

The

FREEMarket

PUBLISHED 11 TIMES PER YEAR BY THE LUDWIG VON MISES INSTITUTE

GREENSPAN'S BOGUS DEFENSE

Robert P. Murphy

Robert Murphy, an adjunct scholar of the Mises Institute and a faculty member of the Mises University, is the author of The Politically Incorrect Guide to Capitalism; The Study Guide to Man, Economy, and State with Power and Market; and The Human Action Study Guide (bob.murphy.ancap@gmail.com).

In a March 11 *Wall Street Journal* op-ed, former Federal Reserve Chairman Alan Greenspan tried to exonerate himself from the housing boom and bust. Even though more and more analysts are realizing that Greenspan's low interest rates fueled the bubble, the ex-maestro himself uses statistics to defend his record.

Greenspan Couldn't Push Up Rates?

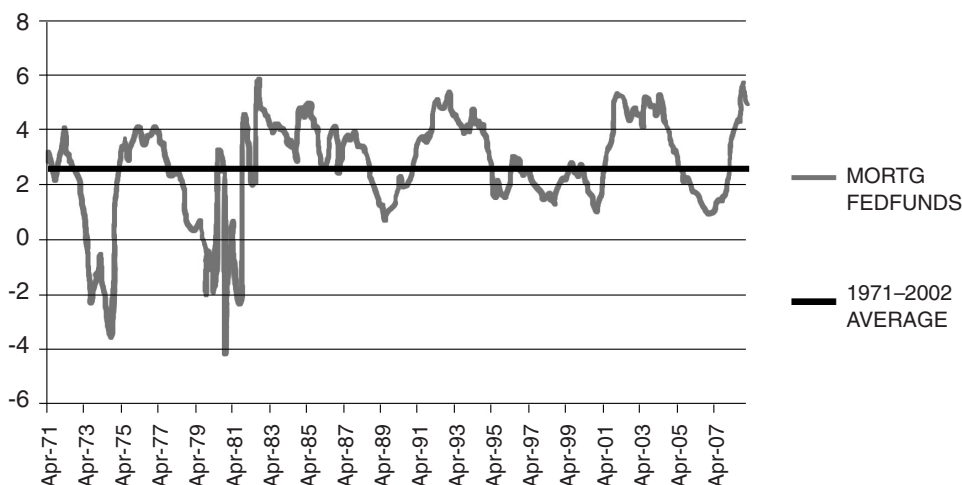
Greenspan's main argument is that the Fed lost control of the ability to move long-term interest rates, especially 30-year fixed mortgage rates. Since it is these longer rates that (at least in theory) ought to influence house prices much more than the overnight federal-funds rate, Greenspan can't possibly be held responsible for the housing bubble. In his words, the Fed "became acutely aware of the disconnect between monetary policy and mortgage rates when the latter failed to respond as expected to the Fed tightening in mid-2004."

Now this is extremely misleading. Judging from Greenspan's description, the reader would think that the federal-funds rate (which the Fed directly targets with its open-market operations) and the mortgage rate moved along in sync, when all of a sudden Greenspan tried to jack up short-term rates in 2004, and yet those pesky mortgage rates refused to move up. Hence, he did what he could to slow the housing bubble, but alas, it was precisely when he tried to help that the markets rendered him impotent.

On the other hand, Greenspan says (truthfully) that the correlation between the two series broke down earlier, in 2002. It's true, that the rates moved pretty much in lock-step up until 2002, as Greenspan claimed. But the disconnect occurred *when Greenspan slashed short-term rates while mortgage rates held steady*. Since the participants in the mortgage market wisely realized that rates wouldn't be held at 1 percent forever, they didn't foolishly drop their own yields down so far. Then in June 2004, when Greenspan began ratcheting the federal-funds rate back up, it is perfectly understandable that mortgage rates wouldn't rise with them.

To repeat, Greenspan's defense of his policies made it sound as if he tried to push up mortgage rates, but that they wouldn't budge. Yet, Greenspan didn't *really* push up very hard on rates. After all, he stopped short of breaking through mortgage rates once the federal-funds rate plateaued in June 2006 at 5.25 percent.





If he really had wanted to push up mortgage rates, he could have pushed up the federal-funds rate more.

Let's look at this issue a little more carefully. In the chart above, I've graphed the *difference* between the federal-funds and mortgage rates. In addition, I overlay the average value of this gap for the period 1971–2002.

Gap Between Mortgage and Federal Funds Rate

The above chart takes a minute to digest, but if the reader masters it, he will see just how silly Greenspan's argument is. The great "divergence" between the two interest rate series that began in 2002 was nothing unusual by historical standards. And once Greenspan tried to slam on the brakes by raising short rates (in 2004), a full year went by before the gap between the two had returned to its average over the 1971–2002 period—the very period that Greenspan says the two series moved "in lockstep."

Only from June 2005 onward was the gap between the mortgage and federal-funds rates even smaller than average.

(And the gap even went negative several times during the 1970s, when the federal-funds rate *exceeded* mortgage rates.)

Finally, just step back and look at the chart. Does it look as if something crazy and unprecedented happened from 2002–2005? Not at all: the whole housing boom period from 1998–2007 looks almost like a mirror image of 1988–1997.

So to repeat, the reason that the correlation between the federal-funds rate and the 30-year mortgage rate broke down during the housing boom was that Greenspan whipsawed short rates way down, then way up, in a fairly narrow window. Mortgage rates (thank goodness) didn't move around in such a volatile manner. If one series goes from 6.5 percent down to 1 percent, then back up to 5.25 percent, while the other series stays roughly flat, then obviously the measured correlation is going to be low.

Those Pesky Asian Savers

Greenspan repeats the claim that Asian savings were the real culprit. But there are two problems with this theory:

Copyright © 2009 by the Ludwig von Mises Institute. All rights reserved. ISSN: 1051-4333.

Editor: Jeffrey A. Tucker

Contributing editors: Thomas J. DiLorenzo, Jeffrey M. Herbener, Robert Higgs, Mark Thornton

Publisher: Douglas E. French

The Free Market is published 11 times a year.

Note: the views expressed in the Free Market are not necessarily those of the Ludwig von Mises Institute.

Ludwig von Mises Institute, 518 West Magnolia Avenue, Auburn, Alabama 36832-4501

Phone: 334-321-2100; Fax: 334-321-2119; Email: info@mises.org; Web: mises.org

first, global savings rates continued to rise throughout the housing boom *and* bust. So it's very difficult to explain the peak of the housing boom with reference to Asian saving. (In contrast, Greenspan's actions with short-term rates fit the fortunes of the housing market much more closely.)

But a second major problem is that even on its own terms, the influx of blind Asian saving—to the extent it existed at all—was itself partially a product of Greenspan's monetary inflation. Remember that the Chinese central bank had maintained a rigid peg to the dollar until it was pressured to drop it—right around the time the housing boom faltered.

To put it somewhat simplistically, when Greenspan flooded the world with more dollars, the dollar fell sharply against most major currencies. But in order for the Chinese to keep the renminbi (yuan) from appreciating against the dollar as well, they had to load up on dollar-denominated assets, such as US Treasuries. Thus, Greenspan's inflation in combination with the Chinese peg, on paper might have appeared as an irrational

influx of Asian investment, which stubbornly refused to subside even as US indebtedness grew.

Conclusion

It is bad enough that Alan Greenspan refuses to acknowledge what more and more people are realizing: his ultralow interest rates—which were in turn accomplished through injections of artificial credits into the banking system—fueled the housing boom. The Greenspan Fed was not a sufficient condition to cause the housing and stock bubbles, but it was almost certainly a necessary factor. If the Fed had let the post-9/11 recession run its course, there would have been no absurd boom (and now bust).

But beyond Greenspan's refusal to admit his mistakes is the ludicrous accusation that high savings rates among the world's poorest people—coupled with growing incomes made possible by technological and legal advances—was cause for misery. What a warped view of how the market economy works, to think that *savings* and foreign investment can cripple an economy. ■



Mises Institute EVENTS

Register for any conference
online at mises.org or by
phone at 800-636-4737.

- ROTHBARD GRADUATE SEMINAR
June 7–12, 2009 • Auburn, Alabama
- REMEMBERING BURT BLUMERT: A MEMORIAL
July 25, 2009 • Auburn, Alabama
- MISES UNIVERSITY
July 26–August 1, 2009 • Auburn, Alabama
- SUPPORTERS SUMMIT
October 21–25, 2009 • Salamanca, Spain
- THE MISES CIRCLE IN HOUSTON
(Sponsored by Jeremy S. Davis)
January 24, 2010 • Hilton Post Oak
- AUSTRIAN SCHOLARS CONFERENCE
March 11–13, 2010 • Auburn, Alabama

BLOWING BUBBLES

Douglas E. French

Douglas E. French is president of the Mises Institute. He is the author of Early Speculative Bubbles and Increases in the Supply of Money (Mises Institute, 2009) (French@mises.com).

As all the world economies writhe in financial pain from the cleansing of the largest bubble in financial history, the same question is being asked—how could this happen? Of course the usual answers are trotted out—human greed, animal spirits, criminal fraud, or capitalism itself. Modern financial history has been a series of booms and busts that seem to blend together making one almost indistinguishable from the next. The booms seduce even the most conservative into taking what in retrospect appear to be outlandish risks speculating on investment vehicles they know nothing about.

In response to the financial meltdown, central banks are slashing interest rates to nearly zero and growing their balance sheets exponentially. With no more room to lower rates, central bankers now speak of a “quantitative easing” policy which in plain English means “creating money out of nowhere.” But no one is shocked or horrified by this government counterfeiting. All this, after the US central bank (the Federal Reserve) has already, at this writing, increased the M2 money supply by eleven times since August of 1971 when the US dollar’s last faint ties to gold were severed.

While history clearly shows that it is this very government meddling in monetary affairs that leads to financial market booms and the inevitable busts that follow, mainstream economists either deny that financial bubbles can occur or that the “animal spirits” of market participants are to blame. Economists running central banks even claim that it is impossible to identify asset bubbles. Meanwhile, the Austrian School stands alone in pointing

the finger at government intervention in monetary affairs as the culprit.

Ludwig von Mises and Friedrich A. Hayek’s Austrian business-cycle theory provides the framework to explain speculative bubbles. The Austrian theory points out that it is government’s increasing the supply of money that serves to lower interest rates below the natural rate or the rate that would be set by the collective time preferences of savers in the market. Entrepreneurs react to these lower interest rates by investing in “higher order” goods in the production chain, as opposed to consumer goods.

Despite these actions by government, consumer time preferences remain the same. There is no real increase in the demand for higher order goods and instead of capital flowing into what the unfettered market would dictate—it flows into malinvestment. The greater the monetary expansion, in terms of both time and enormity, the longer the boom will be sustained.

But eventually there must be a recession or depression to liquidate not only inefficient and unprofitable businesses, but malinvestments in speculation—whether it is stocks, bonds, real estate, art, or tulip bulbs.

Early Speculative Bubbles was my master’s thesis (with slight changes) written under the direction of Murray Rothbard. It examines three of the most famous boom and bust episodes in history. Government monetary intervention, although different in each case, engendered each: Tulipmania, the Mississippi Bubble, and the South Sea Bubble.

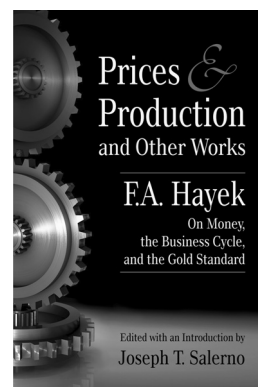
As the seventeenth century began, the Dutch were the driving force behind

News from the Institute

The Age of Hayek

The publication late last year of Hayek's *Prices and Production and Other Works* has initiated a series of releases of Hayek books, including *Choice in Currency* and the *Denationalisation of Money*, along with *The Pure Theory of Capital* and others. We've been very pleased to be working with the Institute of Economic Affairs to publish these.

Hayek had anticipated the end of the age of fiat money, and was very confident that the paper dollar *status quo* could not last forever. He had seen too much evidence from history that governments cannot be trusted to manage money properly. His alternative of a completely free system of money can be a bracing prospect to contemplate. His radicalism on this compares with Mises and Rothbard in many respects. But today he is gaining a new hearing. ■



European commerce. Amsterdam was the center of this trade and it was in this vibrant economic atmosphere that tulipmania began in 1634 and climaxed in February 1637. At the height of tulipmania, single tulip bulbs were bid to extraordinary amounts with the Witte Croonen tulip bulb rising in price 26 times in a one-month period. But when the market crashed: “[s]ubstantial merchants were reduced almost to beggary,” wrote Charles Mackay, “and many a representative of a noble line saw the fortunes of his house ruined beyond redemption.”

What made this episode unique was that the government policy did not expand the supply of money through fractional reserve banking which is the modern tool. Actually, it was quite the opposite. The Dutch provided a sound money policy that called for money to be backed one hundred percent by specie, which attracted coin and bullion from throughout the world. Free coinage laws then generated more money from this increased supply of coin and bullion than what the market demanded. This acute

increase in the supply of money fostered an atmosphere that was ripe for speculation and malinvestment, manifesting itself in the intense trading of tulips.

The Bank of Amsterdam, which was at the center of tulipmania, was an inspiration for one of history's most notorious currency cranks—John Law. Gifted in math, Law learned the banking business from his father in Scotland. But after his father died, the young Law had more interest in games of chance and women. During the day he would write pamphlets on money and trade while enjoying the social life at night.

Law made various proposals to governments around Europe for what we would call today a central bank and was turned down until 1716 when one of Law's partying friends, the Duke of Orléans, assumed control of the French government after Louis XIV died. The French government was on the verge of bankruptcy, and its citizens were fed up with their government's currency depreciation, recoinage schemes, and increased tax collections.

The situation was ripe for Law's monetary magic.

Law sought to "lighten the burden of the King and the State in lowering the rate of interest" on France's war debts and to increase the supply of money to stimulate the French economy, with the opening of General Bank, owned 25 percent by Law and 75 percent by the King, and the formation of a series of companies that when ultimately merged together were known as the Mississippi Company. Two years into his system, the regent granted Law's request that the General Bank be made part of the state, becoming the Royal Bank, patterned after the Bank of England.

With the Royal Bank creating vast amounts of paper currency, Mississippi Company share prices took off which led Law to issue more shares, using the capital to refinance more of the government's debt. Ultimately, the scheme unraveled, despite Law demonetizing gold and silver so that only royal banknotes and Mississippi Company shares would circulate as money. An outraged French public ultimately forced the regent to place the once-revered Law under house arrest.

While John Law was struggling to keep his Mississippi bubble inflated, across the English Channel, a nearly bankrupt British government looked on with envy, believing that Law was working a financial miracle. It was anything but, however Sir John Blunt followed Law's example with his South Sea Company, which in exchange for being granted monopoly rights to trade with

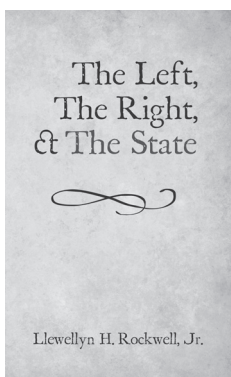
South America, agreed to refinance the government's debt.

As the price of South Sea Company shares rose, as in the case of Law's system, more shares were sold and more government debt refinanced. The company had no real assets, but that didn't matter as speculators bid the share price higher and higher, spawning the creation of dozens of other "bubble companies."

The South Sea Company lobbied the British government to pass a Bubble Act that would shut down these new companies that were competing for investor capital. Ironically, it was the enforcement of that act that burst the bubble with South Sea Company shares falling nearly 90 percent in price. Beloved British statesman Sir Robert Walpole reorganized the technically bankrupt South Sea Company, and it remained in business for years.

Although these episodes occurred centuries ago, readers will find the events eerily similar to today's bubbles and busts: low interest rates, easy credit terms, widespread public participation, bankrupt governments, price inflation, frantic attempts by government to keep the booms going, and government bailouts of companies after the crash.

Although we don't know what the next asset bubble will be, we can only be certain that the incessant creation of fiat money by government central banks will serve to engender more speculative booms to lure investors into financial ruin. ■



The Left, The Right, and The State

Llewellyn H. Rockwell, Jr.

Mises Institute Founder and Chairman Lew Rockwell's manifesto is a clarion call—creative and thought-provoking on every page—for a principled liberty in our time. There are very few books in which you can open up any page and immediately find a quotable and inspiring passage that will make you think hard, laugh out loud, or see things a completely new way. This is certainly one of them.

553 pgs. (hardcover) **SKU: B908**

Reg. Price: \$29.00 **Our Price: \$25.00**

Mises Lives!

at Mises.org

Download for free
or purchase in the store.

It's your choice.

You'll find the complete works of Mises, along with an extraordinary Study Guide to *Human Action* by Robert Murphy.

More than one thousand additional books on liberty are available for free, and the store has hundreds of titles by Rothbard, Hayek, Bastiat, and Hazlitt, along with the most important periodicals of the last century for download.

Come see what gives Mises.org, the website of the Ludwig von Mises Institute (founded 1982), its fame.

Join us for our 2009 Supporters Summit • October 21–25

Salamanca, Spain



For more information contact Patricia Barnett (pat@mises.com)
or go to Mises.org/events.

The

FREEMarket

Ludwig von Mises Institute
518 West Magnolia Avenue
Auburn, Alabama 36832-4501

Nonprofit Org.
U.S. Postage
PAID
Ludwig von Mises Institute

ADDRESS SERVICE REQUESTED