The Greenspan years: more questions than answers

Ed Dodson is unsure of Alan Greenspan's legacy. Opening a two-part article on how the US economy has got to where it is today, he takes us from the establishment of the Federal Reserve, up to 1989.

IN THE last issue of **L&L**, Professor Michael Hudson provided readers with his insights into the personality and thinking of one of the more controversial public servants in recent US history. Alan Greenspan is known for the individualistic ideals he acquired from an early association with Ayn Rand. Despite this brush with the cultish *objectivism* preached by Rand, Greenspan's stock within the Republican Party was established when he was appointed director of policy research for Richard Nixon's presidential campaign in 1968. Gerald Ford later appointed him chairman of his Council of Economic Advisers. That Alan Greenspan served as "an economic lobbyist for the rich" is certainly true. Whether he was also a chief architect of the debt-fuelled inflation in land prices that occurred during his tenure as chairman of the Federal Reserve's Board of Governors is less certain, in my view.

The operation of land markets absent the public collection of location (and other sources of) rental values is the fundamental cause of the so-called *business cycle*. In this sense, politics does indeed dictate economic outcomes. The Federal Reserve System came into existence in an attempt to mitigate the periodic runs on banks and contraction of credit triggered by land, equities and bond market collapses. The Great Depression proved the banking system remained inherently unstable, although at least some, Milton Friedman most prominently, blamed the Depression on the actions – or inactions – of the head of the Federal Reserve Bank of New York allowing the Jewish-owned Bank of the United States to fail. Citizens lost confidence in the banking system and lined up to remove their savings, causing many otherwise healthy banks to close their doors.

Franklin Roosevelt's *New Deal* may have prevented political and social chaos during the 1930s, but what ended the Depression were the orders for war materials from European governments. By the end of the Second World War, savings by US households combined with government spending on the interstate highway system and mortgage loan guarantees provided by the Veterans Administration to stimulate demand for suburban homes and automobiles. Here was the real beginning of the credit and policy-fuelled escalation in land prices that periodically outpaced (and outpaces) any increases in household incomes. Further instability was added by enormous expenditures on the military to achieve superiority over the Soviet Union and to support any and all anti-communist regimes (less for purposes of supporting democracy than for defending global corporate resource-extracting interests).

By the late 1960s, the US postwar economic expansion had run its course. Richard Nixon was forced to abandon the fixed price of US dollars in terms of gold and declared, in 1971: "We are all Keynesians now". A global economy dependent on an ever-increasing supply of fossil fuels was then shocked into stagflation by supply and price agreements reached by the oil-exporting nations. Only the discovery of new reserves in the North Sea and rapid steps to conserve energy saved the West from an even deeper and longer economic collapse.

The credit market response to stagflation was to create an unregulated (ie usury-free) avenue for the flow of surplus financial reserves – the money market funds. At nearly the same time, the influence of Milton Friedman's ideas on the Federal Reserve was translated into a dramatic change in monetary policy. For the next few years the Fed abandoned efforts to maintain interest rate stability; its tools were applied to achieve a constant growth in the money supply. The result was catastrophic. Interest rates surged upward, while the Fed found it impossible to calculate money supply changes in real time. Ronald Reagan's determination to outspend the Soviet Union on the military, combined with a flawed understanding of the outcomes generated by *supply-side* economic policies, extended and deepened the recession. Paul Volcker's strategy of attacking inflation by tightening access to credit drove interest rates up even higher, and non-military investment in new plant and equipment stalled.

Little attention has been paid by economic historians to the fact that the Carter administration initiated broad deregulation of the transportation sector and approved creation of the new money market funds. Reagan continued the process and pushed for further cuts in the taxation of capital gains and high marginal incomes. When Paul Volcker's tight credit and high interest rate policies brought land markets to a crawl, a strong component of inflation was temporarily held in check. A *window of opportunity* was opened for non-inflationary economic growth.

Convinced inflation has been beaten, Volcker then cut interest rates. Recovery in the United States was aided by the fact that elsewhere around the globe the effects of stagflation were even worse. Investors returned to the US dollar as a safe harbour for their financial reserves. While the rising exchange value of the US dollar made exports from the US more expensive in external markets, US consumers benefited by lower prices for imported goods. Moreover, significant efficiencies in fuel consumption were achieved by US producers and automobile manufacturers, softening the impact of continued high costs for fossil fuels. Nearly four years of double-digit interest rates brought down land – and, therefore, housing – prices. However, the window of affordability remained open for only a short while. The nation's inventory of unsold housing units began to move, and those builders who survived the recession refrained from speculative construction. Market forces capitalised the savings from lower interest rates, once again, into gradually increasing land prices.

In 1980 the nation's savings banks were finally relieved from interest rate ceilings on the mortgage loans they made. Unfortunately, thousands of them were already insolvent, faced with rising costs of funds while holding low-yielding mortgage loan portfolios. Fannie Mae and Freddie Mac, the two Government Sponsored Entities (GSEs) and secondary market for mortgage loans originated by financial institutions and mortgage bankers, were similarly faced with eroding capital positions. They were saved from possible bankruptcy by two innovations – the introduction of adjustable rate mortgage loans and the creation of a market for mortgage-backed securities. Fannie Mae and Freddie Mac began to raise funds by pooling mortgage loans together as specific collateral for securities sold to investors. The negative spread (ie the difference between what borrowers were paying under the mortgage loans and the market rate of interest) represented a loss to the two GSEs; however, a ruling by the Federal Accounting Standards Board permitted these losses to be amortised over the life of the securities. This dramatically eased the financial pain and stabilised their financial situation just as the housing market rebounded.

Securitisation also meant that commercial and savings banks could – for a guarantee fee – get Fannie Mae or Freddie Mac to pool their mortgage loans and issue additional mortgage-backed securities. The banks benefited similarly from the ability to amortise losses.

The return to low interest rates also stimulated a prolonged period of mortgage loan refinancings, reducing the annual costs of credit for millions of US households and generating desperately-needed revenue for the banks in the form of loan origination and mortgage servicing fees. At the same time, borrowing secured by second or even third mortgage liens on property skyrocketed after passage of the Tax Reform Act of 1986, which eliminated the deductibility of most non-mortgage interest payments. The banks now began to aggressively market new home equity loans and equity lines of credit. Many US households measured their ability to carry higher and higher levels of debt based on the amount of disposable income they enjoyed after paying their bills each month. For the majority of households in the nation, saving was either not possible or put off into the future. Whether there were one or two adults employed full-time, this meant that any prolonged interruption in household income resulted in credit problems, possible foreclosure on their residential property, and bankruptcy.

Into this financial world Alan Greenspan arrived to take over as Chairman of the Board of Governors of the Federal Reserve. Greenspan was immediately faced with the late-1987 stock market crash. The most-astute investors knew the market was overheated and moved their reserves into land and real estate speculation. Land prices rose accordingly – to levels that made profitable development difficult in many parts of the nation. Newly-constructed condominium units, particularly, started to remain unsold even as asking prices were slashed. Developers defaulted on construction loans, and when the banks foreclosed they were forced to dispose of these properties at prices far below the original cost of the land and construction of the buildings. By late 1989 conditions were set for another broad collapse of land markets and the subsequent failure of hundreds of banks facing heavy loan losses. L&L

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edward j dodson's cooperative individualist view

Some of us are old enough to remember the nearly decade-long United Nations *Convention on the Law of the Sea* that met from 1973 through 1982. The resulting treaty finally took effect in 1994, when a majority of member governments became signatories. Although the present Bush Administration finally agreed to US participation, the US Senate has yet to ratify the treaty. Opposition has come from conservative think tanks fearful of international interference with US security measures and rights as a sovereign nation-state.

I do understand and share concerns regarding transfer of legal authority of the global commons to an agency of the UN (the International Seabed Authority). If, as we argue, the laws of the social democracies have been structured to secure and protect entrenched privilege, the laws of other societies are even more overtly unjust. How can we be convinced that an organisation of governments will ever act in the interests of all?

The social democracies have a very thin claim to any moral high ground. We in the US have been a use, abuse and throw-away society from the earliest European settlement. If there is any universal moral principle, it is that the earth is the birthright of all persons, equally. Our acceptance of the system of sovereign nation-states makes the application of this principle extremely difficult, but within the rules of access to and exploitation of the resources of the oceans is our chance to begin to dismantle the systems of law that have acquiesced to the claims of sovereignty over territory.

A major reason for US reluctance is the structure of the bureaucracy empowered to administer the treaty provisions. The process of issuing licences for mining of the ocean sea beds needs to be depoliticised, with one set of rules for all and licences awarded to the highest bidders. The amount any company will bid for a licence will factor in the costs of compliance with all regulations (rigorously enforced).

A provision of the treaty guarantees the US sovereign control over oil, natural gas and any other natural resources found in the ocean a distance of 200 miles from the US coast. The mining and fishing industries in most nations with access to the oceans should be reasonably satisfied with these provisions, although there are many regions where negotiation over conflicting sovereignties is urgently needed.

A fair and effectively enforced *Law of the Sea Treaty* is in the interest of all. For one thing, our global food supply must be protected. We continue to struggle to protect species from catastrophic overfishing. The ocean ecology evolved over millions of years, and human intervention is on the verge of irreparably destroying the delicate balance that supports our own survival. We ought to call for scientists to determine what the maximum sustainable annual take is, as well as the use of sustainable harvesting methods, set the number of licences to be issued, then conduct an auction for those licences. This revenue stream, as well as that derived from issuing licences to drilling and mining companies, must then be equitably distributed under rules negotiated by members of the UN. This, then, would be a good beginning, but only a beginning. The list of resources rightfully belonging in the commons includes the wind, waves and currents, ocean life other than just fish, clean air, anchorages, locations conducive to floating development (like casinos and desalination plants) and licences issued for flight paths. You can surely think of others.