Why Greenspan does not bear most of the blame

By Martin Wolf

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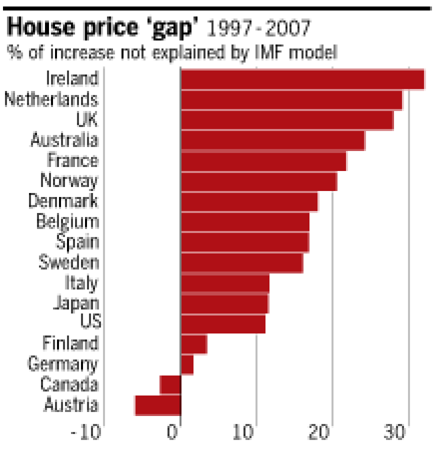
When a wave of destruction hits, everybody looks for somebody to blame. Alan Greenspan, former chairman of the US Federal Reserve, once lauded as the "maestro", has, to his discomfort, become the scapegoat. But even though I dare to disagree with him on some points, much of the criticism is highly unfair. Mr Greenspan remains the most successful central banker of modern times. More important, blame distracts from the challenge, which is to understand what happened, why it happened and what we should do.

As Mr Greenspan pointed out in his response to his critics in the Financial Times on Monday, the housing bubble was not unique to the US. On the contrary, as the background chapter on housing in the International Monetary Fund's latest World Economic Outlook shows, US experience was far from exceptional. On the contrary, the biggest apparent overvaluations occurred in Ireland, the Netherlands and the UK.

The chart shows the proportionate increase in house prices between 1997 and 2007 that cannot be explained by the fundamental drivers: affordability (the lagged ratio of house prices to disposable incomes); growth in disposable incomes per head; interest rates (short- and long-term); credit growth; changes in equity prices; and changes in working-age population. Thus, the rises reveal the extent to which a country has experienced what seems to be a bubble. The US is in the middle ranks.

Similarly, the US is in no way exceptional for the level of residential investment. Somewhat to my surprise, the share of residential investment in UK gross domestic product has been much the same as in the US. The outliers here are Ireland and Spain.

US monetary policy cannot be responsible for all these bubbles. This might not be the case if these other countries had followed US policy slavishly. But they did not (see chart). The Bank of England, for example, followed what seems to be a consistently tighter monetary policy than the Fed. Yet house prices in the UK may be even more overvalued.



The WEO does argue that "the unusually low level of interest rates in the US between 2001 and 2002 contributed somewhat to the elevated rate of expansion in the housing market, in terms of both housing investment and the run-up in house prices up to mid-2005". Moreover, "the impact of easy monetary conditions on the housing cycle presumably was magnified by the loosening of lending standards and excessive risk-taking by lenders". Yet the drawback to these US-specific points, plausible though they may seem, is that they do not explain house-price bubbles elsewhere.

So what might explain these bubbles? I would point to four causes: very low long-term real interest rates, because of the global savings glut; low nominal interest rates, because of both low real rates and the benign inflationary environment; the lengthy experience of economic stability; and, above all, the liberalisation of mortgage finance in many countries. The greater the availability of finance, the easier it was for purchasers to pay higher house prices and the higher those prices, the more willing were people to purchase, in the expectation of still higher prices. The WEO makes clear that house prices tended to rise fastest where finance was most easily available, as one might expect.

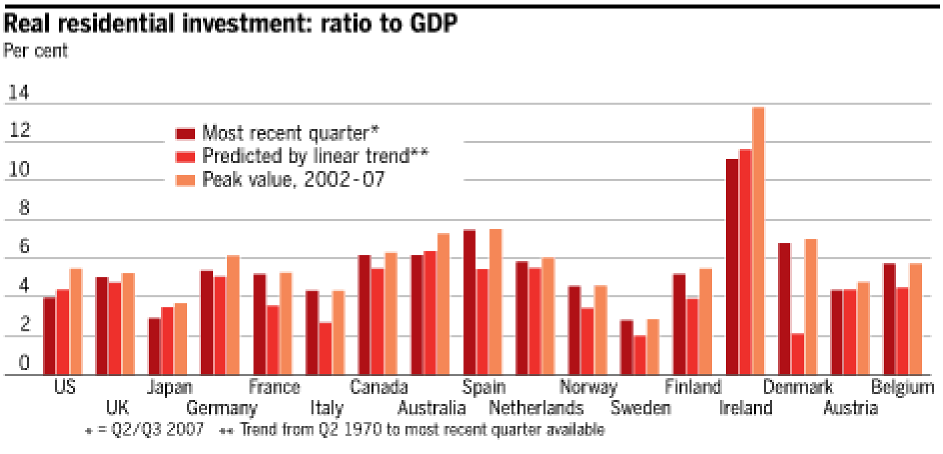
If there is little US-specific to explain, a US policymaker cannot be responsible. There are three qualifications to this argument.

First, it is unclear how far house prices are going to fall elsewhere. If the US fall turns out to be exceptionally severe, the bubble there will be relatively bigger than now appears the case. Second, the consequences of the bursting of the bubble may turn out to be worse in the US, because a higher proportion of lenders was persuaded to take on mortgages they could not afford. I will wait for several years of falling house prices in the UK and elsewhere before deciding on that. Finally, the US is the most influential country in the world. It may be held responsible for the movement towards liberalisation. But US influence on other high-income countries can be exaggerated. For better or worse, the latter made up their own minds.

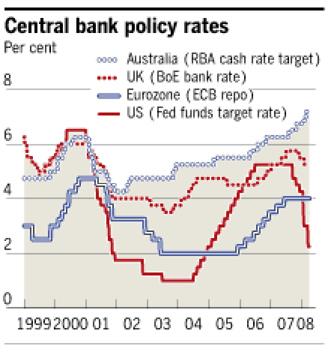
Why, then, are so many Americans determined to blame Mr Greenspan for the mess? I can see three reasons. One is that it is far more painful to admit that the US was, in large measure, the victim of circumstances beyond its control. Another is that it is far easier to complain that the Fed made us do things we now bitterly regret than take responsibility for one's own mistakes. Last, the more one can blame the Fed, the more reasonable become demands for bail- outs now flooding into Washington.

Yet I still disagree with Mr Greenspan on two points.

First, I do believe it should have been possible for regulators to be tougher. In the FT's economists' forum, Mr Greenspan argues that "even with full authority to intervene, it is not credible that regulators would have been able to prevent the subprime debacle". Mr Greenspan is saying that there is nothing to be done, even by attacking grotesque abuses, such as undocumented loans and ridiculous "teaser" rates.



Second, I still do not see why, at a time of soaring asset prices, monetary policy should not be tighter than it would otherwise be. This is what I mean by "leaning against the wind". I do not believe that this is likely to stop a bubble forming. A rise in interest rates from, say, 4 per cent to 5 per cent is not going to stop people borrowing to buy an asset they expect to appreciate by 10 per cent this year. But such a policy would push inflation below the normal target. That would give the central bank room for manoeuvre when the bubble burst, since it is far less likely that its credibility would come into question.



Yet the biggest question raised by Mr Greenspan's views lies elsewhere. Essentially, he is arguing that there is no middle way between repressed financial markets, on the one hand, and almost completely free ones, on the other. This is a counsel of despair. I greatly fear that if the people of the world are given this choice, after what I expect to be an expensive crisis, they will choose the former.

I also do not find it a logical choice. If we accept that we are going to bail out the financial system when it gets into trouble, regulation is inevitable. The trick is to find simple, robust, rules-governed forms of regulation. The view that this is entirely impossible plays into the hands of those who wish to see the end of free financial markets altogether. Regulation cannot be perfect. But the worse the outcomes now become, the more difficult it will be to defend free financial markets at all. Without a credible design for regulatory improvement, it will prove impossible.

Sources for charts: IMF; Thomson Datastream

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