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Greenspan vs. the Gold Standard

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Alan Greenspan recently asked the tantalizing question, "How did we go so wrong?" He answered by asserting that "[there is] little evidence of a learning curve. Asset price bubbles build and burst today as they have since the early 18th century, when modern competitive markets evolved." If anybody should be aware of the absent learning curve, Greenspan should. He has the distinction of having presided over two bubbles during his stint as the chairman of the Federal Reserve—high-tech and home prices—which also partially overlapped.

Paul Volcker, Greenspan's predecessor as Fed chairman, made an interesting and related point at about the same time as Greenspan. He referred to "[t]he mutual trust among respected market participants upon which any strong and efficient financial system must rest." This feature of "strong and efficient" markets never occurred to me, and I do not recall ever seeing any comment of this nature in the literature on the Efficient Market Hypothesis that has come my way. Discussions of rationality, the quality of information, the dissemination of information, and the ability to analyze information are endless, but both adherents and opponents have failed to emphasize the importance of mutual trust in the functioning of efficient markets.

But what has Greenspan's assertion about bubbles and the absence of learning curves to do with this matter of mutual trust? The relation is intimate. Bubbles also require Volcker's "mutual trust among respected market participants." You can have a bust without mutual trust, but stock prices will never rise, or would rise only momentarily, if participants wonder whether the other party is passing a plug nickel or the equivalent.

Indeed, mutual trust must be even more resilient during bubbles than during more sideways trading markets, because the primary motivation in bubbles is each investor's confidence that what others appear to know must be superior information. In more normal markets, many investors take pride in their independent thinking and their willingness to move against the crowd.

Slippage in trust is therefore the necessary condition for the bust to get under way. The events that can set off this turning point vary widely, but they must be sufficiently dramatic to awaken the crowd from the dreams blowing the bubble. Kevin Warsh, a former professor at the University of Chicago School of Business and skilled in the art of metaphors, has described the situation in these vivid terms: "Fish don't know they are wet. They don't learn unless they have long memories or their water is gone."

Participants in the home-price bubble clearly have no long memories, as Warsh emphasized, but their water was gone when subprime mortgages turned out to be subprime. Everybody always knew those mortgages were subprime, but—since everybody knew home prices could only go up—nobody had anything to worry about. The leak that let out the water was the recognition that home prices were falling, and—bingo!—vast multitudes of fish discovered they had been wet. After that, how could mutual trust survive?

Greenspan has his fair share of detractors, but on this occasion I think we can all agree he had it right. There is no learning curve.