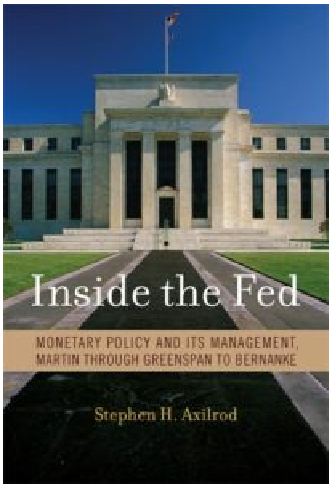

Book Inside the Fed

Monetary Policy and Its Management, Martin through Greenspan to Bernanke

Stephen H. Axilrod
MIT Press, 2009

Recommendation

Stephen H. Axilrod, a former top-level executive at the US Federal Reserve System, has written a dense first-hand report on the Fed's inner workings and its policy development procedures. From the vantage point of his 30-year career at the Fed, he presents a detailed account of working closely with Fed chairmen William McChesney Martin, Arthur Burns, G. William Miller and Paul Volcker, along with astute observations about the tenures of Alan Greenspan and Ben Bernanke. Axilrod discusses how these distinct personalities tackled problems and made policy decisions. Given its slow pace and historical recollections about central bank operations – many of them inscrutable to the average reader – *BooksInShort* recommends this look back to serious Fed observers who relish anecdotes about life inside the US central bank.

Take-Aways

- The Federal Reserve Act created an independent central bank responsible to Congress.
- Before inflation raged in the 1970s, the Fed and its chairmen received little attention.
- While the media portray the chairman of the Fed as the US's second most powerful person, the Fed's Board of Governors wields the real policy-making clout.
- The chairman's main influence comes from his leadership, charisma and craft in maneuvering through thorny economic, social and political thickets.
- William McChesney Martin consolidated the Fed's power in Washington in the 1960s.
- Arthur Burns, the first economist to run the Fed, didn't think that monetary policy affected the business cycle.
- G. William Miller, a corporate CEO, did little to fight inflation in his 18-month tenure.
- With forceful leadership and a strong hands-on attitude, Paul Volcker instituted a historic "practical monetarism" that beat inflation in the 1980s.
- Alan Greenspan is an economic conservative who thrived on data and statistics.
- Ben Bernanke "represents a generational shift in leadership" at the Fed. During the 2008 crisis, he led an unprecedented effort to shore up the financial system.

Summary

The Ultimate Insider

An economist by training, author Stephen H. Axilrod worked at the Federal Reserve System in Washington, DC, from 1952 to 1986. In various roles with the Fed's Board of Governors, Axilrod collaborated closely with Fed chairmen William McChesney Martin, Arthur Burns, G. William Miller and Paul Volcker. Under Burns, Miller and Volcker, Axilrod was the monetary-policy point man actively engaged in the fight against inflation that began in the 1970s. Axilrod continued his study of monetary policy development when he left the Fed to work in the private sector. Based on his Fed experience and trained eye, he followed the tenures of subsequent chairmen Alan Greenspan and Ben Bernanke. Each Fed leader brought his personal style and character to the chairmanship, a role that often must carefully straddle politics and economics.

The Fed

The Board of Governors, along with 12 Federal Reserve Banks in various US cities, make up the Federal Reserve System established under the Federal Reserve Act of 1913. An autonomous body, the Fed is "independent within the government." Because it is responsible to Congress, it is often under legislative scrutiny.

> "A central bank is in effect a deus ex machina that...stands outside the financial system...and thus can act as a sure lender of last resort when all else is failing."

While the press now regularly portrays the Fed chairman as the nation's second most powerful leader, this was not the case when Axilrod began his career. At that time, few economists and investors tracked the Fed or its policies. The central bank remained largely out of the public's eye – that is, until inflation rose and Volcker set aggressive policies to tame it. Nonetheless, the public mistakenly projects too much clout onto Fed chairmen, who hold four-year terms. The chairman's main influence comes from his management and leadership capabilities, charisma, and craft in maneuvering through thorny economic, social and political thickets.

> "A chairman can have an outsized impact on policy, especially at crucial times, if he has sufficient nerve, internal credibility and a kind of unique 'artistic' feel."

The reality is that all seven appointed members of the Fed's Board of Governors (members serve 14-year terms) wield the real policy-making power through their votes on specific actions. They focus on managing inflation and economic growth, yet the causal relationship between the Fed's monetary activities and their impact on prices and economic growth is difficult to ascertain.

> "The immense power of monetary policy resides, of course, not in the individual chairmen, but in the institution of the Fed itself."

The Federal Open Market Committee (FOMC) implements monetary policy through its open market operations in US government securities and other instruments. The Fed has a huge balance sheet, and these operations, which directly affect bank reserves and bank lending, are the source of its singular power. The FOMC has 12 voting members: the chairman, the six Board of Governors members, the president of the Federal Reserve Bank of New York, and four of the 11 other regional Reserve Bank presidents, who take turns in the role. The group traditionally names the Fed chair to head the FOMC and the New York Fed president to serve as vice chairman.

Martin and Monetarism

Before he became Fed chairman in 1951, William McChesney Martin had pushed through post-Great Depression stock market reforms during his time as president of the New York Stock Exchange. As Fed chairman, Martin sought to lessen the big New York banks' influence over financial markets. In the 1960s, he shifted functional power from the New York Fed to the Board of Governors in Washington, DC. In the postwar period, the New York Fed had exercised more sway because of its central role in open market operations.

> "Chairmen can become powerful to the extent they can influence the votes of their policymaking colleagues."

In 1965, the Fed's "blue book" – an analytical report that sets out money supply and interest rate data to help the governors determine whether the Fed should tighten, ease or maintain "money-market conditions" – came into being under Axilrod's supervision. The blue book presents the FOMC's directives clearly to the New York Fed's operations manager, who then must implement them. Because the Fed staff in Washington first prepared this book – and does so to this day – its advent consolidated authority at the national Fed headquarters.

> "The Fed is essentially a creature of the Congress...the president clearly is secondary in importance for the Fed."

Monetary policy – the close monitoring and manipulation of the money supply as a tool to influence economic activity – took on greater importance under Martin. Up to then, the Fed had focused more on interest rates, albeit with imprecise tools. However, the early, inexact use of monetary policy drew criticism. Economist Milton Friedman, for one, thought the Fed should follow a strict rules-based program to increase or decrease the money supply at a predetermined rate, as opposed to a judgment-based approach in response to the Fed's observations of economic conditions. The rigid methodology favored by monetarists like Friedman would theoretically eliminate the lag in response time from when the Fed noted changes in the business cycle to when it acted to adjust the money supply.

> "Faced with an ever-changing and politically complex economic world, policymakers at the Fed and at other major central banks have...steadfastly maintained a judgmental approach to policy."

The Fed began adopting this approach during Martin's tenure, though its implementation was difficult and complex. The policy failed to account for many unknown variables in the economy, markets, politics and society. These monetary explorations, which began in the 1960s, became more intense in the 1970s and 1980s as inflation gained momentum.

Burns "Inside the Box"

During Burns's 1970-1978 tenure as Fed chairman, average inflation grew to 7.5%, three times what it had been a decade earlier. A weakening dollar fueled that inflation and led to the 1971-1973 "devaluation crisis," which delinked the value of the dollar from the price of gold. The Arab oil embargo and the ensuing 1973-1974 oil shock added to the US's economic troubles. World events made it challenging for the Fed to maintain economic and employment growth while keeping prices from accelerating. While Burns paid more attention to the money supply as an operational lever than his predecessors did, he was not convinced it was an effective tool.

> William McChesney Martin was "something of an artist in policy, a man with an intuitive sense, and perceived...as fundamentally fair."

Burns was a conservative, cautious man – and the first Fed chairman who was a professional economist. Burns, who specialized in business-cycle analysis, did not believe that the money supply alone affected the business cycle – especially in the short run, . This view clashed with the ideas of his friend Friedman, a champion monetarist. Burns's wary nature kept his inflation-fighting actions modest and, as a result, he succeeded in merely moderating inflation's growth. Due to Burns's perceived inability to control inflation, President Jimmy Carter did not reappoint him when his term as chairman ended in 1978.

> "Arthur Burns was very unfortunate in the particular decade, the 1970s, where fate placed him as chairman of the Fed."

Burns's successor, G. William Miller, did little to cast the Fed as a serious inflation fighter. A former CEO of Textron, a corporate conglomerate, Miller did not feel comfortable debating monetary policy, sharing diffused decision-making authority or maneuvering the Fed bureaucracy. During his 18 months in office, he also faced a dollar crisis. The Fed began issuing foreign currency bonds – "the infamous Carter Bonds" – to stabilize the exchange markets. Ultimately ineffective, this politically risky intervention gave the impression that the US was not able to defend the dollar.

Volcker Attacks Inflation and Wins

The next Fed chairman, Paul Volcker, realized that rising inflation and the declining dollar called for aggressive action. He also faced the task of restoring the Fed's damaged credibility. He relied on his technical expertise to push for internal changes, including new open market operating procedures and a stronger emphasis on monitoring daily money supply statistics and aggregate reserves. In public, Volcker was a strong, imposing leader: exceptionally qualified for his role, unafraid to take action and supremely knowledgeable about Fed operations. In private, however, he was timid and "almost insecure."

> G. William Miller "was an extremely smart and able man, but central banking...just did not grab him where he lived."

In 1979, Volcker instituted "a paradigm shift" in monetary policy: The Fed would focus strictly on a targeted growth rate in one aspect of the money supply and not concern itself with managing interest rates. Volcker accomplished this historic "practical monetarism" with tremendous leadership and a strong hands-on attitude. He convinced the markets that he was serious about taming inflation, and he promised that "the Fed would stick to preset monetary rates without regard to the consequence for interest rates." But he and the policy got off to a difficult start. Interest rates shot up, and, at one time, the federal funds rate hit 20%.

> "On the public stage...Volcker the actor was in full display. He was totally in command of himself and the subject matter. He spoke with force and conviction."

This new approach to fiscal management popularized a new occupation: "Fed watchers," market specialists who tried to predict money-supply data. The new policy also attracted the attention of global central bankers, especially the Bank of England, which feared Prime Minister Margaret Thatcher would push for more direct control over its monetary operations. Volcker's targeted money supply policy – while hard to implement – had a clear purpose: raise interest rates quickly to curb inflation. The rationale was that the longer inflation raged, the more entrenched it would become.

> "Because Greenspan was such an avid consumer of data...I suspect that he believed his economic insights stemmed more from analysis than from gut instinct."

Still, some Board of Governors members pressed for reductions in a key interest rate, prompting a rare confrontation in February 1986 between four Reagan appointees and Volcker. The board overruled Volcker and passed the rate reduction. He was incensed; rumors swirled that he was considering to resign. After some behind-the-scenes politicking – since the Reagan administration couldn't afford to lose Volcker – the board voted the same day to reverse the rate cut.

Greenspan from the Outside

Greenspan arrived at the Fed in August 1987. He had built his reputation as a forecaster and business consultant. Though he was no ideologue, Greenspan was an economic conservative who favored less-regulated markets dominated by the private sector. While he remained objective about policies and the economy in his role as Fed chairman, he did use his influence to support specific political positions on tax reductions and on curtailing government involvement in markets and the economy. Greenspan approached his job with genuine curiosity and zeal, along with an abiding fascination with data and statistics. He also was one of the first to recognize the impact of information technology on economic growth and productivity.

> Ben Bernanke "will probably come to be judged mainly by the...deployment of the Fed's full panoply of power during the unusually threatening credit crisis of 2007-2008. I would say he rose to that occasion."

Under Greenspan, the Fed began to release reports of FOMC meetings two weeks after they occurred, instead of the previous six or seven weeks. This accelerated schedule appealed to Fed watchers, yet the intent and specificity of this information always remained open to interpretation. Greater transparency produced mixed results. After Greenspan made his famous comment about the stock market's "irrational exuberance" in December 1996, the Fed failed to tighten monetary policy or raise interest rates to inhibit market growth. Either of these steps would have curbed market speculators, but Greenspan subsequently declared the economy was enjoying a productivity spurt, which fueled only more enthusiasm. Critics later accused Greenspan of ignoring the developing asset bubble and instead focusing on promoting economic growth.

> "In the end, the innovative measures eventually put in place by the Fed were path breaking."

In late 1998, the massive Long-Term Capital Management (LTCM) hedge fund collapsed. The failure jolted the markets, and the Fed facilitated meetings among private sector investors to unravel the situation. At about the same time, the Fed eased rates, a move the market considered favorable to resolving the LTCM debacle. To some, this signaled that Greenspan was encouraging institutions to take more risk with the expectation that they would receive federal government help if they ran into trouble. It also appeared to run counter to Greenspan's long-held belief that the private sector should resolve its own issues without government interference.

> "In the last analysis, the immense power of monetary policy resides...not in the individual chairmen but in the institution of the Fed itself."

In mid-2004, the Fed signaled it would gradually begin raising short-term interest rates. That gave markets the impression that rates would remain low for a long time, which encouraged the speculative expansion in real estate and contributed to the 2008 financial crisis. By then, economist Ben Bernanke had assumed the Fed chairmanship.

Bernanke "represents a generational shift in leadership." His handling of the 2008 crisis and the subsequent credit crunch marked an unprecedented use of the Fed's authority to shore up the financial system. However future historians will judge his term in office, one thing is clear: The Fed and its leaders will always have to deal with novel and unanticipated situations.

About the Author

Stephen H. Axilrod rose to Staff Director for Monetary and Financial Policy, and Staff Director and Secretary of the Federal Open Market Committee, at the US Federal Reserve System. Since 1986, he has worked in the private sector.