



**The Northern Trust Company**  
**Economic Research Department**  
**Positive Economic Commentary**

*"The economics of what is, rather than what you might like it to be."*

50 South LaSalle Street, Chicago, Illinois 60675

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Web Page -- <http://www.northerntrust.com> (See Economic Research)

Paul Kasriel (312)-444-4145

Fax (312)-444-4132

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May 14, 2004

### **Has Greenspan's Luck Run Out?**

I am reprising my commentary of August 22, 2003, in which I listed some of the "environmental" factors that enabled Alan Greenspan to be so successful in holding down inflation during his tenure as Fed chairman. With the release of recent inflation data, I wonder if his luck is running out. After rising 1.88% and 1.15%, respectively, in 2003 (December/December), the all-items and core-CPI grew at annualized rates of 4.45% and 2.97%, respectively, in the first four months of this year. The Japanese economy, which had been "dead in the water" for about ten years, grew in real terms by 2.7% last year, and is on track to exceed that growth this year. The second largest economy in the world is demanding more resources, including energy resources, now that it is growing. The Chinese economy, which has been a source of inexpensive goods to the U.S. in recent years, is now overheating. This is another reason for the increase in the prices of raw materials. Global *private* investors are losing their appetite for dollar-denominated securities, sensing that they will be paid back in dollars with less purchasing power. This has led to a decline in the foreign-exchange value of the dollar, which, in turn, has played a role in the reversal of the decline in prices of U.S.-imported non-petroleum goods. Defense expenditures, arguably the most inflationary type of government spending, are now soaring. So, now that the environmental factors are changing for the worse, we might get some insight as to whether Greenspan's ability to contain inflation has been due more to luck than skill.

Paul L. Kasriel

Friday, August 22, 2003

### **Alan Greenspan Is The Luckiest Fed Chairman In The Post-WWII Period**

Back on April 11<sup>th</sup>, I wrote a commentary entitled, "Bill Clinton Was The Luckiest President In The Post-WWII Period." This week's commentary is sort of a reprise to the April 11<sup>th</sup> piece – same melody, but different lyrics. The table below shows what happened to consumer inflation on the watches of post-WWII Fed chairmen. In terms of the growth in the CPI over the entire terms of the five chairmen, William McChesney Martin posted the low score at 2.05%. But Alan Greenspan, while still on the course, is not too many "strokes" off the low net at 3.05%. Another way to look at the inflation records of the chairmen is to compare what inflation was running at when they vacated the chair versus what it was when they assumed the chair. In terms of "most improved," Paul Volcker wins hands down, having shaved 7.54 points off his score. Again, Greenspan still is on the course. But if he were to step down now, he would leave the chairmanship with the lowest consumer inflation

rate, 2.11%, of all of his predecessors. What I will argue is that the low inflation that has occurred during Greenspan's chairmanship has had a lot to do with his luck of the draw. In other words, a Fed chairman would have had to have been really inept to have had a bad record on inflation during the time Greenspan has been chairman. I might add that, in my opinion, Greenspan's successor will not be so lucky.

<b>The Inflation Records of Post-WWII Fed Chairmen</b>				
<b>Fed Chairman</b>	<b>Term</b>	<b>Compound Annual Growth in CPI During Term</b>	<b>Year-over-year % Change in CPI</b>	
			<b>At Start of Term</b>	<b>At End of Term</b>
Martin	4/51 - 1/70	2.05%	9.28%	6.18%
Burns	2/70 - 1/78	6.49%	6.15%	6.84%
Miller	3/78 - 8/79	11.21%	6.55%	11.82%
Volcker	8/79 - 8/87	5.64%	11.82%	4.28%
Greenspan	8/87 - ?	3.05%*	4.28%	2.11%*

\* through July 2003

The factors that have made Greenspan's job in controlling inflation easier than his predecessors are: the breaking of the back of inflation by Volcker, the decade long stagnation of the Japanese economy, the slowdown in growth of government spending, the end of the Cold War and the economic opening up of China, and the formation of the European Monetary Union (EMU).

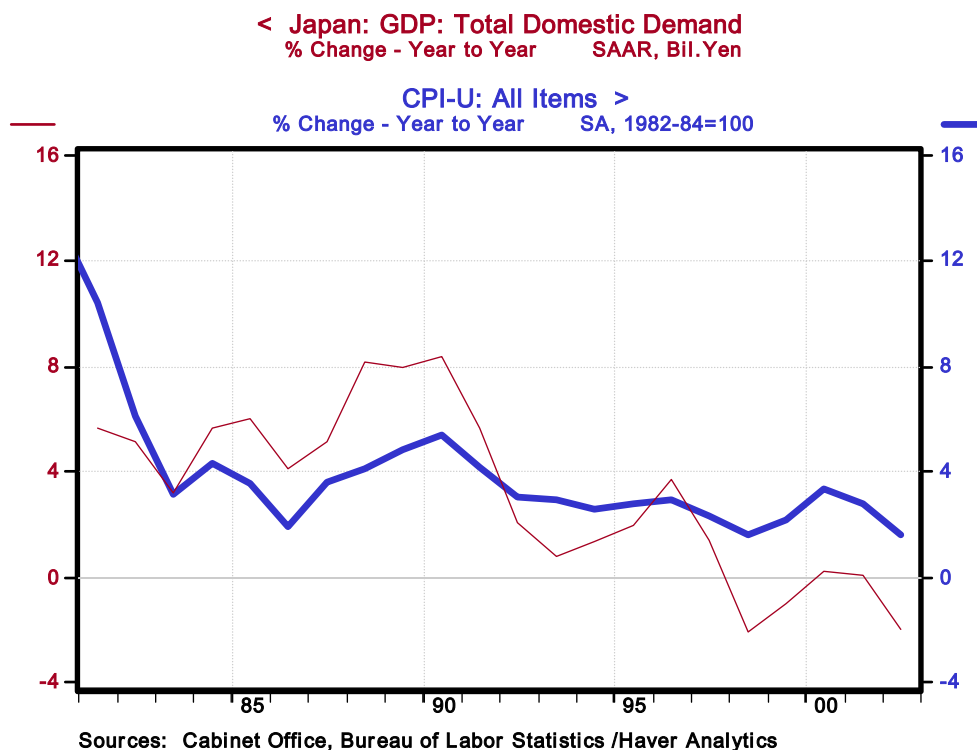
I have already touched on Fed Chairman Volcker's contribution. When he took the helm of the Federal Reserve in August 1979, CPI inflation was running 11.82%. When he handed the helm to Greenspan in August 1987, inflation had slowed to 4.28%. So, Paul Volcker had done most of the heavy lifting in terms of breaking the back of inflation and inflation expectations by the time Greenspan took over.

The Japanese economy is the second largest economy in the world – third largest if you treat the EMU bloc as a single economy. Having the second (or third) largest economy in a stagnant mode for more than a decade takes pressure off global resource markets. In other words, Japan was not a source of global inflationary impulses that the Fed would have had to counter. Chart 1 shows the sharp slowdown in the growth of nominal Japanese domestic demand starting in the 1990s along with the deceleration in U.S. CPI inflation. Correlation does not necessarily mean causation, but causation in this case is not farfetched.

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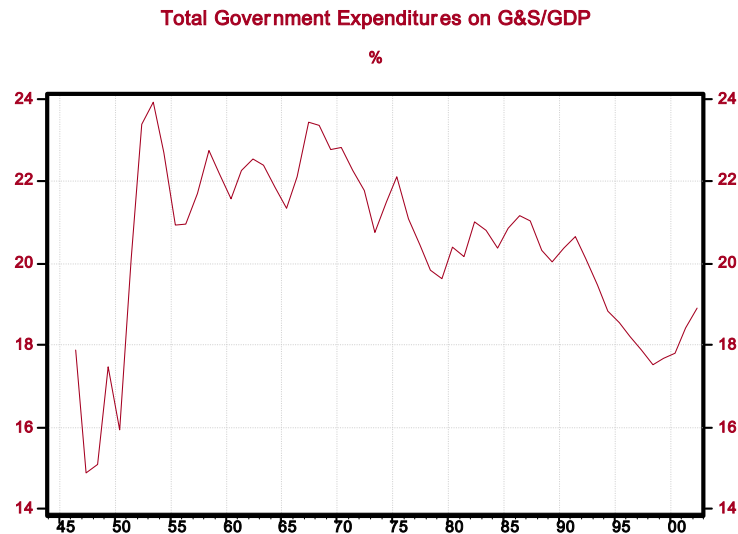
Chart 1



Government spending is inflationary for two reasons. Firstly, the more resources used or under the direction of the government sector, the fewer resources there are available for use by the private sector. The private sector inherently uses resources more economically efficient than the private sector because it faces day-to-day competition. Thus, the more the government spends, the worse the trade-off will be between real output growth and inflation. The Fed is under political pressure to promote higher employment. The economic stagnation brought about by high government spending induces the Fed to follow a more expansionary policy. This results in stagflation. The other way government spending leads to higher inflation is through incipient upward pressure on interest rates, especially if the spending is financed through debt issuance. In part because of political constraints, in part because of inadequate knowledge, the Fed is typically slow to allow the fed funds rate to rise to a level sufficiently high to prevent faster money supply growth. (See *Seven Indicators That Move Markets* by Kasriel and Schap for a discussion of the money creation process.) So, the faster money growth prevents the increased government spending from crowding out private aggregate demand, with higher inflation being the result. Chart 1 shows that total government (federal plus state/local) expenditures on goods and services as a percent of GDP throughout most of Greenspan's chairmanship have been the lowest since early 1950s. So, Greenspan has not had aggressive government spending policies to deal with, unlike his predecessors.

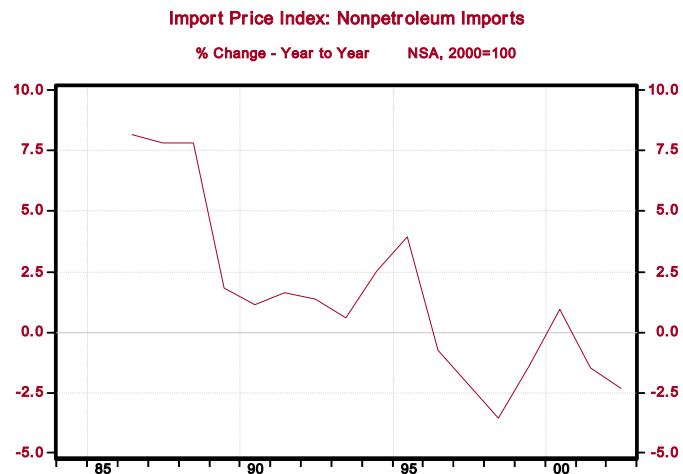
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Chart 2



An important reason why federal government spending had fallen so dramatically relative to GDP in the 1990s was the defeat of the "Evil Empire." With the breakup of the Warsaw Pact, the U.S. could cut back on its military budget. But another economic benefit of this was the inclusion of former Warsaw Pact economies in the global trading community. Even more important was the inclusion of China. In effect, the global economic pie is now significantly bigger with these economies now participating in global trade. This has put downward pressure on U.S. import prices as shown in Chart 3.

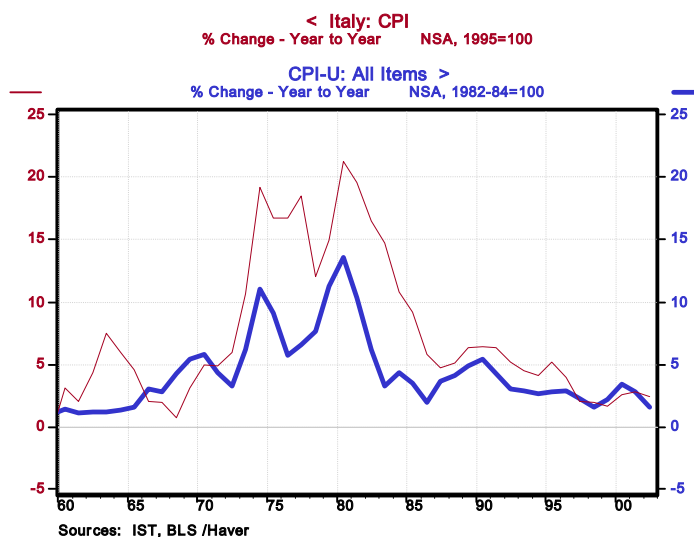
Chart 3



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Lastly, the formation of the EMU forced a number of European countries to get their inflation rates down and get their fiscal houses in order. For example, Italy had for years been the bad boy of Western Europe in terms of inflation. And, as shown in Chart 4, Italian consumer inflation had typically been above U.S. consumer inflation until the late 1990s. Why the convergence in the late 1990s? Italy had to rein in its inflation in order to qualify for EMU membership. Italy, along with other European inflation "offenders" became ex-offenders in preparation for EMU membership in the late 1990s. Similar to the situation with Japan, Italy no longer was a source of global inflationary pressures. This eased the inflationary pressures in the U.S. that Greenspan would have had to combat.

Chart 4



Just as President Clinton enjoyed the "sweet spot" of geopolitical history in the post-WWII era, I believe that Fed Chairman Greenspan has enjoyed the sweet spot of inflation history. Volcker left Greenspan a great inflation hand to play. Greenspan is more likely to leave his successor a hand similar to that which Miller inherited from Burns. Government spending is on the rise for as far as the eye can see. The U.S. indebtedness to the rest of the world is high and will be rising as far as the eye can see. U.S. policymakers will *attempt* to lessen the impact of this indebtedness on the standard of living of Americans by running Fed Governor Bernanke's greenback printing press overtime. At first, this will induce foreign central banks to speed up their printing presses as no country right now wants a strong currency. This will lead to global reflation. Later, however, foreign central banks will get that anti-inflation religion again. This will lead to a run on the dollar and a sharp acceleration in U.S. inflation.

Paul L. Kasriel, Director of Economic Research ([plk1@ntrs.com](mailto:plk1@ntrs.com))