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Thanks Tito and Luigi, but no thanks!

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As the credit market crisis continues, the blame game has already begun. You might have thought that commentators would be putting the blame squarely on subprime mortgage lenders in the United States whose lending standards where abysmally low. Or on the subprime borrowers who took out mortgages that in many cases they had no hope of servicing. Or on the rating agencies that stamped AAA on what where *de facto* high-risk subprime products. Or on the investors who bought these products without fully understanding the risks involved. Or perhaps on a combination of the above.

But the past week has seen some observers on this side of the Atlantic point the finger instead directly at Alan Greenspan. A recent commentary by Tito Boeri of Bocconi University and Luigi Guiso of the European University Institute argues that the "low interest rate policy followed by Alan Greenspan's Fed from 2001 to 2004" was "by far the most important" factor contributing to the current crisis. "Thanks Alan!" they write mockingly, "[t]oday we're paying the cost of your overreaction to the 2001 recession."

The Eurointelligence ECB Watch also sticks the boot into Greenspan, claming that "this crisis is to a large extent produced by a monetary policy that used to be far too lax, in particular in the US. This crisis is largely Alan Greenspan's legacy." ECB Watch goes on to argue that "[w]hatever may happen in the US – we assume that Bernanke is ultimately going to be as irresponsible as his predecessor – the Europeans will this time not follow the largely discredited Fed." No punches pulled there.

But are Greenspan's critics right? Did Greenspan's Fed cut interest rates to inappropriately low levels in 2001 and hold them there for too long? Let's take a closer look.

The Fed slashed the target federal funds rate from 6½ percent in late 2000 to less than 2 percent in late 2001, and then to just 1 percent by mid-2003. The Fed began to tighten monetary policy in mid-2004, pushing interest rates back up to 4¼ percent by late 2005 and 5¼ percent by mid-2006. Putting the critics in Greenspan's shoes, I wonder what they would have done differently.

When the Fed began to ease monetary policy in early 2001, US real GDP growth had already plummeted from roughly 5 percent in the first half of 2000 to only about 1 percent in 2001:Q1. Fixed business investment was contracting, employment growth had stalled, unemployment was rising, and the output gap was widening. Economic growth was well below its estimated potential rate of around 3½ percent. With growing slack in labour and product markets, core PCE inflation was expected to ease to below 2 percent. By late August 2001, the federal funds rate stood at 3½ percent, hardly an irresponsibly low level. The stock market bust resulted in what Alan Blinder later called "the largest destruction of financial wealth in history." Without monetary easing, the shock to wealth and the associated slump in business investment would surely have induced a severe economic contraction.

And then 9/11 happened. In testimony before the Senate Committee on Banking, Housing, and Urban Affairs nine days later, Greenspan warned that the "terrorism of September 11 will, doubtless, have significant effects on the U.S. economy over the short term." Did the critics have a different view at the time? I can't find any articles by Tito Boeri or Luigi Guiso on their personal websites to suggest that they did. In fact, I can't find a single piece that either has written about US monetary policy, except for last week's rant.

In the immediate aftermath of 9/11, economic activity essentially ground to a halt. As the initial shock began to wear off, the economy recovered a little, though some components of spending remained depressed. Additional monetary stimulus was clearly needed to avoid a recession. The Fed responded with four more cuts, lowering the funds target to 1¾ percent by the end of the year. Would the armchair critics have stopped well before that level?

In the first half of 2002, growth picked up moderately on the back of a temporary increase in inventory accumulation. Growth in final demand, however, remained weak. By the fourth quarter of that year, the economy was about to stall, depressed by the effects of the corporate governance scandals, high oil prices, and blows to confidence stemming from the prospects of war in Iraq. The labour market remained in the doldrums. Not exactly ingredients for a robust recovery. Did these shocks not merit a monetary policy response?

Meanwhile, the spectre of deflation had raised its ugly head. Core PCE inflation slipped to 1 percent. The May 2003 FOMC statement expressed the concern that inflation might actually fall too low. Japan's experience with deflation had served as a warning that when the risk of deflation is high, monetary stimulus should go beyond the levels conventionally implied by baseline forecasts of future inflation and economic activity (Ahearne et al, 2002). The IMF recommended in June 2003 that "further easing may still be required if the recovery does not regain momentum" (IMF, 2003)

The stimulus worked. Economic activity began to show signs of a sustained recovery in late 2003 and the process of disinflation came to an end. The recovery in the labour market lagged the recovery in output, but the economy was showing enough vitality by mid-2004 for the Fed to begin monetary tightening.

Critics might argue that the strength of the economic recovery showed that monetary policy did not need to be as accommodative as it was. But this is false logic. It is like saying that all the money spent on the Y2K problem was wasted because no major computer systems failed and no planes dropped out of the sky on 1 January 2000.

Professors Boeri and Guiso criticise Greenspan for "maintaining interest rates at levels significantly below equilibrium" between 2002 and 2004. It is true that policy rates were lower than those implied by a standard Taylor rule. But interest rates over that period were consistent with augmented Taylor rules that took account of the zero lower bound on nominal interest rates (see, for example, Kato and Nishiyama, 2005). Results from monetary rules do not support claims that policy was too lax.

Professors Boeri and Guiso conclude that "[w]ithout Greenspan's policy, the present crisis probably would have never occurred." It's hard to know what to make of that statement. Without subprime mortgage products, securitisation, and cross-border capital flows, the crisis would not have occurred either. What is clear is that the critics would not have responded to shocks as aggressively as Greenspan's Fed did. The subprime crisis would not have occurred. And the US economy would have probably fallen into a Japanese-style economic slump--or worse. Thanks Tito and Luigi, but no thanks!

References:

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