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THE GREENSPAN ERA: DISCRETION, RATHER THAN RULES

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ABSTRACT

What stands out in retrospect about U.S. monetary policy during the Greenspan Era is the ongoing movement away from mechanistic restrictions on the conduct of policy, together with a willingness on occasion to depart even from what more flexible guidelines dictated by contemporary conventional wisdom would imply, in the interest of carrying out the Federal Reserve System's dual mandate to pursue both stable prices and maximum employment. Part of this change was procedural – for example, the elimination of money growth targets. The most substantive demonstration of policy flexibility came in the latter half of the 1990s, as unemployment fell below 6% (in 1994), then below 5% (in 1997), and then remained below 5% for more than four years, yet the Federal Reserve did not tighten monetary policy. This policy stance was consistent with a view of the economy, including faster productivity growth and increased exposure to international competition, that Chairman Greenspan had articulated nearly a decade before.

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> Policy rules ... anticipate that key causal connections observed in the past will remain fixed over time .... But we have found that very often historical regularities have been disrupted by unanticipated change .... The evolving patterns mean that the performance of the economy under any rule, were it to be rigorously followed, would deviate from expectations.... In an ever changing world, some element of discretion appears to be an unavoidable aspect of policymaking.
>
> Alan Greenspan[1]

The Greenspan era (1987-2006) has been a good period for both the practice and the product of monetary policy in the United States. Of the two, outcomes are of course easier to measure. Price inflation has been mostly low and consistently stable. The mean inflation rate in the four years ending in 1987 was 2.9% per annum; in the four years ending in 2005 it was 2.3%.[2] The volatility of output and employment has likewise been limited by historical standards with two business recessions, both short and both of modest magnitude, over eighteen years. The 1990-1 downturn lasted just eight months, and unemployment peaked at 7.8%; the 2001 downturn likewise lasted eight months, and unemployment peaked at 6.3%. Market interest rates have shown little volatility as well, and the nation's financial markets weathered both the collapse of the thrift industry in the late1980s and the 2001-3 stock market decline with little sense of real threat to either the functioning of markets or the integrity of well-managed institutions.

Changes in the practice of monetary policy are harder to document, although some changes made during these years are also easily visible. Most obvious, perhaps, have been steps toward increased transparency of the central bank's actions. As of 1987 the policy directive adopted at each meeting of the Federal Open Market Committee was released to the public only after the elapse of three months, and even then the public statement contained no explicit reference to any specific level of the federal funds rate that the Committee sought to impose. Today a brief statement indicating the Committee's decision, including the specific interest rate target just adopted, is regularly issued at the conclusion of each meeting, with the release of edited minutes following after only three weeks.

The more important change in policy practice, however – indeed, what stands out from the Greenspan era as a whole, in retrospect – has been the ongoing movement away from mechanistic restrictions on the conduct of monetary policy, together with a willingness on occasion to depart even from what more flexible "guidelines" dictated by contemporary conventional wisdom would imply, in the interest of carrying out the Federal Reserve System's dual mandate to pursue both "stable prices" and "maximum employment."[3]

Although the Federal Open Market Committee had stopped setting a growth target for the narrow M1 money stock after 1986, the Committee was, at least as a formal matter, still formulating policy in terms of a targeted growth rate for the broader M2 aggregate when Alan Greenspan assumed the chairmanship in 1987. There is also evidence that in the late 1980s the money growth target was not a mere formality, but rather played a significant role in influencing the Committee's setting of the federal funds rate.[4] That influence steadily waned, however, and in 1993 the Federal Reserve publicly announced that the Committee had "downgraded" its M2 target. Thereafter the Committee continued to set a "range" for M2 growth (and M3 as well, along with a credit aggregate), but it made clear that such ranges were merely "intended to communicate its expectation as to the growth of these monetary aggregates that would result" under specified assumed conditions. By 1998 the Committee stated explicitly that it was setting such ranges "not as expectations for actual money growth, but rather as benchmarks for M2 and M3 behavior that would be consistent with sustained price stability, assuming velocity change in line with *pre-1990* historical experience" (emphasis added). More specifically, they were not "guides to policy." Beginning in 2001, the Committee stopped setting such ranges altogether.

The more substantive demonstration of flexibility in pursuit of the Federal Reserve's dual objective came in the conduct of actual monetary policy, first in the mid 1990s and then, far more so, in the latter years of the decade. After peaking at 7.8% in mid 1992, unemployment had declined as the new business expansion gained strength. In September 1994 the rate fell below 6%. Unemployment had been below 6% throughout 1988 and 1989, in a period when inflation was moving steadily upward – from 2.7% in 1987 (just 2.2% the year before, in part because of the sharp decline in oil prices) to 3.4% in 1988, 3.8% in 1989, and 4.8% per annum in the first half of 1990; hence the Open Market Committee's action, beginning in the spring of 1988, to raise the federal funds rate by some 225 basis points in the lead-up to what became the 1990-1 recession. In 1994 likewise, the Committee began to raise the federal funds rate, moving from just 3% at the beginning of the year to 5½% by yearend, and on to 6% by mid 1995.

Unlike when the Federal Reserve had tightened policy six years earlier, however, the economy did not slow. Output continued to grow, by 2.5% in 1995, then 3.7% in 1996 and 4.5% in 1997. More Americans found jobs, as nonfarm payrolls expanded by 3 million in 1995, 2.4 million in 1996 and 3 million again in 1997. With an ongoing increase in labor force participation as well, the share of the adult population formally employed rose to a record high (higher even than at the peak of World War II, including men and women in uniform). Unemployment continued to decline, falling below 5% in May 1997 – for the first time since 1973, infamously the beginning of the worst increase in inflation in U.S. post-war experience. But also unlike previous experience, not just in the 1970s but also in the years leading up to the 1990-1 recession, this time rapid economic expansion and declining unemployment did not bring increased inflation. Instead, inflation gradually but steadily slowed: from 2.1% in 1994 to 2.0% in 1995, then 1.9% in 1996 and 1.7% in 1997.

But shouldn't inflation have increased? The then-conventional wisdom of the economics profession certainly thought so. Robert J. Gordon's (1998, but actually published in mid 1997) macroeconomics text, for example, which had the especially useful feature of listing relevant data in the back, showed the "non-accelerating inflation rate of unemployment" at an even 6%. Numerous papers of the time, investigating the nexus between potential and actual output, the labor market, and inflation – by Gordon (1997), Kenneth N. Kuttner (1994), and Douglas Staiger, James H. Stock and Mark W. Watson (1997), among others – came to the conclusion that if the economy's "natural" rate of unemployment was below 6%, it was not much below. The implication for monetary policy was clear. Allowing output to expand at such a rate that unemployment had fallen increasingly below 6% was, at best, risky. Now allowing unemployment increasingly below 5% would surely be inflationary.

Little in the conventional economic wisdom of the day, therefore, suggested that an expansion of this magnitude would not be inflationary. Little in the conventional wisdom of monetary policy suggested that the Open Market Committee would forbear tightening policy as the expansion continued, even with the presumed increase in inflation yet to come. Yet the Open Market Committee did not act. Indeed, even as unemployment was falling the Committee had cut the federal funds rate from 6% at midyear 1995 to 5½% by the time unemployment crossed through the 5% mark. A year later, with unemployment now down to 4.4%, the funds rate was still 5½%. After a further, quickly reversed cut at the time when the Asian financial crisis became especially worrisome, the rate remained 5½% at the beginning of 2000, by which time unemployment stood at just 4.0%.

One early anticipation of this unorthodox sequence of policy decisions (and, more directly, of the underlying economics of the situation) was an article, signed by Chairman Greenspan personally, that had appeared in the *Wall Street Journal* in October 1988, back when unemployment had also been below 6% and increasing inflation *was* a problem of concern to monetary policymakers.[5] Greenspan's central theme was "the marked downsizing of economic output," not just in America but throughout the industrialized world: "The creation of economic value in recent decades has shifted toward conceptual values – that is, those created by new scientific insights and technology – with far less reliance on physical volumes."

Viewed in retrospect, with an eye in particular to understanding the rationale underlying the willingness a decade later to gamble that extraordinary economic growth and low unemployment would prove not to be inflationary, two implications of this "downsizing" phenomenon stand out as especially salient: First, the growing economic importance of information technology – "the explosive growth in information gathering and processing techniques, which have greatly increased our ability to substitute ideas for physical volume" (and, one might add, for human inputs to production as well). And second, the greater exposure of ever more sectors of economic activity to international competition – "the increased ease with which economic goods and services can spill over national borders."

Did Greenspan anticipate the speed-up of U.S. productivity growth, and the economy's ability to achieve rapid output growth and low unemployment without increased inflation, nearly a decade before either became a reality? As of 1988 output per hour in the economy's nonfarm business sector had advanced by 1.6% per annum over the prior two decades. During 1988-95 productivity growth averaged only 1.5%. But in the latter half of the 1990s the average pace increased to 2.5% (and since then it has jumped to 3.4%). The noninflationary consequences of unemployment consistently below 6% after mid 1994 and then, for more than four years beginning in late 1997, below 5%, represented a similar departure. Was the *Wall Street Journal* article prescient? Was the monetary policy that followed a decade later a consequence?

The answer remains unclear. And it is likewise unclear to what extent the nonmechanical monetary policy of the Greenspan era was responsible for the favorable economic outcomes that ensued. Olivier Blanchard and John Simon (2001), for example, concluded that while systematic factors, not just small shocks (in other words, luck), have accounted for the reduced volatility of both output and inflation in recent years, improved monetary policy is not among them. Similarly, Athanasios Orphanides (2003) has shown that the systematic component of U.S. monetary policy in the Greenspan era has not significantly differed from that of earlier times when outcomes were far less favorable – in particular, the inflationary 1970s.[6] But even if the *systematic* components of monetary policy have borne little responsibility for the improved outcomes, or have themselves changed little from prior periods, what nonetheless stands out in the Greenspan era, and especially from the mid 1990s onward, is the nonmechanistic flexibility that allowed a forward-looking policy to anticipate what, in retrospect, plainly turned out to be different economic circumstances.

Will this flexibility survive Alan Greenspan's service as chairman? Or will U.S. monetary policy now begin to reverse course, retracing the steps it has traveled in the last two decades (beginning in the later Volcker years) along the spectrum represented by the longstanding "rules versus discretion" debate?

The cutting edge of the current movement to send monetary policy back in the direction of "rules" is the increasingly widespread support for inflation targeting.[7] Although some more elaborate forms of inflation targeting regimes, like that proposed by Lars E.O. Svensson (2005), are fully consistent with the kind of flexible approach to policymaking that has been characteristic of the Greenspan era, many others are not. Here the main point is that the argument for "rules," in terms of implications for the public's expectations of and confidence in future monetary policy and economic outcomes, requires that such rules be simple to enunciate and easy for the public to understand. Yet a further concern, also valid, is that publicly announcing a numerical target for the "price stability" part of the U.S. central bank's dual mandate but not the "maximum employment" part will not only result in a less flexible form of monetary policymaking but also, over time, undermine the Federal Reserve's commitment to the part of that mandate for which there is no numerical target.[8] The core of the argument for central bank accountability is that policymakers inevitably assume greater responsibility for outcomes for which they are held accountable, and (as the experience with money growth targets clearly demonstrated) a publicly disclosed numerical target achieves precisely this purpose.

The Greenspan era, therefore, may stand as the modern-day pinnacle of “discretion,” rather than “rules,” in U.S. monetary policymaking. The record of economic performance that it leaves behind is surely one to be admired. Perhaps some day we shall envy it.

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Footnotes

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1. Greenspan (1997).

2. Figures given refer to the GDP price index. Data for 2005 are for the first three quarters only.

3. The phrases quoted are from the Federal Reserve Act, as most recently amended (for this purpose) in 1988.

4. See, for example, Friedman, (1997), Table 6.2; but the evidence on the subject is voluminous.

5. Greenspan (1988).

6. The reason, in large part, is that the fit is so poor in both periods, especially when using real-time data.

7. See, for example, the papers in Piger and Thornton (2004) and Bernanke and Woodford (2005).

8. See Friedman (2004).

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