

## The risks of being Chairman in the Age of Turbulence

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### *Book review of*

Alan Greenspan, *The Age of Turbulence. Adventures in a New World*, Penguin Books, London England, 2007, 531 pages

(Forthcoming in *International Finance*, 2008)

This is an extraordinary book written by an extraordinary man. The book reads well. In fact it is a real treat...and a big surprise. Wasn't Greenspan known for his Delphic pronouncements that, by being incomprehensible, created a perception of superior wisdom? No such creative ambiguities in this book. Everything is very clear and enjoyable. It strikes the right balance between analysis and anecdote; the secret of enjoyably serious books.

What is most impressive in this book is that the author, who can claim superior achievements, remains remarkably modest. In contrast to most autobiographies which bulge with self-righteousness, this one does not want to show how good the author was.

For many observers, there is little doubt that Alan Greenspan was an extraordinarily successful chairman of the most important central bank in the world. His first major challenge was to deal with the stock market crash of October 1987. He passed the exam with flying colors: his trick was to provide markets with ample liquidity so that the crash was prevented from degenerating into a full-fledged liquidity crisis, bringing down the whole economy. He would repeat such interventions several times, when crises erupted, leading to the idea of a Greenspan put, i.e. an implicit guarantee that liquidity would be available in times of crises, allowing financial institutions and investors to disregard liquidity risks altogether. I will come back to this issue in a moment.

The main reason why so many consider Alan Greenspan to be a monetary hero is that he presided over the period of the Great Moderation: a period of low inflation and

high productivity growth. After two decades of economic soul-searching, the US started in the early 1990s a sustained episode of rapid economic growth and low inflation. Many saw the hand of the Maestro in this economic miracle.

How much of this Great Moderation was due to central banks in general and the Fed in particular? Was it due to stability oriented monetary policies of the 1990s, or were the external shocks benign? The question has been debated intensely. My perception is that the shocks have been relatively benign (although that is not even certain) but that a significant factor has been the return of no-nonsense central banking focused on keeping inflation low. Whether this was done in the form of explicit inflation targeting or in a less formalized way does not seem to matter a great deal. It is interesting to note that Greenspan comes on the side of those who claim that a large part of the Great Moderation is the result of globalization that tended to lower many prices and, through more intense competition, imposed price discipline throughout the economy.

What is the measure of Greenspan's success? If we close the period over which his performance is to be judged in January 2006, when he left the Fed, there can be no doubt that he was extremely successful. He had managed to keep the US on a low inflation path despite an economic boom that, apart from two short downturns, had lasted more than ten years. What a contrast with 1987 when inflation was still relatively high, and the US economy was considered to be performing badly compared to Japan and Germany. This was a time when well-known US economists wrote books about the coming decline of the US as a political and economic power. Surely, early 2006 was very different. The US had reached a pinnacle of economic success, and much of this success could be attributed to the wisdom and leadership of Alan Greenspan.

It was certainly too early to tell in 2006. Two years later much has happened to create doubts about Greenspan's achievements. It is becoming increasingly clear that the eruption of the credit crisis in August 2007 may be interpreted as the legacy of Greenspan's monetary policies and that it may be the price we pay for the previous successes. Is Greenspan to be blamed for the credit crisis?

It would be folly to put all the blame on him. Financial innovations and globalization of financial markets are at the core of the crisis. Yet it is also true that there is a great responsibility that rests on his shoulders. For several reasons.

First, as has been argued by John Taylor, Greenspan kept the interest rate at very low levels for too long after the recession of 2001<sup>1</sup>. He waited until the middle of 2004 to start raising the interest rate from its historically low level of 1%. The point is not that in 2001 he reduced the interest rate too much when he cut it from more than 6% to less than 2% in less than a year. This was probably the right thing to do in a recession. The problem is that he kept the rate there for too long, when the economy showed signs of recovery. This laid the groundwork for a massive credit and liquidity expansion which in turn created an asset bubble in the housing market. The combination of low interest rates and inflated house prices then made it possible for American consumers to easily finance a massive consumption spree. Thus the long period of low interest rates created the seeds of a future collapse.

Second, Greenspan's successive liquidity injections at each sign of a potential crash (1987, the LTCM-crisis, 9-11) created a perception that liquidity crises would always be taken care of by the Fed. In other words, it erased liquidity risk (a tail risk) from the concerns of bankers and investors. It is as if liquidity risk did not exist anymore. A large part of the profitability of banks and their conduits is to arbitrage on the liquidity premium. Much of the money they make is through leverage, i.e. investments in high-yielding long term assets using (cheap) short-term funding. Banks and their conduits failed to price this risk because they believed that liquidity risk was nothing to worry about. They were supported in this belief by the conviction that the Fed would take care of it.

One could argue that the Fed was condemned to provide liquidity in times of crisis. Any other central bank would have done the same thing. Not doing so in the face of an erupting crisis would have showed irresponsibility. The fact that these interventions could sow the seeds of future crises, in no way reduced the need to inject liquidity when the crisis erupted in real time.

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<sup>1</sup> See John Taylor, "Housing and Monetary Policy", paper presented at the Symposium on Housing, Housing Finance and Monetary Policy, sponsored by the Federal Reserve Bank of Kansas City in Jackson Hole, Wyoming, August 2007.

This argument is certainly correct. The corollary of this inevitability to intervene, however, is the responsibility of the central bank to supervise and regulate. Since the central bank provides insurance against liquidity risk, it is obliged to control those who will benefit from this insurance, lest moral hazard will push financial institutions to take on increasing levels of liquidity risks (by over-leveraging their positions). This is exactly what happened.

We arrive at the third and probably the most fundamental failure of Alan Greenspan. This is his failure to take up his mandated responsibility to supervise and to regulate the financial institutions to which he was giving a free insurance against liquidity risk. Why did this happen? The root cause is the religious belief of Greenspan in the benevolence of markets and perniciousness of government interventions. The book, especially the second part, is one long eulogy of the wonders created by the market in general and the financial markets in particular. One recognizes the writing of Ayn Rand, and her libertarian views. Thus, at the moment financiers were increasing their exposure to liquidity risk and made fantastic profits doing so, in the knowledge that the Fed was insuring them freely against such a risk, Greenspan stood by and marveled at the creativity of markets. “Individuals trading freely with one another following their own self-interest leads to a growing, stable economy” he writes on p. 368, when discussing the new financial instruments. Instability comes from external shocks or economic policy. And he concludes with a beautiful metaphor: “Why do we wish to inhibit the pollinating bees of Wall Street” (p.372). After reading this eulogy one might wonder why a central bank is necessary in the first place.

In his flowering analysis of the wonders of free markets, Greenspan repeats many times that financial markets are perfectly suited to regulate themselves. The counterparties in any financial deal do the surveillance, he tells us. We now know better: the counterparties most often had no clue of the risks involved in the new financial instruments they were presented. In fact, quite often the originators of these instruments didn't know either.

The corollary of this religious optimism in the wondrous workings of the financial markets is the belief that governments and the Fed can do nothing to regulate these new financial instruments. On p. 489 Greenspan writes: “Only belatedly did I, and I suspect many of my colleagues, come to realize that the power to regulate

administratively was fading; We increasingly judged that we would have to rely on counterparty surveillance to do the heavy lifting”.

Religion quite often stands in the way of rational analysis. Greenspan, who was at the helm of the most important monetary institution in the world, failed to see the storm coming. He failed to take his responsibility to supervise the financial markets blinded as he, and his colleagues, were by a belief that markets and bankers know better than governments.

The really strong part of this story is that this belief in the superiority of the markets and the perniciousness of governments was to be found in a man who occupied a top position in the government sector. Others would call this cynicism. In this case, I don't think it was cynicism but rather a misplaced trust in the knowledge and foresight of bankers and other financiers.

It will remain difficult to identify individual responsibilities. The fact is that Greenspan was leading an institution which created the conditions for successive asset bubbles to emerge and for a consumption boom to develop that was grounded on shaky financial foundations. This consumption boom had the side effect of attracting massive amounts of savings from the rest of the world, leading to the paradoxical situation in which the rest of the world helped to finance the richest people on earth to amass consumption gadgets. While this was developing, the Federal Reserve refused to do anything to stop the frenzy. It did so partly as a result of a belief that markets are always right and that even if they are not, there is nothing one can do about it.

Greenspan argues that he tried to rein in the asset bubble of the second half of the 1990s. As the stock prices soared he became increasingly convinced in early 1997 that this was a bubble and that something should be done about it (remember his “irrational exuberance” speech). At the FOMC meeting of March 25 1997, the short-term interest rates were raised by 0.25 percent to 5.5 percent. This led to a dip in the Dow Jones of 7 percent. The Dow Jones recovered quickly, however, and continued on its roaring upward path for the next three years. Greenspan concluded from this episode that “Investors were teaching the Fed a lesson. Bob Rubin was right: you can't tell when a market is overvalued, and you can't fight market forces. (...) We never tried to rein in stock prices again” (Page 179).

The surprising thing about this conclusion is that Greenspan arrived at it after an experiment where the rates were increased by a timid 25 basis points. As if that was all the Fed could do. There can be little doubt that a more forceful action of the Fed could have done the trick of bursting the bubble. In fact there is no reason to believe that it is inherently more difficult for the central bank to check the rate of inflation, than it is to prick an asset bubble. And the Fed has been quite successful in keeping inflation in check. In order to achieve the objective of price stability the Fed was willing to use the interest rate instrument in a much more aggressive way. Like in the period 2004-05 when it raised the short-term interest rate from 1% to more than 5% in order to prevent an acceleration of inflation. Quite a different increase than the 0.25% raise that was applied to break the asset inflation in 1997.

If anything, Greenspan's and Rubin's conclusion that "you can't tell when a market is overvalued", is even more surprising. This was a time when upstarts as Yahoo reached market capitalizations that were a multiple of General Electric's. Everybody who ever read Kindleberger's masterly "Manias, Panics and Crashes. A History of Financial Crises" had a sense of déjà vu. Those who remembered the Japanese asset bubble of ten years earlier when the top ten largest companies in the world (according to market capitalization) contained eight Japanese companies recognized all the features of an asset bubble. Precisely at that time the US Secretary of the Treasury and the Chairman of the Federal Reserve, the best and the brightest in the world financial landscape, came to the conclusion that it was impossible to recognize a bubble.

As argued earlier, one of the reasons of such blindness is the ideological preconception that markets are always right. This preconception also influenced Greenspan in the stark contrast between the way he judged public and private debts and deficits. The former are always threatening and dangerous; the latter a sign of economic health and vigor. The former should be fought intensely; the latter should be no cause of concern, because the flexibility of markets will deal with them. Here are some examples of this contrasting view about public and private deficits and debts. In January 1997 Greenspan meets Clinton in the oval office and warns the President about the future dangers of the budget deficits in the following stark words: "So the debt rises markedly into the twenty first century, and the interest on the debt rises, threatening a spiral of rising deficits. Unless it's aborted, that could lead to a financial crisis" (Page 147).

His view on the dangers of private debts is of a totally different nature as the following quote shows: “I do not recall a decade free of surges in angst about the mounting debt of households and businesses. Such fears ignore a fundamental fact of modern life: in a market economy rising debt goes hand in hand with progress(..). Thus a rising ratio of debt to income for households, or of total non-financial debt to GDP, is not in itself a measure of stress” (page 346).

Put differently, when debt is issued by private agents it is good; when it is issued by governments it is bad. Private debt is a sign of economic vigor. In contrast, public debt leads to future financial crises. How wrong was this prediction! In fact it was the rising debt of US households, not of the US government, that triggered the financial crisis of August 2007. And it will be the Government who will have to solve it by taking over the private debt.

One puzzling aspect of “The Age of Turbulence” is that Greenspan occasionally wavers in his belief in the superiority of markets. On two occasions he admits that markets are not always efficient. The first time is when he claims that the crash of 1987 was due to irrational behavior. He admits that there was no new information on October 19, 1987 that could justify a drop of 20% in the Dow Jones industrial average. “As prices careened downward all that day, human nature, in the form of unreasoning fear, took hold, and investors sought relief from pain by unloading their positions regardless of whether it made financial sense” (page 465). Greenspan took the logical step from that analysis and this was a massive intervention in the financial markets by flooding it with liquidity. But if a crash is the result of irrational behavior, why wouldn't the bubble not equally be the result of irrational exuberance which should be countered by massive intervention?

Greenspan shows a second moment of weakness when he admits on page 212 that “recessions are tricky to forecast because they are driven in part by non rational behavior. Sentiment about the economic outlook usually does not shift smoothly from optimism to neutrality to gloom; it's like the bursting of a dam, in which the flood backs up until cracks appear and the dam is breached. The resulting torrent carries with it whatever shreds of confidence there were, and what remains is fear”. Here again the right conclusion was drawn, i.e. that it is the task of the Fed to intervene to counter the recessionary forces. Why the same conclusion was not drawn when market forces led to asset bubbles, will remain a puzzling feature of Greenspan's

mindset. Certainly, there is an inconsistency here. If markets are occasionally gripped by irrational motives, how can they be relied upon to regulate themselves, as Greenspan argued, when the asset and credit bubbles emerged?

The way Greenspan will be judged by historians will depend a great deal on how the credit crisis that erupted in August 2007 will unfold. If this crisis turns out to be a temporary blip with few spillovers in the real economy, he will maintain his stature of the great and wise conductor of monetary affairs. If, however, the credit crisis deepens and spills over into the real economy, historians are unlikely to be kind in their judgment of Greenspan's tenure as the Chairman of the Federal Reserve. And he will then be held responsible for the crisis. The paradox is that in that case much of the evidence against him will be found in this wonderfully well-written book.