been honored to have him on its faculty, Mr. Greenspan spent his private-sector career away from the ivory tower, including stints as a commodities trader and business consultant. His academic background gave him the tools to find the answers, but his real-world experience gave him the instincts to ask the right questions.

This becomes most apparent in his understanding and use of statistics. For example, in late 2000 Mr. Greenspan became concerned about the state of the economy, a concern that led him to cut rates on Jan. 3, 2001. At the time, the available official statistics showed an economy growing robustly, with growth averaging 4.25% during the first three quarters of 2000. The widespread euphoria resulting from the stock-market bubble, coupled with the myopia of the political season, made it extremely hard to publicly doubt the claim that all was well with the economy.

We now know that growth was a full two points lower than originally reported and that the economy actually shrank during the third quarter of 2000. Mr. Greenspan combined his access to, and understanding of, anecdotal information with his accumulated knowledge of market signals to make what, in Washington at least, was a very contrarian decision. The country was fortunate that Mr. Greenspan's experience as a trader and business consultant trained him to combine instinct, experience, reason and facts to operate in the real-time manner required for making successful judgments.

This skill at making intellectual insights relevant to real-time decision-making is important not just in the making of policy, but in explaining it. The ideal Fed chairman must be someone worth listening to even if he were not Fed chairman. A chairman must be able to persuade not just 18 colleagues on the FOMC, but financial markets and elected leaders that the course he is pursuing is rational. Mr. Greenspan's prior experience in both markets and policy making gave him this credibility. Thus, the intellectual skill set the president is likely to seek involves not just raw brainpower and academic credentials, but one honed to making difficult real-time decisions and being able to explain them.

The president is also likely to seek someone who can master the balancing act that preserves the Fed's independence. A Fed chairman must start by recognizing the political supremacy of the nation's elected officials, particularly in the Congress. The Fed's much-vaunted independence is not constitutional like that of the judiciary. In fact, it's not even spelled out in the Federal Reserve Act. As a practical matter, it must be earned like the vote of a citizen for an elected official.

Ironically, earning such respect not only requires diplomacy and tact, but also sometimes candor about things that may not be politically popular. The chairman must be willing to carry the weight of implementing higher interest rates when needed, even if this isn't the path of least political resistance. Pursuing the most appropriate monetary course is essential to maintaining and building credibility. Having earned credibility, Chairman Greenspan was able to also effectively articulate the case for free trade, for long-term fiscal restraint, for smoothly functioning labor markets and for cost-effective regulation. In each case, he was not necessarily taking a position that was universally popular in Washington. He commented on these matters because a smoothly functioning market economy makes the conduct of monetary policy easier. As the 1970s taught us, the country will face a much worse inflation-unemployment trade-off when poor fiscal, tax and regulatory choices are made, and the Fed can be caught in the middle of this increasingly unpleasant set of choices.

Fed independence is needed so it can retain a long-term focus when both the political process and the markets are focused more on short-term issues. This long-term focus comes in large part from the Fed's need to pursue multiple objectives -- most notably stable prices and strong growth -- with only one policy instrument. The Fed has correctly concluded that the prospects for sustained long-term growth are enhanced by a low-inflation environment, even though the tactics needed to contain inflation may at times slow growth temporarily.

Markets also tend to adopt a short-term focus, placing undue weight on each statistic as it is reported; but the Fed must remain patient in interpreting data. Earlier this year, Mr. Greenspan showed patience in first explaining the need to raise rates, and then doing so gradually while a spate of data showed unusually strong growth. Many in the markets concluded that the Fed was "behind the curve" when in fact the market consensus was wrong. While working to help form consensus opinion, the Fed chairman must be willing to be a contrarian when he believes his judgment is correct. There would be no need for an independent Fed if the political or market consensus was always correct.

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The final set of skills the president might consider looking for involves leadership within the Fed. The Fed is one of the most tradition-bound institutions in Washington. That is a key to its political survival and success. It is important that the new chairman be viewed from inside the Fed as someone who understands the strength of the institution and its entire purpose. To do this, a chairman must realize that the Fed does much more than set interest-rate policy. The Fed is a major bank regulator and also a socioeconomic regulator, overseeing the significant fair lending and Community Reinvestment Act regulations. A chairman must give these areas due attention to effectively use all the tools and staff power at his disposal.

No one in the world will be able to fully replace Mr. Greenspan. This is why the president's decision will be a tough one. But even Alan Greenspan wasn't Chairman Greenspan when he started. Many worried then that he could never replace Paul Volcker, and in a sense he did not; he implanted his own personality on the Fed. Fortunately, the world never runs out of talent. Discussion during the campaign of this issue showed that both parties have talented people: Marty Feldstein and Larry Summers, among others. Whoever is chosen will inherit a strong, independent institution, strengthened by Mr. Greenspan's navigation of some turbulent economic waters over the last two decades.

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