On Government Activism

The argument that there are "limits" is highly exaggerated.

BY RICHARD KATZ

In the previous issue of *The International Economy,* Alan Greenspan blamed "governmental activism" for a shortfall in American business investment, saying that it accounted for one-half, perhaps even three-quarters, of the shortfall. Of that amount, 25 percentage points was due to fiscal stimulus allegedly crowding out investment, according a regression produced by Dr. Greenspan. However, as we'll detail below, that regression's results are wrong. For the 25–50 percentage points allegedly produced by regulation and other measures (including the new Dodd-Frank banking reform bill), Dr. Greenspan does not offer a regression. It is simply an unfounded assumption about business fears of uncertainty based upon a reading of the 1930s Depression and the current downturn.

His message—that governmental activism does more harm than good to the economy—was also the philosophy that guided his refusal to use his regulatory powers *vis-à-vis* the subprime and derivatives bubbles during the past decade. And his prescription against fiscal stimulus, if followed, would make recovery from the current slump even more difficult and prolonged.

Dr. Greenspan's stance on governmental activism stands in contrast to his superb judgments—and monetary activism—for nearly two decades as the "maestro of monetary policy," judgments guided by pragmatism and empiricism.

In the 1990s, he said that there was no need to simply accept *a priori* the common presumption that the economy's "speed limit" was 2.5 percent annual GDP growth and that its non-inflationary unemployment rate was around 6 percent. Instead, in the new environment

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produced by the Clinton administration's deficit-cutting and new innovations in technology, he suggested removing the monetary tourniquets and testing how fast the economy could safely grow. The result was higher growth, a budget surplus, and millions more people with jobs—with neither a rise in inflation nor a revolt by the "bond market vigilantes." The lower capital costs provided by the Clinton-Greenspan efforts were a vital ingredient in the famed productivity revolution. They enabled firms to buy the machinery in which the new technology was embedded. Business investment rose from an 8.6 percent share of real GDP in early 1995 to nearly 12 percent by the end of 2000.

During the early 2000s, the markets feared deflation. Even though the Fed thought deflation unlikely, it wanted an insurance policy. Its concerns were based on a careful Fed study of Japan's experience (*Preventing Deflation: Lessons from Japan's Experience in the 1990s*). The study showed that, given the Fed's own forecasts for Japan's growth and inflation in the early 1990s, the Fed would have had an even tighter monetary policy than that of the Bank of Japan. But when it comes to deflation, an ounce of prevention is worth a ton of cure. Hence, Dr. Greenspan chose to err on the side of caution and supply enough money to prevent a recurrence of a similar miscalculation in the United States. Despite jeremiads from critics, no burst of inflation followed this choice.

By contrast, as the chief U.S. policymaker in charge of supervising banks, Chairman Greenspan seemed to operate within a more ideological framework, one that gave excess credence to the desire and ability of financial markets to self-correct. In 1994, for example, a bipartisan coalition in Congress passed the Home Ownership and Equity Protection Act (HOEPA). This act recognized a new financial world, one in which banks no longer kept mortgages on their books, thereby giving the banks a stake in the borrower's ability to repay the loan. In the new world, nonbanks generated mortgages that they then sold off to investment banks, which sliced and diced them into mortgage-backed securities. These securities were readily given an AAA rating by the credit rating agencies paid by the issuers. None of these players had any financial stake in ensuring that borrowers could repay; they only had an interest in spawning as many fee-generating mortgages and mortgage-based derivatives as possible. Thus arose the no-documentation, no-down payment loans later nicknamed "liar loans." HOEPA enabled, but did not compel, the Federal Reserve to force all mortgage generators and lenders to follow the traditional standards applied to banks: thou shalt not issue a mortgage unless the borrower makes a substantial downpayment, can prove he has the ability to repay, and can breathe (yes, in some locations dead people received mortgages). However, despite repeated pleading

by various officials, including Edward Gramlich, a colleague on the Fed Board, Dr. Greenspan refused any significant enforcement of HOEPA. When questioned on this, Dr. Greenspan countered that the Fed issued some "guidances," but these were not mandatory.[1]

Without the unregulated shadow banking system, the bubble would never have become so extreme. Homes were built, not for people to live in, but to provide an excuse for issuing derivatives. Yet Dr. Greenspan, along with the Clinton and Bush administrations and much of the Congress, refused to regulate—or even count—the derivatives.

There are those who blame the 2008 implosion on Dr. Greenspan's earlier monetary ease. But a close look at the numbers shows that regulatory abdication, not easy money, was the dividing line between sound and unsound loans. In the fall of 2008, when the Lehman shock sent the economy plunging, 21 percent of subprime adjustable-rate mortgages were in foreclosure. By contrast, among the loans guaranteed by Fannie Mae, most of which met traditional standards regarding down payments and proof of ability to pay, a mere 0.65 percent were in foreclosure.

During Congressional testimony, when Rep. Henry Waxman (D-CA) pressed Chairman Greenspan on whether "your ideology" prevented him from heeding advice to restrain irresponsible lending practices, Dr. Greenspan acknowledged, "Yes, I've found a flaw [in my economic model]…Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief."

Frankly, it's hard to comprehend this statement given that decades of research have highlighted the divergence of

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interests between shareholders (principals) and managers (agents), and when we live in a world where CEO Stan O'Neal can bring Merrill Lynch to the brink of collapse and still walk away with a $161 million severance package. Firms do not make decisions. Rather, individual executives make the decisions—often at the expense of the firm, its shareholders, its customers, and the nation.

The same approach that guided Chairman Greenspan's regulatory abdication in the 1990s and 2000s permeates the criticism of government activism as expressed in his *TIE* essay. Dr. Greenspan's criticism of governmental activism rests on a regression purporting to show that an activist fiscal policy causes business to invest less. Yet the regression is fatally flawed.

Dr. Greenspan's measure of business investment (his dependent variable) is the ratio of corporate investment to total internal funds (mainly cash flow). He argues that this ratio shows whether firms are choosing to invest in physical capital or financial assets. Yet Dr. Greenspan ignores the one curiosity that invalidates the entire regression. Why is it that this ratio is often the highest during recessions, when real business investment is falling? And why is the ratio sometimes the lowest during expansions when business investment is booming (see Figure 1)? Why, during the four decades from 1970 to 2010, is there a 34 percent *negative* correlation between quarterly investment growth and the ratio of investment to internal funds? The reason is simple. During recessions, internal funds can fall more quickly than investment; hence, even though investment is falling, the ratio of investment to internal funds will rise. Conversely, during booms, internal funds may rise faster than investment; hence, even though investment is growing, the ratio of investment to internal funds can fall. The bottom line is that the one piece of statistical evi-

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dence for the entire Greenspan thesis is skewed by an inaccurate measure regarding firm behavior.

A more careful regression demonstrates the opposite of Dr. Greenspan's assertion. In reality, fiscal stimulus (as measured by the cyclically adjusted federal budget deficit) lessens a recession's severity and brings about quicker recovery. Once recovery has been achieved, it is safe to withdraw the stimulus. Before presenting our own regressions, let's consider how fiscal stimulus works. The initial impact is that more spending and/or increased tax cuts directly inject purchasing power into the economy, thus causing more sales, production, and hiring. However, if that were the only impact, then the result would be reversed as soon as the stimulus was withdrawn.

Therefore, we must look at the longer-lasting secondary effect. Fiscal stimulus helps transform a vicious cycle into a virtuous cycle more quickly than the market can do so on its own. In a recession, low sales lead to layoffs and decreased investment, which lowers consumer spending and sales even more, leading to a new round of layoffs and further investment cuts. Fiscal stimulus reverses this cycle. It raises the operating rate of firms and lowers the unemployment rate. As a result, firms invest more and hire more. Consumers not only have more money to spend but are more willing to spend what income they do have. That leads to more spending, production, investment, and hiring, as firms and consumers come to expect the expansion to continue. Once a critical threshold on the operating rate and unemployment has been reached, the recovery becomes self-sustaining and it becomes safe to withdraw the stimulus.

By contrast, in the current downturn, fiscal stimulus began to be withdrawn long before the critical threshold was reached. In fact, total federal, state, and local government purchases of goods and services actually fell from the last quarter

Figure 1: Investment Growth vs. Investment/Internal Funds Ratio
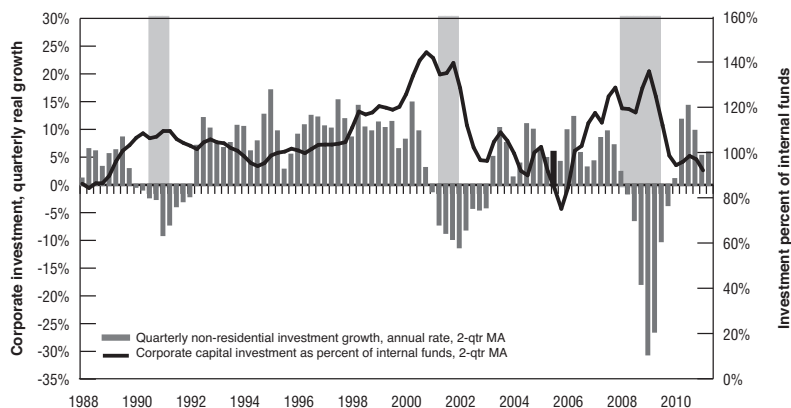
Sources: Federal Reserve "Flow of Funds" and U.S. Commerce Department GDP tables.

of 2010 through the first half of 2011. This premature withdrawal is one of the main reasons why the recovery sputtered in 2011 and why the economy faces the risk of a double-dip recession. In his article, Dr. Greenspan advocates a policy that is preventing recovery and keeping millions of Americans without jobs.

Let's look at the evidence. In Dr. Greenspan's regression on investment, he used as independent variables the level of the nonfarm business operating rate as well as the cyclically adjusted budget deficit. However, how much companies invest and hire depends not only on the level of the operating rate but on the change in that level, as well as the change in the unemployment rate. The current level tells firms about current sales, but the change in the level tells firms about future sales, and, therefore, whether to expand or cut back. Suppose the operating rate is 79 percent with no change in either the operating rate or the unemployment rate. Then investment growth will be zero. If, from that level, the operating rate goes up 1 percent, then investment will expand at a 3.6 percent annual rate. If the operating rate goes down 1 percent, then investment

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will drop 3.6 percent. (See discussion below of regression for Figure 2). Similarly, consumer spending depends not only on disposable inc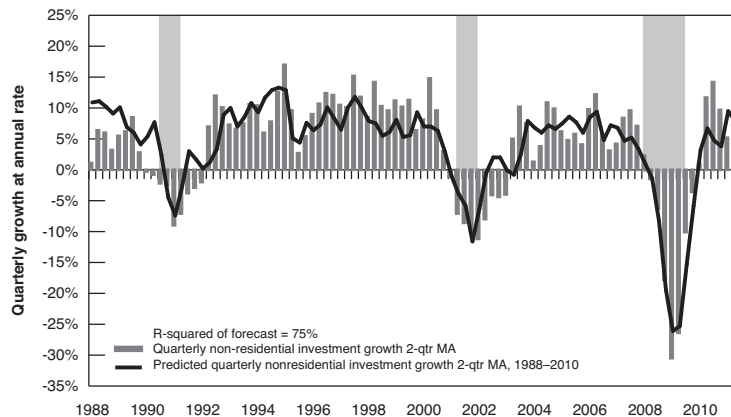ome but on the unemployment rate and on the change in the unemployment rate. At any given level of disposable income, consumers will spend less if unemployment is high and getting worse. To the extent that fiscal stimulus lowers unemployment, it increases not only income but also the propensity to spend. (If we regress real consumption on real disposable income for 1988–2011, the R-squared, that is, the percentage of the ups and downs of consumption that we can explain, is 60 percent; however, if we add the unemployment rate and the change in unemployment, the R-squared rises to 72 percent.)

In Figure 2, we can predict a very high 75 percent of the ups and downs of investment during 1988–2010 based on our regression. For 1995–2010, the prediction capability rises to 84 percent. For the much longer period of 1970–2010, we can predict 72 percent of the changes, compared to 46 percent in Dr. Greenspan's equation. Doing a similar equation, based on the business operating rate and changes in that rate, we can predict 74 percent of the ups and downs of job growth during 1988–2010.

The critical role of fiscal stimulus is to raise the operating rate and thereby

Figure 2: Investment Depends on Operating Rate and Change in Operating Rate

R-squared of forecast = 75%
Quarterly non-residential investment growth 2-qtr MA
Predicted quarterly nonresidential investment growth 2-qtr MA, 1988–2010

Source: U.S. Commerce Department for actual figures, and author for predicted investment. For prediction, investment is regressed on the nonfarm business operating rate (provided by Greenspan Associates), the change in the operating rate, and the change in the unemployment rate.

Note: R-squared means that 75 percent of the ups and downs of the operating rate can be predicted by the equation.

Regression Equation: Quarter-on-quarter change (an annual rate) in nonresidential investment growth (2-quarter moving average) =

-0.818 (t-stat = -3.12)

+1.029 * Nonfarm business operating rate (2-qtr MA) (t-stat = 3.315)

+3.65 * Quarterly change in nonfarm business operating rate (2-qtr MA) (t-stat = 2.585)

-18.0 * Quarterly change in unemployment rate (2-qtr MA) (t-stat = -5.770)

investment and hiring, setting in motion the self-sustaining virtuous cycle. Of course, how fiscal stimulus affects the economy depends on whether or not there are slack resources. If the economy is operating at full employment, then adding more fiscal stimulus will raise interest rates and "crowd out" private investment, as Dr. Greenspan argues. However, in the depths of a recession, fiscal stimulus will boost the operating rate and thus "crowd in" investment and hiring.

In Figure 3, we regress the operating rate on the unemployment rate, the change in the unemployment rate, and the cyclically adjusted budget deficit. For 1988–2010, the R-squared, that is the prediction rate, equals a very high 85 percent. For 1995–2010, it equals an extremely high 92 percent. During 1988–2010, for every increase in the cyclically adjusted budget deficit equal to 1 percent of GDP, the business operating rate rose by 0.83 percentage points. That, in turn, based on the equation for Figure 2, translates into a 3 percentage point hike in investment; it also means a 2.3 percentage point hike in job growth.

How important is fiscal stimulus to the overall result? For the last two decades (1988–2010), removing the fiscal variable from the equation drastically lowers the R-squared from 85 percent to only 52 percent. In other words, out of the entire 85 percent prediction accuracy, 33 percentage points is provided by changes in the budget balance.

Let's also consider Dr. Greenspan's assertions regarding Dodd-Frank and other regulatory efforts. Whatever flaws Dodd-Frank may have—many of which were caused by the continued enormous power of the Wall Street lobby in hog-tieing the bill—it is the first significant attempt to correct the regulatory irresponsibility that led to the 2008 cataclysm. Even if this did cause a slight dip in investment, not all of which is productive, wouldn't that price be worthwhile if it prevented a repeat of the worst crisis since the 1930s?

But why just assume that sound regulations hurt investment? Isn't the opposite more likely? Wouldn't investors be more likely to entrust their savings to financial markets where a triple-A rating actually means something, and where a derivative issued by Wall Street can be trusted? Wouldn't greater investor confidence in the honesty of the markets provide firms with more capital at a lower risk-adjusted cost? Just as effective commodity regulations have helped grain and meat futures provide us more food at lower cost, so would effective financial regulations boost economic output.

For markets to work, they need market institutions. That includes regulations that prevent conflicts of interest and fraud, and that align the compensation packages of top executives with the interests of the firm whose fate is entrusted to their hands. ◆

NOTE

1. See "Did Greenspan Add to Subprime Woes?" *Wall Street Journal,* June 9, 2007; *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States,* Financial Crisis Inquiry Commission, January 2011, pp. 93–97; "Testimony of William Black before the Financial Crisis Inquiry Commission," September 21, 2010, p. 20; and "Memorandum for the Record," FCIC meeting with Alan Greenspan, March 31, 2010.

Figure 3: Business Operating Rate in Recessions Depends on Fiscal Stimulus

R-squared = 85%

Non-farm business operating rate 2-qtr MA
Predicted non-farm business operating rate 2-qtr MA, 1988–2011 with budget
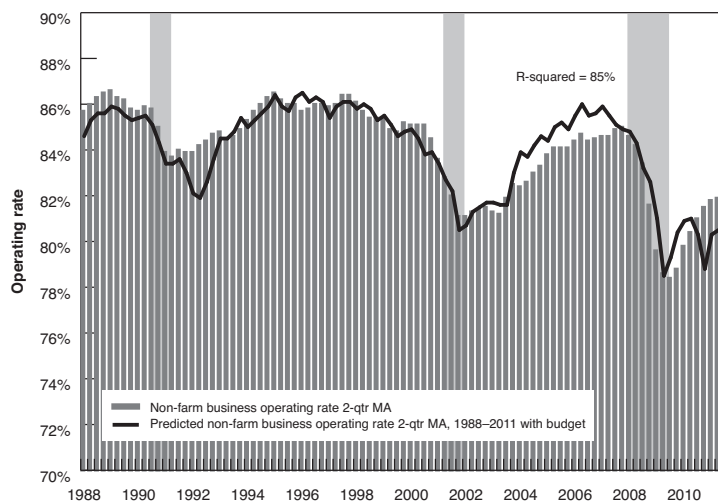
Source: Greenspan Associates for operating rate and author for predicted rate; for the prediction, the operating rate is regressed on the unemployment rate, the change in the unemployment rate, and the adjusted budget deficit (the latter provided by Greenspan Associates).

Note: R-squared means that 85 percent of the ups and downs of the operating rate can be predicted by the equation.

Regression Equation: Nonfarm business operating rate (2-qtr MA) =

+0.9234 (t-stat = 191.03)

-1.4059 * Unemployment rate (2-qtr MA) (t-stat = -16.762)

-2.949 * Change in unemployment rate (2-qtr MA) (t-stat = -9.182)

-0.8305 * Cyclically adjusted budget balance % of GDP (2-qtr MA), lagged two quarters (t-stat = -13.99). (Note: co-efficient is negative because a decline in the budget balance, i.e., smaller surplus or bigger deficit, means more fiscal stimulus, hence a higher operating rate.)