FEDERAL RESERVE
Taking Charge

BY TIM SABLIK

How much does the Fed's success depend on who's at the helm?

On Feb. 3, Janet Yellen became the 15th chair of the Federal Reserve Board, a position that has been called the second most powerful in the country. Her immediate predecessors — Ben Bernanke, Alan Greenspan, and Paul Volcker — have become household names. Financial reporters scrutinize the chair's every word for indications of future monetary policy; in Greenspan's day, they even went so far as to analyze the thickness of his briefcase as he headed to meetings of the Federal Open Market Committee (FOMC). "Every time I expressed a view, I added or subtracted 10 basis points from the credit market," he said in a 2012 interview.

In the eyes of the public, the Fed chair may have the first and last word when it comes to monetary policy. But the chair is just one member of a 12-person monetary committee that, for much of its history, has determined monetary policy using various rules and guidelines. (See "Playing by the Rules," *Econ Focus,* Second Quarter 2013.) In this setting, how much does one person really matter?

Sometimes, at least, the answer is clearly "a lot." For example, many economists predicted that surging economic growth and falling unemployment in the late 1990s would spark inflation. Several members of the FOMC advocated raising interest rates to prevent this, but Greenspan was convinced that the economic growth and increased employment were due to productivity gains that would counteract normal inflationary pressures. Under his leadership, the Fed may have avoided increasing interest rates unnecessarily, and the economy continued to grow without the inflation others had feared.

This episode illustrates the outsized influence the Fed chair can exert over policy decisions, an influence that has been documented by University of California, Berkeley economists Christina and David Romer. In a 2004 *Journal of Economic Perspectives* article, they found that the Fed's response to inflation tends to reflect the views expressed by Fed chairs both before and after they take office. In particular, the Fed's responses to crises and outside pressure have often depended foremost on its leaders.

Former Fed Chairman Paul Volcker speaks to a group of people gathered to protest high interest rates outside the Board in Washington, D.C., on April 14, 1980. Volcker's inflation-fighting policies caused hardship for many workers, but he argued that the long-run benefits were worth the short-term costs.

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Intellectual Leadership

During the height of the financial crisis of 2007-2008, many people feared that another Great Depression was on the horizon. Some were comforted, then, with the knowledge that the chair of the Fed at the time was a scholar of the Depression. Bernanke had foreshadowed his resolve to avoid the central bank's mistakes during the Depression in a 2002 speech he made as a Fed governor. Speaking at a conference to honor Milton Friedman, who along with Anna Schwartz first argued that the Fed's failure to act aggressively had exacerbated the Depression, Bernanke said, "Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again."

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Bernanke's study of history may have convinced him that drastic times call for drastic measures. During the 2007-2008 financial crisis, he led implementation of some of the most dramatic policies that central banks have ever seen. The Fed provided large doses of liquidity to the market by invoking emergency provisions of the Federal Reserve Act not touched since the Great Depression. Bernanke also drew upon his knowledge of Japan's experience with deflation in the 1990s, its so-called "lost decade," when interest rates fell to zero. The Fed communicated a commitment to keeping rates low for an extended period and conducted quantitative easing, buying assets such as mortgage-backed securities in order to stimulate the economy. It is still too early to evaluate how successful these measures were, whether they continued past their effectiveness, or whether the decision to involve the Fed in the allocation of credit will ultimately prove problematic, but the United States did avoid a second Great Depression.

While Bernanke helped guide the Fed's extraordinary response to the financial crisis, the Fed's response to the Great Depression itself was less focused. Leadership in the early Fed was much more decentralized, with each district bank viewed as largely autonomous. Reserve Bank leaders were actually in charge of implementing monetary policy, and the Board and its chair played more of advisory role. The New York Fed took an early leadership role in the System, thanks both to the disproportionate size of the financial sector within its jurisdiction and to the experience of its first leader, Benjamin Strong.

In the eyes of his contemporaries, Strong was born to lead the central bank. A successful and respected banker prior to joining the Fed, he first rose to prominence at the Bankers Trust, a private "banker's bank" that filled a role similar to that of the future Fed. During the Panic of 1907, Strong was instrumental in extending credit to troubled firms. His experience quickly elevated him to a position of leadership at the Fed.

"Strong had high intellectual ability and a knowledge of central banking far superior to that of his colleagues," wrote Lester Chandler, an economist at Princeton University and author of Strong's biography. "As some of his former associates put it, 'We followed him because he knew so much more than any of us.'"

In the 1920s, Strong recognized the potential to use open-market operations — the purchase and sale of Treasury bonds — to provide liquidity in times of crisis. The Fed used such operations in 1924 and 1927 to alleviate recessionary pressures. Strong argued that the Fed's role should be to ensure that "there is sufficient money and credit available to conduct the business of the nation," while at the same time making sure there was not excessive credit to fuel inflation. While many bank leaders deferred to Strong's experience, the Board bristled at what they viewed as a usurpation of power by New York.

When Strong died in 1928, members of the Board saw their opportunity to reclaim the leadership role they felt rightly belonged in Washington. According to Friedman and Schwartz, his death was poorly timed. They wrote: "If Strong had been alive and head of the New York Bank in the fall of 1930, he would very likely have recognized the oncoming liquidity crisis for what it was, would have been prepared by experience and conviction to take strenuous and appropriate measures to head it off, and would have had the standing to carry the System with him."

While other economists such as David Wheelock of the St. Louis Fed and Allan Meltzer of Carnegie Mellon University have disputed this claim, there is little doubt that the Fed's response to the Depression lacked coordination. In a 2006 working paper, Gary Richardson, the Federal Reserve System historian and an economist at the University of California, Irvine, and William Troost, also at Irvine, studied the outcomes of different policies taken by the Atlanta and St. Louis Feds. They looked at bank failures in Mississippi, the lower half of which is in Atlanta's district and the upper half of which is under St. Louis' jurisdiction. During the first 18 months of the Depression, the Atlanta Fed followed a policy of lending freely to financial institutions during crises, while the St. Louis Fed ascribed to the view that the central bank should allow the supply of credit to contract during recessions. Richardson and Troost found that Mississippi banks in Atlanta's district failed at a much lower rate than those in St. Louis' district, suggesting that coordinated lending by all 12 banks, something Strong would have likely favored, could have mitigated bank failures in the Depression.

Standing Up to Pressure

Economists now widely recognize that a central bank can most effectively pursue goals of price stability and sustainable employment if it is independent. But for much of its early history, the Fed faced pressure from Congress and the White House to use monetary policy to foster politically attractive short-term goals. Despite having its independence recognized with the Treasury-Fed Accord of 1951, the Fed continued to face such pressure for decades after. The task of defending the Fed's independence during this time fell predominantly to the Fed chair.

As the first post-Accord chair, William McChesney Martin appeared to have been chosen to limit the central bank's new independence. He had served under President Harry Truman as the chief negotiator for the Treasury during the Accord debates. Some Fed officials feared that Truman had appointed Martin to keep the Fed sympathetic to his interests. Martin proved otherwise, however. He believed that the Fed's primary mission was to "lean against" the forces of inflation and deflation, which required the ability to independently determine monetary policy. He recognized that the Fed was a political creation, and as such was accountable to Congress, but he believed monetary policy would be most effective if it were independent from the executive branch.

During his nearly 20 years in office, he would face no shortage of attempts by presidents to change his mind. Under President Dwight Eisenhower, Martin faced pressure to ease rates ahead of the 1956 election. Martin refused to do so, and Ike backed down and publicly supported the Fed's independence. In the 1960s, President Lyndon Johnson pressured Martin to keep rates low as spending on the Vietnam War and Great Society ramped up. But to Johnson's dismay, Martin proved largely immune to such tactics. When the chairman announced a rate increase in December 1965, Johnson was furious that he had ignored his request to wait until after the new budget was released in January. While such actions earned him the ire of presidents, Martin's collegial style and defense of monetary independence helped garner the support of his colleagues.

"Martin was an iconic figure throughout the Fed — an extremely popular leader," says Al Broaddus, who served as the Richmond Fed president from 1993 to 2004. He first joined the Richmond Fed as a research economist in 1970, Martin's last year as chair.

Despite Martin's efforts, the central bank faced increasing political pressure in the late 1960s and 1970s as growing deficits and inflation limited the effectiveness of fiscal policy. "As it became really hard to tamp down on spending, fiscal policy became less and less reliable as a tool, and monetary policy became the only game in town," says Donald Kettl, dean of the University of Maryland's School of Public Policy and author of *Leadership at the Fed*.

Much of the increased pressure fell on Martin's successor, Arthur Burns. Burns had served as the head of the Council of Economic Advisers under Eisenhower and as an adviser to President Richard Nixon. When Nixon appointed Burns to the chair, he made no great secret of his assumption that Burns would guide monetary policy with the administration's best interests in mind. On the day Burns took office, Nixon joked: "I respect his independence. However, I hope that independently he will conclude that my views are the ones that should be followed."

"He was an intensely political person," Broaddus says of Burns, "and he served as chairman during a period in which the Fed was probably as fully politicized as any time in its history."

While Burns proved more recalcitrant than Nixon had hoped, his decisions were largely in line with the administration's wishes. Burns later argued that his hands were tied by the circumstances of the time. He feared that the Fed's monetary authority would be stripped by Congress and given to the Treasury if he resisted political demands too much. In a speech after leaving office, he lamented that "philosophic and political currents" had created a bias for inflation that made it infeasible for the Fed to pursue tighter policy.

Burns is not alone among Fed chairs in having been influenced, on some level, by the president or by shared party affiliation with the president. In a 2006 paper, Burton Abrams of the University of Delaware and Plamen Iossifov of the International Monetary Fund found that the political affiliation of the chair does influence Fed policy. Their research shows that when the Fed chair shares the same partisan affiliation as the incumbent president, monetary policy becomes significantly more expansionary in the seven quarters leading up to election, though this effect has greatly moderated over time. The evidence also suggests that monetary policy during Burns' chairmanship, in particular, followed this pattern.

The public perception of Burns' political connections damaged the Fed's credibility as an independent bulwark against inflation. It would fall to his successors to rebuild it.

Setting Expectations

President Jimmy Carter chose G. William Miller to replace Burns in 1978. A corporate CEO whose only central banking involvement was as a director of the Boston Fed, Miller was largely unknown both within the Fed and in the broader financial community. It soon became clear that he was out of his element as a central bank leader, and Carter shifted him to secretary of the Treasury after little more than a year.

In contrast, Paul Volcker, Carter's choice to succeed Miller, was well-known before he became Fed chair. Volcker moved between the public and private financial sectors in the 1950s and 1960s, starting as an economist at the New York Fed and later joining the Treasury, where he eventually became undersecretary for monetary affairs. He returned to the New York Fed as president in 1975. As a public figure, he was difficult to miss, thanks to his towering height, bald head, big glasses, and penchant for smoking cigars. Volcker's wealth of experience in both public and private finance gave markets cause for optimism when his appointment was announced. Still, inflation would not be fixed instantly.

"I think the perception is that Volcker came in, took over, and fixed everything overnight," says Broaddus. "That's not exactly what happened."

Volcker recognized that inflation depended in part on expectations of future price increases. During the 1970s, the public had come to doubt the Fed's commitment to tame inflation in the face of political pressure to ease, and that factored into expectations. Volcker wanted to signal the Fed's commitment to controlling inflation, but in the days before 24-hour news coverage and post-FOMC press conferences — the latter began only in 2011 — relaying that message would be tricky. He decided that a dramatic shift in policy would show that the Fed was taking inflation seriously. That shift came on Oct. 6, 1979, when the Fed announced that it would begin aggressively controlling the money supply, allowing interest rates to move freely until inflation came under control.

While the public wanted to reduce inflation, Volcker needed to convince them that eliminating it would be worth the pain of severe recessions in the short term. As unemployment mounted in 1980, protesters marched on the Board in Washington. Volcker, meeting the crowd, sympathized with their hardship, but he stressed that inflation had to be dealt with for their long-term benefit and the Fed would not back down from that mission.

"There were death threats and homebuilders were coming into his office carrying symbolic two-by-fours," recalls Broaddus. "But once Volcker made up his mind that inflation had to be brought under control once and for all, he pursued it with courage. He knew he wasn't going to be popular."

His tenacity paid off. As the public watched Volcker weather biting criticism from legislators during congressional testimony without giving an inch, they came to believe that the Fed under his leadership would resist political pressure to control monetary policy. By 1983, inflation was beginning to subside and Volcker's policies seemed to be paying off. At his reappointment hearings, he was receiving letters of support from the public rather than death threats.

"Volcker personified the Fed in a way that few chairmen ever have before or since," says Kettl. "He exuded a sense of determination and created an expectation that the Fed's policies were going to continue and that inflation wasn't going to reignite."

When Volcker stepped down in 1987, many wondered if anyone would be able to fill his shoes. His successor, Alan Greenspan, certainly had experience monitoring the financial markets, having headed up an economic consulting firm for three decades. It was his public service record that gave some observers cause for concern. Greenspan had long been active in Republican politics and chaired the Council of Economic Advisers under President Gerald Ford, invoking memories of Burns' political ties. In fact, Greenspan had been Burns' student at Columbia University. Many speculated Greenspan would be more politically accommodating than Volcker.

But he was quick to signal to the public that he would maintain the fight against inflation begun by his predecessor. Shortly after becoming chair, Greenspan earned the market's confidence with his deft response to the stock market crash of October 1987, and he demonstrated his political independence by not lowering interest rates ahead of the 1992 election. President George H.W. Bush later blamed Greenspan for his loss to Bill Clinton. Public confidence in Greenspan's stewardship of the economy grew throughout the 1990s, leading to his moniker "the Maestro." Although he developed a reputation for being inscrutable, Greenspan actually presided over major expansions in Fed transparency, such as announcing federal funds rate changes for the first time in 1994.

"Greenspan wasn't a transparency activist, but I give him a lot of credit for allowing and permitting progress toward greater transparency," says Broaddus.

Ben Bernanke would take up the transparency cause when he succeeded Greenspan in 2006. He oversaw the evolution of FOMC press releases to include an explicit inflation target, and he held the first post-FOMC press conference to further explain the committee's actions to the public. Upon leaving office, Bernanke cited transparency as a key part of his legacy. Janet Yellen, who played a key role in transparency initiatives as vice chair, has publicly stated her intention to continue that legacy.

Given the chair's visibility in communicating monetary policy to the public, testifying before elected officials, and responding to crises, it is easy to think of the Fed as a single-headed entity. But the chair serves as part of a committee that determines monetary policy, and that committee is not obliged to share the chair's views. The Board outvoted Volcker on an interest rate cut in 1986, nearly prompting his resignation. Even so, such overrulings are extremely rare, and the chair's importance as a leader for the Fed is undeniable.

"When push comes to shove and there's a late night crisis meeting, it's the Fed chair who takes part in those discussions," says Kettl. "When it comes time to make public pronouncements, it's the Fed chair who makes them. The Fed has changed, but I think the role of the chair as a leader is as important now as it has ever been." **EF**

Readings

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