In Setting Fed’s Policy, Chairman Bets Heavily On his Own Judgment
Greenspan Loves Statistics But Uses Them in Ways That Puzzle Even Friends Some Forecasts Go Awry

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WASHINGTON--. The case for higher interest rates was clear as Federal Reserve officials gathered around the massive oval table in their stately boardroom last August.

Brisk hiring had dropped the unemployment rate to low levels that, in the past, had sparked inflationary wage increases. Fed economists were predicting inflation would be higher in 1996 than in recent years. Presidents of several Fed regional banks, mindful that the Fed often fights inflation too slowly, wanted higher rates. Even Fed Governor Janet Yellen, hardly an anti-inflation zealot, was uneasy.

But Fed Chairman Alan Greenspan wanted to leave rates alone. And with just one exception, Fed policy makers agreed. Mr. Greenspan dominates the Fed that he would have had the votes had he sought to raise rates instead just as he will if he decides they should go up when Fed officials meet next week.

Today, the late-summer decision looks wise. Despite a rebound in economic growth, wages and prices remain, so far, amazingly placid. What did Mr. Greenspan, the 70-year-old economic forecaster now in his 10th year as Fed chief see then, that others didn't? How does he do it?

To listen to him - in public, in newly released transcripts of Fed deliberations and in accounts of present and former Fed insiders - his secret for divining the economy's direction lies in understanding the numbers, the thousands and thousands of numbers that describe its complex workings. But in fact, he relies on a sophisticated seat-of-the-pants approach to monetary policy, informed by nearly 50 years of pondering the economy.

Awash in Numbers

Not that he undervalues statistics. Mr. Greenspan reads numbers-laden Fed staff reports in the bathtub before going to work, a habit acquired 25 years ago when a doctor prescribed long, hot soaks for an aching back. He once told a U.S. senator the best thing about being the nation's most powerful economic policy maker is that it gives him access to "the data."

He complained to the Big Three auto makers in 1994 that their decision to stop reporting auto sales every 10 days "significantly diminished our ability to monitor business activity." Recently, he halted a closed-door briefing to grill staff economists on the peculiarities of the Mortgage Bankers Association's mortgage-refinancing index in weeks with a holiday.

But no one could guide the economy to its current remarkable state of low unemployment
and low inflation simply by scrutinizing such minutiae. These data give clues to the direction of the economy over the next couple of months, says former Fed Vice Chairman Alan Blinder, but not over the next six to 12 months, “the horizons you have to look at in terms of monetary policy.” There has to be more to Mr. Greenspan's approach than that, Mr. Blinder adds. “I find it amazing that such good decisions can be made on the basis of numbers like that.”

Even longtime friends are puzzled by Mr. Greenspan's approach. “He looks at hundreds of variables. Out of them he somehow divines something about the economy. No one knows how he does it,” says Allan Meltzer, a Carnegie-Mellon University economist and fan. “I have no fault with the outcome, but we don't know whether it's hocus-pocus.”

Mr. Greenspan doesn't rely on computerized econometric models, but on old-fashioned judgment. He doesn't invoke economists’ sophisticated rules of thumb - such as a link between low unemployment and future inflation but instead watches gauges - such as how fast suppliers fill orders from factories - that usually signal a buildup of inflationary pressures.

In making the forecasts essential to setting monetary policy, he views the data through a lens of his own design, one that changes with circumstances. Essentially, he searches for the one significant factor that distinguishes the current business cycle from previous ones. Once he finds it, he looks at all the data with it in mind.

It isn't a foolproof approach. Fed transcripts show that Mr. Greenspan was late to realize that the economy was sliding into recession in 1990 and that his usually reliable measures of the industrial economy were blinding him to the reluctance of bankers to lend and of consumers and companies to borrow. In his otherwise-impressive record at the Fed, he is often faulted for cutting rates too slowly during the painfully sluggish recovery of 1991. But he eventually recognized the severity of the credit crunch, described it as “a 50-mph headwind” slowing the economy and used that notion to justify lowering rates and keeping them low.

Now, Mr. Greenspan has a different mantra: Workers' fear of losing their jobs restrains them from seeking the pay raises that usually crop up when employers have trouble finding people to hire.

Even if the economy didn't slow down as he expected, he told Fed colleagues last summer, he saw little danger of a sudden upturn in wages and prices. “Because workers are more worried about their own job security and then marketability if forced to change jobs, they are apparently accepting smaller increases in their compensation at any given level of labor-market tightness,” Mr. Greenspan told Congress at the time.

At meetings of the Fed's rate-setting Federal Open Market Committee, Mr. Greenspan uses similar language, avoiding concepts and jargon dear to Fed and academic economists alike. “One of my biggest surprises,” says Mr. Blinder, now back at Princeton University, “was that what he sounds like around the Open Market Committee table is so similar to what he sounds like in public.”

It took Fed Governor Yellen, herself an academic economist, to translate Mr. Greenspan's worker-insecurity thesis into academically respectable terms. She wrote him a memo tuning his notion into elegant reasoning, and he distributed it to other Fed policy makers.

**Measuring Insecurity**

Not surprisingly, though, Mr. Greenspan found his own way to measure worker insecurity. When jobs are plentiful, more people are usually willing to quit one job and seek another. This raises the number of newly unemployed who tell government survey-takers they
left their last job voluntarily. But despite falling unemployment, this measure has barely budged in the past few years. Mr. Greenspan did tell Congress recently, however, that he is seeing the first signs of the long-expected wage increases, an indication that the unusual wage restraint may be ending.

No one besides Mr. Greenspan knows for sure whether he truly bases monetary policy on such arguments, or whether they are an elaborate cover for what amounts to just doing what seems right at the time. His idiosyncratic approach gives him enormous flexibility, much more than if he tied monetary policy to the ups and downs of the money supply, the price of gold (as he advocated in the past) or strict targets for inflation or economic growth.

One thing is certain. Mr. Greenspan's monetary policy is grounded in confidence that he understands the business cycle, the long-established pattern of booms and busts. This skill is especially useful now because the Fed is fine-tuning a stable economy, in contrast to the early 1980s, when Paul Volcker's Fed drove inflation down to 4% from 10%.

Mr. Greenspan studied economics at Columbia University under Arthur Burns, who was later Fed chairman, and he keeps Mr. Burns's path-breaking 1946 book, Measuring Business Cycles, on a shelf above his desk. Mr. Greenspan's focus on manufacturing reflects his early career of forecasting, steel consumption for steel-makers and his later work for the textile, apparel and oil industries.

His private-sector forecasts weren't impressive, certainly not consistently better than those of other forecasters. But he made a lot of money explaining to companies how he thought the economy worked. In the years between his 1974-to-1977 stint as President Ford's Chief economist and his 1987 Fed appointment, news reports said he got as much as $22,000 for a single speech. He won't confirm that figure.

The Answer Man

Peers think Mr. Greenspan’s ability to understand the figures and how they are assembled is unparalleled. “His reputation was that any time a piece information came out that looked weird, you called Alan Greenspan and he explained it,” says Fed Governor Lawrence Meyer, who was in the forecasting business himself before joining the Fed last year.

Although the Fed’s 232 economists respond rapidly to any Greenspan query, the chairman keeps two computer terminals on his desk - one to check financial markets instantaneously and one to tap the Fed’s huge database. The Fed’s domestic economic-research unit tracks 18,500 data series, 3½ times as many as it did before he arrived.

At meetings of the Open-Market Committee, Mr. Greenspan sounds like the master of all 18,500. After a senior economist briefed the committee on the government’s retail-sales data in a telephone conference call in September 1991, Mr. Greenspan reminded him of a downward revision for the previous month.

“That I don't have,” the economist said.

“It's 0.2%,” Mr. Greenspan told him. “You have more information than I do,” the economist replied.

The crucial issue every six weeks or so when the Open Market Committee convenes is what Mr. Greenspan expects the economy to do over the next six to 12 months. “Because monetary policy works with a lag,” he said recently, “we need to be forward-looking, taking actions to forestall imbalances that may not be visible for many months. There is no alternative to basing actions on forecasts.”
Seizing the Moment

Mr. Greenspan doesn't put his forecast in writing for Fed colleagues or even detail it orally. He hints at it, though, at the pivotal moment in every Open Market Committee meeting when he kicks off discussion about whether to change interest rates. “Greenspan,” says former Cleveland Fed President Lee Hoskins “doesn't come out and say, 'Here is a forecast.' He's looking at a particular indicator and says, 'This is what I've been thinking about.'”

Before each meeting, the Fed's research unit does prepare a detailed forecast, which is known internally as the Green Book because of its green cover and carries the warning: “Strictly Confidential/Class II FOMC.” To the surprise of Fed newcomers, the chairman makes little attempt to influence this forecast. Sometimes, he even takes exception to it. “Measured price inflation is likely to fall somewhat faster than is indicated in the Green Book,” he said at a late-1991 meeting. “In fact, if I had a bet on it, I would take it.”

And Mr. Greenspan ignores staff advice whenever he thinks his personal forecast is better, as he did last August.

Much of what he does is a constant search for indications that economic demand may outstrip supply, a development that, if unchecked, can push up prices. His favorite early-warning gauges include the weekly government tally of new claims for unemployment benefits (“It's the level of initial claims, not their direction, that determines the rate of change in economic activity,” he says), the amount of overtime worked, auto sales and the National Association of Purchasing Management’s monthly survey of its members’ order books, pricing plans and other data.

“Having looked at the order positions in the best detail I could, and having spoken to the purchasing managers in some considerable detail - even going beyond the data that were published - the impression that I am getting is that all the preliminary indications are that their next report will be one of increasing softness on the inflation side,” Mr. Greenspan told the Open Market Committee in his characteristically convoluted syntax a few years ago.

This fixation on numbers frustrates Fed policy makers who want the central bank to rely on a more general, easier-to-understand set of guidelines.

At one committee meeting, the transcripts record, Cleveland’s Mr. Hoskins gave a routine overview of his region's economy and mentioned almost parenthetically that one company’s orders for something called stainless-steel strip were running far below average.

“Did that ever work out as good indicator?” Mr. Greenspan interjected. Mr. Hoskins confessed that he hadn't examined it carefully. Mathematically rigorous inspection later showed the measure didn't reveal much of anything. When Mr. Hoskins mentioned it again a year later, Mr. Greenspan interrupted, “I thought we agreed that that doesn’t work.”

Several months afterward, according to transcripts released this month, Mr. Hoskins half-jokingly told the committee, “You’re probably all waiting for my stainless-steel-strip index, but . . . I’ve latched onto a new one.”

Subtly mocking Mr. Greenspan, Mr. Hoskins said Paul Smucker of Smuckers-jam fame – “who has been through many business cycles” – observes that apple-butter sales turn up when the economy turns down. “So,” Mr Hoskins announced, “I’ll be reporting to you on apple butter.”
