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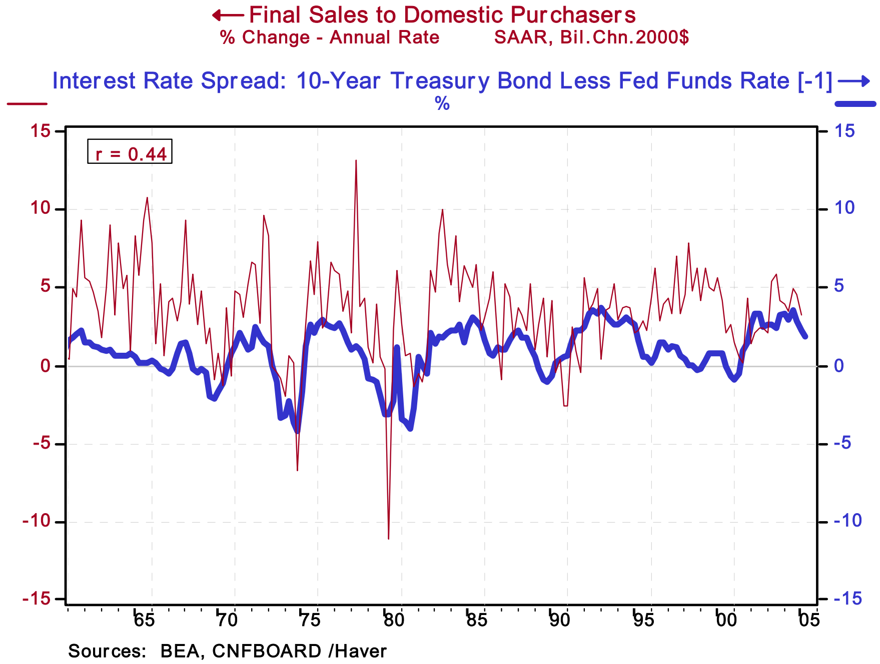
Let's Give Greenspan His Due

When Fed Chairman Greenspan testifies before Congress, he seems to talk a lot about fiscal policy and energy policy, but very little about his area of responsibility – monetary policy. Similarly, when economists and economic journalists discuss the behavior of the economic growth, they seem to talk about fiscal policy and energy prices, but very little about Greenspan's bailiwick – monetary policy. We economists seem to spend an inordinate amount of energy trying to figure out what Fed Chairman Greenspan is *going to do* with monetary policy, but precious little energy analyzing the economic effects of what he has *already done* with monetary policy. For example, Thursday's report by the Commerce Department that real GDP growth came in at a below-consensus 3.1% annualized rate was explained in terms of the December 31, 2005 expiration of accelerated depreciation allowances for tax purposes on business equipment and higher energy prices. There was plenty of discussion about how Greenspan might *react* in his monetary policy decisions to this GDP report, but scarcely any discussion about how his *prior* policy decisions might have led to the GDP growth slowdown.

Is there any evidence that Greenspan's earlier monetary policy decisions might have played a role in the economic growth slowdown? I think so. Consider Chart 1 in which is plotted the quarter-to-quarter annualized growth in real final sales to domestic purchasers, a subset of real GDP, and the quarterly average yield spread (advanced by one quarter) between the Treasury 10-year bond and fed funds. The data on growth in final sales is very "noisy." Despite this, the correlation between these two series is 0.44 out of a possible 1.00. If I were to smooth the data series, I could get a higher correlation coefficient. But even at 0.44, there does seem to be some relationship. And because the yield spread *leads* domestic demand growth, this is *prima facie* evidence, at least, that the spread influences demand growth rather than *vice versa*. (Did I overdue the italics in that sentence?) I'm not the only one impressed by the yield spread being a leading indicator of economic activity. The Conference Board is impressed enough by the leading characteristics of the yield spread to include it in its index of Leading Economic Indicators. In fact, the Conference Board is so impressed with the yield spread as a leading indicator that is has assigned the spread the highest weight of the ten components of the leading index.

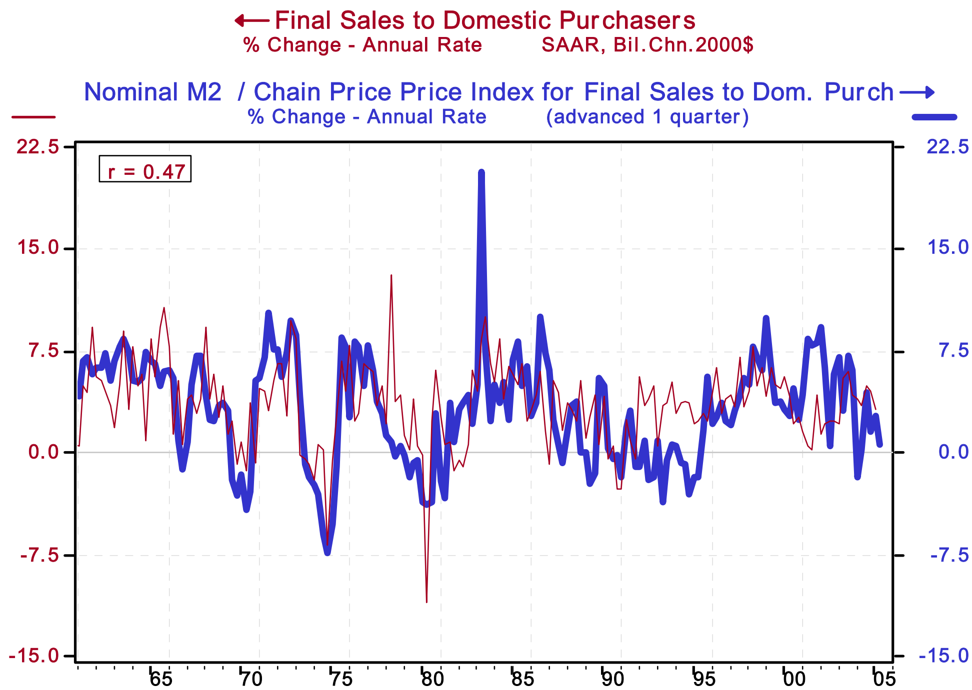
Chart 1



The yield spread has fallen from a cycle high of 359 basis points in the second quarter of 2004, just before Greenspan started raising the fed funds rate, to 183 basis points in the first quarter of this year. As this is being written, the Treasury 10-year bond is trading at 4.14% and the Fed's target funds rate is 2.75%. Thus, the yield spread is now 139 basis points. If, as expected, Greenspan raises his funds rate target to 3.00% on Tuesday, May 3, the yield spread will likely narrow more. I say the yield spread is likely to narrow because neither I nor Alan "Conundrum" Greenspan know what the behavior of the yield on the Treasury 10-year bond will do on Tuesday. More generally, we do not know what the behavior of the 10-year bond will be at any time in the future. We do know with certainty, however, what the level of the 10-year bond yield *has been* in the past and we also know with certainty what the level of the fed funds rate has been. Knowing this, we can make some high probability bets as to what the trend of economic growth will be in the future. We find it interesting that many economists look at the behavior of the 10-year Treasury yield in isolation, that is, not in relation to the behavior of the fed funds rate. Their knee-jerk reaction is to think that any decline in the 10-year yield is a sign of more accommodative monetary conditions. These same economists, who recently were saying how accommodative monetary conditions are, were busy revising *down* there second-quarter GDP growth forecasts right after the first-quarter slower-than-expected data hit their computer monitors.

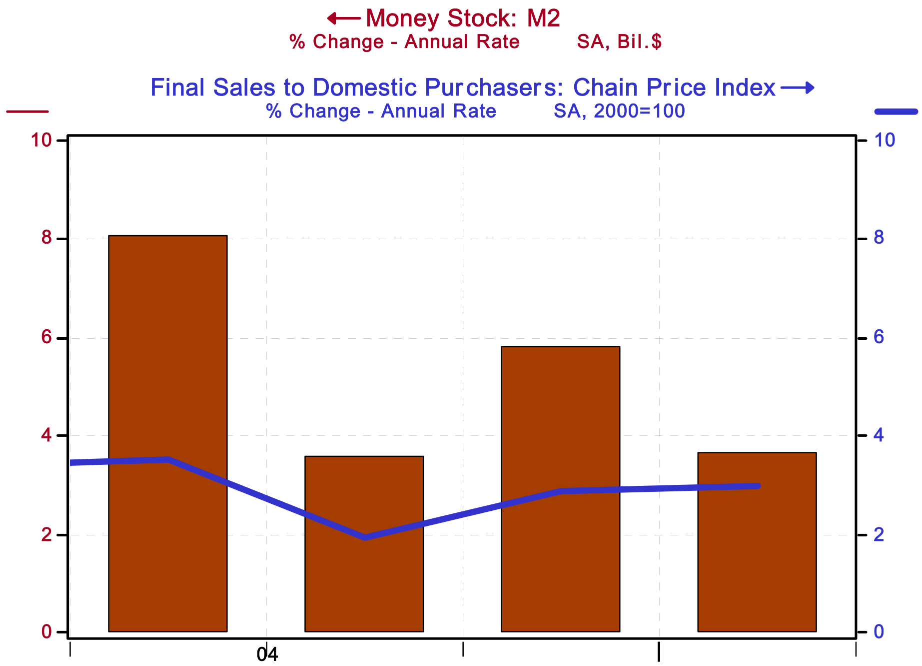
Because the Fed does control the behavior of the fed funds rate, it indirectly has an influence on the supply of money in the economy. And Chart 2 indicates that growth in the M2 money supply, adjusted by some price index, might have some influence on the growth of real final sales to domestic purchasers. This version of real money supply growth, when advanced by one quarter, has an historical correlation with growth in real final sales to domestic purchasers of 0.47. Again, the Conference Board was so impressed with the leading indicator properties of real money supply growth that it included a real M2 concept also in its index of Leading Economic Indicators. The real M2 component has the second highest weight, after the yield spread, of the ten components of the Conference Board's leading index.

Chart 2



My version of real M2 growth slowed from an annualized rate of 4.39% in the second quarter of 2004 to only 0.61% in the first quarter of this year. Now, of course, real M2 growth is function of the behavior of nominal M2 growth, which is indirectly influenced by Fed policy, and the behavior of the price index by which nominal M2 is deflated. If real M2 growth were slowing in the presence of accelerating *nominal* M2 growth, then we would be hard pressed to say that the Fed was directly responsible for the slowdown in real M2 growth and real aggregate demand growth. What has been the case in recent quarters? For the answer to this, we go to Chart 3. In Chart 3, we see that nominal M2 growth has fallen from an annualized rate of 8.06% in the second quarter of 2004, just before Greenspan started raising the fed funds rate, to 3.63% growth in the first quarter of this year. My M2 price deflator was growing at an annualized 3.51% in the second quarter of 2004, slowing marginally to 3.00% growth in the first quarter of this year. So, again, we have to conclude Greenspan's monetary policy actions were responsible for the slowdown in real M2 growth and the slowdown in aggregate demand growth.

Chart 3



Sources: FRB, BEA /Haver

So, let's give credit where credit is due. It was not diminished fiscal stimulus or higher energy prices that led to the recent "soft patch" in the economy. No, it was the monetary policy decisions of the guy who coined the term "soft patch," Alan Greenspan, that led to the slowdown in economic activity.

Now, it may sound as though I am criticizing Greenspan for his recent monetary policy decisions. On the contrary. The asset-price inflation his prior policy decisions contributed to now have spread to an acceleration in the price increases of goods and services. The man had no choice but to make monetary policy less accommodative.

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