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Economic Commentary

The Federal Reserve

During my junior year in college in the fall of 1964, I took a course in macroeconomics. One of the students in the class asked the professor this question, "Do you think the Federal Reserve has a handle on conducting monetary policy?" Our professor replied that, yes, the Fed has a thorough understanding of its role in the economy and can be relied upon to make the appropriate adjustments to monetary policy. The accuracy of his assessment would be tested in the years to come.

In the spring of 1966 I wrote my Senior Thesis on the Federal Reserve's mishandling of monetary policy from the early 1950s through 1965. My argument for criticizing the Federal Reserve's decisions during that time, was based on the shape of the U.S. Treasury "yield curve," a line connecting the data points of yield and maturity in the Treasury market. The yield curve depicted that the Federal Reserve had mistimed the raising and lowering of interest rates, and as a result had not dealt effectively with economic conditions in those years.

The ensuing 50 years were marked by extremely high interest rates in the late 1970s and early 1980s, and by low interest rates from 2008 to the present. Author Sebastian Mallaby recently wrote a biography of Alan Greenspan, "The Man Who Knew," which reveals the conduct of monetary policy during these years. Mr. Mallaby explains Mr. Greenspan's involvement in advising various presidents about the economy, and his role in setting economic policy, from 1964 until 2006.

In 1974 President Richard Nixon nominated Mr. Greenspan to be Chairman of the Council of Economic Advisors. After President Nixon resigned in August 1974 due to the Watergate scandal, Gerald R. Ford became President and presided over Mr. Greenspan's swearing in ceremony. After working for President Ford, Mr. Greenspan also advised President Ronald Reagan. In 1981 he was asked to head a group to work on keeping Social Security solvent, the so-called "Greenspan Commission." I believe author Mallaby greatly understates the role Mr. Greenspan played in enabling new Social Security legislation in 1983. This legislation provided a balanced set of options for individuals, with both costs and benefits based on individual decisions about the timing of taking Social Security payments.

In 1987 President Reagan nominated Mr. Greenspan to become Chairman of the Federal Reserve, replacing outgoing Chairman Paul Volcker. After his Congressional confirmation in 1987 until his retirement in 2006 at age 80, Chairman Greenspan and his views on the economy dominated U.S. monetary policy. He was pragmatic and also possessed a thorough understanding of the economy. This enabled him to persuade the Board of Governors of the Federal Reserve to go along with his judgments about monetary policy.

The Federal Reserve was harshly criticized in the post-Greenspan era for not anticipating the negative consequences building in the economy in 2007-2008. The Federal Reserve decision to stay too long with very low interest rates greatly impacted the mortgage market. This policy contributed to the overall market meltdown in late 2008. Many point to the final years of Chairman Greenspan's tenure as the cause of much of the subsequent damage to the economy. It took until 2016 for the Federal Reserve to gradually start raising interest rates again.

My own view is that in Chairman Greenspan's time as Chairman of the Federal Reserve, he successfully managed the health of the U.S. economy. I believe the challenge facing the Federal Reserve today is the size of its balance sheet, with assets currently in excess of $4 trillion, up from just over $1 trillion in 2008. The shape of the yield curve is now much less important than the quantity of assets held by the Federal Reserve. The assessment of both current and future members of the Board of Governors will be determined by how well they manage these assets.

In reviewing the last 50 years of monetary policy in the United States, I can conclude that the Federal Reserve, even with its large number of Doctors of Economics, has failed to demonstrate that it has a better handle on monetary policy than it did in 1966.

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