

BLAMING GREENSPAN: MONETARY POLICY, THE HOUSING ‘BUBBLE’, AND THE CREDIT CRISIS

Monetary policy alone cannot explain the US housing or financial crisis, argues **Stephen Kirchner**

The recent boom and bust in US housing and subsequent global financial crisis has been widely blamed on the country’s monetary policy. In particular, former Federal Reserve Chairman Alan Greenspan has been blamed personally for supposedly mismanaging Fed policy in the first half of this decade. Greenspan was similarly blamed for the turn of the century boom and bust in technology stock prices.

Many classical liberals share this view, reflecting their skepticism about the ability of central banks to conduct monetary policy in a stabilising rather than a destabilising fashion. While this skepticism is warranted, we should also be wary of exaggerating the importance of monetary policy, at the risk of giving too little weight to other interventions that may have been more important in causing the crisis.

There is no dispute that US monetary policy was ‘easy’ in the years immediately following the recession of 2001, since this was the explicit intention of Fed policy. This easy policy stance was designed to pre-empt what was then perceived as a serious risk of consumer price deflation. In this, Fed policy was successful. The question is whether this easy policy stance then had the unintended consequence of fueling the US housing cycle and,

therefore, being a causal factor in the subsequent global financial crisis.

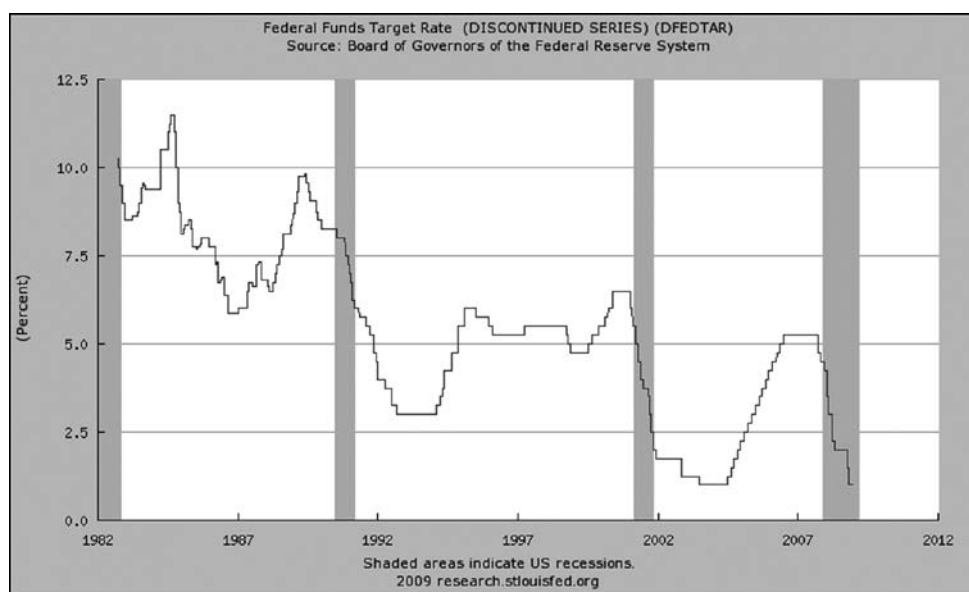
An alternative interpretation of the Fed’s easy policy stance during this episode is that the US economy is not particularly sensitive to changes in official interest rates. The reduction in the US Fed funds rate to 1 percent between June 2003 and June 2004 points to Fed policy being ineffective rather than destabilising. This lack of monetary policy effectiveness can be attributed to the weak relationship between the Fed funds rate and longer term interest rates, including US mortgage interest rates, which are largely market-determined. Classical liberals should welcome the fact that US monetary policy now takes a backseat to markets in the determination of interest rates and economic conditions.

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US monetary policy following the 2001 recession

In the wake of the 2001 recession, the Fed was less concerned with house price *inflation* than with pre-empting the prospect of consumer price *deflation*. The Federal Reserve had closely studied Japan's experience with deflation and the zero bound¹ on nominal interest rates from the mid-1990s onwards. The main lesson the Fed took from the Japanese experience was that monetary policy should respond aggressively to pre-empt the threat of consumer price deflation and the zero bound on nominal interest rates.² This experience heavily conditioned the Fed's approach to monetary policy during its easing cycle between 2001 and 2004. The US official interest rate—the Fed funds rate—was lowered to 1 percent by June 2003, the same month in which the US unemployment rate reached a cyclical peak of 6.3 percent. The Fed funds rate was held at 1 percent until June 2004 (see Chart 1, shaded bars are recessions as defined by the National Bureau of Economic Research). The Fed was hardly alone in its concern with deflation. The International Monetary Fund convened an interdepartmental taskforce on deflation, which concluded in April 2003 that 'it is better to prevent deflation than to try to cure it, and monetary policy must take the lead.'³

Chart 1: US Fed Funds Rate (%)



However, the level of nominal interest rates tells us very little about the stance of monetary policy. High nominal rates may reflect high rates of inflation that, in turn, reflect monetary policy that is too easy. Low nominal interest rates may reflect too low a rate of inflation, suggesting that monetary policy is too tight. What matters is the inflation-adjusted or real interest rate and its relationship with the neutral or equilibrium real interest rate. The Taylor rule, named after the economist John Taylor, suggests that a neutral real interest rate for the United States is 2 percent. As chart 3 shows, the real Fed funds rate was negative between October 2002 and October 2005, implying that monetary policy was relatively easy.

The Taylor rule allows us to benchmark the stance of monetary policy to the historical response of the Fed funds rate to inflation and the level of economic activity. Deviations from the rule measure the degree to which monetary policy is too easy or too tight. Applying his rule, Taylor maintains that 'during the period from 2003 to 2006, the federal funds rate was well below what experience during the previous two decades of good macroeconomic performance—the Great Moderation—would have predicted.'⁴ Taylor concludes from this episode that monetary policy should 'stay with the systematic, predictable, principles-based policy that has worked well for most of the Great Moderation period. That is, adjust the short-term interest rate according to

macroeconomic developments in inflation and real GDP and be wary of adjustments based on other factors.⁵

While monetary policy was designed to be easy from 2001 until 2004, there is little empirical support for the view that this accommodative policy stance relative to the Taylor rule exerted a positive influence on house prices.⁶ Federal Reserve Board research has found only a weak relationship between interest rates and house prices.⁷ Moreover, if house prices were particularly sensitive to changes in the Fed funds rate, these prices should have started deflating rapidly from mid-2004 when the Fed began a new tightening cycle. By the time the credit crisis hit in August 2007, the Fed funds rate had been unchanged at a broadly neutral setting for more than twelve months.

In the context of globally integrated capital markets, long-term interest rates are likely to reflect global influences as much as domestic policy.

The next section offers an explanation for why the relationship between Fed policy and the housing cycle appears to have been so weak. In any event, if monetary policy were responsible for fuelling house price inflation, we need to ask why this inflation was not observed in relation to other asset prices, and why previous episodes of easy monetary policy did not also result in similar housing booms and busts.

The Fed funds rate and long-term interest rates

Financial institutions make use of the Fed funds rate in their overnight transactions with each other. In adjusting the Fed funds rate, monetary policy seeks to influence a broad range of other lending rates that are used more widely throughout the economy. However, especially in the United States, there is not a straightforward relationship between the official interest rate and longer term interest rates, which are largely market-determined and reflect expectations for a wide-range of factors,

including future changes in the Fed funds rate.

In the context of globally integrated capital markets, long-term interest rates are likely to reflect global influences as much as domestic policy. In an interview with the German newspaper *Die Zeit* on 30 January 2008, Greenspan highlighted the implications of the globalisation of capital markets for the effectiveness of monetary policy:

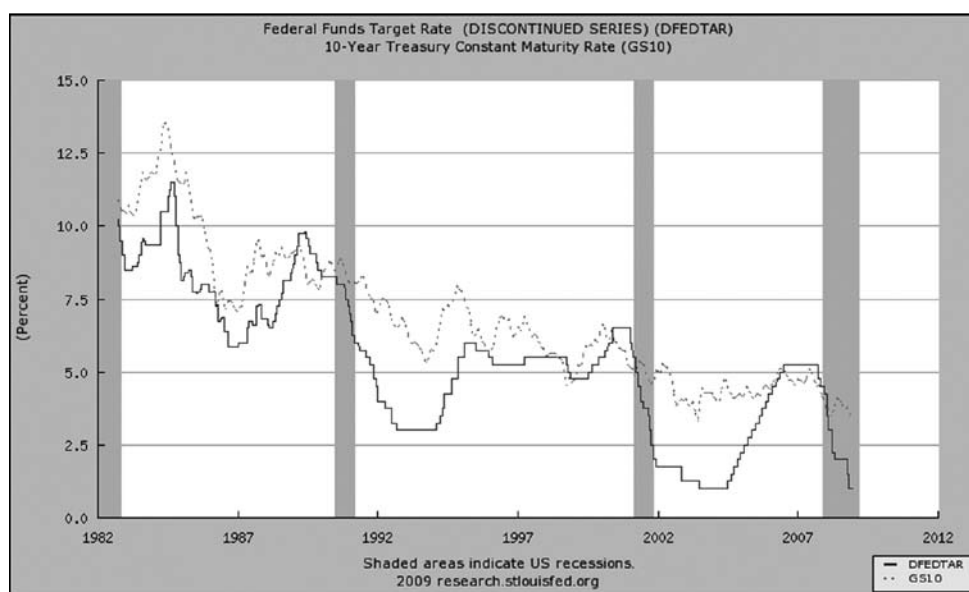
Global forces can now override most anything that monetary and fiscal policy can do. Long-term real interest rates have significantly more impact on the core of economic activity than the individual actions of nations. Central banks have increasingly lost their capacity to influence the longer end of the market. Two to three decades ago central banks were dominant throughout the maturity schedule. Thus, the more important question is the direction of long-term real interest rates...

The resources of central banks relative to the size of global forces have markedly diminished. We have 100 trillion dollars of arbitragable long-term securities in the world today so that even large movements initiated by central banks have little impact ... Global forces fostering global equilibrium have become by far the most dominant influence for financial and economic activity. Governments have ever less influence on how the world works...

There is no mechanism suggesting that US monetary policy with its rates for one-day money affects global long-term real interest rates.

Consistent with Greenspan's view, the ten-year bond yield remained relatively steady compared to the Fed funds rate through the 2001–04 easing cycle and most of the subsequent tightening cycle (see chart 2).

Longer-term interest rates were not nearly as accommodative as the level of the Fed funds rate might otherwise suggest. By the same token,

Chart 2: US Fed Funds Rate and 10-Year Treasury Yield (%)

longer-term yields did not increase dramatically after the Fed began tightening again in 2004. The behaviour of long-term bond yields must be attributable to factors other than Fed policy or policy expectations. Greenspan called the behavior of bond yields at this time a ‘conundrum.’⁸ Since this was also a global phenomenon, country-specific explanations for the ‘conundrum’ are unsatisfactory. Greenspan’s successor, Ben Bernanke, attributed low bond yields to a ‘global saving glut,’⁹ whereby ‘excess saving’ in developing countries lowered interest rates in developed countries. The repression of domestic capital markets in many developing countries makes the United States and other developed economies the only ones with capital markets deep and liquid enough to accommodate the flow of global saving.

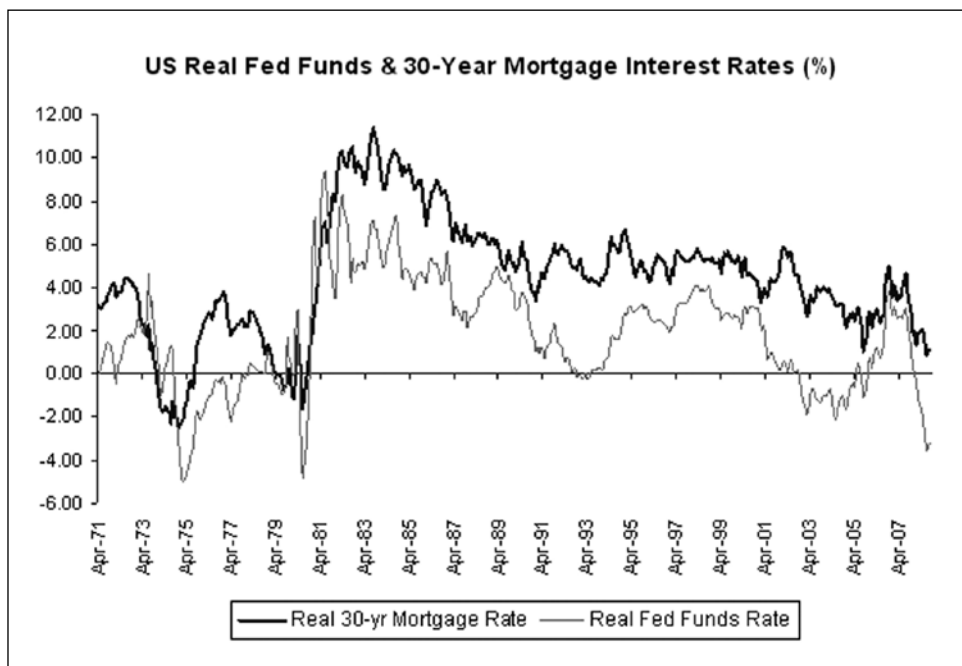
The Fed funds rates and US mortgage interest rates

US mortgages are typically funded at even longer maturities further out along the yield curve. Chart 3 shows the US real Fed Funds rate and the real thirty-year mortgage interest rate.

Like the ten-year bond yield, the thirty-year mortgage interest rate remained relatively stable between 2001 and 2004 compared to the Fed

funds rate. The failure of the Fed funds rate to influence market-determined interest rates further out along the yield curve helps explain why monetary policy struggled to gain traction over the US economy following the 2001 recession. This in turn explains why the Fed took its official interest rate as low as it did. Even in the wake of the recent credit crisis and the dramatic easing in Fed policy seen in 2007 and 2008, the thirty-year mortgage rate has been so stubbornly resistant to reductions in the Fed funds rate that there have been proposals, even from conservative economists, for government intervention to fix the thirty-year mortgage interest rate at 4.5 percent.¹⁰

It should be conceded that many of the new, adjustable-rate mortgages that were written in the first half of the decade were set at rates that were at a discount to fixed thirty-year mortgage rates, reflecting cheaper short-term funding available as a result of the low Fed funds rate.¹¹ The low official interest rate may have had a larger impact on new rather than established lending, so easy monetary policy may have been more influential at the margin than in aggregate. However, longer-term rates are still a better reflection of the overall cost of funds to US borrowers and, therefore, of the implications of interest rates for the housing sector and the economy more broadly.

Chart 3: US Real Fed Funds Rate and 30-Year Mortgage Interest Rate (%)

Housing and the US economy

The expansion in US housing construction from its early 1990s trough showed little regard to the general business cycle. The housing sector was barely affected by the broader downturn in the US economy in 2001. Chart 4 shows the annual growth rate in US industrial production, a proxy for the US economy generally, together with private new dwelling starts, a proxy for activity in the housing sector. The shaded bars are once again recessions as defined by the National Bureau of Economic Research.

The 2001 recession was exceptional compared to previous business cycles in that housing activity did not see a significant downturn with the rest of the US economy. Industrial production was subdued coming out of the 2001 recession (note the double dip into negative annual growth during 2003 as the Fed funds rate was lowered to 1 percent), while housing starts continued to increase. This decoupling from the broader economy might be thought to support the view that US housing was a 'bubble,' but it also highlights the danger of policy responding to sector-specific asset price inflation that is not related to broader economic activity. Had monetary policy been calibrated to conditions in the housing market, the broader US economy

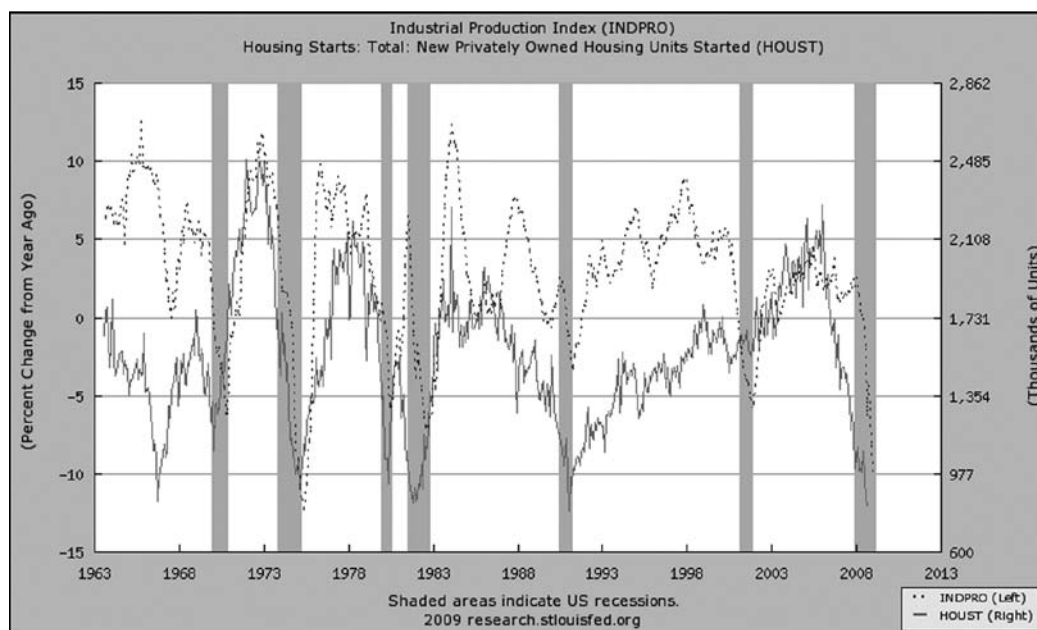
would have suffered. If the 2001 recession could not tame the US housing boom, then it is hard to see how tighter US monetary policy could have done so without inflicting significant, and potentially deflationary, collateral damage on the rest of the economy, a danger both Greenspan and Bernanke highlighted throughout this episode.

The Fed was not alone in presiding over accommodative policy settings in the early part of this decade. Based on Taylor rule benchmarks, monetary policy in Australia, Canada and much of Europe was also 'too easy' at this time. This might be thought to reflect the example set by US monetary policy, but it points to a common policy environment globally to which all central banks were responding. While there is cross-country evidence of a positive relationship between the ease of monetary policy and the strength of housing investment during this period, this is entirely consistent with the objective of an accommodative policy stance, which is to broadly stimulate economic activity.¹²

Greenspan's legacy

The US monetary policy easing cycle between 2001 and 2004 was a success on its own terms, because it achieved exactly what it set out to do: pre-empt

Chart 4: US Industrial Production (Annual Percentage Change) and New Privately Owned Housing Starts (Level)



the threat of consumer price deflation. This is not to say that there were no unintended consequences from this policy stance or that Fed policy had no role in the US housing boom and subsequent bust. However, relative to other factors, such as US government subsidies to financial risk-taking by home-buyers and financial institutions, together with global influences on long-term interest rates, the contribution from monetary policy was likely much smaller than Alan Greenspan's many critics assume.¹³ This is also strongly suggested by the fact that the boom in house prices in the early to middle part of this decade was a global phenomenon, which makes country-specific explanations implausible. If a monetary policy mistake was made, then it was a global one. Even Robert Shiller argues that US monetary policy cannot possibly account for a nine-year uptrend in US house prices.¹⁴

During Greenspan's tenure at the Federal Reserve, the US and world economy experienced what came to be known as The Great Moderation, a new period of relative stability in output and prices attributable to a much stronger focus by central banks on consumer price inflation.¹⁵ In terms of the Federal Reserve's dual statutory price stability and employment mandates, US monetary policy under Alan Greenspan was a success. The Fed did

not have a mandate to pursue stability in the prices of houses or equity securities. It is now widely recognised that it was the Fed's attempt to curb asset price inflation in the late 1920s that led to the 1929 stock market crash and the Great Depression of the 1930s.¹⁶ Greenspan implemented what most of the economics profession has come to regard as best practice in relation to monetary policy.

David Henderson and Jeffrey Rogers Hummel render a balanced assessment of Greenspan's legacy in concluding that:

Alan Greenspan stands out as the most competent—and arguably the only competent—helmsman of United States monetary policy since the creation of the Federal Reserve System...

His policy may have ended up slightly too discretionary. But that possibility hardly justifies the 'asset bubble' hubris of those economic prognosticators who, only well after the fact, declaim with absolutely certainty and scant attention to the monetary measures, how the Fed could have pricked or prevented such bubbles.¹⁷

Endnotes

- 1 The zero bound refers to the inability of nominal interest rates to fall below zero.
- 2 Alan Ahearne et al., 'Preventing Deflation: Lessons from Japan's Experience in the 1990s,' International Finance Discussion Papers No. 729 (Washington, DC: Board of Governors of the Federal Reserve System, 2002).
- 3 International Monetary Fund, 'Deflation: Determinants, Risks, and Policy Options—Findings of an Interdepartmental Task Force,' (Washington, DC: International Monetary Fund, 2003).
- 4 John Taylor, 'Housing and Monetary Policy,' Federal Reserve Bank of Kansas City Jackson Hole Symposium (Federal Reserve Bank of Kansas City, 2007).
- 5 Taylor, 'Housing and Monetary Policy.'
- 6 Marco Del Negro and Christopher Otrok, '99 Luftballons: Monetary Policy and the House Price Booms across US States,' *Journal of Monetary Economics* 54 (2007).
- 7 Donald Kohn, 'Monetary Policy and Asset Prices Revisited,' 26th Annual Monetary Policy Conference (Washington, DC: Cato Institute, 2008).
- 8 Alan Greenspan, 'Federal Reserve Board Semiannual Testimony,' House Committee on Banking, Housing and Urban Affairs (Washington, DC: US Congress, 2005).
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- 10 Glenn Hubbard and Christopher Mayer, 'Low Interest Mortgages Are the Answer,' *Wall Street Journal*, 17 December 2008.
- 11 Lawrence White, 'How Did We Get into This Financial Mess?' Briefing Paper (Washington, DC: Cato Institute, 2008).
- 12 Rudiger Ahrend, Boris Cournede, and Robert Price, 'Monetary Policy, Market Excesses and Financial Turmoil,' Economics Department Working Paper No. 597 (Paris: OECD, 10 March 2008).
- 13 Charles Calomiris, 'The Subprime Turmoil: What's Old, What's New and What's Next?' Maintaining Stability in a Changing Financial System, Jackson Hole Wyoming (Federal Reserve Bank of Kansas City, 2008).
- 14 Robert Shiller, *The Subprime Solution* (Princeton: Princeton University Press, 2008), 48–49.
- 15 Richard Clarida, Jordi Gali, and Mark Gertler, 'Monetary Policy Rules and Macroeconomic Stability: Evidence and Some Theory,' *Quarterly Journal of Economics*, February 2000.
- 16 Ben Bernanke, 'Asset Price "Bubbles" and Monetary Policy,' Remarks before the New York Chapter of the National Association for Business Economics (New York: 15 October 2002).
- 17 David Henderson and Jeffrey Rogers Hummel, 'Greenspan's Monetary Policy in Retrospect: Discretion or Rules?' Briefing Papers (Washington, DC: Cato Institute, 3 November 2008).

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F. A. Hayek

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