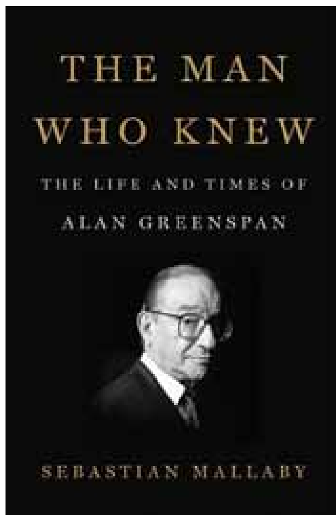
Greenspan Revisited



The Man Who Knew: The Life and Times of Alan Greenspan *(Penguin Press, 2016), won the 2016* Financial Times *and McKinsey Business Book of the Year.*

David Smick speaks with Sebastian Mallaby, author of The Man Who Knew: The Life and Times of Alan Greenspan.

Smick: Your new book is a unique achievement. Instead of the normal black-or-white biographical approach, you present former Federal Reserve Chairman Alan Greenspan in shades of gray. No decision ever lacked unintended consequences. Mistakes were put in context. But what is it about us that we can't resist from time to time creating a superman? In this case, a maestro?

Mallaby: A gridlocked political system, as exists in the United States, creates frustration, and that frustration breeds a hunger for supermen who will cut through the gridlock, rise above politics, and act as the saviors.

Smick: Would the average person reading this book conclude that central banking is a bit of a confidence game? It tries to create the impression that a small group of policy officials in Washington, D.C., really know more than the rest of the market. The central bankers are disastrous at predicting asset prices. They're poor at identifying bubbles until it's too late. They can't seem to decide whether we are reflating or disinflating. Is your book essentially is an indictment of the profession?

Mallaby: My book is a warning against the specific superman about whom I write. Greenspan's reputation did overshoot, which not only created a false impression which then had to be corrected, painfully, for him. It also lulled traders and banks into a false sense of security that they could take excess leverage because a maestro was in control of the system. That was an unhealthy impression.

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The message at the end of the book is that fighting bubbles and financial instability is extremely difficult and we shouldn't bet that either regulation or monetary policy can reliably head off future instability.

You asked whether central banking is a confidence game. Well, central bankers have three sources of power. One is early access to data. The second is a fairly formidable team of model builders and forecasters. I doubt there's any other center of analysis of the macro economy, whether it's a bank like JPMorgan or a university, that really rivals the engine room of the Fed. Advantage number three is that the central bank can create money, and it traditionally has used that power to conduct open market operations and peg the short-term interest rate. It has demonstrated more recently that it can do the same thing via quantitative easing on longer-term interest rates.

Traders need to think about what the central bank is going to do. Some hedge funds, for example, go to great lengths to understand who is the big elephant in the marketplace—who is the big institutional investor whose selling might move the price of the stock. The central bank is that, but on steroids. Its activity in the government bond markets, traditionally at the short end but sometimes also at the longer end, will move the price. To that extent, central bankers really are powerful.

Manipulative Genius?

Smick: You called Alan Greenspan a "manipulative genius."

Mallaby: In some sense, Greenspan was less good at controlling the economy than he was at controlling the perception that he could control the economy. The "manipulative genius" lay in shaping how people saw him and the awe in which he was held, even as his real power over what was going on in the macro economy was less than people thought.

Alan Greenspan

To be fair, Greenspan understood that those powerful secular forces were in operation. More than anybody else, he understood that globalization and the China effect would mean that import prices were being held down, contributing to disinflation. He understood that technology was taking pressure off prices.

Greenspan will be remembered more favorably than he is remembered now, and I think other Fed chairs may be revised downward.

Where they are not so powerful or omniscient is in understanding the relationship between the interest rates that they do set and other parts of the yield curve. A constant theme in my book is that the Fed would do something at the short end, and then be surprised about what happened at the long end. Greenspan described the flat yield curve at the end of his tenure as a "conundrum," but it was not new. The same thing existed in the 1970s. My chapter, "The First Housing Conundrum," describes how the expansion of Fannie Mae and Freddie Mac meant that longer-term borrowing rates, particularly for mortgages, were not responding to monetary policy as they would have done before. Just as in 2004 and 2005, the Fed was hiking short rates but longer rates were not responding.

Equally, the Fed was completely wrong in 1994 when it thought that a hike in short rates would cause long rates to remain calm. The theory was that the hike in short rates would signal seriousness about inflation, which would mean lower inflation expectations, which would mean lower long-term bond rates. Instead, long-term rates went up sharply, the bond market crashed, and hedge fund manager Michael Steinhardt and other traders suffered enormous losses. That uncertainty about the yield curve is one way in which central bankers are not powerful.

The way central bankers think about their tools and their objectives changes rather rapidly. If at any given moment we hear central bankers speak as if they are the possessors of the golden key, the truth is they're redesigning their key all the time so it can't be golden. It's not right to think of central banks as having a fixed and settled

understanding of what they're doing. They're constantly improvising.

Smick: You called Alan Greenspan a "manipulative genius." You say he was very good at developing a fawning press that played its part in the confidence game. You describe the television reporters fixating on the size of his briefcase, for example. How much of that manipulation was a sideshow? Weren't there powerful global forces at work, particularly after the fall of the Berlin Wall, that had an effect on long-term interest rates and the mispricing of financial assets?

Mallaby: In some sense, Greenspan was less good at controlling the economy than he was at controlling the perception that he could control the economy. The "manipulative genius" lay in shaping how people saw him and the awe in which he was held, even as his real power over what was going on in the macro economy was less than people thought.

To be fair, Greenspan understood that those powerful secular forces were in operation. More than anybody else, he understood that globalization and the China effect would mean that import prices were being held down, contributing to disinflation. He understood that technology was taking pressure off prices. In his 2007 book, *The Age of Turbulence,* the last chapter is devoted to an acknowledgement that he presided in an extraordinary time when these tailwinds of technology and globalization were helping him.

Even so, Greenspan still achieved a lot. People forget how, during the first George Bush Administration from 1989–1993, Greenspan was under huge amounts of political pressure. The Fed's independence was not yet established. Both the Reagan Administration and the Bush Administration were perfectly happy to put pressure on the Fed. The idea that then-Chairman Paul Volcker established the Fed's authority is not quite right. There was more to be done. Greenspan did it, partly by refusing to cave to pressure from the Bush White House and partly by actually being so good at politics that if the politicians tried to push him around, he pushed them around.

My book is a warning against the specific superman about whom I write.

Smick: Greenspan had a great call in diagnosing productivity growth in the 1990s and its effect. I assume you would give him an A on his report card. What about his other grades?

Mallaby: I would give him an A as you suggested on his response to political pressure from George H.W. Bush. That's his most important single achievement. I'd also give him an A on that productivity call in 1996. I would give him an A actually on the central bank's response to the Y2K problem, although that proved to be not a problem in the end. That kind of contingency planning was helpful. The response to 9/11 overall was also good.

The crisis response the 1987 stock market crash gets a B. There would have been more chaos if they hadn't bailed out the Chicago derivatives dealers. Jerry Corrigan of the New York Fed really gets the A and Greenspan more deserves a B. For Mexico in 1994 and 1995, I would say a B. With the benefit of hindsight, it would have been a good idea to bail in the creditors, but the Fed didn't consider that option seriously. They could have imposed a cost on the creditors, rewritten the contracts under domestic law, and forced the creditors to take a haircut. That would have been healthy for the global system in the next fifteen years, but at the time nobody thought about it.

The Fed response to the 1997–1998 emerging market crisis probably earns a B. The response to the Long-Term Capital Management failure gets a C. The LTCM operation began well in the fall of 1998, but three interest rate cuts to stabilize the markets was too much.

I would actually give a D to 1999 and the failure to normalize interest rates more quickly. After three interest rate cuts as insurance for potential market turbulence following LTCM's collapse, once the market stabilized and began a crazy bull run because of the tech euphoria, they should have taken back all three cuts straight away. I find it very hard to see any good excuse for not doing that.

Dealing with the subprime buildup was a tougher call, but turned out to be more consequential later. I have this slightly contrarian take that it was a big mistake, but not for the reasons most people give. The Fed tried harder with regulation than people realize. In 2001, for example, the Fed wrote a new rule designed to forbid the worse kinds of subprime mortgage. But making those rules stick was an insurmountable political problem. I'm giving that a B-minus.

But then what earns a clear D is the combination of being slow to raise rates from mid-2004 to the end of Greenspan's tenure in January 2006, plus his forward guidance. Forward guidance was a huge mistake because it anchored the yield curve and encouraged everyone on Wall Street to think that short rates were not going to go up suddenly as they had in 1994. Traders assumed they weren't

going to be surprised by a 75-basis-point hike in one meeting, therefore they could risk keeping a lot of leverage. That's an important reason why there was so much in the way of conduits and SIVs borrowing short and lending long.

Smick: I found the section on financial regulation fascinating. You say Greenspan adored power, was willing to fight aggressively for it, and he was a pretty good infighter. But you say at one point he was bored with regulatory issues. He believed a little too much in the rationality of financial agents. What about the rest of the regulatory community? Why didn't they stand up more and shout the alarm? Did they fall for the Maestro illusion? Or was the problem the regulation, or deregulation, itself? The demise of Glass-Steagall?

Incidentally, your book criticizes some and makes others into heroes. Some of the hero worship lacks credibility. You mentioned former New York Federal Reserve President Jerry Corrigan as a "brilliant" operator during turbulent times. Corrigan was certainly a useful bully during times of crisis management, but he hardly seemed a genius. Later, as the chief risk officer at Goldman Sachs, he wasn't exactly on the front page of the *New York Times* in 2007 predicting what was about to happen. Goldman wasn't sounding the alarm on the regulatory front prior to the crisis. So Corrigan may have been brilliant at bullying, but wasn't he part of the problem? Moreover, another of Greenspan's colleagues you praise as a policy master went on to one of those European financial institutions that was taken down by its massive exposure to derivatives.

Why didn't more people within the system stand up, particularly after they left the Fed and were working in financial markets and could see that the banks had no clue what was on their balance sheets? Were they intimidated? Unaware? Dare I say, greedy?

Mallaby: The common rap was people believed too much in market efficiency. The markets would be self-policing because people would look after their own risks. But that's way too simple. To the contrary, Greenspan understood markets were not efficient. He'd lived through crisis after crisis. He was not stupid. As someone who'd written academically precisely about market inefficiency and bubbles, Greenspan never believed in pure market efficiency.

The way central bankers think about their tools and their objectives changes rather rapidly.

Monetary policy is like faith healing.

Greenspan was not the only financial official who was skeptical of market efficiency. Treasury Secretary Robert Rubin was never a believer that things would always go right. He'd been running risk at Goldman and he knew damn well from firsthand experience that you could get it wrong. By temperament he was an extraordinarily circumspect person. Rubin was more skeptical about derivatives than either Greenspan or Summers, yet he also didn't do anything to regulate them. So the question is: why did these people who understood financial risk not do more to control it? It's a combination of elements. Some understood that there was risk, but they didn't realize how big the risk was, and they didn't prioritize fighting that risk because there always seemed to be more urgent things to worry about.

Look at Brexit as an example of thinking about risk. Brexit means the complete rethinking of the United Kingdom's commercial relationship with its trading partners. What is UK business to do? Does it immediately stop all investment and completely freak out? No. There's a bit of slowdown in UK investment, but it's remarkable how most British business people cannot get their minds around how bad this really is, and therefore they're just carrying on with their heads down and pretending nothing much has happened.

The same is true of regulators in the 1990s and early 2000s. Until the size of that tail risk in derivatives and modern finance really revealed itself in 2008, markets were like a village that's having a nice time even though there's a volcano a mile away. They didn't think about the volcano erupting until it did.

Smick: What about the sheer political power of the financial sector to overwhelm the central bankers? Did you ever sense any financial market intimidation from Greenspan in your many hours of discussions?

Mallaby: No. I think it does exist, but I wouldn't say I sensed it directly from him. Greenspan as a person is fairly immune from that kind of consideration, in the sense that he had enough money and didn't care too much about having more. By the time he got to the Fed he was beyond

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that. He understood that Wall Street had political power, of course. But he also had political power and he probably reckoned that in any public argument with Wall Street, people would believe him. But Wall Street does have campaign finance muscle, for sure, and that affected how people in Congress were willing to vote on certain things.

In the story I tell about Fannie Mae and Freddie Mac, Greenspan belatedly tried to make an alliance with the White House in order to get some regulation going. Then Fannie and Freddie ran a TV ad to serve notice to members of Congress that if they supported the Greenspan reform they would face a barrage of negative ads in their districts. Lo and behold, Congress lost interest in Greenspan's arguments for capping the size of Fannie and Freddie.

But the reality of lobbying and financial muscle is not the only reason why regulation wasn't tougher. It's also that designing regulation is difficult. With the complexity of markets, if you squeeze the regulatory balloon at one end, all the water just goes to the other end. The problem was the sense that if you regulated the banks, more risk would go to the shadow banks. If you clamped down on derivatives, the risk would wind up somewhere else.

Smick: You describe Greenspan as a Washington animal, a political survivor, who was quite willing to engage in fights, often to protect his ability to influence monetary policy. But he was calculating about whether to get into a knockdown political fight that he knew he couldn't win.

Mallaby: You're definitely on the right track. Fannie and Freddie was a clear example of Greenspan understanding the lobbying muscle of financial companies and then backing off because he didn't want to put his face in the buzz saw. At the same time, it's always healthy to remember what happened after 2008 with the Dodd-Frank reform. Most people would view it as a mixed bag. There's probably good things in it, but also some quite complex and messy and dysfunctional stuff. So Dodd-Frank illustrates the point I was making earlier. A big obstacle to financial regulation is that it is so hard to design well.

Smick: Something had to be done in response to the crisis, but sadly the financial reform legislation and the Fed's response has led to the consolidation of U.S. banking into a small collection of risk-averse giant zombie banks. The banking sector used to have a dozen banks that controlled 45 percent of all banking assets. Now even fewer control 80 percent of those assets. The unintended consequences of financial reform regulation have been unfortunate.

Mallaby: But nobody really could foresee that. After 2008, the clear things that needed to be done were more capital, moving derivatives onto exchanges, and putting a finger on the scale to push proprietary trading into hedge funds. I like the Volcker rule for that reason.

Smick: No doubt something had to be done. They had to move quickly. But I'm always leery when legislation is written but the rules dribble out over a multi-year period. We still don't have all the rules for Dodd-Frank. The danger is the development of campaign finance arbitrage, which is exactly what happened. The longer the rules remain uncertain, the more the political fundraising dollars roll in from the nervous bankers.

I would give him an A on his response to political pressure. I would give a D to 1999 and the failure to normalize interest rates more quickly.

Mallaby: But as we were saying earlier, the reformers were never able to come up with a clear, simple set of rules. They didn't believe intellectually that it was possible to write three rules that would be fix the challenge of unstable finance. It was going to be a massive sausage factory. Getting the Gramm-Leach-Bliley Act passed in 1999 was hard enough, as was the Commodity Futures Modernization Act of 2000.

Passing legislation was extraordinarily tough, and also they didn't really have a clear sense of what the reforms should be. Think about bank capital. People debate endlessly. Should we have a simple leverage rule? Should it be risk-weighted? If it's risk-weighted, how do we design the risk buckets in a way that won't be gamed?

Smick: Look at the Bank for International Settlements' rules. It's amazing how the banks manipulate the rules.

Mallaby: But then the bottom line is that regulation is very hard to do whether at the BIS or through Congress.

Smick: I came to the conclusion that you found Alan Greenspan to be essentially honest. He could offer po-

litical spin, but you wrote this book in a nuanced way with shades of gray that I think is quite fair to the Chairman. It shows an awful lot of warts, but my sense is that he didn't try to spin things in any extreme way. He was pretty realistic about his foibles and things he missed. You didn't have to unravel the spin.

Mallaby: I always try to be fair to anybody I write about, whether or not they have been straight with me. As a journalist, some people refuse to talk to you, or lie to you, or agree to a meeting and don't show up. You may on a personal level resent that. But you shouldn't let your own resentment drive your judgment of somebody when you're trying to do your readers a service and give a full representation of what a person really is like. I give people good or bad treatment depending on what I think the full evidence shows.

And although Greenspan spoke to me for more than seventy hours, that's a fraction of the number of hours I spent speaking to people who know him, worked with him, and dated him. I showed up at 10:00 a.m. at the apartment one of his former girlfriends. I didn't leave until 6:00 p.m., and then with an armful of photographs, letters, and recordings. That one source gave me ten hours, and there were hundreds of sources. The archival work was even more important. This project took five years, and the hours I spent with Greenspan were actually not very many relative to all the other research.

Smick: You took Greenspan's libertarian background and made that a common thread. You described the times he'd return to that background, but also when he'd engage in a bit of reinvention. To what extent was his libertarian background a hindrance or a help?

Mallaby: Most people who are thoughtful about public policy probably go through an early phase when they are attracted to some broad and simple concept of how politics and the economy ought to work. This could be Marxism, or libertarianism, or any big, sweeping theory. But as people learn more and acquire real-world experience, they should, if they are honest, introduce qualifications to their initial framework.

Smick: I was struck by how Greenspan was able to avoid the pitfall of cynicism. He seemed to be just an intensely ambitious guy on a journey of discovery.

Mallaby: Greenspan begins with this fairly pure libertarianism. He joins the Nixon Administration, and you can see in the memos he writes that he moves from libertarian advice toward much more political advice on message and spin and political polling. This transitioning from pure theory to political realpolitik progresses in the 1970s as he has experience in government. So by the time he's at the Fed, he's basically a pragmatist.

He's not cynical through this process. His failing at the end of his career is not so much cynicism as complacency. To your point earlier that most people make their biggest mistake at the end of their career, he got a little bit too comfortable in his last three or four years. He'd seen problems in macroeconomic management present themselves over and over again. He'd thought through how to best respond to these challenges, and he had ceased to feel he had to think them through anew. He would fall back on his earlier judgments. I think he did that much less than people who are in their late seventies would normally do.

But that played into his failure to make more of a fuss when the real estate bubble started to inflate. Compare 1996, where the Fed staff presented him with data and he challenged it, to 2004 where he's happy to say nationally there cannot be a nationwide real estate bubble. The younger Greenspan would have demanded to know city by city what was going on with real estate.

Smick: So you're saying he had an impressive curiosity that faded in the final phase.

Mallaby: In the last chapter about his retirement phase, I say Greenspan is coming at the present through the past. The younger analysts at PIMCO got bored of him—I heard that directly from the economists at PIMCO. He understands all the precedents for everything and he falls back on that instead of grappling with today in a fresh way.

Smick: You end with this quotation from one of the people you interviewed. The individual asks, "Who knows what history will say about Alan Greenspan?" What does your crystal ball say? Will he be remembered fifty years from now? What will be his legacy?

Mallaby: Greenspan will be remembered more favorably than he is remembered now, and I think other Fed chairs may be revised downward.

The sort of post-Greenspan Bernanke consensus in favor of a publicly announced inflation target was the ultimate overreach in technocratic self-assurance. When you reduce central banking to just one thing, the inflation target, you've oversimplified your model.

People used to make this critique of monetarism and say that's absurd. How can you run the whole economy just by looking at one quantity? After all, there are multiple measures of money. The same is true of inflation. There are multiple kinds of inflation, multiple ways of

measuring it, and to obsess about core PCE inflation is to reduce the whole puzzle much too much.

Bernanke, in going for that target and also in proposing these ingenious mechanisms like forward guidance, was taking his eye off the ball of financial stability as well as ignoring a lot of complexity. The Greenspan method follows a more discretion-based, maestro-like approach to central banking. For all its flaws, it's still better than saying we'll just follow one simple rule.

Smick: I once asked then-Chairman Bernanke whether he might come to regret this new communications strategy. In times when he and his colleagues are uncertain about where the economy is going, do they really want the world financial system to know they're that uncertain?

Mallaby: I can tell you that Greenspan agrees with you. Monetary policy is like faith healing—the patient has to believe, and if you talk incessantly even when you don't really have any information, you undermine your credibility, or overuse your credibility in a way that makes people feel too safe. They think they understand exactly what you're going to do, and that was a problem in 2004–2005.

Smick: To what extent do a bunch of guys sitting in Washington really know what's going on in a world financial system as complex as it is today? Isn't hubris the greatest danger for policymakers?

Mallaby: The formula calls for talking sometimes and being quite explicit, and other times being like the proverbial bespectacled sea squid who emits black ink and then glides away silently. Greenspan was selective about the questions he answered. Other times, he gave no answer on purpose and I think that was smart.

Bernanke's approach of being blunt and straightforward and clear all the time intuitively feels more like a straight-up way to behave, but in fact is not a good idea. Volcker went too far in the opposite direction. He didn't communicate enough. Greenspan understood the importance of discretion, and understood the importance of leadership.

Right now, I think the Fed speaks with too many voices. What proportion of the voice of the Fed in the Greenspan era was Greenspan himself? The answer would be 99 percent. For current Fed Chair Janet Yellen, the answer is probably somewhere between 35 percent and 50 percent, because the other governors are talking all the time and people pay attention to them, too.

Smick: The Fed's currently reminiscent of the economics department of a university. The head of the department doesn't have control. There are a lot of prima donnas and they're all spouting off. The department chair tries to herd the cats, but it's not easy.

Mallaby: The Fed has been criticized from the left by people who say it's too tight, most prominently Larry Summers. From the right, people say it should exit the zero bound faster. Nobody is clearly making the case for the policy as it is. Yellen ought to do that, but she's only one voice amongst this cacophony of voices coming out of the Fed.

The way the Fed is being attacked by Donald Trump and people in Congress, and the way Hillary Clinton talked during the presidential campaign about reorganizing the regional federal reserve banks, all point to a declining status for the Fed.

Greenspan will be judged by history as somebody who presided over a moment when the Fed's prestige was at an all-time high, partly because he was lucky due to the tailwinds of the Great Moderation and Chinese technology, but partly because he was darn good at it and he understood that you had to be the voice of the Fed, manage the political perception of the Fed, and not be pushed around by politicians like George H.W. Bush. By contrast, Bernanke will be viewed as somebody who was excessively hung up on one objective, inflation targeting, and put too much faith in forward guidance.

Smick: Bernanke deserves credit for analyzing the crisis side of it.

Mallaby: I agree. After Lehman failed, the response was heroic.

Smick: All over the world, the independence of central banks is under assault. Some of it is their own doing, but part of it is that globalization's being rolled back. The Bank of Japan isn't even a central bank anymore. With the pressures on ECB President Mario Draghi and the assaults on the Fed, could we quickly end up with a new era for central banks in which they become little more than political appendages?

Mallaby: Outside of the United States, the case I know well is Britain. Bank of England Governor Mark Carney has faced a lot of political pressure, with Prime Minister Theresa May complaining about the distributional consequences of quantitative easing. The Chancellor of the Exchequer, Philip Hammond, has been slightly critical in public and more forcefully critical in private. Other people in the Conservative party have been writing newspaper op-eds saying central bank independence will be ended if Carney doesn't behave differently.

Smick: When the history is written on this period, part will be that the central bankers for some strange reason allowed themselves, in response to the 2008 crisis, to be depicted as the saviors of the world economy, even though they didn't really have the tools to fully do the job. Why did they paint themselves into that corner? As you've described in the book, there was a model for the Fed not being the first to promise to save the system. In other words, once the political side did what they had to do, the central bankers would come in as the final ingredient. But instead, central bankers after 2008 accepted the responsibility for saving the world. And now they could be the fall guys.

Mallaby: You're right. You're alluding to the 1990 budget deal, in which the politicians did their part to close the budget deficit, rather than relying on the Fed to go first and raise interest rates. Later, central bankers went through this period when their tools did seem incredibly powerful, and so people forgot about fiscal policy. The high point of that in the United States came when Bernanke went to Congress and said he was going to bail out AIG. Congress said, "Wait, do you have $85 billion?" and he said, "Well, I've got $800 billion. I've got unlimited amounts of money." They gulped disbelievingly and then he proved that he had actually more than he said.

There was a period when central banks' money-printing powers were really genuinely mindboggling, because the threat of inflation, which had been the traditional inhibitor, was gone. With no threat of inflation, central bankers could print as much money as they wanted. But wind the clock forward to 2016, and we're running out of space for that stuff. Negative interest rates create problems for the banks. So monetary policy is running out of space and, at least until the promise of a fiscal stimulus from President-elect Donald Trump, it felt as though fiscal policy was dormant.

Smick: And the problem is that a lot of politicians are saying that if the medicine's not working, there's only one solution—up the dosage. Thank you very much. ◆