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Philip Arestis
Levy Economics Institute

Warren Mosler
CFEPS

Bard

CFEPS

Center for Full Employment and Price Stability

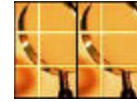
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BY
PHILIP ARESTIS
WARREN MOSLER

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BY PHILIP ARESTIS* AND WARREN MOSLER†

INTRODUCTION

In July Federal Reserve Chairman Alan Greenspan testified for the last time before a joint session of Congress (Greenspan, 2005a, 2005b). Below are excerpts of his testimony followed by a brief analysis of his stated positions. We suggest that this last testimony of the 'maestro' is illustrative of a number of 'innocent frauds' that he has promoted throughout his career.

The purpose of this short note is to identify these errors and discuss the actual operational realities behind our current monetary system. A final section summarizes and concludes. In pursuing these arguments we are reminded of the contributions of John Kenneth Galbraith, and most specifically of the arguments of his latest book, *The Economics of Innocent Fraud* (Galbraith, 2004).

THE INNOCENT FRAUD OF 'ACCOMMODATION'

In light of these developments, the Federal Open Market Committee raised the federal funds rate at its June meeting to further reduce monetary policy accommodation. (Greenspan, 2005a)

The current notion of 'accommodation' is based on a fixed exchange rate concept that historians of thought date back to Wicksell's (1898) theory of 'real interest rates.' Interestingly, about 5 years ago the Fed very quietly abandoned the notion of a 'Non Inflationary Accelerating Rate of Unemployment' (NAIRU) as a basis of policy formation when unemployment fell below 4% and inflation failed to materialize. Without notice, discussion, or in any way missing a beat, the Fed seamlessly morphed into an even earlier framework (Wicksell, 1898) from a very different era. The spread between the rate of inflation and the risk free nominal interest rate was defined as the 'real' interest rate, and this became the Fed's focus.

* Cambridge Centre for Economic and Public Policy, University of Cambridge; Levy Economics Institute

† Senior Associate Fellow, Cambridge Centre for Economic and Public Policy, University of Cambridge.

Under a gold standard system, the nominal rate of interest is in fact a real interest rate as without devaluation one accumulates additional gold at the nominal rate of interest, since the conversion ratio from the currency to gold is fixed by the government. By raising and lowering the nominal rate of interest the government directly alters the real rate, and, at the same time alters the real cost of bank reserves and the real cost of borrowing. On a gold standard, bank reserves play a different role than they do with today's floating exchange rate regimes, as actual convertible cash is needed by banks to meet depositor withdrawal demands. This is a reserve constrained 'loanable funds' world; in other words, the 'money multiplier' rules.

Unfortunately this has no application in a floating exchange rate regime, where lending is not bank-reserve constrained, and where there is no basis for stating that a nominal rate of interest in excess of a measure of changes in a price index is 'accommodative.'

THE INNOCENT FRAUD OF A SAVINGS GLUT

In addition to these factors, the trend reduction worldwide in long-term rates surely reflects an excess of intended savings over intended investment. This configuration is equivalent to an excess of the supply of funds relative to the demand for investment. What is unclear is whether the excess is due to a glut of savings or a shortfall of investment. Because intended capital investment is to some extent driven by forces independent of those governing intended saving, the gap between intended saving and investment can be quite wide and variable. (Greenspan, 2005a)

While it may be correct that an excess of intended savings has resulted in some lowering of long-term interest rates, this phenomenon is a description of a condition universally known and taught at the University level as a deficiency of aggregate demand. In today's monetary economy, intended savings refers to desires to 'not spend' income. By identity, if intended investment falls short of intended savings, the excess of unspent income results in unsold output. This is also called involuntary inventory accumulation. Unsold inventory can be a damper on business plans to borrow long-term funds for investment to increase output, and thereby be a moderating influence on long-term interest rates. The causation runs from a lack of aggregate demand to reduced sales and unsold inventory, to reduced demand to borrow for investment. The concept of a savings glut in particular, and loanable funds theory in general, simply does not apply in a floating exchange rate regime.

In Greenspan's words: "We can directly observe only the actual flows, not the savings and investment tendencies. Nonetheless, as best we can judge, both high levels of intended savings and low levels of intended investment have combined to lower real long-term rates over the past decade" (Greenspan, 2005a). Precisely, and this is a very good example of a lack of aggregate demand, and not a savings glut!

THE INNOCENT FRAUD OF CAUSATION OF SAVINGS

It is real interest rates that bring actual capital investment worldwide and its means of financing global savings into equality. (Greenspan, 2005a)

Regardless of interest rates, savings will equal investment *ex post*. Furthermore, loans create deposits, and therefore investment is not constrained by available savings, global or otherwise. The business community borrows to invest, which creates the funds it spends on investment. Those funds will consequently be held by some combination of domestic and non-resident entities and accounted for as savings of financial assets.

THE INNOCENT FRAUD OF WORLD SAVINGS

Since the mid-1990s, a significant increase in the share of world gross domestic product produced by economies with persistently above-average saving -- predominantly the emerging economies of Asia -- has put upward pressure on world savings. (Greenspan, 2005a)

These foreign economies are following a policy of deficient domestic aggregate demand coupled with net exports and the accumulation of foreign exchange reserves from the sale of those net exports. Rather than consume all of their output domestically, they would rather net export and accumulate foreign exchange.

This policy benefits the importing nations by lowering domestic aggregate demand, and thereby giving those nations the option of lowering taxes or increasing government spending to sustain domestic demand. In this sense, it surely is the case that exports are necessarily an economic cost and imports a benefit. In fact, a great deal of the study of the economy, and of economics in more general terms, primarily focuses on, and is concerned with, consumption.

THE INNOCENT FRAUD OF SOCIAL SECURITY

But it's certainly also going to be the case that retirees are going to need something like 80 percent of their immediately pre-retirement income to maintain a reasonable standard of living. And that means a very substantial part of retirement resources is going to come from other than Social Security out of necessity.

And that inevitably means private pension funds, defined benefit, 401(k)s, personal savings, other forms of income. And in that, I suspect that we will require fairly significant expanding forms of private savings initiatives. (Greenspan, 2005a)

Note that Greenspan (op. cit.) omits the option of simply raising social security benefits, presumably due to the fixed exchange rate notion of an operational Federal budget constraint. This is not the case with a floating exchange rate policy. We have in this case another example of what Chairman Greenspan discusses below, where he promotes a need to act as if one was on a gold standard or other fixed exchange rate policy, when in fact a floating exchange rate policy is in place.

THE INNOCENT FRAUD OF BORROWING FROM ABROAD

But without getting into the economics of this, capital gains do not finance capital investment. Only savings at its book value, if I may put it that way, do that. And as a

consequence, we have a reasonably high capital investment in this country, but we don't have enough domestic savings and personal savings as part of that to finance it.

A significant part of our investments are, as you know, financed by borrowing from abroad -- and that's our current account deficit. So in the sense that we don't have adequate domestic savings and we can't count indefinitely that we will be able to borrow at the rate we are borrowing from abroad, clearly, then, our savings rate is inadequate and we must address that over the longer run. (Greenspan, 2005a)

Chairman Greenspan has causation the wrong way round again. It is domestic credit creation that results in non-resident savings of \$US financial assets. For example, a US resident will borrow from a US bank to buy an imported car. The loan creates the deposit, and the deposit is exchanged for the car. The non-resident exchanges his car for a \$US financial asset, created by the US bank, making a domestic loan, which in this example becomes the non-resident's savings. Savings do not finance expenditures, domestic or foreign, for either consumption or investment. Nor does the concept of borrowing from abroad have any application whatsoever in this context.

INNOCENT FRAUD OF THE FEDERAL DEFICIT

The following exchange between the Chairman Greenspan and a member of the committee is revealing.

BACHUS: [addressing concerns about low savings] Now, you mentioned some other concerns about this. One was federal spending and the amount of the federal deficit. So, obviously, one thing that we in Congress could do would be try to reduce federal spending. Is that...

GREENSPAN: That would be most helpful. And indeed I have testified before this committee on numerous occasions, as well as other committees in the House and Senate, that this is a critical aspect of the long-term planning of this country, and that, unless we address that issue, I think we are in potentially serious difficulty as we move into the next decade (Greenspan, 2005a).

By identity, the federal budget deficit *equals* **non-government** savings of \$US financial assets. Lowering the federal budget deficit will necessarily lower non-government savings of (net) financial assets. For example, the current US budget deficit of approximately \$300 billion is adding exactly that much to the non-government sectors in total. The non-resident (foreign) sector is accumulating approximately \$700 billion by net selling goods and services to the US domestic sector, and the domestic sector is reducing its savings of financial assets by a net of \$400 billion. Note that the three sectors taken together, by identity, sum to 0.

ON THE YUAN AND STERILIZATION

Well, first of all, I've said previously that I believe that it is in China's interest to allow its currency to move up, largely because its procedures that it uses to support its currency requires that their central bank accumulate very large quantities of U.S. Treasury

securities. Unless they sterilize that very substantial inflow, they create significant distortions in their financial system and ultimately could be very serious for the Chinese economy. (Greenspan, 2005a)

Sterilization is operationally automatic and does not create ‘distortions.’ It simply allows exporters to be paid in yuan instead of \$US, with the Chinese government as intermediary. For example, an exporter who sells to a US buyer may get paid in \$US. These are then exchanged at the Bank of China for a (non-interest bearing) yuan bank deposit. To support the overnight rate at the Central Bank of China’s target, it will offer interest bearing securities in exchange for the yuan deposit. The reason this routine process of offsetting operating factors at the Central Bank is called ‘sterilization’ is a throwback to a different type of fixed exchange rate policy, which (unlike current policy) would guarantee conversion from yuan deposits to \$US. In this case, failure to exchange the yuan deposits for longer-term yuan securities would subject the Central Bank of China \$US reserves to depletion on demand of the yuan holders. However, this is not the case with current policy.

ON GOLD AND FIAT MONEY

And, indeed, since the late '70s, central bankers generally have behaved as though we were on the gold standard. And, indeed, the extent of liquidity contraction that has occurred as a consequence of the various different efforts on the part of monetary authorities is a clear indication that we recognize that excessive creation of liquidity creates inflation, which, in turn, undermines economic growth. So that the question is: Would there be any advantage, at this particular stage, in going back to the gold standard? And the answer is: I don't think so, because we're acting as though we were there. So I think central banking, I believe, has learned the dangers of fiat money, and I think, as a consequence of that, we've behaved as though there are, indeed, real reserves underneath the system. (Greenspan, 2005a)

This is a revealing explanation of why in general demand has been suppressed globally for many years, with the resulting widening output gaps. It spills over into his advice on fiscal matters.

A member of the committee poses an interesting question, with the answers by the Chairman being equally interesting:

SCHUMER: So my question is: Given these deficits and the cost of repeal, if there are no offsets, can we afford to repeal the estate tax and increase the deficit by another \$750 billion, if there are no offsets?

GREENSPAN: Well, I think that's the critical question because as I've testified on numerous occasions, I'm strongly in favor of reducing the taxes on capital but under PAYGO. And as a consequence, I would say if there are no offsets, obviously, PAYGO is operative in that respect and the issue is moot

SCHUMER: But is it unfair to say that you would advise not to repeal the estate tax if there are no offsets, if there is no PAYGO?

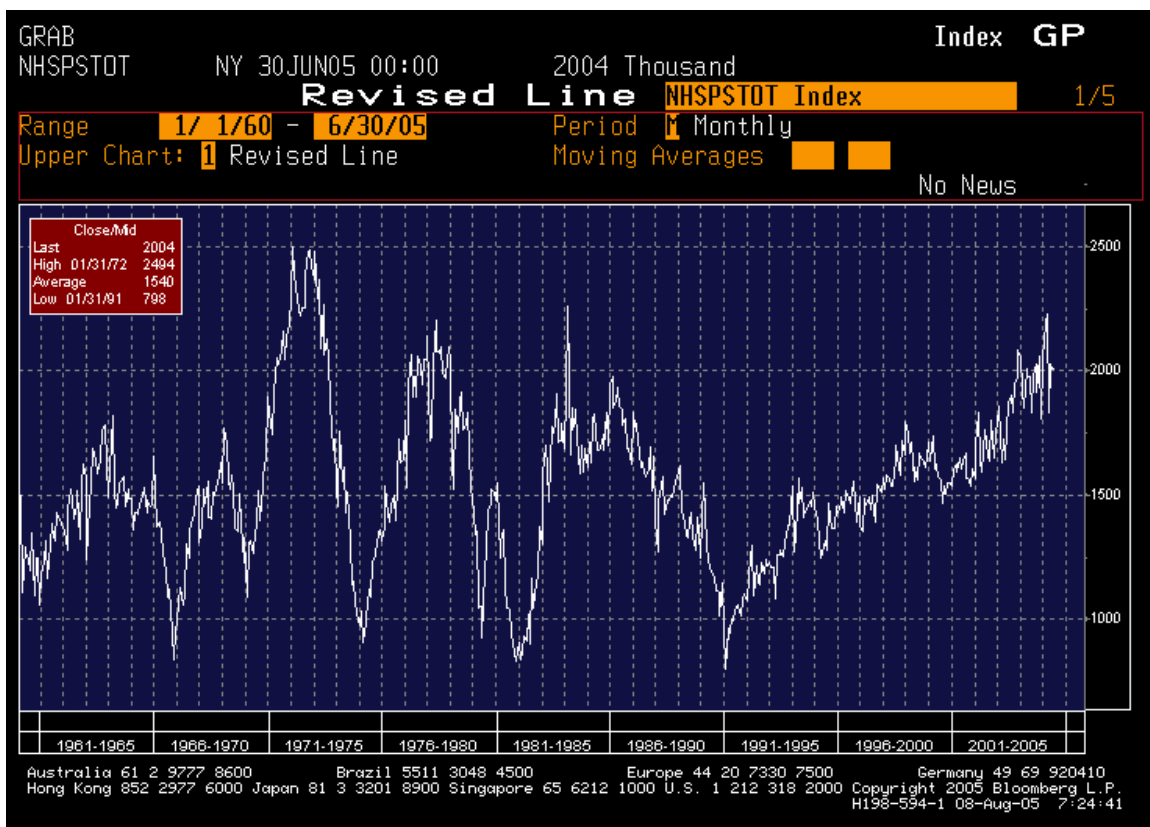
GREENSPAN: That is correct. (Greenspan, 2005a)

SCHUMER: Thank you.

SUMMARY AND CONCLUSIONS

The last testimony of Chairman Greenspan is full of ‘innocent frauds’ as this short note has attempted to demonstrate.

The Greenspan years are characterized predominately by excess capacity and overall sluggish economic performance. Even housing, the poster child of the current recovery has languished, as shown by the following chart:



As shown in the above chart, US housing starts peaked at 2.5 million starts in 1972, 2.3 million in 1984, and now over 20 years later, with a population that has gone from 215 million to 295 million, expectations have been sufficiently altered for 2.1 million housing starts to be considered ‘gangbusters.’

We have made the case elsewhere that it is not the level of interest rates, the only actual tool of Federal Reserve monetary policy, that have been responsible for the persistent lack of aggregate demand that Chairman Greenspan described. The culprit is overly tight (and often misapplied) fiscal policy. Chairman Greenspan has been a major contributor to

world fiscal restraint from his ‘bully pulpit’, and we submit that here his influence on the world economy has been substantial and ongoing.

The legacy of Chairman Greenspan is one of an extended period of economic underperformance. The full realization of potential gains from technological advancement and associated productivity increases have been stifled and delayed. This is likely to continue until the current presumed constraints on fiscal policy are recognized as self imposed and rejected.

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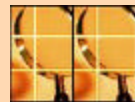
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Center for Full Employment and Price Stability
University of Missouri - Kansas City
Department of Economics; 211 HH
5100 Rockhill Road
Kansas City, Missouri 64110

tel.: 816-235-5835
fax: 816-235-6558
www.cfeps.org
cfeps@umkc.edu