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Commentary

Market Opinions and Topics of Interest

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Memo to the Markets: Alan Greenspan Is No Longer Fed Chairman

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Alan Greenspan was the chairman of the Federal Reserve for almost 19 years (1987 to 2006). By the end of his tenure, he was being hailed as the greatest central banker of the 20th century. It is very difficult to follow such a legend, as Ben Bernanke is finding out.

Remember there is no set way to conduct monetary policy. And, to complicate the matter, the Federal Reserve has a dual mandate to keep inflation as low as possible and employment as high as possible. Having two goals often leads to a conflict, so every Federal Reserve chief runs the Fed in his own unique style.

The Greenspan Fed

Alan Greenspan emphasized the high employment mandate as much as possible. To this end, he adopted a "risk management" approach to monetary policy. Federal Reserve policy would seek to shield businesses from any uncertainty that would cause them to refrain from hiring. This is why events like a stock market crash or a geopolitical crisis would elicit a quick response from the Greenspan FOMC.

The problem with this kind of approach is that current events would demand abrupt changes in monetary policy. In order to keep the market informed about policy, in what became known as Federal Reserve transparency; Greenspan would communicate policy to the markets. In other words, he would tell them what the FOMC was going to do.

During Greenspan's tenure, economists who were honest would say they did not know why Greenspan was tightening or easing. However, they knew what was coming because Greenspan would tell them by using words in the FOMC statement like "considerable period," "patience," and "measured." These forward-looking statements became critical to determining the future course of Federal Reserve policy.

The Bernanke Federal Reserve

Bernanke has been conducting FOMC policy in a much different manner. He emphasizes the low inflation mandate more than the high employment mandate. To this end he focuses on measures of inflation. And, to remove the volatile effects of energy and food prices, he focuses on core inflation measures. Recognizing that inflation is a lagging indicator, the Federal Reserve forecasts where it will go. Understanding that such forecasts can be errant, Bernanke stresses that the FOMC is "data-dependent."

Under such a regime, transparency is offered to the markets through understanding the rules that guide Federal Reserve policy and following them. Therefore, opinions such as those offered in the FOMC statement have little-to-no value. Furthermore, this regime allows Bernanke to speak freely and clearly. If the market understands his rules and what data results will cause a change, he does not need to hedge his bets by engaging in the "Fedspeak" that Greenspan made famous.

Current Policy

The Bernanke Federal Reserve last raised rates on June 29, 2006 to 5.25% where it still stands today. Bernanke has been very clear that the current level of core inflation is "above the FOMC's comfort zone." While the parameters of this zone have not been clearly defined, it is believed that core CPI above 2.25% is too high. Currently core CPI is at 2.50% and has been above this perceived upper target since April 2006.

The reason the Bernanke Federal Reserve has not continued to raise rates is they forecast that core inflation will fall back into the FOMC's comfort zone

in the coming months. So, the Federal Reserve has held rates steady and remains "data dependent" waiting for core inflation to confirm them correct.

By now it *should* be pretty clear how FOMC policy is conducted and what could cause it to change. But, old habits die hard. Some Fed-watchers are still operating with the Greenspan rules. They continue to pore over the FOMC statement, parsing its language changes for clues. Under Bernanke this approach will not work, and has not worked. At the March 21 FOMC meeting, the Federal Reserve changed its language slightly. Under *Greenspan*, the changes made would be suggestive of a more neutral monetary policy stance. Under a data-dependent Bernanke, however, these minute changes in wording meant very little. Bernanke himself had to explain this to the markets (yet again) a week later and it was emphasized in the FOMC minutes for this meeting in early April.

Conclusion

This episode showed that 15 months after Greenspan has left, too many Fed-watchers are acting as if he is still running the FOMC. This is why they are constantly confused by a policy that is easy to understand and clearly explained.

When Fed-watchers finally understand that the Greenspan rules no longer apply, they will understand the FOMC statement does not mean that much anymore. Maybe they will even suggest the Federal Reserve do away with it in favor of a press conference (like the ECB) where a clear-speaking Bernanke can articulate policy. They will also understand that the key drivers of core inflation, such as owners' equivalent rent, will determine FOMC policy more now than in the past.

Finally, these Fed-watchers will understand that the old "Greenpsan Put," the belief that the FOMC will act quickly to calm volatile markets, applies when high employment is emphasized and not so much when low inflation is favored. In market parlance, the "Bernanke Put" is further out of the money than the Greenspan Put – meaning market volatility has to ratchet far higher than Greenspan's threshold before the Bernanke Federal Reserve will respond. Since no one could explain what drove Federal Reserve policy under Greenpsan, responding to market volatility was easy and even expected. All that was needed was a statement that the FOMC was changing. For Bernanke, "exercising this put" means abandoning a carefully crafted policy designed to rein in inflation. Such things are not easy to do. Therefore the Federal Reserve needs overwhelming evidence that action is warranted.

Following in a legend's footsteps is difficult as expectations slowly change. As such, we are still waiting for the Bernanke era to begin.

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