Journal Of Investment Management, Vol. 3, No. 4, (2005), pp. 104–105

JOIM
www.joim.com

CASE STUDIES

"Case Studies" presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

Jack L. Treynor, Senior Editor

QUIZ FOR FED CANDIDATES

In a short time Alan Greenspan will be retiring: Washington has the unenviable task of choosing his successor. There is no shortage of candidates. But chairman of the Fed is not, of course, just another important Washington job.

Expert students of the Fed have given us important clues in considering candidates.[1]

"We have had 12 chairmen . . . and some of them have made expensive blunders"—Allen H. Meltzer

He should be able to distinguish "between the economic models we construct and the real world."—Alan Greenspan

He shouldn't be "brainwashed into use of the doctrines"—Allen Sinai

The next chairman will undoubtedly be diplomatic with congressmen and other central bankers, articulate in his public utterances, perspicacious and discreet in his defense of the Fed's independence. But has he been so thoroughly brainwashed that he cannot see the real world beyond the academic models?

We have put together a brief quiz intended to reveal the inner applicant.

Quiz for candidates for Fed chairman

Do you think "money matters"? How would you measure the degree of monetary ease or restraint?

How well would the US economy function under hyperinflation?

What are the main limits on the sustainable level of prosperity?

True or false: Inflation results from a failure to invest in home goods plant.

True or false: Trade deficits result from a failure to invest in tradables plant.

What is the primary lesson from the great panics of the last two centuries? What do they tell us about demand failure?

Explain the significance of the *term premium*. Estimate its size.

To other countries, the United States is an independent economic entity. How should they determine whether we are pulling our weight? Should they be willing to make investments in the US that increase our home goods plant?

Estimate what it costs the private sector to create one job. $5,000? $50,000? $500,000? What is the role in the country's saving of households with a high low marginal propensity to consume? In its risk taking? In the distribution of the country's wealth? Will raising their taxes reduce consumption?

True or false: In contributing to the volume of our country's output, labor and capital are substitutes for each other.

How would you go about calculating the effect of a change in domestic demand on the trade balance?

Define *liquidity trap*. Explain why the concept is important to the Fed.

Discuss the impact of the spot inflation rate on the long Treasury rate. Assume that the US economy is at least partly open.

Special difficulty—double points:

Explain how the value of the dollar is determined in a *pure float* (as distinguished from a dirty float, or flexible exchange rates). Assume that

1. US economy is at least partly open.
2. Interest-rate parity holds.

The level of consideration that you give to policy suggestions from other members of the Board will be

1. about the same as your predecessors
2. even less.

In your view, how important to the Fed is its independence? What are the implications for its transactions in the capital markets? Can the Fed afford to be transparent with journalists? With legislators? With investors?

McChesney Martin dealt with the predictability transparency problem by drawing on a pipe, Volcker by chewing on a cigar. Or would you adopt Greenspan's solution? (Please limit your answer to 500 words.)

Answers will be revealed after the new chairman is chosen.

Note

[1] *New York Times*, Friday, August 26, 2005, p. 1.