Greenspan's new inflation vigilance
(Federal Reserve Board Chairman Alan Greenspan)
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Alan Greenspan is one of those rarities in Washington. He's been Fed chairman for nearly seven years, and his reputation is still rising. But the job may be entering its toughest phase yet, as the economy heats up and inflation starts to rear its ugly head.

"We used to have a debate in our universities, you know, zero inflation versus jobs," said Representative Toby Roth (R-Wisconsin), to Federal Reserve Chairman Alan Greenspan at the February 22 Humphrey-Hawkins hearing before a key House subcommittee. "In other words, you had some inflation to create jobs. It was good for the job market if you had some inflation. Is that all heresy today?" Roth asked.

"Yes," was the one-word reply of the normally loquacious Greenspan, who had already patiently debunked what Roth referred to, which was the mainstream Keynesian view of macroeconomics that had prevailed for the first three decades after World War II. In doing so, Greenspan publicly completed for the Federal Reserve the long intellectual journey begun by his predecessor Paul Volcker, who inherited the worst inflationary environment of any Fed chairman since the Federal Reserve System was founded in 1913. Volcker managed to largely wring out the worst of it from the economy by the time he left the Fed in 1987.

The one-word answer was also remarkable for its certain, almost absolute quality. So rare is such an utterance from a Fed chairman that reporters in the press section looked at each other in astonishment. One veteran reporter turned to the others and said, "That's the best answer he's ever given." That might not prove far from the truth.

While Greenspan had already told the Joint Economic Committee on January 31 that the old paradigm on inflation and growth was dead, the Federal Open Market Committee (FOMC) put actions behind those words. On February 4, the FOMC approved the first increase in the federal funds rate since 1989, when that rate peaked at 9 3/4 percent. The quarter-point increase in the target for the federal funds rate, which rose from 3 percent to 3 1/4 percent, was done as a preemptive strike against inflation, which has been running at around 3 percent. The move took on added punch when Greenspan announced it rather than waiting for the markets to discern it from Fed market actions.

The Fed acted again on March 22 to boost the fed funds rate to 3 1/2 percent. The two back-to-back moves raising short-term rates confirm Greenspan's intent to act before inflation has clearly taken hold, rather than wait for clear signs of inflation.

Chairman Greenspan and the Fed are now widely given credit for successfully taming inflation significantly below the levels that former Fed Chairman Paul Volcker had achieved. This noteworthy achievement is a product of the policies the central bank has pursued in the nearly seven years since Greenspan replaced Volcker.

Even after recent increases, long-term interest rates are at their lowest in decades--although not as low as the 3.75 percent to 4 percent levels before the Vietnam War, the milestone event that separates the early postwar noninflationary period from the inflationary era that followed and is only now winding down. As Greenspan testified February 22, the outlook for the economy is "the best we have seen in decades."

Many economists across a broad political and ideological spectrum agree with Greenspan that the Fed's success on the inflation front has laid the groundwork for steady, noninflationary real growth averaging around 2.5 percent to 3 percent a year for the foreseeable future, barring unforeseen shocks to the economy. Greenspan computes the optimum, noninflationary growth level by adding the real growth in the labor force to gains in productivity, which has been rising rapidly in recent years

Implicit in this new, more sanguine view of future economic possibilities is a new paradigm that has firmly taken hold at the Federal Reserve. Greenspan did more to explain that new view on February 22 than he has on previous occasions. "We would like to replicate what occurred in past history, very considerable economic strength and long expansions without inflationary imbalances," Greenspan told Congress.

He reviewed for the House Subcommittee on Economic Growth and Credit Formation what the Fed had now learned about the relationship between inflation and growth. For starters, "inflation is not necessarily a consequence of growth." The corollary to that, he explained, is that "there is no downside to low inflation, it's consistent with the maximum increase in growth and the highest level of growth in productivity." Furthermore, inflation will not flare up, he said, unless the Federal Reserve provides the "financial tinder," meaning accommodative monetary policy. The benefits of taming inflation, on the other hand, are now viewed by the majority of economists as greater than previously thought, he argued.

This new view contrasts with the views held before 1980 when it was assumed that "a mildly increasing rate of inflation greases the wheels of economic growth and lower rates were detrimental to the system. This has been shown to be false," Greenspan said.

This is not only a long intellectual journey for the Fed, but also for Greenspan, who personally subscribed to the old view when he was chairman of the Council of Economic Advisers in the Ford administration from 1974 to 1977. One of his professors at Columbia University, Arthur Burns (himself a former Fed chairman), espoused the notion that there is a trade-off between inflation and growth, which the Fed has now rejected. Burns, who served as chief of Eisenhower's Council of Economic Advisers, and who considered himself an inflation fighter, nevertheless, went on to become Federal Reserve chairman in the postwar era, presiding over the Fed from 1970 to 1978 when inflation took off.

Greenspan had already become a committed inflation fighter when he was appointed chairman in 1987. Even so, inflation hawks have criticized the Fed chairman for straying too often from fighting inflation to managing the business cycle. Greenspan's latest testimony and the Fed's recent rate increases suggest he has strengthened his commitment to fighting inflation. Even some inflation hawks are impressed. Under Greenspan, the Fed has made "a progressively increasing commitment to keeping the inflation rate low, as distinct from managing business cycles," says William A. Niskanen, the chairman of the Cato Institute and a former acting chairman of the White House Council of Economic Advisers under President Reagan.

When Representative Roth asked Greenspan if the Fed has a game plan like a football coach, the chairman largely agreed. "To some degree," he responded, the Fed does have something like a game plan--"a philosophical structural framework" that explains how the economy works and responds to monetary policy. "Thirty years ago, we didn't know how economies responded to monetary policy," he said, but during the past two decades, there has been a considerable increase in knowledge about how economies work from macroeconomic research at major American universities. "We |now~ know that if we do x, then y is likely to happen," he explained.

A key element in Greenspan's new price stability policy is his willingness to act to counter inflationary expectations, instead of waiting for clear evidence that inflation is already occurring. The reason for this action, he said, was that there was a considerable lag of a year or more between the time that the Fed took an action and the time it affected the economy. Waiting until inflation was in place was "looking in the rear-view mirror" he told Representative Paul E. Kanjorski, chairman of the House Subcommittee on Economic Growth and Credit Formation. When Kanjorski asked why the Fed raised rates when there was no evidence of inflation, Greenspan said that the

more pertinent question is, "what are the processes in development now that will affect price pressures later on as we progress into 1995 and beyond?"

Congressman Kanjorski was not satisfied with Greenspan's answer. "We wonder if it's a matter of studying entrails or is there an objective tool" to measure inflationary expectations? Greenspan, who is said to thrive on studying the mass of economic data that pours into the Fed's research department, could not, of course, say the Fed had no objective measure of inflationary expectations, that it is all a matter of judgment--that the Fed is largely "flying by the seat of its pants," to use the standard metaphor.

Yet, from all the advances in the science of predicting the effect of changes in monetary policy on the economy, the tools of monetary policy remain horribly inexact. Thus, monetary policy remains more of an art than a science, according to David M. Jones, chief economist for Aubrey G. Lanston in New York, perhaps the leading Fed watcher outside academia.

As economists would tell you, a focus on inflationary expectations would lead one to watch spot prices for industrial commodities, from oil to aluminum, lumber and cotton. But, Greenspan also identified the price of gold as an important indicator of inflationary expectations in his testimony. Representative John J. LaFalce (D-New York) dismissed the notion of following gold prices, suggesting it was "a guessing game." "I don't think so, Congressman," Greenspan replied. "The price of gold reflects a basic desire to hold hard assets rather than currency." Because virtually all the gold ever produced still exists, Greenspan argued, and a change in new production will not appreciably affect the price of gold, it is "a reasonably good indicator of inflationary expectations."

Greenspan observed that following gold was more helpful than following some spot prices of industrial commodities, which are affected by both supply and demand. "I believe things were better when we had a gold standard," Greenspan added to underline his admiration for this indicator.

By publicly giving more weight to spot commodity prices and gold, Greenspan is differentiating a new policy that seems substantially different from what the Fed chairman has publicly focused on in the past. While Greenspan has cited some leading inflation indicators in the past, like inventory levels and late deliveries, many of the indicators he has publicly cited previously, such as unemployment, capacity utilization and the consumer price index, are considered lagging inflation indicators.

Congressman LaFalce also asked if Greenspan used gold as a single commodity in a basket of indicators or was he giving gold "primary attention" among other indicators? "No, not necessarily," replied Greenspan. "We need confirmation of various different indicators. Price is not a perfect indicator, but it is a good indicator," he said. This suggests that, while Greenspan believes that gold can be a signal of inflationary expectations, the Fed most likely will look for other indicators to confirm that signal before proceeding to change monetary policy.

Just as the Fed is not following gold exclusively, neither has it ceased to weigh the importance of monetary aggregates, Greenspan suggested. "We will not dispense with other |indicators~ until they prove inadequate to the task."

A gold bug?

Greenspan's statements on gold prompted The Wall Street Journal to declare in a lead editorial that the Fed chairman is "a gold bug." In the past The Wall Street Journal's editorial pages have suggested that the Fed has, since the early 1980s, been following what it calls the price rule--relying heavily on spot commodity prices, as reflected in the Dow Jones Spot Commodity Index, as an indicator of inflationary expectations and adjusting monetary policy accordingly.

"There's something to that," thinks Niskanen, who suspects that spot commodity prices and gold prices have figured importantly into the calculations of the Fed for some time. Thomas E. Nugent, vice president of Santa Barbara Bank & Trust, noted in an op-ed piece in The Wall Street Journal on February 23 that the Dow Jones Spot Commodity Index had risen dramatically in December and

early 1994, hitting 130 on February 4, the day the Fed announced a quarter-point increase in its target federal funds rate.

Some monetarists dispute the view that the Fed has in the past been following the price rule--or giving considerable weight to spot prices in commodities. Thus, they argue, the Fed's comments on gold really do mark a departure. From the earliest days of Greenspan's tenure, the Fed has been too sensitive to changes in lagging inflationary indicators such as unemployment and producer prices "because they are important to the political process," says Allan H. Meltzer, chairman of the Shadow Open Market Committee and an economist at Carnegie Mellon University. By focusing on lagging indicators, Meltzer says, the Fed has responded too slowly when it was time to ease or tighten.

Meltzer and other monetarists are firmly committed to using monetary policy to keep a steady, moderate rate of growth in money supply, usually defined as cash, bank deposits, savings accounts and CDs. Nobelist Milton Friedman, the preeminent monetarist, has long suggested that a computer could run the Fed, simply tracking money supply and easing and tightening to keep it steady on a policy that was neither inflationary nor deflationary.

Greenspan's current fascination with commodity prices has led him to renew contact with his old alma mater and his former professor Geoffrey H. Moore, who taught him statistics. Moore heads the Center for International Business Cycle Research at Columbia University. A letter to the editor of The New York Times on February 16 pushed Moore into the congressional limelight after the letter was cited by Representative Stephen L. Neal (D-North Carolina) during Greenspan's testimony.

Moore had criticized the doyen of Keynesianism, James K. Galbraith, who had written an op-ed piece in The New York Times attacking the Fed's decision to tighten on February 4. Moore noted that his center had, for years, been developing a Leading Inflation Index. "This index, which has had an extraordinarily reliable record in forecasting upturns and downturns in inflation, rose sharply last month, and it is growing at its fastest pace in eight years," Moore wrote. Moore suggested that his index would indicate that inflation will start rising later this year.

When Neal asked Greenspan if the Fed used Moore's index, Greenspan replied that the Fed was "in the process of looking at it." In fact, the Fed sent a letter by facsimile to the center the following day to further inquire into the composition of the index, according to Anirvan Banerji, an economist at the Center for International Business Cycle Research. The basic indicator in the index is the Journal of Commerce's Industrial Materials Price Index, which the center developed in 1986, according to Banerji. That index was expanded to include six other indicators that now make up the center's composite Leading Inflation Index: (1) the growth rate of import prices, excluding fuels; (2) the growth rates of federal and nonfederal debt; (3) the percent of the total population that is employed; (4) the percent of businesses expecting higher selling prices in Dun & Bradstreet's quarterly survey; (5) the percent of purchasing managers reporting higher prices in the monthly reports of the National Association of Purchasing Managers, and (6) the percent of purchasing managers reporting slower deliveries.

When asked about Moore's assertion that the index had proven reliable over time, Banerji said that most of the indicators in the index have been around for several decades and that, using those indicators to create a composite, the center had demonstrated that the index had reliably predicted "turning points in inflation" since 1948. The Leading Inflation Index, however, has been in its present form for only five years.

Spooked markets

A policy of acting to counter inflationary expectations is not without its own risk. Indeed, the bond markets have remained spooked by Greenspan's testimony and the Fed's February 4 fed funds rate target increase. The yield on the 30-year Treasury bond rose from 6.30 percent to nearly 7 percent five weeks after the Fed tightened, additionally propelled by a revision of the fourth quarter, real gross domestic product (GDP) from a robust 5.9 percent to a sizzling 7.5 percent. The Dow Jones industrial average, which plummeted 96 points the day the Fed increased the target rate for federal funds, also zigzagged to a 4 percent loss of its value in the next 30 days.

The market jitters led some FOMC members to publicly call for the Fed to make another rate hike to reassure the market of the Fed's commitment to fighting inflation. The Fed did follow through with a subsequent rate hike. The worry on Wall Street is that higher interest rates could choke the recovery.

Greenspan's policy of "watch-everything" and fine-tune contrasts starkly with the term of the former Fed Chairman Paul Volcker (1979-1987), when the Fed gave top priority to keeping the money supply steady. While Greenspan has kept close tabs on monetary aggregates, money supply has played a varying secondary and tertiary role during his tenure, according to Jones.

While crunching numbers at a numbing pace, Greenspan soon established his niche in Fed history when he tried a novel approach to Fed policy he called "the soft landing," Jones says in his 1991 book The Politics of Money: The Fed Under Alan Greenspan. The Fed chairman sought to slow the very strong growth rates he inherited and to maintain growth at a pace slightly but not far below the growth rate in the labor force plus gains in productivity--normally about 2 1/2 percent a year, Jones says. Greenspan apparently believed that if the Fed kept monetary policy sufficiently tight, supply/demand pressures on labor and capital resources would lessen and the underlying core inflation rate would fall from the 4 percent to 5 percent range to a lower level.

In 1990, the Fed intensified its soft landing focus on inflation, pushing the economy into "the twilight zone between expansion and recession" by setting a target real economic growth rate in the 1 1/2 percent to 2 percent range, Jones claims. While the Fed had begun easing in 1989, that easing had stalled by the middle of 1990. It was not until late 1990, after Bush had concluded his budget agreement with Congress, that included tax increases to bring down the deficit, that the Fed began to ease more aggressively, but in numerous, small adjustments in the federal funds rate, then at 7 1/2 percent.

Bouncing on the runway

By March 1991, the federal funds rate was at 6 percent. Meanwhile, it had become clear that the economy had tipped into recession in August 1990. "There was no soft landing," Jones says. "Greenspan bounced on the runway." Despite continued Fed easings until September 1992, when the funds rate hit 3 percent, the recession lingered for what seemed an eternity to the Bush administration, which ultimately was swept out of office when the economy remained too anemic in the months running up to the 1992 elections.

Economic growth strengthened in late 1992 and gained momentum in the fall of 1993. In spite of Greenspan's tardiness in easing monetary policy in 1990, Greenspan and the Fed have largely succeeded in his goal of reducing the core rate of inflation. Inflation at the consumer level is now running at about 3 percent while the economy has been growing at a respectable 3 percent since 1992, albeit unevenly.

Greenspan's performance "has helped put the much-maligned concept of fine tuning in a better light," says Jones. With a low-inflation steady-growth economy as a feather in his cap, Greenspan's reputation is flying high these days, even though the strength of this recovery is much weaker than past ones. Also, inflation fears have been revived, leaving Greenspan's victories tentative.

A bankrupt aggregate

Greenspan appears to have been laying the groundwork for a more determined fight against inflation for nearly a year. He considers 3 percent too high an inflation rate and would prefer that it fall to 1 1/2 percent to 2 percent, according to Jones, which he believes is closer to zero, given the bias inherent in the Consumer Price Index. Greenspan's first step was to admit last July what nearly every economist had already observed--that the Fed's key measure of money supply, M-2, is no longer reliable. M-2 consists of cash, checking and savings account balances and certificates of deposits less than $100,000. In recent years, as more and more funds have been held outside depository institutions, particularly in mutual funds, M-2 has captured less and less of the nation's true money supply.

As Greenspan's policies succeeded in lowering interest rates and promoting noninflationary growth, they also accelerated the flow of funds out of banks and thrifts and into mutual funds. Additionally, there are huge flows of currency out of the United States and overseas, where the dollar has become a substitute hard currency in countries experiencing hyperinflation.

It came as no surprise, last July 20, when Greenspan notified Congress that the Fed no longer considered M-2 a reliable measure. At the same time, the Fed lowered its target for the growth of M-2 for 1993 from a 2 percent to 6 percent range to a 1 percent to 5 percent range. The target for 1994 is also a 1 percent to 5 percent range. This appeared to tilt the target toward a harder anti-inflationary stance. Traditionally, a neutral policy for money supply would be a target for M-2 that was in the mid-range of the sum of the underlying growth potential of the economy (which the Fed pegs at 2 1/2 percent to 3 percent) plus the inflation rate. With inflation running at least 3 percent, the old formula would have dictated a Fed monetary target with a median around a 5 1/2 percent to 6 percent.

Greenspan, however, has not entirely abandoned M-2. In his testimony last July 20, he said that it might regain its value in the future "once the yield curve has returned to a more normal configuration, borrowers' balance sheets have been restored and traditional credit demands resume, savers have adjusted to the enhanced availability of alternative investments and depositories finally reach a comfortable size relative to their capital and earnings."

Quarrels with monetarists

Not surprisingly, monetarists have had ongoing quarrels with Greenspan for his abandonment of money supply growth as the most important predictor of inflation. While Meltzer agrees that M-2 is no longer as reliable as it once was, he believes the Fed should adopt a substitute monetary aggregate to watch--the monetary base--which in-dudes all the reserves and currency in all the banks and thrifts in the United States. Meltzer thinks this measure is particularly important because it's something the Fed can control. "It's the raw material from which all money is created at the central bank," he says. "You can't watch everything. That's a mistake. You have to put weights on things."

If the Fed watches everything, Meltzer argues, the FOMC might put too much weight on something of marginal value and misinterpret changes in various indicators. Take a decline in inventories, he says; "does that mean a strengthening economy, or is it a temporary blip?" There's really no way of knowing the answer to that question, he says, because it is so difficult to sort out permanent from temporary changes in most economic indicators.

Last July, Greenspan told Congress that the Fed had been focusing on real short-term interest rates, which had been essentially zero for some time. Meltzer says it is a mistake to give low short-term interest rates a paramount role, because they can indicate either a weakening economy or inflation, and it's not always possible to tell, which it will be. "That's not because economists are bad forecasters; it's because the future is uncertain," Meltzer says. "Looking at everything is the same thing as looking at nothing."

Meltzer and the Shadow Open Market Committee (SOMC) have criticized Greenspan for being too late to ease in the late 1980s and too slow to tighten in the early 1990s. If the Fed had followed the monetary base as its key indicator, it would not have been late on both those occasions, Meltzer says. In 1989, the SOMC said that Fed policy was too tight and that it would lead to recession, but the Fed did not ease appreciably until late 1990. In 1991 the SOMC said the Fed was too easy and that this would lead to inflation, which Meltzer believes is now on the way. The Fed has been sowing the seeds of future inflation for at least two years by allowing the monetary base to grow at an annual rate of 9 percent to 10 percent while focusing on lagging cyclical indicators like unemployment and inflation, Meltzer says.

The Fed focuses too much on unemployment and inflation data because that's where the politicians are focused, according to Meltzer. The Fed should now slow the growth of the monetary base to a range between 7 percent and 8 percent to keep inflation from surging back to a range between 4

1/2 percent to 5 1/2 percent, Meltzer says. If the Fed delays, it will require harsher steps that will bring on a recession, he predicts.

Not all inflation hawks are as critical as Meltzer and the shadow FOMC. "There's no such thing as an ideal monetary policy," says Daniel J. Mitchell, a senior fellow and economist at the Heritage Foundation, a conservative think tank. That's because it's difficult to measure the supply and to calculate the demand for money. While Mitchell believes that the Fed under Greenspan has at times "strayed from ensuring price stability into the discredited task of stimulating the economy," he believes that, on balance, "monetary policy has been a little on the easy side--but not very much or enough to get me upset." Mitchell says that although a zero inflation rate is desirable, the Fed, to avoid the costly mistake of deflating the economy, should "err a little on the side of inflation." Furthermore, he adds, given that the Fed operates in a political system that does not understand monetary policy, "I'm relatively happy."

Other inflation hawks "still have some concern about the strength of commitment to price stability at the Fed," says W. Lee Hoskins, president and CEO of the Federal Reserve Bank of Cleveland from 1987 to 1991 and currently chairman and chief executive officer of the Huntington National Bank in Columbus, Ohio. Hoskins, who generally approves of Greenspan's stewardship of the FOMC, says that the best judgment of the Fed's performance is the long-term bond rate. That rate has risen since the Fed tightening of February 4, suggesting that the market remains uncertain about the Fed's ability to keep inflation under control. "If the Fed had credibility on price stability," Hoskins says, "you wouldn't see the long bond rate where it is today." This suggests, Hoskins says, that "the Fed needs to do more to convince people."

Hoskins believes that the recent departure of two of the Fed's inflation fighters could be unnerving the markets, coupled with the prospect of their replacements being chosen by a Democratic administration. Wayne Angell departed January 31, when his term expired and Vice Chairman David Mullins resigned unexpectedly a few days later to go into the private sector. If the Clinton administration replaces these two with people who think that the Fed's job is to manage economic growth, then Greenspan's task will become more difficult, Hoskins says. Even so, appointees do not always follow their expected course. At press time, the Clinton administration had indicated it was considering two nominees: Alan Blinder, a respected liberal Princeton University economist who serves on President Clinton's Council of Economic Advisers; and George L. Perry, a respected mainstream liberal economist at the Brookings Institution. Both Blinder and Perry could turn out to be inflation doves at FOMC meetings if the economy were to falter, predict inflation hawks.

A hard act to follow

Business-cycle economists seem happier with Greenspan's performance than the inflation hawks, who tend to think that recessions are always the work of bad economic policy, not a naturally recurring business cycle. Robert Solomon, guest scholar at the Brookings Institution, rates Greenspan's overall performance very high--"at least a B plus." Asked to compare Greenspan's performance to Volcker's, Solomon said, "Volcker's a hard act to follow, but I think Greenspan has done it."

While few other Fed watchers are ready to give Greenspan the same standing as Volcker, who is generally seen as one of the greatest Fed chairmen, Solomon argues Greenspan seems ideally suited to these times, when the economy has been in flux and it has been increasingly difficult to discern an appropriate measure for monetary policy. In particular, he supports Greenspan's "watch-everything" approach. Volcker, too, was right for his time, Solomon said, when an exclusive focus on money supply and bringing down runaway inflation required a man with Volcker's singular focus and drive.

Those who believe it is appropriate for the Fed to be watching everything also agree that this makes the job of managing monetary policy more difficult. For Lyle Gramley, consulting economist with the Mortgage Bankers Association and a Fed governor from 1981 to 1985, this suggests that the Fed's recent success is all the more impressive. "The Fed was almost flying blind in very murky slop--to have kept the ship of state on an even keel under those circumstances is a relatively remarkable performance," Gramley says. Gramley attributes Greenspan's acumen in watching everything to the

fact that he is "an old-fashioned business-cycle economist par excellence, and he knows the numbers better than anyone I've ever run into."

Gramley also thinks Greenspan's gradualist approach to changes in interest rates is one of his strengths. Under Greenspan's tenure, the Fed has tended to take many, but smaller steps either up or down in interest rates. Volcker, by contrast, was more prone to take bigger strides. Some Fed watchers, like Jones, attribute this difference to Greenspan's personality. "He's basically a shy, self-conscious man, the opposite of Volcker," Jones says. When Greenspan enters a big room, he gravitates to the corner, Jones says. "Volcker, on the other hand, would stand in the middle, tall in stature and dominate the room and everyone in it."

Greenspan's baby steps

Robert D. Hormats, vice chairman of Goldman Sachs International, also sees Greenspan's gradualism as a great strength. Greenspan's baby steps on interest rates are not merely a reflection of his personality, but of his ability to be in tune with the financial markets, Hormats says. "His experience as an economist and his involvement in the market lead him to conclude that the markets are giving you signals all the time. He responds to them and does not try to outguess the market or get too far out in front of them, or too far back."

Hormats has known Greenspan since he worked down the hall from him in the Ford administration. Greenspan, a flee-market Republican, who had once been an admirer of philosopher Ayn Rand, came to Washington, D.C., after he was recommended to President Nixon by Leonard Garment, an attorney now at Mudge Rose Guthrie Alexander & Ferdon in Washington, D.C. He had built a stellar reputation as a forecaster at Townsen-Greenspan & Co., Inc., a Wall Street firm. Greenspan took over as chairman of the Council of Economic Advisers just as Nixon resigned in the wake of the Watergate scandal. Hormats was on Henry Kissinger's National Security Council staff, while Greenspan was the chairman of the CEA.

Hormats blasts monetarist critics of Greenspan in academia. He argues that it has been appropriate for the Fed chairman to be concerned about growth in the economy in the last five or six years because Washington's unending budget deficits have made it impossible to use fiscal policy to stimulate economic growth. Thus, Hormats explains, "Greenspan's role has been more complicated than Volcker's. He has had to continue the process of bringing inflation down and steer the economy into a successful recovery--and that's basically what he did."

Black Monday accolades

All sides of the debate over an appropriate Fed monetary policy agree on one thing. Greenspan handled his biggest crisis to date brilliantly, the stock market crash of Black Monday, October 19, 1987. He handled it well because he was prepared for it, according to Gramley at MBA. When Greenspan arrived at the Fed, he asked the research department to prepare a contingency plan to deal with such an emergency, Gramley says. The day of the crash, Greenspan was not even at the Fed, but it did not matter. Former Vice Chairman Manuel Johnson pulled the contingency plan off the shelf, Gramley says, "and started issuing orders" to provide the market all the liquidity necessary to avoid a collapse.

Greenspan was, in fact, on his way to Texas to address a convention of the American Bankers Association, according to Robert H. Boykin, former president of the Federal Reserve Bank of Dallas (1981-1991). "He arrived in Dallas just at the close of the trading day on Wall Street," Boykin remembers. "He didn't speak to the convention. He turned around and went back to Washington."

Members of the FOMC tend to disagree with those who fault Greenspan for lagging on moves to ease and tighten. Given the way the FOMC operates, it is difficult to respond quickly to signals that suggest a turnaround in direction, says Boykin. The FOMC has traditionally operated by a kind of consensus. Before an action is taken, there usually has to be general agreement by a supermajority of its 19 members (only 12 of which vote). The FOMC would not take an action based on a seven-to-five vote, Boykin says. On the other hand, it does not require a unanimous vote. The minutes of the December 19, 1993 meeting suggest that the FOMC was moving toward tightening, but lacked

the necessary level of agreement to proceed. By February 4, however, there was little doubt that the time had come to move, even though two of the FOMC's inflation fighters had already resigned.

Jones, for one, thinks Greenspan was a little too collegial in his early days and failed to focus the FOMC sufficiently for it to react in a more timely manner. As a result, the FOMC was often bitterly divided between hawks and doves and, as a result, delayed its actions too often. Greenspan has done a better job in recent years of demonstrating leadership at the FOMC meetings without compromising the collegial atmosphere of those meetings, Jones says.

Greenspan became more determined to respond in a timely manner after the economy failed to respond to the Fed's easing that began in December 1990, Jones asserts. Greenspan came to attribute the delayed reaction to the fact that the economy was facing "50-mile-an-hour head winds" from a credit crunch in the banking system and a fall in credit demand by business and households, which were focusing on paying down their debts to reduce highly leveraged positions taken on during the 1980s. Businesses were restructuring by laying off hundreds of thousands of workers, a process that ultimately drove dramatic improvements in productivity while holding down labor costs.

Though tardy in easing, Greenspan eventually made up for it, Jones says, so that "in the final analysis, he came out looking well." The Fed "saved the banking system and the remaining thrifts by steepening the yield curve," he says. Because of the casing of short-term rates, banks were able to repair their balance sheets by a widening spread between their cost-of-funds and what they charged for loans. As a result, the banking industry avoided a major crisis and the nation avoided a potential depression--a considerable achievement, according to Jones.

Jones and many other economists give the Fed credit for the current cost consciousness of households and businesses, a sure sign, he says, that inflationary expectations have been largely wrung out of the economy. In a normal cycle, businesses raise prices and add to capacity to maintain profits, Jones explains. In this recovery, however, they are continuing to cut costs and sometimes capacity to maintain their profits.

Congressional woes

While Greenspan's reputation is perhaps at its highest point since the aftermath of the stock market crash, his congressional woes have paradoxically grown like kudzu. Congressional opposition to Greenspan's newly assertive devotion to price stability was on display during his February 22 testimony.

"You almost have a phobia on inflation," Roth taunted Greenspan, a charge that might have riled a more combustible man. But Greenspan, unperturbed, quietly and patiently disagreed. He told Roth that his question presupposes that the Fed's actions constitute an "irrational response." "From all we know, the most virulent element for creating economic distress and misery is inflationary pressures," Greenspan said. If Roth meant to suggest that the Fed chairman was vigilant against the reappearance of inflation, Greenspan said he could only reply, "I certainly hope so."

The charge of an irrational Fed, in the face of its widely acclaimed success, may strike some as itself irrational. Yet, it is not an unfamiliar theme on Capitol Hill. When the Fed tightened on February 4, Senators Paul Sarbanes (D-Maryland) and Jim Sasser (D-Tennessee) were sharply critical in a joint statement that accused the Fed of acting "without any evidence whatsoever" that inflation is a problem now or in the future. "The current situation defies reaching this kind of conclusion on the basis of rational analysis," Sarbanes said.

Congressional bashing of the Fed has been going on for decades and was raised to an art form by former House Banking Chairman Wright Patman, a populist whose views shaped the current chairman of the Housing Banking Committee Henry Gonzalez (D-Texas). Yet, the disdain Congress has for the Fed's price stability policies seems to have taken on new vigor in the last year, as key members of Congress have taken initiatives to rein in the independence of the Fed. Such initiatives, if they were to become law, most economists say, would likely politicize monetary policy, leading to

a surge in inflation. It could also prompt a resurgence of the boom-bust cycles of the 1970s, along with stagflation, according to Mitchell.

What particularly concerns economists is that some in Congress seem to have forgotten the lessons of the inflationary 1970s.

The apparent philosophical gap between the Fed and some key members of Congress is growing as Greenspan strengthens his commitment to price stability and some congressional leaders intensify their attacks on the Fed's independence. This is not taken lightly by the markets, primarily because it is Congress that created the Federal Reserve as an independent central bank, and Congress has the authority to rein in its independence, with or without the president's support. For now, the president is content to leave the Fed alone and to resist entreaties from Congress to back Fed reform.

The chief congressional critic of the Fed is Banking Committee Chairman Gonzalez, who last fall stepped up his denunciations of the secret meetings of the FOMC, putting new heat on Greenspan to open up more of the Fed's proceedings to public scrutiny. Currently, only minutes of FOMC meetings are available about five to six weeks after each meeting. In response to Gonzalez's probings, Greenspan revealed that the Fed has for many years tape recorded its FOMC meetings, a revelation that shocked some members of the FOMC, who had not been aware of it. Gonzalez demanded transcripts of the tapes. Greenspan, after due deliberation, agreed to release a lightly edited transcript of each meeting--five years afterward.

A chill on FOMC meetings

Greenspan's compromise seemed to ease Gonzalez's concerns, but it has apparently left a chill on the subsequent meetings, starting with November 16, according to members of the board. Former Vice Chairman David Mullins, who announced his resignation in late January, said he found himself less willing to openly discuss the state of the economy and what response the Fed should make.

In fact, it may have been Greenspan's intention to more emphatically state the goals of the Fed during his February 22 testimony to counter some of the chilling effect that recent congressional efforts have had on FOMC meetings. It may be also why Greenspan has gone for the jugular, at least philosophically, in his recent testimony--engaging in an intellectual frontal assault on the economic assumptions of the inflationary 1970s and early 1980s, views that seem to survive on Capitol Hill.

The task of convincing a few key members of Congress of the wisdom of Greenspan's price stability policies seems Herculean, if not quixotic. Gonzalez last year introduced a bill (the Federal Reserve Accountability Act of 1993) to have the president appoint the presidents of the regional Federal Reserve Banks, with the advice and consent of the Senate. They are currently appointed by their respective boards of directors with the approval of the Fed board of governors in Washington, D.C.

In an open letter to President Clinton on July 22, 1993, Gonzalez ripped into the composition of the FOMC, including its seven members of the board of governors, all appointed by Reagan and Bush. He blasted the 12 presidents of regional Federal Reserve Banks because they are selected by boards who mostly represent commercial banks. "In general, the Federal Reserve decisionmakers are bankers or friends of bankers. Decisionmakers representing the concerns of agriculture, small business, labor, consumer and community groups are almost unheard of. Yet advocates of price stability even at the price of stagnation are well represented at the FOMC," Gonzalez said. He blasted the lack of meaningful representation of minorities and women on the board.

Restrictions on the Fed's independence are supported by Joint Economic Committee Vice-Chairman Paul Sarbanes and Representative Lee Hamilton (D-Indiana). Their proposed legislation (the Monetary Policy Reform Act of 1993) and other related bills would take the FOMC vote away from the Reserve Bank presidents.

"This approach would lead toward excessive centralization of power in the board of governors, and thus subject monetary policy to undue political pressures from inside the Washington Beltway," says Fed-watcher Jones.

A year ago, Senator Donald Riegle, chairman of the Senate Banking Committee, (D-Michigan) who is leaving Congress after this session, made his own dramatic points about the Fed. He took the lead in calling all 12 Reserve Bank presidents to appear before Congress for the first time. "The purpose of these high visibility...congressional hearings was to challenge the prevailing means of selecting these Reserve Bank presidents and to try to intimidate them, with a view to getting them to be more accommodative," Jones says. The 12 were ridiculed by some senators for being all male and all white. This "staged spectacle" was an exercise that encroached on Fed independence, Jones says.

While the strength of the new assaults on Fed independence seem puzzling on their face, Niskanen, a Republican, suggests that some Democrats in Congress resent the fact that the Fed is still composed of Republican nominees. They may view their attacks as being on the Reagan and Bush administrations more than attacks on the Fed per se. Niskanen also thinks congressional attacks on the Fed derive from the sense of a loss of power that has occurred in Congress as it has grown more constrained in what it can do with its own budget. The same fiscal restraint that is driving unfunded mandates on state and local governments, Niskanen argues, is also driving the anti-Fed campaign. It is also leading to increased micromanagement of banking activities, including efforts to direct credit allocation. "There's an increasing pattern of trying to control the nation's resources through regulation," Niskanen says.

In spite of the ferocity of some attacks from Congress, there is little support in Congress for efforts to curtail the independence of the Fed or for anything that might lead to a resurgence of inflation. "There's not much sentiment in the land to hand over policy to people who have made a hash of fiscal policy," says Hoskins, the former Cleveland Fed president.

Congress is not the only source of challenges to the Federal Reserve. Last fall, Treasury Secretary Lloyd Bentsen drafted and had introduced a bill to consolidate all the federal banking and thrift regulatory agencies into one, a Federal Banking Commission. Under the measure, the Federal Reserve would cease to regulate any banks but continue in its central bank role of managing monetary policy. The Federal Deposit Insurance Corporation, which now regulates some banks, would continue only as a deposit insurer. The Office of Thrift Supervision and the Office of the Comptroller of the Currency would cease to exist. Greenspan has argued vigorously against this proposal, claiming that it would end the Fed's important role of being the lender of last resort in a financial crisis. "We have to act in real time to contain a crisis or in advance to prevent the issue from arising," Greenspan told Congress on February 22. "Our hands-on supervision and regulation give us information on the financial system, so that we know which buttons to push when problems may arise. If we did not have it I'm not sure we'd be able to contain crises as we have over the years," he said.

Greenspan has indicated he would accept a system with two regulators, the Federal Reserve and a new Federal Banking Commission, but, at press time, Bentsen had not yet agreed to this compromise. Many observers are betting that Bentsen will have to compromise. The Bentsen proposal "doesn't have a ghost of a chance," says Gramley. "There's no political constituency for regulatory reform or consolidation. If the Fed fights hard against it, |the board~ will find allies in Congress to stop it."

Aside from the banking proposal from Bentsen, Greenspan's smooth relationship with the Clinton administration has been a source of amazement ever since Greenspan sat next to Hillary Rodham Clinton during the president's inaugural address to Congress in January 1992. When the first lady invited Greenspan to sit in the executive box with other Clinton guests, "Greenspan said, 'How could I refuse, given the source?'" says a source who has discussed the matter with the chairman. It came as a surprise to Greenspan that he was asked to sit between Hillary and Tipper Gore, the vice president's wife.

Such coziness with the first family at first raised speculation on whether Greenspan may have made a deal to delay raising interest rates in return for Clinton reappointing him to a third term when his

present term as chairman expires in March 1996. The Fed's recent increase in interest rates has dispelled much of that talk.

Clinton had already made points with Greenspan even before they met. During the televised debates of the presidential campaign, Clinton had forcefully defended the Fed's independence, while Bush and Perot stumbled. When the two met in Little Rock at Clinton's economic summit, Greenspan and Clinton "got off real well," says Jones. "Clinton came off almost like a college professor in his command of the issues," Jones adds. Even though they were opposites--Greenspan, the urbane introvert and Clinton the down home extrovert--they were "two peas in a pod" when it came to the love of details. It soon became evident that the two shared the same goal. They agreed that the budget deficit had to be brought down to bring down interest rates. "This administration understood early that they needed Greenspan," says Hormats.

Hormats, who has discussed the matter with the president, says Clinton understands the effect of various tax and budget policies on the yield curve. Thus, "it was no accident he sought early advice from Rubin and Altman," Hormats says. Robert Rubin is a former co-chairman of Goldman Sachs and now the chairman of the National Economic Council. Roger C. Altman, deputy secretary, Department of the Treasury, has known Clinton since they were both students at Georgetown University, and is the former vice chairman at The Blackstone Group, a private merchant banking firm in New York.

"I'm sure Clinton has discussed with them |Rubin and Altman~ quite frequently the way the market responds to his policy," Hormats says. It was that understanding that led Clinton to abandon his middle-class tax and embrace a deficit-reduction policy, Hormats says. "That policy was aimed at achieving credibility in the financial markets." Budget deficit reduction also required lower interest rates to counteract the deficit reduction's drag on the economy.

Since it became apparent last fall that the recovery had gained considerable strength, the Clinton administration has said that its deficit reduction package had propelled the economy forward. Some economists, however, point out that the recovery still remains far weaker than traditional recoveries, when economic growth has averaged around 5 percent. During 1992 and 1993, the economy has grown at an average rate of only 3 percent. Hormats, for one, attributes the strength of the current recovery equally to Clinton's deficit reduction and Greenspan's monetary policies, but most of the economists interviewed for this article put more weight on Greenspan's policies.

Jones, for example, says that Clinton's early embrace of deficit reduction had only a limited short-term effect on interest rates between September 1992 and early 1993.

The long, slow decline in interest rates since early 1989 that ended February 4 is attributed primarily to the Fed's savvy hand on the money supply. Stephen Roach, co-director of global economic analysis at Morgan Stanley, says the Fed's decision to avoid any interest rate increases in 1993 "offset what might have been a weaker economy," which would otherwise have been depressed by the Clinton budget package. Greenspan, too, has given some credit to the administration's budget deficit package, while expressing reservations with some of its points, without naming them. The Fed chairman is circumspect in his compliments, however, saying only that the Clinton budget package is helpful because it has convinced the markets that real deficit reduction will occur for the next few years.

The political triangle consisting of Greenspan, the Clinton administration and Congress will shape the political pressures that may be brought on the Federal Reserve in the coming two years. The dynamics of this three-way relationship present the Fed chairman with his second major test--comparable to the test of the stock market crash of 1987, according to Jones. The test is to maintain low inflation while enlisting the Clinton administration in any battles with Congress over the Fed's independence--all this without compromising any independence from the White House. How Greenspan handles this challenge will determine how he is ultimately judged, Jones says.

While Greenspan currently has the support of the Clinton administration for his anti-inflation policies, that could weaken if the economy begins to slow in 1995, as many economists expect. Then, with at least two Clinton appointments at the Fed who could argue for easing to support economic growth,

and with the threat of legislation to curtail the Fed's independence at his back, Greenspan might be tempted to ease in order to secure a reappointment as chairman in 1996, some Fed watchers fear. The conventional wisdom is that Greenspan, who is dedicated to his work at the Fed and is attracted to the power and lifestyle in Washington, wants to be reappointed as chairman. And, the worriers note, the recovery could very well be slowing by 1996 to the same level of very low growth that inspired the voters to send Bush packing in 1992.

Most Fed watchers, however, doubt Greenspan would buckle to Clinton administration pressure to ease up his fight against inflation. That's because ultimately, if Greenspan stands strong against any potential Clinton pressure to ease, as he did against Bush, his reputation for independence and integrity will be largely unassailable.

Most economists expect Greenspan to tighten policy again at least once and maybe more before the end of the year. While that will draw howls from some in Congress and increasingly furrowed brows from the Clinton administration, it will not end the recovery. "The Fed will not have to put the economy through the wrenching interest backup that was the case in the past," says Roach. The economy will slow from its 7.5 percent torrid pace in the fourth quarter of 1993 to about 3 1/2 percent for 1994, most economists say. It could be slower if the Fed has to make more rate increases to convince the markets that inflation will not be tolerated.

A number of problems lie ahead that could prove inflationary. As overseas economies recover, it will put pressure on the prices of raw materials as well as the available supply of savings around the world, according to Stephen Axilrod, vice chairman of Nikko Securities Company in New York, who was formerly staff director for monetary and financial policy at the Fed. "If there is a bag expansion in the industrial world next year, strong export growth will create inflationary pressures in the U.S.," says Axilrod.

The other big worry is a resurgence in the U.S. budget deficit. Both the Clinton administration and the Congressional Budget Office see deficits rising again by 1997. Deficits could rise even sooner, however, if a health plan is adopted that includes a great deal of Clinton's original plan, according to the Congressional Budget Office's director, Robert D. Reischauer. He estimated that the Clinton proposal would increase the deficit by $74 billion in its first six years, instead of cutting it by $59 billion as the president had originally claimed.

A number of economists are more sanguine about the outlook for inflation because they believe that either there will be no health care reform at all or that the final version will be modest.

Notwithstanding Greenspan's intensified battle against inflation and political pressures in Washington, most observers expect inflation to rise somewhat this year. Few expect inflation to decline further. Greenspan will, however, try to gain further disinflation, according to Roach, by raising real short-term interest rates--as Greenspan suggested he might do last July. Greenspan does not have to further disinflate, however, to enhance his reputation. If he can prevent inflation from rising significantly--preserving what has been won so far--then long bonds will ultimately fall back nearer to 6 percent and maybe below, closer to the level that prevailed in the halcyon days of the 1950s. If that should happen, and rates remain at or below that level for the rest of Greenspan's current term, he will have consolidated the hard-earned gains of the past seven years and earned a place of honor for himself in Fed history.

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