Economy

Will Federal Reserve Become Next Political Battleground?

By Kenneth Silber

As the economy slows and the presidential race speeds up, the policies of the nation's central bank could become a hot issue. An important question: Will Fed Chairman Alan Greenspan be reappointed?

The Federal Reserve's imposing marble headquarters in Washington will be the site of intense economic and political debate in the coming months. The impending expiration of Alan Greenspan's term as head of the nation's central bank, combined with signs of a sluggish economy and the opening of the presidential campaign season, has introduced an element of uncertainty into the nation's monetary policies. A recession in 1996 would guarantee a round of frantic finger-pointing among bureaucrats at the White House and Congress as well as in the Federal Reserve.

President Clinton must decide by March whether to appoint Greenspan to another four-year term as chairman of the Federal Reserve's board of governors — a position at times described as the "second most powerful" in Washington because of the chairman's ability to influence interest rates, financial markets and the economy. If Greenspan gets the nod, the reasons will have little to do with any ideological affinity between him and the White House. The chairman, who was appointed to his first two terms by Presidents Reagan and Bush, has spent much of his career advising or serving in Republican administrations, and his early views on economics were shaped for the most part by his former mentor, the free-market philosopher Ayn Rand.

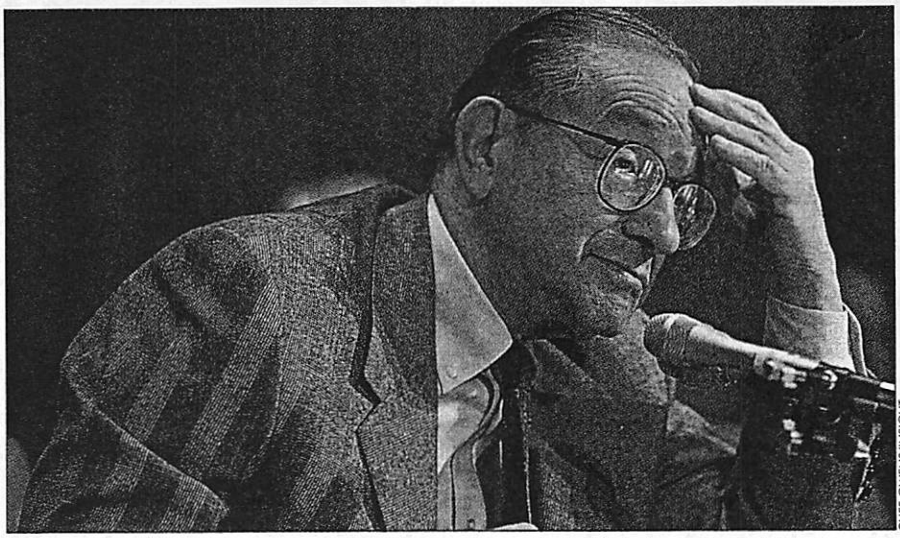
But Greenspan often has sought to build alliances with Democrats as well. His appearance with Hillary Rodham Clinton at the president's 1993 State of the Union speech was seen by many in Washington as a gesture of support for the administration's effort to reduce the deficit. More recently, Greenspan cooperated with the White House in drumming up support for a controversial bailout of the Mexican peso.

Greenspan's prospects for reappointment are strengthened by several other factors. One is the difficulty the administration would have in steering a Democratic nominee toward confirmation by a Republican-dominated Congress. Another is the nervousness with which investors would respond to a new chairman with unknown views on interest rates and other economic issues. "Rightly or wrongly, Wall Street doesn't like to figure out a new guy," says Alan Reynolds, director of economic research at the Hudson Institute, a conservative think tank.

Concerns that a new chairman might relax the Fed's fight against inflation could roil markets for U.S. government and corporate bonds because inflation erodes the value of such securities. The idea of inflation tends to raise interest rates as bondholders demand higher returns to compensate for the higher risk. In turn, increases in bond yields and other interest rates tend to slow economic growth by raising the cost of borrowing for consumers and businesses.

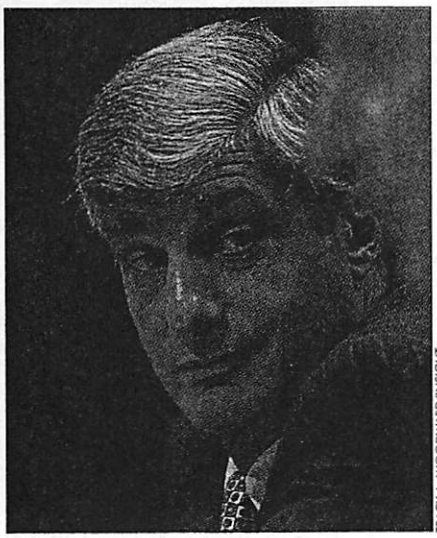
Even delaying the reappointment decision until March might have a negative effect on financial markets and the economy. "For the sake of the American economy, Bill Clinton should make up his mind about Alan Greenspan," asserted a recent editorial in the *Economist*. To leave the decision until the last minute, the editorial argued, would encourage speculation that Greenspan might try to boost his chances by cutting interest rates rapidly to spur short-term economic growth, even at the risk of reviving inflation in the long run.

But an early decision seems unlikely. Appointments to the Fed's board of governors have a long history of delay, and the Clinton administration has been notoriously slow to fill vacancies in high-level government posts, including positions in the Cabinet and on the Supreme Court. "I think it probably will go to the last minute," says F. Ward McCarthy Jr., managing director of



CLIFF OWENS/INSIGHT

Greenspan: *Adept at consensus-building among Fed officials and politicians.*



TRACY A. WOODWARD/INSIGHT

Rubin: *Boosted the dollar's value.*

Stone & McCarthy Research Associates, a financial consulting firm in Princeton, N.J. "The Fed chairmanship is such a political plum that President Clinton is unlikely to want to commit himself any earlier than he has to."

Meanwhile, speculation about possible successors to Greenspan is growing. Treasury Secretary Robert Rubin has won praise for his department's efforts to boost the dollar's value in foreign-exchange markets. Rubin is well-known on Wall Street, having served as cochairman of Goldman Sachs, a large investment bank. If Rubin were appointed to the Fed, however, his close ties to the Clinton administration could spark fears that the central bank's independence in monetary policy decisions would be compromised.

Another possible nominee: Federal Reserve Vice Chairman Alan Blinder, a respected economic theorist and former member of Clinton's Council of Economic Advisers. "Blinder is certainly one of the leading intellectuals among economists affiliated with the Democratic Party," says the Hudson Institute's Reynolds. Many Fed watchers believe that Blinder will leave the central bank if not appointed to the chairmanship. But the vice chairman may have damaged his chances for the top job last year by giving a speech that some investors interpreted to be soft on inflation.

KENNETH LAMBERT/INSIGHT

Blinder: *Soft on inflation?*

Greenspan has maneuvered the central bank through politically tricky times since his initial appointment in 1987. During the recession of the early 1990s, the chairman performed a delicate balancing act, lowering interest rates enough to stimulate economic growth but not so much as to induce inflation. Greenspan also is credited with reassuring financial markets following Wall Street's crash in October 1987 and with restoring public confidence in the banking industry following the failures of numerous savings and loans.

As chairman, Greenspan has proven an adept consensus builder among Fed officials on policy matters — a stark contrast to the more confrontational approach taken by many previous Fed chairmen, including Greenspan's predecessor, Paul Volcker. "He's been a much more collegial type of chairman than Volcker," says Allan H. Meltzer, an economist at Pittsburgh's Carnegie Mellon University and a visiting scholar at the American Enterprise Institute in Washington. "Much less willing to force his authority on people. Much more willing to establish his authority through a process of respect."

Nevertheless, the Fed chairman in 1996 — whether Greenspan or a successor — will have to navigate treacherous economic and political currents. That makes the choice of who will be chairman all the more crucial, and ensures that financial markets will become more jittery as the end of Greenspan's term approaches.

Some Greenspan supporters worry that the Clinton administration fails to share their enthusiasm. "He's the best chairman the Federal Reserve has had in the last 40 years and perhaps in the history of the Federal Reserve," says Meltzer. "So if they don't reappoint him, it's because they have no good sense of what constitutes useful Federal Reserve policy. That wouldn't surprise me." •

A Delicate Balance

The question of Alan Greenspan's reappointment as head of the Federal Reserve comes at a time of uncertainty about the economy and the direction of interest rates. The gross domestic product, which grew at an impressive rate of 5.1 percent in the final quarter of 1994, slowed to 2.7 percent in the first quarter of 1995 and 1.3 percent in the second quarter, the slowest rate in more than three years.

DOUG STEVENS/INSIGHT

The Fed, after raising interest rates repeatedly during 1994, reversed course in July with a quarter-point cut in the federal-funds rate, the interest rate at which banks lend money to one another. The central bank's goal is to ensure an economy slowing sufficiently to keep inflation under control, but not stalling into recession.

While some analysts believe that the Fed has struck a delicate balance between economic growth and price stability, others argue that the central bank has moved too slowly to lower interest rates. "The Fed has way overstated the inflation risk, and the net effect of that is an economy that is growing too slowly," says Lawrence Chimerine, managing director and chief economist at the Economic Strategy Institute, a Washington think tank. "If [the] economy doesn't do well next year, everybody will be blaming the Fed — and they should."

Complicating matters further, the Fed's policies may need to be adjusted in response to the outcome of the budget negotiations in Congress. Some economists say the Fed should cut interest rates rapidly if large cuts in government spending are enacted, for such budget cuts could stall economic growth. Other analysts argue that the Fed should move cautiously because the prospect of a balanced budget would reassure bond markets that inflation is under control. In addition, there are concerns that the Fed will cut rates quickly in response to a balanced-budget plan — only to watch Congress retreat from the plan before it is fully implemented.

If the economy slips into a recession, the Fed's policies likely would come under fire from both the Clinton administration and the Republican congressional leadership, each eager to avoid blame. Previously, much criticism of the Fed has come from Democrats, while Republicans have been relatively supportive of the central bank's anti-inflation emphasis. Yet growing populist sentiment within the GOP increasingly is translating into criticism of the Fed as an elitist institution serving Wall Street. — *KS*