

RESEARCH SPOTLIGHT

Influential Chairmen

BY ERNIE SICILIANO

Former Federal Reserve Chairman Alan Greenspan reportedly received an \$8.5 million advance for his memoir, *The Age of Turbulence*. The lofty price illustrates the large cache of the title “Chairman of the Federal Reserve,” a position that is widely perceived as second in power only to the president.

Indeed, “central banks’ policies can have significant macroeconomic effects, and it is often assumed that the governor exerts a disproportionate influence over those policies,” say economists Kenneth Kuttner of Oberlin College and Adam Posen of the Peterson Institute for International Economics, explaining the lionization of bank governors. In their new study published by the National Bureau of Economic Research, “Do Markets Care Who Chairs the Central Bank?” they find that markets respond to central bank governors even before they have a chance to act.

Kuttner and Posen looked at the behavior of markets after a new governor is announced and find that announcements result in fluctuations in exchange rates, bond yields, and, to a lesser extent, stock prices. Such fluctuations indicate that markets expect certain behaviors from the new governor.

Kuttner and Posen test two related hypotheses of what financial markets anticipate from new governors. (The authors use the term “governors” interchangeably with “chairmen.”) First, markets believe that new central bank governors are “weak” on inflation until proven “strong.” If true, then this hypothesis would mean that the announcement of new governors would be associated with heightened inflation expectations. Second, markets may interpret the announcement of a new governor as a harbinger for future monetary policy, but without the presumption that new chairmen will be “weak.”

To test their hypotheses, the authors analyze data from 1974 to 2006 from 15 industrialized countries with flexible exchange rates. They found 62 announcements of a new central bank governor. The economists divided the announcements into 42 “newsworthy” and 20 “non-newsworthy” announcements. Non-newsworthy announcements were when the incoming governor was already anticipated, while newsworthy appointments were surprise resignations by incumbent or unknown appointments.

If, as the first hypothesis suggests, incoming governors are initially viewed as weak, Kuttner and Posen argue that

expected inflation will rise, causing falling exchange rates, rising bond yields, and falling stock prices. However, the authors find that financial markets do not follow this trend when a new governor is named. The lack of directional movement suggests that financial markets do not specifically view incoming governors as weak or strong.

The markets’ reactions indicate that the announcement of a central banker provides some tidbit of information about future policy. The markets do respond to this tidbit, the authors find, but the reaction only occurred the day of the announcement, and there was no significant reaction in two days before or after the announcement. (Indeed, this

is what one would expect if the announcement was not leaked in advance and the capital markets efficiently incorporated the new information.)

Further demonstrating the efficiency of financial markets, the economists found that the foreign exchange market react only to newsworthy appointments — as the market had already

priced in previously named governors. The bond market reacts to newsworthy events, but curiously also react to non-newsworthy events. Stock markets react only to newsworthy events. According to the authors, the weaker significance is probably due to the fact that stock prices reflect future earnings more so than central bank policy. Moreover, future earnings are affected by many factors, of which central bank policy is only one. However, the economists cited “a few strong reactions” in the stock market, such as in 2005 when Ben Bernanke took control at the Federal Reserve.

Such strong reactions are emblematic of U.S. financial markets, which generally react more aggressively than foreign markets. Kuttner and Posen offer two explanations: First, U.S. data “tended to contain a larger element of surprise than many of the other appointments in the sample,” and thus may have biased the results. Second, the Federal Reserve’s announcements may face more scrutiny in America — the result of more aggressive press coverage, a more active Federal Reserve, a lack of “a clearly defined policy mandate” such as inflation targeting, or what the authors describe as a “certain American institutional tendency to ‘personalize’ monetary policy.” By that, the authors refer to the tendency of the public to attribute the effectiveness of monetary policy to the individual personality or wisdom of the chairman. **RF**

“Do Markets Care Who Chairs the Central Bank?” By Kenneth N. Kuttner and Adam S. Posen. National Bureau of Economic Research Working Paper 13101, May 2007.