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Greenspan's Fatal Conceit

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In a recent interview for *Bloomberg Businessweek*, Alan Greenspan was asked about his role in the creation of the 2008 financial crisis. He flatly denied any responsibility.[1] Coming to his own defense, he pointed to his explanation of the financial crisis in a 2010 paper for the Brookings Institution, offering a challenge for others to disprove him.

In the aftermath of the 2008 collapse, Alan Greenspan received a great deal of criticism from almost every direction. Some were wary of Greenspan's monetary policy, and many became skeptical after his failure to predict the housing bubble and the subsequent meltdown (despite his claims to the contrary). Many more were critical of Greenspan's support of the "deregulation" of the banking industry during the 1990s and early 2000s. Given his political and economic ideology — he was a follower of Ayn Rand in his earlier years — and the influence he projected over American public policy, perhaps Greenspan made an easy target.

As the former Federal Reserve chairman was bombarded with criticism, some economists were brave enough to come to his defense. In November 2008, David Henderson and Jeffrey Rogers Hummel published a Cato Institute Briefing Paper titled "Greenspan's Monetary Policy in Retrospect: Discretion or Rules," arguing that the Federal Reserve's monetary policy under Greenspan's tenure was neither inflationary nor excessive.[2] Henderson and Hummel's conclusions do not widely differ from those presented by Benjamin Friedman in 2006, two years prior to the crisis, in an academic article titled "The Greenspan Era: Discretion, Rather than Rules."[3] And Warren Coats similarly absolved the Federal Reserve of any influence on interest rates, blaming a rise in East Asian saving rates as the cause.

This debate has remained largely superficial. Greenspan's detractors — the critics of his monetary policy — have attacked him for maintaining low interest rates, but much of the theory underlying these criticisms has been left unsaid. The discussion has been between sides operating within different theoretical frameworks, and thus some of the nuances are ignored or misunderstood.

Given the superficiality of the attacks, it is unsurprising that the defenses of Greenspan have been equally as shallow. Responses to these defenses have been combative, but very few of them have actually dived into the more relevant aspects of the argument. Whether inflation and interest were high, low, excessive, insufficient, or perfect offers nothing of value in regards to the consequences of the money manipulation that actually did occur.

This essay is meant as a response of sorts to Greenspan's challenge. I intend to explore the relationship between Greenspan's monetary policy, prices, the structure of production, and the role of these variables in creating and popping the housing bubble.

The Curse of East Asian Savings

While critics aimed at the Federal Reserve's monetary policy between 2003 and 2007, Alan Greenspan sought to shift blame elsewhere. In his paper "The Crisis," Greenspan offers his explanation of the causes of the financial crisis. Arguments similar to Greenspan's have been made by Henderson and Hummel, Deirdre McCloskey, and others.

The post-2003 Greenspan chairmanship was characterized by very low interest rates. But in a 2000 paper, Deirdre McCloskey argues that Alan Greenspan's ability to set market interest rates is more limited than his critics believe.[4] She looks at the impact of the global supply of savings on the loanable-funds market, arguing that the Federal Reserve's monetary operations are irrelevant in the grand scheme of global savings. Finally, McCloskey posits that the interest rate at any particular geographic location *must* be influenced by the worldwide supply and demand for loanable funds by merit of what one could call a uniformity-of-interest principle.

Greenspan applies this argument in his own defense. He explains low interest rates by pointing to the rise in East Asian savings. Strong economic growth during the 1990s and early 2000s, according to Greenspan, led to a rise in incomes without a proportional rise in consumption. (Greenspan bizarrely blames this on "consumption [being] restrained by culture and inadequate consumer finance.") This led to a rise in savings without an equal rise in the "intention" to invest — and thus led to a fall in the rate of interest. In less roundabout wording, a rise in East Asian savings caused an increase in the supply of loanable funds without an equal rise in the demand for loanable funds.

As it turns out, low interest rates played only a small role in creating the housing bubble. Instead, Greenspan blames "irrational exuberance" and a miscalculation of risk. Greenspan notes the increase in the volume of subprime mortgages from 7 percent of all home loans in 2000 to 20 percent in 2007, thanks largely to the above-average yield on these loans and a declining rate of foreclosure.

Furthermore, credit ratings were often ballooned and did not reflect the underlying risk, which revealed itself after the initial collapse of the housing market. Finally, given low interest rates — spurred by a rise in global savings — the price signals meant to reflect risk remained too low until the onset of the recession. What triggered the recession, in

Greenspan's opinion, was a transition from falling risk aversion to rising uncertainty — a fall in effective demand.

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The ongoing housing boom led banks to reduce reserved capital, increasing their susceptibility to financial disruptions. Had banks' "financial assets [been] funded by greater equity," argues Greenspan, the deflationary episode that followed the initial crash might never have occurred. Instead, the recession would have looked similar to that of 2000–2003 (where the dotcom crash of 2000 was not followed by a fall in gross domestic product until 2002, and the financial system remained intact).

How did the risk of a fall in effective demand for packaged securities relate to the liquidation of a great deal of the individual loans issued? Greenspan does not explain. Risks related to the inability to repay issued loans do not play a major role in Greenspan's version of the causes of the recession, at least as it is laid out in "The Crisis."

But the former Fed chairman does not fall short of blaming a lack of regulation. In his interview with *Bloomberg Businessweek*, Greenspan says,

One of the things that I had been almost taking as a given was that corporate executives, specifically bank executives, knew enough about their organizations and cared enough to act in the support of the solvency of their institutions. I was wrong. They did not.

Greenspan argues in favor of greater Fed oversight of the degree of risk assumed by the banking sector. His case stands on shaky grounds, though; even Greenspan admits that present models cannot accurately or efficiently predict credit risk — for example, he admits the fact that money-market mutual funds were perceived to be virtually riskless (and events following the collapse of Lehmann Brothers proved this to be untrue).[5]

Contra Greenspan, Henderson, and Hummel, George Selgin has provided a short empirical case ("Guilty as Charged") showing a correlation between Fed monetary policy and market interest rates.

Frank Shostak has also taken a look at Fed policy and interest rates in "Greenspan Absolves Himself." Most importantly, Shostak has also shown how a rise in global, non-American savings *did not* cause a fall in dollar-denominated interest rates ("The Fed Did It, and Greenspan Should Admit It"). Shostak rightfully posits that foreign markets do not regulate the total supply of dollars, as the supply of money is firmly regulated by the Federal Reserve and the American financial sector.

Even in the event of a current-account deficit (trade deficit), or a capital-account surplus, foreign currencies must first exchange with the dollar. Thus, an increase in demand for US products or an increase in the inflow of foreign capital (currency) would increase the value of the dollar relative to those currencies. Instead, what occurred was a steady increase in the supply of US dollars — and US dollars are only printed in the United States. Blame for a fall in interest rates should properly be placed on the shoulders of the banking industry and its cartelization by the Federal Reserve.[6]

Another shortcoming in Greenspan's analysis is that he pays little attention to why the real risks involved with the various housing loans did not manifest themselves in the pricing process. Nor was there much aversion to risk in the industries like construction, which produce higher-order goods for the housing industry.

That Greenspan did not take a closer look at the nature of the pricing process during the boom years is unsurprising given that this particular area of macroeconomics has long been ignored by most economists. However, as it turns out, it is the distortion of the pricing process that best explains the housing bubble and the recession that followed.

Capital Theory

The crowning achievement of the Austrian School and like-minded economists, including William H. Hutt, is the creation of a macroeconomic theoretical framework that explains the market and pricing processes. The pricing process and the principle of profit and loss, in effect, guide the distribution of goods in an economy. While most economists have come to agree that the pricing process is the most efficient method of allocating goods, its full implications have not been completely recognized.

One woefully underdeveloped area of the theory of the pricing process remains the theory of capital, which could also be called the theory of the intertemporal pricing process ("intertemporal" because production takes place over time). In other words, how do prices regulate the distribution of goods through time? That is, how do prices affect the distribution of capital goods in an economy throughout the various stages of production? For example, if the production of product A requires the production of product B, which in turn requires the manufacturing of product C, then product C would be considered to be two stages of production away from the consumer good (product B being the first capital-goods stage and product C being the second capital-goods stage). How do prices affect the distribution of resources across different stages of production?

Drawing largely on the theories of Friedrich Hayek, developed from the late 1920s to the mid-1940s, Austrians believe that the structure of production —the distribution of industries and goods in a market — is shaped by the pricing process and the changes in relative prices between the different stages of production.

For a simple example of this process, imagine an increase in the price of product B, which is one stage of production away from the final consumer good, product A. This will cause an increase in investment in product B, and thus also in the previous stage, product C (which is required for the production of product B), as entrepreneurs take advantage of a surge by seeking profitable opportunities.

The economics of the capital structure work analogously to those of interest rates and global savings in McCloskey's argument: where local interest rates are influenced by the fact that savers will invest money where it is most profitable (thereby causing savings to flow to where they are most scarce). Changes in relative prices will change profitability, which in turn will change how individuals invest money and economic goods. While this part of price theory has been practically ignored by the mainstream, none of this should be particularly controversial.[7]

Knowing that the pricing process guides intertemporal investment and thus the structure of production, it is sensible to believe that changes in the supply of money can cause changes in the prices of the various factors of production. One could only assume otherwise if he or she were to argue that money is neutral.

In fact, the Federal Reserve's monetary policies, in conjunction with the nature of the United States's cartelized banking industry, have caused adverse and unsustainable changes to the structure of production. If we agree that the pricing process guides intertemporal investment and that changes in the supply of money can distort the pricing process, then the conclusion naturally follows that the Federal Reserve has caused changes in the structure of production.

What makes these changes unsustainable? Monetary savings are a veil for *real* savings, the setting aside of real capital goods. An increase in the money supply and the injection of this money into the loanable-funds market increases the amount of monetary savings *without an increase in the quantity of goods actually set aside*.

Thus, while the structure of production lengthens and widens in accordance with changes in the pricing process, there is simply an insufficient amount of saved *real* goods. When prices readjust, after a deceleration or the end of monetary expansion, the true nature of the scarcity of capital-goods is unveiled. Investments that were made are shown to be unsustainable, simply because there are not the required amounts of capital goods to finish them.

Few people were aware of the risk involved in the loans being made, because the Federal Reserve unknowingly manipulated the pricing process in such a way that it masked the true nature of the market. For all intents and purposes, investors genuinely believed in the relative safety of their decision making. The 2008 collapse of the market came as a surprise precisely because the pricing process *suddenly* adjusted to show how unsustainable the housing boom was.

There was no "irrational exuberance"; the exuberance was completely rational given the price signals at the time. A mass of market agents had simply been misled by a distortion-inducing monetary policy and a flawed, monopolized banking system.

The Fatal Conceit

There were, of course, secondary factors behind the recession. It is true, for example, that the packaging of securities and their sale to other financial institutions decreased the amount of risk assumed by the banks that originally made the loans. This is especially true with regard to mortgage bundles purchased by government-sponsored enterprises such as Fannie Mae and Freddie Mac.

There were a variety of other factors that influenced in what direction the bubble developed and how the structure of production adapted to changes in prices (i.e., why the bubble occurred in the housing market).

To the credit of economists who looked to blame the banking industry, it is also true that there are policies that can incentivize the assumption of greater risks — that is, the creation of greater moral hazard. But this is not a problem of a free-market banking system; it is the result of the Federal Reserve System and federal policies that reward bad behavior (whether intentionally or unintentionally).

The main cause of the recession is the fatal conceit of central bankers, including Alan Greenspan. They conduct their monetary policy following established rules, but without any consideration for the effects that changes in money can have on the underlying economy. That is, they believe they can intervene without having any repercussions on the economy except those they want.

It was bureaucrats' and economists' ignorance of the true nature of markets that caused the recession.

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Notes

[1] It is important to remember that the Federal Reserve is a bureaucracy and that the chairman does not exercise absolute power. In other words, Federal Reserve policy is not the product of a single man's decision making. When accusing Greenspan of any role in the present economic recession, it is important to remember that Greenspan is merely the personification of the entirety of the Federal Reserve.

[2] In response to Henderson and Hummel, see George Selgin, "Guilty as Charged." Selgin argues that the Federal Reserve's rate-cutting policies following the 2001 dotcom bubble crash persuasively correlates with an increase in housing loans. Also, see Robert P. Murphy, "Did the Fed Cause the Housing Bubble?".

[3] Benjamin M. Friedman, "The Greenspan Era: Discretion, Rather than Rules," *The American Economic Review* 96, 2 (2006).

[4] Deirdre McCloskey, "Alan Greenspan Doesn't Influence Interest Rates," *Eastern Economic Journal* 26, 1 (2000).

[5] Admittedly, Greenspan shows some skepticism about central planning and heavy government oversight and regulation, noting that no system has ever achieved perfect stability and that heavy regulation can cripple the competitive nature of an industry. Thus, what results is the creation of a very poor framework for regulatory improvements. Effectively, Greenspan calls for greater research on the topic.

[6] The theory of a monopolized currency system and a cartelized banking industry is well explained and critiqued in George Selgin, *The Theory of Free Banking* (Totowa, New Jersey: Rowman & Littlefield, 1988).

[7] Many of the nuances of capital theory have been critiqued, including during the Cambridge capital controversies, but our purposes do not require delving into the issue quite to that depth.