The Questionable Legacy of Alan Greenspan

Thomas Palley

Alan Greenspan will retire soon, and many analyses, most of them swooning, will soon be upon us. This economist offers an original and perhaps lasting postmortem on Greenspan's reign. He believes that Greenspan has been responsible for a new business cycle whose foundation is financial boom and cheap imports. The resulting borrowing is not a basis for stable future growth.

ALAN GREENSPAN was appointed chairman of the Board of Governors of the Federal Reserve on August 11, 1987, and for most of the eighteen years since then, he has been widely regarded as an oracle of economic policy. Now, with Greenspan preparing to step down and relinquish the reins of the Federal Reserve in 2006, it is timely to offer an assessment of his legacy.

The focus of the current assessment is Chairman Greenspan's impact on the goals and systemic conduct of Federal Reserve policy rather than his policy judgment. Much has been written on the question of whether Greenspan raised interest rates too abruptly in 1987, causing the stock market crash; whether he raised rates too much in 1988–89, causing the recession of 1990; whether he raised rates too much in

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1994, causing the economic slowdown of that year; and whether he contributed to the stock market bubble of the late 1990s by keeping monetary policy too easy for too long. However, these episodes are not the focus of the current assessment. Instead, this assessment is structural in character, focusing on changes in the Federal Reserve's construction of monetary policy under Greenspan. To the extent that the above policy episodes matter, they do so because they illustrate the real consequences that follow from changes in policy construction initiated during his tenure.

That said, a first conclusion is that the Greenspan era has cemented a transformation of monetary policy whereby policy now privileges financial markets over employment and labor markets. Prior to 1980, monetary policy was significantly driven by labor market concerns and, in many regards, worked hand in hand with other elements of the policy apparatus to put a floor under labor markets. Now, monetary policy is significantly driven by financial market concerns and looks to put a floor under financial markets.

A second conclusion is that the policy transformation cemented by Alan Greenspan was begun by his predecessor, Paul Volcker, and in many respects it was Volcker who did the difficult political spadework that has enabled Greenspan's policy regime. Many progressives love to hate Greenspan as the representative of conservative financial market interests. Yet, the reality is that construction of today's monetary policy regime began under a Democratic administration, and it has been very much a bipartisan affair.

A third and final conclusion is that the U.S. economy is fragile, and a full assessment of the Greenspan era must therefore wait for what happens over the next few years. This policy transformation of the last twenty-five years has elevated the significance of finance in the U.S. economy. This process of transformation has provided an economic shot in the arm as American households have used their enhanced access to credit to finance increased consumption spending. The open question is what will be the long-term consequences of this increased financial access. The new economic regime clearly has a powerful financial accelerator powered by borrowing. The next few

years will show whether or not it is sustainable once consumers and business have loaded up on debt.

Financial Markets and the New Business Cycle

Alan Greenspan took office in August 1987 when the Reagan economic expansion of the 1980s was still in process. That expansion was marked by several features that have come to delineate a new business cycle. Whereas earlier cycles were characterized by growth of manufacturing, the new business cycle has been marked by deindustrialization, growing trade deficits, and robust consumer spending financed by booming financial markets and growing household debt.

This new cycle emerged out of the deep recession of 1981, which saw large-scale deindustrialization, unemployment above 10 percent, and a brief flirtation with wage deflation. Thereafter, there followed a long economic expansion, but it was marked by robust appreciation of the dollar that contributed to record trade deficits and also caused a double-dip recession in the manufacturing sector. As a result, for the first time since before World War II, manufacturing employment failed to recover its previous peak employment level recorded in 1979.

On the financial side, the 1980s expansion saw a huge stock market boom, albeit briefly interrupted by the crash of October 1987. In addition, the decade witnessed the emergence of the corporate junk bond market, which gave rise to the phenomenon of leveraged buyouts. Household borrowing also rose to record levels relative to income, and there was a house price boom that eventually imploded in 1990. Finally, the expansion saw a sustained widening of income inequality, epitomized by the CEO pay explosion.

These features have been present in the business cycles that have since followed. In the 1990s, the Clinton business cycle began with a period of extended economic weakness that became known as "jobless recovery." When the boom eventually gathered steam in 1996, it was marked by an even more robust stock market expansion, and there was a repeat of the dollar appreciation that had been so damag-

ing to U.S. manufacturing in the 1980s. As a result, the trade deficit rose to new highs, and manufacturing again failed to recover the peak employment level of the prior boom.

Similarly, under President George W. Bush there has been a second episode of jobless recovery. Like the recession of 1990–91, the recession of 2001 was supposedly short and shallow, yet it took four years for private-sector employment to recover its pre-recession peak. In foreign currency markets, the dollar continued to appreciate until early 2003, helping the trade deficit break records year after year. Manufacturing and manufacturing employment have therefore continued to find themselves in the economic crosshairs. On the financial side, the stock market's bounce back from its large fall in 2001 has provided some economic support, but this time around the principal driving financial force has been house price appreciation. This outcome has contributed to a construction boom, and it has also provided the wherewithal for further household borrowing that has financed another consumption binge and pushed household debt to record highs.

Though history never repeats itself precisely, the business cycles of Ronald Reagan, Bill Clinton, and George W. Bush bear robust structural similarities that unify them and distinguish them from the business cycles of the 1945–80 period. To summarize, these similarities include deindustrialization, overvaluation of the dollar, record trade deficits, widening income inequality, and stock market and housing price appreciation that have supported record consumer debt burdens. Thus, the foundation of the new business cycle is financial boom and cheap imports. Financial boom provides consumers with borrowed finance that funds spending, while cheap imports ameliorate the impact of widening income inequality, deindustrialization, and periodic bouts of increased economic insecurity.

Behind this new business cycle lies a new economic structure. Deregulated financial markets have ensured a proliferation of lenders providing easy access to credit, while financial product innovation (such as home equity loans) ensures a steady flow of credit leveraged against rising home prices. In goods markets, globalization of pro-

duction and an overvalued dollar have ensured a steady flow of cheap
The Role of Policy in the New Business Cycle

Much of the economic structure that supports the new business cycle would likely have come into being on its own as a result of market innovations. However, policy has also played a critical role by actively promoting the emergence of these structures. More importantly, there has been a refusal to contemplate new policies that would have moderated or altered these trends. This is where Chairman Greenspan's impact has been so critical.

As chairman of the Federal Reserve, Greenspan has consistently used his bully pulpit to promote the current path of globalization, and he has also thrown his support behind wide-ranging financial deregulation and bank mergers. However, the most important change under Greenspan has concerned the conduct of monetary policy. In the post–World War II era, the Fed's macroeconomic policy goals have always been a combination of full employment and price stability, and all Federal Reserve chairmen have wrestled with the problem of inflation. However, under Greenspan there has been a significant shift of policy weight toward concern with inflation. Between 1945 and 1979 the shadow of the Great Depression ensured that the weight placed on full employment was far greater than the weight placed on price stability, and attention to full employment concerns helped ensure that productivity gains were shared and supported rising real wages and a rising popular standard of living. Across the board, White House, Congress, and Federal Reserve policymakers felt the need to react to labor market weakness, an approach that was formally enshrined in the 1946 Employment Act that mandated that all branches of government work together toward full employment. In effect, the era was characterized by a labor market–centered policy regime that put a floor under employment and real wages.

The Greenspan era has seen a significant shift in policy focus. Whereas the earlier regime aimed at putting a floor under labor markets, the new regime aims at putting a floor under financial markets. The new regime manifests itself in several ways, the most noticeable feature of which is the prominence given to combating inflation.

This objective has replaced the earlier regime's policy goals of full employment, easy job availability, and rising real wages. Indeed, rising wages are actively fought on the grounds that they are inflationary, but the same logic is never applied to rising profit rates.

This policy transformation has been justified by appeal to the theory of the natural rate of unemployment, a theory developed by Milton Friedman and his Chicago school colleagues. The theory maintains that there is a minimum unemployment rate below which the economy cannot go without producing ever-accelerating inflation. Initially, the theory was used to justify a floor on the unemployment rate and to retreat from earlier notions of full employment such as a level of job vacancies equal to the number of job seekers. Subsequently, it has been used to shift policy attention to inflation, which becomes the indicator of when full employment is breached. In this fashion, concern with inflation displaces a direct concern with unemployment, and it is the theory of the natural rate that is ultimately behind today's policy vogue of inflation targeting.

The theory of the natural rate has been extensively criticized on both theoretical and empirical grounds. At the theoretical level, it makes grand unrealistic assumptions about wage flexibility and the way labor markets work, and at the empirical level, it has been impossible to establish a tight stable estimate **<<comma after tight, i.e., two adjectives for estimate, rather than describing a stable estimate?>>**. Indeed, the concept is more akin to religion than science since it is incapable of disproof.

Despite this **<<need a noun to clarify—criticism?>>**, the theory has been adopted by the Greenspan Fed, with enormous consequences for policy. First, it has elevated the policy significance of inflation. This elevation was then compounded by shifting to a concern with expected inflation that is used to justify preemptive monetary policy strikes against inflation even before it has emerged. Such preemptive-strike thinking played a role in the interest-rate policy miscalculations of 1987 and 1994. A second problem is that it has made inflation the sole indicator for policy. This **<<this what? pattern?>>**, then, explains the Federal Reserve's neglect of asset prices in the late 1990s

(which are not included in inflation statistics), which allowed the stock market bubble—and may also be allowing a house price bubble now.

In addition to shifting away from direct concern with unemployment, the Federal Reserve's new policy regime turns a blind eye to the foreign-exchange value of the dollar despite its critical impact on manufacturing employment and the trade deficit. Indeed, to the extent that the Fed has even engaged the question of the dollar, it has tended to view the "strong dollar" as a bonus that helps contain inflation by putting the squeeze on prices of manufacturing goods.

Finally, the new policy regime is evident in the Fed's deferential treatment of financial markets and its response to financial market crises. Having created deregulated, highly leveraged financial markets that are free to wheel and deal, the Fed is now implicitly obliged to obtain market approval or face the fallout of their displeasure. And when financial markets get themselves into trouble, the Fed must now come to their assistance to save the system from itself. This happened in the crash of 1987, in the recession of 1991 when Citibank was granted temporary exceptional regulatory relief, in the peso crisis of 1994, and again in the Long Term Capital Management crisis of 1998.

It is important to recognize that this regime shift started under Paul Volcker, who promoted a policy of disinflation centered on high interest rates. Inflation is especially bad for financial market interests, as it erodes the value of financial assets. The 1970s saw a spike in inflation as business and workers tried to resolve who would bear the burden of rising oil prices and determine how slower productivity growth would be shared between wages and profits. The Volcker Fed initiated a period of high interest rates that was good for financial investors in two ways. First, high interest rates raised the unemployment rate, thereby effectively settling the income distribution conflict in favor of business. Second, high interest rates directly raised the returns to financial investors. In addition, the Volcker Fed began the process of financial market deregulation that has created the space for expanded provision of credit to households.

The shift initiated by Volcker was tectonic, and, in combination with Ronald Reagan's political rhetoric, it fractured the New Deal policy consensus that had ruled since 1945. In this regard, Volcker is a critical historical figure who oversaw the preliminary initiation of a new policy paradigm. Viewed in this light, Alan Greenspan's policy configuration can be thought of as a logical extension of the paradigm initiated by Volcker.

That said, there are also critical differences between Chairman Volcker and Chairman Greenspan. In particular, whereas the policies of the Volcker Fed were justified as a form of "crisis" response to the high inflation of the late 1970s, under Greenspan the appeal to a crisis justification has completely fallen away, and the policies have become a form of "business as usual" that is good for Americans. What began under Chairman Volcker as an anti-inflation crisis regime has evolved under Chairman Greenspan into a de facto financial market–centered policy regime in which financial markets have replaced the labor market as the principal focus of policy.

Similarly, when it comes to deregulation, there are also large differences in approach between the two. Whereas Volcker's approach to deregulation was partial and very much circumstance-driven, Alan Greenspan's approach appears much more doctrinally driven. He has been aggressively promotional in his approach to eliminating regulatory limits and controls, as evidenced by his strong support for the repeal of the Glass-Steagall Act (1933), which divided financial power between commercial and investment banks.

Compounding these developments is the fact that the new policy priorities have been ensconced in an institutional framework that has become increasingly free of political accountability. Since its inception in 1913, the Federal Reserve has always been a relatively autonomous institution, evidenced in its part-public, part-private ownership structure. However, under Chairman Greenspan the political autonomy of the Fed has increased. Though still subject to congressional oversight through hearings first mandated by the Humphrey-Hawkins Act (1978), the Fed has established an expanded position of independence. Multiple factors have been at work. First,

the fact that the Volcker-Greenspan regime has been a bipartisan creation has meant that neither major political party has significantly challenged the Fed, creating space for new practices to take root. Second, Greenspan's oracular status has made it politically difficult to criticize the Fed for even those few politicians who would like to do so. Third, academic economists have promoted the notion that monetary policy is highly technical and should be left to the experts. Fourth, economists and conservative public policy institutes have also promoted the notion that politicians are not capable of objectively overseeing monetary policy. Instead, it is asserted that monetary policy should be left to independent central bankers, who will conduct it in a nonpartisan fashion that advances the national interest. The implication, never explicitly spelled out, is that central bankers are capable of objective nonpartisanship, but the rest of society is not.

This institutional and political setting has provided the Fed with a shield to ward off policy criticism, and the shield has been reinforced by Greenspan's brilliant use of the rhetoric of free competitive markets. This rhetoric implicitly presents the Fed as bowing out of markets and leaving the market to itself. Yet the reality is that the Fed is intervening, just as it always has in the post–World War II era. The difference is that it now intervenes on behalf of financial interests and financial wealth holders.

The new regime has momentous consequences. In the real economy, it has meant that full employment, robust real-wage growth, and a healthy manufacturing sector are no longer explicit policy priorities. In the financial economy, it has created a moral hazard among investors that generates asset price inflation. Since investors increasingly realize that the stability of the system is configured around asset prices, they realize the Fed cannot afford to let asset prices go to hell in a hand basket, and they have an incentive to put everything in stocks and other such assets. Moreover, this incentive also encourages debt bubbles, since economic agents have an incentive to finance their asset purchases with debt, thereby maximizing their gain from asset price inflation. Finally, the new regime may have had collateral ef-

fects on social attitudes toward risk sharing, perhaps most clearly reflected in the debate surrounding social security privatization. In that discussion, the construction of a new policy regime conducive to asset price inflation may have encouraged people to think that the stock market is a perpetual motion machine that generates appreciation without regard to the performance of the real economy.

Is the New Regime Sustainable?

The unusually weak recovery from the recession of 2001 suggests that the regime constructed over the course of the Greenspan era may be unsustainable. Despite the Fed's pushing interest rates to forty-five-year lows of 1 percent and the federal government's running a budget deficit of close to 4 percent of gross domestic product, the recovery has been the weakest in the post–World War II era, and the economy has kept hitting fresh "soft spots."

Ideologically grounded belief in the benefits of globalizing production has encouraged neglect of the trade deficit and the overvalued dollar, with catastrophic consequences for manufacturing. The prolonged weakness in manufacturing has in turn made for weakness in business investment spending, thereby compounding the obstacles to robust recovery. While low interest rates may have helped support consumer spending, they may also have created a new problem in the form of a housing price bubble. The good side of the bubble is that rising home equity has created wealth that has financed consumer spending and helped recovery. The bad side is that it has led to the buildup of debt secured on an asset whose price can fluctuate significantly. This is a feature that the Federal Reserve has consistently overlooked. Households own "flexible price" assets, but they are taking on "fixed value" debts, which exposes them to a major financial mismatch. Should the price of those assets fall, they will still owe the debts, but they will be less able to cover them with asset sale proceeds.

In a sense, the need for recourse to artificially low interest rates points to the contradiction in the current policy regime. Low rates

have been used in the hope of jump-starting sustained recovery, but they have also triggered a debt-financed housing price bubble. That result means trouble down the road when debt has to be repaid and assets come to be cashed in. Driving up prices today beyond what is economically warranted tomorrow has severe consequences.

There are two core problems with today's system. First, owing to flawed international economic policies governing trade and the value of the dollar, too much spending is leaking overseas through purchases of imports. This outcome reduces domestic job creation—though it is good for foreign economies. Second, the long-term decline in real-wage growth and the widening of income inequality have called for household borrowing to fill the demand gap these trends created. Over time, such borrowing needs ever-lower interest rates to be sustained, but eventually it will hit the wall as households reach their borrowing limits, and interest rates hit the market floor determined by default risk.

These considerations point to a potential contradiction. Borrowing is a powerful economic stimulant that finances spending. At the same time, borrowing results in the accumulation of debt, and debt is a drag on the economy because it requires interest-service payments. The Greenspan era has been marked by the creation of a new financial regime characterized by a massive increase in borrowing by all sectors, and rising borrowing has made for robust economic growth. The open question is what will happen as accumulated debt burdens begin to exert a drag. Analytically speaking, the economy may exhibit robustness and vitality along the transition path from the old regime to the new, but once that transition is completed, the new regime may turn out to be economically fragile.

A Suggested Agenda for the Next Fed Chairman

The restoration of soundly based and widely shared prosperity will need an economic program that includes rules for labor markets, corporate governance, international trade, and financial markets. As one of the nation's preeminent policy-making institutions, the Federal

Reserve has an important role to play, especially as regards the financial markets piece of that program.

A first important contribution that the next chairman can make is to use the Fed's bully pulpit to shape opinion supportive of a new policy configuration. Formally, the Fed controls monetary policy and has an important role in financial regulation. However, the Fed does far more than that through its influence over the shaping and coordination of elite policy opinion. This influence works through the research activities conducted by hundreds of Federal Reserve economists, Fed conferences and publications, and Fed links into the business community. Via these activities, the Fed contributes to shaping and legitimizing understandings of the economy that in turn drive policy.

As the senior and most visible executive of this powerful institution, the chairman of the Federal Reserve can powerfully influence the direction of this opinion-shaping power. Not only has Greenspan used this power to promote financial policy that is friendly to financial interests, he also has used it to address all manner of policy questions unconnected to the Fed's main mandate. These issues have included promoting trade liberalization, regressive social security reform, tax cuts favoring the wealthy, and even an attack on the economic merits of the minimum wage. Looking to the future, Alan Greenspan's replacement should be a person who will use the Fed's pulpit in a way that is more in tune with the Fed's institutional traditions and that is less economically ideological.

With regard to management of financial markets, the problem of asset price bubbles points to a need to regain control over the financial system to prevent its creating excessive liquidity that generates asset price inflation. At the policy level, the problem is that the Fed has relinquished all of its tools except interest rates, so that it must now manage activity in both the real economy and financial markets with just one instrument—interest rates. If it uses interest rates to target asset prices, it risks tanking manufacturing and the broader economy—what can be termed the "blunderbuss effect." Conversely, if it ignores asset prices, it risks an unstable asset price bubble and debt buildup.

The Fed's shortage of policy tools is a direct result of policies pursued during the Greenspan era. During this period the Fed has given up on quantitative regulatory controls, and even where controls remain, it has ideologically refused to use them. A case in point is margin requirements on debt-financed equity purchases that the Fed could have used to chill the stock market bubble of 1999–2000, but Chairman Greenspan resisted doing so.

In the wake of two decades of financial deregulation and innovation, the Fed needs some policy instrument innovation of its own. One such tool is adjustable, asset-based reserve requirements. Such requirements oblige financial institutions to hold cash reserves against different asset classes. The level of reserves would be adjustable and set by the Fed. Thus, if the Fed wanted to reduce speculation in a particular asset class, it would raise the cash reserve requirement for holding that type of asset and thereby cool speculation in that asset. For instance, if the Fed wanted to cool housing speculation, it would raise reserve requirements on mortgages. This action would de facto raise the cost of mortgages, since banks would have to hold more cash for each mortgage they issued, but the level of interest rates for other types of loans would be unchanged, thereby avoiding the blunderbuss effect.

A popular fallacy is that financial markets can no longer be regulated. However, the reality is that it is possible to invent new market-consistent controls over the financial sector. Some analysts have criticized Chairman Greenspan for lowering the federal funds interest rate to 1 percent in the last recession and leaving it at this low rate for too long. The argument is that this decision created a housing price and debt bubble. My personal view is that the chairman did the right thing to stop the recession from developing into an extended slump—though that may still happen. Instead, the real criticism of Alan Greenspan is his long-term promotion of a financial system that is unstable and his refusal to maintain existing instruments of financial control and to develop new ones. Asset price inflation and debt accumulation are the natural outcomes of the new policy regime, but the new policy structure gives the Fed only the blunderbuss of interest rates to control these processes.

Politics, Ideas, and the Greenspan Era

Over the past eighteen years Chairman Greenspan has been an enormously influential policymaker. It is important to recognize that his importance and position are not just the products of his own accomplishment. Instead, they should be understood in a broader context of politics and ideas. The new business cycle that the Fed has helped create is not a partisan affair. Rather, its creation has been supported by both Republican and Democratic administrations, and there has also been significant (but not universal) bipartisan support in Congress. Indeed, the creation of this new business cycle was, as noted, already well in hand under Volcker, Greenspan's predecessor, who was appointed by the Democratic President Jimmy Carter. As for Greenspan, he was first appointed chairman of the Fed by Republican Ronald Reagan, and then successively reappointed by Republican George H. Bush, Democrat Bill Clinton (twice), and Republican George W. Bush. The net result is that there has been little competition in the political market for policy. Should America's new business cycle unravel, it will open a historic opportunity to challenge the existing policy configuration. The question is, will progressives be equipped with an inspiring and coherent economic vision backed by a consistent set of economic policies that can take advantage of that moment.

This consideration leads to the fundamental observation that ideas matter, something that conservatives have long appreciated and which was emphasized in Richard M. Weaver's canonical conservative text *Ideas Have Consequences* (1948). Volcker's anti-inflation program, which set the stage for Greenspan's tenure, grew out of intellectual work on inflation, the natural rate of unemployment, and competitive free markets. Policy independence for the Federal Reserve has been supported by academic work that emphasizes government policy incompetence. These features point to a symbiotic relationship between ideas, politics, and economic outcomes. Ideas shape politics and outcomes and are in turn shaped by them. This contribution that ideas present is often obscure and difficult to track at any given moment, and for this reason politicians are inclined to dismiss their importance. Keynes acerbically captured this reality:

> [T]he ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slave of some defunct economist. (Keynes 1936, 383)

Ideas are the spectacles through which we see the world, and different spectacles reveal a different world. Progressive political leaders and policy advisers, critical of the legacy of Chairman Greenspan, would do well to recognize this reality as they attempt to chart a new course in the post-Greenspan era.

For Further Reading

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