It's All About Alan

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In an article in the March 11, 2009 Wall Street Journal, "The Fed Didn't Cause the Housing Bubble", Alan Greenspan, the number one government scapegoat for the housing bubble and financial crash, defends himself and blames … China.

Introduction

In an article in the March 11, 2009 *Wall Street Journal*, "The Fed Didn't Cause the Housing Bubble", former Federal Reserve Chairman Alan Greenspan defends himself from the chorus of charges blaming him for the housing bubble and financial crisis[1]. Since the sub-prime mortgage crisis surfaced in 2007, conservative, libertarian, and business sources have repeatedly fingered Alan Greenspan and the Federal Reserve as the culprit for Citigroup and other giant banks huge sub-prime losses in 2007 and rapidly expanding sub-prime, Alt-A, prime, and so forth losses in 2008 and 2009. Alan Greenspan and the Federal Reserve remain the leading government scapegoat for the fiasco, with the government sponsored enterprises Fannie Mae and Freddie Mac and the Community Reinvestment Act (CRA) as the other two major scapegoats[2,3,4,5,6,7,8,9,10,11,12].

Leading the lynch mob is Alan Greenspan's "good friend and former colleague, Stanford University Professor John Taylor". Professor Taylor, also a senior fellow of the conservative Hoover Institution, penned an article in the February 9, 2009 *Wall Street Journal* in large part blaming the Federal Reserve for the housing bubble and financial crisis[13]. Professor Taylor is also the author of the recent book *Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis* from Hoover Institution Press. The basic notion is that the Federal Reserve kept interest rates too low from 2003 to 2005 relative to Professor Taylor's eponymous "Taylor Rule" and this somehow caused the housing bubble.

Needless to say, Greenspan does not agree with Professor Taylor's diagnosis. Greenspan emphasizes that the Federal Reserve only directly controls short-term rates, specifically the federal funds rate, claiming that low long term interest rates caused the housing bubble. His explanation:

As I noted on this page in December 2007 ***[after the first sub-prime crisis]****, the presumptive cause of the world-wide decline in long-term rates was the tectonic shift in the early 1990's by much of the developing world from heavy emphasis on central planning to increasingly dynamic, export-led market competition. The result was a surge in the growth in China and a large number of other emerging market economies that led to an excess of global intended savings relative to intended capital investment. That ex ante excess of savings propelled global long-term interest rates progressively lower between early 2000 and 2005.*

It should be noted, before dissecting Greenspan's illogical arguments, that Alan Greenspan and the Federal Reserve did not cause the housing bubble nor the financial crisis. Banks such as Citigroup, Bank of America, and so forth *decided* to either make unsound loans or purchase unsound loans. Home buyers *decided* to borrow money and buy houses at highly inflated prices sometimes based on false or inaccurate information from luminaries such as Alan Greenspan. Neither low short term nor low long term interest rates force banks to make unsound loans. In fact, the banks have a fiduciary responsibility to make sound loans. In this, Alan Greenspan is completely correct to assert that the Fed didn't cause the housing bubble, but this is not the argument that he makes in his article.

In particular, as the housing bubble inflated, the banks now in trouble abandoned traditional lending standards dating back over fifty years, supported by decades of lending data. They clearly ignored long standing rules of thumb about the maximum percentage of income that can be safely devoted to house payments. These rules can be found in numerous pre-bubble books on housing and real-estate. For example:

...brokers say you should only spend between 25 and 33 percent of your monthly gross (before taxes) pay on housing[14].

Even more egregiously, in some cases, the banks made loans with no down payment and without verifying the income of the loan applicants, something that takes at most a few weeks part time (send a letter to the loan applicant's employer requesting confirmation of income and duration of employment).

The standard down payment is 20 percent of the sales price of the home. If the home costs $100,000, a conventional lender would require that you have $20,000 in cash for a down payment plus closing costs. ***The reason lenders ask for 20 percent down is that home owners with a large equity stake in the home are less likely to default on the mortgage than those home owners with a smaller equity stake. [emphasis added]***[15]

Had these traditional lending rules been followed, the housing bubble would have died in infancy and few loans would be now in trouble.

Banks also adopted a wide range of confusing and *unproven* adjustable rate mortgages (see below), not on a prudent trial basis where even a total loss could be absorbed but on a massive scale. No long term lending data on the default rates for these novel adjustable rate mortgages, often with confusing teaser rates, could have existed in 2001.

While the Federal Reserve as a major banking regulator probably had the power to stop these dubious practices and obviously did not, the Federal Reserve did not *force* banks to adopt these bad lending standards[16].

Conservative, libertarian, and business sources have a long history of blaming bad economic and financial news on the Federal Reserve[17,18]. When the economy is going well, this is the "miracle of the market". Individual business leaders and "entrepreneurs" are touted as supermen who are "creating wealth" and "adding value". When the bubble bursts, the Federal Reserve monetary policy was too tight or too loose. Alan Greenspan has been accused of both[19]. Monetary policy is a fact of life. Governments are never going to stop setting monetary policy. This is a basic function of government. A gold standard is also a government monetary policy; the government sets the gold standard by law and by accepting gold as payment for taxes and government fees. Businesses can protect themselves from changing monetary policy through contracts that take monetary policy into account such as contracts with automatic inflation adjustments.

Now for Alan Greenspan's illogical arguments:

First, long term and short term interest rates are not unrelated. Long term rates often follow short term rates up or down in response to Federal Reserve actions. Second, the housing bubble was driven by adjustable rate mortgages or ARMs which are closely tied to *short-term rates*, not long term rates, unlike the traditional 30 year fixed rate mortgages. Alan Greenspan actually urged homeowners to take out ARM loans instead of fixed rate mortgages during the bubble[20,21,22,23]. ARM rates fell unusually low both in absolute terms and relative to standard 30 and 15 year fixed rate mortgages during the 2003 to 2005 period in question.

Month and Year[24]	**30 Year Fixed**	**15 Year Fixed**	**1 Year ARM**
January 2001	7.03	6.64	6.70
January 2002	7.00	6.48	5.18
January 2003	5.92	5.30	3.99
January 2004	5.74	5.04	3.85
January 2005	5.71	5.17	4.12
January 2006	6.14	5.71	5.17
January 2007	6.22	5.97	5.47
January 2008	5.78	5.32	5.27

Table 1 US Mortgage Rates

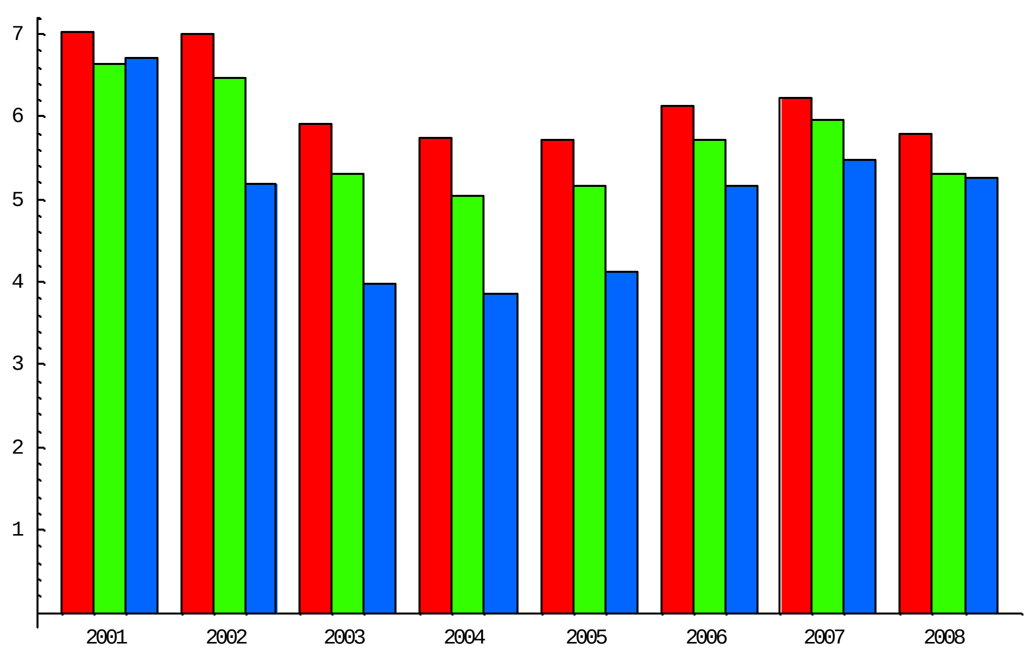

Figure 1 Mortgage Rates (2001-2008)

Notice that both long term mortgage rates and ARM rates drop during the contested 2003 to 2005 time period when Federal Reserve monetary policy was very loose, too loose according to the "Taylor Rule". The ARM rates (blue bars in Figure 1) drop much more sharply as might be expected. Keep in mind that these are "conforming" ARM rates tracked by Freddie Mac, tied to Treasury note rates and not for example the very short term LIBOR (London Interbank Offered Rate), and do not represent the many dubious ARM loans made during the housing bubble, often with confusing teaser rates.

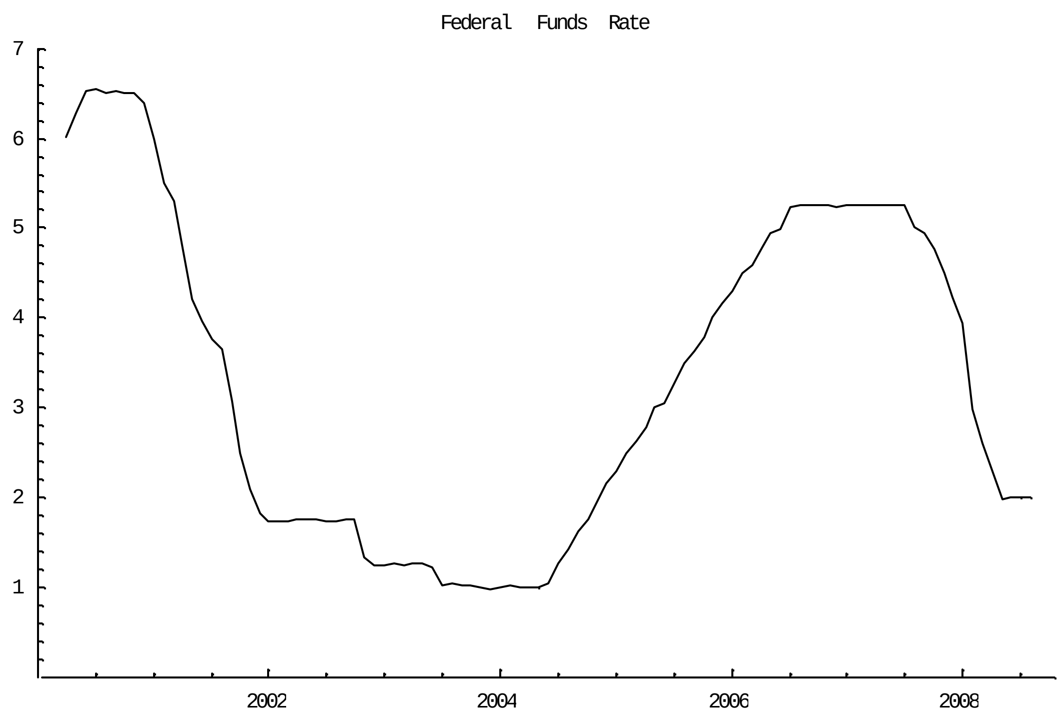

Figure 2 Federal Funds Rate

Looking at the federal funds rate data from the Federal Reserve Bank of New York (Figure 2), one can see that the federal funds rate was quite low from 2002 through mid 2004. The Federal Funds rate was presumably lowered to counteract the recession in 2001 and the aftermath of the September 11, 2001 terrorist attacks. Curiously, Alan Greenspan was promoting ARM mortgages only a few months before the Federal Reserve began to raise rates which would have been expected to raise the ARM rates – as in fact appears to have happened.

Third, what tectonic shift? China is not a free market economy. Newsflash. *China is a communist dictatorship.* China remains highly centrally planned. The Chinese exporters are either directly owned by the Chinese government or funded by Chinese government banks[25]. China has a fixed currency relative to the dollar, in clear violation of the selectively applied World Trade Organization (WTO) "free trade" agreements. China's massive move into exports, especially advanced manufacturing, research and development, and electronics is a centrally planned government policy that probably drains vast resources out of China's poor rural regions.

There is no doubt that businesses from WalMart to Microsoft like cheap Chinese goods and services. There is little doubt that they have made substantial profits in the short term from reselling cheap Chinese goods and services. This does not mean China is not a centrally planned communist economy with some market features pasted on. When businesses profit from government intervention or ownership, conservative, libertarian, and business sources such as the *Wall Street Journal* start applying labels such as "market-based" or "free market" or "market economy" independent of reality. In the long run, it is likely that China will pull the plug on the US, redirecting its resources to its own people, leaving the companies dependent on Chinese subsidies in serious trouble.

Year[26]	**US China Trade Deficit (millions of US Dollars)**
1996	**-39,520.2**
1997	**-49,695.5**
1998	**-56,927.4**
1999	**-68,677.1**
2000	**-83,833.0**
2001	**-83,096.1**
2002	**-103,064.9**
2003	**-124,068.2**
2004	**-161,938.0**
2005	**-201,544.8**
2006	**-232,588.6**
2007	**-256,206.7**
2008	**-266,332.7**
Total (1996-2008)	**-1,727,490.0**

Table 2 US China Trade Deficit

Assuming that the US Census Bureau Foreign Trade Statistics are accurate, China has US currency reserves of about $1.7 trillion (the sum of all US China trade deficits from 1996 to 2008). About $1.4 trillion of these US currency reserves were accumulated between 2001 and 2008. These reserves, about $1.7 trillion, could finance the purchase of 3.45 million homes costing $500,000 each. Thus, arguably, China alone *might* have been able to provide the funds for the housing bubble either directly through purchases of mortgages or mortgage backed securities or indirectly. If the US China trade deficit is substantially larger than the official figures indicate, then China might have US currency reserves substantially in excess of $1.7 trillion. Curiously US banks such as Citigroup, Bank of America, Goldman Sachs, Morgan Stanley, and so forth seem to have trillions of dollars in bad mortgages, not the government of China (so far).

Year (Quarter)	Real Home Price Index[27]
1995	110.2707
1996	109.9246
1997	109.6387
1998	113.0745
1999	119.4819
2000	126.2996
2001	133.0421
2002	142.0489
2003	153.0958
2004	168.3678
2005	189.1465
2006	202.8297
2007.125	194.5344
2007.375	188.7413
2007.625	183.9739
2007.875	173.6275
2008.125	160.5215
2008.375	154.2611
2008.625	145.3831
2008.875	136.9689

Table 3 US Real (Inflation Adjusted) Home Prices

Figure 3 US Real Home Prices

Looking at real, inflation adjusted, US home prices, real home prices rose sharply from 2001 to 2006, peaked in 2006 and began to decline, tracking the decrease and subsequent increase in the federal funds rate and the ARM rates closely. In contrast, the US China trade deficit and presumably Chinese purchases of US Treasury and other securities continued to soar through the end of 2008. This is consistent with the Federal Reserve providing the bulk of the funding for the housing bubble.

Most importantly, whether the Bush Administration's tax cuts, the Federal Reserve's cheap money policy, China's massive purchases of US Treasury Bills and other US investments, or other sources made available funds for the housing bubble, how did any of these *cause* the housing bubble? Banks and home buyers made the decisions. No one forced them to make the mortgages. Why didn't the infallible market that both Alan Greenspan and the *Wall Street Journal* editorial page tout efficiently allocate the funds to productive capital investments, research and development, and so forth instead of a speculative housing bubble?

Greenspan closes with a paean to minimal government regulation, if not more deregulation -- perhaps more accurately described as *selective deregulation*. How "deregulated" is a market in which the Federal Reserve and the US Treasury routinely intervene in an ad hoc manner on behalf of a few large, politically connected financial firms such as Goldman Sachs and Citigroup? Greenspan repeats the typical conservative, libertarian, and business line that things have never been better, all due to the miracle of the market:

Global market competition and integration in goods, services and finance have brought unprecedented gains in material well being.

Implicitly, the current financial crisis is just a fluke, not indicative of fundamental problems with the economy. Our vast, incredibly expensive financial system, approaching 10% of Gross Domestic Product[28,29] now and costing over $2 Trillion in federal bailouts so far, and computer technology is somehow boosting productivity and raising the standard of living to unprecedented heights, all in the absence of the substantial advances in power and propulsion technology that usually accompany a large increase in the standard of living.

Is this rosy view really accurate? Most official economic figures, especially widely watched numbers such as the unemployment rate and the inflation rate, have been remarkably good for about fifteen years, since revisions to the way the numbers were calculated in the early Clinton Administration. For example, the unemployment rate from the Bureau of Labor Statistics household survey, the unemployment rate usually cited in news reports, and similar figures from the BLS establishment survey diverged dramatically during the 2001 to 2003 period with the establishment (or payroll) survey showing a so-called "jobless recovery" in sharp contrast to the rosier household survey:

Both surveys contain valuable information about current economic developments, but, as with all economic statistics, the data from both surveys are imperfect. The Bureau of Labor Statistics has stated that the establishment survey is generally the more reliable indicator of current trends in employment. ***Still, the explanation for why these two surveys' results have diverged so markedly over the last few years, and what this might indicate about the economic recovery, remains a puzzle*** *[emphasis added][30].*

Can we trust these official numbers which often do not match the everyday experience of Americans outside of the sheltered elite like Alan Greenspan and former US Senator Phil Gramm?

Most importantly, Americans seem to work much longer, more hours, for a seemingly similar standard of living to that of the 1970s, thirty years ago. Americans still have houses or apartments, cars, a few children, televisions, all the same superficial measures of prosperity.

There has been no catastrophic drop in the standard of living, not like the Great Depression (yet). But it looks like people are working longer hours for these items. Both parents usually work full time and full time is often more than the forty hour work week of the 1970s. Jobs seem less secure. Household debt seems much higher as the current economic crisis illustrates dramatically.

Certainly, there have been significant and visible advances in computer and electronic technology. This is nothing new. There have been steady advances in electrical and electronic technology since at least the early nineteenth century: telegraphs, telephones, radio, television, and so forth. Many other areas such as aviation, rocketry, propulsion, power systems, and so forth have slowed or stagnated in recent decades compared to the rates of advance typical in the nineteenth and early twentieth century: low pressure steam engines, high pressure steam engines, internal combustion engines, jet engines, rocket engines, nuclear fission. Electronic gadgets like Blackberries and personal computers stand out in recent decades because more substantive technological advances in other fields have not occurred. The recent run-up in food and energy prices illustrates graphically how much more important these other areas are to the global economy.

Perhaps nothing illustrates this ominous state of affairs more poignantly than the bizarre spectacle of physicists and other technical professionals (like Henry Paulson's sidekick Neel Kashkari, formerly a NASA engineer), having failed to produce substantive advances in their own fields, tramping to Wall Street to produce the computerized financial models implicated in the current financial crisis[31,32,33,34,35,36]. This certainly does not look like either a prudent or an efficient allocation of research and development skills and capital in the global economy. This lack of progress should also raise serious questions about the general direction and approach of present day research programs, primarily funded and directed by agencies such as NASA, DOE, NIH, and so forth.

Alan Greenspan and the Fed contributed to the housing bubble and financial crash. They did not cause it. In blaming their former idol Alan Greenspan and other government scapegoats, conservative, libertarian, and business sources are avoiding facing the dismal substantive results of literally trillions of dollars in "investments", first in dubious dot coms and telecom companies in the 1990s and now in a speculative housing bubble, *made by businesses*.

About the Author

John F. McGowan, Ph.D. is a software developer, research scientist, and consultant. He works primarily in the area of complex algorithms that embody advanced mathematical and logical concepts, including speech recognition and video compression technologies. He has many years of experience developing software in Visual Basic, C++, and many other programming languages and environments. He has a Ph.D. in Physics from the University of Illinois at Urbana- Champaign and a B.S. in Physics from the California Institute of Technology (Caltech). He can be reached at jmcgowan11@earthlink.net.

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