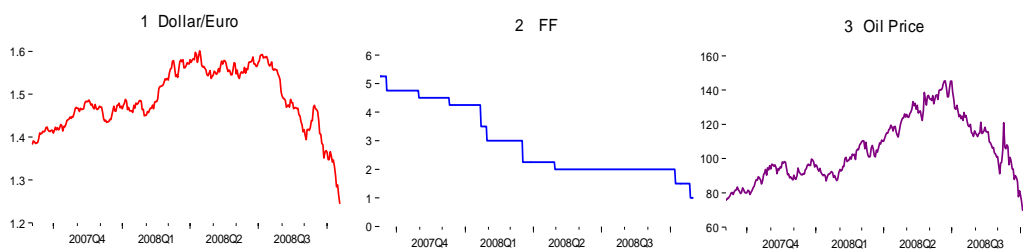


## Fallen Idol

Greenspan is not having an easy time in his retirement after almost 20 years at the helm of the Fed. The WSJ described his recent (October 23) testimony before Congress as “a painful spectacle to watch” (i.e. pathetic). Expressions like “the mess that Greenspan made” or “Greenspan’s folly” are frequently heard. To Jeffrey Sachs, among many others, “this crisis is mostly the Fed’s doing during the period of easy money...”

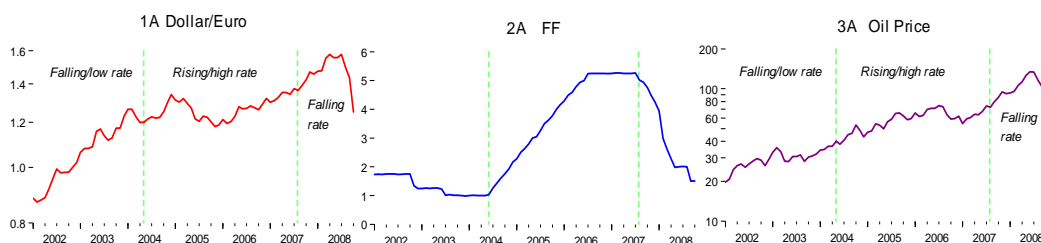
There are bubbles galore. The WSJ argues that after the internet bubble, there was the house bubble and now we are witnessing the popping of the last bubble – commodity prices and of currencies not tied to the dollar – with all the bubbles being the result of the Fed’s easy money policy. While Greenspan is responsible for the first two, the last one is the creation of Bernanke who, by interpreting a solvency problem as a liquidity problem flooded the economy with money while taking the Federal Funds (FF) rate from 5.5% in September 2007 to 1% today.

The “Bernanke bubble” is clearly shown, according to the WSJ argument, in the following set of pictures (daily data). When interest rates were driven down starting in September 2007 (fig. 2), important prices in the world economy such as the price of oil (fig. 1) and the Dollar/Euro exchange rate (fig. 3) surged in typical bubble fashion, popping when something happens or common sense is reestablished.



The verdict for a “Bernanke bubble” seems convincing. Nevertheless, when we gather “additional evidence” by extending the observation period we observe that the “trends” had long been in place.

Figures 1A, 2A and 3A show the same variables in figures 1, 2 and 3 only now using monthly data going back to 2002. Funny how the price of oil and the Dollar/Euro exchange rate went up when the FF rate was falling and low, rising and high and continued to increase for a time when the FF rate was again falling.



Apparently we would have to conclude that the oil (more generally commodities) and exchange rate “bubbles”, in addition to the 1998-2000 internet bubble and the ?-2006 house price bubble were also of Greenspan’s making through his “easy money” policy!

To many, Greenspan is now known as the ultimate “bubble blower”. During most of his tenure at the Fed, and especially over the past 12 years, the usage frequency of the word “bubble” has grown tremendously, usually as a description of any rise in asset price, be it stocks, homes exchange rate or commodities.

Greenspan is arguably responsible for setting off the “bubble mania” with his famous remark during a speech in December 1996 where he coined the term “irrational exuberance” when discussing the stock market (at that time he was not referring to the Nasdaq but to the more traditional Dow and S&P indices).

Although terms such as “bubble” and “irrational exuberance” (other equivalent expressions would include “Ponzi scheme”, “tulipmania”, “chain letter” and “herding”) suggest that an event is inexplicably crowd-driven, what they really mean, as Peter Garber put it very nicely in his 2000 book *Famous First Bubbles*, is that “we have grasped a near-empty explanation rather than expended the effort to understand the event”.

I suggest that figures 4, 5 and 6 help us better understand two of the “bubbles” – technology stocks and house prices - that Greenspan is charged with “blowing”.

Figure 4 highlights the explosion in the value of the NASDAQ, composed of the technology companies something which was not replicated by the more traditional Dow and S&P 500 indices. While the NASDAQ was skyrocketing between end 1998 and early 2000, the FF rate was relatively stable and at a comparably high level. In any case it is hard to imagine that an “easy money” policy could be almost perfectly discriminating! More likely, the NASDAQ “bubble” is associated with fundamentals much discussed at the time such as the rise in productivity that had brought forward a “new economy” based on IT and the Internet. By his frequent discussion of productivity in his many speeches and testimonies in 1997-99, to justify monetary policy despite the fact that growth was high (seen by many as far above potential and, thus, inflationary) Greenspan may have indirectly influenced investors.



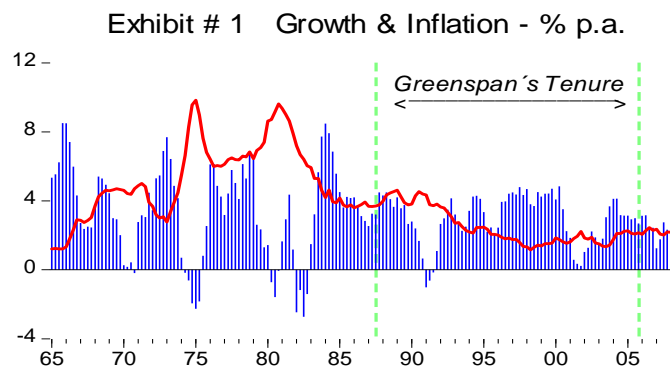
With regard to house prices figure 6 shows that they were rising during most of the period, independently of interest rates being “high”, rising or falling. The S&P Case-Shiller Home Price Index, closely followed in the last couple of years because it shows a steep fall in house prices, is biased due to its methodology. In any case, the explanation for the rise in house prices is closely tied to the “homeownership program”, especially targeted to moderate and low income households, sponsored by Congress together with HUD beginning in 1992 (see my October 19 post “The hand that rocks the cradle” for more details). This view is consistent with one of the conclusion’s of Garber’s book, to wit, that in most instances governments rather than markets are the source of financial crisis. In this setting, interest rates may have had at most a marginal effect on the process.

As for the commodity and exchange rate “bubbles” from 2002 one can always refer to the “China effect”, following China’s acceptance as a full-fledged member of the OMC in December 2001. From that moment China’s exports and imports multiplied by a factor of five and four, respectively, and growth was at the two digit level for most of the time. India, Brazil and Russia, the rest of the Bric’s also saw growth rates increase. At times, speculative activities may have had some influence, but that is inherent to capitalist systems and is not always, or even mostly, destabilizing.

Unfortunately, Greenspan was not an effective advocate for his own defense during his Congressional testimony. He pinned the crisis on mortgage securitizers, risk modelers and lending institutions. But his defense was really quite easy. As his own defense counsel he would argue that the Fed’s mandate is to:

1. Keep inflation low and stable and,
2. Attain maximum employment (equivalently, keep growth close to potential)

And then show “defense exhibit #1” (and only) to Congress’s “jury” panel:



Volker was responsible for “restoring order”, Greenspan is responsible for “maintaining order”, something of the utmost importance.

**João Marcus Marinho Nunes – November 9, 2008**