Whiskey and Gunpowder

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How Greenspan Ignored the Housing Bubble

Greg's Note: Former Fed chair Alan Greenspan can be seen everywhere you look. He's been in the press more lately than the current chairman. *Whiskey* contributor Fred Sheehan is gobbling up all the Greenspan coverage he can get and has noticed how much credit this maestro deserves for the problems the economy has been through. It appears there is enough to fill a book. Enjoy, and send your comments here: greg@whiskeyandgunpowder.com

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By Frederick J. Sheehan

While Humpty Dumpty Sat on a Fence

IN THE DEC. 12, 2007, *WALL STREET JOURNAL,* Alan Greenspan warned readers that the mortgage crisis was "an accident waiting to happen." This was already true and obvious when he was Federal Reserve chairman. He chose not to act. His recent article rationalizes the inactivity of the Fed during both the stock market and housing bubbles:

"After more than a half century observing numerous price bubbles evolve and deflate, I have reluctantly concluded that bubbles cannot be safely defused by monetary policy or other policy initiatives before the speculative fever breaks on its own. There was clearly little the world's central banks could do to temper this most recent surge in human euphoria, in some ways reminiscent of the Dutch tulip craze of the 17th century and South Sea Bubble of the 18th century."

When he was chairman, Greenspan testified before Congress as the voice of the central bank ("We at the Federal Reserve…"). Yet several members of the Federal Open Market Committee (FOMC) would have acted aggressively to attack asset inflation and prick the stock market bubble in 1998. The chairman dismissed both activities as beyond the mandate of central bank policy. Transcripts of the Federal Open Market Committee tell the story of committee members with an understanding of the terrors to come. (Since FOMC transcripts after 2001 have not been released to the public, Greenspan's behind-the-curtain discussion of the housing bubble has yet to be revealed.)

By late 1997, the chairman was convinced stock market prices simply reflected improved productivity. Given this, there was no stock market bubble. Thus, the markets did not need to be considered when surveying inflation. (As background, the NASDAQ rose 21.6% in 1997, 39.6% in 1998 and 85.6% in 1999.)

At the Dec. 16, 1997, FOMC meeting, Jerry Jordan, president of the Cleveland Fed, had a different opinion: "Some board members referred earlier to the dichotomy between the prices of services and the price of goods. That clearly is the case, but the notion of dichotomy also has to be applied in the case of asset prices… I was reading some material about the operations of the FOMC in the early 1930s."

Jordan then draws a conclusion from the Fed's myopic concentration on the steady price level of goods and services during the 1920s: "I think it's a useful reminder of what can go wrong if we are too narrow in thinking about the words 'inflation' and 'deflation'... What do we mean by the word 'inflation'? Clearly, it cannot refer simply to the current price of goods..."

Greenspan, speaking a few minutes after Jordan, thought, "Something very different is happening." The "something" Jordan identified was never addressed by the chairman: "[W]e keep getting reams of ever-lower CPI readings that seem outrageous in the context of clearly accelerating wages and an ever-tighter labor market… I was startled by this morning's CPI report. We cannot keep getting such numbers and continue to say that inflation is about to rise." Jordan had just told Greenspan that inflation was out of control: It was Microsoft, rather than mayonnaise, that was inflating.

At the March 31, 1998, FOMC meeting, Michael Prell, a Federal Reserve staff economist, reviewed current conditions:

"The gravitational pull of valuation may no longer be operating. The P/E ratio for the S&P 500 recently reached 27, based on trailing 12-month earnings, even as companies were issuing warnings and analysts were lowering their 1998 profit forecasts. In the prevailing psychological environment...the market can keep going appreciably higher on its own momentum."

Jerry Jordan reminded the chairman: "I also continue to be concerned that we may never see the effects of monetary excesses in output prices, but rather we will see them in asset prices."

Cathy Minehan, president of the Boston Fed, was also worried: "This speculation is fed by financial markets, which are extremely accommodative. From every perspective that we can see in our region and nationally, monetary policy is not tight; it is not even neutral. It is accommodative to an increasingly speculative environment."

Nor was board member Susan Phillips attuned to the productivity miracle: "The situation is starting to feel a bit surreal, perhaps even unbelievable... The stock market may be too good to be true, and I must say this is the first time I have felt really uncomfortable about the market."

The chairman's response was mixed. He seemed to understand the economy was now driven by the stock market: "We have an economic policy that is essentially unsustainable… There is no credible model of which I am aware that embodies all of this." Then he decided to sit on the fence: "I do not think it is appropriate to move, at this stage. Were we to do so, I believe we would create too large a shock for the system, which it would not be able to absorb quickly." ("To move" meaning to reduce the speculative money flows by raising the fed funds rate.)

This to-and-fro continued from meeting to meeting. In March 1999, board member Alice Rivlin warned, "There is the risk that the stock market's apparently unwarranted continued upward price march may accelerate again to even more bubbly heights, leading to a devastating crash when the bubble bursts."

Greenspan's reference in the *Journal* to the Dutch tulip craze and South Sea Bubble is interesting. Michael Prell warned the FOMC of exactly that when the stock market bubble was still inflating. At the Dec. 21, 1999, meeting, the Fed economist read from a recent prospectus in which VA Linux stated it lost $14.5 million in 1999 and expected to continue incurring significant expenses. Yet it rose 700% on the first day of trading. Prell went on: "The warning language I've just read is at least an improvement in disclosure, compared with the classic prospectus of the South Sea Bubble era, in which someone offered shares in 'A company for carrying on an undertaking of great advantage, but nobody to know what it is.'"

Prell wondered "whether the spirit of the times isn't becoming similar to that of the earlier period." He then described how impervious speculators were to the Fed's rate hikes:

"Earlier this year, those stocks supposedly were damaged when rates rose, because people said, quite logically, that the present values of their distant earnings were greatly affected by the rising discount factor. At this point, those same people are abandoning all efforts at fundamental analysis and talking about momentum as the only thing that matters."

Prell might as well have read a laundry list. The enlightened members of the FOMC had lost their spark by now. Greenspan had hopped off his fence a year earlier, claiming, at the Dec. 22, 1998, meeting: "I do know that the presumption we have discussed in the last year or so that we can effectively manage a bubble is probably based on a lack of humility. As I've said before, a bubble is perceivable only in retrospect."

If he had said this before, it is unrecorded. A reading of the FOMC transcripts shows this was an entirely new theory. Perhaps the FOMC meeting was his off-Broadway rehearsal. On June 17, 1999, he took his claim public, this time before Congress: "Bubbles generally are perceptible only after the fact. To spot a bubble in advance requires a judgment that hundreds of thousands of informed investors have it all wrong. Betting against markets is usually precarious at best."

There was only scattered resistance. A *New York Times* editorial expressed concern: "The new Greenspan is brimming with self-assurance. Let us hope the market does not test his new confidence." The Maestro could do no wrong. Whatever he said must be. The stock market bubble, probably the greatest in the history of such bubbles, would burst in early 2000. It was negligible, compared with the brewing mortgage bubble. But Greenspan had learned nothing from VA Linux and was just as blind to the speculative fury engendered by negative-amortizing mortgages. He can keep writing, but nothing will stop the popping of credit bubbles blown so large by Greenspan's Fed.

Regards,
Fred Sheehan

Greg's Endnote: Greenspan may not be able to see a bubble while it is forming, but some cases are more obvious than others. We've already heard the warning shots of the housing market, but when the bubble truly bursts we may want to do more than just duck and cover. Click here to find out more…

Greg's Final Endnote: Fred's new book, *Greenspan's Bubbles,* written with Bill Fleckenstein, will be published by McGraw-Hill in January 2008. You can pre-order it right now by clicking here.