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Chairman Greenspan's Retirement from the Federal Reserve

Marc Labonte
Specialist in Macroeconomics
Government and Finance Division

Summary

Chairman Alan Greenspan's non-renewable term as governor on the Board of the Federal Reserve System (Fed) expired on January 31, 2006. On the same day, the Senate confirmed President Bush's nomination of Ben Bernanke to be Greenspan's successor. Bernanke has been Chairman of the President's Council of Economic Advisers, a Fed governor, and professor of economics at Princeton University. The Federal Reserve is responsible for setting the nation's monetary policy, among other duties. This report briefly outlines Chairman Greenspan's legacy and some of the issues facing his successor. It will not be updated.

On January 31, 2006, Alan Greenspan retired from the Board of Governors of the Federal Reserve System (Fed). On October 24, 2005, President Bush nominated Ben Bernanke to be Greenspan's successor. On January 31, the Senate confirmed Bernanke's nomination by a voice vote. Bernanke was Chairman of the President's Council of Economic Advisers in 2005. From 2002 to 2005, he was a Fed governor. Prior to that, he was chair of the Economics Department at Princeton University, where he specialized in monetary economics. His research and theories on inflation targeting, the monetary transmission mechanism, and a global saving glut have been widely cited.

The Chairman of the Board is also Chairman of the Federal Open Market Committee (FOMC), which sets the nation's monetary policy. The FOMC meets every six weeks to set monetary policy by setting a target for the federal funds rate, the overnight interbank lending rate. The Federal Reserve is also responsible for regulating financial holding companies, enforcing certain financial regulations, issuing paper currency, clearing checks, and collecting economic data.[1]

[1] See CRS Report RL30354, *Monetary Policy: Current Policy and Conditions*, by Marc Labonte and Gail Makinen; and CRS Report RS20949, *The Federal Reserve: Recurrent Public Policy Issues*, by Marc Labonte.

The Federal Reserve System has seven governors who are appointed by the President and confirmed by the Senate. Since the Eisenhower Administration, the Senate has never rejected a nominee appointed by the President.[2] A governor's term lasts for 14 years, and a governor may serve only one, non-renewable complete term. All seven governors serve on the FOMC. Congress can only remove a governor for cause, and no governor has ever been removed by Congress. If a governor is appointed to serve out the unexpired portion of another governor's term, however, that governor may then be reappointed to one new complete term after the first term ends. Greenspan first took office to fill an unexpired term on August 11, 1987. When that term ended on January 31, 1992, he was reappointed to a full 14-year term, which ended January 31, 2006. By law, he is ineligible to be reappointed to another term. Among the seven Fed governors, the President appoints and the Senate confirms one of the governors to be Chairman of the Board. Like Bernanke in 2006, when Greenspan was appointed governor in 1987, he was also appointed chairman. The term for chairman runs for four years, but there is no limit on how many times it can be renewed. Greenspan served five terms as chairman. There have been 13 chairmen since the Fed was established in 1913.[3]

Although there is little nominal difference between the powers of the Chairman of the Board and the other governors,[4] there is a widespread perception that the chairman wields enormous influence over the FOMC's decisions. For example, a recent St. Louis Fed study found that in the period from 1989 to 1997, Chairman Greenspan's initial interest rate policy proposal was adopted at every single FOMC meeting. Furthermore, voting members of the FOMC voiced disagreement with Chairman Greenspan's proposal 28% of the time, but cast votes against the proposal only 7.5% of the time.[5]

Chairman Greenspan's Legacy

There is widespread agreement among economists, many elected officials of all political stripes, historians, financial market participants, and commentators that Greenspan's tenure as chairman was a success. He initially gained praise for the Fed's swift reaction to the stock market crash of October 19, 1987, because this crash did not lead to a recession and the stock market started rising again soon afterwards. Much of his legacy stems from the 1990s expansion, which was the longest on record. The 1990s expansion was also noted for persistently low price inflation, which did not significantly accelerate even at the end of the expansion. Although the Fed was unable to prevent the 2001 recession, it reduced the federal funds rate rapidly and sharply in response.

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[2] Irwin Morris, *Congress, the President, and the Federal Reserve* (Ann Arbor: University of Michigan Press, 2000), p. 78. The Senate can prevent an appointment without a formal rejection, however. For example, the Senate did not give President Clinton's nominee Carol Parry a confirmation hearing before the 106th Congress ended. Parry was nominated on Aug. 6, 1999.

[3] For information on the Federal Reserve's structure, see CRS Report RS20826, *Structure and Functions of the Federal Reserve System*, by Pauline Smale.

[4] Each governor has one vote on Board and FOMC decisions, although the Chairman sets meeting agendas, passes out assignments, administers the Federal Reserve system, and is the public spokesman for the Fed.

[5] Ellen Meade, "The FOMC: Preferences, Voting, and Consensus," *Federal Reserve Bank of St. Louis Review*, vol. 87, no. 2, Mar./Apr. 2005, p. 93.

Many of the economic accomplishments for which Chairman Greenspan is credited would not reasonably be attributed to monetary policy. Monetary policy is widely believed to ultimately influence only two things — inflation and the stability of the business cycle. To fairly judge his record, it is best to look at data over the entire business cycle. Chairman Greenspan's tenure coincided with the end of the 1980s expansion, the 1990-1991 recession, the entire 1990s expansion, the 2001 recession, and the beginning of the current expansion.

As can be seen in **Table 1**, the 1990-1991 and 2001 recessions were two of the shortest, mildest recessions of the post-World War II era.[6] Likewise, the 1990s and 1980s expansions were the longest and third longest expansions of the era, respectively. Contrary to popular belief, **Table 2** shows that economic growth was not faster in the 1990s than in earlier expansions (growth was rapid in the second half of the 1990s, but relatively slow in the first half). However, the 1990s were more successful than previous expansions in that the economy had never before maintained such steady, stable growth for such an extended period of time. And unlike the expansions of the 1960s-1980s, high rates of growth at the end of the 1990s expansion were not achieved at the cost of rapidly rising inflation.

Table 1. Comparing the Two Recessions of the Greenspan Era to the Previous Eight

	Duration (months)	Contraction of GDP (cumulative)
1945-1982 Recessions (average)	10.6	2.3%
1990-1991 Recession	9	1.5%
2001 Recession	8	0.2%

Source: CRS calculations based on data from National Bureau of Economic Research (NBER) and Bureau of Economic Analysis (BEA).

Table 2. Comparing the Expansions of the Past Five Decades

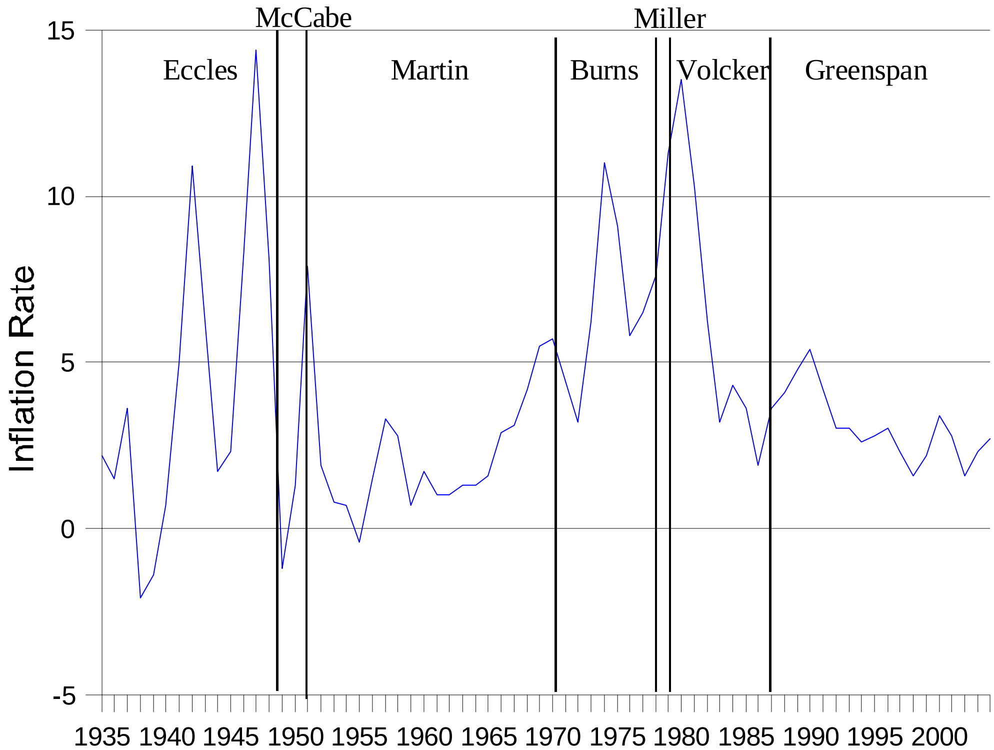
	Duration (months)	Average Growth Rate (Peak to Peak)
Three Expansions of 1950s (average)	36	3.8%
1960s Expansion	106	4.3%
Two Expansions of 1970s (average)	47	3.1%
1980s Expansion	92	3.3%
1990s Expansion	120	3.2%

Source: CRS calculations based on data from NBER and BEA.
Note: There was an expansion lasting 12 months from 1980 to 1981 that is not included in this table.

As can be seen in **Figure 1**, inflation was consistently low during Chairman Greenspan's tenure. Inflation fell from 5.4% in 1990 to 3% or less in every year except one from 1992 to 2004. From 1967 to 1991, by contrast, inflation was above 3% in every year except one, reaching double digits four times. Only in the period from 1952 to 1966, during the tenure of Chairman William McChesney Martin, was inflation consistently lower. However, inflation has risen sharply to 3.4% in 2005.

[6] For more information, see CRS Report RL31237, *The 2001 Economic Recession: How Long, How Deep, and How Different From the Past?*, by Marc Labonte and Gail Makinen.

Figure 1. Inflation Rate Under Different Fed Chairmen, 1935-2004



Source: Bureau of Labor Statistics, Federal Reserve.

Despite the economy's success, Fed policy under Greenspan was not without its critics. Perhaps the most salient criticism surrounds how monetary policy should treat "imbalances" in the economy, which during the Greenspan era included a stock market bubble in the 1990s (particularly in the high-tech sector), a potential housing bubble today, large and rising trade deficits from the mid-1990s to the present, and rising household and government borrowing. The orthodox view, which Greenspan consistently followed, was that monetary policy could respond to these types of events only insofar as they manifested themselves in the form of rising inflation or a change in aggregate spending. In this view, the Fed has only one tool at its disposal, short-term interest rates, and any attempt to use it to tackle ancillary economic issues would divert the Fed from its mandate of low inflation and a stable business cycle.

Critics respond that these imbalances will eventually spill over to the broader economy, even if they do not necessarily cause the inflation rate to rise. For example, the 2000-2001 stock market crash contributed to the 2001 recession. Critics also argue that imbalances can be a precursor of higher inflation. For example, higher stock or house prices may induce unsustainable levels of consumer spending. The shortcoming of the critics' argument is that by tackling an imbalance with the blunt tool of higher interest rates, the Fed risks inducing the very recession that it is feared the imbalance will cause.[7] Tackling imbalances also requires the Federal Reserve to, in effect, outwit the market,

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[7] Greenspan made this point in a speech "Risk and Uncertainty in Monetary Policy," at the American Economic Association annual meetings, Jan. 3, 2004.

since a phenomenon identified by market participants as unsustainable would come to a halt on its own. As Greenspan puts it, "To spot a bubble in advance requires a judgment that hundreds of thousands of informed investors have it all wrong. Betting against markets is usually precarious at best."[8]

Perhaps the aspect of Chairman Greenspan's legacy that is most important for his successor is that he leaves behind no "model" or formal method for how to make monetary policy decisions. As chairman, Greenspan eschewed policy rules and regimes that would reduce the Fed's discretion. Federal Reserve transparency and predictability were increased during Greenspan's tenure — by announcing changes to the federal funds rate immediately and making the minutes of the FOMC meetings public, for example. Nevertheless, Greenspan's decisions and views often appeared, at least to outside observers, to be based more on hunches than a predictable, well-defined decision-making process. Often these hunches proved to be correct and prescient. For example, Greenspan was credited with correctly identifying the acceleration in productivity growth that began in the mid-1990s before it was evident in the data. Had he failed to identify the acceleration, he might have raised interest rates when economic growth began to accelerate, for fear that faster growth would make inflation rise. As it turned out, higher productivity growth meant that the economy could grow faster without causing inflationary pressures.

Issues For the New Chairman

Gaining the Financial Markets' Confidence. The major challenge a new chairman faces is gaining the confidence of financial market participants that the FOMC will make decisions that support economic stability. Were participants to lose confidence in the new chairman at some point, U.S. stock, bond, or currency prices could temporarily fall. As discussed in the previous section, Greenspan leaves behind no explicit, transparent model for setting monetary policy. Therefore, the new chairman will likely be starting from scratch in the financial markets' eyes. Traditionally, the new chairman gains confidence by building his or her own "track record" over time.

The difficulty of this challenge may be overstated. When Greenspan became chairman in 1987, many observers feared that he could not fill the shoes of his predecessor, Paul Volcker, who had brought inflation down from double digits to low levels at the end of his term. Perhaps Chairman Bernanke's time as Fed governor during the Greenspan era will help him gain market confidence more quickly.

A related challenge for the new chairman will be clearly communicating the Fed's intentions in order to prevent policy "surprises." While the Fed has never — and would never — pre-announce its next policy decision, in the later years of the Greenspan era, the Fed conveyed its intentions to financial market participants clearly enough that a rate change was rarely a surprise. This kept the Fed's contribution to financial uncertainty, and thus market turbulence, to a minimum. Since the Fed chairman's statements are generally guarded, it is possible that it will take some time before market participants can decipher the new chairman's intentions.

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[8] Testimony of Chairman Greenspan before the Joint Economic Committee, 106th Congress, June 17, 1999.

Is There Still a New Economy? Many of the economic questions raised during the 1990s have still not been resolved by economists. How fast can the economy grow on a sustainable basis? How low can unemployment fall before triggering inflationary pressures? How long will the acceleration in productivity last? Answers to these questions are necessary to make sound monetary policy decisions, yet remain elusive.

Should the Fed Adopt an Inflation Target? In the past two decades, central banks in most of the developed world have adopted a single mandate of price stability, and have set inflation targets to meet this mandate.[9] As chairman, Greenspan resisted calls for the Fed to adopt a numerical inflation target, partly on the grounds that it would hinder the Fed's flexibility to respond to unforeseen economic events, and partly on the grounds that the Fed has provided price stability without one. Greenspan's retirement will likely rekindle the targeting debate because Chairman Bernanke has been a long-time advocate of inflation targeting.[10] Proponents believe that adopting an inflation target would give the Fed a clear, achievable mandate, and safeguard against a return to the days of high inflation. Opponents believe, like Greenspan, that inflation targets needlessly restrict the choices available to policymakers, and that it is unrealistic and undesirable for the Fed to respond only to inflationary pressures.[11]

Nonpartisanship. Although Fed governors are political appointees, they are widely viewed (and expected to behave) as nonpartisan. That is partly due to the technical, apolitical nature of monetary policy decisions. Arguably, monetary decisions require fewer "judgment calls" as to how to balance competing interests than most policy questions, and therefore do not require political values. Decisions are not supposed to be made in a political context, such as how they would influence an upcoming election.[12] Fed governors do not explicitly endorse or reject political proposals or candidates.

As chairman, Greenspan rigorously adhered to this nonpartisan tradition, and was widely respected by both parties. Some critics, however, claimed that he crossed the partisan line by tacitly endorsing the 2001 tax cuts. Unlike previous positions Greenspan had taken, the tax cuts were highly controversial among economists. Some observers believed that his endorsement greatly improved the tax cuts' chance of congressional approval. A key challenge for the new chairman will be how to respond in similar situations. Bernanke's time as Chairman of the President's Economic Advisers (a position also held by Greenspan) may color people's perceptions of his nonpartisanship. At least initially, Chairman Bernanke, who is relatively unknown with the American public, could potentially find it difficult to defend himself from accusations of partisanship by drawing on his stature, as Greenspan was able to do.

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[9] See CRS Report RL31702, *Price Stability (Inflation Targeting) as the Sole Goal of Monetary Policy: The International Experience*, by Marc Labonte and Gail Makinen.

[10] See, for example, Ben Bernanke et al., *Inflation Targetin*g (Princeton, New Jersey: Princeton University Press, 1999).

[11] See CRS Report 98-16, *Should the Federal Reserve Adopt an Inflation Target?*, by Marc Labonte and Gail Makinen.

[12] There is a large body of literature investigating whether the Fed's decisions are influenced by the election cycle. For an overview, see Allan Drazen, *Political Economy in Macroeconomics* (Princeton: Princeton University Press, 2000), pp. 232-238.