A CLASS ACT

Prakash Loungani **profiles Stanley Fischer, academic, IMF deputy, and central bank governor extraordinaire**

IN 2012, the magazine *Global Finance* gave Stanley Fischer, then central bank governor of Israel, an A for his handling of the economy during the financial crisis. It was the fourth year in a row that Fischer had received an A. It's a grade the former professor—who taught both Federal Reserve Board Chairman Ben Bernanke and European Central Bank (ECB) President Mario Draghi—cherishes: "Those were some tough tests we faced in Israel."

Fischer stepped down as central bank governor in June this year after eight years in the job, bringing the curtain down on an extraordinary third act of his career. The second act was as the IMF's second-in-command during the tumultuous period of financial crises in emerging markets from 1994 to 2001. This role as policymaker came after a rousing opening act in the 1970s and 1980s, during which Fischer established himself as a preeminent macroeconomist, one who defined the contours of the field through his scholarly work and textbooks. It speaks to Fischer's success that stints as the World Bank's chief economist in the 1980s and as vice chairman at Citigroup in the 2000s—which would be crowning achievements of many a career—come across as interludes between the main acts.

Prelude

Fischer grew up in Mazabuka, a town in Northern Rhodesia, now Zambia, where his family ran a general store. The house in which he was raised was behind the store; it had no running water and was lit with hurricane lamps. When he was 13, his family moved to Southern Rhodesia, now Zimbabwe.

Fischer became active in a Jewish nationalist youth movement and first visited Israel in 1960 on a program for youth leaders. For both Fischer and Rhoda Keet—then his girlfriend and later his wife and mother of their three sons—the trip marked the beginning of a lifelong commitment to Israel. When he was appointed governor of the Bank of Israel several decades later, many in Israel recalled the person they had grown up with in southern Africa. "We always knew he was bright, but he must have been a hell of a lot brighter than even we thought he was," said Judy Dobkins, who was in the same youth program in 1960.

An economics course in high school and an introduction to the work of John Maynard Keynes set Fischer on the road to specializing in economics. He says he was "hooked by Keynes's use of language" and by the knowledge that, during the Great Depression, the "world as we knew it had nearly collapsed" and Keynes's ideas had saved it. The London School of Economics (LSE) was a natural choice for an undergraduate degree: "For us, England was the center of the universe," Fischer has said. Of his professors at LSE, Fischer remembers one who predicted in 1963, based on a study of past patterns, that the United Kingdom would have a balance of payments crisis in 1964: "The crisis took place on the appointed date, and I was very impressed."

Fischer went on to graduate school at the Massachusetts Institute of Technology (MIT), drawn by the presence there of Paul Samuelson and Robert Solow, famous economists who would both go on to receive the Nobel Prize. MIT was then at the forefront of the development of a mathematically rigorous approach to macroeconomics. Fischer has said that his "MIT experience was truly formative," marked by great professors and "a remarkable group of fellow students"—among them Avinash Dixit ("he could do the [New York] *Times* crossword puzzle in about 10 seconds"), Robert Merton, and Joseph Stiglitz, who later became a fierce critic of Fischer (see box).

Fischer's first job was at the University of Chicago, which was then at the cutting edge of applying economics to policy problems. Fischer says he made the choice because Chicago "was the best place that made me an offer" and because he felt that he had learned a lot of economics but "didn't know much about the economy." Chicago enabled Fischer "to combine MIT's analytics and the policy relevance that [Chicago professor] Milton Friedman typified."

Uniting the wings

Bridging the worlds between MIT and Chicago was good training for the role Fischer was to play in the 1970s, which was to broker a peace between warring wings of classical and Keynesian macroeconomists.

The Keynesian school advocated an active role for monetary policy—that is, actions by the central bank—to smooth out fluctuations in the economy. If unemployment was higher than its long-run average, the central bank could try to nudge it back down by increasing the growth rate of the money supply. In the Keynesian model, the ability of the central bank to lower unemployment came about because prices and wages were assumed to be difficult to change in the short run—in the jargon of macroeconomists, prices and wages were "sticky."

The classical wing objected that if unemployment could be lowered simply by printing more money, the economy would be getting what Friedman—a leading proponent of classical views—called a "free lunch." He predicted that repeated attempts by the central bank to lower unemployment would lead to prices and wages starting to adjust instead of remaining sticky. Once that happened, Friedman said, inflation would rise and unemployment would go back to its long-run average. The economy would thus eventually end up with higher inflation and no long-run benefit in terms of reduced unemployment.

As events in the United States and other economies in the 1970s started to mirror these predictions—the drop in unemployment proved short lived and inflation crept up—the balance of power started to shift toward the classical school. Classical economists now went a step further and started to assume that, far from being sticky, prices and wages would adjust quickly to any attempts by the central bank to affect unemployment. Under that assumption—known as "rational expectations"—the central bank would be ineffective in smoothing out fluctuations in the economy, even in the short run.

Enter Fischer. In a 1977 paper—he had by then been lured back to MIT from Chicago—he combined the assumption that people had rational expectations with the key features of Keynesian models. Fischer made the realistic assumption that wages are set in advance through an implicit or explicit contract between employers and their workers. This renders wages—and, through this channel, prices—temporarily sticky. As long as the central bank can act more frequently than contracts can be renegotiated, it can have an impact on unemployment in the short run, as in Keynesian models. But this is not an option in the long run because, over time, con-

Defending the Washington Consensus

It is not surprising that Fischer, as someone of Latvian-Lithuanian descent who grew up in southern Africa, has always been interested in issues of the economic development of nations. His tenure as the World Bank's chief economist gave him a chance to leave his imprint on these issues. According to economist Brian Snowdon, Fischer's work "emphasizes the importance of establishing a stable macroeconomic environment and sound financial institutions for achieving the key long-run goals of growth and economic development." Fischer also emphasized, Snowdon writes, that "poverty reduction occurs fastest where there has been rapid growth, and also that openness to the international economy is a necessary, though not a sufficient, condition for sustained growth."

Many of the policies that Fischer championed became known as the "Washington Consensus." Despite criticism of the policies, and the term itself, over the years, Fischer says he still has "faith in the set of policies" but that the label attached to them was an unfortunate one. "It was a mistake to call it 'Washington Consensus' because it was at that time a global consensus." He says the importance of openness to trade, sound macroeconomic policies, and a market orientation has been "proven over and over again." He defends the move to open capital markets to foreign capital, arguing that the experience has shown, not its undesirability as a long-term goal, but rather the need to manage this capital account liberalization carefully.

Fischer was also associated with the advice given to transition economies—the economies of the former Soviet bloc—on the pace and nature of the reforms they should undertake. This advice too has come in for criticism, not least from Joseph Stiglitz, for pushing for too much, too soon. Stiglitz has said that the transition economies should have followed a more gradualist path, learning from the "enormous success of China, which created its own path of transition rather than use a blueprint or recipe from Western advisors." The advice given by Fischer and others has its defenders. Harvard University's Ken Rogoff (previously IMF chief economist) endorses the need for speed: "It is unlikely that market institutions could have been developed in a laboratory setting and without actually starting the messy transition to the market." Rogoff notes that the transition economies had already tried "a Chinese-style approach of limited reform"—for instance, under Gorbachev in the Soviet Union, Kadar in Hungary, and Jaruzelski in Poland—and it was the failure of these attempts that "led to more aggressive efforts towards a market economy."

tracts would take into account the inflation that the central bank has generated. Thus, the economy would behave in the long run according to the classical models.

Fischer's paper marked the beginning of New Keynesian Economics, which now draws support from both the classical and the Keynesian camps and provides a synthesis in which the economy has Keynesian features in the short run and classical features in the long run. Chris Erceg, a senior official at the Federal Reserve—and a Chicago graduate who made important contributions to New Keynesian Economics in the 1990s—says that Fischer's paper is now seen as a "critical turning point" in scaling back the "internecine warfare" of the two wings.

From theory to policy

Over the course of the 1980s, Fischer continued to contribute to scholarly work while also becoming active in the policy arena. As a scholar, his most famous work was in the form of two textbooks—coauthored with his MIT colleagues—which played a key role in charting the changing landscape of macroeconomics. One was a textbook for undergraduates written with Rudi Dornbusch, and the other for graduate students, coauthored with Olivier Blanchard, currently the IMF's chief economist. Blanchard says that writing the book with Fischer "was one of the most exciting intellectual adventures of my life. We both felt there was a new macroeconomics, more micro founded and full of promises. . . . While we had not thought of it as a textbook, it quickly became one, and it is nice to know that it still sells surprisingly well today."

Fischer first tried his hand at policymaking when George Shultz, then U.S. secretary of state, called on him and Herbert Stein, a former chairman of the U.S. Council of Economic Advisers, to help Israel's government deal with triple-digit inflation, dwindling foreign exchange reserves, and slow growth. Fischer and Stein concluded that Israel needed to come up with a firm plan to reduce the excessive government spending that was the source of the other problems. Without such a plan, Fischer told the U.S. Congress in April 1985, "the likelihood is strong that two years from now, she [Israel] will still be growing slowly, still fighting high inflation, and more than ever reliant on outside aid." Fischer and Stein also recommended that milestones be set to measure Israel's progress toward reducing its budget deficit and that the flow of U.S. aid to the country be conditional on the attainment of those milestones.

Shimon Peres, Israeli prime minister at the time, later recalled that he didn't know enough about economics to argue with Fischer. But he followed Fischer's advice and was "amazed" to discover that it worked. Inflation fell from a peak of 450 percent to 20 percent in the course of a year. "No one could have advised us better," says Peres.

Fischer soon got a chance to tackle a much broader range of policy issues as the World Bank's chief economist from 1988 to 1990. He then returned to MIT but found that "it was hard readjusting" to academic life: "I remember going to theory seminars and saying to myself, what difference does it make whether this guy is right or wrong?" Harvard's Greg Mankiw—former chair of the U.S. Council of Economic Advisers and another famous Fischer student—recalls that he "got the sense [Fischer] was a little impatient with academics." Even becoming chairman of the economics department at MIT "was only partly inspiring," says Fischer, likening the role to Alfred Kahn's description of a dean's role: the dean is to the faculty as the fire hydrant is to the dog.

Bring on the crises

Fischer's turn on the policymaking stage came in 1994 when he was appointed the IMF's first deputy managing director, the institution's number two spot. Over the next seven years, Fischer dealt with crises in Mexico, Russia, several Asian countries, Brazil, Argentina, and Turkey—and that list still leaves out quite a few.

During the Mexican crisis of 1994–95, Fischer was content to "leave the driving" to Michel Camdessus, who was IMF managing director from 1987 to 2000. Fischer thought he had not yet fully earned Camdessus's trust and that he didn't know enough yet about how to steer through a financial crisis. By early 1995, it became clear that the resolution of the crisis required a large and swift injection of money, $20 billion from the U.S. Treasury and $20 billion from the IMF. The IMF Executive Board balked at making such a huge loan. It took, says Fischer, "the most dramatic board meeting I have seen [and for] Camdessus to challenge the board to fire him" to win approval for the loan.

In mid-1997, a financial crisis hit Thailand and spread quickly to many other Asian countries, including Indonesia, Korea, Malaysia, and the Philippines. By now, Fischer had gained Camdessus's confidence and was ready to cocaptain with him in navigating through the crises. But their initial advice turned out to be a misstep. The IMF advised Thailand and the other Asian countries to tighten fiscal policy even though—unlike the situation in Israel in 1985—government profligacy was not the root cause of the crisis. Fischer now says that "the tightening of fiscal policy was mistaken. That is why the IMF quickly reversed that policy [in Thailand] by the end of 1997 and in Korea by the beginning of 1998. So I do not think that the initial fiscal mistake had a big impact on what happened later."

The IMF's advice to the Asian economies regarding monetary policy also came under fire, particularly from Stiglitz, then the chief economist at the World Bank, who advocated lowering interest rates to help the domestic economy. But Fischer has stuck to his guns and steadfastly argued that this "criticism of monetary policy was not correct." Fischer says the IMF "argued that a short period of interest rate tightening was necessary to stabilize the currency, after which interest rates would be reduced to normal levels. And that is what happened." Fischer also notes that many Asian countries had foreign-denominated debt; a further depreciation of their currency, the likely consequence of lowering interest rates, would have increased the burden of that debt.

Thailand and Korea quickly recovered from the crisis, but Indonesia entered a long period of economic turmoil. Fischer blames this on politics rather than on inappropriate economic advice: "I don't think people understood, us [the IMF] or anybody else, that a regime that looked so stable was not. It soon became clear that [former Indonesian president] Suharto had no intention of delivering [on agreed reforms]. And that was sort of how the thing got out of control."

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Many have remarked on how in control Fischer stayed despite the crises raging around him. Blanchard says that "from the peeks I got of [Fischer] during those times, what strikes me most is how he remained the same he had been at MIT: calm, careful about the facts, analytical, using macroeconomic theory even in the middle of the most intense fires." Horst Köhler, former IMF managing director, adds that in the midst of crisis it was reassuring "to hear Stan Fischer's sonorous, calm, balanced, unexcited voice. That voice restrains you from panicking and encourages you by itself to a considered and systematic way of thinking."

"The responsible adult"

Fischer left the IMF in 2001 when his term as deputy expired—his bid to win the IMF's top job had failed—and started at Citigroup the following year, drawn by the fact that he "had never been in the private sector." He says he enjoyed the work at Citi; the intellectual challenges, and the organizational challenges of working in an institution with 280,000 people, were as tough as what he had faced in other jobs. But the chance to be the governor of the Bank of Israel drew him back into the public sector.

The situation Fischer faced in 2005 was significantly better than in 1985 when he had last actively advised the Israeli government. The low-inflation environment had persisted and the economy was on its way to recovering from a recession. But there were challenges nonetheless. Fischer had to resolve a long-standing labor dispute involving the staffs of both the central bank and the treasury. He also had to shore up the political will to make changes to the central bank law to give it an explicit mandate for "flexible inflation targeting," a system under which the central bank targets price stability while keeping other objectives in mind; in the case of the Bank of Israel, these other objectives were employment and growth as the second objective and financial stability as the third. The law also set up a monetary policy committee so that the central bank governor was no longer the sole decision maker. "This was the advice we gave central banks when I was at the IMF," says Fischer, "and so it was only fitting that I take it myself."

Then the global crisis struck. On October 6, 2008, Fischer cut policy interest rates, a day before similar policy moves by the U.S. Federal Reserve, the Bank of England, and the ECB. Throughout the crisis, Fischer stayed ahead of the curve, making the needed policy changes—such as launching a program of quantitative easing by buying long-term bonds—before markets had anticipated them. *Bloomberg News* found that among central bank governors of the Organisation for Economic Co-operation and Development, Fischer's policy actions during the crisis surprised markets more than those of any other governor.

Fischer also had to take strong and prompt actions to keep Israel's exports competitive. As the crisis engulfed first the United States and then many countries in Europe, foreign capital started to flow into the relatively safe haven of Israel. As a result, the shekel appreciated 20 percent against the dollar, a problem in a country where exports constitute 40 percent of GDP. After Fischer started buying $100 million a day in foreign currency in 2008, the shekel started to fall, and Israeli exports remained robust. Noted author and economist David Warsh credits Fischer with "having steered Israel's economy with barely a scrape through the worst [global] crisis since the Great Depression."

No wonder then that Fischer's announcement in January 2013 that he would step down on June 30 led to much breast-beating in Israeli press and policy circles. The newspaper *Haaretz* said it marked the departure of a "superhero," named "the responsible adult," who had served admirably not just as central bank governor but also, at times, as the "unofficial foreign minister of the Israeli economy: it was Fischer who calmed foreign investors and assured them that the economy was in good hands." Fischer says he has been touched by the response: "I cannot tell you how gratifying—and moving—it is for Rhoda and me to be walking along the beach and have someone stop us and thank us for our service to Israel."

Encore, encore

Fischer's announcement that he was stepping down provoked much speculation about his next act. *Haaretz* said Fischer was holding out for a job as Israeli foreign minister or even president. In the United States, there was talk that he would succeed his student Ben Bernanke as chairman of the Fed. In academia, there was hope that Fischer would turn to a reconstruction of textbook macroeconomics to incorporate what had been learned from the experience of the Great Recession.

Fischer remained tight lipped, saying only that "he was not ready to leave the stage. We always feel younger than we are: when I jog, I realize that I run more slowly than I used to, but I don't feel I've lost speed in other regards." ■

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