Sympathy for Greenspan?

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In the circles in which I travel, there is near-universal consensus that America's monetary authorities made three serious mistakes that contributed to and exacerbated the financial crisis. This consensus is almost always qualified by declarations that the United States has been well served by its Federal Reserve chairmen since at least Paul Volcker's tenure, and that those of us who have not sat in that seat know that we would have made worse mistakes. Nevertheless, the consensus is that U.S. policymakers erred when:

- The decision was made to eschew principles-based regulation and allow the shadow banking sector to grow with respect to its leverage and its compensation schemes, in the belief that the government's guarantee of the commercial banking system was enough to keep us out of trouble;
- The Fed and the Treasury decided, once we were in trouble, to nationalize AIG and pay its bills rather than to support its counterparties, which allowed financiers to pretend that their strategies were fundamentally sound;
- The Fed and the Treasury decided to let Lehman Brothers go into uncontrolled bankruptcy in order to try to teach financiers that having an ill-capitalized counterparty was not without risk, and that people should not expect the government to come to their rescue automatically.

Should Greenspan have kept interest rates higher in order to avert the growth of a housing bubble?

There is, however, a lively debate about whether there was a fourth big mistake: Alan Greenspan's decision in 2001–04 to push and keep nominal interest rates on U.S. Treasury securities very low in order to try to keep the economy near full employment. In other words, should Greenspan have kept interest rates higher and triggered a recession in order to avert the growth of a housing bubble?

If we push interest rates up, Greenspan thought, millions of Americans would become unemployed, to no one's benefit. If interest rates were allowed to fall, these extra workers would be employed building houses and making things to sell to all the people whose incomes come from the construction sector.

Full employment is better than high unemployment if it can be accomplished without inflation, Greenspan thought. If a bubble develops, and if the bubble does not deflate but collapses, threatening to cause a depression, the Fed would have the policy tools to short-circuit that chain.

In hindsight, Greenspan was wrong. But the question is: was the bet that Greenspan made a favorable one? Whenever in the future the United States finds itself in a situation like 2003, should it try to keep the economy near full employment even at some risk of a developing bubble?

I am genuinely unsure as to which side I come down on in this debate. Central bankers have long recognized that it is imprudent to lower interest rates in pursuit of full employment if the consequence is an inflationary spiral. Some days I think that, in the future, central bankers must also recognize that it is imprudent to lower interest rates in pursuit of full employment when doing so risks causing an asset price bubble. Other days, however, I think that, even with the extra information we have learned about the structure of the economy, Greenspan's decisions in 2001–04 were prudent and committed us to a favorable and acceptable bet.

What I do know is that the way the issue is usually posed is wrong. People claim that Greenspan's Fed "aggressively pushed interest rates below a natural level." But what is the natural level? In the 1920s, Swedish economist Knut Wicksell defined it as the interest rate at which, economy-wide, desired investment equals desired savings, implying no upward pressure on consumer prices, resource prices, or wages as aggregate demand outruns supply, and no downward pressure on these prices as supply exceeds demand.

On Wicksell's definition—the best, and, in fact, the only definition I know of—the market interest rate was, if anything, above the natural interest rate in the early 2000s: the threat was deflation, not accelerating inflation. The natural interest rate was low because, as the Fed's current chairman Ben Bernanke explained at the time, the world had a global savings glut (or, rather, a global investment deficiency).

You can argue that Greenspan's policies in the early 2000s were wrong. But you cannot argue that he aggressively pushed the interest rate below its natural level. Rather, Greenspan's mistake—if it was a mistake—was his failure to overrule the market and aggressively push the interest rate up above its natural rate, which would have deepened and prolonged the recession that started in 2001.

But today is one of those days when I don't think that Greenspan's failure to raise interest rates above the natural rate to generate high unemployment and avert the growth of a mortgage-finance bubble was a mistake. There were plenty of other mistakes that generated the catastrophe that faces us today. ◆

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