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Alan Greenspan – Ted Williams or Willie Mays

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As a kid growing up, my two favorite Major League baseball players were Ted Williams and Willie Mays. Both retired from playing at age 42. In his last at-bat, Ted Williams, one of the greatest hitters in the history of the game, belted out a home run. What a way to go out! In his last season in 1973, Willie Mays, one of the best all-around players in the game, hitting, fielding and base running, played in the World Series. His performance in the series was undistinguished, exemplified by his falling down in the outfield in pursuit of a fly ball. It was so sad to see such an outstanding athlete end his career that way. Willie Mays obviously had played well past his prime.

Watching former Fed Chairman Alan Greenspan being grilled in front of Congress on Thursday brought back memories of Ted Williams and Willie Mays. In no way would I place Alan Greenspan in the same category as Williams and Mays. That is, I do not consider Greenspan to have been an “all-star” central banker. But Greenspan did remind me a little of Willie Mays in the sense that he “played” well past his prime.

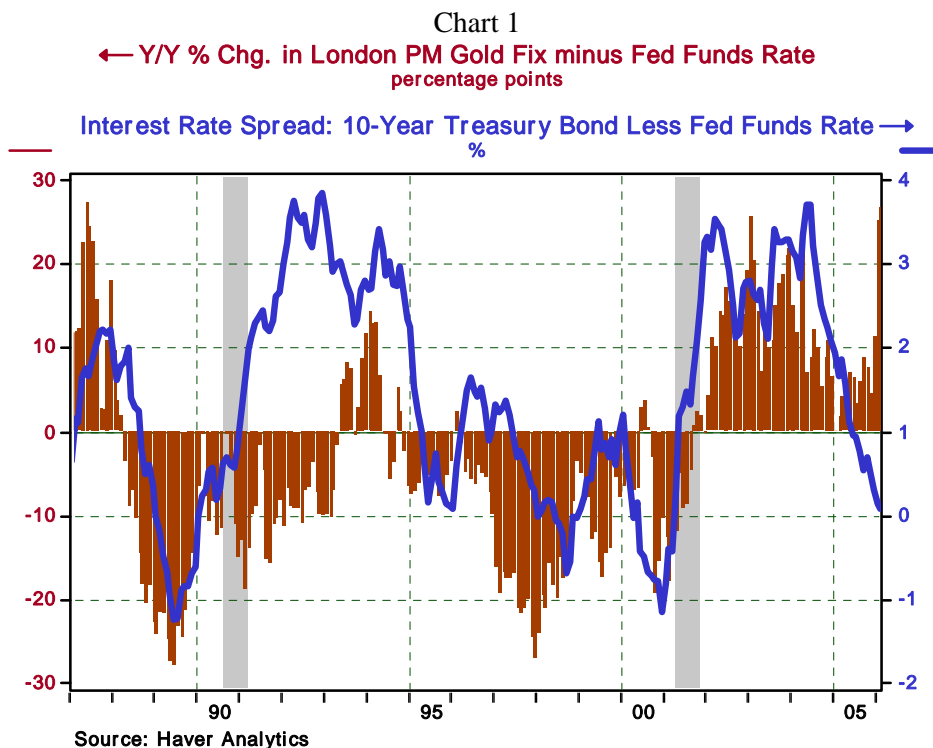
I must be getting soft in my old age. Despite the years of criticism I have heaped on Greenspan, I was saddened by the public humiliation he had to endure. Congress excels at assigning blame *after the fact*. Congress is the Fed’s only overseer. Other than Ron Paul, what member of congress ever substantively questioned Greenspan about his conduct of monetary policy? When he was chairman of the Fed, most members of congress queried Greenspan on almost every subject *except* his conduct of monetary policy. And yesterday, I believe that Congress persisted in asking the wrong questions.

There are two types of sins – sins of omission and sins of commission. Congress was pounding Greenspan on Thursday of his sins of omission – his failure to recommend new regulatory policies. And Greenspan confessed to these sins.

But to me, a wannabe Austrian economist, and the real deals, Greenspan’s most grievous sin was one of commission – keeping central bank credit too easy too long. And I will argue that he was most guilty of this sin of commission in the twilight of his “playing” career at the Fed. Had he retired in 2001 before he was past his prime, he might have been able to avoid the humiliating grilling he received before Congress on Thursday.

To argue my case with regard to Greenspan’s sin of commission, consider Chart 1 below. The red bars represent the difference between the year-over-year price of gold and the level of the federal funds rate. The federal funds rate is the price of overnight interbank credit, which is targeted and controlled by the Federal Reserve. The blue line in the chart is the spread between the yield on a Treasury 10-year security and federal funds rate (hereafter, referred to as the “yield spread”). The years charted cover roughly Greenspan’s tenure as Fed chairman – 1987 through 2005. I argue that when the percentage increase in the price of gold exceeds the federal funds rate and, *at the same time*, when the yield spread is positive and widening, the Fed is keeping the price of short-term credit too low. By keeping the price of short-term credit too low, the Fed sows the seed of accelerating price increases of goods/services and/or assets. Gold does not yield a rate of return except for its appreciation in price. Investors turn to gold to protect the purchasing power of their accumulated wealth. Investors seek purchasing-power protection when they perceive that the central bank is keeping the price of credit too low. If

the price of gold is increasing at a faster rate than the level of the fed funds rate, then this suggests that the Fed is keeping the funds rate too low.



When Greenspan assumed the Fed chairmanship in August 1987, the positive differential between the gold price increase and the federal funds rate was narrowing. From 1988 through 2001, the percentage increase in the price of gold was less than the federal funds rate for most of the period. One major exception was 1993. But starting in 2002, the year-over-year percentage change in the price of gold consistently exceeded the level of the federal funds rate.

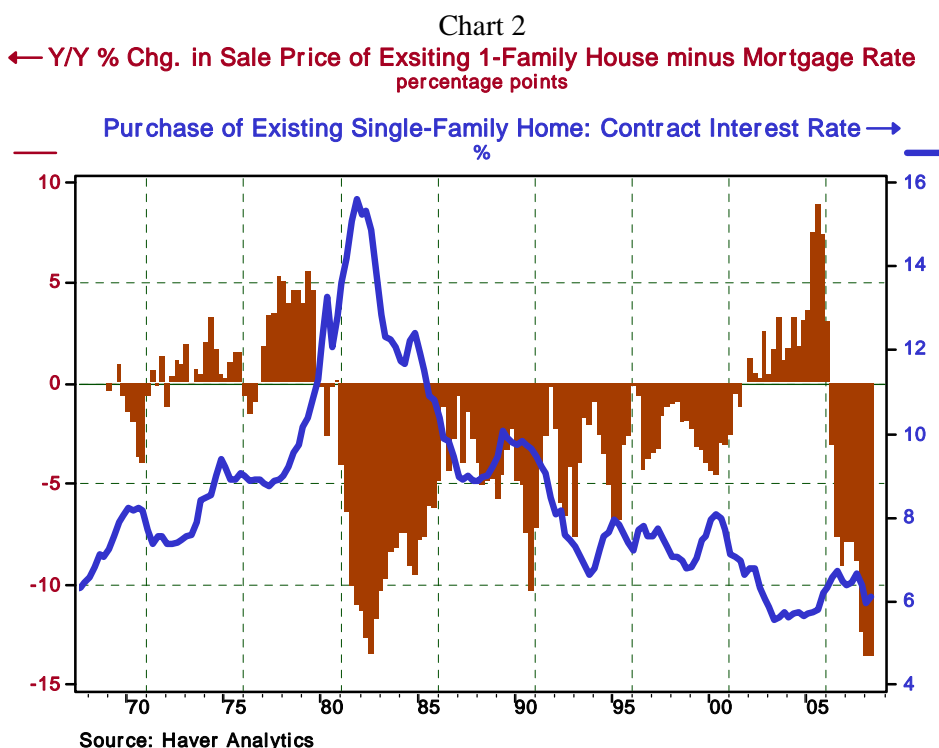
A positive and widening yield spread usually, but not always, suggests that the demand for credit to purchase goods, services and/or assets is increasing and that the Federal Reserve is *preventing* short-term interest from rising as fast as they otherwise would in a free market. The Fed prevents this rise in short-term interest rates by *creating* more credit. This suggests that the Federal Reserve is sowing the seeds of CPI or asset-price inflation.

An exception to this was the positive and widening yield spread in 1991 and 1992. During those years, the U.S. Treasury was issuing billions of dollars of debt *not* for the purpose of purchasing goods and services, but to make depositors of failed S&Ls whole. This increased demand for credit on the part of the U.S. Treasury did not result in increased demand for goods and services. A similar situation exists today. The yield spread has been widening in recent months because of the Treasury's increased demand for credit to simply replace financial capital that has been extinguished due to credit market losses.

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Notice in Chart 1, that from 2002 through 2005 the yield spread was very wide *and* that the percentage change in the price of gold consistently exceeded the level of the federal funds rate by a wide margin. This suggests that the Federal Reserve under the chairmanship of Alan Greenspan had kept the price of short-term credit too low.

The red bars in Chart 2 below shows the differential between the year-over-year percent change in the median sales price of an existing single-family home and the mortgage rate for financing that sale. The blue line shows the level of that mortgage rate. From approximately 1980 through 2001, the house-price change – mortgage rate differential was negative. But from 2002 through 2005, the differential was positive, meaning that the cost of financing an asset (a house) was less than the rate of price appreciation of that asset. This was a clear market signal to invest in residential real estate. And this was a clear indication that the Federal Reserve was *fixing* the price of short-term credit too low.



Had Greenspan not committed his sin of commission, fixing the price of short-term credit too low in the early 2000s, there might not have been any sins of omission. And if Greenspan had known when to “retire”, as Ted Williams did, he might still be looked upon as a hero.

Paul Kasriel is the recipient of the 2006 Lawrence R. Klein Award for Blue Chip Forecasting Accuracy

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