End of an era for the world

George Bush has made his choice to replace Alan Greenspan. Despite initial praise, Ben Bernanke faces months of close scrutiny and the markets face a period of increased uncertainty. Demonstrating his independence will be key to Bernanke's success, writes David Rowe

Early in James Michener's book *Hawaii*, a South Sea island is experiencing the rise of a new and violent deity. The high priest of this new religion periodically turns and points to a bystander who must be sacrificed to appease the new god's anger. A haunting phrase echoes through these pages as people lament that "life is dangerous when the gods are changing". Well, Alan Greenspan hasn't quite been deified but he has become widely regarded as the apotheosis of a central banker.

Having worked closely with Greenspan for over seven years before he was chairman of the Fed (yes, there was a time when he wasn't chairman of the Fed!) I have followed his tenure with great interest. I must say that the US has been inordinately fortunate in having either Paul Volcker or Alan Greenspan as head of their central bank for more than a quarter century. On the other hand, maybe this was merely just recompense for the damage done by Paul Volcker's predecessor (on which more later).

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The Treasury/Federal Reserve Accord

The principle of broad independence of central banks is widely recognised today even where it is not practiced. It is so well established in the US that many believe it was enshrined in the Federal Act of 1913. In fact, it is much younger than that, dating back to March 1951. That is when the US Treasury Department and the Fed released a joint announcement of what has become known as the Treasury/Federal Reserve Accord.

Until then, the Fed largely acted to keep US government bonds trading close to par. When prices fell in the face of rising interest rates, the Federal Open Market Committee would buy up bonds that private investors wished to liquidate. This kept interest rates low, to the benefit of the Treasury. Former Fed governor Andrew Brimmer has noted that this meant institutional investors effectively controlled the creation of bank reserves and the availability of money and credit.

This arrangement posed serious problems in 1951. Korean War expenditures were boosting domestic demand and triggering inflationary pressures. Continued pegging of US Treasury security prices would have reinforced the already worsening inflationary pressures. The Fed's proposal to terminate its support of government bonds was vigorously opposed by President Truman and his Treasury secretary. Fed chairman Thomas McCabe proved unwilling to stand up to White House hardball tactics and ultimately resigned.

William McChesney Martin, an assistant secretary of the Treasury for monetary affairs, was able to work out a series of compromises that resulted in the Treasury/Federal Reserve Accord. The primary long-term provision of that Accord was to eliminate the Fed's obligation to support prices of US government securities, and with that the tradition of central bank independence was born. For his efforts, Martin was appointed chairman of the Fed and served in that role for 19 years.

Tradition not law

The key point is that the tradition of central bank independence is just that – tradition and not law. It has had to be defended repeatedly over the years from attempts by presidents and congressional leaders of both parties to manipulate monetary policy for political advantage. The main advantage of Alan Greenspan's quietly rational dominance of economic policy has been to assure markets of the Fed's operative independence. Indeed, George Bush Senior was the last president to oppose Fed policy aggressively. It is easy to forget, however, that such market confidence was not always the case.

Having been active in Republican party circles and having served as President Gerald Ford's top economic adviser, many thought Greenspan would be a patsy for the Reagan White House. Senator William Proxmeyer voted against his confirmation, calling him a "go along to get along kind of economist". Knowing him as I did, I was totally confident that Greenspan would not go down in history as the man who wasted the hard-earned inflation gains so painfully achieved by the Volcker Fed. Others less familiar with the man, however, were understandably less certain.

Jimmy Carter's disastrous appointment of G William Miller as Fed chairman lingered in people's memories. Combining the self-assurance of a successful corporate chief executive with severely limited insight into economic and financial realities, he engineered such rapid money supply growth that it induced the worst inflationary episode in US history. Eliminating the resulting inflationary psychology imposed painful hardships on the American public. In addition, it effectively killed President Carter's chances for reelection, the very opposite of what Miller's policy was intended to accomplish.

Political risk and economic risk

The overwhelming respect accorded to Greenspan from across the political spectrum has effectively removed Fed bashing from American political discourse for over a decade. It is unlikely that this happy state will survive his departure. Despite his many achievements, markets will remain uncertain of Bernanke's willingness and ability to maintain the Fed's staunch independence from political pressure. The greater this doubt, the more restrictive the Fed will have to be to re-establish market confidence in its determination to control inflation. It is in everyone's interest, particularly that of George Bush, that the new Fed chairman demonstrate his independence quickly not only in words but in actions. The markets and the country, indeed the world, will be watching closely. ■