Case Archive

# Chapter 10: Decision Making: Rationality and Risk

## Steering the Economy: Decision Making at the Federal Reserve

No story about former Federal Reserve Board chairman Alan Greenspan, who served from 1987 until 2006, is more famous than the tale of his love of baths. He was said to love nothing more than a good early-morning soak, poring over arcane economic statistics and thinking the big thoughts that would drive his day.

He has a bad back, so the hot bath eased the pain. But Greenspan long cultivated the image of a man whose idea of relaxing is to digest information that would put other people to sleep—and by being in command of the numbers, to run what might well be the most powerful institution in the world.

When the economy began to dip in 2001, the once-invincible Greenspan began taking shots from critics who charged that he had missed the chance to help steer the economy out of its recession. As complaints rose, William Webster, former FBI and CIA director, said simply, “He will shoulder it as he always has, but maybe with 15 more minutes in the bathtub every morning.”[[1]](#footnote-1)

Greenspan’s power came from his leadership of the Federal Reserve, and the Fed’s power comes from its management of the nation’s money supply as well as its direct and indirect influence over the world’s economies. Decisions Greenspan made about the U.S. domestic economy had ripple effects across the globe.

The Fed is a little-known but highly complex organization that is independent of the executive, legislative, and judicial branches of government. Greenspan was chair of its seven-member Board of Governors, which sits in Washington. Board members are appointed for fourteen-year terms; their long terms, coupled with the fact that they don’t face the voters at the polls, give them unusual political independence. (In fact, not counting the lifetime appointment of federal judges, the Fed’s board members serve the second-longest terms in the federal government, after the fifteen-year term of the Comptroller General at the Government Accountability Office.)

In addition to that Washington-based board, there are twelve Federal Reserve Banks, scattered around the country, which manage the system’s regulations. Five rotating presidents of the Federal Reserve Banks join the seven members of the Federal Reserve Board to comprise the Federal Open Market Committee, which sets the nation’s monetary policy.[[2]](#footnote-2)

The Fed doesn’t actually set interest rates or directly control the economy. Rather, it uses some highly intricate tools, such as its power to set the rates at which banks borrow from the Federal Reserve and its ability to shape the supply of money and credit, to help manage the economy. Financial reporters often write about the Fed’s efforts to guide the nation’s economic activity, but its controls are loose. Many other factors also play into economic performance, from the sometimes unpredictable behavior of American consumers to the impossible-to-control behavior of other nations.

As the federal budget has grown increasingly out of control in recent years, spawning large, persistent deficits that suggest that many federal policymakers have given up hope of balancing the budget, the Fed has increasingly seemed to be the only game in town for steering the economy. But how should it operate its steering wheel?

Since the 1930s, Fed officials have tried to guess the direction of the economy and to adjust monetary policy accordingly. When the economy looked like it was slowing down, they would make money “easier” (providing a larger money supply, which tends to reduce interest rates, make it cheaper to borrow, and spur the economy). When the economy started to heat up, they would make money “tighter” to slow down the boom before it overheated into inflation.

For decades, critics such as economist Milton Friedman argued that the Fed often guessed incorrectly the direction and size of the movement. The Fed, they charged, often acted too late and, then, it often overreacted, which only tended to make things worse. It would be better (and more rational), they claimed, to put the Fed on automatic pilot—to adjust the money supply by means of a fixed target and let the economy sort itself out.

Believing that they could do better, Fed officials resisted that argument. And they knew for sure that, if the economy should seem too weak (with too much unemployment) or too blustery (with too much inflation), they would catch political heat for not stepping in. After all, the Fed’s history is full of presidents sending signals, sometimes subtle and sometimes not, trying to nudge the Fed to act to make sure the economy won’t slow down near an election.

Under Greenspan, the Fed began worrying that it was having an increasingly hard time affecting the economy because the financial markets—and the thousands of financial analysts who worked in those markets—were trying to outguess the Fed. Often, by the time the Fed announced a policy decision, the markets had already anticipated and reacted to the news. Sometimes, when the analysts had guessed wrong, the Fed had not only to steer the economy but to put the financial analysts back on course.

So, in the early 1990s, Greenspan and his colleagues began gearing their efforts toward a concept of “rational expectations”: trying to influence economic behavior not only by affecting the money supply but also by seeking to shape *expectations* about the money supply—and what the Fed was going to do about it. Fed officials discovered that they could exert tremendous leverage over the markets by sending subtle signals about what they were likely to do. Like a pebble tossed into a still lake, these signals rippled out with broad effect.

But the Fed also realized that trying to guess too far into the future was dangerous, since both the economy and world events often proved wildly unpredictable. Therefore, rather than jumping suddenly into a new policy, the Fed would signal which way it was leaning toward moving. Then, when it started to move, it would do so in a series of small steps. In response to the weak economy in 2001, for example, the Fed lowered one of its interest rate targets eleven times, moving gradually from 6.5 percent to 1.75 percent.

These incremental moves gave the Fed three advantages. First, it could maintain maneuvering room to adjust its policies along the way. Second, it avoided signaling the markets when it was going to start and when it was going to stop, so it retained flexibility about the total size of its policy change. And, third, by taking small steps, it generated a continuing buzz in the markets about what was going to happen next, and thus encouraged the rational expectations of money managers.

The result, the *Wall Street Journal* concluded, was that Greenspan “has deftly steered the American economy by relying on two strengths: an unparalleled grasp of the most intricate data and a willingness to break with convention when traditional economic rules stop working.”[[3]](#footnote-3) There must be something to those hot baths surrounded by statistics.

His successor, Ben Bernanke, was a Princeton economics professor who had no reputation for Greenspan’s hot baths or statistical magic. In late 2007 and early 2008, Bernanke had to tackle an enormous financial challenge with a different set of tools. Borrowers had gradually accumulated large amounts of debt for home mortgages, sometimes with little or no money down and with clauses in their mortgages that allowed banks to increase their monthly payments substantially. Many homeowners began having a very difficult time making their payments and the banks foreclosed. Some communities turned into ghost towns. In others, buses took potential investors on tours of foreclosed homes that were available at bargain-basement prices. Bernanke stepped in aggressively to help stabilize the market. Among other things, he led the Fed over a March 2008 weekend in brokering a purchase of a major investment banking firm, Bear Stearns, by the mega-bank JPMorgan Chase. The Fed supplied a $30 billion credit line to help finance the deal. Fed officials also said they would take over the enormous Bear Stearns investment portfolio. With so much of their money invested in the deal, they took over control of many of the investment decisions to reduce the Fed’s risk—but at the cost of inserting the Fed ever more deeply into basic financial decisions in the economy.

As the nation’s banking problems continued in 2008, the Fed said it might extend its tough oversight powers. Experts acknowledged that Bernanke’s emergency intervention into the markets made sense in the middle of the crisis, but extending that role would mean continuing its oversight over financial institutions that the Fed did not regulate, including investment banks (which are institutions that concentrate on raising large sums of money to support big corporate expansions). The announcement, as the *Wall Street Journal* reported, had Bernanke “walking a difficult line.” He was signaling he was still worried about the financial system and was trying to keep interest rates low. At the same time, rising energy costs, sinking home values, and tightening credit were all leading the Fed to push interest rates higher, to restrain inflation.[[4]](#footnote-4) He might well have felt he needed one of Greenspan’s long soaks.

## Questions to Consider

Consider Alan Greenspan’s decision-making style. How would you characterize it?

Its critics have long called for less discretion and more predictability in the Fed’s decision making. Apart from the complexities of the economic issues, what are the advantages and disadvantages of discretion in decision making in an institution such as the Fed?

How does the concept of “rational expectations” fit in with the theories of decision making we have explored in this chapter?

Think about Greenspan’s strategy of ratcheting interest rates up and down in small (incremental) steps. What are the advantages and disadvantages of such a strategy of decision making?

The institution’s relative stability and its status make this perhaps the best place in American government to ask: what constitutes a “good” decision? Can—and should—the Fed try to be “rational”? (And, if so, what does that mean?)

Bernanke’s idea of “rationality” included leading the short but secret negotiations to help JPMorgan Chase buy out Bear Stearns. Do you think it is good for an organization like the Fed to be helping private organizations make enormous investments? Or is it the price for economic stability in a global marketplace?

1. Richard W. Stevenson, “Once Unthinkable, Criticism Is Raised against Greenspan,” *New York Times,* April 2, 2001, A1. [↑](#footnote-ref-1)
2. For information on the Fed’s structure and role, see its website, http://www.federalreserve.gov/general.htm. [↑](#footnote-ref-2)
3. Greg Ip, “Fed Chief’s Style: Devour the Data, Beware of Dogma,” *Wall Street Journal,* November 18, 2004, A1. [↑](#footnote-ref-3)
4. Damian Paletta and Sudeep Reddy, “Bernanke Moves to Extend Fed’s Powers Over Wall Street,” *Wall Street Journal,* July 9, 2008, A1. [↑](#footnote-ref-4)