Alan Greenspan: Nomination hearing

Testimony by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System before the Committee on Banking, Housing, and Urban Affairs, US Senate, Washington DC, 15 June 2004.

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I want to express my gratitude to President Bush for his confidence in me and to you, Mr. Chairman and members of the committee, for expeditiously holding this hearing on my renomination for a fifth term as Chairman of the Board of Governors of the Federal Reserve System. The Federal Reserve has had a close and productive relationship with this committee over the years. If you and your Senate colleagues afford me the opportunity, I look forward to working with you in advancing our shared goal of strengthening the firm foundation upon which the American people have built a prosperous economy and a sound and efficient financial system.

The performance of the U.S. economy has been most impressive in recent years in the face of staggering shocks that in years past would almost surely have been destabilizing. Economic policies directed at increasing market flexibility have played a major role in that solid performance. Those policies, aided by major technological advances, fostered a globalization, which unleashed powerful new forces of competition, and an acceleration of productivity, which at least for a time has held down cost pressures.

We at the Federal Reserve gradually came to recognize these structural changes and accordingly altered our understanding of the key parameters of the economic system and our policy stance. But while we lived through them, there was much uncertainty about the evolving structure of the economy and about the influence of monetary policy.

The Federal Reserve’s experiences over the past two decades make it clear that such uncertainty is not just a pervasive feature of the monetary policy landscape; it is the defining characteristic of that landscape. As a consequence, the conduct of monetary policy in the United States has come to involve, at its core, crucial elements of risk management. This conceptual framework emphasizes understanding the many sources of risk and uncertainty that policymakers face, quantifying those risks when possible, and assessing the costs associated with each of the risks.

This framework entails devising, in light of those risks, a strategy for policy directed at maximizing the probabilities of achieving over time our goals of price stability and the maximum sustainable economic growth that we associate with it. In designing strategies to meet our policy objectives, we have drawn on the work of analysts, both inside and outside the Fed, who over the past half century have devoted much effort to improving our understanding of the economy and its monetary transmission mechanism. A critical result has been the identification of key relationships that, taken together, provide a useful approximation of our economy's dynamics. Such an approximation underlies the statistical models that we at the Federal Reserve employ to assess the likely influence of our policy decisions.

However, despite extensive efforts to capture and quantify what we perceive as the key macroeconomic relationships, our knowledge about many of the important linkages is far from complete and, in all likelihood, will always remain so. Every economic model, no matter how detailed or how well designed, conceptually and empirically, is a vastly simplified representation of the world that we experience with all its intricacies on a day-to-day basis. Policymakers have needed to reach beyond models to broader - though less mathematically precise - hypotheses about how the world works.

A central bank needs to consider not only the most likely future path for the economy but also the distribution of possible outcomes around that path. The decisionmakers then need to reach a judgment about the probabilities, costs, and benefits of the various possible outcomes under alternative choices for policy.

As the transcripts of Federal Open Market Committee meetings attest, faced with these abundant challenges, we find the making of monetary policy to be an especially humbling activity. In hindsight, the paths of inflation, real output, employment, productivity, stock prices, and exchange rates may seem to have been preordained, but no such insight existed as we experienced these developments at the time.

Yet, during the past quarter-century, policymakers managed to defuse dangerous inflationary forces and to deal with the consequences of a stock market crash, a large asset price bubble, and a series of liquidity crises. These developments did not divert us from the pursuit and eventual achievement of price stability and the greater economic stability that goes with it.

Going forward, we must remain prepared to deal with a wide range of events. Particularly notable in this regard is the fortunately low, but still deeply disturbing, possibility of another significant terrorist attack in the United States. Our economy was able to absorb the shock of the attacks of September 11 and to recover, though remnants of the effects remain. We at the Federal Reserve learned a good deal from that tragic episode with respect to the impact of policy and, of no less importance, the functioning under stress of the sophisticated payments system that supports our economy. Our efforts to further bolster the operational effectiveness of the Federal Reserve and the strength of the financial infrastructure continue today.

Each generation of policymakers has had to grapple with a changing portfolio of problems. So while we importantly draw on the experiences of our predecessors, we can be sure that we will confront different problems in the future.

The Federal Reserve has been fortunate to have worked in a particularly favorable structural and political environment over the past quarter-century. But we trust that monetary policy has contributed meaningfully to the impressive performance of our economy in those years. I have been extraordinarily privileged to serve my country at the Federal Reserve during most of these years and would be honored if the Senate saw fit to enable me to continue this service.