A global outlook

By Krishna Guha
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Most people think that if Alan Greenspan were still chairman of the Federal Reserve, the US central bank would have cut interest rates more quickly and aggressively in response to the turmoil in financial markets. Not so, Mr Greenspan says. Over the course of three hours of interviews in his office on Washington, DC's Connecticut Avenue, the former Fed chairman argues that times have changed.

"We are in a period now when it is far more difficult than it was when I was chairman," Mr Greenspan says. "We were not worried about inflationary resurgence but now you have to be." He adds: "You have got to be a lot more careful in lowering rates in response to crises."

Mr Greenspan's analysis puts him at odds with those – including Martin Feldstein, the influential president of the National Bureau of Economic Research – who argue that the Fed should cut rates aggressively on the grounds that making a mistake on inflation (as opposed to growth) would be the "lesser of two evils" at this juncture. The former Fed chairman does not share this assessment of the balance of risks. "I weigh them differently," he says.

Mr Greenspan – who is revered in the market for his aggressive handling of past market crises – praises his successor Ben Bernanke's so-far cautious response to this one. "I would be hard-pressed to see what I would have done differently," he says.

The former Fed chairman is at once candid and slightly uncomfortable about commenting on current monetary policy debates. "I figured that there is no way to maintain what I have been doing and not comment on monetary policy, because I did so effectively – implicitly – in the book."

Mr Greenspan says: "I am basically saying that the trade-off between unemployment and inflation has shifted." There are two planks to his argument. The less controversial one is that the US is entering a period of more subdued productivity growth. The former Fed chairman says companies would not be returning vast amounts of cash to their shareholders if they saw good opportunities for productivity-enhancing investment. "Innovation opportunities are, for the time being, somewhat saturated, whereas they were extraordinary in the 1990s," he says.

The more controversial one is that the disinflationary effect of globalisation will soon start to ebb. "The rate of change of prices – or the degree of disinflation – is related to the rate of change of globalisation," he argues.

The integration of a billion workers from the once centrally-planned economies of China and the former Soviet bloc into the global market system had a profoundly disinflationary effect on prices worldwide. But once all these workers are connected to the world economy, he says, "the rate of change goes to zero."

"In the intermediate period, the disinflationary pressures I was fortunate to operate under are gradually disappearing."

Mr Greenspan is unimpressed by the rejoinder that inflation expectations look to be quite firmly anchored at low rates. "It is going to change," he says, fixing the interviewer through his trademark thick black-rimmed glasses.

Underlying cost pressures are beginning to increase. He also sees oil going to $100 a barrel and worries about rising deficits driven by entitlement spending as America and the rest of the rich world ages. "In that environment, inflation expectations will rise," he says, without the need for the Fed to make a policy mistake first.

Many economists contest Mr Greenspan’s version of the relationship between globalisation and inflation. But in some respects his precise formulation of this relationship is less important than his deep conviction that it is no longer possible to understand how the US economy operates without seeing it as part of a global economic system that is undergoing profound transformation. “The issue is that the global forces are profoundly overwhelming,” he says. “We cannot make a forecast for the US economy the way we used to.”

This global analysis lies at the heart of his explanation of what caused the housing bubble that emerged during his watch as Fed chief. Mr Greenspan says the housing bubble was “fundamentally engendered by the decline in real long-term interest rates” caused by a cascade of surplus savings from fast-growing emerging market economies such as China. The fall in long-term rates provided the initial gain in house prices that unleashed later speculative activity. He blames human nature – though he talks about “euphoria” rather than “greed”.

To his critics, who argue that the Fed fuelled the bubble by keeping interest rates too low for too long in the early 2000s, this is an exercise in passing the buck. But to Mr Greenspan, theirs is a parochial explanation that greatly exaggerates the Fed’s power in a world of globally integrated capital markets.

When the Fed raised rates in 2004 and 2005, he points out, long-term rates went down rather than up. “We were pushing against something we could not control,” he says. Long-term rates were “being determined external to monetary policy” by shifts in the global balance of desired savings and investment.

Critics say the Fed should have tried harder, raising rates sooner and faster. Mr Greenspan counters that that would not have been acceptable “to the political establishment” given the very low rate of inflation. He says “the presumption that we were fully independent and have full discretion was false.”

But he says that even if the Fed had moved to raise rates more aggressively “we would have failed as miserably in trying to get the long-term rate up or the mortgage rate up as we failed in 2004.”

Mr Greenspan is more certain than ever before that central banks should not try to burst bubbles once they begin to inflate. “I am coming to the conclusion that bubbles are inevitable,” he says. “Human beings cannot avoid them . . . They cannot learn.”

Indeed, he argues that limited efforts to suppress bubbles generally fail and make them “worse rather than better”. Instead, he says, a central bank should clean up afterwards – while avoiding doing anything that might reflate the bubble. After the dotcom bust, he says, “we actually delayed moving the Fed funds rate down until it was very clear that the Nasdaq was significantly deflated.”

Many who support Mr Greenspan’s argument that Fed rate policy did not cause the housing bubble still think it should have done much more on the regulatory front to limit its damage.

The former Fed chairman, though, contests this. “The real problems you are dealing with are criminal,” he says, pointing to abusive mortgage brokers who misrepresented the products they were selling. “It is called fraud – fraud or stealing. In this country it is a criminal offence,” he says – raising his voice for the first and only time in the interview.

Mr Greenspan says fraud is a matter “for the attorneys-general of the states”, not the Fed. “Putting 10 of these guys in jail will do more than you can imagine,” he says.

The former Fed chairman says he resisted expanding the Fed’s supervision of mortgage lenders out of fear that unscrupulous brokers would “put a sign in their windows saying ‘regulated by the Federal Reserve’” and fleece even more people.

Mr Greenspan points out that there was a housing boom – he avoids using the word bubble this time – in at least 40 different countries.

"The US is by no means above the median," he says, adding that long-term interest rates "were falling everywhere, including in the developing world" – where he says inflation has fallen to remarkably low levels.

Other big central banks were also running easy monetary policy in the early 2000s, but Mr Greenspan does not believe that even collectively they were driving long-term rates. "Every central bank was confronting the same global forces we were and responded as a central bank would," he says.

In Mr Greenspan's eyes, these global forces are largely market forces, unleashed by global economic liberalisation. He says central banks could probably not control long-term rates even if they tried to intervene directly in long-term markets.

Moreover, he thinks the influence of even those governments that control large foreign exchange reserves is not all that great on the markets. Japan, he notes, sold yen for dollars on a massive scale in 2003 and early 2004 before abruptly stopping its currency intervention. "The impact of their going from huge accumulation of dollars to none was barely visible in the dollar-yen exchange rate and in interest rates and in everything else," he says.

Mr Greenspan admits that if China stopped buying dollars and switched its holdings into euros "it would move the long-term Treasury rate." But, he says, "I would bet you it is not more than 50 basis points."

The surplus savings, he says, have to be put somewhere, and do not disappear from the global financial system even if they are swapped out of dollars into other currencies.

The world he is describing looks like a global market nirvana – with one very odd feature: profits are much higher than they should be in a world of ever-intensifying global competition.

He says: "We know in an accounting sense what is causing it" – the share of worker compensation in national income in the US and some other developed countries is unusually low by historical standards – "but we don't know in an economic sense what the processes are."

In the long run, he says "real compensation tends to parallel real productivity, and we have seen that for generations, but not now. It has veered off course for reasons I am not clear about."

It is striking that he does not, as many do, blame China. He agrees that companies should not be able to price above their marginal cost, as many apparently can today. "They should not be able to," he says. "And the issue here is that there are restrictions that they are not identifying that enable them." He adds: "The competition should be moving in."

Mr Greenspan says "I did and still do" expect some normalisation of profit and wage shares. But asked whether the high profit share remains a puzzle to him, he says: "Yes, it does." In his book, he worries that if wages for the average US worker do not start to rise more quickly political support for free markets may be undermined.

Longer term, his big concern is that the economic context for the US will become less favourable as the disinflationary force of global integration ebbs and rising consumption in China and other emerging markets reduces the savings glut and pushes up longterm interest rates.

He says his analysis of global savings trends is very similar to that put forward by Mr Bernanke in a speech to the Bundesbank last week – "with one exception."

"He is calculating adjustment over the decades," he says. "I doubt that."

Mr Greenspan admits that he lacks strong evidence that it is short term" but he adds with a smile: "I know he doesn't have any evidence that it is long term either."