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Greenspan's Four Lessons

An important senior Tokyo financial strategist sizes up the last two decades of U.S. monetary policy.

BY MAKOTO UTSUMI

The curtain has finally closed on the eighteen-year tenure of Chairman Alan Greenspan, and we would like to draw some lessons from the policies implemented by this great leader of the U.S. Federal Reserve Bank.

FIRST LESSON. Always be ready to face an unforeseen crisis in managing monetary policy. Here's an example. Since June 2004, the Federal Reserve has been raising the fed funds rate by a quarter of a point at each FOMC meeting. Some in the markets questioned why it was necessary to create waves on flat waters against the backdrop of a looming economic slowdown.

Trying to read Chairman Greenspan's mind, one might infer that he wanted to bring monetary policy to a neutral position as soon as possible. If this could not be achieved, the Fed would not be able to play its role as a responsible central bank if any unforeseen risk arose, as monetary policy would not be effective.

Looking at the current monetary policy situation in Japan in the light of this thinking, one cannot help but feel frightened by the fact that the exit from the monetary policy measures necessitated by the darkest economic situation in the past

Makoto Utsumi is President and CEO of Japan Credit Rating Agency.

One of Fed Chairman **Alan Greenspan's** *lessons: Always be ready to face an unforeseen crisis in managing monetary policy.*

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years cannot yet be found, and no margin of maneuver is left for policy action in case of an unforeseen crisis.

Besides, Greenspan recently commented on the fact that long-term interest rates in the United States have been kept at abnormally low levels, hinting that he expected this situation to be corrected. The true thinking behind this, one suspects, is that Chairman Greenspan might be worried about the risk of a possible sudden rise in long-term interest rates in the wake of an event.

SECOND LESSON. Greenspan's second lesson is found in his response to asset inflation. During his tenure, stock prices rose far more than the historical average. Moreover, in recent years, land prices have gone up consistently, causing some to regard the situation as close to the bubble in some areas. On the other hand, the inflation rate has remained quite stable. The rise in asset prices against the backdrop of a stable inflation rate—a situation that to a certain extent resembles that of Japan in the late 1980s—has this author taking careful note of Chairman Greenspan's response.

The Fed Chairman's response was that the role of monetary policy was to control consumer inflation rates, not deal with asset inflation. While verbally blocking the sharp stock price increase by calling it "irrational exuberance," he did not accompany those words with monetary policy measures such as interest rates hikes.

In Japan, monetary authorities facing the same situation of asset inflation with stable consumer prices concluded that it was the role of the central bank to deal with the issue, and the Bank of Japan fought aggressively, with a very fast hike of the official discount rate, from 2.5 percent to 6 percent, within fifteen months in 1989–90. While this policy was successful in bursting the real estate and stock bubbles, it pushed the Japanese economy and the Japanese banks to the bottom of darkness.

In Japan, no margin of maneuver is left for policy action in case of an unforeseen crisis.

One can well imagine that Chairman Greenspan drew lessons from the Japanese experience. He made sure that the financial surveillance authorities carefully monitored the soundness of the banking system due to the active role played by banks in stimulating asset inflation. And indeed the Fed's area that oversees banking activity aggressively pursued its mission. But at the same time Chairman Greenspan refrained from implementing monetary tightening. This policy response in facing asset inflation with stable consumer prices could become a model policy if such a situation occurred in other countries.

In Japan, many discussions and analyses are held inside and outside the Bank of Japan as to who was responsible for monetary policy that led to asset inflation. However, there are almost no discussions as to how monetary policy should have responded

WHITE HOUSE PHOTO BY KIMBERLEE HEWITT

President George W. Bush *shakes the hand of* **Ben Bernanke** *after he was sworn in as Chairman of the Federal Reserve. People are carefully watching the transition from Greenspan to Bernanke and trying to guess how the latter will lead the Federal Reserve.*

to asset inflation. Going beyond the way monetary policy should be generally conducted, we need to suffer through this painful process of precisely analyzing and drawing lessons from past policy mistakes. This must include the way banking surveillance is done, particularly as banks were involved in lending to short-term land speculators who were using the services of yakuza gangs—whether those facts were known and ignored by banking regulators, how future banking regulation should be conducted, and so forth.

THIRD LESSON. The third lesson taught by Chairman Greenspan: the uses of a gradual approach in monetary policy, particularly in a phase of monetary tightening. Through many of his speeches, including testimonies before the Congress, Greenspan underscored the need to take into account the substantial time lag between monetary policy action and the point at which its effects show in the economy. In fact, as seen through the prudent interest rate hike process initiated in June 2004 at the "measured pace" of a quarter point each instance, this gradual approach epitomizes Chairman Greenspan's style of implementing monetary policy.

On the other hand, his decisive monetary easing process after the September 11 terrorist attacks is also fresh in our memory. When we look back on Japan's policy as seen in the aforementioned tightening from 2.5 percent to 6 percent within fifteen months, the tendency is the failure to recognize that a time lag exists between the time a policy measure is implemented and that when the effects actually show. Is it an overstatement to say that there is a Bank of Japan culture that favors decisive tightening but prudent relaxation?

FOURTH LESSON. Anecdotal evidence should be given great weight. Greenspan always looked beyond economic indicators. By asking his staff to collect all kinds of facts, data, and news that reflected the mood of the country's economy, as well as direct quotes from corporate executives, investors, and consumers, he stayed in touch with the real world, taking appropriate policy decisions on the basis of the real economy.

At the beginning of the 1990s, a true economic recovery started in the United States as a result of corporate restructuring resulting in a surge in corporate profits, which led to active corporate capital outlay centering on the information technology revolution. However, based on the experience of harsh corporate restructuring of the 1980s which produced more than five million layoffs from the Fortune 500 companies, consumers had been tightly watching their wallets. A few years later Greenspan was quoted as saying, "Since a few months ago, cases of job changing in search for better conditions are

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seen quite often. The era of sluggish consumption based on job insecurity seems to be reaching an end."

Adding socio-psychological analysis to economic analysis through feeling the mood of society through his own means was Greenspan's prominent characteristic. And in order to achieve this, he was said to take the time to meet many people and listen to what they had to say in spite of his heavy responsibilities.

People are carefully watching the transition from Greenspan to the new Chairman, Ben Bernanke and trying to guess how the latter will lead the Federal Reserve. Some market participants are voicing the expectation that the new Chairman would be a so-called "dove" and that a policy correction will happen. However, when one looks back at the track record left by Chairman Greenspan, a formidable trust relationship between FOMC members and the chairman formed, as he placed great emphasis on team play. Toward the end of the tenure of former Chairman Paul Volcker, the number of votes against the chairman's proposals at FOMC meetings exceeded the number of votes in favor. This is unthinkable in today's Fed. It is difficult to imagine that this firm consensus-making process would suddenly change, and one could think that the new Chairman would not want to change that either.

Within the Fed, cautionary feeling against inflation is mounting against the backdrop of the consequences of rising energy prices on consumer prices, an ascending trend—though mild—in wage levels, as well as massive fiscal expenditure for post-disaster reconstruction. The FOMC meeting in January 2006 raised rates another quarter point to 4.5 percent, in line with the basic policies established earlier, but in its statement slightly eased its suggestion of the need for future modest rate hikes. On the other hand, as winter comes, consumers might reduce their spending, taken by surprise by surging heating costs. The next FOMC meeting in March 2006 under the new chairman will be the center of attention in reading U.S. monetary policy in the next year or two. ◆