

## Immoral Hazard

Jeremy Grantham

### Greenspan, Bernanke, and Volcker: A Study in Contrasts

It's not that the former Fed boss Greenspan was incompetent that is remarkable. Incompetence is common enough after all, even in important jobs. What's remarkable is that so many people don't seem, even now, to get it. Do people just believe high-quality self-justifying blarney? Or is it that they apparently want to believe that critical jobs in a great country attract great talent by divine right. Sometimes, of course, they do, but sometimes the most important jobs – even that of a presidency or a Fed boss – end up with mediocrities. Let us pause here to regret the absence of Mr. Volcker and wonder what a parallel Volcker universe would have been like. Just as we can wonder how much a few votes in Florida or a vote in the Supreme Court would have changed our world from what it is today.

Paul Volcker inherited about as big a mess as we have today. He worked out what he had to do and did it with unusual lack of concern about what Congress thought of the necessary pain involved and the number of enemies he might make. He paid the price for forthright behavior by being replaced, despite a record for correct and tough behavior that makes for the most invidious comparison today. When Volcker was replaced, by the way, he did not moan and groan but like an old soldier quietly disappeared. There were no high-profile announcements about the economy or any \$300,000-an-evening appearances paid for by financial firms.

Greenspan came onto my radar screen in the late sixties as a seller of economic and financial advice to the investment industry. To be brutally honest, he was considered run of the mill by anyone I knew then or have met later who knew his service then. His high point in most memories, certainly mine, was a famous call in January 1973 that, "it is rare that you can be as unqualifiedly bullish as you now can," a few days before a market decline of over 60% in real terms, second only to the Great Crash in a century,

accompanied also by a bitter recession. This was one of the first of a long line of terrible prognostications for which he has remarkably not been remembered, except by a handful of us amateur historians. Then in the mid seventies he disappeared into some government job, of which I was barely aware, until he re-emerged with a bang in 1987, without as far as I can find having done anything documentably very well. And we can agree that at least occasionally people can indeed prove their effectiveness beyond doubt. This was obviously not the first or last time such appointments were made where a job crying for proof of character and achievement under pressure is awarded more for what you might call political skills.

This has indeed not been our finest hour in the U.S. Times are bad enough, in fact, to make us mourn the American leadership skills of WWII and the generosity and foresight of the Marshall Plan. We can all wonder at the incredible vision, drive, organizational skill, and willingness to sacrifice resources that were required by the Manhattan Project and compare it to the rudderless or even deliberate avoidance of leadership of the greatest issues today: climate change and energy security. We can only wonder what a Manhattan Project aimed at alternative energy might have accomplished by now, had it been started 15 years ago. What we have had in lieu of vision, leadership, and backbone is a series of easy paths taken.

At the time that Paul Volcker broke the back of inflation in the early 1980s, the recognition that risk and leverage had consequences was baked into the pie: if you were to take excessive risk you had better win the bet. If you missed the target, the expected result would be more or less total failure, and that seemed then and for decades earlier a reasonable law of nature. Now in contrast we get ready to celebrate the 20th anniversary of the era of the Great Moral Hazard. Slowly at first, but with steadily growing traction, the idea was planted that asset bubbles would be tolerated, but consequences of their bursting would be moderated or avoided entirely by increasingly vigorous

actions sometimes, like now, bordering on the hysterical. This is to say that if all went well, enormous profits could be made by speculators – largely the great financial firms, including some formerly conservative blue chip banks – by riding and leveraging the bubbles. If all went badly, then the costs would be passed on to others.

The idea that occasional economic setbacks might benefit the system in the long run was one of the early ideas to disappear. Yet if you prop up weak sisters who would otherwise fail and in failing present their more efficient competitors with extra growth, you must surely weaken the system. Desperation pricing from weak firms who simply should not exist can weaken the profitability of a whole industry, as it has for the airlines. The average efficiency of most industries is reduced with at least some effects on our global competitiveness. With a slightly lower average return on equity, the ability to reinvest drops so that, in this world of moral hazard where recessions are few and mild, GDP growth is a little less than it might have been.

What's worse, those who took on unjustified risk live to prosper and reinforce the existing agency problems. These problems were big enough already: stock options, for example, that encouraged risks by rewarding upside success and not punishing failure. If you win, you take some of the shareholders' company, and if you lose, you lose nothing. In fact, if you lose, you rewrite your options at depressed or crisis prices, just as some financial companies are doing as we write. Similarly some hedge funds and private equity firms can take a level of leverage that might guarantee failure in the long run but with asymmetrical returns they pocket gains and sidestep the worst impacts of a potential terminal loss. To maintain a healthy respect for risk taking, it is surely necessary to punish egregious over-reaching or spectacular misjudgment with the spectacular penalties they deserve and used to get but get no longer. Bear Stearns and others leveraged 20, 30, and 40 times. They simply took too much risk and were too illiquid. They were disasters waiting to happen when a bump in the road was hit. Bear Stearns, ironically, was famous for its risk aversion in the good old days. Their recent excesses were typical of the Ponzi phase, the end of Minsky's speculative cycle where everyone is seduced into dancing to the bitter end. And all managements had a great financial incentive – their take is about half of total profits – to take excessive risks. Such extreme leverage may be fine if you get away with it, but of course failure should have very painful consequences or the leverage will be 50 times next time. But this time the Fed volunteered

to transfer the pain from ineffably rich bankers to the taxpayers. No wonder Volcker could hardly control his disgust last week: "The Federal Reserve has judged it necessary to take actions that extend to the very edge of its lawful and implied powers [spit], transcending in the process certain long embedded Central Banking principles and practices." (Hawk and spit!)

The defense of bailouts is that the alternative is ugly. But surely the penalties for excessive risk taking, issuing flaky paper, passing it on – often in its entirety – to others, and not even understanding the consequences of the low grade paper that you yourself issue should be ugly. "Yes, of course, we would like to punish the excessive risk takers" goes the line, but we can't do it without hurting the innocent economy. But we will never know what can be absorbed if the penalties are always removed by a bailout. In more traditional times, say, from 1945 to 1985, the economy could absorb substantial punishment from recessions and still grow faster than it has done in the last 10 years. So in a crisis à la Bear Stearns we now transfer pain from risk takers to innocent tax payers. Worse, even the routine treatment for the bubble breaking disease does the same. By raising the slope of the yield curve, the Fed deliberately benefits its bankers and hedge funds that borrow short and invest long and punishes pensioners and others who are trying to make a safe but still reasonable return at the short end.

Yes, this is a real credit crisis, substantially the worst since the Depression, so it now invites unusual responses, and what we have is a series of harried and hasty responses, perhaps even panicky, but we can at least understand the urgency. The real incompetence here goes back over 20 years: the refusal to deal with investment bubbles as they form, combined with willingness, even eagerness, to rush to the rescue as they break. It's almost as if neither Greenspan nor Bernanke allows himself to see the bubbles. Greenspan was always conflicted and contradictory about whether bubbles could even exist or not. Bernanke, in contrast, has more of the typical academic's certainty that the established belief in market efficiency is correct and therefore investment bubbles must be merely the product of investors' overheated imaginations. It would be convenient to have such an important role as Fed Chairman filled by someone who actually deals with the real world, messy or not, that is given to inconvenient bursts of euphoria and riddled by considerations of career and business risk, which modify behavior far away from economic efficiency.

Back in the real world, major asset bubbles are easy to see. They are nearly impossible to miss, in fact. But we travel in a world with a systemic bias to optimism that typically chooses to avoid the topic of the impending bursting of investment bubbles. Collectively this is done for career or business reasons. As discussed many times in the investment business, pessimism or realism in the face of probable trouble is just plain bad for business and bad for careers. What I am only slowly realizing, though, is how similar the career risk appears to be for the Fed. It doesn't want to move against bubbles because Congress and business do not like it and show their dislike in unmistakable terms. Even Fed chairmen get bullied and have their faces slapped if they stick to their guns, which will, not surprisingly, be rare since everyone values his career or does not want to be replaced à la Volcker. So, be as optimistic as possible, be nice to everyone, bail everyone out, and hope for the best. If all goes well after all, you will have a lot of grateful bailees who will happily hire you for \$300,000 a pop. By the way, that such payments to prior Fed officials are in themselves a moral hazard and an obvious conflict of interest that could moderate their prior behavior, is apparently too crude an accusation even to have surfaced yet. Well it should surface. Selling services to financial interests whose fates have been in your hands should simply not be tolerated as acceptable or ethical behavior by a former Fed Chairman.

#### **Time Out for Some More on the Presidential Cycle**

Over the last few years we have added quarterly letter by quarterly letter to what we have learned or suspect about the Presidential Cycle in the stock market. We found out that changes in employment in years three and four appear to have the most effect on votes, which would suggest big problems for the Republicans this time. We found that it is hard to find factors in the financial system such as money supply or interest rate changes that are big enough to cause the observed market effect. We concluded that it is likely that it is the whole financial package topped off and dominated by moral hazard that is the key factor: the unspoken promise is that if you speculate in years three and four and things go badly you are likely to receive help because the Administration and its typically co-operative Fed hate things to go badly wrong as the election nears. (Don't judge Fed co-operation by what is said, by the way, but by the strength of the market effect.) In contrast, in years one or two, when financial conditions are typically tightened, if you speculate and lose you will typically be left on your own to rue the errors of your ways. We

found that the year three stimulus effect since 1932 is so profound (plus 22% real return for the S&P 500) with no year worse than -2%, that it could not be luck at the 1 in 10,000 level. Years one and two, in remarkable contrast, return an average of less than 1% real. Well to update the story, it turns out that up to 1970 the market followed the general battle plan of two tough first years and two friendly second years almost three-quarters of the time. Sadly, nothing in markets is completely dependable. The other weekend, though, I was staring at the output for the 1970 through 2007 period and I saw that it played ball 28 times and "failed" 10 times. Not too bad. And then I saw it. Five of the 10 "failures" came during one man's 8-year tenure, someone apparently who just refused to play the game and the only Fed boss since 1932 to have a failing grade. Of course there is no prize for guessing who the culprit was: Paul Volcker, of course! He so obviously had no interest in playing ball with the administration on re-election stimulus that replacing him must have been appealing. But what of the other five "failures?" Two came in 1997 and 1998, hard on the heels of Greenspan's vision that the market might be showing "irrational exuberance" late in 1996, and with his face still stinging from a few Senatorial slaps. Encouraged to be a perma-bull, he critically forgot to show a little constraint and dampen the market's animal spirits a little in the first two years of the cycle to buy some space for later stimulus. Quite the reverse, he became, if anything, a tout for the new internet world order of higher productivity, higher profit margins, and higher P/Es. He encouraged two run-away strong years. These were the best back to back years one and two of the Presidential Cycle since the post-war recovery's 1948 and 1949, and only the second since 1932. Come 1999, he was in the critical year three of the election cycle when the Fed almost always stimulates. What was the poor man supposed to do? The problem is that a typical year three does not get the slingshot head start that 1999 had. It accelerated into deep space with the NASDAQ index blowing off by 60% in the last 6 months of 1999.

The trouble with markets is that if you let them get totally out of control, they will likely burst at the most inconvenient of times. That is precisely what happened in 2000, the third of our five "failures." The election year is when above all you want no rocking of the boat, and usually don't have any. It is usually treated with great care, but not this time. With internet stocks selling at large P/Es of unfortunately huge negative earnings and the whole NASDAQ at 65 times earnings, things just

began to pop of their own weight in February and March and nothing that anybody could have done would have been likely to stop it. The S&P blue chips fought a noble rearguard action, peaking in October, but the rot had set in and the year was down with spectacular declines in the internet and tech favorites. It is not that I question Greenspan's willingness to please the administration, which was of course immense, just his effectiveness in doing it. Ironically, by being over-eager to please, he overdid it. In a dead heat election, it is not hard to imagine that Greenspan's miscalculation cost the Democrats the election. Even a fraction of 1% of the voters disgruntled by stock losses pushed into voting against the incumbent party would have been more than enough to change the outcome. If it did move a few votes, shall we say it was not without consequences?

That leaves two more "failures" to account for. Skipping a perfect four for four Presidential Cycles (2001 to 2004), we then arrive at 2005 and 2006, the first two years of the current cycle. Totally undeterred by previous experience, Greenspan over-stimulates years one and two again. So eager to please that, like Ado Annie from *Oklahoma*, he just "cain't say no." But this time it was not just the stock market that was unusually strong. More importantly, the housing market should have met with the Fed's package of constraints in 2005 and 2006. And housing bubbles are both much rarer and more dangerous than stock bubbles for they affect more people. And this time, with a far greater percentage of total housing wealth borrowed (over 50%) and on much less credit-worthy terms, it was very much more dangerous than normal. The quality of mortgages should have been queried. The soundness of the repackaging of mortgages should have been publicly discussed and constrained. Off balance sheet financing by commercial banking should have been discussed and curtailed. All of this is in the Fed's job description, which is more than could be said for touting the new era of the internet back in the late 1990s or the virtues of the new mortgage instruments in the 2000s as Greenspan did. And what did Greenspan do this time? Absolutely nothing except to protest that there was only just a little fizz here and there in the housing market in late 2006. More recently he was quoted on television as saying that "the housing boom will soon simmer down." As Churchill might have said, "Some simmer!" (And by the way, does this mean he can see "booms" but never "bubbles?") His successor, Bernanke, as I never tire of saying, proved what a tough and different successor he would be by saying in late 2006, "The housing market merely reflects

a strong U.S. economy." Perhaps it was this promise of continuity that got him hired! (Following the wrong policy might be semi-defensible, but failure to analyze obvious data suggests incompetence or extraordinary faith in efficiency to the point of denial. Take your pick.) But back to the main plot: come 2007 we are back to the stimulate-at-all-cost year three. And let's all agree that as usual that is precisely what happened despite warning bells going off all over that an over-stimulated major asset class was going "hyperbolic" again. Well 2008 could be said to be the year of Santayana: we ignored history and we were condemned to repeat it. The critical election year arrived again as an asset class that had been pushed too far and too fast did its usual, inconvenient thing and started to implode. In all likelihood nothing that has been done would have stopped this housing bubble from deflating fully. It had all gone too far and been left too late. Similarly in 2001 and 2002, the then greatest stimulus package in American history of interest rate cuts and tax cuts could not stop the complete implosion of the internet and the NASDAQ. So in 2000, a Democratic administration had its chances critically hurt and now a Republican administration gets a dose of the same medicine. Well at least these guys are even-handed! It might be an improvement, though, to either learn how to play the re-election stimulus game effectively and safely in the time-honored way or, better yet, to ignore it entirely à la Volcker and run a tight ship.

But it is not just that the Fed of recent years has lost the plot. They apparently don't know it. Greenspan's book and, even more disgraceful, articles in the *Financial Times* (and that's a very high hurdle!), sidestep all blame and admit few errors. His article described housing "as an accident waiting to happen." Actually it's brilliant when you think about it: take a distant, almost academic tone and perhaps people will ignore the facts that: first, you allowed the situation to develop; second, did not apparently see it forming (despite 2½ to 3 standard deviation data for housing that suggested a 1 in 80-year event); and third, obliquely or directly blame others. It really is shameful!

**Back to the Point:  
It Really Is the Asset Bubbles, Stupid(s)**

Long-term economic growth involves labor availability, quality of education, technological change, and capital investment, none of which the Fed has any control over, unless it is in slightly lowering efficiency and growth through an extreme aversion to recessions. The role of

the Fed in influencing this critical factor of growth and hence employment is thus greatly exaggerated. Why indeed should we expect attempts at centralized control – shades of Soviet 5-year plans, as Jim Grant would say – to be effective? Inflation obviously can be strongly influenced by the Fed but, even there, external influences like commodity price surges are in the short term at least totally uncontrollable. More to the point, inflation itself, although undesirable and destabilizing, is not as important a long-term factor as we like to think for there is no easily proven correlation between inflation and economic success. Italy rocketed past England from 1945 to 1985 with much higher inflation, for example.

Bubbles bursting in major asset classes are a completely different story. They are extremely dangerous and, ironically, they really are substantially controllable by the Fed. If major asset classes are allowed to bubble away without moving to moderate them, we will all have to deal with the consequences of an excessive number of major asset bubbles breaking. An increasing number of us believe that nothing is a greater threat than this to financial and economic stability. Six years ago as we reeled from round one of this twin bubble show, I wrote in “Feet of Clay” a diatribe against Greenspan’s behavior then (attached to this letter on our website); “If everything goes right (as a bubble breaks) there will always be lots of pain. If anything is done wrong there will be even more. It is increasingly impressive and surprising how much we have done wrong this time! The stability of the U.S. economy can only be protected against the very real dangers of (an asset pricing) bubble breaking by the Fed and its Chairman being willing at rare intervals to take some political risk.” It’s a pity that nothing has changed in six years.

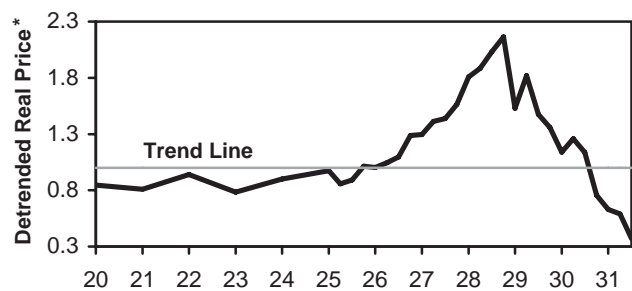
Looking back at the evidence (strong circumstantial evidence is all you can often get in economics), we can see that the two great economic setbacks of the 20th Century – the 1929-34 Depression and the rolling depression in Japan since 1989 – were both preceded by major asset bubbles and speculation. Milton Friedman and his troops can maintain that this suggested relationship between bubbles and troubles is nonsense and that all that was needed was good monetary policy. My response is that this view represents a touching faith in economic and financial theory of which tricky humans make a mockery. I am a Minsky man myself. I believe that occasional financial crises are inevitable and that they are almost always preceded by extreme speculation. Even the other

two important U.S. equity bubbles of the 20th Century, by the way – the 1965-72 Nifty Fifty and the 2000 Tech bubble – were both followed by tough and unsettled times. The break of the Nifty Fifty in 1972 led to what is still the worst recession since the Depression and was followed by a miserable decade. In contrast, the unraveling of the 2000 bubble is a tale still being told.

It is very important, perhaps even vital, to our financial and economic well-being that the Fed recognizes a responsibility to move against the formation of major asset class bubbles. Exhibits 1, 2, and 3 review the three most important bubbles. Look at them! They each announced

### Exhibit 1

#### S&P 500: 1920-1932

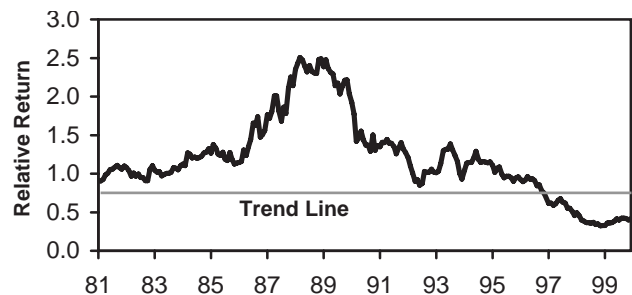


Note: Trend is 2% real price appreciation per year.  
 \* Detrended Real Price is the price index divided by  $CPI+2\%$ , since the long-term trend increase in the price of the S&P 500 has been on the order of 2% real.

Source: GMO

### Exhibit 2

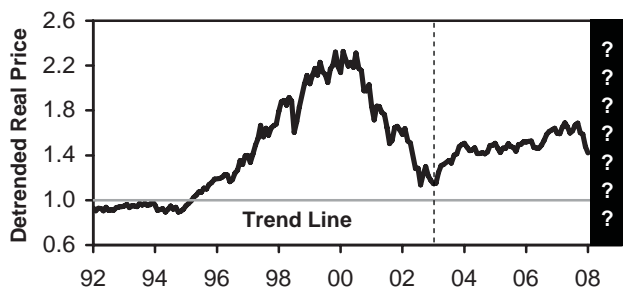
#### Japan vs. EAFE ex-Japan: 1981-1999



Source: GMO

### Exhibit 3

#### S&P 500: 1992-February 2008



Note: Trend is 2% real price appreciation per year.  
 Source: GMO As of 2/29/08

their presence unequivocally, breaking well through the two-standard-deviation (40-year events) that we deem to be a reasonable threshold for worrying about bubbles. The Fed's persistent denials of its ability to see the two in America reflects one of two possible causes. One would be a blinkered academic view over-influenced by neat and tidy economic theories aimed at a reasonable world rather than the real one: first, the world of The Efficient Market Hypothesis of French, Fama, Malkiel, and others (but not, of course, Modigliani); and second, the fantasy world described by Andrew Smithers as The Efficient Central Banker Hypothesis where steady increases in money supply à la Friedman are believed to be able to protect us from all evils, including the madness of crowds. This academic faith in efficiency seems to apply more to Bernanke than Greenspan, since Greenspan oscillated between believing in extreme efficiency (who am I to disagree with thousands of informed investors) and talking about "spectacular speculation" and "booms." The second alternative is that moving to contain asset bubbles that the Fed might see appearing is so guaranteed to face broad resistance that it poses career risk as well as lovability issues. This seems to apply more to Greenspan, but both reasons probably apply in some degree to both of them.

The saddest part of this story is of wasted opportunity. Our research into the Presidential Cycle effect in the market has led us to realize that jaw-boning and moral hazard are the largest part of this very strong market effect, not actual changes in money supply or rates. It is fairly clear that had Greenspan moved against the growing bubble in growth stocks in 1997 and 1998, he could have knocked 20% or 30% off the final bubble price and had a correspondingly smaller fallback in the bear market. This in turn would have lowered the need for 3 years of negative rates (2½ of them after the recovery had started!) and thereby moderated the ensuing housing bubble. The tools needed to cool the markets were readily at hand despite protestations to the contrary. The first action needed was a statement delivered with Volcker-like resolve that the Fed intended to discourage bubble pricing, and that where necessary it would increase rates and margin requirements (the latter of which Greenspan suggested in the minutes in 1996 had the power to check equity bubbles). Even more to the point, the Fed should have made it clear that there was to be at least a temporary removal of moral hazard: that anyone hurt in any ensuing crash would receive no help and that in general the punch bowl would be removed until a more normal market returned. For those who ask on the Fed's behalf "precisely at what level is there a

bubble?" I would refer them back to the exhibits on page 5, and ask them, for heaven's sake, to use their judgment as they are paid to do, and take some risk of being wrong. The alternative is what we have: declining fiduciary standards and chain-linked bubbles. This is the point at which I wonder why on earth we appoint a particularly academic economist to follow a lightweight commercial economist when an experienced banking background would be more relevant. Would a banker, with even a hint of John Pierpont Morgan in him, have allowed such a sad deterioration of credit and banking standards? But let me end this section with Greenspan's repentance: "I have no regrets on any of the Federal Reserve's policies that we initiated back then."<sup>1</sup> What can you say to that? Chutzpah that even Paul Bremer would have to admire!

### **What's Been Happening in the Markets?**

In fixed income the credit crisis was, not surprisingly, treated as a very serious event with an extreme widening of credit spreads. By March, just before the Bear Stearns "bailout," many credit spreads had flashed through normal and several were so ridiculously wide that in our asset allocation group we were beginning to play the recovery. In a semi freeze-up of credit this is not a surprising outcome. What makes life difficult now, though, is that some credit spreads may be attractive but others still do not reflect likely future problems. In short, you have to be expert in the details and, regrettably, the easy pickings, when broad themes that are sufficient to win on their own are finished.

Equities, though, are the Mr. Hyde to fixed income's Dr. Jekyll. Where poor Dr. Jekyll sees drawn out problems, Mr. Hyde sees opportunities and quick recoveries. The animal spirits of the stock market have been nurtured by strong fundamentals and generous credit globally and fertilized by increasing quantities of moral hazard since 1982. Stocks refuse to worry that this is indeed the end of an era, as we believe, and apparently as much of the fixed income market believes.

Look at the amazing earnings estimates for the S&P 500! On January 1 the first quarter estimate was +12%. It is now -8%. Was the credit crisis still hiding on January 1? Even now the forecast for this year is +15%. Plus 15%! What is going on? With denial skills of this magnitude it is surely not a surprise that subtleties within the equity market such as quality versus junk have been misjudged. But in the end

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<sup>1</sup> *Los Angeles Times*, April 2008

reality usually wins out and the outlook for the riskier end of U.S. stocks is ugly indeed. They are vulnerable on three fronts. First, a credit crisis: on corporate accounting there is no vulnerability in the highest quartile of quality and little in the next half. All the vulnerability is concentrated in the bottom quartile by quality. These lower quality companies have used increased leverage and some are very vulnerable, although the largest vulnerability of all is in smaller companies below the S&P 500. Second, profit margins: the profitability of smaller and more marginal companies ebbs and flows relative to the S&P on a multi-year cycle. When you have a long, drawn out economic cycle, particularly one characterized by a sustained series of pleasant surprises like this one, capacity will be tighter and secondary suppliers, the more marginal companies, will especially thrive. (For four consecutive years, global GDP growth was a pleasant surprise every quarter compared with year-earlier consensus estimates, until rudely interrupted in the third quarter last year. Since then estimates for both U.S. GDP growth and global growth have dropped each month.) The third vulnerability is in price/earnings ratios. As discussed in earlier letters, the market has never gotten the need to normalize for good times. Periods of above average margin should be expected to have below average P/E, but not a whisper of this is to be heard. The correlation between margins and P/E is +.32. It doesn't even have the right sign. And this has been a classic case where secondary, low-quality companies that have fundamentally thrived in this extended boom ended up with both peak margins and a premium P/E. Because of this past favorable set of circumstances, the low-quality companies are exposed to a triple threat: their absolute and relative margins decline; their P/Es fall relative to the market, multiplying their pain; and they are far more exposed than average to a severe credit crisis. On our 7-year data, there is a 9.5% a year spread in anticipated total return between high- and low-quality companies. If done in a hedge fund format, 100% long quality stocks and 100% short low-quality stocks, it would on our estimates deliver 9.5% over a T-bill. T plus 9.5% is likely to look handsome in the next 7 years. Although precisely how accurate our 7-year forecast is will be another question and one that certainly comes without any guarantees!

Yet another demonstration of the extraordinary resilience (or denial) in U.S. equity markets is shown in their outperformance of foreign equity markets. Many local economies are hanging tough, and not just in emerging countries. Germany and France for two are both looking resilient, at least for now. But they all have serious stock

market concerns about U.S. economic weakness and the U.S. credit crisis. On worries over U.S. problems, their markets have declined more than ours has, although our market sits at the very heart of the problem. Quite remarkable!

### **First Quarter Performance**

Despite a sensational opening week for our relative performance, the Fed's waves of intervention neutralized our U.S. equity performance with the U.S. Quality Strategy ahead by 75 basis points after being up 4.5% in early January and the U.S. Core Strategy being down just over a point relatively. International Active was down a little to EAFE, and International Intrinsic Value and International Disciplined Equity were both up a little. The Emerging Markets Strategy was down 91 basis points. Risk aversion has still not taken hold in global equity markets. GMO fixed income strategies continued to do poorly. Overall, asset allocation strategies were a little ahead. Our hedge strategies were our bright spot for once, with Multi-Strategy up 5.4% absolute where the average competitor was down. A considerable amount of this was earned early in the year from being short risk in fixed income, with the Completion Strategy up nearly 24%. Now if only the equity markets would get the same point!

### **Recommendations**

Look through the fixed income rubble to find some nuggets, if you have the skill set. Otherwise avoid risk, particularly within the U.S. market where low-quality stocks have defied the laws of gravity and relative to high-quality stocks look an even better short sale than 6 months ago. Unfortunately, government bonds globally are now badly over-priced as they become sought after as havens in bad times.

To us, these seem to be the best bets for the next year, in rough order. Short UK real estate – it is much more overpriced than the U.S. market was and is just turning down. Sadly, it is very difficult for most of us to play. Short the GBP – it is slightly overpriced on purchasing parity, but extremely vulnerable to many factors that have gone wrong in the U.S. market, but not yet to the same degree in the UK, like the decline in house prices, trouble with high consumer debt levels, high dependence on the financial world, and large internal and external deficits. In general the UK looks to be in big trouble. Land in emerging countries is also generally attractive but that's a long story, best left for next time. Otherwise, though,

just take a deep breath, hunker down with cash, and live to fight another day. It's a difficult task for most of us who easily get ants in our pants. Since I still believe that the U.S. market will not bottom for some time – 2010 still

looks good – we must be prepared for plenty of rallies to fill in the time. High animal spirits, fortified for so long by good times and moral hazard, will not give ground easily.

Disclaimer: The views expressed are the views of Jeremy Grantham through the period ending April 24, 2008, and are subject to change at any time based on market and other conditions. This is not an offer or solicitation for the purchase or sale of any security and should not be construed as such. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.

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*Letters to the Investment Committee XIV\**

## The Emerging Emerging Bubble

Jeremy Grantham



In asset allocation work at GMO we have always concerned ourselves with one particular event: overpriced asset classes. We have not had to worry about whether they were caused by Black Swans – genuine unpredictable extreme events – or just “normal” behavioral craziness: herding carried to such extremes that most investors believe they have entered a new golden era. We have never attempted to guess when or why asset prices will diverge from trend. We have limited our job to predicting that, when diverged, they will sooner or later return to normal. That much, much easier task has been hard enough. But still, never calling a major divergence does leave a gap in one’s résumé. So, perhaps once in a career any self respecting strategist, even a one trick “mean reversion” pony like GMO, should have a go at predicting a major divergence, a true bubble. And this is ours.

It was a long and wonderful run in the stock market to get the trailing 12 months P/E of emerging market equities to overtake that of the S&P 500, but it finally made it this September. From its low in 2002 the emerging index (the IFC Investable Composite) rose by 460% against 98% for the S&P and, as if to rub it in, the emerging index finished its run with a 30% surge in a few weeks from its August low. How could it only have reached parity after such a huge move, you may ask? First, emerging started much cheaper (as I’m happy to say we really hammered on about), and second, their earnings rose substantially faster (22% per year compared to 16%). So in the fall we were suddenly reading about the premium P/E for emerging. But then, riding to the rescue, came the unexpectedly large drop in U.S. earnings. Using trailing actual net earnings, the P/E of the S&P suddenly jumped

in November from 18x to 22x, leaping ahead of emerging once again.

So emerging is still selling at a slight discount. It also has the usual psychological advantage of being the body in motion – everyone loves a winner, and emerging has not just won in the markets; it is also a relative beneficiary of strong commodity prices, the general beneficiary of strong global growth, and an enormous beneficiary of the U.S. trade deficit. Emerging countries have simply become (at least for now) financially strong powerhouses with strong currencies (in complete and utter contrast to their former reputation) and everyone knows it!

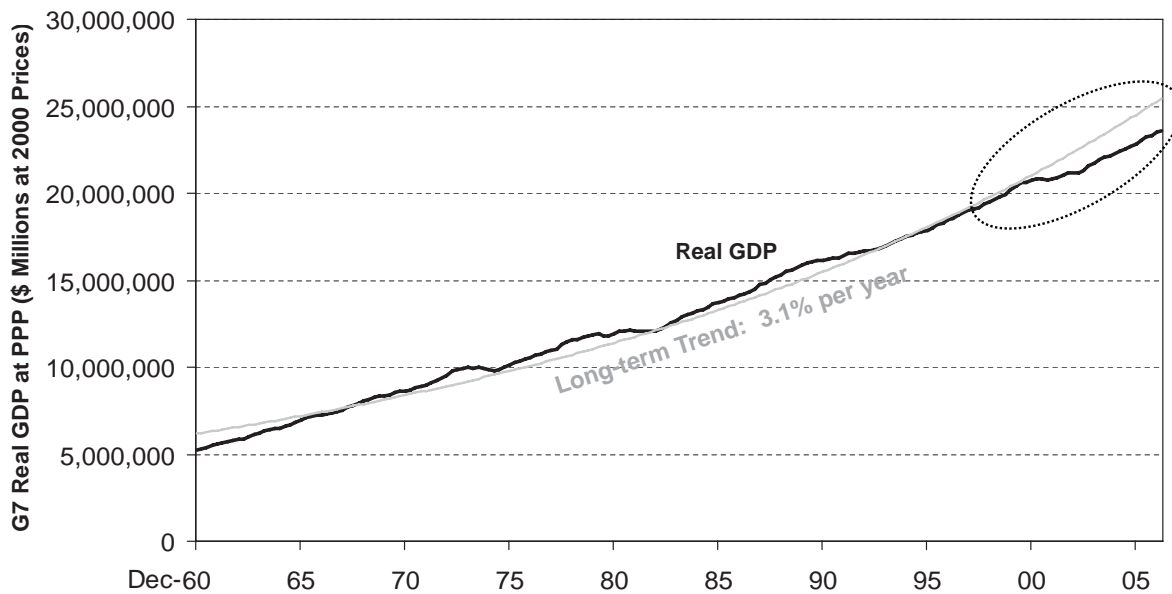
Still the thing that interests me most is the potential for further relative gains, perhaps even the emergence of a fully fledged bubble in emerging. Such a bubble will probably need a positive case that is clean and simple and seems much longer term than the case made so far. And I think there is a strong candidate.

We are all used to parts of the developed world growing very slowly. Japan – with the triple punch of declining population, a financial bubble, and poor conservative financial management – has floundered for over 15 years. Americans are also inherently aware of so-called Eurosclerosis – that particular European countries are so limited by their rigid social and economic structures that their growth opportunities are thought to be modest for the indefinite future. But what we are approaching now is the unthinkable: that the U.S. too is past its prime and that the whole developed world is suffering from irreversible middle-aged spread. Exhibit 1 shows the developed world’s GDP long-term growth, which could be interpreted

\* The Letters to the Investment Committee series is designed for a very focused market: members of institutional committees who are well informed but non-investment professionals.

**Exhibit 1**

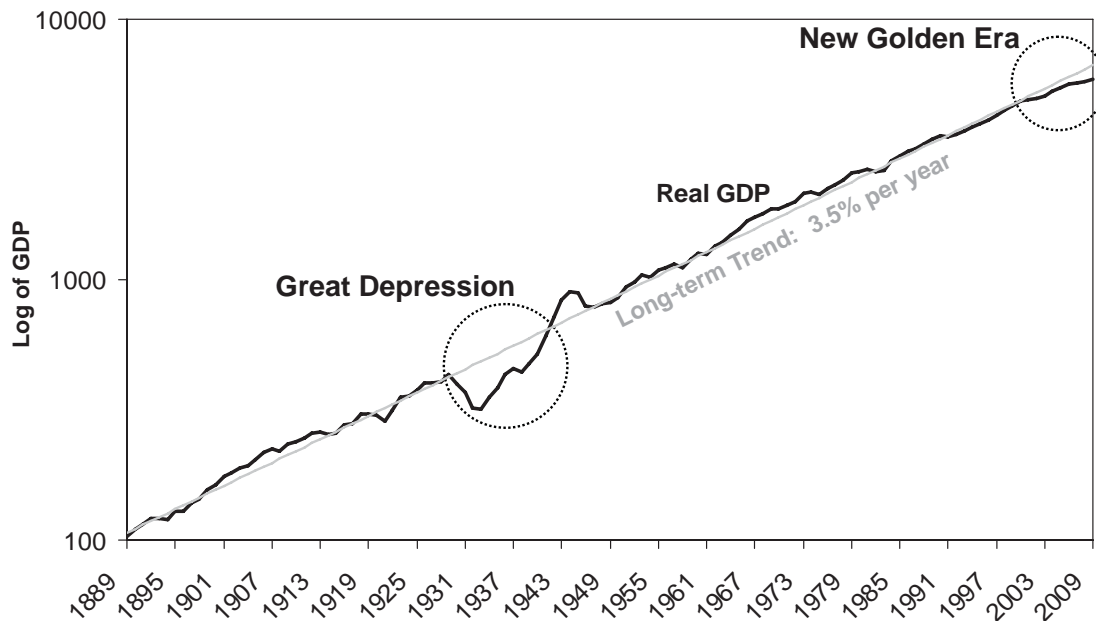
**G7 Growth – Not So Golden**



G7= U.S., UK, Canada, France, Germany, Japan Source: Datastream As of 3/31/07

**Exhibit 2a**

**U.S. GDP Growth: 1889-2009**



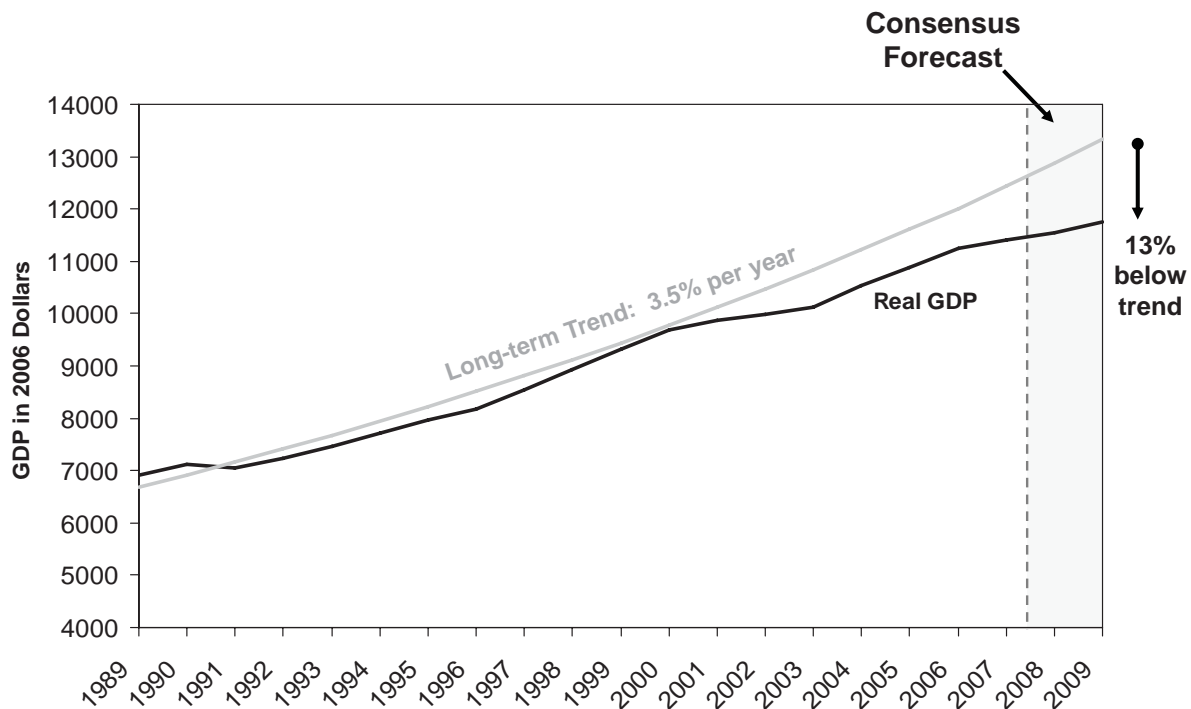
Source: Current BEA since 1929, average of sources before that As of 3/31/08

as modestly but persistently sliding off its former trend line. Exhibit 2a (with blow-up shown in Exhibit 2b) has always been my favorite example of the remorselessness of U.S. growth – the GDP battleship as I call it. But it too has fallen off the pace in recent years. And remember

both of these fall-offs have occurred despite an extended period of nearly perfect global economic and financial conditions until recent months and, in the case of the U.S., a tripling of the total debt to GDP ratio in the last 25 years as covered in last quarter’s letter.

## Exhibit 2b

### Blow-up of the "Golden Era" in U.S. GDP



Source: Dept of Commerce, BEA As of 3/31/08 – Forecast through 2009

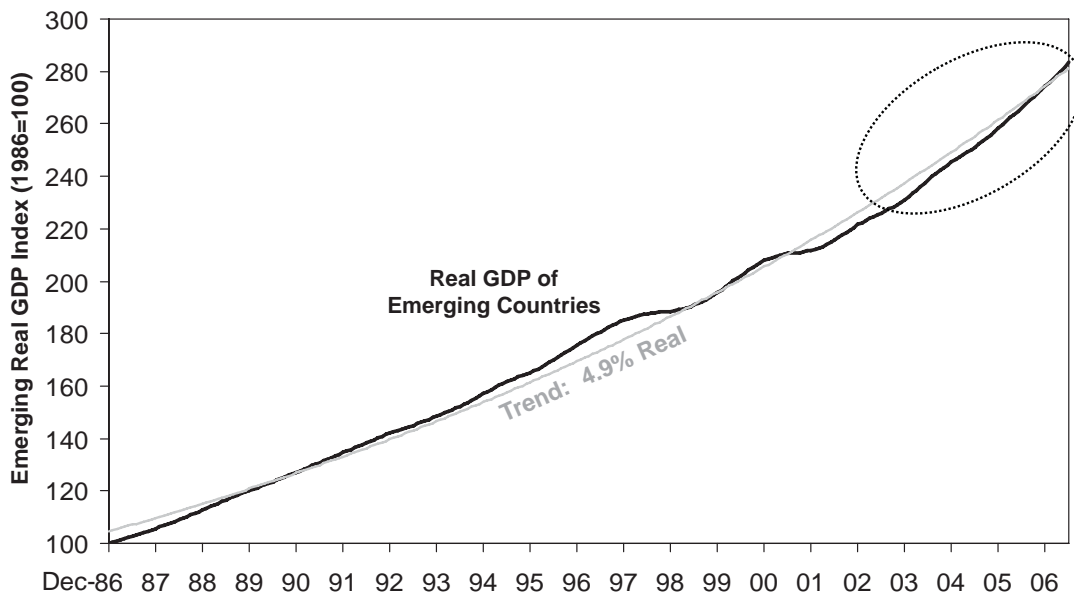
Now admittedly much the largest piece of this decline in GDP growth trend is from population and labor force; productivity as measured in the U.S., over the last 10 years of slowing growth, has held up well. All of the U.S. decline in GDP growth has come from a decline in the growth of rate of hours worked, not from a decline in productivity, and most of the decline in other developed countries has also been from work force effects. An increasing number of economists, however (interestingly including Greenspan by the way), are concluding that future productivity in the U.S. and Europe is also likely to decline enough to worry about from the level of the last 10 years. This may indeed be the case, but what is certainly the case is that the growth rate of hours offered to the workforce will: a) continue to decline; and b) decline at an accelerated pace in the next 20 years. But even if 80% of the decline in GDP growth will be explainable by trends in the workforce rather than a more disturbing decline in productivity, will investors care? Will not their focus be, as always, top line growth *über alles* regardless of subtleties?

And think of the comparison that is developing with emerging countries. Exhibit 3 shows the same GDP aggregate growth rate for them. Ta-dah! Not a hint of

a slowdown. Economists are also confident that as subsistence farmers move into factories, the productivity in emerging countries will continue stronger than in developed countries. So in addition to the current tactical advantages for emerging that may or may not have legs, we have a plausible and probably accurate long-term case that their GDP growth will stay faster for years, even decades! (A potential spin on the negatives for developed countries by the way is that as Baby Boomers retire, starting now, there would appear to be more sellers of houses and stock portfolios than buyers, and this certainly feels like it would put pressure on prices.) Can't we just see over the next 2 or 3 years this case getting repeated annoyingly often and with varying degrees of hype: "They have the growth. We don't. What's to discuss?" For all bubbles you need an underlying strong fundamental case (or at least one that looks like it for a while). Compare this case for example with, say, the one for Japan in 1989 where a careful reading of the serious data – GDP growth, productivity, and profit margins – revealed weaknesses long before the peak. And how about the TMT bubble? Yes, that was a much less flaky argument than for Japan, but still you would have to be high on Greenspan and the internet pushing back the dark clouds of ignorance to compare it to this case: the

### Exhibit 3

### Emerging Countries GDP – Still on Trend



Source: EIU, GMO As of 6/30/07

emerging countries have the savings, the resources, the inclination, the momentum, and, above all, the people and the GDP growth. This case is far harder to argue with than the two other recent spectacular bubbles. And just think what happened in those two bubbles. The entire Japan Inc. sold at 3x the P/E ratio of the rest of the world. 3x! (Okay, 2x if you adjust for cross holdings, but still not bad.) And the NASDAQ also sold at 3x the P/E of the rest of the world. (By the way can you remember back in 2000 that only fuddy duddies followed the S&P? The greasy spoon, lunch-time restaurants that had their TVs showing nothing but CNBC screaming about internet stocks and the NASDAQ have now returned once again to showing baseball highlights, happily for Bostonians at least. Well it's 8 years later and the NASDAQ is still well below 40% of its peak in nominal terms or well below one-third in real terms. So life is not always a bowl of cherries for perma-bulls either!)

Well, if Japan and the NASDAQ bubbles could sell at such premiums, what will happen this time with a better story? A bubble historian would have to conclude that selling at 2x the developed markets is obviously not out of the question, but this is the problem with dealing with bubbles that haven't arrived; reasonable minds gag on the degrees of possible unreasonableness. So let's at least try to accept the idea of a 50% premium. This is far, far less

than normal but would still make a lot of money from here. Unfortunately, if we budget for a "modest" 50% premium, it would still allow us at GMO to maintain our unbroken record of selling early.

Now, there are as usual caveats. For one, emerging will increasingly be seen on a country-by-country basis. Nevertheless, the second wave of let's-look-like-Yale money from state plans is still in its early stages and looking to invest overwhelmingly in emerging market funds, not in the specific country funds of the Yales and Princetons. For another caveat, the GDP growth rate of a country does not in the very long term necessarily determine how much money a country's stock market will make. Long-term market return may depend more on profit margins. But investors believe GDP growth really matters, and Japan went to 65x earnings despite average or lower corporate profit margins. But the third caveat is the most serious; this emerging bubble can easily be postponed or even stopped before it really begins by the current financial problems and the slowing growth rates of the developed world that are likely to follow. My own view is that our credit problems will impact and interrupt the recently sustained outperformance of emerging in the intermediate term, say, the next 3 years, even as the acceptance of this emerging bubble case grows. Such interruptions may be quite violent but, despite them, at the next low point for

the U.S. market the emerging markets are quite likely to do no worse and in the recovery they will go to a very large premium. And if, just if, the U.S. gets very lucky indeed and muddles through without serious market and economic problems, then the emerging bubble will of course occur more quickly and smoothly.

### Summary

A) The U.S. and all developed countries will have slower GDP growth in the future, finally falling off their very long-term trends; B) This will be mostly due to lower growth in hours offered to the workforce, but is also likely to be hurt incrementally by a small decline in productivity;

C) The emerging markets will keep up their strong growth of the last 10 years; D) This comparison will lead to a growing acceptance by investors that developed countries are a tired old story and that those who want to make money should buy emerging; E) That despite probable interruptions caused by problems in the developed world, this will lead to emerging markets selling at least at a 50% premium, either quite soon if developed countries hang in, or within 5 years or so if the current problems worsen; F) This bubble, like all bubbles, will not be justified by long-term value but at least will be one of the least flaky bubble cases ever; G) You heard it here first; H) Despite all our efforts, GMO will still probably sell too soon!

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Jeremy Grantham, Chairman

## Feet of Clay

### *Alan Greenspan's Contribution to the Great American Equity Bubble*

—Part 1 in a Series on The Great American Equity Bubble—

#### **Introduction:**

#### **What Is the Fed Chairman's Job Description?**

In its earlier years, the Fed's emphasis seems to have been on economic activity, a reasonable response to the high unemployment of the 1930s and the fears of a post World War II depression. By the nineties, the heavy emphasis had transferred to inflation control following the pain of the high inflation years from 1973 to 1983. Both of these factors were emphasized when they seemed to be critical to stability, and I believe that the underlying job of the Fed probably is, and certainly should be, the maintenance of general economic stability.

Nothing threatens economic stability more than the deflating of a major stock market bubble, particularly this time when there was a chance of global deflations even before the bubble broke. This severe risk brushes aside the argument that bubbles are hard to detect, for the stakes are just too high not to try; great bubbles are, in any case, like mountains sticking out of the plain of normal stock prices. Comparing 36 times earnings to a previous 1929 high of 21 and a 75-year average of 14 times would not seem to take particularly sharp analytical skills. The potential dangers overwhelm Greenspan's defense that the techniques to resist bubbles are not certain, for what in economics is certain? The stability of the US economy can only be protected against the real dangers of a bubble breaking by the Fed and its Chairman being willing, at rare intervals, to take some substantial political risks. They must attempt to identify and moderate major stock bubbles and be prepared to bear some consequences. If they are not prepared to do this, then the risk level of the economy will rise substantially.

#### **Setting the Scene**

Major stock market bubbles are indeed about the most dangerous thing that can happen to an economy. They cause wasteful over investment in hot areas. Through the vast paper wealth they create, they substantially increase

the amount of greed that is in any case in plentiful supply in a vigorous capitalist system. This in turn increases corruption a little and unethical behavior a lot. Bubbles also redistribute wealth. Much of it goes temporarily to stockholders and is later given back. But while it is there, the unexpected wealth changes behavior. It increases consumption that further boosts the economic side of the bubble and hence corporate profits and share prices. By the same token, it will reduce saving and the flow of funds into retirement plans, which seem in the bubble to be doing so well from capital gains that they need no further help from incremental savings. When the market tide recedes, the retirement funds will be revealed as inadequate and will be several years of low savings behind the game. The loss of this fools' paradise will cause resentment.

Most of the redistribution of wealth these days will end up in the hands of corporate managers, particularly in this cycle where they have been the beneficiaries of stock options to a remarkable degree. Stock options in this cycle have not been effectively tied to good performance, and most stock option wealth has been awarded at precisely those companies where shareholders have been most hurt. Under the influence of the great wealth created by options, some managers and their accountants crossed from the grey area into outright illegality. All of this will be resented in the aftermath of the bubble. In general, the size of the 'bezzle' – as Galbraith called the weasel factor – will increase in a bubble, and investors, workers, and of course belated politicians, who had done little proactively, will jump to correct or over correct the problems.

The downside of the great bull markets will in fact always prove to be a paradise for Murphy's Law: whatever can go wrong will pick this time to do it. The over investment caused by excessive stock prices and excessive lending will be followed by a capital spending bust. An investing

public who feels to some extent betrayed will lose confidence in investing. The excessive lending that was facilitated by high stock prices will tend to dry up as will foreign investment that was encouraged by both rising stock prices and a booming economy in the US. Many of these factors will interact and it will always be impossible to know how badly things will work out. Certainly, stock prices themselves have always over corrected below their trend-line value. For all these reasons bubbles should be avoided at any reasonable cost. It will be worth taking some risks with the economy and some career risk to decrease the chances of a major bubble forming. The person in the best position to take effective action is the Fed Reserve Boss, Alan Greenspan. The purpose of this article is to ask how he did and give him a scorecard.

### **Did He See the Bubble Coming and What Could He Do?**

There were many contributory factors to the building and bursting of the 1995-2000 bubble, by far the largest and most important in American history. Many things were done badly or left undone, but I believe the facts and common sense indicate that the single largest contributor to our present problem was indeed Alan Greenspan, for only he had the power to head off or reduce the equity bubble.

Greenspan could have raised rates a little back in 1996 and added a lot of jawboning about determination to prevent an asset price bubble. Most obviously, perhaps, he could have increased margin requirements. Had Greenspan been prepared to use all the tools available and shown his determination, it almost certainly would have worked and cut the last substantial piece off the upswing and offsetting downswing in the US equity market. In addition, it would have reduced the over investment, greed, and corruption that go with a truly major bubble.

While I've been trying to marshal my thoughts on the Greenspan fiasco, he has overtaken my efforts with his breathtakingly shameless and complete denial of responsibility for the bubble at Jackson Hole in late August this year.

According to Greenspan, jawboning the market "would have been ineffective unless backed by action." We can agree on that one. He claimed that the belief that "well-timed incremental tightening" of rates could have succeeded against "the late 1990s bubble is almost surely an illusion." Even more controversially, he argued that increasing the margin requirement would also have had little effect. He further asked whether even the size of the

bubble could be limited by policy and replied: "From the evidence to date, the answer appears to be no." But what evidence did he offer? Since he did not try any of the above, there is precious little evidence that his case was valid. But the circumstantial evidence that strong action would have indeed been effective is quite substantial.

When he was not the one dodging bullets, Greenspan himself had a very different view as to the responsibilities of the Federal Reserve and what it could achieve. In 1966 he had written scathingly of the consequences of weak-kneed behavior by the Fed in 1928 and the dire consequences of delayed and weak action for everyone in the ensuing crash. He wrote in his chapter in Ayn Rand's *Capitalism: The Unknown Ideal*: "When business in the United States underwent a mild contraction in 1927, the Federal Reserve created more paper reserves in the hope of forestalling any possible bank reserve shortage. The excess credit which the Fed pumped into the economy spilled over into the stock market - triggering a fantastic speculative boom. Belatedly, Federal Reserve officials attempted to sop up the excess reserves and finally succeeded in breaking the boom. But it was too late: by 1929 the speculative imbalances had become so overwhelming that the attempt precipitated a sharp retrenching and a consequent demoralizing of business confidence. As a result, the American economy collapsed..." He is clearly blaming the Fed for both the boom and the resulting crash.

J.K. Galbraith, with presumably no axe to grind, having studied the last great equity bubble of the late twenties for his book *The Great Crash* (John Kenneth Galbraith, *The Great Crash*, 1929, pp. 189-194, New York, Mariner, 1997), concluded his analysis with a resounding vote that the Federal Reserve did indeed have the tools to prevent a major bubble but argued presciently it seems that such tools would never be used! He argued "that the chance for recurrence of a speculative orgy (like that leading up to 1929) remains good. No one can doubt that the American people remain susceptible to the speculative mood ... The government preventatives and controls are ready. In the hands of a determined government their efficacy cannot be doubted. There are, however, a hundred reasons why a government will determine not to use them ... Action to break up a boom must always be weighed against the chance that it will cause unemployment at a politically inopportune moment. It will always look, as it did to the frightened men on the Federal Reserve Board in February 1929, like a decision in favor of immediate as against ultimate death. As we have seen, the immediate death not only has the disadvantage of being immediate but of

identifying the executioner ... One might expect that ... The Federal Reserve would be asked by bankers and brokers to lift margins to the limit ... The public would be warned sharply and often of the risks inherent in buying stocks for the rise ... all this might logically be expected. However, it did not happen in the go-go years of the late sixties ... nor will it ever come to pass ... Long-run salvation by men of business has never been highly regarded if it means disturbance of orderly life and convenience in the present. So inaction will be advocated in the present even though it means deep trouble in the future ... It is what causes men who know that things are going quite wrong to say that things are fundamentally sound." This unfortunately for everyone sounds all too like the present Fed Reserve Boss.

Greenspan himself back in 1996, when the market at under half its final price was already irrational in his eyes, lets on that a bubble can indeed be broken. Paul Krugman recently pointed out Greenspan's remarkable September 1996 statement to fellow Open Market Committee colleagues, "I recognize that there is a stock market bubble problem at this point. We do have the possibility of increasing margin requirements. I guarantee that if you want to get rid of the bubble, whatever it is, that will do it." This is only one of several smoking guns.

So despite believing that bubbles were dangerous and delay potentially ruinous, despite knowing that he had the tools to break it, and despite sensing back in 1996 - probably with perfect timing the time to act - he did not act, leaving us to face the painful consequences, one of the worst of which is being forced to listen to his excuses and to see the willingness of so many acolytes to nod agreement.

Why did Greenspan not follow through after "irrational exuberance?" Galbraith probably had it nailed. No one wants to be the one caught "holding the pin." No one looks forward to taking a lot of political heat and we know that Greenspan took a good deal because of "irrational exuberance." Hesitating under that pressure is reasonable, and hesitation in dealing with a bubble has been likened to jumping off a London bus as it accelerates. It is at first an unpleasant proposition, but as soon as you delay it becomes just plain dangerous. At such times, wishful thinking becomes an appealing proposition, and Greenspan seems genuinely to have been deep into wishful thinking. As a believer in the new era, only a few sell-side strategists such as Goldman Sachs' Abbey Cohen and Lehman Brothers' Jeff Applegate ran him a close second for relentless and

increasing enthusiasm for the new economy, its new high plateau of productivity, profitability and growth, and its justification for higher stock prices. Greenspan, though, was not selling shares and yet he seems to have believed more completely in this new era nonsense by March 2000 than anyone else. (What an unfortunate coincidence that the title of 'most credulous' and the title of Federal Reserve Chairman belong to the same man.)

Some elements of the conflict between his earlier views and later wishful thinking can be seen in the carefully hedged use of language in the great Jackson Hole Denial of Responsibility. "It is very difficult to definitely identify a bubble until after the fact." Of course it is difficult to definitely identify a bubble, although he himself had claimed in September 1996 to have identified one, and even now he confesses to "strongly suspecting" that one existed then. "No monetary tightening ... can reliably deflate a bubble," he went on. No, of course monetary tightening would not have 'reliably' worked, but together with jawboning and increased margin requirements (which he claimed to know would work), it very probably would have worked. The consequences of a bubble breaking are also not definitively or reliably known, but are typically severe. In any responsible job dealing with the soft sciences of economics and finance, certainty is too high a hurdle. His job is to do the best he can with uncertainties, and in this he failed and failed badly.

### **What Was in His Head?**

Greenspan's vacillation and change of heart may have involved some woolly thinking, although it is hard to separate woolly thinking from a tendency to change arguments to fit the politically convenient position. There are two prime examples. First, his view of market efficiency. His 1966 view is that excesses or bubbles do indeed exist and can be identified and acted on. After having his head slapped by congressmen for his 'irrational exuberance' miscalculation, he hurriedly moves to cover his tail by adopting a view that the market is efficient: "to spot a bubble in advance requires a judgment that hundreds of thousands of investors have it all wrong." Yet his suspicions in his earlier 1996 statement did sound like flat-out belief in an inefficient market. Now in the summer of 2002 he returns to his earlier view: "history attests, investors too often exaggerate the extent of the improvement in economic fundamentals. Human psychology being what it is, bubbles tend to feed on themselves and booms in later stages are often supported by implausible projections of potential demand." "Implausible projections!" Here he

sounds like a behavioralist who believes the market is a dangerous jungle of psychological impulse!

His other remarkable intellectual woolliness regards the cost of capital. His new defense includes an apparent belief that productivity improvements might permit corporate profits to rise at a rate that would have justified the new high stock price. This is a common enough error, but an oddly amateurish one for Greenspan. If indeed profit margins, and hence return to corporations, had improved in a permanent way, then return to stockholders must also improve - and this only occurs with lower stock prices and higher yields, not higher prices. This counter-intuitive result is only the same as saying that the cost of capital must be in balance with the return to capital. Without this balance, there is set up a classic capitalist arbitrage. If the return to stocks is higher than the return to corporate investment, then no company will invest but simply buy cheaper assets in the stock market until a shortage of new assets drives up corporate returns. Conversely, if it is less, then corporations will raise new capital by selling expensive shares and invest in new plant (shades of the telecom boom), bidding down the returns on new investment until the system is in balance. Greenspan's logic would fail a Finance 101 final!

### **Greenspan: the Great Promoter**

With Galbraith's help, it is easy to understand how a politically minded Federal Reserve Chairman would avoid taking decisive action against an asset class bubble. We can even understand that his muddled thinking on several issues would not have helped him be decisive. Much harder to understand, though, are his statements of bullishness about the economy. Given his stated misgivings and "suspicions" on the probability of a bubble, why would he frequently make the most extravagantly optimistic statements about the new economy to a broad public? Given his status, did he not expect this to be used as fuel for the fire? Did he not realize it would encourage precisely the "exaggeration" of economic progress he now blames for the bubble? Did he really see this as being in his job description whereas controlling an asset class bubble was not?

It is worth reminding ourselves of the extravagance of some of his statements. In January 2000, for example, he claimed that "the American economy was experiencing a once-in-a-century acceleration of innovation, which propelled forward productivity, output, corporate profits and stock prices at a pace not seen in generations, if ever." Phew! The internet, which had "pushed back the fog of uncertainty" for corporations, was his particular

pet. "Lofty equity prices," he said, "have reduced the cost of capital. The result has been a veritable explosion of spending on high-tech equipment ... And I see nothing to suggest that these opportunities will peter out anytime soon ... Indeed many argue that the pace of innovation will continue to quicken ... to exploit the still largely untapped potential for e-commerce, especially the business-to-business arena." All this within one week of the peak from which the Nasdaq's "lofty prices" declined by 75% and the business-to-business sub index fell by over 95%!

The economic basis for his enthusiasm always looked shaky. Not that the economy and productivity were not doing well. They were much better than the seventies, eighties, and early nineties. It simply did not seem to be as good as Greenspan believed. Skeptics argued, for example, that hedonic inflation adjustment, which argued that four times the speed in a computer was equivalent to a 75% reduction in real prices, was unrealistic. It added some ½% a year to productivity and was not used by many perfectly serious countries. Too much of the productivity gains came from an unsustainable boom in capital equipment for technology. Productivity was calculated per person, not per hour, and Americans and Brits were alone in working longer in the nineties as they got richer. The rest of the developed world quite sensibly worked less. This list of earlier challenges to the validity of the new economy is just a sample. In short, for many of us, the case for a permanent and significant improvement was possible but absolutely not proven, and the degree of improvement was seen as entirely unlikely to rival Greenspan's vision.

Whatever Greenspan's motives for voicing his enthusiasm for the new economy, we know what its effect was. It removed reasonable doubt for most investors. The *Financial Times*, who incidentally get the award for least boot-licking of the major papers regarding Greenspan over the last 5 years, pointed out that his "increasingly bullish observations ... may well have contributed to the explosion of exuberance in the late 1990s." Morgan Stanley's economist, Stephen Roach went further, arguing that Greenspan's outspoken belief in the unique features of this cycle - rapid growth yet low inflationary pressure - removed the need to raise interest rates. "That was the buy signal every investor and speculator dreamed of."

### **Summary**

In the end, what Greenspan faced was not a moral dilemma. The morality was clear. He had the knowledge, experience, and belief and failed to act. What he had was

a career dilemma. If he jumped off the moving bus early, he would have taken some considerable grief. If the economy had slowed, he would have been blamed. The timing of occasional ordinary recessions is not of vital importance to society. Indeed, an occasional moderate recession may be necessary for a healthy economy in the long run, although you could find economists who would argue the other side. The real cost to society comes from the corruption, disappointments, reduced savings, and the wasted investments brought on by a bubble. The timing of recessions is, however, of real importance to politicians who want to be re-elected and who face an electorate whose view of their political platforms is often a simple, "It's the Economy, Stupid!" In Greenspan's defense, we can agree he would have received little or no thanks for preventing the evils of a boom and bust for it could never be proved. What we do know is the world's willingness to believe that things would work out well despite the bubble. So if he had acted, his reputation and career would have suffered at least temporarily. If he had engaged in wishful thinking, he could believe that there would be either a chance that things would muddle through or a chance that his denials of responsibility, muddled and contradictory as they are, would suffice. For a Federal Reserve boss to have volunteered to have taken a lot of political heat and certain short-term damage to his

reputation without a realistic hope of offsetting rewards simply because it was the right thing to do would have taken very high ethical standards and considerable strength of character. Paul Volker perhaps might have made that choice.

As for Greenpan's recent defense, in the end what did we expect? That he would repent his lack of character? That he would admit even partial fault? His complete denial on this regard brings to mind an incident in the Profumo sex scandal of the 1960s in England. One of the women involved, Mandy Rice Davis, on hearing that the government minister had denied having sex with her, replied with the immortal words, "Well he would say that, wouldn't he?" Sometimes the blindingly obvious is funny. This time the equally predictable denial of responsibility and the apparent credulousness of many opinion makers (but encouragingly not all of them) in accepting his argument are merely irritating.

Irritating or not, it must be conceded that in terms of avoiding blame he appears to have mostly gotten away with it. You can indeed 'fool most of the people all of the time.' 'Most of the people' this time probably included Her Majesty who recently knighted him for his global services. My secret hope though is that she justified it by having had a good short position for the last 3 years.