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Remarks by

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Today I should like to reflect on some of the ways in which economic policy both affects and is affected by the increasing flexibility of the U.S. economy.

For this country's first century and a half, government was only peripherally engaged in what we currently term the management of aggregate demand. Any endeavor to alter the path of private economic activity through active intervention would have been deemed inappropriate and, more important, unnecessary. In one of the more notable coincidences of history, our Declaration of Independence was signed the same year in which Adam Smith published his *Wealth of Nations*. Smith's prescription of letting markets prevail with minimal governmental interference became the guiding philosophy of American leadership for much of our history.

With a masterful insight into the workings of the free-market institutions that were then emerging, Smith postulated an "invisible hand" in which competitive behavior drove an economy's resources toward their fullest and most efficient use. Economic growth and prosperity, he argued, would emerge if governments stood aside and allowed markets to work.

Indeed, within a very few decades, free-market capitalism became the prevailing stance of most governments' economic policy, even if it was often implemented imperfectly. This framework withstood the conceptual onslaughts of Robert Owen's utopians, Karl Marx's communists and later, the Fabian socialists.

The free-market paradigm came under more-vigorous attack after the collapse of the world's major economies in the 1930s. As the global depression deepened, the seeming failure of competitive markets to restore full employment perplexed economists until John Maynard Keynes offered an explanation that was to influence policy practitioners for generations to come. He argued that, contrary to the tenets of Smith and his followers, market

systems did not always converge to full employment. They often appeared to settle at an equilibrium in which significant segments of the workforce were unable to find jobs. In the place of Smith's laissez-faire approach arose the view that government action was required to restore full employment and to rectify what were seen as other deficiencies of market-driven outcomes.

A tidal wave of regulation soon swept over much of the American business community. Labor relations, securities markets, banking, agricultural pricing, and many other segments of the U.S. economy became subject to the oversight of government.

The apparent success of the economy during World War II, which operated at full employment in contrast to the earlier frightening developments during the Depression years, led to a considerable reluctance to fully dismantle wartime regulations when the hostilities came to an end.

However, cracks in the facade of government economic management appeared early in the post-World War II years, and those cracks continued to widen as time passed. At the macro level, the system of wage and price controls imposed in the 1970s to deal with the problem of inflation proved unworkable and ineffective. And at the micro level, heavy regulation of many industries was increasingly seen as impeding efficiency and competitiveness. By the early 1980s, the long-prevalent notion that the centrally planned economy of the Soviet Union was catching up with the West had begun to be discredited, though it was not fully discarded until the collapse of the Berlin Wall in 1989 exposed the economic ruin behind the Iron Curtain.

Starting in the 1970s, U.S. presidents, supported by bipartisan majorities in the Congress, responded to the growing recognition of the distortions created by regulation, by deregulating large segments of the transportation, communications, energy, and financial services industries.

The stated purpose of this deregulation was to enhance competition, which had come to be seen as a significant spur to productivity growth and elevated standards of living. Assisting in the dismantling of economic restraints was the persistent, albeit slow, lowering of barriers to cross-border trade and finance.

As a consequence, the United States, then widely seen as a once-great economic power that had lost its way, gradually moved back to the forefront of what Joseph Schumpeter, the renowned Harvard professor, had called “creative destruction”--the continual scrapping of old technologies to make way for the innovative. In that paradigm, standards of living rise because depreciation and other cash flows of industries employing older, increasingly obsolescent technologies are marshaled, along with new savings, to finance the production of capital assets that almost always embody cutting-edge technologies. Workers, of necessity, migrate with the capital.

Through this process, wealth is created, incremental step by incremental step, as high levels of productivity associated with innovative technologies displace less-efficient productive capacity. The model presupposes the continuous churning of a flexible competitive economy in which the new displaces the old.

As the 1980s progressed, the success of that strategy confirmed the earlier views that a loosening of regulatory restraint on business would improve the flexibility of our economy. No specific program encompassed and coordinated initiatives to enhance flexibility, but there was a growing recognition that a market economy could best withstand and recover from shocks when provided maximum flexibility.

Beyond deregulation, innovative technologies, especially information technologies, have contributed critically to enhanced flexibility. A quarter-century ago, for example, companies often required weeks to discover the emergence of inventory imbalances, allowing production to continue to exacerbate the excess. Excessive stockbuilding, in turn, necessitated a deeper decline in output than would have been necessary had the knowledge of the status of inventories been fully current. The advent of innovative information technologies significantly shortened the reporting lag, enabling flexible real-time responses to emerging imbalances.

Deregulation and the newer information technologies have joined, in the United States and elsewhere, to advance flexibility in the financial sector. Financial stability may turn out to have been the most important contributor to the evident significant gains in economic stability over the past two decades.

Historically, banks have been at the forefront of financial intermediation, in part because their ability to leverage offers an efficient source of funding. But in periods of severe financial stress, such leverage too often brought down banking institutions and, in some cases, precipitated financial crises that led to recession or worse. But recent regulatory reform, coupled with innovative technologies, has stimulated the development of financial products, such as asset-backed securities, collateral loan obligations, and credit default swaps, that facilitate the dispersion of risk.

Conceptual advances in pricing options and other complex financial products, along with improvements in computer and telecommunications technologies, have significantly lowered the costs of, and expanded the opportunities for, hedging risks that were not readily deflected in earlier decades. The new instruments of risk dispersal have enabled the largest and most

sophisticated banks, in their credit-granting role, to divest themselves of much credit risk by passing it to institutions with far less leverage. Insurance companies, especially those in reinsurance, pension funds, and hedge funds continue to be willing, at a price, to supply credit protection.

These increasingly complex financial instruments have contributed to the development of a far more flexible, efficient, and hence resilient financial system than the one that existed just a quarter-century ago. After the bursting of the stock market bubble in 2000, unlike previous periods following large financial shocks, no major financial institution defaulted, and the economy held up far better than many had anticipated.

If we have attained a degree of flexibility that can mitigate most significant shocks--a proposition as yet not fully tested--the performance of the economy will be improved and the job of macroeconomic policymakers will be made much simpler.

Governments today, although still far more activist than in the nineteenth and early twentieth centuries, are rediscovering the benefits of competition and the resilience to economic shocks that it fosters. We are also beginning to recognize an international version of Smith's invisible hand in the globalization of economic forces.

Whether by intention or by happenstance, many, if not most, governments in recent decades have been relying more and more on the forces of the marketplace and reducing their intervention in market outcomes. We appear to be revisiting Adam Smith's notion that the more flexible an economy, the greater its ability to self-correct after inevitable, often unanticipated disturbances. That greater tendency toward self-correction has made the cyclical stability of the

economy less dependent on the actions of macroeconomic policymakers, whose responses often have come too late or have been misguided.

It is important to remember that most adjustment of a market imbalance is well under way before the imbalance becomes widely identified as a problem. Individual prices, exchange rates, and interest rates, adjust incrementally in real time to restore balance. In contrast, administrative or policy actions that await clear evidence of imbalance are of necessity late.

Being able to rely on markets to do the heavy lifting of adjustment is an exceptionally valuable policy asset. The impressive performance of the U.S. economy over the past couple of decades, despite shocks that in the past would have surely produced marked economic contraction, offers the clearest evidence of the benefits of increased market flexibility.

We weathered a decline on October 19, 1987, of a fifth of the market value of U.S. equities with little evidence of subsequent macroeconomic stress--an episode that hinted at a change in adjustment dynamics. The credit crunch of the early 1990s and the bursting of the stock market bubble in 2000 were absorbed with the shallowest recessions in the post-World War II period. And the economic fallout from the tragic events of September 11, 2001, was moderated by market forces, with severe economic weakness evident for only a few weeks. Most recently, the flexibility of our market-driven economy has allowed us, thus far, to weather reasonably well the steep rise in spot and futures prices for oil and natural gas that we have experienced over the past two years. The consequence has been a far more stable economy.

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In perhaps what must be the greatest irony of economic policymaking, success at stabilization carries its own risks. Monetary policy--in fact, all economic policy--to the extent that it is successful over a prolonged period, will reduce economic variability and, hence, perceived credit risk and interest rate term premiums.

A decline in perceived risk is often self-reinforcing in that it encourages presumptions of prolonged stability and thus a willingness to reach over an ever-more-extended time period. But, because people are inherently risk averse, risk premiums cannot decline indefinitely. Whatever the reason for narrowing credit spreads, and they differ from episode to episode, history cautions that extended periods of low concern about credit risk have invariably been followed by reversal, with an attendant fall in the prices of risky assets. Such developments apparently reflect not only market dynamics but also the all-too-evident alternating and infectious bouts of human euphoria and distress and the instability they engender.

Therefore, because it is difficult to suppress growing market exuberance when the economic environment is perceived as more stable, a highly flexible system needs to be in place to rebalance an economy in which psychology and asset prices could change rapidly. Indeed, as I have pointed out in the past, policies to enhance economic flexibility need to be as integral a part of economic policy as are monetary and fiscal initiatives.

Relying on policymakers to perceive when speculative asset bubbles have developed and then to implement timely policies to address successfully these misalignments in asset prices is simply not realistic. As the Federal Open Market Committee (FOMC) transcripts of the mid-1990s duly note, we at the Fed were uncomfortable with a stock market that appeared as early as 1996 to disconnect from its moorings.

Yet the significant monetary tightening of 1994 did not prevent what must by then have been the beginnings of the bubble of the 1990s. And equity prices continued to rise during the tightening of policy between mid-1999 and May 2000. Indeed, the equity market's ability to withstand periods of tightening arguably *reinforced* the bull market's momentum. The FOMC knew that tools were available to choke off the stock market boom, but those tools would only have been effective if they undermined market participants' confidence in future stability. Market participants, however, read the resilience of the economy and stock prices in the face of monetary tightening as an indication of undiscounted market strength.

By the late 1990s, it appeared to us that very aggressive action would have been required to counteract the euphoria that developed in the wake of extraordinary gains in productivity growth spawned by technological change. In short, we would have needed to risk precipitating a significant recession, with unknown consequences. The alternative was to wait for the eventual exhaustion of the forces of boom. We concluded that the latter course was by far the safer. Whether that judgment continues to hold up through time has yet to be determined.

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Flexibility is most readily achieved by fostering an environment of maximum competition. A key element in creating this environment is flexible labor markets. Many working people equate labor market flexibility with job insecurity.

Despite that perception, flexible labor policies appear to *promote* job creation. An increased capacity of management to discharge workers without excessive cost, for example, apparently increases companies' willingness to hire without fear of unremediable mistakes. The

net effect, to the surprise of most, has been what appears to be a *decline* in the structural unemployment rate in the United States.

Protectionism in all its guises, both domestic and international, does not contribute to the welfare of American workers. At best, it is a short-term fix at a cost of lower standards of living for the nation as a whole. We need increased education and training for those displaced by creative destruction, not a stifling of competition.

Moving forward, I trust that we have learned durable lessons about the benefits of fostering and preserving a flexible economy. That flexibility has been the product of the economic dynamism of our workers and firms that was unleashed, in part, by the efforts of policymakers to remove rigidities and promote competition.

Although the business cycle has not disappeared, flexibility has made the economy more resilient to shocks and more stable overall during the past couple of decades. To be sure, that stability has created some new challenges for policymakers. But more fundamentally, an environment of greater economic stability has been key to the impressive growth in the standards of living and economic welfare so evident in the United States.