The Monetary Realist

Landing the Reverse Greenspan

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Central bankers should be evaluated much like Olympic gymnasts, figure skaters, and platform divers—that is, they should get marks for landing their policy moves properly and for technical proficiency, but also for the degree of difficulty in execution. Unlike the controlled environments under which these athletes compete, however, central bankers are exposed to a host of political and economic winds as well as a great deal of uncertainty about underlying conditions. To earn a gold medal in monetary policymaking, the central banker has to compensate for these factors and still land the economy where the public expects it.

By common assent, Alan Greenspan's performance that earned a perfect score was his success in getting the Fed to hold off raising interest rates when U.S. productivity and investment surged in 1995–97. There was no question in theory that a sustained productivity improvement would mean the economy could grow faster without generating inflation—the brilliance of the move began with Greenspan's early recognition that there was a rise in the U.S. productivity trend in reality, a feat of technical mastery.

Adding to the degree of difficulty were the risk involved of inflation rising, the possibility of his productivity forecast being incorrect or even just slow to pan out, and the understandable reluctance of many members of the FOMC to hold back from tightening policy when standard macroeconomic indicators suggested they should. Yet Greenspan pulled off the policy move politically and economically, and the American economy landed gracefully with higher growth rates and lower inflation.

All central banks have since added "the Flying Greenspan" jump—holding off interest rate increases in response to forecast improvements in potential growth—to their practice repertoire, but only a handful have been brave enough to attempt it in competition. The cleanest example was probably the Bank of England's decision in the early 2000s to take seriously the inflow of low-wage workers from eastern Europe as a damper on wage inflation and let the British expansion extend as a result.

Both the European Central Bank and the Bank of Japan are currently facing possible opportunities to execute their own versions of the move, depending upon their risk tolerance for inflation and their assessments of their economies' underlying growth trends. What these central banks share is a common emphasis on the technical proficiency aspect of the maneuver, that is, the research and forecasting challenge of determining whether productivity growth has risen and/or the NAIRU has fallen. There is little political headwind, though, since it is almost universally popular in low-inflation countries when central banks are slow to tighten.

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Ben Bernanke and his colleagues, however, face a more daunting prospect than just emulating his predecessor's signature move. Bernanke will have to land the "Reverse Greenspan"—holding off on cutting rates because of a forecasted fall in trend productivity growth. Clearly, this will require less risk-taking as a technical matter, for the Fed and its staff have been focused on productivity trends in the United States since the path-breaking impact of Greenspan's foresight in this area. Already, there are clear indications from the Fed's studies and FOMC minutes that trend labor force growth has declined, and the rate of U.S. productivity growth has fallen back from its blistering pace during the 2001–05 boom to that of the late 1990s.

The degree of difficulty for Bernanke executing the Reverse Greenspan successfully will nonetheless be higher, precisely because it is a reverse of the popular previous move. This shows up in two ways. First, obviously, a Reverse Greenspan means bearing bad rather than good news about the U.S. economy and doing the responsible but unpopular thing of keeping rates higher than they would have been expected to be in the absence of that news. While there is little political resistance to so doing within the current FOMC, it could become an issue with Congress and during the upcoming presidential election as mortgage problems spread and growth slows.

Second, the impact of monetary policy is determined in part by how anchored long-term inflation expectations remain. If expectations are sticky, monetary policy need not react aggressively to every short-term fluctuation in inflation. If the slowdown in productivity growth is not recognized by U.S. wage and price setters, however, that puts the stability of U.S. long-term inflation expectations at risk from price shocks—in which case the Fed may have to raise rates to re-anchor expectations, not just postpone cuts, even if the straight-up forecast suggests no need to do so. Judging the politics and economics of when and how much to preempt erosion of inflation expectations' persistence is something for which there is no simple formula, and from which the positive supply shocks of the 1990s spared the Greenspan Fed. The stage is set for a new gold medal performance if the Bernanke Fed can land the Reverse Greenspan. ◆

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