

ALAN GREENSPAN

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Alan Greenspan is regarded as a national hero of the nineties. In the course of performing the function of chairman of the FED, Greenspan had to deal with a period of strong growth, low inflation and unemployment, with a crisis, stock market crash and terrorist attack. Greenspan became the embodiment of the „new economy“. The result of his prudence was prosperity, from which millions of Americans profited in the form of a boom in business, higher wages and development of the stock market. Greenspan assumed that information technology would increase productivity, which would lead to rapid economic growth without inflationary tendencies. It is necessary to say that vigorous growth in productivity is continuing in the present period of slower economic growth. On the other



hand, he is blamed for the fall in the technology and telecommunications sector, the threat of deflation and the still continuing stagnation in the labour market. The expert public fear that he is not flexible enough and is not finding a strategic solution to the present problems of the economy.

Alan Greenspan took over the office of chairman of the Board of Governors on 20th June 2000 for the fourth time and his four year term of office will end in 2004. He is also chairman of the Federal Open Market Committee, which is a key body for carrying out monetary policy. He was repeatedly appointed to the committee for a period of 14 years, starting from 1st February 1992. He was appointed chairman of the FED by presidents Reagan, Bush and Clinton.

Alan Greenspan was born on 6th March 1926 in New York. He showed a great gift for numbers from an early age and often surprised his mother by solving mathematical puzzles. After leaving secondary school, he studied music at the Julliard School. His first job was connected with music. He played the clarinette and saxophone in a swing band. When he was nineteen he registered to study economics at New York University, where he gained the degree of B. S. (summa cum laude) in 1948 and M. A. in 1950. At the beginning of the fifties, Greenspan found himself in financial difficulties, so he had to leave his doctoral study at Columbia University and start work as a professional economist. He gained his PhD. from New York University in 1977. From 1954 to 1974 and 1977 to 1987 he was chairman of the consultancy firm Townsend-Greenspan & Co. Inc. in New York. His career in the state administration started in 1974, when he became chairman of the Council of Economic Advisors to President Ford. He was originally proposed for this position by Richard Nixon, who had to resign after the notorious Watergate affair. From 1981 to 1983, Greenspan was chairman of the National Commission on Social Security Reform.

Greenspan was also a member of President Reagan's Economic Policy Advisory Board, a member of the committee of economists of TIME magazine, senior advisor on questions of economic activities and consultant to the Congressional Budget Office. We can include membership of the following among his other activities:

- The Council of Advisors to the President for Foreign Affairs,

- The Commission on Financial Structure and Regulation,
- The Commission on an All-Volunteer Armed Forces,
- The Task Force on Economic Growth.

Before his appointment to the board, Alan Greenspan held management positions in many companies including the Aluminium Company of America (Alcoa), Automatic Data Processing Inc., Capital Cities/ABC Inc., General Foods Inc., J. P. Morgan & Co. Inc., Morgan Guaranty Trust Company of New York, Mobil Corporation and the Pittston Company. Apart from his posts in the business sphere, he held many others, among which the most important included: member of the Board of Trustees, director of the Institute for the International Economy, member of the committee of the Economic Club in New York and director of the National Economists Club.

Alan Greenspan received many awards for his activities from prestigious universities, among which we should mention: Harvard, Pennsylvania, Notre Dame, Wake Forest and Colgate University. There are also awards, which emphasize his immense activity and highly expert activity, including: the Thomas Jefferson Prize awarded by the American Institute for Public Service for the most important public service performed by an elected or appointed person (1976), the decoration of the Legion of Honour (Commander) in France in 2000 and honorary Knight Commander of the British Empire in 2002.

Two years ago, when Alan Greenspan held the function of chairman of the American central bank, he was described as the most powerful man in the world and the majority of commentators expressed a highly positive view of



his work in directing the financial system of the USA. However, more recently, doubts have been expressed about this "icon" of central banking, and he has even become the target of variously formulated accusations. His hesitant decision making during the stock market boom of the nineties, when company shares climbed to dizzy heights, is described as his greatest mistake. According to the critics, he should have solved the situation differently by raising interest rates, so that the bubble would have burst without irreparable losses. They are even beginning to speak of the "Greenspan bubble", which brought the loss of 7 billion USD in the stock markets and 3 billion USD outside the stock markets, when it burst. The arguments of those, who would like to change the strategy of the central bank after Greenspan's departure, are still strengthening. In 2002, for the first time in four years, two of his staff openly disagreed with his view that the strategy of the central bank on the setting of interest rates should not change. Support for the flexible type of monetary policy oriented towards the new

The Monetary Policy of the Central Bank

Greenspan's approach to monetary policy means great progress for central banking. Up to now, this area was directed by fixed rules and strategies, based on personal opinion and the claim that the development of the economy is always a reaction to particular changes, for example, in technology. As a result the guidelines for monetary policy, which function and are successful in a certain period, need to be changed in a different period. Greenspan is convinced that the central bank has learnt to quickly identify changes in the functioning of the economy. The central bank continually monitors a wide range of data and information in real time and on the basis of these observations consistently adjusts its prognostic models. The result of this approach is a monetary policy, which changes in harmony with changes in the structure of the economy. This means progress in comparison with the traditional methods of economic forecasting, which were often applied without noticing important changes in the economy.

Views on the Asset Market

According to influential economists of the type of Cecchetti and Henry Kaufman, the central bank needs new rules for monetary policy, not only because of inflation, but also to moderate the excesses of the financial markets. They accuse Greenspan of allowing the stock market bubble to deform the economy in the nineties. Lawrence B. Lindsey was one of the first to point to the danger the bubble brought. In autumn 1996, as a member of the board of the FED, Lindsey privately demanded higher interest rates, which would guarantee control of "irrational volatility", to which Greenspan pointed only two months after this event. Lindsey finally gave in to Greenspan and voted to keep interest rates at the same level. Other "anti-bubble" economists include A. Crockett, director of the Bank for Internati-

economy, of which Alan Greenspan was the main representative, is weakening.

Decline of unemployment to the lowest level and achieving price stability in the economy are regarded as Greenspan's main successes. In the mid nineties, he observed the faster growth of productivity and came to the correct conclusion that more rapid growth was safe for the economy. Monetary policy under his leadership dealt with the results of negative shocks, brought by the stock market crash of 1987, the Asian financial crisis of 1997, non-payment of Russian debts in 1998 and the terrorist attacks of 2001.

His critics point to a second aspect of his rule in the FED. He is accused of enabling the origin of the market bubble at the end of the nineties, which led to the collapse of the market. He is also accused of an excessively flexible monetary policy, which it will be difficult for his successors to continue. A further area of criticism appeared in 2002, when he supported a strategy of tax cuts over several years, which brings the risk of relatively large budget deficits.

onal Settlements in Basel, who considers that financial bubbles can be a cause of economic instability with deflationary consequences, which will be difficult to control. Precisely these critics would like to see someone in Greenspan's position, who would intervene against excesses in all markets, that is, against dangerous growth in the price of shares, property price bubbles and an overvalued currency. Bankers are increasingly discussing the need to set a public inflation target. The FED carefully monitors the development of price levels, but Greenspan resists the setting of explicit inflation targets. He is convinced that an inflation target cannot be precisely determined, because of the constantly changing character of the economy. In his view, an inflation target could tie the hands of the FED, when taking decisions in the event of unexpected deviations.

He thinks that setting a target for inflation makes little sense. He fears that any formalization of the monetary-policy strategy will limit its flexibility and squeeze interest rate policy into a tight corset. According to Greenspan's supporters, the success of the FED lies especially in the fact that the American central bank can react to rapidly changing conditions in the economy. At a central bank conference in August 2002 at Jackson Hole in Wyoming, Greenspan declared that "it is not at all clear that bubbles can be prevented, even if they are discovered in time, except by the central bank limiting economic activity, which is something we should certainly want to avoid." According to analysts, Greenspan has not forgotten the lessons of history, which point to the fact that when a central bank attempted to extend its mandate to the stock market, this always brought complications. At the end of the 1920s, governor Adolph Miller started his campaign to gain control over the uncontrollable share prices. In 1928-1929, the FED consistently tightened its interest rate policy in spite of zero inflation. This step was one of the factors, which contributed to the stock market crash of October 1929. After the crash,



the bank could not radically reduce interest rates, by which it actually facilitated the coming of the great economic crisis of the thirties.

Greenspan chose a different strategy in a similar situation. He was convinced that from the long-term point of view, it was better to take the blame for the rising cost of shares, than to burst the bubble prematurely by raising interest rates. As soon as the bubble burst, Greenspan immediately attempted to limit the impact on the real economy. He reduced interest rates 11 times in 2001, the most rapid campaign of interest rate reduction in the history of the central bank. In spite of being convinced of the over-valuation of shares, Robert J. Shiller from Yale University agrees with Greenspan's policy in the critical period, since raising of interest rates in the nineties, which would have burst the bubble, could have had catastrophic effects on the economy. However, together with Alice M. Rivlin, an economist from the Brookings Institute, who held from 1996 to 1999 the position of deputy chairperson of the Board of Directors of the FED, he blames Greenspan for the FED failing to struggle with the stock market bubble without raising interest rates. They think that tightening demands on the margin trading would have helped. This would have increased the cost of buying shares on credit, although this would have affected only some investors. It would have emphasized the fact that investors should behave more cautiously. According to the former governor of the central bank Janet L. Yellen, Greenspan could have used his influence to apply this idea. However, he was criticized in 1996 for warning of the danger of irrational volatility and from then he completely avoided this theme.

Greenspan still doubts that the public can be successfully convinced without increased interest rates. He also doubts whether the central bank has a mandate to intervene in this situation, since he is afraid that raising interest rates could provoke a strong political reaction. However, the objection immediately appears here that the mandate of the FED developed at a time when the Carter administration emphasized the struggle against inflation and conditions of rising prices and a weakening dollar forced Carter to appoint Paul A. Volcker as chairman. A comparable situation exists today – Greenspan should give more attention to the financial markets.

According to Greenspan, the stock market bubble is a side-effect of a successful monetary policy. In a period when the central bank has successfully reduced inflation and minimized the risk of recession, investors are inclined to take risks with their money. This can lead to waves of rapid growth in the investment markets and then to deep falls, but it also supports investment spending, innovation and rising productivity. This means that financial instability can be an accompanying phenomenon of good policy and sustained long-term growth.

The Problem of Deflation and the Central Bank

In many ways, the future of the FED depends on the development of the American economy. If the economy

does not revive and fear of deflation grows, the central bank will be under pressure to secure short-term growth by any means. If, however, prices and incomes begin to fall, this could lead to complications in the financial system. It would be more difficult for debtors to repay their debts and banks would not be inclined to lend money at interest rates close to zero. The FED would not be able to use traditional instruments, since the central bank usually struggles against recession and attempts to create so-called negative interest rates. However, if the economy is accompanied by recession, this strategy is not usable and it will continue to fall behind.

Greenspan believes that many of the problems, which Japan has with deflation, are a result of her culture and structure. He is convinced that the United States of America cannot suffer the fate of Japan, which is caught in a deflationary trap. Japanese society is based on the principle of consensus, and so offices are not able to apply the unpopular measures, which are an essential pre-condition for changing the banking system. Greenspan is willing to adopt unconventional strategic measures if the USA experiences deflation and short-term interest rates fall to a level close to zero. In his speech to the Council for Foreign Relations on 19th September 2002, he stated that the general view that the FED is out of the game, if the rate for inter-bank loans from federal funds falls to zero, is mistaken. In his view, the potential strategies, which could be used in this situation, include purchase of bonds, with the aim of reducing long-term interest rates, or purchase of foreign currencies, which would reduce the value of the dollar and so strengthen exports. These measures should stimulate growth. However, in practice, the FED has much less control over long-term interest rates than over short-term interest rates.

On the Value of the Dollar

Greenspan has a similar wait and see approach to the value of the dollar as to financial bubbles. Some representatives of the FED think that the dollar is over-valued and compare the situation to the stock market before the crash. There are fears that a trade deficit supported by the dollar is unsustainable in the long-term and could lead to economic decline. However, according to everybody, Greenspan and his colleagues have no idea what to do about the value of the dollar. They fear that measures could limit aggregate demand, reduce imports and so push the economy into recession. This means that Greenspan is waiting and in the event of a fall in the value of the dollar, he is prepared to rapidly adopt measures to minimize the impact on the economy.

The Unknown Period of Young Greenspan

Few know that in the fifties, Alan Greenspan was a committed member of the intellectual circle of Ayn Rand, an objectivist with strongly liberal views, who applied them to many areas, such as economics, politics, religion and cul-



ture. Under her influence, Greenspan wrote an article for the first issue of the Objectivist Newsletter. In 1967, Rand published the book *Capitalism the Unknown Ideal*, which included a contribution by Alan Greenspan: *Gold and Economic Freedom*, in which he paradoxically defends the gold standard and opposes the concept of a central bank.

In this essay, Greenspan described the social state as a mechanism, with the help of which governments confiscate the wealth of the productive members of society and support a wide range of social programmes. A substantial part of the confiscation is done by taxation. According to Greenspan, the statist rapidly find that if they want to retain political power, they must limit the level of taxation and borrow money to finance social spending by issuing government bonds.

On Central Banking

Money, with its functions as a store of value and a medium of exchange, is something, which enables society to function with the aim of achieving economic progress. The ability to store the results of our labour for future consumption is essential to the accumulation of capital, the extension of technological progress and raising of the standard of living. In this context, the general price level, that is, the average exchange rate between money and all goods and services, plays an important role in every society, since it influences the nature and extent of economic and social relations, without regard for time.

In a democratic society, the central bank is a filter and magnet for various tensions and confrontations, which exist in society. Every institution, which has the ability to influence the purchasing power of money, is regarded as an institution, which can influence the level and distribution of wealth between the members of society. The most important task of the central bank is monetary policy. As Greenspan observes, he would like to say that he has on his desk a thick volume of instructions on how to effectively implement policy to achieve the maximum level of employment, sustainable economic growth and price stability. Instead of this, however, the central bank must confront a dynamic, constantly changing economy, the structure of which changes during every business cycle. Since monetary policy must work with a delay, the central bank needs to look forward, to adopt measures to deal with future imbalances, which are, however, often not visible. There is no alternative to the central bank acting on the basis of prognoses. However, this means that the central bank must often tighten or relax monetary policy, although these steps may not appear necessary to the public. At the same time, it must be as transparent as any other government institution. According to Greenspan, it is unacceptable in a democratic society, for a group of unelected individuals with important legal powers not to be sufficiently open to public scrutiny and responsibility. There is no simple model of the American economy, which can effectively explain the levels of output, employment and inflation. Therefore, it

appears to be unavoidable for the central bank to use specially produced partial models and intensive information analyses, which facilitate the evaluation of economic development and implementation of the relevant measures.

All the recent initiatives, which strengthened the payments system and supervision, are very important for the main aim of the central bank. This aim is the maintenance of financial stability and reduction of risks to the system. This mission is a widening of the original understanding of monetary policy. A country will not experience a maximum level of employment and stable prices in the long-term, if its financial system is unstable. In this context, Greenspan considers that success means not so much solving visible problems, as avoiding potential crises.

Alan Greenspan is described as the most influential man in the American economy. His words can move the markets. He is regarded as the most powerful banker, whose words cause billions of gains or losses on the stock market. It is said that large numbers of shares change owners in the stock markets after his speeches. He starts every morning with one and a half hours in the bath, where he also studies statistics and the development of the economy. The majority of his statements, which are so carefully monitored, are born here. As Greenspan jokingly says to his friends, his IQ is twenty points higher at six in the morning than at six in the evening.

The journalist Bob Woodward has called Greenspan the "Maestro", which expresses admiration, not only for his musical abilities – as a young man, Greenspan passionately loved playing the clarinette and saxophone, but also for his financial mastery – he is not described as a financial guru for nothing, and his knowledge of every instrument in both the political and economic orchestras.

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