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Map for Predicting Finances and Human Nature*

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Alan Greenspan:
The Map and the Territory 2.0: Risk, Human Nature, and the Future of Forecasting
Penguin Books, 2014, p. 432.
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Alan Greenspan was the Federal Reserve's Chairman for more than 18 years during the presidential cycles of four presidents in total. In his book, Greenspan attempts to answer why everyone was mistaken in their forecasts during the global financial crisis, and the lessons that can be drawn. The knowledge he has accumulated as a central banker helps him map this phenomenon. His thoughts can be grouped around three topics dealing with human nature, financial regulations and the importance of productivity.

Predicting human nature

Human nature demands foresight, therefore forecasts are badly needed, despite their imperfections. The economic models used for forecasts necessarily simplify the actual and complex economic relationships. During the financial crisis this was apparent in the forecasting errors stemming from the insufficient understanding of increasingly complex finances. Economies may be driven by rational economic decisions in the longer run, but human thinking is a lot more intuitive than that. So according to Greenspan, a detailed model must contain variables that capture human nature in a relatively stable way, even in the longer run. In his view, propensities without a rational basis (often referred to as "animal spirits"), such as fear or euphoria to mention two of the most important ones, play a crucial role in economic outcomes. This is especially true for financial matters that are based on fast decisions.

* The views expressed in this paper are those of the author(s) and do not necessarily reflect the offical view of the Magyar Nemzeti Bank.

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The 2008 financial crisis urged Greenspan to review his previous perspective according to which animal spirits are random and hence unmanageable in economic modelling. Some factors are measurable (risk aversion, time preferences) and can be modelled thanks to their systematic nature. But due to the vagaries of human nature, forecasts will always be uncertain. Euphoria will cause temporary booms on the market, also fed by herd behaviour in the good times, followed by sudden fear-induced declines when the bubble bursts. Greenspan argues that the accuracy of forecasting could be improved if we could integrate certain aspects of the animal spirits that can be modelled.

Regulating finances

At the onset of the financial crisis, the magnitude of the problem could not be seen clearly for a prolonged period. The securitised US subprime mortgages only triggered the crisis. According to Greenspan, a typical euphoric bubble characterised by intense demand and rising asset prices was created prior to the crisis. Even though a crisis might hit, financial companies expected that they would still have time to get rid of their problematic portfolios without substantial losses. But they failed to consider that market liquidity depends heavily on the level of investor risk aversion. In parallel with a jump in risk aversion, liquidity disappeared from the money markets, which pushed the global economy into a downward spiral. A dangerous animal spirit, the fear-induced run, manifested itself.

In his view, it was high time to tighten regulatory capital requirements, and regulations must be harmonised internationally. Greenspan points out that the financial crisis was caused by the flaw of an important pillar of a stable economy, i.e. rational financial risk management. To eliminate this flaw, the crisis triggered regulatory measures. The risks of an unstable financial system can be mitigated by increasing capital requirements, but excessive regulation can be just as counterproductive as the lack of regulation in the past.

By definition, regulations impose limitations on competition, and therefore a proper balance must be found between growth and stability considerations. In his view, the burden of massive new financial regulations must be lifted as it will increasingly create an effect contrary to that intended. Uncertainty must be reduced and bank lending must recover. He does not see any way of eliminating the irrational optimism unfolding from time to time without reducing the average rate of economic growth and living standards in the longer run.

Greenspan considers the "too big to fail" doctrine to be one of the most problematic developments of the crisis. On the one hand, the role of finances is to enable the most promising investments to obtain funds. On the other hand, the existence of the economic system necessitates that inefficient institutions can go bankrupt. But

there is no simple solution for handling systemically important financial institutions. To maintain financial stability and prevent serious real economic effects, the state intervenes in the insolvency of systemically important institutions, but this is in conflict with the above-mentioned considerations.

High level of uncertainty, low level of investments

Due to the high level of uncertainty, households and companies are refraining from long-term investments, which explains the weak business activity and the rise in the unemployment rate. In the USA, long-term investments have been replaced by shorter-term investments and greater emphasis has been placed on accumulating cash and repaying debts. Moreover, Greenspan also considers government measures aimed at speeding up the recovery and regulating finances as a retracting force. A more active economic policy was justified during the acute stage of the crisis because market forces were unable to move towards a new equilibrium while the market structure was impaired. But he reckons that financial markets became operational once again by early 2009. According to Greenspan, highly regulated markets substantially impair the automatic stabilisers of market processes.

The ultimate measure of economic success is productivity. It determines the average living standard and is a key feature that differentiates developed and emerging countries. According to his expectations, increased productivity would add more to material wealth over the coming decades than any other economic variable. The key component of productivity growth is innovation. Time is needed for innovations to spread, and efficient financial markets play a key role in that. Yet productivity is an economic variable that is extremely difficult to predict because its novelty represents the essence of innovation.

Greenspan draws attention to the fact that the good performance observed with businesses is attributable to low costs. Persistently subdued costs are supported by both competition and technology. However, in the longer run it does not seem feasible, despite some innovations, for companies not to invest more. The fact that productivity has declined from the levels seen between 1870 and 1970 causes tangible differences, to which the GDP-proportionate increase in social benefits and the decrease in the domestic savings rate may also have contributed. Decreasing capital investments and productivity are expected to result in a slower increase in living standards.

To increase living standards, emphasis should be placed on the accumulation of capital goods and savings instead of immediate consumption. The financial system is the link between savings and economic performance. In addition, culture may also bear decisive relevance as it influences risk appetite and innovations. The euro is only the latest example of the crucial role played by culture in the economy.

The euro could be regarded as one additional step towards European political integration. It was considered that the common currency would help break down economic and cultural obstacles. After the positive experiences of the initial period, when the crisis erupted the substantial differences in the competitiveness of the various member states became apparent, and there was growing concern over high government debts. The example of the euro also showed that culture was able to change more slowly than what the financial markets expected.