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Financial Comment: The bubble makers

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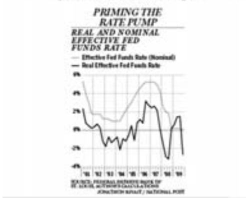
Alan Greenspan likes to blame the housing bubble on a savings glut. Instead, look at his negative real rates

By Steve Hanke

In 2002, Ben Bernanke, left, persuaded his Fed colleagues that deflation was a danger. For the next three years, Alan Greenspan kept the real effective Fed funds rate negative.



In Washington, the blame always lies elsewhere. Yesterday, a Senate committee launched its questioning of Goldman Sachs with a broad claim that Goldman inflated the housing bubble. There was no real mention of the real bubble makers on Capitol Hill, including the policies that did so much to create the subprime mortgage industry at Fannie Mae and Freddie Mac.

Also unmentioned in any serious way was the Federal Reserve. One reason for the current low profile of the Fed as perpetrator of the financial crisis is that the Fed has artfully talked its way out of any responsibility, a skill honed by a succession of Federal Reserve leaders over the years.

When the U.S. financial crisis inquiry commission convened on Capitol Hill in early April, the assembled members witnessed the spectacle of former Federal Reserve chairman Alan Greenspan asserting, with a straight face, that the Fed's monetary policy during his tenure did not contribute to the U.S. housing bubble. According to Mr. Greenspan, the origin of the financial crisis, in large part, resided elsewhere — literally overseas. The "blame the foreigners" ploy is always popular.

For Mr. Greenspan, a major culprit was an international savings glut. According to this hypothesis, the international savings rate exceeded the investment rate. In consequence, markets pushed long-term interest rates (both real and nominal) down. And as night follows day, Mr. Greenspan concludes: "Equity and real-estate capitalization rates were inevitably arbitraged lower by the fall in global long-term real interest rates. Asset prices, particularly house prices, accordingly moved dramatically higher."

There is a little problem with the global savings glut story, however: It is not supported by the facts. The rate of global savings and investment has been in rough balance since the early 1990s. This inconvenient fact should create a problem for the Fed because both Mr. Greenspan and the current Fed chairman, Ben Bernanke, have repeatedly bamboozled audiences with the global savings glut story.

If not global savings gluts, then what? Let's take a look at the Greenspan-Bernanke years to see if the Fed has been as innocent as it claims in the rise and fall of the financial bubble.

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0:00

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What is a bubble? There are many types. One type is created when the Fed's laxity allows aggregate demand to grow too rapidly. Specifically, a demand bubble occurs when nominal final sales to U.S. purchasers (GDP – exports + imports – change in inventories) exceeds a trend rate of nominal growth — a trend rate that is consistent with "moderate" inflation — by a significant amount.

During Mr. Greenspan's 18-year tenure as Fed chairman, nominal final sales grew at a 5.4% annual trend rate. This reflects a combination of real sales growth of 3% and inflation of 2.4%. But there were deviations from the trend. The first deviation began shortly after Mr. Greenspan became chairman. In response to the October 1987 stock market crash, the Fed turned on its money pump and created a bubble: Over the next year, final sales shot up at a 7.5% rate, well above the trend.

Having gone too far, the Fed then lurched back in the other direction. The ensuing Fed tightening produced a mild recession in 1991. From 1992 through 1997, growth in the nominal value of final sales was quite stable. But successive collapses of certain Asian currencies, the Russian ruble, the Long Term Capital Management hedge fund and finally the Brazilian real triggered another excessive Fed liquidity injection. This resulted in a boom in nominal final sales and a bubble in 1999-2000. This was followed by another round of Fed tightening, which coincided with the bursting of the equity bubble in 2000 and a slump in 2001.

The last big jump in nominal final sales was set off by the Fed's liquidity injection to fend off the false deflation scare in 2002. Fed governor Ben Bernanke (now chairman Bernanke) set off a warning siren that deflation was threatening the U.S. economy when he delivered a dense and noteworthy speech, "Deflation: Making Sure it Doesn't Happen Here," on November 21, 2002. He convinced his Fed colleagues that the deflation danger was lurking. As then-chairman Greenspan put it, "We face new challenges in maintaining price stability, specifically to prevent inflation from falling too low." By July 2003, the Fed funds rate was at a then-record low of 1%, where it stayed for a year. This produced the mother of all liquidity cycles and yet another massive demand bubble.

During the Greenspan years, and contrary to his claims, the Fed overacted to real or perceived crises and created three demand bubbles. To obtain a better handle of the mother of all liquidity cycles, observe that, by late 2001, the central bank had already pushed the effective Fed funds rate below the 3%-4% range for the neutral rate (a rate consistent with long-run price stability).

The effective rate stayed well below the neutral range until early May, 2005. The pattern for the real effective Fed funds rate was similar to the one followed by the nominal effective rate. By late 2002, the real rate had dropped into negative territory, where it stayed until mid-2005.

It's not surprising that Stanford University Professor John B. Taylor, in his highly critical book on the Fed's pre-crisis policies, *Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis*, concluded that there "is clear evidence of monetary excesses during the period leading up to the housing boom."

The most recent aggregate demand bubble wasn't the only bubble that the Fed was pumping up. As the above chart of price indexes shows, the Fed's favorite inflation target — the price index for personal consumption expenditures, less those for food and energy — was increasing at a regular, modest rate. Over the 2003-08 period, this metric increased by 13%.

The Fed's inflation metric signalled "no problems." But abrupt shifts in major relative prices were underfoot. Housing prices measured by the Case-Shiller index were surging, increasing by 44.8% from the first quarter in 2003 until their peak in the first quarter of 2006. Share prices were also on a tear. The most dramatic price increases were in the commodities. Measured by the Commodity Research Bureau's spot index, commodity prices increased by 92.2% from the first quarter of 2003 until their peak in the second quarter of 2008.

The dramatic jump in commodity prices was due, in large part, to the fact that a weak U.S. dollar accompanied the mother of all liquidity cycles. Measured by the Federal Reserve's trade-weighted exchange index for major currencies, the greenback fell by 30.5% from 2003 to mid- July 2008. As every commodity trader knows, all commodities, to varying degrees, trade off changes in the value of the U.S. dollar.

When the value of the U.S. dollar falls, the nominal dollar prices of internationally traded commodities — like gold, rice, corn and oil — must increase because more dollars are required to purchase the same quantity

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of any commodity. Contrary to claims by Messrs. Greenspan and Bernanke, the Fed played a central role in blowing asset bubbles, shifting relative prices and creating massive distortions in the economy.

Military history is written by the victors. Economic history is written by central bankers. Lawrence H. White calculated that, in 2002, 74% of the articles on monetary policy published by U.S. economists in U.S.-edited journals either appeared in journals published by the Fed, or were authored (or co-authored) by current or former Fed staff economists.

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Financial Post
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by Denis Pakkala Apr 27 2010 9:52 PM	Good article Ron Paul: Greenspan is responsible, audit the Fed! www.youtube.com/watch
by AJR79 Apr 28 2010 12:06 AM	Monetary policy no doubt contributed to the problem greatly, but there is so much blame to go around here. Frannie and Freddie were followers into the sub-prime mess, not leaders. Government encouragement of home ownership is in many ways a laudable goal, but when taken to excess it makes for a bubble. Also Clinton and Bush have to take their lumps. Repealing Glass-Steagall, and letting the derivative/housing markets get out of control had serious consequences. The reform on the table seems to be headed in the right direction, but I don't know if it goes far enough.

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