How Should History Judge Alan Greenspan?
December 5, 2016
by Laurence B. Siegel

If you care about finance and markets, you may think that the Fed chairman or chairwoman, not the U.S. president, is the most powerful person in the world. Thus, Alan Greenspan, who held that position longer than anyone else except William McChesney Martin a generation earlier, was arguably the most influential public official in the lifetimes of most readers of this publication. Yet Greenspan’s legacy is tarnished by the suspicion that he should have done more to avoid the asset bubbles of the early 2000s, particularly the housing bubble and crash that decimated the balance sheets of many households. Should history regard Greenspan as a “maestro” who managed the economy to new heights of prosperity or as a blunderer who let the housing crisis, and other simultaneous crises, unfold?

To answer that question, one must first understand Greenspan’s life and the history of his economic thinking. In The Man Who Knew: The Life and Times of Alan Greenspan, Sebastian Mallaby, a British-born senior fellow at the Council on Foreign Relations, provides that understanding. Mallaby has written a magisterial – and very long – biography of Greenspan with a deep emphasis on the economic reasoning behind Greenspan’s decisions. I highly recommend the book.

In his early years, Greenspan was an enigmatic character. A devotee of Ayn Rand and, in the 1950s and 1960s, a member of her cultish group of proto-libertarians, Greenspan – an anti-government rebel – seemed more likely to succeed in academia than as an advisor to six presidents. He made significant contributions to economics as a young man although he did not finish his Ph.D. until he was 50 years old. He was also a moderately successful jazz musician. Not much of a family man – his only long-lasting marriage (to Andrea Mitchell) began at age 72 – Greenspan enjoyed a complex love life that Mallaby details with bemused detachment.

Greenspan not only served Presidents Nixon and Ford and ran the Fed under Presidents Reagan, the elder Bush, Clinton, and the younger Bush, he also ran a successful consulting firm and wrote a popular memoir, The Age of Turbulence. It is impossible to appreciate the economic successes and disasters of the last half-century without understanding Greenspan, his role in public life, and his intellectual history. Mallaby does a brilliant job of covering these issues and shedding light on the way that American economic policy has been made.

Greenspan’s intellectual heritage

The “un-Keynesian”

While the prevailing winds were Keynesian at the time Greenspan was studying economics, he never bought into Keynes’ prescription for an activist government. Greenspan the student worshiped the heroes of America’s golden era of entrepreneurial capitalism: the railroad, steel, and automotive barons of the nineteenth and early twentieth centuries. Only in such an atmosphere of unrestrained growth, he believed, could the economy realize its full potential.

Along with this perspective, which he never abandoned, came a passionate adherence to the libertarianism of Friedrich Hayek, Ayn Rand, and other figures who swam against the Keynesian tide. He would later parlay this set of beliefs into a career of service not only to a series of Republican presidents but, less predictably, to Bill Clinton. Greenspan admired Clinton for his commitment to economic growth above other values often associated with Democratic governance. The Clinton years, in the middle of Greenspan’s five terms as Fed chair, would be celebrated as Greenspan’s triumph, a period when Fed policy and the economy were in almost perfect harmony.

The social value of capital markets

Greenspan’s acclaimed 1959 paper, “Stock Prices and Capital Evaluation,” put him on the map as a thinker and addressed the relationship between capital markets and the real economy.[1] Most economists before Greenspan had regarded capital markets as a sideshow where “speculators” could make largely irrelevant bets on companies. Greenspan, in an insight for which James Tobin would later receive a Nobel Prize, showed that the role of capital markets was not incidental but central.
Here is the insight: we already know that goods markets provide the price signals needed for businesses to decide how much of each good to produce. In an analogous process, capital markets provide the price signals needed for entrepreneurs to decide whether to start, continue to operate or close a whole company. Just as a developer will build a building for $10 million if he can sell it in the marketplace for $15 million, a company will be formed at a cost of $100 million if the shares can be sold on the stock exchange for $150 million. It will not be formed, and its potential productivity will be lost to the economy, if the cost of building the company is greater than the price that can be obtained for the shares.

Thus, to paraphrase Greenspan’s paper, stock prices are not just a forecast of economic activity but a central determinant of it. Through the mechanism just described, high stock prices cause booms and low stock prices cause slowdowns. Former Treasury Secretary Larry Summers would later honor this insight by saying that the Nobel committee should have given Greenspan half of Tobin’s prize money.

**A different kind of un-Keynesian**

Even Greenspan’s un-Keynesianism was unconventional. In the 1950s and 1960s, when Greenspan was building his academic reputation and consulting practice, the mainstream of non-Keynesian thought was the monetarism of Milton Friedman and the “Chicago school” of which Friedman was the best-known exponent. While deeply respecting the importance of data in economic analysis, the Chicago school placed heavy emphasis on theory. In contrast, the “New York school” to which Greenspan belonged, a less well-known but significant thread in the history of economic thought, was almost entirely concerned with describing economic activity – it was a data collection effort. Greenspan’s love for, and command of, economic data was legendary and it was around this expertise that he built his consulting firm and early claim to political relevance.

But Greenspan, unlike some other New York-school economists, had strong free-market beliefs, including the idea that a self-regulating financial system – one that is allowed to do what financial executives think is best for their firms – is ideal. After the crash of 2008 Greenspan would partially recant, but he avoided a hands-on approach to financial regulation during his Fed tenure.

**The apprentice: advising Nixon and Ford**

Already a respected and prosperous business economist, Greenspan stumbled into politics in 1968 when his old jazz bandmate Leonard Garment, then a talent scout for Richard Nixon, invited him to join his boss’ campaign – what Greenspan now calls an “unplanned adventure.” Greenspan and Nixon did not get along well, but in an age of youthful rebellion Nixon’s conservative manner and politics appealed to Greenspan. Mallaby writes,

To a libertarian business consultant now entering middle age, [the] cultural revolt [of the late 1960s] was not appealing. Greenspan dressed himself each morning in a crisp white dress shirt and a neatly pressed dark suit…

– a style that earned him the nickname “the Undertaker.” “His idea of a late-night jam session,” Mallaby continues, “involved…Bach and Beethoven.”

Despite Nixon’s reservations about him, Greenspan’s influence on the 1968 campaign was considerable, partly because he became an ally of the young Pat Buchanan, a speechwriter who had Nixon’s ear. But in six years of governing, Nixon moved away from Greenspan’s libertarianism and adopted a more activist posture, even imposing wage and price controls – any libertarian’s **bête noire**. After Nixon was elected, Greenspan, who had returned to private life and his economic consultancy (and was profiled in Barrons as a “worldly philosopher”), gradually became a vocal critic of Nixon, blaming him for rising inflation and an overbearing government.

Greenspan’s relationship with Nixon’s successor, Gerald Ford, was much better. In 1974 Ford named Greenspan chairman of his Council of Economic Advisers, one of the three top economics posts in government. (The others are Secretary of the Treasury, a position to which Greenspan aspired, and Fed chair.)

Unfortunately Ford did not understand that monetary policy was the main reason for the increasingly alarming inflation rate. Instead, and against Greenspan’s advice, Ford pursued an absurd strategy of “massive civic engagement” to combat rising prices. It didn’t work, and the “WIN – whip inflation now” buttons distributed by the Ford administration became objects of derision. Furthermore, Ford cut taxes (also against Greenspan’s advice), but struggled to contain spending. When Ford was narrowly defeated for reelection in 1976, Greenspan’s political future did not look assured, but his best was yet to come.

**Greenspan and Reagan**
It’s hard to imagine a U.S. president entering a meeting of economists and, hearing that they were discussing the gold standard, asking, “Didn’t Bastiat say that ‘no civilization has survived fiat money’?” But that is exactly what Ronald Reagan, referring to the French classical liberal economist Frédéric Bastiat (1801-1850), said to a group that included Greenspan in 1986.

Reagan, an undergraduate economics major with a lifelong interest in capitalism and markets, had been deeply influenced by Milton Friedman and, as a fellow supporter of free markets, might appear to be a natural ally of Greenspan’s. But, as I indicated earlier, Friedman and Greenspan differed on many important issues.

Moreover, Greenspan had advised Presidents Nixon and Ford, who came from a different Republican tradition than Reagan, so it took Greenspan some years in a helping role before Reagan saw fit to promote him to the top economic job in U.S. government, the chairmanship of the Federal Reserve.[3] Although Greenspan sought the Secretary of the Treasury’s job, he instead served, early in the Reagan administration, as “quiet counselor” to the “bumptious” David Stockman, the president’s budget chief who later resigned from the administration in a dispute over balancing the budget.[4]

Supply-side economics versus traditional balanced-budget conservatism

Greenspan’s new position was more reflective of his early self-assessment as a “sideman” than of his later towering ambition. He played a mediating role between the classic budget-balancing conservatism of Friedman (and Stockman) and the aggressiveness of the tax-cutting supply siders, such as Arthur Laffer, who had been Reagan’s biggest boosters before his election.

While these may seem like small doctrinal differences to an outsider, they were crucial to determining how Reagan would govern. A third of a century later, Reagan is best remembered for massive tax cuts, deficit spending and the rekindling of economic growth that had become dormant. This legacy represents the victory of the supply-siders, a setback for the more cautious Greenspan. But Greenspan, accustomed to being “a minority of one,” swallowed his discomfort and fell in line behind the president.

It was not entirely a bad decision. The tax cuts, combined with deregulation and other reforms, set off a two-decade economic boom, and would have been politically unachievable if they had to be matched by corresponding spending cuts. The formula of cutting taxes now to increase long-term economic growth later, so that the tax cuts would eventually pay for themselves, was risky – George H. W. Bush called it “voodoo economics” – but it was ultimately successful. (Kennedy did it first.)

The Fed chairmanship: replacing a legend

By 1987 it was clear that Paul Volcker’s heroic tenure as Fed chairman would come to an end; having been reappointed by Reagan for an atypically short term, Volcker was feuding with the Republican administration. But Volcker was still revered for having brought the Great Inflation of the 1970s to an end by triggering two recessions with sky-high interest rates. (While he drew much fire for the recessions, in the long run inflation is by far the greater danger, destroying savings, distorting incentives and rearranging the terms of agreement between debtors and creditors.)

On June 1, 1987, Volcker announced his resignation, suggesting as a replacement either John Whitehead, of Goldman Sachs, or Greenspan. Having by this point gained Reagan’s confidence as the “Republican Volcker,” a man who would continue the hard-money policies needed to keep inflation on the downswing, Greenspan was selected. The “sideman” was in the center of the world’s financial power structure.

The crash of 1987

New Fed chairs are usually tested by the markets soon after they take office, and Greenspan’s test was spectacular. On October 19, 1987, five months into Greenspan’s tenure, the S&P 500 fell 20.4% in one day, about as much as it falls in a typical year-long bear market. This crash came at the end of a succession of down days, so the top-to-bottom decline was 33% in a two-month period. This decline was matched by drops in every stock market in the world, with only Japan falling less than 10%.

Although the market had never fallen that much in one day before, declines of that magnitude over longer periods had historically been followed by depressions or severe recessions. (For comparison, the one-year decline in 2008, the worst single year in decades, was 37%, and the top-to-bottom decline between 2007 and 2009 was 57%.) While privately Greenspan was very worried, he tried to reassure the markets: “The Federal Reserve, consistent with its responsibilities as the nation’s central bank, affirmed today its readiness to serve as a source of liquidity to support the economic and financial...
system.” In just two days, on October 20 and 21, the market recovered 57% of its October 19 loss.

While there was more volatility in late 1987, there was no recession and the market moved to new highs by 1989. The brief but dramatic crisis was over. Greenspan, a hard-money man, had used easy money – an infusion of liquidity into the financial system to prevent a 1929-style panic and depression – and his reputation as an exceptionally skilled Fed chair was established only a few months into his first term.

The dot-com years and irrational exuberance

By the mid-1990s, the crash of 1987 was half-forgotten. What the journalist Kevin Kelly called the Long Boom was making Greenspan look like a genius. Of course, Greenspan had nothing to do with the technological innovations that were underfoot. He did, however, pursue a pro-growth monetary policy that would have spooked less confident Fed chairs into raising interest rates sharply to stave off inflation. Greenspan thought that technological change meant inflation was headed lower, not higher, and he was right.

Still, Greenspan remained a hard-money advocate, in contrast to his critics’ view that he had gone soft in the crash of 1987 and remained soft thereafter. In meetings when other Fed economists pushed for a 2% inflation target, he argued that the right inflation rate, “properly measured,” was zero – otherwise, “if the Fed’s explicit policy was to devalue the currency by 2% per year, was it not perpetuating a fraud on the saving public?”[5]

In late 1996 the stock market was soaring and corporate bond yield spreads over Treasury bonds had dwindled to tiny amounts, as though corporate bonds had no risk. At an American Enterprise Institute dinner in December of that year, Greenspan gave a lengthy presentation that, according to Mallaby, put the audience half to sleep. (This was not unusual; Greenspan is not an inspiring speaker.) At the end of his talk, Greenspan wondered out loud, “How do we know when irrational exuberance has unduly escalated asset values?”

They were the most famous words Greenspan would ever utter. Reporters seized on them and the stock and bond markets opened dramatically down. Robert Shiller, who would later win a Nobel Prize partly for the work in his book, *Irrational Exuberance*, remembers:

Immediately after he said this, the stock market in Tokyo, which was open as he gave this speech, fell sharply, and closed down 3%. Hong Kong fell 3%. Then markets in Frankfurt and London fell 4%. The stock market in the U.S. fell 2% at the open of trade.[6]

Greenspan did not want this kind of power. While he was glad that his concerns were noticed, Mallaby recalls,

Greenspan almost reveled in his lack of influence… By speaking out, he had preserved his intellectual integrity…But by failing to make an impact [other than in the short run], he was absolving himself of responsibility to do more: the stock market was not his problem, because there was little he could do about it.

Greenspan thought it was not the Fed chairman’s job to move markets. It was the markets’ job to move the Fed. Thereafter, his famously vague utterances became even vaguer.

Yet the markets continued their march upward for three more years, right up to the last day of the millennium and, briefly, for a few weeks in the new one. Then all hell broke loose. In the first three years of the 21st century, the United States was attacked, the stock market fell by half, and the economy entered a recession. The bursting of the tech bubble was the main economic event, driving the tech-heavy NASDAQ index down 79% from top to bottom, a Great Depression-like decline.

Nevertheless, the 2000-2002 bear market was orderly, with almost none of the panic that would characterize the crash of 2008. To prevent the recession from worsening and to lock in the economic gains from the prior boom years, Greenspan cut interest rates very aggressively, with the Federal funds rate reaching 1% at the bottom of the recession in early 2003.

This stance caused some observers to question his commitment to hard money and made at least a few wonder whether the Fed would run out of ammunition in a really serious crisis — a worry that would become vitally relevant in the 2007-2009 decline, which occurred under his successor Ben Bernanke’s watch. But this time, the worry was premature: the economy recovered strongly and most measures of economic activity hit new highs in 2005 and 2006. Greenspan’s last term as Fed chair ended on January 31, 2006.

Too much praise

As Greenspan’s chairmanship came to an end, the praise he was receiving in the media and from other public officials
reached the silly stage. He was widely nicknamed the Maestro, as if the economy were an orchestra and he were conducting it masterfully, with each player doing exactly what Greenspan wanted.

Of course, the economy is not an orchestra, and no Fed chairperson is a maestro. Economic agents do what they think is in their best interest, guided by incentives over which the Fed has limited influence. The Fed only controls monetary policy – in Ben Bernanke’s words, a “blunt tool.” You wouldn’t successfully control an orchestra, much less an economy consisting of hundreds of millions of independent agents, with such a blunt instrument.

Still, Greenspan was described as a “living legend” - “the maximum maximorum.” Economists Alan Blinder and Ricardo Reis, in a sophisticated, serious paper presented at the Fed, said Greenspan had “a legitimate claim to being the most successful central banker who ever lived.”[7]

From that height, one can only fall.

It is to Greenspan’s credit that he did not fall much farther than he did. He has been blamed – I think unfairly – for the crash of 2008 and the weakness of the subsequent recovery. Are we really going to fault one man and one institution, no matter how great their apparent power, for the failure of the financial sector to self-regulate in the face of overwhelming incentives to do otherwise? Greenspan’s ability and integrity have never been seriously questioned, only his apparently single-minded determination to advance economic growth despite mounting evidence that leverage and liquidity risks were building in the financial system.

**How should we judge Greenspan?**

While Mallaby generally approves of Greenspan’s conduct in office, he acknowledges that Greenspan had weaknesses including the desire to go along to get along in public life, rather than always adhering to economic logic. Other commentators have been harsher. Greenspan is widely blamed for inflating asset prices – including the prices of housing as well as equities and bonds – to the point of bursting, and of presiding over an era of loose banking oversight that led directly to the 2008 crash and the subsequent severe recession, which in some senses is still not over.

This critique of Greenspan’s tenure is wrongheaded and ignores the Nobel Prize-winning economist Robert Lucas’ dictum: “Economic growth is so important that it is hard to think about anything else.”[8] Presiding over the fastest growth since the 1960s, Greenspan did not want to shut off the spigot with higher interest rates for two reasons: (1) the Fed’s mandate is price stability and there was no evidence that inflation was increasing, and (2) more importantly, growth is tremendously valuable. Usually the economy is stable, but when the Four Horsemen of the Apocalypse ride, destroying wealth and opportunity, as they inevitably do sooner or later, you want as high as starting point as possible! For providing the monetary support for the last great expansion, Greenspan is a hero, not a goat.

**Greenspan and the housing bubble**

Moreover, the crisis associated with the bursting of the housing bubble in 2007-2009 was not the result of Fed policy keeping interest rates too low for too long. We have had low interest rates many times before, in the 1930s, 1940s, and 1950s, and in 2000-2002, and there was no housing bubble in any of those episodes.

The housing bubble and crash was due to a confluence of unfortunate circumstances, complex and hard to control, of which low interest rates were only one component. One such circumstance, according to the American Enterprise Institute scholar Peter Wallison, was the congressional mandate requiring Fannie Mae and Freddie Mac to make a specified portion of its loans to low-income and (separately) very-low-income households.[9] This could not have been the only cause, though, because houses owned by high-income households also inflated and then deflated.

Furthermore, at the peak of the housing bubble, Greenspan had raised interest rates to 5.25%, relatively high by modern standards – any higher and politicians and borrowers would have screamed bloody murder. It is not always possible to control asset bubbles through Fed policy and there is nothing in the Fed’s mandate saying it should try.

**Greenspan and bank supervision**

But Greenspan could have overseen banks more closely. Why? Because the Fed is charged with the responsibility of supervising and regulating the banking system as well as governing the money supply. When many banks become so leveraged that they effectively become risky hedge funds instead of safe depository and lending institutions, it’s the Fed’s responsibility to pull in the reins so it can avoid an expensive bailout or bank failure later.

This lesser critique of Greenspan’s tenure is valid, and conforms to his later insight that he “found a flaw” in his...
freewheeling view of the way financial markets and institutions should function. The flaw was the age-old conflict between principals and agents, causing managers of financial institutions, pursuing their own bonus-seeking interests, to take extraordinary risks with other people’s money, endangering the institutions they were supposed to be protecting. Every economics student knows about principal-agent conflicts; Greenspan should have thought more carefully about them.

Conclusion

Sebastian Mallaby's prose is well-crafted and easy to read, even if it lacks the brio of a Michael Lewis or the erudition of a Peter Bernstein. He had “almost unlimited” access to Greenspan, so his account of the man’s career is richly detailed. The most valuable contribution of the book is the way that it connects Greenspan’s decisions to his unique take on economic theory, data and reasoning. Anyone interested in the recent history of the United States through the eyes of one of its greatest figures should allocate some serious time to reading The Man Who Knew.

Larry Siegel is the Gary P. Brinson Director of Research for the CFA Research Foundation. Prior to that, he was director of research in the investment division of the Ford Foundation. He is a member of the editorial boards of The Journal of Portfolio Management and The Journal of Investing and serves on the board of directors and program committee of the Q Group. He may be reached at lbsiegel@uchicago.edu.


[3] To be precise, chairman of the Board of Governors of the Federal Reserve System. In central banking, “governor” (not “president”) is the highest term of respect and is given to those really in charge. The presidents of the regional Federal Reserve banks have less influence.


