by Steve Hanke

US Federal Reserve Chairman Ben Bernanke (L) confers with former Chairman Alan Greenspan

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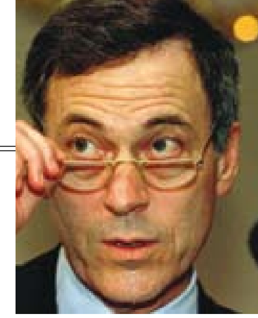
The great dissemblers

When the Financial Crisis Inquiry Commission convened on Capitol Hill in early April, the assembled members had to endure the spectacle of the former Chairman of the Federal Reserve Alan Greenspan asserting, with a straight face, that the Fed's monetary policy during his tenure did not contribute to the U.S. housing bubble. According to Dr. Greenspan, the origin of the financial crisis, in large part, resided elsewhere – literally overseas. The "blame the foreigners" ploy is always popular.

For Dr. Greenspan, a major culprit was an international savings glut. According to this hypothesis, the international savings rate exceeded the investment rate. In consequence, markets pushed long-term interest rates (both real and nominal) down. And as night follows day, Dr. Greenspan concludes: "Equity and real-estate capitalization rates were inevitably arbitraged lower by the fall in global long-term real interest rates. Asset prices, particularly house prices, accordingly moved dramatically higher."

There is a little problem with the global savings glut story, how-



ever: it is not supported by the facts. As the accompanying global savings-investment chart shows, the rate of global savings and investment has been in rough balance since the early 1990s. This inconvenient fact should create a problem for the Fed because both Dr. Greenspan and the current Fed Chairman Ben S. Bernanke have repeatedly bamboozled audiences with the global savings glut story.

Let's take a look at the Greenspan-Bernanke years to see if the Fed has been as innocent as Messrs. Greenspan and Bernanke claim.

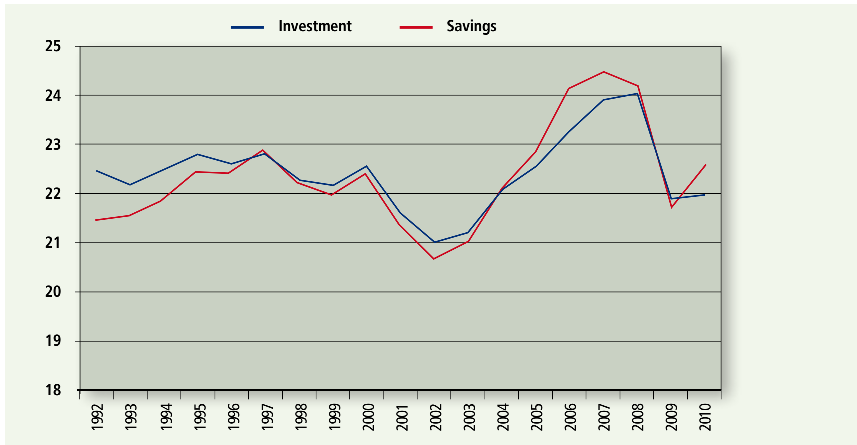
What is a bubble? There are many types. One type is created when the Fed's laxity allows aggregate demand to grow too rapidly. Specifically, a demand bubble occurs when nominal final sales to U.S. purchasers (GDP – exports + imports – change in inventories) exceeds a trend rate of nominal growth – a trend rate that is consistent with "moderate" inflation – by a significant amount.

During Dr. Greenspan's 18-year tenure as Fed chairman, nominal final sales grew at a 5.4% annual trend rate. This reflects a combination of real sales growth of 3% and inflation of 2.4%. But there were deviations from the trend.

The first deviation began shortly after Dr. Greenspan became chairman. In response to the October 1987 stock market crash, the Fed turned on its money pump and created a bubble: over the next year, final sales shot up at a 7.5% rate, well above the trend.

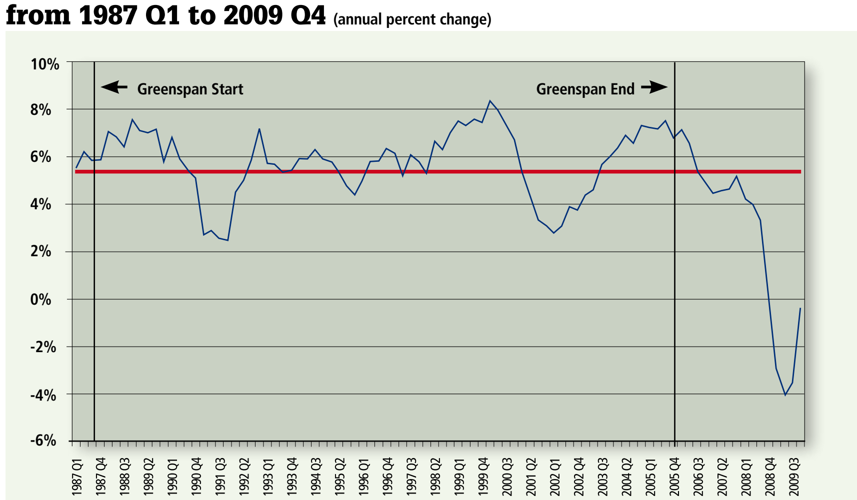
Having gone too far, the Fed then lurched back in the other direction. The ensuing Fed tightening produced a mild recession in 1991. From 1992 through 1997, growth in the nominal value of final sales was quite stable. But successive collapses of certain Asian currencies, the Russian ruble, the Long Term Capital Management hedge fund and finally the Brazilian real triggered another excessive Fed liquidity injection. This resulted in a boom in nominal final sales and a bubble in 1999-2000. This was followed by another round of Fed tightening, which coincided with the bursting of the equity bubble in 2000 and a slump in 2001.

Global Savings and Investment as a Share of World GDP (in percent)



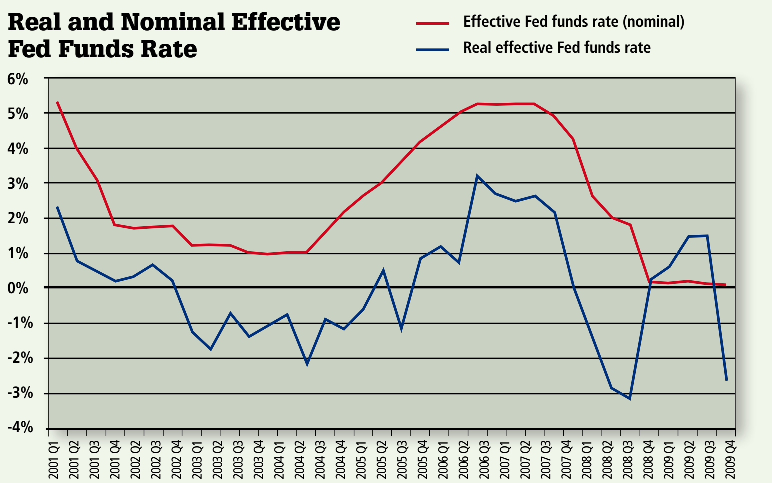
Source: International Monetary Fund, World Economic Outlook, October 2009

Final Sales to Domestic Purchasers from 1987 Q1 to 2009 Q4 (annual percent change)

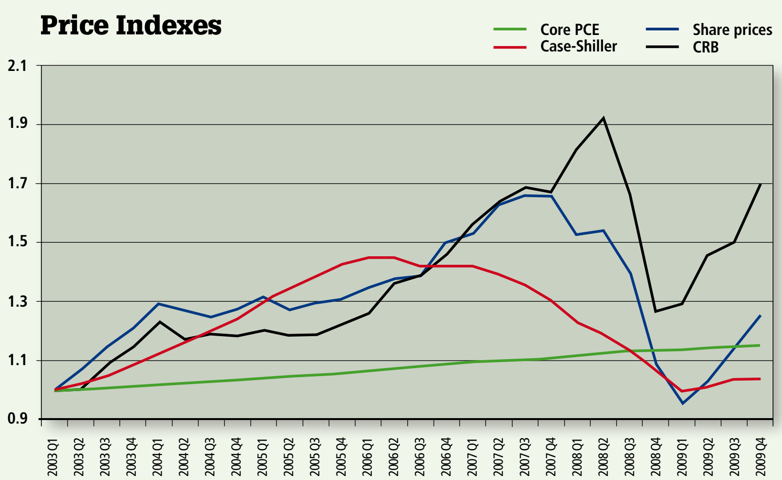


FSDP = GDP - Exports + Imports - Change in Inventories
Sources: Bureau of Economic Analysis, U.S. Department of Commerce and Author's Calculations

The last big jump in nominal final sales was set off by the Fed's liquidity injection to fend off the false deflation scare in 2002. Fed Governor Ben S. Bernanke (now Chairman Bernanke) set off a warning siren that deflation was threatening the U.S. economy when he delivered a dense and noteworthy speech, "Deflation: Making Sure it Doesn't Happen Here," on November 21, 2002. He convinced his Fed colleagues that the deflation danger was lurking. As then-Chairman Greenspan put it, "We face new challenges in



Sources: Federal Reserve Bank of St. Louis and Author's Calculations



Sources: International Monetary Fund, International Financial Statistics; Bureau of Economic Analysis, U.S. Department of Commerce; Standard and Poor's; Bloomberg and Author's Calculations

maintaining price stability, specifically to prevent inflation from falling too low." By July 2003, the Fed funds rate was at a then-record low of 1%, where it stayed for a year. This produced the mother of all liquidity cycles and yet another massive demand bubble.

During the Greenspan years, and contrary to his claims, the Fed overacted to real or perceived crises and created three demand bubbles. To obtain a better handle of the mother of all liquidity cycles, observe that, by late 2001, the central bank had already pushed the effective Fed funds rate below the 3-4% range for the neutral rate (a rate consistent with long-run price stability).

The effective rate stayed well below the neutral range until early May 2005. The pattern for the real effective Fed funds rate was similar to the one followed by the nominal effective rate. By late 2002, the real rate had dropped into negative territory, where it stayed until mid-2005.

It's not surprising that Stanford University Professor John B. Taylor (of Taylor Rule fame) in his highly critical book on the Fed's pre-crisis policies, *Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis,* concluded that there "is clear evidence of monetary excesses during the period leading up to the housing boom."

The most recent aggregate demand bubble wasn't the only bubble that the Fed was pumping up. As the accompanying chart of price indexes shows, the Fed's favorite inflation target – the price index for personal consumption expenditures, less those for food and energy – was increasing at a regular, modest rate. Over the 2003-2008 (Q3) period, this metric increased by 13%.

The Fed's inflation metric signaled "no problems." But abrupt shifts in major relative prices were underfoot. Housing prices measured by the Case-Shiller index were surging, increasing by 44.8% from the first quarter in 2003 until their peak in the first quarter of 2006. Share prices were also on a tear.

The most dramatic price increases were in the commodities. Measured by the Commodity Research Bureau's spot index, commodity prices increased by 92.2% from the first quarter of 2003 until their peak in the second quarter of 2008.

The dramatic jump in commodity prices was due, in large part, to the fact that a weak dollar accompanied the mother of all liquidity cycles. Measured by the Federal Reserve's Trade Weighted Exchange Index for major currencies, the greenback fell by 30.5% from 2003 to mid-July 2008. As every commodity trader knows, all commodities, to varying degrees, trade off changes in the value of the dollar.

When the value of the dollar falls, the nominal dollar prices of internationally traded commodities – like gold, rice, corn and oil – must increase because more dollars are required to purchase the same quantity of any commodity.

Contrary to claims by Messrs. Greenspan and Bernanke, the Fed played a central role in blowing asset bubbles, shifting relative prices and creating massive distortions in the economy. Military history is written by the victors.

Economic history is written by central bankers. Indeed, Prof. Lawrence H. White calculated that, in 2002, 74% of the articles on monetary policy published by U.S. economists in U.S.-edited journals either appeared in journals published by the Fed, or were authored (or co-authored) by current or former Fed staff economists. When it comes to military and economic histories, you have to take official accounts with a large dose of salt. GA

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