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by

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This paper was prepared for the meetings of the American Economic Association, January 2006, in a session titled “Alan Greenspan’s Legacy: An Early Look.”

Abstract: This paper discusses five questions the incoming chairman of the Federal Reserve must ponder as he assumes his new post. How important are monetary rules? Should the Fed adopt inflation targeting? Should he be free with his opinions? Should he be a high-profile public figure? Is it more important to be good or lucky?

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A Letter to Ben Bernanke

By N. Gregory Mankiw*

Dear Ben,

Congratulations on your appointment to become new Chairman of the Federal Reserve. I am delighted both for you and for the nation. President Bush could not have made a better choice.

Of course, you have big shoes to fill. Alan Greenspan is widely acknowledged to have been a superb Fed chairman. Alan Blinder and Ricardo Reis (2005) may even prove right in their judgment of Greenspan as “the greatest central banker who ever lived.” His tenure exhibited low and stable inflation, as well as robust and stable growth in production and employment. There is little more that we could ask of a Fed chairman.

But there is little point now to you or I heaping praise on Greenspan. Most activities run into diminishing returns. Given all the praise that Greenspan’s been getting lately, the marginal utility of one more accolade must be close to zero.

There are, however, several intriguing issues that the Greenspan legacy raises. In my mind, there are at least five questions that monetary economists, economic historians, and future Fed chairmen (this means you, Ben) will need to ponder as they decide what lessons to learn from the Greenspan era.

How important are monetary rules?

As you know, over the past twenty years, academic economists have been fascinated with monetary rules. A widespread consensus has developed that we need to

think about monetary policy not as a series of discretionary policy actions but, instead, as the implementation of a systematic rule. As Finn Kydland and Edward Prescott (1977) showed so forcefully, monetary policy set by discretion is tempted to be time-inconsistent, leading to more inflation than is optimal. That is why so many academic macroeconomists now believe that monetary policymakers should tie their hands and commit to some sort of policy rule.

Greenspan's success provides a real challenge to this widespread view. As you know, Greenspan has long been skeptical of policy rules. He knows that the future will ask central bankers to deal with events that they cannot now imagine. In light of this Knightian uncertainty, Greenspan values flexibility as a higher priority than commitment.

So now you must ask yourself: Which position do you believe? Are you going to follow the prescription of the academic literature and look for ways to tie yourself to the mast, as Odysseus did and as Kydland and Prescott would recommend. Or are you going to follow in the footsteps of "the greatest central banker who ever lived?" This is closely related to my next question.

Should the Fed adopt inflation targeting?

I know, Ben, that you have long advocated inflation targeting, under which a central bank sets a numerical target for the inflation rate. You will soon be in a position to put your monetary policy where your mouth is.

This will not necessarily be easy. Inflation targeting has worked well in other countries, and it is supported by many U.S. economists, but the support is not universal. As you know, Alan Greenspan has long been a skeptic. More important, so is

Greenspan's close protégé Donald Kohn, who remains a member of the Federal Reserve Board of Governors and commands broad respect among the other members and the Fed staff.

Some recent news reports have suggested that inflation targeting would mean a big change in policy from the Greenspan era. You and I know that is not right. We know that inflation targeting is not a hard-core policy rule. It would leave you with a substantial amount of the short-run discretion that Greenspan values so highly.

Starting where we are today, a switch to inflation targeting is not so much a change in monetary policy as it is a change in the way the Fed communicates about monetary policy. To a large extent, Greenspan's policy can be described as "covert inflation targeting." Greenspan has never announced a commitment to any particular target inflation rate, because he wants to maintain maximal flexibility, but there is little doubt about his goals. As former Fed governor Laurence Meyer has pointed out, anyone who doesn't know that Greenspan is aiming for a measured inflation rate of about 1 to 2 percent is just not paying attention.

The evolution toward your vision of inflation targeting can, therefore, be very gradual. This would be consistent with your pledge to continue the policy of the Greenspan era, and it would ease the minds of skeptics like Kohn. Over time, your speeches and the Fed policy statements can make increasing reference to medium-term inflation forecasts and whether they are deviating from desirable levels. The financial world will start seeing monetary policy through the lens of inflation-targeting, even if you never offer a grand announcement of a new regime.

Should you be free with your opinions?

Greenspan has, over the years, not been shy about expressing opinions on a broad range of economic issues. This proclivity has at times made some Fed staff cringe. The political independence of the Fed is one of institution's most valued features. That independence was created by Congress, and it can be taken away by Congress. Whenever the Fed chairman ventures off the reservation and opines on a politically charged topic, he puts the Fed's independence at risk.

Yet the issue is far from one-sided. Although Fed staff would prefer that the chairman stay silent on issues not directly relevant to monetary policy, doing so would entail a significant cost. Greenspan has offered intelligent analysis of many economic issues that are vital to the nation. If the Fed chairman refrained from offering his views, someone less knowledgeable would fill the void.

One of the big questions you must decide for yourself, Ben, is how far you are willing to go. Although as an economist you are just as broadly insightful as Greenspan, you will not inherit Greenspan's political credibility. This should make you more circumspect, at least initially.

Here are my suggestions about how far you should go. You should be prepared to talk not only about monetary policy but also about issues related to financial stability. Regulation of Fannie Mae and Freddie Mac, for example, is a tremendously important issue. During my two years in Washington, I saw Greenspan play a central role in pushing policy toward these institutions in the right direction. You should do the same.

You should be willing to explain the views of professional economists when there is a consensus. For example, like Greenspan, you should remind us about the benefits of

free trade when the protectionists in Congress get restless—which they do often. You should not hesitate to remind Congress about the impending fiscal problems that will arise when the baby-boom generation retires and starts collecting Social Security and Medicare. The economics profession is pretty sure that the government has to live within its present-value budget constraint, even if Congress likes to pretend otherwise.

But you should stay away from issues that have a trifecta of problems—those that are distant from monetary policy, controversial among economists, and politically divisive. The repeal of the estate tax, for instance, is not an issue that you should comment on anytime soon. Most social issues and foreign policy fall into the same category.

Should you be a high-profile public figure?

Alan Greenspan is a rock star, at least by the standards of American Economic Association. So high has his profile been that I am surprised that we have not yet seen a TV drama written around the life of a central banker. Much of the general public may fail to understand what monetary policy is, but they know that it is important, and that Greenspan is the man. That is why the choice of Greenspan's successor was awaited with such anticipation.

You and I know, of course, that that monetary policy is set not by a single person but by a large committee supported by one of the most talented staffs of professional economists working in government. If you as the new Fed chairman accept a lower public profile than Greenspan had, the true nature of the Fed could be more widely appreciated, and that would be step in the right direction. Monetary policy is not so

complex that we need an inscrutable wizard to do it well. A group of competent, well-meaning, hard-working public servants can do it just fine.

My recommendation to you is to become as boring a public figure as possible. For an economist, boring is an occupational hazard. For a central banker, however, it is just the ticket. The central bank's job is to create stability, not excitement. One way of doing that is to increase confidence in the institution of the Federal Reserve and to educate the public that the institution matters more than the individual who happens to be leading it at the moment. It would be ideal if, after a long, successful tenure, your retirement as Fed chairman were a less momentous event than your arrival.

Is it more important to be good or lucky?

If you were to poll monetary historians, most of them would tell you that Alan Greenspan is a hero among central bankers and that Arthur Burns is a goat. Just as Greenspan gave us low and stable inflation, together with robust and stable growth, Burns gave us high and rising inflation, together with anemic and volatile growth. The standard assessment of these two men is easy to understand.

Yet, in looking back at these polar two experiences, I wonder whether we exaggerate the role of policy decisions and understate of role of luck. One reason is that the bad inflation performance of the 1970s and the good inflation performance of the 1990s were not limited to the United States. Most developed countries had about the same experience. If there was a policy failure in the 1970s and success in the 1990s, the blame and credit go to the world community of central bankers, not to the single person leading the Federal Reserve.

I suspect, however, that the difference cannot be fully explained by policy at all. These two eras saw very different exogenous supply shocks. The relative price of food and energy was extraordinarily volatile during the 1970s and extraordinarily tame during the 1990s. The standard deviation of this relative price differs in these two decades by a factor of almost three. (Table 1.3, Mankiw 2002) Moreover, the 1970s witnessed an unexpected slowdown in productivity growth and an increase in the natural rate of unemployment, whereas the 1990s witnessed an unexpected acceleration in productivity growth and a decline in the natural rate of unemployment. The favorable supply-side developments of the 1990s were not caused by monetary policy, but they did make the job of monetary policymakers a lot easier. Luck plays a large role in how history judges central bankers.

So, Ben, I wish you the best of luck in your new job. You may well need it!

Sincerely,

Greg Mankiw

P.S. I will miss seeing you as regularly at conferences, but I must admit that I will not miss you as a competitor in the textbook market.

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