I am pleased to have been invited to address the MVEA this year on the State of the Economy. I think I might actually be able to contribute to our understanding of the issues by focusing on the Greenspan legacy and the Bush budget. My remarks this evening, especially on money matters, will entail a heavy dose of stocktaking. But this approach to the topic could hardly be otherwise. A fresh look at the path actually traveled (and at the roots of Greenspan’s thinking) can give us a healthy understanding of where we now are—and possibly of where we might be headed.

Further, the timing seems right for a retrospective on the Greenspan Fed. At 79 years of age and scheduled to retire at the end of January of next year, this second-longest serving Fed Chairman is worthy of some attention. What is his vision of the economy? And how have his pronouncements and policy moves, often shrouded in mystery, related to that vision? It has been widely recognized that when Greenspan leaves, he won’t be leaving a rule book behind. Hence, plausible answers to my vision questions may be the next best thing. And those answers may be revealing about the State of the Federal Reserve if not also about the State of the Economy.

Little known—or at least underappreciated—is the fact that Greenspan’s earliest exposure to the issues of central banking consisted of his reading and even lecturing on the Austrian theory of the business cycle as set out by Ludwig von Mises and developed by Friedrich A. Hayek. As reported by Justin Martin in his popular biography of *The Man Behind the Money* (2000, pp. 35-52) Greenspan was involved in—indeed, immersed in—Ayn Rand’s philosophy of Objectivism during his formative years, from his late 20s to his early 40s. Beginning as early as 1954, Greenspan joined the Randians in their discussions not only of Rand’s philosophical writings but also of the economics that Rand took to be most compatible with her views, namely the economics of the Austrian school. They discussed the dangers of central banking generally and, predating the monetarist counterrevolution, they discussed the Federal Reserve’s errant policies that brought on the
Great Depression.

Beginning with the establishment of the Nathaniel Branden Institute in 1958 (Branden was Rand’s protégé), Greenspan gave lectures on the Economics of a Free Society. He included much about central bank policy and business cycles. Following Mises, he favored the gold standard and was strongly opposed to central banking. Greenspan’s lectures were given in New York, sometimes with Ludwig von Mises in the audience, and were made available on tape in some 30 cities across the country. (I’ve had the benefit of seeing notes on some of these lectures taken by Sam Bostaph, currently Chairman of the Department Economics, University of Dallas.) The nature of the opposition to central banking is conveyed by a particularly vivid metaphor attributed to Greenspan by Nathaniel Branden (1966, p. 80): Putting a central bank in charge of the money supply is like putting a penny in the fuse box.

The Austrian theory is a theory of boom and bust. Focusing on the late 1920s, when the Fed lowered interest rates to stem the flow of gold from Britain, Greenspan drew on the Austrian theory to show how this international cooperation led to domestic disaster: “The excess credit which the Fed pumped into the economy spilled over into the stock market—triggering a fantastic speculative boom” (Greenspan, 1966, p. 100). The Fed eventually broke the boom, Greenspan went on to explain, but its manipulation of interest rates broke the economy as well. Picking up on Greenspan’s metaphor, we can say that substituting the penny (Fed-determined interest rates) for the fuse (market-determined interest rates) is fraught with danger, and the subsequent blowout can leave the economy in a state of depression.

Branden’s account of Greenspan’s metaphor makes it clear that the mechanisms being protected by the fuse (and threatened by the Fed) are the mechanisms of the loan market, very broadly conceived. These are the mechanisms that allocate resources intertemporally. If undisturbed by the central bank, the loanable-funds market keeps investment, which is reflected by the demand for loanable funds, in line with saving, which constitutes the supply of loanable funds—and structures the production process so that the timing of consumable output is consistent with consumer preferences.

Thinking in real terms, we see that it is investable resources that are being supplied and demanded. The interest rate that strikes a balance between saving and investment—and hence maintains an intertemporal equilibrium—is called the “natural rate”—a term borrowed by the Austrians from the Swedes. The “natural rate” traces to Knut Wicksell and his 1898 book, *Interest and Prices*. By implication, an “unnatural rate,” as might be imposed upon the macroeconomy by a politically motivated central bank, creates an imbalance between saving and investment. An unnaturally, or artificially, low rate of interest causes investment to outpace saving, misallocates the investable resources intertemporally, and sets the economy off on an unsustainable growth path. This is the Austrian theory.

There is no evidence that Greenspan has ever explicitly rejected the Austrian theory in some wholesale fashion—or that he has ever rejected the philosophy of Objectivism, for that
matter. He still considers Rand a serious thinker and credits her articulating the moral dimension of capitalism (Martin, 2000, p. 52). And we can note, in fact, that Rand herself was on hand at the White House when Greenspan was sworn in as Chairman of the Council of Economic Advisors in 1974.

Dating from before Greenspan became Fed Chairman in 1987, The Fed had reverted to targeting interest rates instead of targeting some monetary aggregate. The short-lived monetarist experiment—if it could even be called that—had fallen victim to monetary deregulation. MV still equaled PQ, but velocity had gone silly, and money had become more difficult to distinguish from saving. Interest rates were seen not as an alternative guide to money management but as the only guide. According to Greenspan, as reported by Bob Woodward (2000, p. 63) those who still advocated Friedman’s monetary growth rule were simply out of date. Woodward explained: “The Fed couldn’t even measure the money supply accurately, let alone control it.”

Nonetheless, it is instructive to locate the natural rate of interest, which is so critical to the Austrian theory, within the monetarist tradition. While no interest rate makes any direct appearance in the equation of exchange, Milton Friedman included an interest rate as one of the minor independent variables in his money-demand function. It represented an opportunity cost (forgone interest) of holding money. Though his point was that this interest rate is a minor variable, his critics labeled him a Keynesian for including it at all. Keynes’s argument, of course, was that the interest rate—or, rather, expectations about future movements in the interest rate—dominate the money-demand function.

This brief detour into monetarism and Keynesianism is old stuff. My point is that it has nothing to do with the natural rate of interest. The natural rate appears—though behind the scene—on the other side of the equation of exchange. The Q in MV=PQ stands for the economy’s output; the rate of interest governs the intertemporal structure of the resources that yield this output. More specifically, the rate of interest allocates resources to long-term, intermediate-term and short-term undertakings, thus giving shape to the time profile of the subsequent consumption. A low market rate of interest, for instance, favors long-term undertakings and pushes consumable output some distance into the future. The natural rate of interest is the rate that is consistent with resource availabilities, technology, productivity, and the preferred temporal profile of output. In a phrase, it is the rate that is consistent with sustainable economic growth.

It follows by logical extension that a rate of interest below the natural rate will set the economy off on an unsustainable growth path. Too many resources will be allocated to long-term undertakings. The unemployment rate may well be low during the early phases of the boom, but in the end, the boom will fail and a high unemployment rate will characterize the piecemeal realignment of resources with economic realities. Again, this is the Austrian theory, and this is the theory that Greenspan exposited in the mid 1960s under the auspices of the Nathaniel Branden Institute. This is the theory that Branden himself exposited in the very article in which he attributed the penny-in-the-fuse-box metaphor to Greenspan.
We can note here that the natural rate plays no role in Keynesian theory because Keynes assumed throughout his *General Theory* (1936) a fixed structure of industry. The issue of allocation within the output magnitude was thus summarily removed from consideration. The natural rate of interest plays no role in Friedman’s monetarism because Friedman took it on the authority of Frank Knight that the issues of capital and interest could be safely ignored in this context. Knight judged the Austrian theory to be unworthy of attention, and Friedman adopted the view that theorizing about the actual make-up of the output magnitude could safely be left to the microeconomists.

Is there evidence that Greenspan has had the Austrian theory in mind—even if only in the back of his mind—while managing the economy’s money supply? There is, I think, though not without some ambiguities and outright deviations. But it is not difficult to point to several aspects of Greenspan’s thinking that are suggestive of, consistent with, or resolvable in terms of the Austrian theory. I list five hints that Austrian theory is the underpinning of the Greenspan vision:

1. There is no rational way of establishing that you’re in a bubble while you’re actually in it. You know for sure only when the bubble bursts. This is how Woodward (2000, p. 217) summarizes Greenspan’s thinking. This view of boom and bust is consistent with—virtually a corollary to—the realization that there is no way of knowing just what the natural rate of interest is. The natural rate is a market rate. But in a Fed-driven economy in which the rate of interest has been ratcheted up, ratcheted down, and then ratcheted back up, there is no way of establishing just what the interest rate would be in the absence of all the ratcheting.

2. Sustainable growth and unsustainable growth are integral to Greenspan’s thinking. And he worries, in this context, about interest rates being artificially low. Greenspan has indicated, for instance, that a credible federal funds rate is one that is “seen by the markets as the best rate for the economy, not as an artificially low rate influenced by political pressure” (Woodward, 2000, p. 62). An artificially low rate, of course, would give rise to an unsustainable boom—that is, a boom which inevitably goes bust. This is the Austrian theory.

3. Even Greenspan’s most famous phrase, “irrational exuberance,” is ripe for an Austrian interpretation. He introduced this phrase in late 1996, when stock prices were dramatically on the rise. It was an election year and, not so co-incidentally, a boom year. Arguably, the boom had been triggered—or, at least, bolstered—early in 1996 by “an artificially low rate influenced by political pressure.” Critics at the time suggested as much, and it was widely accepted in any case that Greenspan had signed on as a team player in the Clinton administration. But “irrational exuberance” is not quite the right phrase. A more descriptively accurate one might have been “policy-induced exuberance.” We might even wonder if Greenspan was cryptically chiding the market for being fooled by Fed policy. (Here, the old Austrian theory and the modern rational expectations hypothesis link up to show just why the exuberance was irrational.)

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4. Greenspan has earned a reputation for moving against inflation even before there are compelling signs of rising prices and wages—much to the chagrin of those who would make the supposed inflation-unemployment trade-off in the direction of inflation. This aspect of his policymaking is certainly understandable in terms of the Austrian theory, according to which the bust is brought on not by rising prices and wages per se, but by the misallocation of resources during the boom. And if the Austrian theory is in play here, then the real concern stems not from some anticipated price and wage inflation but from lingering worries about the Fed’s having lowered interest rates a number of months earlier—especially if that earlier monetary ease had political motivation.

5. At times Greenspan seemed to lose sight of his Austrian grounding. If he has been guided by the Austrian vision, it is a blurred vision. In fact, during the mid-1990s boom, Greenspan articulated a theory—or, at least, a belief—that ran completely counter to the Austrian theory. As Woodward reports, he persistently held to the belief—though a belief without proof—that productivity had increased on an economywide basis, creating what was popularly called the “New Economy.” Higher productivity would mean increasing output, which would hold price and wage inflation in check even as the Fed pursued an easy-money policy. His calculations, however, are especially revealing. Inexplicably, he made his estimates of the supposed increase in productivity on the basis of the assumption that non-labor costs are constant. Surely, though, this is a peculiar assumption for the Fed Chairman to make in light of the fact that non-labor costs include the cost of borrowing, which are impacted rather dramatically by Fed policy. Lower borrowing costs—a.k.a. artificially low rates of interest—get reflected in increased profits for a wide variety of business firms. If non-labor costs are (unjustifiably) assumed to be constant, then those increased profits will be mistakenly seen as evidence of a general increase in productivity. But since productivity gains are rarely across-the-board gains, it is much more likely that what Greenspan was observing was not some New Economy at all but rather the Old Economy goosed up by credit expansion.

This handful of particulars suggest that the Austrian theory underlies Greenspan’s thinking to a much larger extent than is generally recognized. Yet, as my fifth particular illustrates, the Austrian theory does not quite constitute the Greenspan Rule Book. By my account, Greenspan mismeasured the effects of an artificially low interest rate as increased productivity. The Austrian Rule Book would read: If the interest rate is artificially low, cut back on credit expansion. Greenspan’s increased-productivity-cum-New Economy interpretation would suggest that credit could be further expanded without causing inflation.

More fundamentally, the Austrian theory is critical of the very existence of a central bank, as implied by Greenspan’s penny-in-the-fuse-box metaphor (and by the first of my particulars). Once a central bank is up and running, there is no way for the natural rate of interest to reveal itself. Hence, the prospects of successfully targeting the natural rate are dim. And in any case, it would be ironic if the goal of the Fed were to keep the market rate of interest at a level that would have prevailed in the absence of a central bank.
I turn now to consider the implications of all of this for Greenspan’s successor and hence for the economy. It is interesting to contemplate the Greenspan legacy in the context of the post-Greenspan challenges. Greenspan’s successor will inherit neither a rule book nor even a consistent vision of the Fed in its relationship to the macroeconomy. And even the blurred vision—some unarticulated mutation of the Austrian theory—is not likely to be in play. It has existed only in the deeper recesses of Greenspan’s mind.

As suggested earlier, the Fed once had a choice between interest-rate targeting and money-supply targeting. But if the latter choice was out of date when Greenspan took charge of the Fed, it is even more so now. The large number of dollars in circulation outside the U.S. or in cash hoards outside the U.S. precludes any straightforward application of the equation of exchange. A global M plugged into an equation with an national PQ has no theoretical integrity and no policy implications. As I understand matters, even Milton Friedman has ceased recommending a money-growth rule. Possibly the only thing that remains of monetarism is the long and variable lag (between monetary expansion and price and wage inflation), which warns against adopting the policy of inflation targeting. By process of elimination, we can predict that Greenspan’s successor will rely on interest rates and credit conditions as the primary guides for managing the money supply.

In the post-Greenspan episode of interest-rate targeting, there are three factors that suggest a strong bias in the direction of inflation. First is the factor that I mentioned at the beginning of my remarks, namely, the Bush budget. Here, I need only remind you of what we all know. The Bush administration’s deficit spending—on the War in Iraq and Homeland Security and on relief programs for victims of hurricanes and earthquakes—is pushing the annual deficit towards the half-trillion dollar mark. Clearly, the Bush administration has not adhered to the principles of fiscal conservatism. And current trends indicate that Treasury borrowing, far in excess of a billion dollars per day, is increasingly accommodated by foreign lenders.

It is interesting to note, I think, that apologists for the deficit have switched in recent years from the old bromide “We owe it to ourselves” to a new one “We have access to world capital markets”—in other words, “We owe it to someone else.” It is not clear how either notion justifies the administration’s dismissive attitude toward the dangers of deficit finance. More likely, the dismissiveness is to be traced to Bush’s political base, which is characterized by religious or cultural conservatism and not by fiscal conservatism. From all appearances, a large budget deficit is to Bush conservatives what color is to a cat. (Fluffy is colorblind.)

The point of all of this, of course, is that any future reluctance of foreign lenders to buy increasing quantities of U.S. debt will translate into pressure on the Fed to accommodate the Treasury. How will Greenspan’s successor respond to that pressure? Fiscal conservatives are justified in worrying that debt monetization may be the order of the day—especially if the next Fed Chairman is focused on interest rates and credit conditions. Of course, one of the primary reasons for concern about fiscal irresponsibility is that out-of-control debt,
whether owed to “ourselves” or “others,” tends to get inflated away. What happened in Argentina just a few years ago could happen here.

A second factor suggesting a bias toward inflation is the increasing popularity among monetary economists of the so-called debt-deflation theory of the Great Depression. A debt-ridden economy that experiences deflation will suffer a self-reinforcing and ultimately debilitating increase in real indebtedness. This is the theme of Ben Bernanke’s *Essays on the Great Depression* (2000). Here, the focus has shifted from avoiding an unsustainable boom to countering the deflationary forces that may accompany the bust. A former member of the Board of Governors and now the Chairman of Bush’s Council of Economic Advisors, Bernanke is a “deflation hawk.” As a practical matter, a strong bias against even the possibility of deflation translates rather directly into a bias toward inflation. Last year’s interview with Bernanke in Minneapolis Fed’s *The Region* is revealing. When asked about the dangers of deflation, Bernanke made the case for inflation—whose purpose is to keep nominal interest rates appreciably above zero. With interest rates sufficiently high, the Fed would have room to respond whenever deflation threatened.

Still a third factor suggesting a bias toward inflation is the confidence factor—which may well dominate the early going of any new Fed Chairman. Whether warranted or not, confidence in Greenspan was high almost from the beginning of his appointment in August of 1987. Just two months after assuming the Chairmanship, the October stock market crash and consequent increased demands for liquidity put upward pressure on real interest rates. Greenspan pledged immediately to accommodate the demands for liquidity and followed through with a hefty increase in the money supply. The whole episode was a short-lived one, and Greenspan enjoyed the confidence of the financial community from that point forward. A case could be made that a dramatic increase in the demands for liquidity associated with a particular event is more easily dealt with than are chronic but irregular increases associated with nothing in particular. But the latter sort of increases are likely to plague a new Fed Chairman who has yet to gain the confidence of the financial community. These liquidity problems are not so easily detected and separated from other forces that may put upward pressure on interest rates. Nonetheless, the Fed is likely to respond to even a hint of a liquidity problem with monetary ease—all the more so if the new Fed Chairman is a deflation hawk.

And so there you have it: a new Fed Chairman, possibly a deflation hawk, with no rule book, trying to gain confidence while dealing with some unholy mix of demands for liquidity from the financial community and demands for deficit accommodation from the Bush Treasury.

May we live in interesting times. Let’s hope for the best—but not be too surprised if we see some serious inflation.
References:


Follow the economic glories and bumbles in the career of the previous Fed chair.Â In all honesty, the former chairman of the United States Federal Reserve Board is not the most intimidating man in the world. In fact, he studied the clarinet and saxophone at New York's Juilliard School before getting an economics degree and a Ph.D. that he conferred without a dissertation. He certainly does not inspire awe when compared to an economic giant like Bill Gates or a leader like Sir Winston Churchill, but when Greenspan speaks the world trembles.Â Greenspan will always be remembered as the Captain of the American economy when it was the biggest ship on the sea. He was not always right, but with a combination of patience and adaptability he was able to keep the ship on an even keel. Alan Greenspan KBE (/ˈælÉ™n ˈɡriËnspæn/; born March 6, 1926) is an American economist who served as Chair of the Federal Reserve of the United States from 1987 to 2006. He works as a private adviser and provides consulting for firms through his company, Greenspan Associates LLC. First appointed Federal Reserve chairman by President Ronald Reagan in August 1987, he was reappointed at successive four-year intervals until retiring on January 31, 2006, after the second-longest tenure in the position.