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What Greenspan Missed by Sheldon Richman

The former chairman of the Federal Reserve, Alan Greenspan, made headlines around the world with this assertion:

[Those] of us who have looked to the self-interest of lending institutions to protect shareholders' equity (myself especially) are in a state of shocked disbelief. Such counterparty surveillance is a central pillar of our financial markets' state of balance. If it fails, as occurred this year, market stability is undermined.

Greenspan's claim that he had overestimated the "virtue of selfishness" in the marketplace took place before the House Committee on Oversight and Government Reform. During that hearing in late October, this exchange took place between Chairman Henry Waxman (D-Calif.) and Greenspan, as reported in the *New York Times*,

Waxman: You had the authority to prevent irresponsible lending practices that led to the subprime mortgage crisis. You were advised to do so by many others. Do you feel that your ideology pushed you to make decisions that you wish you had not made?

Greenspan: Yes, I've found a flaw. I don't know how significant or permanent it is. But I've been very distressed by that fact.

Libertarians had better get used to hearing, "Even Alan Greenspan concedes that the free-market philosophy is flawed." But those who were skeptical about Greenspan before might want hold off believing the statement just quoted. If he was wrong before, he just may be wrong now.

Greenspan's reputation for being a free-market advocate is largely undeserved. Yes, in the 1960s he associated with Ayn Rand and wrote three essays that were republished in *Capitalism: The Unknown Ideal*. They were good essays too: critiques of antitrust law in "Antitrust";

government consumer protection in “The Assault on Integrity”; and central banking in “Gold and Economic Freedom.” Given that last topic, it was strange indeed that he became chairman of the Fed in 1987.

Greenspan in government

But I get ahead of myself. Before chairing the Fed, Greenspan was Gerald Ford’s chairman of the Council of Economic Advisers (CEA) from 1974 to 1977. If he was giving free-market advice, it apparently wasn’t being taken. During his tenure Ford continued Richard Nixon’s wage and price controls and campaigned against inflation by wearing a “Whip Inflation Now” button, as though inflation was the public’s fault. I don’t recall Greenspan’s protest. Any self-respecting free-market advocate would have resigned in disgust from the CEA and used his prominence to reiterate what he had written in “Gold and Economic Freedom”:

The abandonment of the gold standard made it possible for the welfare statist *to use the banking system* as a means to an unlimited expansion of credit...

The law of supply and demand is not to be conned. As the supply of money ... increases relative to the supply of tangible assets in the economy, prices must eventually rise.

But he didn’t.

Maybe he foresaw a shining future in government “service.” If so, he was right. Early in the first Reagan administration he was appointed to chair a special commission to “save” Social Security. The commission formulated a plan, later approved by Congress, that called for a series of payroll-tax increases and other measures intended to extend the life of that shaky government transfer program. Thus, instead of joining the growing movement questioning the legitimacy and long-term viability of Social Security, Greenspan became its savior.

It was a short step to the Federal Reserve, where he became steward of the country’s money supply and hence the economy, holding the job for a record 18 and a half years. It is appropriate to point out that Greenspan helped keep inflation in check. This conflicts with the common view that monetary policy was loose, especially in the early 2000s, driving down interest rates. As Jeffrey Rogers Hummel and David R. Henderson wrote in *Investor’s Business Daily*, low interest rates are not necessarily a sign of easy money:

Greenspan is ... correct when he attributes the unusually low interest rates early this decade to a massive flow of savings from emerging Asian economies and elsewhere.

The better way to judge monetary policy is by the monetary measures: MZM, M2, M1 and the

monetary base. Since 2001, the annual year-to-year growth rate of MZM fell from over 20% to nearly 0% by 2006. During that time, M2 growth fell from over 10% to around 2%, and M1 growth fell from over 10% to negative rates.

The Fed most directly controls the monetary base. Its year-to-year annual growth rate since 2001 fell from 10% to below 5% in 2006 and now [March 2008] is 2%. Also, nearly all of the growth of the monetary base went into currency, much of which is held abroad.

The banking deregulation of the early 1980s admittedly attenuates the Fed's control over the broader monetary aggregates. But when all the measures agree, the message is clear: Monetary policy was not expansionary.

(For a dissenting view, see Robert Murphy's "[Did the Fed Cause the Housing Bubble?](#)")

Thus Greenspan's career from 1974 was hardly that of a dedicated free-market activist. He often paid lip service to self-regulating markets, but his professional conduct reveals someone who does not truly believe in laissez faire. It calls to mind how, when being screened for his first government job, he explained that his belief in Ayn Rand's philosophy didn't actually apply to the world as we find it.

Housing interventionism

Conspicuously missing from Greenspan's testimony before the House committee was any reference to the perverse incentives that the government in many ways created for the mortgage industry. Interesting enough, he told the committee,

What went wrong with global economic policies that had worked so effectively for nearly four decades? The breakdown has been most apparent in the securitization of home mortgages. The evidence strongly suggests that without the excess demand from securitizers, subprime mortgage originations (undeniably the original source of crisis) would have been far smaller and defaults accordingly far fewer. But subprime mortgages pooled and sold as securities became subject to explosive demand from investors around the world.

The questions that cry out for answers are: Why were the securitizers clamoring for subprime mortgages? What can explain the "excess" and "explosive" demand for mortgages for people with low incomes and poor credit histories?

We know the answers. A government effort spanning several decades and the administrations of both parties, including the George W. Bush administration, pressured and even compelled lenders to make such mortgages. The idea was to eliminate poor credit history and lack

of down payment as barriers to home ownership. This was carried out on many fronts, including the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, the Federal Housing Administration, the Department of Housing and Urban Development, the Community Reinvestment Act (aimed at promoting loans to low-income people), and Greenspan's announced readiness to provide liquidity when asset bubbles burst. A major part of the encouragement was the "too big to fail" doctrine, under which the government would bail out troubled lenders. Another major component was the "implicit guarantee" to Fannie and Freddie. As government-linked corporations, they could buy up dubious mortgages, bundle them into securities, and sell them to investors worldwide with an assurance that the investment would keep paying even if the mortgagors didn't. Everyone involved assumed the government stood behind the GSEs — a correct assumption in light of events. When they got in trouble this year, the government took them over while pushing them to continue buying up mortgages.

The result of this campaign to promote home ownership (while creating lucrative profit opportunities for the GSEs and others) was the relaxing of lending standards and the weakening of the market's natural discipline. If a local bank was being pressured to write as many loans as possible, knowing the mortgages would be sold to a GSE or another institution before close of business and turned into guaranteed mortgage-backed securities, there was little reason to enforce high standards on borrowers. After all, the banks had a mandate from the highest levels of government to make home ownership easy. Specialized mortgage brokers arose to take advantage of the opportunity. Every institution along the line was happy to go along. The lenders lent and the builders built. As long as housing values kept going up, the system could be sustained. If a home owner got in trouble with his adjustable-rate mortgage, no problem. He could refinance at the new higher value or sell the home for a profit.

But since the rise in housing prices was fueled by government-created demand, it couldn't go on forever. When interest rates rose and the housing glut became apparent, values turned south. Now many troubled mortgagors who found they owed more than their homes were worth saw default as their best option. The rest, as they say, is history.

Why Greenspan blamed the "free" market rather than the perverse incentives created by the government-banking complex is a matter of speculation. Since he was a party to this rotten system, acknowledging the government's role would reflect poorly on a major part of his career. So perhaps he thought he'd look better in the history books by blaming the free market and his misplaced faith in it.

Of course, the point is that there was no free market. You'd think that Greenspan would know that a free market would have no government safety net for the financial industry. But you'd be wrong.

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