



# Alan Greenspan's Property Bubble U-Turn

May 26, 2006

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The Maestro has dropped his baton. In a series of stunning about-faces, Federal Reserve Chairman Alan Greenspan has just recast his perceptions of the critically important relationship between monetary policy and asset markets. Not only does he finally own up to the perils of America's housing bubble, but he now concedes that speculative froth in asset markets may well have been a direct outgrowth of the Fed's policy stance. These revisionist views are in stark contrast to the Chairman's public stance over the last decade. This raises profound questions about the Greenspan legacy and also underscores the tough problems that are about to be passed on to his successor.

The first step in this two-part confession came in the form of a rare research paper just published by the Chairman and a Fed staffer (see Alan Greenspan and James Kennedy, "Estimates of Home Mortgage Originations, Repayments, and Debt on One-to-Four-Family Residences," September 2005). On one level, this is a very technical paper, providing a detailed statistical decomposition of the sources of mortgage lending activity in the US. But on another level, it reveals the full force of one of the key drivers of the Asset Economy – equity extraction from residential property.

According to the Greenspan-Kennedy framework, US homeowners tapped the ever-expanding home equity till to the tune of about \$600bn in 2004 – equivalent to about 7% of disposable personal income, or more than double the 3% share recorded in 2000. In a companion speech, Greenspan goes on to concede that this equity extraction from ever-rising property values was large enough to have accounted for all of the decline in the personal saving rate since 1995 (see his 26 September speech, "Mortgage Banking").

Bingo! It then follows that the substitution of asset-based saving (i.e., home equity extraction) for income-based personal saving created a major shortfall in national saving. And what is a saving-short US economy to do under such circumstances? Two choices – curtail investment and grow more slowly; or stay the course by importing surplus saving from abroad and running massive current-account deficits to attract that capital.

Of course, it was an easy choice for the world's leading economy – witness America's gaping current-account deficit running at close to an \$800bn annual rate in the first half of 2005. But with this easy choice has come tough consequences – namely, a US current account deficit that accounts for fully 70% of all the external deficits in today's unbalanced world.

In short, equity extraction has spawned the "mother" of all imbalances – not just for the US but for the global economy at large. This, in my view, is when asset bubbles become most destructive – when they

create distortions and dangers that transcend the asset class itself. America's housing bubble and its current account deficit are joined at the hip – and the rest of the world is being sucked into the funding side of the equation. And Alan Greenspan has just figured that out?

But that pales in comparison to the second step in this two part confession – Greenspan's admission that the Fed's monetary policy stance may have played an important role in fostering asset bubbles and the imbalances they engender. In what he refers to as "the greatest irony of economic policymaking" the Chairman has also come around to the conclusion that success can breed peril – or that sustained very low levels of nominal interest rates can give rise to asset bubbles (see his 27 September speech, "Economic Flexibility").

But this is not a shocker to anyone else. At low levels of inflation and the equally low levels of nominal interest rates that accompany such an outcome, excess liquidity can become a much more powerful force in shaping asset values than otherwise might be the case. The IT- and internet-enabled technological breakthroughs were the icing on the cake in taking productivity growth higher and, as a result, in pushing inflation and interest rates lower.

So after all these bubbles, Greenspan finally gets it. Yes, under certain conditions, equity valuations can be turbo-charged by monetary accommodation. Those stars were in perfect alignment in the latter half of the 1990s. The Fed chairman appears to have come to the same realisation with respect to property bubbles. Even couched in all the caveats of Fed speak, this is a stunning admission for a central banker who has long been against the targeting of asset values. This gets to what I have long felt was Greenspan's most egregious policy blunder – failing to use the tools of monetary policy to nip the first bubble in the bud back in the late 1990s. What is particularly galling about this aspect of the confession is Greenspan's effort to re-write the role he personally played during this era of froth. In his 27 September speech on flexibility, he notes, "As the FOMC transcripts of the mid-1990s duly note, we at the Fed were uncomfortable with a stock market that appeared as early as 1996 to disconnect from its moorings."

If the Chairman shared this discomfort, as the "we" in that statement seems to suggest, then why was he taking on the role of cheerleader as the Nasdaq spiked toward 5000? Don't forget this is the same central banker who proudly proclaimed in early 2000, "We may conceivably conclude from that vantage point that, at the turn of the millennium, the American economy was experiencing a once-in-a-century acceleration of innovation, which propelled forward productivity, output, corporate profits, and stock prices at a pace not seen in generations, if ever" (see his 13 January 2000 speech, "Technology and the Economy").

Selective recall or not, Alan Greenspan was the pied piper of the New Paradigm and the equity bubble it spawned. And up until recently, he took a similar tack with respect to the property bubble – constantly maintaining that excesses in certain local real estate markets could not morph into a nationwide problem. With 25 states plus the District of Columbia now in double-digit house price appreciation mode over the last year, the Fed chairman suddenly sees the light!

Greenspan, of course, will not be there to pick up the pieces. That unfortunate task falls to his successor – whoever that may be. History tells us that even under the best of circumstances, transitions to a new Fed chairman are fraught with peril. Financial markets are quick to test the new central banker. That was certainly the case when Alan Greenspan took over in August 1987 – the stock market crashed two months later. That was also the case when Paul Volcker became chairman in August 1979 – the bond market

quickly tanked. And the onset of G William Miller's brief tenure in March 1978 ushered in a dollar crisis. Just from that perspective alone, there's good reason to worry about the markets in early 2006.

But there's an even greater reason to worry about the coming transition to a new Fed chairman. Courtesy of bubble-induced distortions that Greenspan condoned, today's saving and current-account disequilibria dwarf anything that a new chairman has had to face in the past. The average net national saving rate that Miller, Volcker, and Greenspan inherited was 7.4%; today it is 2% and likely to be a good deal lower in early 2006. Similarly, America's current account deficit averaged -1.5% of GDP in the three most recent Fed chairmen transitions; today, it is closer to -6.5%.

In the end, America's current-account funding problem remains very much a confidence game. To the extent that the confidence of foreign lenders is shaken as it normally is by the transition to a new Fed chairman, America's unprecedented imbalances imply that financial market risks could be all the more acute. That could be the cruelest legacy of all for Alan Greenspan to leave to his successor. Right about now, the Maestro could certainly use a new baton.

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