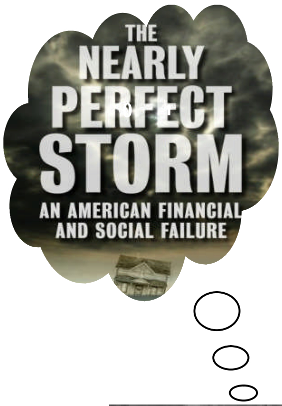

Your on the
Street Reporter

Uyless Black

Epilogue VIII to *The Nearly Perfect Storm*

Alan Greenspan: The Oracle of Illusion and Animal Spirits

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Preface

My intent in writing *The Nearly Perfect Storm: An American Financial and Social Failure,* and these epilogues is to spark your ire. I am not one to compose inflammatory compositions. I began my studies of the 2008 financial crisis with a neutral view of the subject, perhaps even skewed toward the financial world (specifically, the investment banking industry), reflecting my former employment at the Federal Reserve.

No longer. The more I learned about the institutions and individuals who were involved in the meltdown, the more disgusted I became. I wish this turn of events had not come about. I wish I had found the Great Recession occurred because of a downturn in a conventional business cycle. It did not.

Do not expect this series to be light-hearted, although I will attempt some gallows humor to lighten the load.

The Nearly Perfect Storm: An American Financial and Social Failure
Epilogue VIII: Alan Greenspan: The Oracle of Illusion and Animal Spirits

January 26, 2014

These epilogues are written on occasion as follow ups to *The Nearly Perfect Storm: An American Financial and Social Failure*, available at Amazon, Barnes & Noble, and local book stores. Epilogue VIII discusses the recent comments made by former Oracle and Chairman of the Federal Reserve Board, Alan Greenspan.

Quotes from *The Nearly Perfect Storm* about the issue.

Page 3:
To any but the experts, the news on the subject is almost bewildering. And I am coming around to the notion that it may be bewildering to many of the experts as well. Even the once esteemed Alan Greenspan, former chairman of the Federal Reserve Board, now confesses he was clueless about a system he was supposedly managing.

Page 62:
The long period of low return on U.S. Treasuries (because of Federal Reserve Board Chairman Greenspan's emphasis on low interest rates) had investors looking for other instruments with a higher return.

Page 73:
The data put into the risk-management models generally covered only the past two decades, a period of euphoria.[comments Greenspan made about the meltdown]

Page 90:
We will see that laws were passed in the 1990s to allow the Federal Reserve to oversee and regulate what became the subprime market and that Fed Chairman Alan Greenspan ignored the laws.

Page 107:
What is particularly disheartening about Greenspan's tenure is that he had the legal authority to prevent the subprime fiasco. In 1994 Congress passed the Home Ownership and Equity Protection Act. It authorized the Federal Reserve to require all mortgage lenders to adhere to traditional banking standards: forbidding lending to people with poor credit or with no down payment. The law was passed because nonbank lenders were not subject to the stricter rules imposed on banks. Greenspan refused to use this law to regulate the emerging subprime market.

Page 108:
In addition, those financial weapons of mass destruction—namely, credit default swaps (see Report 8 [in the book itself])—begged for oversight. In an astounding display of irresponsibility, Greenspan, working with Senator Phil Gramm (R-Tex.), helped guide the passage of a 2000 law named the Commodity Futures Modernization Acts. This act "virtually outlaw(s) the monitoring and regulation of many types of derivatives."

Page 113:
…the Senate asked Greenspan, "With Taylor [Greenspan's right hand man] gone who is in charge of regulatory policy at the Board?" The answer surprised the Senate staff when it came back in writing because Chairman Greenspan said he had delegated the task to E. Gerald Corrigan, the president of the New York Fed.

For the first time, the Board was not managing its own supervisory policy. Instead it was delegating that important duty to the New York Fed, an organization that operated hand in glove with the banks it was supposed to regulate.

Page 154:
"It is precisely the greed of the businessman, or more appropriately, his profit-seeking, which is the unexcelled protector of the consumer." [A quote from Greenspan.]

Greenspan wrote an essay, "Never Saw it Coming," which appeared in *Foreign Affairs*, November/December 2013 issue; here are a few pieces from the article:

First, Greenspan cites "animal spirits" as one factor in the meltdown. He is referring to this term in the context that John Maynard Keynes used it in 1936: "a spontaneous urge to action rather than inaction." Greenspan goes on to say, "The trouble is that such behavior is hard to measure and [is stubborn to] any systematic analysis. For decades, most economists, including me, had concluded that irrational factors could not fit into any reliable method of forecasting."

In other words, no one is to blame. That's it. Everyone is off the hook, including Alan Greenspan…except animal spirits.

Additionally, his statements above claim that software models ("methods of forecasting") cannot be used to simulate "irrational factors." Then why was he using them if they were flawed? Ah, because he did not know animal spirits were a reality until he discovered them after the meltdown.

Mr. Greenspan, here are the "animal spirits" that caused this tragedy. I have underlined the parts of this simple snippet of reality that are attributable to you and the Fed:
(1) <u>Excess liquidity</u> coupled with
(2) <u>a long period of low interest rates</u> for
(3) subprime mortgages (<u>that did not meet banking standards</u>) with
(4) adjustable rate interest loans led to
(5) massive loan defaults and
(6) foreclosures, which fueled a decline in
(7) home prices, leading to the collapse of
(8) <u>unregulated</u> mortgage-backed securities and other Wall Street instruments.

Animal spirits. This man was one of the most important people in the world for many years. And he claims animal spirits caused the Great Recession. Saturday Night Live, here we come.

Another key point which Alan Greenspan refuses to acknowledge: What did he do about regulating critical aspects of the financial world (several years before the 2008 meltdown)? As listed in (8) above, *he refused to regulate the Wall Street financial instruments that were tied to the home-mortgage market. In so doing, the animal spirits of irrational investors, blinded by greed, threw gas on the fire of an irrational housing bubble.*[1]

But Greenspan says he and everyone else never saw it coming. That is incorrect. Noted economists warned of the dangers. And even low-level financial propeller heads who examined the home mortgages inside those greed-driven Wall Street instruments discovered they were absolute junk. They did what the regulators should have done but did not: They did their homework. As a result, they bet against the rising animal spirits of irrationality and became billionaires.

But greed is good. See Greenspan's statement above. Anyway, I will not go into the details of Greenspan's fantastic illusions about the marketplace that are written in my book. I will only state that in a subsequent issue of *Foreign Affairs* (January/February 2014), the article, "Blind Oracle," by Richard Katz summarizes the chapters in my book about the incompetency and hubris of Alan Greenspan.

For now, here is another quote from Greenspan in the *Foreign Affairs* piece: "Financial firms could have protected themselves against the costs of their increased risk taking [of a rising bubble] if they had remained adequately capitalized---if, in other words, they had prepared for a rainy day."

Permit me an exclamation point: Surreal! What Greenspan suggested the banks should have done was to take actions that the Federal Reserve was responsible for making them take in the first place. Asking a bank to set aside reserves for a rainy day is like asking an alcoholic to put his bottle away on Sundays. The action is not in a banker's DNA. Here is another passage from my book:

Pages 46-47 (Some sentences are paraphrased from the book. Notations in italics and bold are my comments added for this report):

In the 1990s the international bankers' consortium called the Basel Committee of Bank Supervision established rules that ***reduced the capital requirements on riskier assets***. In addition, the Federal Reserve ***[chaired by Greenspan]*** followed by allowing banks to include some riskier securities in the banks' calculation of [some types of] capital that a bank could issue to raise funds.[2] The effect was the relaxation of a heretofore conservative measure of a bank's financial health.

Greenspan says the banks should have regulated themselves on holding reserves for a rainy day, yet he worked to encourage banks to hold even less cash.

1 *The Nearly Perfect Storm* devotes several pages to tutorials on these financial insturments, such as Mortgage-Backed Securities, Credit-Default Swaps, and Collateralized-Debt Obligations.

2 Gretchen Morgenson and Joshua Rosner, *Reckless Endangerment* (New York: Henry Holt, 2011), 111-114.

Greenspan is a software model geek. But he concludes his apologia in *Foreign Affairs* with, "We will forever need to reach beyond our equations to apply economic judgment." Greenspan knew these models were using inadequate data for their forecasts. On page 74, I quote him as follows, "The data put into the risk-management models generally covered only the past two decades, a period of euphoria."

If he *did not know* this fact before the meltdown, he violated The First Commandment of modeling: Know what you are modeling. If he *was aware* of this fact before the meltdown, he violated The Second Commandment of modeling: Garbage in, garbage out.

Either way, a sin was committed. A lot of people suffered, and are still suffering.

By the way, most of the stores up here in north Idaho that shut down in 2008-2010 are still shuttered. And for all us who do not live on debt, our CDs are paying less than one percent. But going into debt, well, that's another thing: small interest fees on the loans. And the banks? They borrow money from the Fed at rates you and I would kill our banker's mother-in-law for…make that our banker…make that…never mind.