



EDITORIAL COMMENTARY

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Blame the Fed

By **SHLOMO MAITAL**

There's none so blind as a maestro who will not see a bubble.

Alan Greenspan, The "Maestro," won that title because so many people believed he saved America and the world economy when lesser men might have panicked and done rash things, or nothing at all.

On Oct. 19, 1987, just two months after his confirmation as Federal Reserve Chairman, the stock market fell 20%. Greenspan's 30-word sentence issued at 8:41 a.m. on Oct. 20 promised "a source of liquidity," which perhaps prevented a global recession.

In 1998, Greenspan and the president of the New York Federal Reserve Bank organized a quasiprivate bailout of Long-Term Capital Management. The hedge fund was registered in the Cayman Islands, beyond the Fed's legal jurisdiction, but its debts had soared to an estimated trillion dollars and threatened to topple major banks.

Two great accomplishments, but from 2001 to 2005 Greenspan helped create an unsustainable housing bubble through credit expansion and interest-rate cuts that ultimately led to the global crisis of 2008.

He denied this charge in an essay published this year by the Brookings Institution: "I fear that preventing bubbles will in the end turn out to be infeasible. Assuaging their aftermath seems the best we can hope for."

Invisible Bubbles

The current Fed chairman, Ben Bernanke, took up the theme, saying, "The Fed cannot reliably identify bubbles in asset prices."

Greenspan and Bernanke are fundamentally wrong on both counts. The Fed can anticipate asset bubbles and excess financial leverage because it bears much responsibility for creating both. And it can forestall them by changing its misguided policies.

Greenspan defines an asset bubble as a "protracted period of falling risk aversion that translates into falling capitalization rates that decline measurably below their long-term trendless averages." Translation: People incur debt to bid up prices because they expect to be wealthier in the future, and they're often wrong about that.

Many economists believe the Fed's radical interest-rate cuts between 2000 and 2003 led people to believe that their risk in borrowing was also low. Greenspan himself has cited a Wall Street Journal survey of Jan. 14, 2010, showing 77% of business economists thought "excessively easy Fed policy in the first half of the decade helped cause a bubble in house prices."

Greenspan's Fed slashed short-term federal-funds rates from an average of 6.24% in 2000 to 1.13% in 2003. The Maestro says the Fed saw the 1% rate "as an act of insurance against the falling rate of inflation in 2003 that had characteristics similar to the Japanese deflation of the 1990s." But he's trying to have it both ways, justifying active intervention to forestall predicted deflation and claiming the Fed cannot forecast and forestall looming asset bubbles.

Greenspan blames the decline in long-term interest rates on market forces—a "global savings glut." But there was no such glut. Massive Asian saving fed America's equally massive borrowing and spending, while American borrowing and spending created a seemingly secure place for Asian producers and savers to put the money they earned from selling stuff to the rest of the world.

Casino Housing

Due to low interest rates and easy money, U.S. house prices doubled between 1997 and 2006. Many Americans believed that they needn't save because their soaring home values were saving for them by creating wealth.

Greenspan said in his Brookings essay that homeowners would have taken large mortgages even if interest rates and terms were much higher and more disciplined. This is clearly false. Home buyers are sensitive to monthly mortgage payments, and they took on more debt to get more house for the same monthly payment.

The Fed missed the chance to generate early warnings of the impending mortgage crisis. In three forthcoming academic papers, Brown University economist Jerome Stein shows there were early-warning signals in 2005 that financial institutions were overleveraged. The tool he uses is one used by NASA to guide rocket trajectories, with the daunting name of stochastic optimal control.

Stein argues that optimal debt and leverage are not one-size-fits-all numbers but rather constantly changing variables that can and should be tracked and optimized.

In rocket science, stochastic optimal control continuously reads the position and orientation of the rocket, identifying very small unexpected changes in the flight path to predict the next unexpected changes and offset them as they happen—before they throw the rocket seriously off course. It's a statistical substitute for artificial intelligence.

Mechanical Maestro

Applied to economic analysis, stochastic optimal control would read changes in capital gains, interest rates, debt and supply and demand for goods and services, identifying excessive, unsustainable leverage and generating early-warning signals to change monetary policy. It would be a statistical substitute for the Fed's fine-tuning.

Stein shows that had SOC been used, it would have sounded alarm bells as early as 2005. The Fed has never used the tool Stein proposes, but surely it is at least worth a try. Quantitative analysts use sophisticated math to create risky instruments; why not use it as well to track risk?

Many economists and politicians -- but not Greenspan -- now realize that Greenspan's Fed failed to curb irrational exuberance during the dot-com asset bubble in 1996-2000 and the real-estate asset bubble of 2003-2007. Instead, the Fed waited for the bubble to burst, and then tried to clean up the mess.

This is Bernanke's policy now. Quantitative easing is a new way to create a bubble. Let the Fed refrain from creating bubbles, and there will be fewer messes to clean up.

There is a Hebrew saying that clever people can extricate themselves from disasters but wise people avoid them.

Greenspan and Bernanke say, in effect, that the Fed can only hope to be clever. It must be wise, or it must stop trying to be so clever.

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