CAUTIONARY TALES

Alan Greenspan's memoir is a lesson in heeding market warnings.

BY JOHN ILKIW

Alan Greenspan's recently published memoir, The Age of Turbulence, provides two cautionary lessons for us all: our ideologies and their consequent economic models can provide seriously flawed guidance to future events and they can blind us to flashing warning signals until it is too late.

The ideology and economic model used by Greenspan to guide his economic management of the U.S. economy are best summarized in his own words: "Free and competitive markets are by far the unrivalled way to organize the economy. We have tried regulation; none meaningfully worked." At the core of Greenspan's ideology is the principle that the self-interest of economic agents protects shareholder equity, including systemically critical lending institutions. Greenspan, at an October 23, 2008 Congressional hearing, conceded that his ideology and economic model were flawed: "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief."

Greenspan credits his early career discussions with Ayn Rand for his deep-seated belief in unfettered market competition and his decision to advance free-market capitalism as a government insider rather than an outside pamphleteer. The importance of Randian thinking in shaping Greenspan's faith in self-interest decision-making and his distrust of market regulation is underscored by Ayn Rand's attendance at his oath of office ceremony as the Chairman of the President's Council of Economic Advisors in 1974.

Greenspan's deep-rooted ideology seemed to blind him to the flashing warning signals of asset bubbles. While still publicly worried in 1999 that stock market prices might be too high—some two years after his "irrational exuberance" assessment—he stated that the Federal Reserve would not second-guess "hundreds of thousands of informed investors." Similarly, he recognized in 2006 that the U.S. housing bubble was being fuelled by subprime and interest-only mortgages, which he knew accounted for some 40% of the $3 trillion of home mortgage originations that year. In both situations, Greenspan concluded no policy or regulatory actions were needed. His memoir states that an equity bubble could only be addressed after the fact, and the benefits of broadened home ownership were worth the financial risk.

As further support for deregulation, Greenspan points proudly to product innovation in the fast paced financial sector, citing credit derivatives as an example. He emphasized that the same entrepreneurial culture that gave us the Starbucks latte also gave us credit derivatives.

With hindsight, each of the above was in reality a flashing warning light that went unrecognized by Greenspan and millions of other market participants. Most people's ideologies, mental market models and vested interests coincided with Greenspan's thinking. Those who voiced contradictory views were judged to be Cassandras because recent economic history provided a powerful counterfactual argument. Ironically, this included the feeling of increased wealth we all enjoyed, but failed to see as transitory. Had we collectively recognized the asset bubbles for what they were—flashing warning lights—we may not now be facing a deep slowdown in economic global activity.

In 1935, John Maynard Keynes observed that the ideas of economists and political philosophers—be they right or wrong—are more powerful in shaping our individual lives than is generally understood. Our ideologically driven retreat from market regulation over the past two decades may have misfired to the detriment of us all. Another ideological approach to market regulation will soon emerge to shape our future well-being. ∎

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