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What Greenspan Missed **by Sheldon Richman**

Former Federal Reserve Chairman Alan Greenspan made headlines around the world with this admission: “[T]hose of us who have looked to the self-interest of lending institutions to protect shareholders’ equity (myself especially) are in a state of shocked disbelief. Such counterparty surveillance is a central pillar of our financial markets’ state of balance. If it fails, as occurred this year, market stability is undermined.”

Greenspan made his confession before the House Committee on Oversight and Government Reform. During that hearing, this exchange took place between Greenspan (AG) and Chairman Henry Waxman (HW), as reported in the *New York Times*:

HW: “You had the authority to prevent irresponsible lending practices that led to the subprime mortgage crisis. You were advised to do so by many others. Do you feel that your ideology pushed you to make decisions that you wish you had not made?”

AG: “Yes, I’ve found a flaw. I don’t know how significant or permanent it is. But I’ve been very distressed by that fact.”

Now it will be said endlessly, “Even Alan Greenspan concedes that the free-market philosophy is flawed.” But not so fast.

While he paid lip service to the efficiency of markets, his professional career reveals someone who does not believe in *laissez-faire*. After all, in a free market there would be no government money monopoly or government-banking cartel. These interventions deeply distort the market process. Yet that is what Greenspan ran for nearly 20 years.

Greenspan says he was shocked that self-interest didn’t prevent reckless investments. But conspicuously missing from his testimony was any reference to the perverse incentives that the government in many ways created for the mortgage industry. He told the committee that the demand for securitized subprime mortgages worldwide was “excessive” and “explosive,” and without that demand our economic problems would be less severe.

But that raises the question: Why were securitizers and investors clamoring for subprime mortgages?

We know the answer. A government effort spanning several decades and the administrations of both parties, including that of Bush 43, pressured and virtually compelled lenders to make mortgage loans to people who wouldn't have otherwise qualified. This was carried out on many fronts, including the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, the Federal Housing Administration, the Department of Housing and Urban Development, and the Community Reinvestment Act (aimed at promoting loans to low-income people), backed by Greenspan's announced readiness to provide liquidity when asset bubbles burst. A major factor was the "too big to fail" doctrine under which the government would bail out troubled lenders.

The result of this campaign was the relaxing of lending standards and the weakening of the market's natural discipline. If a local bank or mortgage broker knew its subprime loans would quickly be sold to a GSE or another institution and turned into guaranteed mortgage-backed securities, there was little reason to enforce high standards on borrowers. As long as housing values kept going up, the system could be sustained. If a homeowner got in trouble with his adjustable-rate mortgage, he could refinance at the new higher value or sell the home for a profit.

But the rise in housing prices couldn't go on forever. When interest rates rose and the housing glut became apparent, values turned south. Now many mortgagors found they owed more than their homes were worth.

Why Greenspan blamed the "free" market rather than the perverse incentives created by the government-banking complex is a matter of speculation. Since he was a party to this rotten system, acknowledging the government's role would reflect poorly on a major part of his career. So perhaps he thought he'd look better in the history books by blaming the free market and his misplaced faith in it.

Of course, the point is that there was no free market. You'd think that Greenspan would know that a free market would have no government safety net for the financial industry. But you'd be wrong.

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