VOLUME XVII, NUMBER 1, WINTER 2016/17

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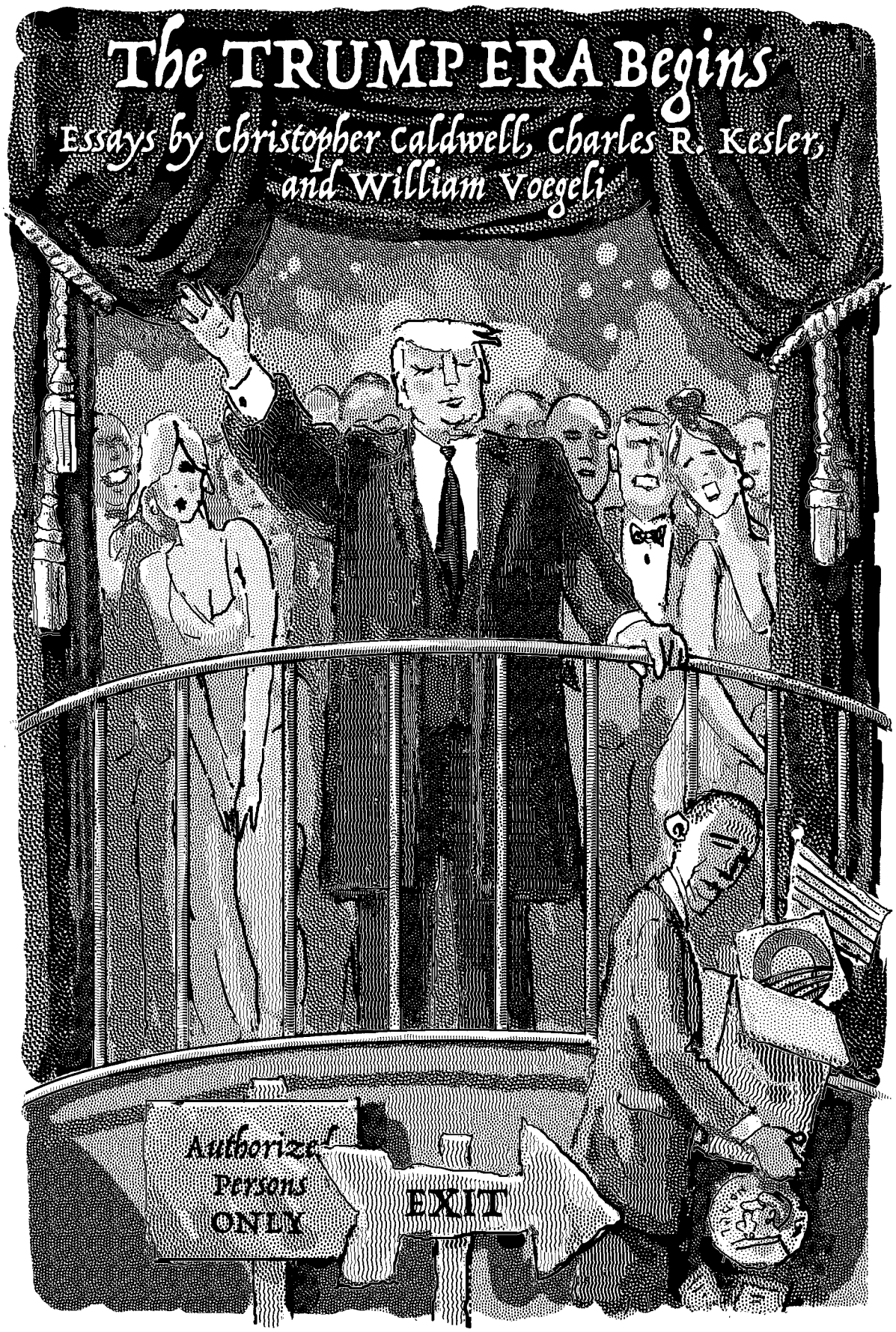

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A Publication of the Claremont Institute

PRICE: $6.95

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Book Review by Robert J. Samuelson

What Hath Greenspan Wrought

The Man Who Knew: The Life and Times of Alan Greenspan, by Sebastian Mallaby.
Penguin Press, 800 pages, $40

Can we demystify Alan Greenspan? Few public figures have seen their reputations descend so far, so fast. While chairman of the Federal Reserve Board from 1987 to 2006, Greenspan was routinely hailed as a peerless economic sage, guiding the U.S. economy through the longest expansion in its history. Journalist Bob Woodward called him "the maestro" in a book by that title, and the label stuck. Then came the 2008-09 financial crisis and Great Recession. A legion of critics blamed Greenspan's policies—providing easy credit, and accommodating, instead of regulating, the financial industry. Some of the same people who had lavishly praised him went on to denounce him scornfully.

The clashing stereotypes define the Greenspan enigma. Was his "mastery" just good luck? How inherently stable or unstable is the American financial system? Did Greenspan possess unique insights that, once he retired, went missing with disastrous consequences? Or was he really Wall Street's tool?

In an exhaustive new biography, financial writer Sebastian Mallaby delivers a mixed verdict. He shares some of Greenspan's doubts about regulators' capacity, through new rules and exacting examination of lending practices, to deflate "bubbles" slowly before they become dangerous. That ignores too many practical problems. Greenspan's real error, Mallaby argues, was his assumption that if the Federal Reserve kept inflation low, every other problem would take care of itself. This mindset, widely shared at the time by economists, caused the Fed to keep interest rates too low for too long. Inflation remained subdued, but financial speculation soared.

The irony, Mallaby says, is that Greenspan was more aware than most economists that unstable financial markets—self-fulfilling booms and busts; bad lending practices; and investors' herd mentality, from "irrational exuberance" to contagious pessimism—themselves posed danger. For many years, mainstream economics had paid scant attention to fragile financial markets' pernicious side effects. Not Greenspan. As a private economic consultant to corporations and banks, he had spent a lifetime studying financial hazards. But, Mallaby contends, he wrongly believed that as long as inflation remained tame, these dangers were second-order threats. They weren't.

Mallaby is well qualified to tell this story. For 13 years, he wrote for *The Economist*, finishing as Washington bureau chief. He is a senior fellow at the Council on Foreign Relations, author of a superb book on hedge funds, *More Money than God* (2010), and columnist for the *Washington Post*. (Disclosure: Though I also write a column for that paper, and know and like Mallaby, we are not close friends.) Although the biography is not "authorized," Greenspan openly responded to Mallaby's questions and was interviewed for more than 70 hours. His friends and associates cooperated. The inter-

views were supplemented with scholarly studies and transcripts of congressional hearings and Fed meetings.

The result is a critical but fair-minded narrative of nearly 750 pages, with almost 50 pages of endnotes. One of its chief virtues is to humanize Greenspan. In our mind's eye he was a compulsive recluse, toting thick briefing books and uttering self-serving obscurities. After becoming Fed chairman he once said, only half-jokingly, "Since I've become a central banker, I've learned to mumble with great incoherence. If I seem unduly clear to you, you must have misunderstood what I said." All that is true, but it's not the only truth.

Mallaby's tale, for example, shatters the notion that Greenspan was a life-long disciple of Ayn Rand, the Russian émigré author of *The Fountainhead* and *Atlas Shrugged*. To be sure, Greenspan was for a time—during the 1950s and 1960s—taken by Rand's ideas and became a member of her inner circle. Both believed in extreme laissez-faire. According to Mallaby, Greenspan had long admired some of the great capitalists of the 19th century, men like railroad tycoon James Hill, as titans who had built America's prosperity. When the *New York Times* panned *Atlas Shrugged* Greenspan wrote a strong defense, which the paper published. The novel, Greenspan argued:

> is a celebration of life and happiness. Justice is unrelenting. Creative individuals and undeviating purpose and rationality achieve joy and fulfillment. Parasites who persistently avoid either purpose or reason perish as they should.

But by the late 1960s, there was competition for Greenspan's energy and intellectual loyalty: politics. He had become friends with Martin Anderson, a young Columbia University economist who worked as an advisor to Richard Nixon's 1968 presidential campaign. Anderson asked Greenspan if he wanted to participate. He said yes, and soon was writing positon papers on the economy, urban riots, and farm policy, as well as meeting with such higher-ups as Nixon advisor and speechwriter Pat Buchanan. "If it were not for Anderson," Greenspan said later, "I may have made a lot of money being a private economist but that would have been it."

Greenspan knew that knowledge is power, but soon learned *how* one translated into the other. When government leaders need to understand an issue, they rely on unelected "experts" who already know or can learn quickly. He excelled at this work, as Mallaby's title, *The Man Who Knew*, conveys. Greenspan's power derived, in part, from his analytical skills, but becoming political meant ditching ideological purity. Compromises were essential. Although Greenspan did not initially join the new administration, Nixon nominated him in 1974 to be chairman of the Council of Economic Advisers—in effect, the administration's chief economist. President Gerald Ford swore him in after Nixon's resignation. Greenspan, writes Mallaby, had completed his journey from rigid ideologue to flexible political insider.

By this time, he was heading a thriving economic consulting business. His career as an economist had begun at NYU, where he obtained his bachelor's and master's degrees before moving on to Columbia's Ph.D. program in 1950. Greenspan was an early skeptic of John Maynard Keynes's theories. Specifically, he rejected "secular stagnation," an idea advanced in 1938 by the Keynesian economist Alvin Hansen (and now revived by former Treasury Secretary Larry Summers; both Harvard economists). By "secular stagnation" Hansen meant the exhaustion of profitable investment opportunities. The causes included slow population growth, the closing of the nation's frontier, and technological decline. The investment slump, in turn, justified greater government spending and bigger budget deficits to keep the economy advancing.

All this struck Greenspan as implausible. "The contention that excess savings would pile up, with nobody willing to spend or invest them, seemed just too pessimistic," writes Mallaby. Events vindicated this skepticism. In the 1950s the economy soared, propelled by rapid population growth (the baby boom), pent-up consumer demand (cars, housing, appliances), and new technologies (television, plastics, antibiotics).

Greenspan became an "empiricist" in the spirit of the NYU and Columbia economics departments. The empiricists deemphasized elaborate theories of economic growth and focused on the mechanics of business cycles, which could be gleaned by examining different industries and sectors. He practiced empiricism by taking a job—necessary to cover his expenses—at the National Industrial Conference Board (now just the Conference Board), where he cranked out studies on "small manufacturers' profits, housing starts, and consumer credit."

His work attracted attention. In early 1953, William Wallace Townsend, a successful investment advisor 38 years older than Greenspan, proposed a partnership. Townsend-Greenspan would be built around Greenspan's studies and data analysis. (Out of gratitude, Greenspan kept Townsend's name in the title after his partner's death in 1958.) "The facts could come from almost anywhere: engineering manuals, old congressional testimony, statistics on freight car loadings," writes Mallaby. "The more facts he assembled, the more his list of clients grew. The more clients he had, the more facts he assembled."

Few, if any, academic economists had this sort of detailed knowledge of the economy's plumbing. By the mid-1970s Greenspan was making about $300,000 a year—roughly $1.4 million in 2015 dollars. Still, when President Ronald Reagan nominated him to head the Fed, he was hardly a household name (few economists are), and to the extent he had a public identity, it was misleading. Greenspan was still depicted as an avid follower of Rand, a borderline "kook." The reality, Mallaby shows, is that he was an *ex*-ideologue, a realistic conservative who believed in free markets and limited government, but applied those beliefs pragmatically.

The praise for chairman greenspan's economic stewardship, when it still was being praised, rested on two realities. First, strong economic growth: Greenspan's tenure included the longest sustained economic expansion in American history, the decade from March 1991 to March 2001. From August 1987 to January 2006, the beginning and end of Greenspan's tenure as Fed chairman, there were only two recessions (1990-91 and 2001), both mild by historical standards. From 1988 to 2005—the first and last full years of Greenspan's leadership—unemployment averaged 5.5% and inflation 3.1%. Median household income rose 7% to $56,244 (in 2015 constant dollars). The Standard & Poor's 500 stock market index rose nearly six-fold.

How much credit Greenspan deserves for this prosperity is unclear. His greatest contribution was controlling inflation. Put differently, he protected the legacy of Paul Volcker, Greenspan's predecessor as Fed chairman from 1979 to 1987. Volcker, with Reagan's support, broke the nation's inflation psychology. From 1980 to 1984, annual consumer price increases dropped from nearly 14% to just below 4%. But the process was ugly. Tight credit meant companies could no longer automatically pass along the higher costs of doing business, especially paying higher wages, so they clamped down on hiring and compensation. Unemployment rose to 10.8% in late 1982. The reward was the end of ruinous stop-and-go economic policies. The Fed had vacillated for more than a decade between easy money to spur job creation and tight money to arrest inflation. From 1969 to 1982, there were four recessions (1969-70, 1973-75,

1980, and 1981-82). To most Americans, inflation was destabilizing and demoralizing.

Though protecting Volcker's achievement was crucial, it was not inevitable. A different Fed chairman might have pursued different policies. In 1989, for example, Greenspan raised interest rates sharply. He focused on inflation, in part, because he shared the belief of many economists that there was no long-run conflict between low inflation and low unemployment. Still, he enjoyed some good luck. China's entry into the world economy exerted downward pressure on the prices of many consumer goods, while the expansion of personal computing and the internet seemed to accelerate productivity growth. The resulting efficiencies helped companies absorb costs without raising prices.

It's also important to note that disinflation itself served as a continual stimulus to the economy. As inflation subsided, and people began to believe the decline was permanent, interest rates—which reflected inflation expectations—also subsided. Declining interest rates increased the present value of stocks, bonds, homes, and many other assets. As households' wealth increased, people spent more from current income or borrowed more against the appreciated value of their homes and stock portfolios. This virtuous circle, the economy's main engine during these years, is still underappreciated and understudied by economists.

To this expansionary bias, Greenspan added his own stimulus. Despite his reputation as an "inflation hawk," the record reveals a more nuanced approach. He declined to raise rates when he believed the economy still had adequate "slack" to dampen price increases. In the most famous episode of this, well-told by Mallaby, Greenspan argued in 1996 that flawed productivity statistics overstated inflationary pressures by understating productivity in many service industries. Some liberal members of the Federal Open Market Committee (FOMC), the Fed's main decision-making body, thought it time to raise interest rates. By convincing them to delay, Greenspan may have avoided a recession.

The second reality underpinning Greenspan's reputation was the absence of any major American or global financial crisis. The recent one (2008-09) has taught us that such panics can devastate the "real economy" of production and jobs. We also know that a panic in one corner of the financial system can quickly spread throughout it. None of this happened on Greenspan's watch though there were many opportunities. A couple of months after he arrived at the Fed in 1987, the stock market fell 20% in a single day. In 1997-98 the Asian financial crisis erupted, the default (or near default) of Thailand, Indonesia, South Korea, and other "emerging market" nations. Long-Term Capital Management (LTCM), a large hedge fund, verged on insolvency in 1998. And, of course, the 9/11 attack was a non-economic event with a huge potential to cause economic havoc. Despite widespread fears, none of these isolated crises turned into a worldwide or American financial crisis.

The escapes from these threats fortified the idea that the Fed's knowledge and power, enhanced by advances in understanding and managing the economy, could steer us away from *all* calamities. Moving the short-term interest rate (the so-called Fed funds rate on overnight loans) up or down triggered corresponding shifts of long-term interest rates, which slowed the economy when inflation was a threat and spurred it when recession was a danger. With hindsight, this conviction turned out to be complacent. But it was real at the time, and contributed to the feeling that the economy had grown less risky.

To prevent financial disaster, the Fed lowered interest rates after the 1987 stock market crash, the Asian financial

crisis, and 9/11. But, as Mallaby notes, others also deserve credit for the Fed's performance, credit that has mostly accrued to Greenspan. Gerald Corrigan, then head of the New York Federal Reserve Bank, pushed the Fed in 1987 to make credit liberally available to offset the stock market crash, and subsequently organized an industry-financed bailout of LTCM. Treasury Secretary Robert Rubin and his deputy Lawrence Summers played an important role in handling the Asian financial crisis. And Fed vice chairman Roger Ferguson oversaw much of the response to 9/11.

Why, then, the disastrous 2008-09 crash? If the Fed was so smart and powerful, why didn't it prevent it? The standard story is that Wall Street got carried away at a time when Greenspan's permissive policies—superficial regulation of financial institutions—encouraged greed and sloth. Lenders made millions of questionable "subprime" mortgages, and when defaults mounted, the damage to the financial system cascaded through the entire economy. Credit evaporated; businesses delayed or cancelled investment projects; companies fired workers, stopped hiring them, or both. The debacle could have been reduced or prevented, so the argument goes, if the Fed had policed lending practices more aggressively.

Mallaby is skeptical. For starters, "regulatory tools are hard to wield," he points out. What seems clear with hindsight was not so obvious at the time. Spotting bubbles involves "interpreting vague reports of market abuses." There's usually pushback from affected industries. Economists and housing specialists recognized that there were excesses in the real estate market, but these had occurred before and were not seen as a major threat to the economy. "Greenspan's complacency on housing was shared by nearly everyone," writes Mallaby.

Moreover, the Fed had attempted to tighten mortgage lending standards. In late 2001, it issued tougher regulations on home lending, but lenders evaded the restrictions, whose language was ambivalent. Another weakness of the standard narrative is that the Fed had regulatory oversight of banks and bank holding companies (such as JPMorgan Chase, Citicorp, and Wells Fargo), but much of the buying and selling of mortgage securities was done by investment banks (Bear Stearns, Lehman Brothers, Merrill Lynch, and Goldman Sachs). *Their* primary regulator was the Securities and Exchange Commission.

Mallaby also demolishes the oft-told story that the 2008-09 financial crisis could have been avoided if Greenspan had only listened to economist Edward Gramlich, a Fed governor from 1997 to 2005. By this account, Gramlich warned Greenspan as early as 2000 that subprime lending was awash in abuse. With hindsight, Greenspan and others should have paid more attention. But to what? Was this consumer fraud or a threat to the entire economy? Mallaby meticulously reconstructs the Gramlich-Greenspan relationship and shows conclusively that Gramlich was talking about consumer fraud, not a complete economic breakdown. He contended that people were exposed to scams, not that the economy was exposed to meltdown. Before his death in 2007, Gramlich made the same point in a book for the Urban Institute: there was a "failure to connect the dots between abusive lending and systemic [economic] risk," in Mallaby's words.

The anti-Greenspan hypothesis faces another hurdle. In 2004 the Fed began raising short-term interest rates, previously lowered to cushion the 2001 recession. There was an expectation that long-term interest rates on home mortgages and corporate bonds would also rise, as had happened in many previous business cycles. Had this occurred, the higher mortgage rates might have quashed the worst excesses of the real estate boom by making home-buying costlier. But long-term rates *fell*, to the surprise of Greenspan and most economists. He called it a "conundrum," one that clearly thwarted the Fed's ability to slow the housing boom.

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After digging into Greenspan's past, Mallaby discovered a long paper delivered to the American Statistical Association in 1959. In it, Greenspan contended that there are important connections between financial markets, especially stock and bond markets, and the real economy of production, construction, jobs and prices, a novel idea at a time when financial markets were considered an economic sideshow. At best, economists figured that financial markets reflected economic sentiment: confidence or pessimism; fear or hope. At worst, they were a "casino" for financial bets, ruled by "animal spirits" instead of rationality. Either way, they were only loosely tied to economic fundamentals.

Greenspan rejected this view. Stock prices, he argued, influenced both consumption spending and business investment in factories, buildings, and machinery. When stock prices rose, people felt richer and spent more; when prices fell, they felt poorer and spent less. (This "wealth effect" is now widely accepted.) Similarly, stock prices affected business investment. If a company could build a new factory for less than the price of buying one with stock, it would build; if not, it wouldn't. The lesson, Greenspan said, was that when setting interest rates and credit conditions, the Federal Reserve and other central banks should pay attention to the prices of such major assets as stocks, bonds, and homes, being especially vigilant for possible "bubbles." If permitted to grow to a sufficient size, one could burst and inflict enormous damage on the economy.

The underlying cause of the financial crisis, Mallaby writes, is that Greenspan disregarded his own sound advice. He discounted the danger from the housing bubble and didn't preemptively "prick" it with yet higher interest rates. Mallaby's plausible assumption is that if that asset bubble had been deflated sooner, the damage to the real economy and to confidence would have been far less severe. His puzzle is that Greenspan never abandoned the view that financial markets were prone to destructive spasms. One task of the Fed was surely to prevent financial crises and panics. And yet, Greenspan fell into the trap. "The upshot of the older Greenspan's policies was precisely what the younger Greenspan feared: financiers were encouraged to take ever wilder risks."

What Greenspan should have done was raise interest rates earlier before the housing bubble became truly dangerous, Mallaby argues. While it was unrealistic to expect regulation to prick every possible bubble, the Fed could have used interest rates and credit conditions to discourage destructive financial speculation. The trouble was that Greenspan and the Fed were still under the thrall of Volcker, in Mallaby's view, meaning that they viewed keeping inflation low as their primary mission. If they achieved that, other problems would either solve themselves or could be addressed without putting the economy into a tailspin. These were not just unconscious assumptions but semi-official policy.

In 2002, after the spontaneous bursting of the late 1990s "tech bubble," both Greenspan and Ben Bernanke, the economist who was then a Fed governor and would later succeed him as chairman, gave speeches questioning the wisdom and practicality of deliberately popping financial bubbles before they became too treacherous. Both reached the same conclusion for the same reasons. First, it's not easy to identify a bubble until it actually deflates.

Second, using monetary policy to pop a bubble would probably require large increases in interest rates that might result in more economic damage—higher unemployment, lower incomes—than waiting for the bubble to collapse on its own. It's easier to "clean up" after the bubble than to destroy it preemptively.

Although this sounds sensible, it's doubtful that Greenspan and Bernanke would say exactly the same thing today. What was missing from their analyses was the possibility that the bursting of the bubble would affect most of the economy, as it did when housing prices cratered. Rather, their assumption was that the damage would be limited to one sector of the economy, the way the dot-com collapse was largely limited to technology companies. If the actual risk were much larger, then the economic and social costs of letting the bubble inflate would be much greater, as would the stakes of getting it wrong. Everything hinged on how dangerous the bubble might be, and that was a matter of judgment. To have squeezed the speculation out of housing prices would probably have required a severe slump, which would have invited an anti-Fed backlash.

The real problem goes deeper than Mallaby and, it seems, Greenspan and Bernanke imagined, however. There is a massive contradiction at the heart of the Fed's mandate. The more it does what people want it to do—encourage stable and steady economic growth, with low inflation and low unemployment—the more it sows the seeds of greater instability and interrupted growth. The faith that the Fed can make the economy more stable and less risky, paradoxically, justifies behavior that makes the economy more risky and less stable. People and businesses take more risks because they believe the underlying economy is sound, or can always and easily be made so by government. The consequence of the Greenspan magic was that optimism evolved into recklessness.

The unstated implication is that periodic recessions and financial bubbles are *essential* to maintaining the larger stability of a capitalist economic system. Prosperity can't stand prosperity, at least not indefinitely. People need to be reminded that frugality, prudence, and caution are virtues, and that risk-taking, speculation, and aggression can be dangerous. Too much success at securing stable, long-term growth may undermine prosperity by creating unattainable expectations about the future. Few economists, and certainly no significant politicians, draw this lesson from the financial crisis and Great Recession. Yet, it exposes a central dilemma for democracies, for which there are no obvious answers. How often do we need a recession and how severe? Will a formula provide the answer or must we rely on human judgment? Who will admit that uninterrupted prosperity can foster a debacle?

That was the lesson of 2008. There was a widespread view then that the economy had become less risky. Practices that once seemed irresponsible now seemed prudent. If the problem were only inflated home prices, the escape would have been costly but isolated. In 2007, housing investment represented only 5% of the gross domestic product of the United States. Thus, a one-fifth decline would have shaved about one percentage point off GDP. Unpleasant, but bearable.

Unfortunately, housing was only the tip of the speculative iceberg. Homeowners had borrowed against the increased values of their houses or, feeling wealthier, had spent more of their income, as the young Greenspan foresaw. Once home prices fell, this spending abated. Consumption spending, representing roughly 70% of GDP, slumped. Commercial banks and investment banks increasingly had funded themselves with short-term borrowings (commercial paper, repurchase agreements) with maturities of a day to some months. This made these banks vulnerable to abrupt withdrawals of these loans. Finally, there were losses on "credit default swaps," securities that protected buyers against losses on mortgage-backed securities. Most notoriously, the insurance giant AIG was on the hook for billions it didn't have.

The economy, in short, had become heavily dependent on unsound financial practices that were bound to break down. The housing crisis merely exposed these weaknesses. Once this occurred, arguably with the failure of Lehman Brothers in September 2008, fear fed on itself. Companies laid off workers and cancelled investment projects, which led to more layoffs and cancellations. To see matters this way profoundly alters the nature of the crisis. The apparent success of Greenspan and later Bernanke in extending the economy's multidecade expansion—called the Great Moderation by economists, signifying the infrequency and mildness of recessions—became the basis for both Greenspan's lofty reputation and, when it ended, his fall from grace.

Greenspan's public standing has ebbed and flowed with the rise and fall of public faith in monetary policy. We are now in the midst of another reappraisal, as central bankers experiment with "forward guidance," "quantitative easing," "negative interest rates," and other techniques for pumping money into weakened economies. Mallaby wisely steers clear of these topics, because they are not part of his epic. Alan Greenspan is undoubtedly a major figure of our era, and Mallaby's magnificent biography is worthy of its subject. It's intellectually rigorous, consistently informative, well-written, and highly readable despite its length.

Washington journalist William Greider's *Secrets of the Temple*, a chronicle of the Fed focusing on the rise and fall of high inflation from the late 1960s to the early 1980s, was published in 1987. It is a classic of first-rate reporting and writing. Mallaby has effectively written the sequel. It deserves a place next to Greider's on any shelf of books on contemporary political economy.

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