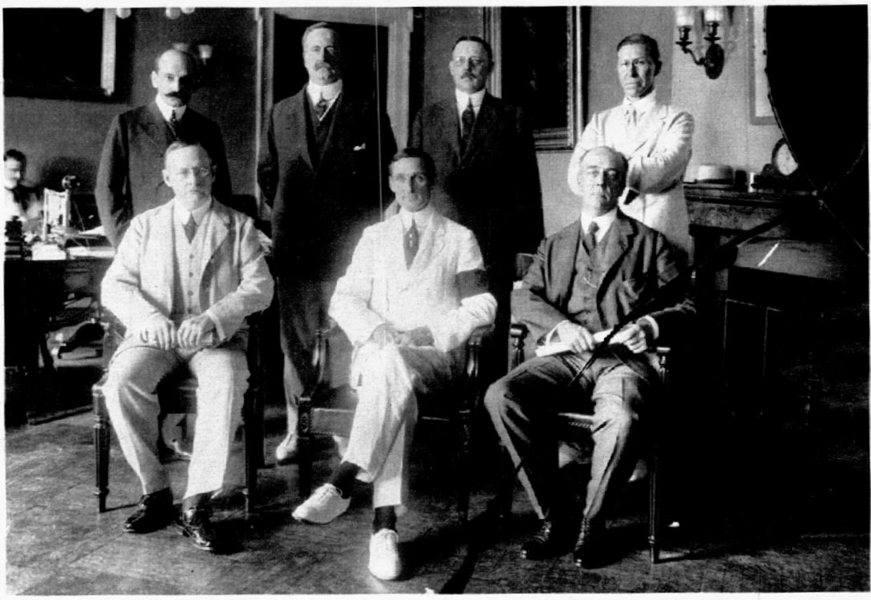

The first Federal Reserve Board in 1914.

Reserved

Globalization and Alan Greenspan's own influential stewardship have steered the Fed back to something like its original state: an institution with limited power. By Roger Lowenstein

Power, as Jimmy Breslin once wrote, is the illusion of power. Few are more dependent upon cultivating the illusion than the chairman of the Federal Reserve. After the last mostly prosperous 18 years, no economic figure in the world is thought to be as influential as Alan Greenspan. Every blessing that has befallen America — impressive growth rate, high productivity, low inflation — is laid at Greenspan's door. So, too, our periodic misfortunes, like the occasional bubble or bust or the recent inflationary uptick. Senator John McCain once joked that if he were elected president and Greenspan were to die, he would prop him in his chair and hope no one noticed. But is it possible that no one would notice — that prosperity, or sound monetary management, at any rate, would go on?

The most oracular and idiosyncratic of Fed chairmen, Greenspan has personalized the office like no one before. But while he has been issuing those Delphic pronouncements, a funny thing has happened to central banking. It has become more normative — less an art and more a discipline. Central bankers have gotten better. They have also gotten luckier.

When Greenspan's reign began in August 1987, long-term interest rates touched 9 percent. Today they are half that. It challenges credulity to think a single man could have fashioned such a tectonic shift. After all, long-term rates and inflation have also fallen in every other highly industrialized country (though their economies did not grow as quickly as ours). Greenspan, like other bankers, rode a forgiving current as nations regulated less and traded more. World economies benefited from the software revolution and, until recently, falling energy prices. And each central bank, including the Fed, was tugged along the path of monetary discipline by its neighbors. In a closed economy, in which only dollars matter, the Fed alone could regulate liquidity; in a global economy, it must collaborate. This is why Greenspan has been exhorting China to revalue — and why he needs London and Frankfurt to avoid inflation almost as much as Washington. It may bruise American

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pride to think of Ben S. Bernanke, nominated to succeed Greenspan, as resembling another dully professional Eurobanker, but that image may be closer to his future than that of the man pulling the levers behind the curtain.

Before Congress created the Federal Reserve System in 1913, America did rely on monetary wizards — often J.P. Morgan — to bail it out of panics. The Fed was meant to replace them, to be a banker of last resort. Also, the country wanted to free itself from relying on the Bank of England to finance its agricultural exports. But the notion of limited power was inherent in the Fed's creation. Farm states were wary of letting Eastern bankers control the money supply; thus, Congress established a network of semiautonomous regional banks. The chairman of the Fed is, in this network, merely the first among equals, one of seven governors who preside over the federal system.

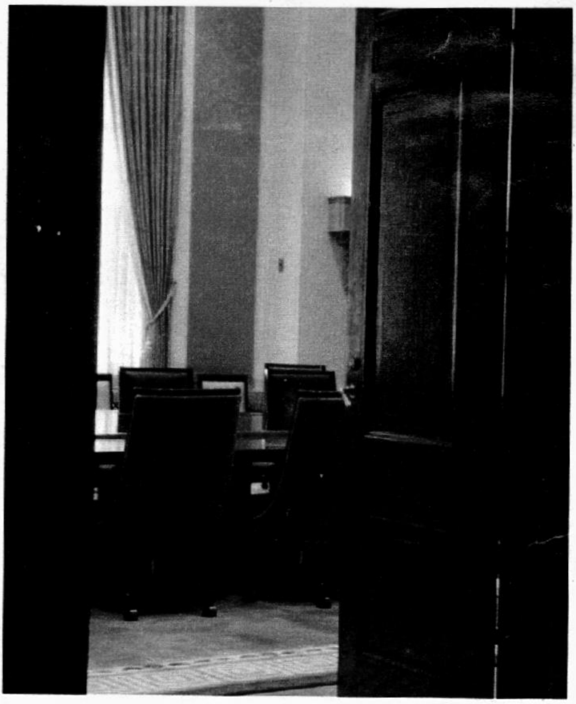
For years, he was barely even that. During the 1930's, the Fed was blamed for either causing or deepening the Great Depression. To diminish its potential for further mischief, Franklin Roosevelt turned it into the handmaiden of the Treasury Department. During World War II, the Fed meekly agreed to keep interest rates at 2.5 percent, thus letting Treasury finance the war at a price of its own choosing. President Truman reluctantly acknowledged the Fed's need for autonomy, but the deed came slower than the pledge.

In 1965, after voting to bump up interest rates, William McChesney Martin Jr., the only Fed chairman to hold the job longer than Greenspan, was summoned to Lyndon Johnson's ranch and accused of putting himself above the presidency. According to Robert P. Bremner, Martin's biographer, Martin was subjected to the classic Johnson punishment: a hair-raising ride at 60 miles per hour over dirt roads with the president at the wheel. L.B.J.'s demeaning treatment reflected Martin's more subservient view of his job (you could scarcely imagine Greenspan submitting to such humiliation). He failed to pursue a tight money policy when it counted, and by the time he retired, in 1970, inflation was 6 percent and beginning to escalate out of control.

Even a truly "independent" chairman cannot act alone. He has only one of 12 votes on the Federal Open Market Committee, the body that sets the "federal funds" rate — the interest rate that banks charge for overnight loans. A Fed chairman who cannot command an overwhelming majority of his fellow governors, as well as of the regional bank presidents, will be perceived as weak, and so will his policy. When Paul Volcker was appointed Fed chairman in 1979, inflation was raging. In his first attempt to raise rates, he suffered a split vote. The market reacted badly. Inflation depends on expectations; to stop raising prices, business needed to be sure that the Fed chief was truly in charge.

Volcker quickly gained wide respect and decisively broke the inflationary spiral. He put the country through two rough recessions in the process. This suggests another limitation on the Fed's power: its principal weapon is rather blunt. In theory, when the Fed tightens or loosens the overnight rate, the impact courses through the economy, affecting the rates available to corporations, homeowners, credit-card holders and so forth, over both the short and long terms. But the process is indirect and not always effective.

Given that the Fed is trying to regulate a complex modern economy — everything from mortgage rates to industrial output to the stock market to employment — the federal funds rate is a rather imprecise tool. To be even somewhat successful, the chairman has had to rely on unwritten powers and influence people's expectations. In particular, he has had to impress the bond market, for it is bond traders



No one behind the curtain: the boardroom of the Fed.

who set long-term interest rates, which have a more direct impact on investment and economic growth.

In 1987, only two months into the job, Greenspan faced a daunting hurdle to managing expectations — a stock-market crash. The next morning he issued a terse statement proclaiming the readiness of the Fed to "provide liquidity." Lou Crandall, chief economist of Wrightson ICAP, a bond market research firm, says he wondered: "Yeah? Like how?" No less than inflation, "liquidity is a state of mind," according to Crandall. "Once it is lost, the Fed has no magic wand to bring it back."

People cannot be forced to invest, and no one who lacks faith in the system will do so. After the crash, the highly unlikely rumor spread that the Fed was buying stocks. The rumor was not unhelpful. People believed that Greenspan was doing *something*. And so, they recommenced to take risk.

Greenspan has been especially adroit at using the power of the pulpit to heighten his seeming omnipotence. The chairman appears before Congress, twice a year, to expound on the condition of the economy. There and in his other public appearances, he has mastered a syntax at once knowing and a trifle obscure. Unlike other officials — even the president — he is not subjected to press conferences or public interviews, where he might seem diminished. The Fed chairman also sits at the helm of a remarkable information network and an awesome organization. He feeds off some 200 economists, who pounce on every bit of economic news, every speech by a corporate C.E.O., and digest and analyze their significance. Each Monday, he convenes his fellow governors so that each may share his or her outlook. It is only then, having received the collective wisdom as to the state of America's economy, that the chairman proposes a policy response. "One reason his pronounce-

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ments are viewed so heavily," says Kevin Hassett, a former Fed economist now with the American Enterprise Institute, "is he really does know the most about what's going on of anyone on earth."

The disinclination to vote against Greenspan is considerable, but the board's near-unanimity in recent years has been based on more than a cult of personality. According to Alice Rivlin, a governor during the Greenspan era, the times when the chairman had to twist arms were few. One was in the mid-90's, when he recognized that computers were making workers more productive. Sooner or later, however, the board would have arrived there without him. Although Greenspan is famously unconventional, willing to examine the most unusual data, the dirty secret about central banking is that, more and more, consensus, not personal idiosyncrasy, prevails. By making the workings of the Fed more transparent, Greenspan has ensured that the Fed's mystique will fade, and that in the post-Greenspan era, personality will matter even less.

Nowadays, markets rarely move when the Fed takes action, because its actions are anticipated. There is simply more agreement among economists over what the Fed should and will do. In lay terms, the job is to nip inflation before it arises, and relax as the threat recedes.

John Taylor, a former under secretary of the Treasury, once translated the factors he thought should guide the governors in setting the federal funds rate into an algebraic formula. To his surprise, the formula turned out to be predictive both for the Fed and for central banks overseas. William Poole, president of the St. Louis Fed, affirmed this in a speech at the Cato Institute just before Bernanke was nominated. While not suggesting that the Federal Open Market Committee saw itself as "implementing an equation," Poole cited the Taylor Rule as evidence that "the general contours of F.O.M.C. policy actions are broadly predictable."

Any process that a formula can come close to replicating is unlikely to be the fruit of a single bureaucrat's genius. And however adeptly the chairman has negotiated the economic cycles, the influence of broader, superseding trends is evident over time. In a backhanded way, Greenspan has acknowledged his limitations. Over the past two years, the Fed has raised the funds rate 11 times, yet long-term interest rates have failed to rise with them. Greenspan has called this a "conundrum."

Last March, a Fed governor proposed that perhaps the explanation lay outside our borders. We know that Asia is selling us more goods than it is buying from us. Its surplus has been reinvested in America — in the stock market during the 90's, more recently in bonds. A surplus of capital depresses the price of money — thus, Asia's surplus liquidity has kept the lid on U.S. interest rates. This specific chain of events has been much debated, but it is indisputable that markets, including capital markets, are interconnected. Over the past several decades, Americans have gotten used to the notion that the prices of toys and televisions may be set overseas. Increasingly, the same may be true of our money. If so, the Fed chairman of the 21st century will share his influence not only with his peers in Washington but also with bankers around the world. The governor who proposed this theory, of course, was Ben Bernanke. A becomingly modest start. ■