

The Fed's Changing of the Guard

Ben Bernanke, a Federal Reserve governor from 2002 to 2004, became the 14th chairman of the Board of Governors in February. Harvey Rosenblum, the Dallas Fed's director of research and a 35-year veteran of the Federal Reserve, discusses what happens during the transition from one chairman to another.

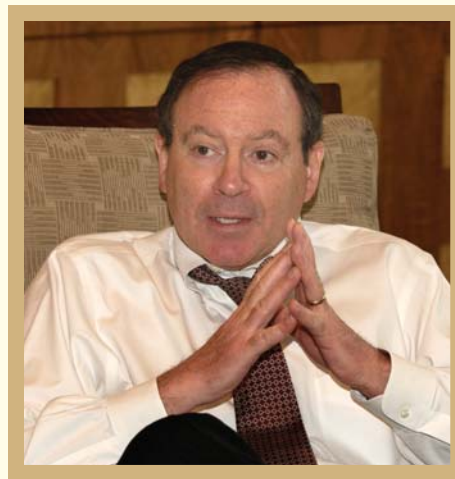
Q: Could you start with some historical perspective about one of the rare events in the public arena—transition at the top of the Federal Reserve?

A: I joined the Fed in 1970, when Arthur Burns had just become chairman. He served eight years. Paul Volcker also served about eight years. In between, G. William Miller served for less than two years, so he's the exception rather than the rule. I've been working for about 18 years now for Alan Greenspan, the chairman with the longest tenure other than William McChesney Martin, who served for 19 years.

So Ben Bernanke is following great chairmen—Martin, Volcker and Greenspan, all of whom are icons in the history of central banking around the world. I left out Burns and Miller because their records as Fed chairmen are somewhat blemished by the inflation records they left behind. Ben Bernanke has been appointed to a full 14-year term as a member of the Board, and given his age, reputation and the nature of the job, I would think there is a high probability he will serve the full 14 years. Of course, his term as chairman is only four years, so future U.S. presidents would have the opportunity to renominate him for that position.

Q: The chairman has one vote, just like every other member of the Federal Open Market Committee. So why is he so important?

A: Sherman Maisel, who served on the Board of Governors from 1966 to 1973, returned to the University of California, Berkeley, and wrote a book called *Managing the Dollar*. It had a little chart of "The Power Within the Fed," based on his



service with Martin and Burns. Maisel gave the chairman 45 percent of the power within the FOMC. He gave another 25 percent to the committee staff because they write the documents that everybody has to react to. It turns out that all the important staff members are directed by the chairman, so give the chairman 70 percent of the power. If anything, under Volcker and Greenspan, I think the chairman's power has actually increased. Considering his influence over the staff and ability to set the agenda and represent the committee before Congress, the chairman probably gets 80 percent of power in the Federal Reserve System. It's an enormous amount of influence. But, yes, at the end of the day, the chairman still has only one vote.

Q: Does a new chairman obtain all the power on his first day, or does he have to earn it?

A: The chairman's power depends on the individual as well as the office. When Greenspan became chairman in 1987, it was obvious that most committee members were used to following Volcker and were very

comfortable with Volcker. They didn't know Greenspan, and they weren't sure they were ready to follow him. So a new chairman doesn't come in with all the power of the one he replaces. He really has only his one vote and the aura that surrounds the chairman. No member of the FOMC reports to the chairman, and he has no ability to set their salaries. He didn't hire them, and he can't fire them. It's only his ideas and his powers of persuasion that allow him to be the leader.

Q: How does a new chairman go about establishing his leadership style and his role on the FOMC?

A: The chairman has to become the intellectual leader of the group, and that is not easy. The FOMC includes several of the country's most renowned macroeconomic experts. With Bernanke, everybody knows him. He served as a governor for roughly three years and quickly established himself as one of the committee's intellectual leaders. Interestingly, I think he became intellectually influential within the committee by giving important speeches on critical topics at just the right time, raising ideas for other committee members to react to and think about carefully *outside* the FOMC meeting. One of his first speeches as Fed governor was on the potential for deflation, and follow-up speeches discussed how the Fed might deal with deflation in a modern financial system. Several of the speeches have actually become somewhat famous.

Q: What's in store for Bernanke in his first FOMC meeting as chairman in March?

A: He's been through this before, but let me walk you through what it's like for the chairman. An agenda is set out and followed—to the letter. The meeting starts with a report from the Open Market Desk of the New York Fed, followed by questions and answers. A staff report analyzes the economy and gives a forecast. Then there's a go-round in which all the members of the committee talk about

*“There is no honeymoon—
not in a financial system like ours.”*



what's going on in the economy. Usually the Federal Reserve Bank presidents go first, adding a district perspective, followed by the governors.

There's usually a coffee break, then another staff report going over the policy alternatives. And then, finally, the chairman gets to speak—after having heard each person's view of what he or she thinks is happening in the economy, with many having set out their views on policy as well. It's an awesome, and at the same time difficult, position to be in. Everybody says the chairman has all this power, but if everybody has already spoken and kind of outlined where they stand, how do you change minds that are already made up? That is the difficulty every chairman faces. Greenspan has somehow managed to go through the last seven to eight years with maybe 10 dissents over the course of 50 to 60 meetings. He's gotten unanimous decisions nearly every time, while still being the last one to weigh in on where he thinks the economy is going and what the right policy prescription is.

Q: Is that kind of unanimity unusual?

A: As I look back on it, the chairman is in a very powerful position because people are reluctant to challenge the chairman's position. That doesn't mean they won't. Volcker was once on the losing end of a 4–3 vote on the discount rate. There were a few close votes at other FOMC meetings, with Volcker on the winning side—but just barely. In recent years, we've gotten very used to unanimity. People have been following Greenspan—they're under no compulsion to necessarily follow Bernanke just because he is the chairman.

Q: How does the current transition compare with previous ones?

A: Every transition is different. In some ways, Bernanke's is similar to the handoff from Volcker to Greenspan. Volcker had stomped down hard on inflation. So Greenspan inherited an economy that was

functioning reasonably well, with reasonably low inflation, and a committee united behind the goal of combating the inflation devil.

Bernanke will inherit a similar kind of economy, but the Federal Reserve has been going through a tightening cycle. Whenever the Fed tightens, whatever financial fragilities there are in the economy are going to get exacerbated. It's possible Bernanke will encounter some financial vulnerabilities that were not necessarily of the Fed's making, but the higher short-term interest rates will adversely impact some industries that are sensitive to high interest rates. At the same time, the yield curve is flat and actually has the potential to invert. An inverted yield curve has often been a precursor to a recession occurring within a year.

Q: The transition from Volcker to Greenspan was smooth, but what about the arrival of Volcker?

A: Well, Volcker was the right person in the right place at the right time. He came from within the Federal Reserve System—he was president of the New York Fed—and he understood the task at hand. Inflation had crept up from 3 percent in the early 1970s to about 13–14 percent at the end of the decade. Volcker knew what had to be done—and he did it. He showed remarkable focus—as far as he was concerned, the Fed's only job was controlling inflation. It was a difficult time for the Fed. It was necessary to run the federal funds rate up near 20 percent.

It's hard for businesses to operate at those kinds of interest rates. The monetary policy of the day meant hardships for the automobile industry and the housing industry. It wreaked havoc on the savings and loan industry. Was it worth it? I think the answer is yes. If you look at the economy since about 1983–84, once inflation was beaten down, you see the most stable period for the

economy in U.S. history. We've had healthy and stable economic growth, and we've had very stable and fairly low inflation. We've had only a few months of recession. So I think it was worth it in the long run. But as you went through it, you weren't sure it would be worth the cost.

Q: Despite the smooth transitions, didn't Greenspan have his mettle tested early in his tenure?

A: Quite early in his tenure, and right here in Dallas, by the way. He had come to give a speech to the American Bankers Association, which was scheduled for a Tuesday morning. He flew in on Monday evening, Oct. 19, 1987. The stock market had fallen 508 points that day, or roughly 20 percent—a record decline that still stands. Greenspan quickly decided what to do. The very next morning, he issued a press release stating that the Fed stood ready to lend to support the economic and financial system. He took immediate action, going through the necessary cuts in the federal funds rates to add liquidity to the system. It established his reputation as being quick, decisive and doing the right thing at the right time. As soon as the market recovered somewhat, monetary policy got back on its long-term track of fighting inflation.

Q: So the new chairman is not guaranteed a honeymoon?

A: There is no honeymoon—not in a financial system like ours, not in this country where people are free to take risks and reap the consequences.