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Alan Greenspan

Monetary myopia

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The accolades bestowed upon Alan Greenspan ahead of his retirement on January 31st have a strong whiff of irrational exuberance

ALAN GREENSPAN, now in his final weeks as the chairman of America's Federal Reserve, has been proclaimed "the greatest central banker who ever lived". Among ordinary Americans he enjoys almost rock-star status. He has been awarded the Presidential Medal of Freedom, a British knighthood and the French Legion of Honour. Does he really deserve such uniform praise? And after the accolades have faded, what will economists conclude about his tenure?

It is ironic that when Mr Greenspan took over from Paul Volcker, his inflation-busting predecessor, in 1987, some questioned whether he was really up to the job, and he went through some rocky times in his early years. The stockmarket crashed within two months of his taking office, and America's growth fell behind that of Europe and Japan for several years. For the past decade, however, he has been viewed as possessing almost magical powers. He is credited with saving the world economy—from the stockmarket crashes of 1987 and 2000-01, and from Russia's default and the near collapse of LTCM, a hedge fund, in 1998—by pumping in liquidity when it was vulnerable. At a dinner for the members of the G7 in December, Mervyn King, the football-mad governor of the Bank of England, presented Mr Greenspan with a cartoon depicting him as a goalkeeper saving one penalty after another.

On the surface, America's economic performance has been remarkable on his watch. Not only has inflation been reduced, but America has enjoyed the two longest expansions on record, marred only by two mild recessions. The previous 18 years, by contrast, suffered four recessions, including the two severest since the Great Depression of the 1930s.

On closer inspection, however, Mr Greenspan's record looks less impressive. The drop in America's core rate of inflation has in fact been no greater than the average for all the industrialised countries in the Organisation for Economic Co-operation and Development (OECD). Global disinflationary pressures have made fighting inflation easier for all central banks.

Nor has Mr Greenspan done a much better job than foreign central banks at smoothing the business cycle. It is true that America has enjoyed faster GDP growth than other big OECD economies, but that should not be attributed to the Fed. Long-run growth rates are driven by structural factors not monetary policy, which mainly affects output over the cycle. America's potential growth rate is higher than that of the euro zone and Japan, thanks largely to faster population growth and more flexible labour and product markets.

An analysis by Martin Barnes, of the Bank Credit Analyst, finds that if America's growth performance is instead measured by the gap between actual and potential output, it looks much less stellar. America has on average had a slightly larger negative output gap than the rest of the OECD. Other economies have also enjoyed shallow recessions. Indeed, research by two American economists, James Stock and Mark Watson, has concluded that the decline in America's economic volatility over the past two decades was due chiefly to smaller economic shocks or the growing share of services (which are less recession-prone than manufacturing); only one-tenth of the increased economic stability was, they reckon, due to better monetary policy.

The Greenspan fan club claims that the chairman's skilful policies have not only reduced economic volatility, but may also, at least temporarily, have increased America's potential growth rate. Spotting the spurt in productivity growth in the late 1990s before almost anybody else was one of Mr Greenspan's greatest achievements. Recognising that this would allow the economy to grow faster without fuelling inflation, Mr Greenspan allowed the boom to continue and unemployment to fall, dragging many disadvantaged workers back into the labour force.

However, this short-term gain came at a long-term cost. His faith in the productivity miracle may have blinded him to the dangers of excessive monetary growth. His policies allowed domestic demand consistently to grow faster than supply, causing America's current-account deficit to swell alarmingly.

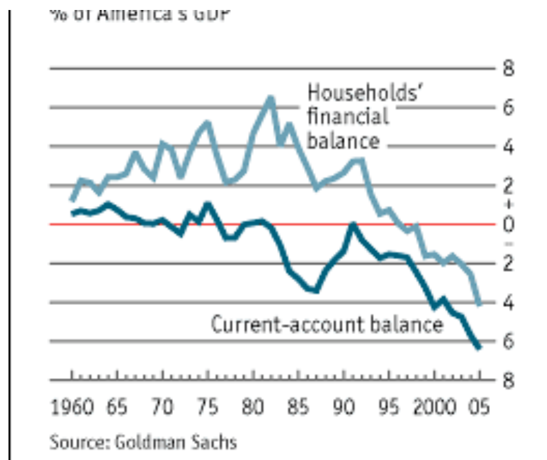
On Mr Greenspan's watch, America has also experienced the biggest stockmarket and housing bubbles in history. Presiding over one bubble could be seen as bad luck; presiding over two smacks of carelessness. The Greenspan era will not end on January 31st. Instead, his legacy will linger in the shape of the biggest economic imbalances in American history: a negative household saving rate and a record current-account deficit (see chart 1). Until these imbalances unwind—a process that could prove painful—it is too soon to applaud Mr Greenspan's record.

Toil and trouble

The Economist's long-running quarrel with Mr Greenspan is that he chose not to restrain the stockmarket bubble in the late 1990s or to curb today's housing bubble. He has declared himself vindicated in not pricking the equity bubble with higher interest rates, but instead to let it burst and then cut rates sharply to “mop up” the damage. The economy has fared better than we expected since share prices slumped, with only a mild recession in 2001. But a better test of Mr Greenspan's policies is not whether America escaped a deep recession, but whether the economy would today be on firmer foundations if the Fed had acted against that bubble.

How monetary policy should respond to increases in the prices of assets such as houses or shares is the biggest dilemma facing central banks everywhere. The Fed takes account of rising asset

Borrowing from the future 1

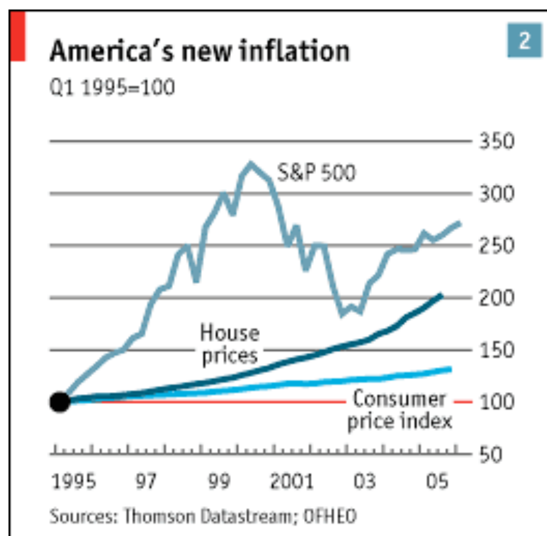


prices to the extent that they boost spending and hence future inflation. But the burning question is: should it respond to asset prices even if inflation seems under control? Three main arguments are given by Mr Greenspan and his colleagues for why central banks should ignore asset prices other than their impact on inflation. First, that monetary policy focused on inflation and growth is the best way to achieve economic stability. Second, that one can never be sure that what looks like a bubble really is a bubble. And third, that interest rates affect the economy more like a sledgehammer than a scalpel. A modest rise in rates is unlikely to halt rising share prices, but an increase sufficient to pop the bubble would slow the whole economy and could even cause a recession. Mr Greenspan thus concludes that it is safer to wait for a bubble to burst by itself and then to ease monetary policy to soften a downturn.

Consider each of these arguments in turn. First, the job of a central bank is not just to prevent inflation, but also to ensure financial stability. Yet the three biggest stockmarket bubbles in the past century—America's in the 1920s and 1990s and Japan's in the 1980s—all developed when inflation was low. Arguably, Mr Greenspan has defined the role of monetary policy too narrowly. Inflation is often described as too much money chasing too few goods. But in a world awash with cheap money and with potent new sources of supply, such as China, to hold prices down, inflation will remain low and so fail to signal if an economy is overheating. Increased central-bank credibility also helps to anchor inflation. If central banks hold interest rates low, this will encourage risk-taking in financial markets and excess liquidity will spill over into asset prices rather than traditional inflation (see chart 2).

Asset-price inflation can be as harmful as conventional inflation. A sudden collapse in share or house prices can trigger a deep downturn. And surging asset prices also distort price signals and cause a misallocation of resources—by encouraging too little saving, or too much investment in housing, so reducing future growth. This is why central banks need to pay closer attention to asset prices.

Second, it is not, as Mr Greenspan argues, impossible to identify bubbles. When prices have lost touch with fundamentals and there are other signs of excess, such as rapid credit growth, alarm bells should ring. Mr Greenspan's "irrational exuberance" speech in December 1996 shows he was concerned about a bubble inflating long before the bubble reached its full extent. And transcripts of meetings of the Federal Open Market Committee (FOMC, which meets to set interest rates) now make clear that several Fed officials were fretting about the bubble in 1998 and 1999. At the December 1999 meeting, when discussing the stockmarket, Mr Greenspan said: "It is only a question of how much of a bubble there is."



Moreover, central banks do not have to be certain they have identified a bubble before they act. Monetary policy has constantly to deal with uncertainty—such as the size of the output gap. Uncertainty is a reason for responding cautiously, but not for doing nothing.

What of Mr Greenspan's third claim that, even if a central banker is pretty sure there is a bubble, there is little he can do about it because interest rates are a blunt tool? In August 2005 Mr Greenspan said: "Given our current state of knowledge, I find it difficult to envision central banks successfully targeting asset prices any time soon." But he was setting up a straw man. Nobody is seriously arguing that central banks should "target" a particular level of asset prices. Most economists accept that aggressive action to "prick" bubbles could also be risky. Instead, the debate today is whether central banks should "lean against the wind" when asset prices appear dangerously out of line with fundamentals, raising interest rates by a bit more

than inflation alone would call for.

Beyond inflation

Contrary to what Mr Greenspan said, some central banks are already doing exactly that. The Bank of England and the Reserve Banks of Australia and New Zealand have raised interest rates in recent years by rather more than inflation alone justified, because of concerns about house prices. Mr Greenspan is also wrong to argue that only a big rise in rates can halt a bubble. In both Britain and Australia, rate increases of just 125 basis points, along with clear warnings from the central banks that house prices were overvalued, were enough to slow the annual pace of house inflation from around 20% to close to zero.

Britain's Mr King was one of the first central bankers to lay out the case for why monetary policy may sometimes need to be tightened in response to rising asset prices, even if forecast inflation is within its target range. This, he argues, implies accepting a modest undershoot of inflation in the short term, in order to avoid a bigger undershoot later when a bursting bubble could lead to a deep downturn and even deflation. Jean-Claude Trichet, the president of the European Central Bank, also agrees that central banks should, in exceptional circumstances, tighten policy to restrain asset-price booms, even if inflation is low. This is a justification for the ECB's much criticised two-pillar monetary-policy framework, which focuses on money-supply growth as well as inflation: asset-price bubbles are usually accompanied by rapid growth in money and credit.

Several members of the FOMC argue that in practice the Fed and other central banks have responded to surging house prices in similar ways. The only difference, they claim, is in what they say, not what they do. That real interest rates have been much lower in America than in Britain or Australia undermines this assertion. But in any case, if a central bank wants to influence bubbling asset prices and the imbalances they cause, it needs to speak out. Not only did the Fed raise interest rates too late and by too little in the late 1990s, but instead of trying to talk down the bubble Mr Greenspan acted as a cheerleader for the new economy. Although he was right about faster productivity growth, his exuberance unintentionally encouraged investors' unrealistic profit expectations, pushing share prices still higher.

The deepest flaw in Mr Greenspan's policy towards asset prices is its asymmetry. If the Fed always cuts interest rates when asset prices tumble, but never raises them when they soar, then investors will be encouraged to take bigger risks. That makes bubbles more likely. The Fed was right to ease when the stockmarket bubble burst, to avoid repeating the Bank of Japan's mistake in the 1990s. But such “mopping up” should be a last resort, not a concerted strategy that cushions the bursting of one bubble by inflating another—since 2002, in housing.

Pragmatist, not purist

So a strong case can be made that the Fed's neglect of asset prices has caused it to pursue an overly loose monetary policy. The strange thing is that Mr Greenspan was one of the first central bankers to draw attention to the growing importance of asset prices in economies. In private discussions, it is clear that his views are less rigid than is commonly assumed. Moreover, Mr Greenspan conceded in testimony to Congress in 1999 that “If we could find a way to prevent or deflate emerging bubbles, we would be better off.” And more recently: “I certainly do not rule out that future work could improve our understanding of asset-price behaviour, and with it, the conduct of monetary policy.”

Indeed, Mr Greenspan's public pronouncements on asset prices seem to have changed subtly. Until recently, he denied the possibility of a nationwide housing bubble; now he admits the market is frothy and has warned that house prices could fall. In September a research paper co-written by him drew attention to the massive scale of mortgage-equity withdrawal. He estimates that this could account for all of the fall in America's personal saving rate in the past decade. This implies that a drop in house prices could trigger a sharp slowdown in spending. It was only the second study he put his name to while in office.

In a further shift, Mr Greenspan acknowledged in September that the Fed's policy might have played a role

in fostering bubbles. He argued that the Fed's success in delivering a long period of economic stability and low inflation—and hence low interest rates—may have caused investors to demand less compensation for risk, inflating the prices of assets.

Mr Greenspan's new thinking about bubbles would be consistent with the risk-management approach that he favours for monetary policy. This looks not only at the likely path for the economy, but at the risks and costs and benefits of other possible outcomes and policies. Within this framework, tightening monetary policy in an asset boom is like buying insurance against a later risk of a larger economic bust. The cost of some short-term loss of output must be set against the risk of larger future losses if asset prices slump.

Who will save us in future?

From a risk-management perspective, the case for acting against the housing bubble is even greater than for the stockmarket bubble. A housing bubble has bigger wealth effects on consumer spending, so a collapse in house prices would cause more economic harm than one in share prices. Such a bubble is more likely to create financial instability because people borrow more to buy homes. And raising interest rates is a more powerful tool against rising house prices than share prices.

In contrast to Mr Greenspan's pragmatic approach to asset prices, Ben Bernanke, his successor, believes that interest rates should not respond to movements in asset prices unless they affect forecast inflation. Research co-written by Mr Bernanke in 1999 concluded that if a central bank responds to asset prices it risks only creating more economic instability compared with pursuing an inflation target. However, his model assumed that bubbles just happen. In reality, monetary policy can contribute to the inflating of a bubble—not least if investors expect the Fed to cut interest rates when share prices fall, but to do nothing to prevent their rise.

Parting of the ways

Alongside his views on bubbles, Mr Bernanke is keen to introduce a formal inflation target, which could reduce the Fed's room to respond to asset prices. So it would seem that at the very moment when the gap between Mr Greenspan and other central bankers was narrowing, the Fed might unfortunately be about to take a step back under Mr Bernanke.

Mr Greenspan's past reluctance to tackle asset prices is partly understandable: central banks do not have a mandate to pop bubbles. It is therefore hard to justify an increase in interest rates to Congress when inflation is low, as it was in the late 1990s. Nevertheless, views change over time. In the 1960s the main objective of monetary policy was full employment, not inflation. Persuading the public today that asset bubbles are as dangerous as inflation is surely no harder than switching focus from unemployment to inflation.

But first, Mr Greenspan and other central bankers need to start arguing the case for raising interest rates in response to rising share and house prices—and to be prepared to live with the unpopularity that would follow. Mr Greenspan would certainly not be so popular today if he had spoken out and leant more firmly against the stockmarket and housing bubbles.

Indeed, as the farewell tributes to Mr Greenspan reach fever pitch, ironically it is perhaps his extraordinary popularity and perceived wizardry that best explain the problems he will leave behind. Investors' exaggerated faith in his ability to protect them has undoubtedly encouraged them to take ever bigger risks and pushed share and house prices higher. In turn, American consumer spending has become dangerously dependent on unsustainable increases in asset prices and debt.

In December Mr Greenspan was made a Freeman of the City of London. One of the traditional perks of this honour is that he can be drunk and disorderly without fear of arrest. The snag is that his policies have also

encouraged drunk and disorderly asset markets and intoxicated consumers. When the party ends, Mr Greenspan will not be there to clean up the mess. But end it surely will.

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