Greenspan: He thought he'd seen it all

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Alan Greenspan has seen stock markets rise to dizzying heights and sink to discouraging lows. In 80 years, he has lived through depression, war, periods of high inflation, globalization and threats of terrorism.

But the former chairman of the Federal Reserve Board is incredulous these days as he watches the global economy unfold.

What astounds him, he told a crowd of 1,500 business people yesterday, are the low inflation and low interest rates that have spread so persistently to economies throughout the developed world – and most emerging markets, too.

"This is the first time I remember when we could see a period in which we took all of the developed countries and the major emerging market countries, [except Russia and Turkey] where inflation is all single digit, and interest rates are all single digit," Mr. Greenspan told the audience by video conference from Washington. (He had planned to address the crowd in person, but was snowed in.) But it won't last, he added.

"This is a global phenomenon, and it is quite extraordinary. And I suggest we enjoy it so long as it's going on. I doubt if it's anything permanent, unless human nature has changed."

The era of low rates was brought on by the fall of the Soviet Union, as millions of people shifted out of a centrally planned economy that had no impact on global markets. As Eastern European workers and businesses embraced the rest of the world, they exerted downward pressure on wages as they adjusted to an open economy, Mr. Greenspan said.

"It became very apparent that central planning meant economic ruin."

China is continuing the process, with masses of workers moving from rural, disconnected areas to cities that are firmly tied to the global economy. All told, a billion people are moving to a market economy for the first time.

"This has had a dramatic effect on wage economies throughout the world," said the former Fed chairman, now a private consultant.

Eventually, however, the markets of Eastern Europe and China will be fully competitive, he added.

"At that point, the adjustment is over, and the disinflation will start to lift, and probably interest rates will move up, inflation will pick up a bit," he predicted in a question-and-answer session with Sherry Cooper, chief economist for BMO Nesbitt Burns Inc.

For now, though, rates remain low, partly because a surplus of liquidity in global markets is pushing down yields across the board – not just top-notch corporate bonds, but lower-quality corporate bonds and emerging markets alike, Mr. Greenspan noted.

"People are looking for yield," he said. "That's what's pressing the yields down."

While some central bankers have raised red flags about low yields, saying they reflect complacency about risk, Mr. Greenspan suggested today's low rates are appropriate for now.

"It can't last forever," he added.

Still, the dynamism and resilience of global markets these days means the massive current account deficit in the United States is not a huge threat to the international economy, he said.

Bank of Canada Governor David Dodge and other central bankers frequently and consistently argue that the U.S. deficit – and its corollary, the current account surplus in Asia – put the global economy at risk. If investors suddenly decide the United States can't finance its deficit, and they lose confidence in the U.S. dollar, then currencies and economies throughout the world, particularly Canada, would be thrown into a downward spiral, they warn.

But Mr. Greenspan did not espouse that theory yesterday. Rather, he said the world's capital markets are so liquid these days that even if foreign central banks begin selling off big chunks of their U.S.-dollar holdings, "we can absorb the adjustment."

He said he was "somewhat sympathetic to David Dodge's concerns," but research by the Federal Reserve has shown him that the U.S. financial system is flexible enough that a U.S. current account deficit would probably not induce a crisis.

"We concluded that the effects would be modest," he said. "I think we have a degree of flexibility in this system that augurs well for the international financial system."

Where the world is going wrong, he added, is in greenhouse gas emissions and the widespread belief that a cap-and-trade system to control them will solve global warming.

"I don't think it will," he said.

The European Union has adopted a cap-and-trade system, which caps emissions but allows companies to trade emission credits so they can meet their targets. Canada is also considering such a system, and many environmentalists and economists alike believe that such a system is the only way business will be prompted to reduce emissions.

But Mr. Greenspan said he doubts voters will buy in to such a system because the costs are immediate and felt personally, while the benefits are long term and shared globally.

As well, a cap in emissions would only have a material impact on "egregious uses of coal." For dramatic effects on industry as a whole to occur, the cap would have to be set so low that companies couldn't buy their way out of having to make production changes, he said.