

IS GREENSPAN FUELING THE FIRE?

Vincent Godin, CRL Staff

Former Federal Reserve Chairman Alan Greenspan said he expects the fallout from subprime-mortgage defaults to spread to other parts of the economy, especially if home prices decline.

"If prices go down, we will have problems -- problems in the sense of spillover to other areas," Greenspan said in remarks to the Futures Industry Association meeting in Boca Raton, Florida today. While he hasn't seen such spreading yet, "I expect to."

Subprime borrowers, or those with poor or limited credit histories, are increasingly defaulting after looser lending standards allowed them to take on more debt than they could afford. Last month, Greenspan told an audience in Toronto that "disarray" in the subprime mortgage market isn't likely to create greater financial instability in the rest of the economy.

Greenspan, who was Fed chairman for almost two decades until Ben S. Bernanke took over 13 months ago, has contrasted from his successor in his remarks on the economy. Greenspan said at least three times in the past month that a recession is possible. He didn't say one was likely. He said in an interview this month there's a "one-third probability" of a 2007 recession.

According to a model created when Greenspan ran the Board of Governors of the Federal Reserve System, the probability that the U.S. economy will shrink for two quarters has risen to 50 percent. The formula is based on differences in yields on Treasuries.

The economy has gone into recession six of the seven times since 1960 that short-term interest rates topped longer-term bond yields, as they do now. The difference between three-month bills and benchmark 10-year notes is close to the widest since 2001. Investors say the so-called inverted yield curve is a sign the Fed will cut borrowing costs because the economy is decelerating.

Investors have used interest rates to predict the economy since 1913, according to a Fed study. Short-term rates have exceeded long-term yields since July, in part because of demand for Treasuries from China and other

central banks. The yield difference may now be sending a message about the economy, some investors say.

A yield-curve model the Fed developed in 2006 is based on research by staff economist Jonathan Wright, as well as analysis from the 1990s by two economists at the Federal Reserve Bank of New York, Arturo Estrella and Frederic Mishkin. Christopher Low, chief economist in New York at FTN Financial, used the model to determine that the 50-basis-point yield gap between three-month bills and 10-year Treasuries would amount to a 50 percent likelihood of a recession over the next year.

Estrella and Mishkin's study said Treasury yields are a better predictor of recessions than stock prices. That is because relatively high short-term rates slow the economy while lower longer-term rates reflect the outlook for weaker growth and inflation, they wrote.

"We are in the sixth year of a recovery; imbalances can emerge as a result," the 81-year-old Greenspan said in a March 5 interview with Bloomberg. "Ten-year recoveries have been part of a much broader global phenomenon. The historically normal business cycle is much shorter" and is likely to be this time, he added.

Three-month bills have exceeded the yield on notes since July 19, three weeks after the central bank raised its overnight lending rate between banks to 5.25 percent. The gap widened to as much as 60 basis points on Feb. 27, the widest since February 2001.

"The economy's growth pace is moderating and will probably grow below potential," said Tony Rodriguez, who oversees \$70 billion, as head of fixed income at FAF Advisors in Minneapolis, the asset-management arm of U.S. Bancorp. Treasury yields are "pointing toward an economy that's moderating." (Bloomberg).

Greenspan's speeches mark a return to economic forecasting, a role he enjoyed before entering government service during the administration of President Gerald R. Ford in 1974. Since retiring in January 2006, Greenspan, 81, has been working on a book, ``The Age of Turbulence,`` scheduled for publication in September, and speaking to companies and business groups.

It's ``quite remarkable that we have not seen impact on personal consumption" from the broader housing slump, Greenspan said. The boom in home prices from 2001 to 2005 accounted for a ``fairly significant" portion of consumer spending, he said. ``At the moment we are not seeing impact" on consumption, he said.

As a result of all these comments, once the darling of Wall Street, many of his old buddies are now souring on Greenspan, seeing tinges of hypocrisy and opportunism in his newfound gloom. "I'm kind of disappointed with Greenspan," said Andrew Brenner, a market analyst at MAN Financial. "I find it unusual that he's been talking so much."

Making matters worse, his critics contend that many of the troubles facing the U.S. economy -- including growing tumult in the housing market -- are a direct product of his prolonged policy of rock-bottom interest rates. His outlook was not always glum. On the contrary, Greenspan always seemed to be looking at the bright side when holding the economy together was part of his job description.

This is what he had to say back in 2005 about the subprime mortgage market, where rising default rates have now sparked concern about a broader economic crisis: "Lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately," he argued at the height of the housing boom. With many of those very same lenders now declaring bankruptcy, their efficiency in measuring risk now seems a lot less sturdy -- making Greenspan's assessment seem off target.

It's not just housing that has suddenly yanked the former central bank chief off the pedestal where he once stood. For some, the biggest beef comes from his prediction that a U.S. recession was possible this year.

Coming at a difficult juncture for financial markets, his comments contributed to the biggest plunge in U.S. stocks since September 11, 2001, and revived an aversion to risk from which global investors had yet to recover.

Again, this is a departure from statements near the end of his term at the Fed, when he endorsed the theory that growth was likely to slow moderately to a more sustainable pace.

"Now that he needs material for his \$150,000 speeches, is he quoting studies he previously disagreed with?" asked Jim Bianco, president of research firm Bianco Research. Pressed on the issue at a New York conference last week, Greenspan said he was surprised by the market's reaction, adding that he would like to continue making economic predictions now that he is no longer in public office.

Some analysts have also defended his right to express whatever views he pleases. "It's not so much that Wall Street didn't like that Greenspan spoke, but that some people didn't like what he had to say," said Marc Chandler, senior currency strategist at Brown Brothers Harriman in New York. "But should we say everyone has freedom of speech except former chairmen of the central bank?"

But to the extent that Greenspan's words affect the markets, potentially making it tougher for the central bank to keep the economy humming along, his loose lips could be detrimental to the country.

So the question is whether we can believe Greenspan. Was he purposely understating potential risks to the economy as Fed Chairman or is he just trying to increase his demand to make speeches at 150k each? Personally, I am apt to believe that Greenspan wouldn't be saying such comments unless he truly believed them. Now that he is no longer Fed Chairman, he doesn't have to spin every situation in order to try and calm the markets. Is the US economy in trouble if the bastion of optimism in the US economy over the last 25 years has turned negative?