Alan Greenspan fights back

mschoeller_greenspan.top.jpgBy Geoff Colvin, senior editor at largeFebruary 5, 2010: 4:43 PM ET

(Fortune Magazine) -- When the Senate grudgingly reconfirmed Ben Bernanke as Fed chairman two days before his term expired, he was only a stand-in for the man 30 senators were really mad at. "I knew that he would continue the legacy of Alan Greenspan, and I was right," said an angry Jim Bunning, a conservative Republican from Kentucky who voted no. Fumed Bernie Sanders of Vermont, the Senate's only (admitted) socialist: "He said it publicly -- I want to follow in the footsteps of Alan Greenspan. Alan Greenspan's philosophy is a disaster." Jeff Merkley (D-Ore.) said Bernanke "helped set the fire that destroyed our economy." Only helped, that is -- and we all know whom he helped.

Seldom has conventional wisdom on so recondite a topic -- Federal Reserve interest rate and regulatory policy from 2002 through 2005 -- converged so thunderously on one person. Greenspan, in his final four years as Fed chairman, kept rates too low and regulation too light, goes the argument. The result was the housing bubble.

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The bubble's inevitable bursting caused the worst financial crisis in 80 years, bank failures across the land, the longest recession since the Great Depression, towering unemployment, and economic misery for millions.

People and institutions normally at each other's throat all seem to agree: Editorial pages from the Boston Globe on the left to the Wall Street Journal on the right, think tanks from the liberal Institute for Policy Studies to the beyond-conservative Cato Institute, Nobel Prize--winning economists including Keynesian Paul Krugman and rationalist Gary Becker -- they all know who's to blame for the mess we're in. Four years after leaving the Fed as the Greatest Central Banker Ever, the longest-serving chairman, the Maestro, Alan Greenspan is the designated goat.

Seemingly the only person in America who hasn't weighed in on this matter lately is Greenspan. In the past year or so, as unemployment climbed and criticism of him became broadly accepted, he has written little and rarely spoken publicly on this topic, though he occasionally comments on the economy's current state.

So what does he think about his reversal of fortune? No surprise: He believes the case against him is wrong. What is surprising is how deeply he analyzes the debate. He studies the data and is confident it will exonerate him. He is marshaling his facts and will present his data-driven analysis in a 12,000-word article, but hasn't said when.

Of course he doesn't like what's happening to his reputation, yet he seems sure that when this recession is past and informed people can look at the whole picture dispassionately, they'll agree that he didn't

cause the crisis and couldn't have prevented it. Could he be right?
Track the stimulus spending

"My actual business life hasn't changed since 1948," says Greenspan, referring to the year he became a Conference Board economist -- having previously worked as a saxophonist in the Henry Jerome jazz band. "The only thing that has changed is my employer."

His employer now is himself. He's sitting in his expansive, oval-shaped office overlooking Washington. It's a cold winter day, and over his white shirt and quiet tie he's wearing a hunter-green zip-up fleece with "G-20" embroidered on it in gold thread. His title is president of his consulting company, Greenspan Associates, the associates being three young assistants.

The "business life" he mentions is easily described: "studying data and trying to figure out how the world works." He did it long ago at the Conference Board, then at his consulting firm, Townsend-Greenspan, and on President Ford's Council of Economic Advisors. For 18 years he did it as Fed chairman, and he's still doing it.
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In understanding how he's bearing up against the assault on his reputation, it's important to realize that studying data is his passion. As a boy in New York City, he became a statistical encyclopedia of the Yankees and claims that today, at age 83, he can tell you the batting average of every player on the team's 1936 starting lineup (DiMaggio: .323). As Fed chairman, with a staff of 200 Ph.D. economists, he still reserved half his time for what he calls personal research, poring over data by himself.

Today, he says, "I have fewer meetings and spend less time on uninspiring matters," like preparing congressional testimony. Which means, happily, that he can spend even more time on personal research, seated at his desk in front of three extra-large computer screens. That is what revs his engine. Much of his research now focuses on what he did from 2002 through 2005, a small fraction of his time leading the Fed but the crux of his reputation, at least now.

The heftiest version of the case against him comes from a friend, John Taylor of Stanford University. Taylor once worked for Townsend-Greenspan and served with Greenspan on Ford's Council of Economic Advisors.

The two men still talk, and Taylor sometimes drops by Greenspan's office. But he has written scholarly papers intended to show that badly misguided Fed actions under Greenspan created the disastrous housing bubble.

Taylor's case, which has been cribbed shamelessly by many Greenspan critics, is a short chain of logic: First, Fed policy from 2002 through 2005 deviated wildly from the highly successful policy of the previous 20 years. During that golden age of low inflation, strong growth, and rare, mild recessions, Fed rate decisions had mostly followed a formula that Taylor identified in 1993 and that others named the Taylor rule. (Its inputs are the inflation rate, the target inflation rate, economic growth, and the economy's production capacity.)

Taylor showed that, starting in 2002, the Fed veered from the formula, keeping rates too low by Taylor-rule standards. Second link in the chain: The Fed funds rate is correlated with housing starts. Taylor showed that when the rate is low, housing starts go up, and vice versa.

Third link: If the Fed had stuck to the Taylor rule, the housing boom wouldn't have happened. Taylor plugged the Taylor-rule Fed funds rates into his model of housing starts and showed that under those rates, starts would barely have exceeded their level in the late '90s. No boom, no bust, no financial crisis. Other factors may have contributed to the crisis, Taylor says, but Fed rate policy was "at the top."

Greenspan likes Taylor but not his analysis: "He is a very good friend. But his evidence doesn't show what he says it shows." Greenspan and his defenders counter Taylor in several ways. They don't dispute that Fed policy in the critical period deviated from the Taylor rule, though less than Taylor claims.

They insist that the second link in the chain, the correlation between the Fed funds rate and the housing boom, just doesn't hold in today's global economy. Robert Shiller of Yale University, an authority on housing prices, says the housing boom began in 1998, four years before the Fed went off the Taylor rule.

For many years the Fed funds rate and mortgage rates did move up and down almost in lockstep, but starting in 2002 that correlation evaporated. Says Greenspan: "Mortgage rates started moving down six months before we lowered the Fed funds rate."

Mortgage rates seemed to be floating off on their own. Why? The answer brings us to a key element of Greenspan's case for why he isn't this story's villain: The Fed was setting U.S. rates, but the housing bubble was global.

An International Monetary Fund study shows that 20 countries experienced housing bubbles during the critical period, and 11 of them were worse than America's (the worst: Ireland, the Netherlands, and Britain). It obviously makes no sense, Greenspan reasons, to think that the Fed's rate decisions inflated housing bubbles around the world from Sweden to New Zealand.

Instead, a more logical thesis explains what happened: the global saving glut. It holds that when China and other countries switched to market-oriented economies in the early '90s, they became more productive and unleashed a tsunami of capital onto world markets.

All that new capital naturally pushed interest rates down globally -- thus the decoupling of mortgage rates from the Fed funds rate, and the global nature of the housing boom.

John Taylor doesn't like the global-saving-glut explanation for a simple reason: "There is actually no evidence for a global saving glut." Global saving and investment as a percentage of world GDP have been in long-term decline since the early '70s, he points out.

Greenspan's riposte? You have to look at intended saving and intended capital investment, not actual saving and investment. After all, saving and investment by definition will always balance.

So if, let's say, the world's businesses decide not to invest much, perhaps because they're strengthening their balance sheets by paying down debt, then global investment will be low, and by definition actual global saving will be low as well; they have to match. But if intended saving was high -- if a ton of capital was out there looking for a home -- then interest rates would fall.

That's what happened during the housing boom, says the IMF. There was an "excess supply of saving." Combine low mortgage interest rates caused by that flood of capital with other factors -- the incredible complexity of mortgage securitization, which no one fully understood, plus clueless rating agencies and

the euphoric atmosphere of boom times -- and that's how you get a housing bubble. Or so argues Greenspan. And the Fed is blameless.

But, but, but, say his critics -- the bubble was so obvious! And you did nothing to stop it! To which Greenspan responds, in essence, yes. The Fed can do little to stop a bubble, or at least to stop it responsibly.

As the Financial Times' Martin Wolf, a Greenspan defender and former World Bank economist, has written, "The Fed could only have halted the U.S. bubble if it had been willing to put the economy into permanent recession." That's because strangling the boom would have required short-term rates as high as 10%, Wolf argues.
What happens if China's 'bubble' pops?

The reality of bubbles cannot be escaped, Greenspan believes. A central element of his worldview is that "bubbles are built into human nature." But why were the effects of this bubble so much more devastating than almost any other? The reason strikes at the heart of Greenspan's beliefs.

Indeed, if you're wondering how he's doing through all this, we've reached a part of the answer that's profound for a man whose life is largely the intellectual life. This bubble was catastrophic because self-interest failed. At Bear Stearns, Lehman Brothers, AIG (AIG, Fortune 500), Citigroup (C, Fortune 500), Merrill Lynch, and others, the firm's interest in its own profits should have stopped the housing bubble insanity. That's how the system is supposed to work. It didn't.

For America's most famous libertarian, an Ayn Rand acolyte, that is more than troubling. It's foundation-shaking. It put him into "shocked disbelief," he told Henry Waxman's House Energy and Commerce Committee in October 2008.

"I found a flaw in the model that I perceived is the critical functioning structure that defines how the world works." David Henderson, an economist (and fellow libertarian) at the Hoover Institution, says, "Bartlett's Quotations, if it exists in 20 years, will have that quote in it."

Self-interest failed, Greenspan believes, mainly because no one, including himself, understood the costs of the extremely unlikely risks the big banks faced. "This is a once-in-a-century event," he says.

It may seem unsurprising that in those rare circumstances the banks disastrously misjudged their counterparties, mainly other institutions that owed them payments. But a central element of Greenspan's belief system was that such things don't happen. "Counterparty surveillance failed to protect the system this time," he says. "I always thought it would. I held that belief for 60 years."

Yet he doesn't believe tougher regulation by the Fed could have saved the banks. The problem in his view is that regulators would be much worse than the banks themselves at judging banks' counterparty risk. "I was on the board of J.P. Morgan (JPM, Fortune 500) prior to becoming Fed chairman," he says. "I knew what J.P. Morgan knew about Citi, Bank of America (BAC, Fortune 500), Wells, and others. When I arrived at the Fed, I quickly learned that J.P. Morgan's knowledge of those organizations was far greater than what the Fed knew."

Greenspan isn't opposed to more regulation, mostly fine-tuning. But on the central issue of self-interest, the safeguard that failed, he isn't giving up. He wants banks more exposed to market discipline by making sure that the "too big to fail" doctrine disappears. "Counterparty surveillance will remain the

regulators' first line of defense," he says. The banks may have blown it, but now they've learned how to do it better, and that's what they must do.

As endless as the controversy is, it doesn't consume him. He has consulting clients -- Pimco, Deutsche Bank (DB), and Paulson & Co., the hedge fund that made billions betting on the housing bust. He still gives speeches (list price: $180,000). Conference organizers who have booked him believe his appeal has held up through the financial crisis. "Has he been tarnished? Maybe," says one from a major accounting firm. "But it really doesn't matter. People still want to see him in person. They want to go back to the office and say, 'Well, Alan Greenspan says ...'"

And Greenspan does have a life beyond the office. He and his wife, NBC News chief foreign-affairs correspondent Andrea Mitchell, do the Washington dinner circuit. He plays tennis.

Standing just behind the tumult of today's controversy is the matter of his legacy. What is the consensus view of him likely to be, say, 40 years from now? The best answer comes from Allan Meltzer of Carnegie Mellon University. The 1,300-page second volume of his history of the Fed has just been published (the 800-page first volume appeared in 2003).

His take: "Greenspan will be remembered for maintaining a long period of low inflation and stable growth punctuated by short recessions and followed by the error of believing that deflation was a problem. That caused him to keep policy too easy too long. But he did not force bankers to buy subprime. That was their decision, encouraged by a mistaken government housing policy that he testified against and the 'too big to fail' doctrine that he did not try to end. So if truth prevails, the deep crisis will be blamed on housing policy, 'too big to fail,' and the mistake by [Hank] Paulson, [Tim] Geithner, and Bernanke of letting Lehman fail without much warning after 30 years of bailing out large failures."

As an assessment, that isn't the king-of-the-world adulation Greenspan was getting four years ago, but it's not bad. It fits with his own often-quoted view that as Fed chairman, "I was praised for things I didn't do, and I'm now being blamed for things I didn't do." To top of page