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# Beyond Greenspan

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**With the economy dominating today's headlines** and conversations it is hard to remember that we were preoccupied with economic events during the last decade, too. The 1990s were mostly a time of tremendous growth and innovation, but they were not without their own trials and crises. In fact, the conventional wisdom was that only one man truly understood what was happening, and he was leading the economy to prosperity amidst the perils of capitalism.

Alan Greenspan was a rock star to the political and financial establishments of his time. The Federal Reserve chairman had the capacity to change the economy's destiny through his monetary policy powers and his choice words. Interest rate announcements and his appearances before Congress took on the importance of state visits. Perhaps no two words impacted the economy as much as his utterance of "irrational exuberance" in the stock market. No matter that his Fed meetings were predictable or his public testimony laconic, Greenspan's coy style only encouraged exaltation. Time magazine put him on its cover as the head of "The Committee to Save the World," a septuagenarian suavely managing the great game of global finance. Bob Woodward wrote an aptly-titled biography called "Maestro."

The most intriguing reporting of Greenspan during that era was Robert Reich's hilarious memoir of his time as Bill Clinton's first secretary of labor. As he related in *Locked in the Cabinet*, the 4-foot-10-inch Reich would go into Greenspan's office at the Federal Reserve headquarters and plead for him to expand money growth in the hope of boosting wages. Each time, Greenspan would listen and hear out Reich's cries for help, only to send him away gently with the explanation that it couldn't be done because the Fed was worried about inflation. Reich was gone from the administration after the first term, having made no headway in convincing Greenspan to loosen up or in getting the president to complain on his behalf.[1]

Reich's account of Greenspan also gave conservatives someone to credit for the surging economy. In this model, Greenspan's crusade against inflation formed the policy-making that shaped the accompanying economic growth. His discarding of Reich and fellow liberal Clinton proved that old-fashioned tax-and-spend liberalism played no part in delivering the prosperity of the 1990s. Greenspan's commitment to price stability, coupled with the balanced budgeting efforts of his deficit-hawk allies on Capitol Hill, kept the bond market healthy and allowed the expansion to be financed at low interest rates.

This was true, but it is only a sidebar to the main story. The nineties boom was powered by equity, not debt. The stock market that Greenspan had scolded provided the capital for the business expansion, particularly in the tech sector. How much did low interest rates and low inflation have to do with the wave of entrepreneurial capitalism that was lifting the economy? They certainly helped sustain it, but they did not spawn it.

Something much more important happened on the fiscal policy side that did not square with the initial analysis. By August 1996, President Clinton had apologized for his rookie year income tax increase. A year later after winning reelection, he signed the Tax Relief Act of 1997, which had passed Congress with near unanimous Republican approval and 80 percent Democratic support.[2] The law cut the capital gains tax from 28 to 20 percent and excluded the tax on gains from home sales up to certain levels. In short, by taxing capital less it made investing it in the economy more appealing. Over the next three years, average quarterly economic growth rose from 3.7 to 4.3 percent and the Dow Jones soared past 11,000.[3] It was not Greenspan's mysterious practice of central banking that served up this windfall prosperity, it was fiscal policy, specifically tax cutting.

What made this lesson even harder to understand was that President Clinton never took credit for it. He signed the 1997 tax bill as a favor to Republicans, with the expectation that he would receive payback down the road for his own initiatives. After the Monica Lewinsky scandal, that could not happen. So Clinton's major accomplishment for the economy was enveloped in political stratagem, and the president of limited horizons failed to see what great good he had done. Neither party really wanted to talk about the tax cutting of 1997 after that, wary that the other side would covet the credit. So as the economy expanded the Fed chair was happy to claim it.

Greenspan emerged from the nineties triumphant, but his retirement from the Fed in 2006 came amidst a swirl of unrest in the economy. The Fed began the new decade by cutting the Fed Funds rate, the interest rate it charges banks for overnight loans which in turn sets the prime rate that businesses and consumers borrow at, from nearly 6 percent to 1.82 percent over the course of 2001. This dramatically lowered the cost of borrowing. For the next two-and-a-half years it remained low at an average of 1.32 percent. Then in the middle of 2004 the Fed reversed course and raised the Fed Funds rate back up dramatically. At its high point it stayed at 5.25 percent for 12 months over 2006-2007 under the supervision of Greenspan's successor Ben Bernanke. This seesawing had the practical effect of incentivizing people to take risky loans, and then punishing them by making them harder to service. Homeowners and consumer borrowers enjoyed the fruits of cheap money in the inflationary period then endured the pains of being debtors in a monetary contraction. Many who took out adjustable rate loans, which by the beginning of 2006 composed 26 percent of the mortgage market, in the belief that low interest rates were permanent were shocked into delinquency and foreclosure.[4]

Economist John Taylor argues that in keeping the Fed Funds rate so low, Greenspan's Fed deviated from its traditional role of responding to inflation. This convinced the market that a different monetary policy was emerging which would reduce the response of long-term rates like mortgages to inflation. So even as expected inflation rose and real interest rates sunk negative, lenders were content to accept lower returns on their loans because they saw the Fed doing the same thing. This misadventure created ripples throughout the marketplace. "A key lesson here is that large deviations from business-as-usual policy rules are difficult for market participants to deal with and can lead to surprising changes in other responses in the economy," Taylor concludes.[5]

Naturally, Greenspan's legacy has since suffered an undressing, but not in the way it should have. The main thrust of criticism toward him in his reappearance before Congress last fall was his reluctance in the past to call for stricter regulation of mortgages and the financial instruments behind them. His great blunder in monetary policy, what his job centered upon, was ancillary to lawmakers. For his part, Greenspan admitted he had placed too much faith in the market over government regulation, and his ultimate assignment of blame on greedy investment banks dovetailed with Congressional Democrats' sentiments.

More recently Greenspan struck back in a Wall Street Journal op-ed arguing that the Fed did not create the housing bubble. He points out that between 2002 and 2005, for the first time in modern finance U.S. short-term interest rates and mortgage rates did not have a close statistical correlation. It wasn't Fed interest rate cutting that brought down mortgages, he claims, but something larger. His answer lies in the advance of global capitalism. "The result was a surge in growth in China and a large number of other emerging market economies that led to an excess of global intended savings relative to intended capital investment. That ex ante excess of savings propelled global long-term interest rates progressively lower between early 2000 and 2005."[6] In other words, tremendous worldwide economic growth produced more capital than could be invested, so the remainder went into savings. This larger global savings pool brought down long-term rates like mortgages. Or, to put it glibly, the Chinese financed the housing bubble.

The overheating of the housing market has other culprits: Freddie Mac and Fannie Mae gobbling up mortgage-backed securities, Washington mandating riskier loans for the disadvantaged, and the bulge-bracket banks' willingness join the government-sponsored entities and thrifts in this action. Yet it's hard to believe that the Fed suddenly lost influence over long-term interest rates for a few years. Taylor refutes Greenspan's excess of savings argument by pointing out that while it was high in some countries, global savings as a percentage of GDP in 2003-2005 was lower than it was in the early 1970s.[7] Since 2005, mortgages have correlated significantly with the Fed Funds rate again as the Fed began raising it in mid-2004. Its recent move of chopping it to near zero in response to the financial crisis has been followed by mortgages hitting their lowest levels in at least 37 years.[8] The Fed clearly has a grip on interest rates again, if it ever lost it.

Even though he is on the defensive for the housing bubble, Greenspan isn't getting any credit for the 65 straight months of economic growth that surrounded it.[9] Perhaps this conclusion can serve as a reappraisal for his record during the 1990s. If there was anything to learn from the Greenspan years, it was this: monetary policy alone can't grow the economy, but it can certainly derail it. The mistaken interpretation of Greenspan's steady stewardship of the banking system in the nineties as a decade-long masterstroke of economic planning confused us as to how prosperity starts and ends, and how we got to where we are today. The sooner we come to grips with what the Greenspan years really were about, the better understanding we'll have to get out of this mess.

### Endnotes

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