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Alan Greenspan: A response to my critics

On March 17, Alan Greenspan wrote an article for the FT entitled "We will never have a perfect model of risk", in which he argued: "We will never be able to anticipate all discontinuities in financial markets." He concluded: "It is important, indeed crucial, that any reforms in, and adjustments to, the structure of markets and regulation [do] not inhibit our most reliable and effective safeguards against cumulative economic failure: market flexibility and open competition."

The article attracted a number of critical responses in this forum. For example, Paul de Grauwe wrote: "Greenspan's article is a smokescreen to hide his own responsibility in making the financial crisis possible." (Read all the responses.)

The article below is Mr Greenspan's reply to those criticisms, written exclusively for the Economists' Forum:

I am puzzled why the remarkably similar housing bubbles that emerged in more than two dozen countries between 2001 and 2006 are not seen to have a common cause. The dramatic fall in real long term interest rates statistically explains, and is the most likely major cause of, real estate capitalization rates that declined and converged across the globe. By 2006, long term interest rates for all developed and major developing economies declined to single digits, I believe for the first time ever.

Doubtless each individual housing bubble has its own idiosyncratic characteristics and some point to Fed monetary policy complicity in the US bubble. But the US bubble was close to median world experience and the evidence of monetary policy adding to the bubble is statistically very fragile. Paul De Grauwe depends on John Taylor's counterfactual model simulations to conclude that the low funds rate was the source of the US housing bubble. Taylor (with whom I rarely disagree) and others derive their simulations from model structures that have been consistently unable to anticipate the onset of recessions or financial crises. This suggests important missing variables. Counterfactuals from such flawed structures cannot form the basis for policy.

De Grauwe asserts that "signs of recovery" (I assume he means sustainable recovery) were evident before 2004 and hence the Federal Reserve should have started to tighten earlier. With inflation falling to quite low levels, that was not the way the pre-2004 period was experienced at the time. As late as June 2003, the Fed reported "conditions remained sluggish in most districts." Moreover, low rates did not trigger "a massive credit . . . expansion." Both the monetary base and M2 rose less than 5% in the subsequent year, scarcely tinder for a massive credit expansion. In fact, growth in total credit market debt owed by the U.S. financial sector declined from a 13% gain during 2001 to an 8% gain during 2004. Nonfinancial sector growth was less.

Some argue that adjustable rate mortgage (ARM) originations fueled the bubble. Yet the ARM's share of total originations is a very weak forecaster of home prices, implying ARMs, although a source of cheap financing, are not a determinant of home prices. If ARMs were not available from 2001 to 2004, home purchases presumably would have been financed with long term debt, which was also very affordable.

De Grauwe is correct; I do believe bank risk managers and loan officers are more knowledgeable than government bank regulators. Bank loan officers, in my experience, know far more about the risks and workings of their counterparties than do the bank regulators that examine those counterparties.

Regulators, to be effective, have to be forward looking to anticipate the next financial malfunction. This has not proved to be feasible. Regulators confronting real time uncertainty have rarely, if ever, been able to achieve the level of future clarity required to act preemptively. Most regulatory activity focuses on activities that precipitated previous crises and that investors have long since largely abandoned, although new laws may prevent recurrences. New problems, to repeat, are by their nature incapable of being anticipated with any degree of confidence.

Aside from far greater efforts to ferret out fraud (a long time concern of mine), would a material tightening of regulation improve financial performance? I doubt it. The problem is not the lack of regulation, but unrealistic expectations about what regulators are able to anticipate and prevent. How we otherwise explain how the FSA, whose effectiveness is held in such high regard, fumbled Northern Rock? Or in the US, our best examiners have repeatedly failed over the years. These are not aberrations.

Could tightened regulation of subprimes have contained some of the reprehensible, and presumably criminal, acts of lenders? Probably. But the broader crisis would likely have arisen even with increased micro-surveillance.

The core of the subprime problem lies with the misjudgments of the investment community. Subprime did not break from its localized niche status until 2005. As Ben Bernanke recently put it: “The deterioration in underwriting standards …appears to have begun in late 2005.” I assume that judgment reflected the increased delinquency behavior that is now evident for loans initiated in late 2005 and subsequently.

Subprime securitization exploded because subprime mortgage-backed securities (MBS) were seemingly under-priced (high-yielding) at original issuance. Subprime delinquencies and foreclosures (in a rising home price market) were modest at the time, creating the illusion of great profit opportunities. Investors of all stripes pressed securitizers for more MBS. Securitizers, in turn, pressed lenders for mortgage paper with little concern about its quality. As a consequence underwriting standards collapsed, and mortgage originations and securitizations rose to far greater heights than would have occurred without securitization. Even with full authority to intervene, it is not credible that regulators would have been able to prevent the subprime debacle. It would have required insights that would enable regulators to override the investment judgments of the most experienced analysts of the private sector, the very people on whom regulators rely for their market insights. When investment judgments are distorted by euphoria, even so valuable a financial innovation as securitization will perform poorly.

Counterparties, of course, also confront uncertainty but they appear invariably to know more about their customers than do regulators. They have a much better, but clearly not a flawless record, as the subprime breakdown exposed.

If counterparty surveillance is abandoned or significantly weakened, we are left with regulation by the less informed. Counterparty surveillance needs to be repaired, not abandoned. In the meantime markets are readjusting risk spreads, as a precursor to the new structure that will evolve with time.

I admit to being surprised and appalled at the recent collapse in bank underwriting standards. In response, since last summer, market forces have driven leverage down materially and leverage will doubtless fall further before it stabilizes. Basel II eventually will be altered accordingly.

Investors henceforth will balk at the fees that most hedge funds and private equity funds have been able to obtain during the past surge of euphoria. Future stand-alone SIVs will find financing costs prohibitive. The CDO market will revive, but in a more viable form, perhaps with the relevant counterparties determining the credit ratings of individual tranches through issuance of CDS rather than through credit rating agency evaluation. Securitization, though abused in its subprime applications, is a valued transferor of risk from highly leveraged institutions. It will revive largely in its current form. CDS back office operational risks will not be tolerated.

Indeed, the current low volume of issuance of all such securities suggests much of the fall away of bids has already happened. The restoration of bids and issuance when it occurs will be in a fundamentally changed pricing environment from that which existed prior to last August 9.

I agree with Wolf that social insurance has its price and with his concern of privatizing profits and socializing losses. If we are to have a system in which some financial firms are designated officially as being “too large to liquidate quickly,” we need to recognize that such institutions will gain the advantage of a competitively lower cost of capital. The implicit subsidy of those firms who choose to be “too large” will have to be addressed.

I disagree with Wolf that I have ignored “evidence of malfeasance and gross incompetence.” I have consistently bemoaned criminal fraud and the “excessively lax terms to encourage (subprime) mortgage applications,” for example, last fall in London (HM Treasury Financial Stability Forum).

Wolf argues that central banks “can surely lean against the wind” even if they cannot eliminate bubbles. I know of no instance in which such a policy has been successful. For reasons I have outlined elsewhere, (American Economic Association presentation, January 2004) I doubt that it is possible. If it turns out it is feasible, I would become a strong supporter of “leaning against the wind.”

As far as US monetary policy being (in Wolf’s words) “dangerously asymmetrical,” I point out that over the past half century the US economy has been in recession only one-seventh of the time. Yet the unemployment rate exhibits no trend. Hence the average rate of rise of the unemployment rate has been far greater than its average pace of decline. Monetary policy in response has been more active during recessions than during periods of expansion, but scarcely “dangerous.”

Much of the commentary critical of my FT article is directed less at its substance and more, as Wolf describes it, to “the ideology I display.” Ideology, which regrettably has become a pejorative term, defines that set of ideas that we each believe explains how the world works and therefore how we need to act to achieve our goals. Some of our views of causative forces are rational, some are otherwise. Much of what we confront in reality is uncertain, some of it frighteningly so. Yet people have no choice but to make judgments on the nature of the tenuous ties of causation or they are immobilized.

I do have an ideology. So does each of the members of the Forum. I trust our views are subject to the same standards of evidence that apply to all rational discourse. My view of how the efficiency of global capitalism has evolved over the decades as new evidence has appeared contradicting some earlier judgments and confirming others. I have been surprised by the fierceness of investors in retrenching from risk since August. My view of the range of dispersion of outcomes has been shaken, but not my judgment that free competitive markets are by far the unrivaled way to organize economies. We have tried regulation ranging from heavy to central planning. None meaningfully worked. Do we wish to retest the evidence?

The writer is former chairman of the US Federal Reserve.