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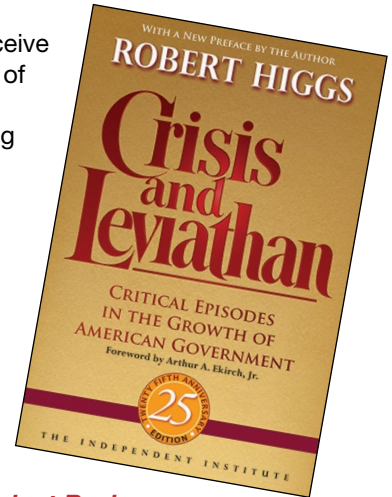
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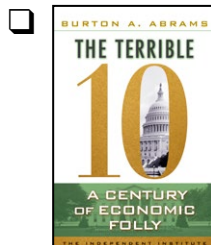


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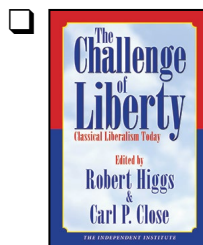


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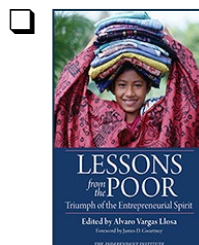
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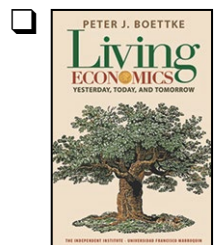
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Did Greenspan Deserve Support for Another Term?

— ◆ —

JOSEPH T. SALERNO

On April 22, 2003, President George W. Bush declared in response to a reporter's question, "I think Alan Greenspan should get another term" (Maer and Associated Press 2003; see also Hill 2003). Bush's expression of support for Greenspan's reappointment for another four-year term as chairman of the Federal Reserve System (the Fed) came more than a year in advance of the expiration of the chairman's term in June 2004. Regardless of his decision to accept or decline reappointment, the question of whether Greenspan deserved support for another term merits consideration for the light it sheds on the performance of the U.S. economy in the dawning years of the twenty-first century.

To begin with, my answer to the question posed is a resounding "No!" I have two reasons for this negative response. First, the Fed's performance has been astoundingly bad throughout Greenspan's tenure as chairman. Second, and perhaps worse, Greenspan has been a relentless purveyor of economic fallacies designed to obscure and justify this egregious performance. Unfortunately, his exalted position, combined with his unrivaled facility for circumlocution and obfuscation, has led the media, the markets, and even many professional economists to treat his fallacious dicta as profound insights into the economic process. Astonishingly, the media-fueled cult of Chairman Greenspan continued throughout the 1990s even though some of the most celebrated pseudoprofundities that he uttered represented blatant reversals of views he had expressed just months earlier. For example, Greenspan's famous "discovery" that the productivity growth of the New Economy was causing the stock-market

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boom of the late 1990s came hard on the heels of his contradictory and equally famous declaration that “irrational exuberance” was driving the stock-market run-up (Woodward 2000, 172–74, 179–82, 195–96, 223).

An Austrian Perspective on the Recession

In an address a few years ago, I gave a detailed analysis and critique of Greenspan’s public utterances on money and the economy. I concluded that they added up to little more than empty rhetoric that served as a cover for the Fed’s cheap-money policy of the Clinton years, which had caused massive and unsustainable malinvestments in the real economy and an inflationary bubble in financial markets (Salerno 2001). I need not repeat this analysis here. However, I quote the concluding paragraphs of my address because they bear on Greenspan’s more recent words and deeds at issue in this article. In February 2001, I wrote:

This monetary tightening [of 2000] devastated the New Economy and the NASDAQ tanked, falling by over 50 percent from its high in March 2000. But, even more importantly, it also brought the investment boom in the real sector of the economy to a screeching halt. This momentous news was duly noted in the *Wall Street Journal*. . . . “And new numbers out yesterday [January 31, 2001] show that investment did drop in last year’s fourth quarter. . . . [B]usiness investment on equipment and software actually fell at a 5% rate—a dramatic reversal from 21% growth in the first quarter of 2000. A big drop reported last week in orders for capital goods, excluding aircraft and defense, suggest that capital retrenchment isn’t over.”

This news should give Greenspan a great pain in the pit of his stomach.¹ Unfortunately, it is unlikely to do the economy any good, because Greenspan and the legion of economists, journalists and business leaders that he has misled with his empty talk believe that the slowdown is a simple matter of sagging spirits and lost faith and that this malaise can be cured by the psychological hocus focus of reducing short-term interest rates—i.e., turning on the monetary spigot full blast again. This does not appear to be working however. Although Greenspan’s first interest-rate cut on January 3 appeared to give the NASDAQ a boost, despite a second cut in interest rates on January 31, the index has fallen back into the doldrums where it began the year. So I hold out great hope that before the end of this year, with the arrival of a full-blown recession, all will finally see that the Maestro has no clothes—and absolutely no real knowledge of how the economy works. I wonder what the probability would be of his resigning in that case?

1. This passage refers to Greenspan’s belief that the visceral discomfort he experienced when poring over economic data was a good predictor of the economy’s going sour (Woodward 2000, 120).

Permit me to boast of my prowess as a contrarian economic forecaster for a moment. One month after I wrote those words, the U.S. economy plunged into recession, according to the official definition of the National Bureau of Economic Research (NBER). Actually, my forecast that the economy stood on the precipice of recession, when almost everyone else was misled by Greenspan's talk of a "soft landing," was based squarely on the Austrian theory of the business cycle. This theory informs us that a fall in real investment resulting from a reversal of inflationary monetary policy, which occurred in 2000, presages the inevitable onset of economic recession. Moreover, the theory focuses our attention on the pattern of real investments in the economy, which is distorted by the Fed's persistent manipulation of interest rates. Once such distortions have built up over time and have been embodied in the economy's structure of physical capital goods, a long period of readjustment, which non-Austrians call a "recession," is required for their correction. Most economists and market pundits unfortunately ignored this insight and focused exclusively on financial markets rather than on the underlying entrepreneurial combinations of concrete capital goods to which stocks and bonds are mere property titles. Thus, they were taken in by Greenspan's assertion that the Fed could pilot the economy safely in for a "soft landing" by slowly letting the air out of the stock-market bubble.

The prevailing consensus overlooked that a cessation or even a slowing in the growth of the money supply precipitates a rise in interest rates back toward levels that reflect voluntary saving and risk preferences in the economy and, in the process, reveals to entrepreneurs the unsustainability of many capital investments. This revelation induces a time-consuming process of liquidation and destruction of various capital-labor combinations and the reallocation of the more versatile of these resources, especially labor, to more valuable uses. Thus, for example, when interest rates suddenly rise, investment in the continued construction and utilization of new plants manufacturing oil-drilling equipment may be abandoned as unprofitable. Construction and factory workers are laid off from these projects and must then search for employment opportunities in plants producing consumer goods or in the retail sector, while the idled raw-material stocks, power-generating capacity, and transportation equipment are also diverted back toward consumer-goods production and distribution.

Deflation Phobia and the Fed

Now let us return to Greenspan. As 2003 dawned, the economy had been mired in recession and "jobless recovery" for two years, and Greenspan's tattered reputation was threatening to disintegrate along with the New Economy he had trumpeted for so long. His convoluted and banal pronouncements were increasingly met with skepticism, if not with outright incredulity, by the media and the markets. His cherished *serioso* image as the profound Maestro of Money was giving way to the perception of a cunning but clueless Master of Illusion who has suddenly run out of tricks.

Greenspan did have one more trick up his sleeve, however, and so he played the deflation card—and he did so with all the guile at his command.

Deflation phobia had been ignited earlier in the United States by a few isolated monthly declines in consumer and producer prices that occurred in the latter half of 2001. Almost immediately a deluge of articles gushed forth to warn of the looming prospect of a catastrophic, Japanese-style deflationary depression in the United States if the Fed did not promptly and drastically cut interest rates. The authors of the first wave of these articles were mainly financial columnists and think-tank economists associated with the supply-side school, although a few Keynesian academic economists also issued dire warnings. The deflation hysteria abated somewhat after the Consumer Price Index (CPI) and Producer Price Index (PPI) finished 2001 at levels 2.8 percent and 2.0 percent higher, respectively, than their levels of a year earlier. The Fed, to its credit, ignored this initial wave of deflation phobia.

As the recession/jobless recovery lingered, relentlessly dragging down Greenspan's prestige along with the number of jobs, the Fed's tune began to change. Thus, in November 2002, Fed governor Ben Bernanke (2002), a former Princeton University professor and prominent macroeconomic theorist, delivered remarks to the prestigious National Economists Club in Washington, D.C., titled "Deflation: Making Sure 'It' Doesn't Happen Here." Now, given Bernanke's status as a Fed governor, the topic, content, and venue of his remarks would have required Greenspan's clearance; indeed, Greenspan might even have actively suggested them.

Bernanke began his speech by affirming his belief "that the chance of significant deflation in the United States in the foreseeable future is extremely small." He further expressed confidence "that the Fed would take whatever means necessary to prevent significant deflation in the United States and, moreover, that the U.S. central bank in cooperation with other parts of the government as needed, has sufficient policy instruments to ensure that any deflation that might occur would be both mild and brief." In a Greenspan-like equivocation, Bernanke added: "So having said that deflation in the United States is highly unlikely, I would be imprudent to rule out the possibility altogether." He then went on to identify the cause of deflation in standard Keynesian terms as "in almost all cases a side effect of a collapse of aggregate demand—a drop in spending so severe that producers must cut their prices on an ongoing basis in order to find buyers" (Bernanke 2002).

Bernanke devoted the rest of his remarks to detailing the measures available to the Fed to prevent deflation from occurring and to cure it if such preventative measures somehow failed. Not surprisingly, all of these preventive and remedial measures amounted to little more than conventional and unconventional guidelines and techniques for creating money.

For example, Bernanke suggested that to prevent an unanticipated fall in aggregate demand from initiating a deflation, the Fed needed to establish "a buffer zone for the inflation rate," which means that it should deliberately aim at inflating prices in the United States from 1 to 3 percent per year. In addition, the Fed should remain

continually on the alert for any sign of weakness in financial institutions and markets and stand ready to flood the financial system with inflationary credit in case of, for example, a stock-market crash or even a shock to confidence caused by a terrorist attack. Finally, *even with the inflation rate safely within the buffer zone*, if the Fed were to observe a sudden deterioration of the fundamentals of the macroeconomy, such as a fall in investment or consumption spending, it must act “more preemptively and more aggressively than usual” to forestall deflation.

In the unlikely event that these tried and true precautionary measures fail to stave off the dreaded fall in prices and the Fed has already reduced the fed funds rate to zero, Bernanke assured us that the Fed has an arsenal full of additional weapons at its disposal capable of generating the desired positive inflation. These unconventional techniques for money creation include:

1. Reducing and capping yields on medium- and long-term Treasury debt by committing itself to making unlimited purchases of these securities at a fixed price consistent with the targeted yields.
2. Following the same strategy in the market for foreign government debt, which the Fed has been legally empowered to purchase since 1980 and the outstanding stock of which is several times the size of U.S. government debt.
3. To circumvent the restrictions on Fed purchases of private securities, extending zero-interest-rate loans to banks accepting commercial paper, corporate bonds, and even mortgages as collateral, thus effectively driving down the yields on these debt instruments.
4. Financing a massive Treasury tax cut dollar for dollar by monetizing the resulting deficit to the full extent of the lost tax revenues or by monetizing direct Treasury purchases of current goods and services or of private financial and physical assets. (Bernanke 2002)

As Bernanke pointed out, this last alternative is tantamount to showering the country with money à la Milton Friedman’s famous hypothetical helicopter. Make no mistake about it, the Fed governor was proposing inflation pure and simple—and plenty of it—as the panacea for an economy beset by a falling price level. Bernanke made this fact explicit in the following passage:

The conclusion that deflation is always reversible under a fiat money system follows from basic economic reasoning. A little parable may prove useful: Today an ounce of gold sells for \$300, more or less. Now suppose that a modern alchemist solves his subject’s oldest problem by finding a way to produce unlimited amounts of new gold at essentially no cost. Moreover his invention is widely publicized and scientifically verified, and he announces his intention to begin massive production of gold within days.

What would happen to the price of gold? Presumably, the potentially unlimited supply of cheap gold would cause the market price of gold to plummet. Indeed, if the market for gold is to any degree efficient, the price of gold would collapse immediately after the announcement of the invention, before the alchemist had produced and marketed a single ounce of yellow metal.

What has this got to do with monetary policy? Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude then that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.

This passage is both true and chilling. Bernanke's analogy is based on correct economic analysis: the Fed indeed does have the power to bring about a collapse in the value of the dollar. What is so frightening is that Fed governor Bernanke, an allegedly moderate free-market macroeconomist who was appointed by a Republican administration, dares to propose the use of such power as the remedy for a minor rise in the value of money. After all, the deflation of consumer prices in Japan, which Bernanke is so determined to avoid here in the United States, has averaged less than a paltry 1 percent per year since it began in mid-1999.²

Now one might plausibly object that I have misinterpreted Bernanke's remarks, that they were meant to apply only in the realm of theoretical conjecture, and that no one in full possession of his senses really expects a Japanese-style deflationary recession to take hold in the United States. This objection, however, ignores the context of the remarks, for Bernanke was only setting the stage for the latest performance by the Master of Illusion himself. The very fact that a prominent member of the Fed would focus on deflation in his remarks before a business group on such a highly visible occasion signaled the unfolding of a new strategic tack by the beleaguered Fed chairman.

Sure enough, a few months later, when Greenspan testified before Congress in April 2003, he shocked the markets by proclaiming that a further drop in inflation was "an unwelcome development," (U.S. House of Representatives 2003), slyly stoking the still smoldering fears of deflation. A few weeks later the Fed Open Market Committee

2. According to the Fed's own publications, the annual declines in the Japanese Consumer Price Index from 1999 through 2002 have been 0.3 percent, 0.7 percent, 0.8 percent, and 0.9 percent, respectively (Federal Reserve Bank of Cleveland 2003, 10). Also see Bullard and Seiffert 2003, 1.

(FOMC) followed up Greenspan's bombshell by releasing a typically ambiguous, Greenspan-era statement indicating a "minor" probability that "an unwelcome substantial fall in inflation" outweighed the risk of higher inflation (qtd. in Berry 2003). The FOMC's oblique warning appeared to be confirmed a week later when data were released showing small declines in April's CPI and retail sales, although these developments were owing for the most part to falling oil prices as the U.S. invasion of Iraq wound down. Nonetheless, deflation fears were running high once again. These fears were at fever pitch when Greenspan valiantly leaped into the breach a few days later, solemnly declaring before a Congressional panel, "we see no credible possibility that we will at any point . . . run out of monetary ammunition to address problems of deflation" (qtd. in Wolk 2003). Although May's data did not bear out the threat of the imminent onset of deflation widely perceived in April's numbers, the FOMC subsequently cut the fed funds in late June to its lowest level since 1958.

Despite the rate cut and the Maestro's soothing words, payrolls continued to shrink, the unemployment rate was stuck at its highest level in nine years, and industrial production continued to grow at a snail's pace—fully twenty months after the NBER declared the official end of the recession. Moreover, doubts began to spread among economists about the wisdom of the Fed's inexplicably sudden concern with deflation. Stated Chicago economist David Hale, "They let themselves get swept up in the deflation delirium and it's locked them into a rate cut that they may not want or need to make right now" (qtd. in Gosselin 2003).

Nonetheless, Greenspan would not be deterred from reinventing the Fed as an antideflationary crusader that could be depended upon to pump progressively cheaper money into the economy for as long as necessary to slay the fictitious deflation monster. Indeed, Vincent Reinhart, the Fed's director of monetary affairs, laid out the rationale for Greenspan's strategy in a little noted speech the month before the June 2003 rate cut. Reinhart suggested that the central bank conduct monetary policy to bolster markets and revive the economy by "shaping expectations" without necessarily cutting rates. According to Reinhart, "A central bank can provide impetus to the economy at an unchanged short-term interest rate by encouraging investors to expect short term interest rates to be lower in the future than they currently anticipate" (2003, 5). In other words, Greenspan's strategy was deliberately to mislead the markets regarding the future course of interest rates. Thus, Greenspan himself again transparently played the deflation card in his semiannual monetary policy report to Congress in mid-July, alluding to the "especially pernicious, albeit remote, scenario in which inflation turns negative against a backdrop of weak aggregate demand" and avowing that "the FOMC stands ready to maintain a highly accommodative stance of policy for as long as it takes to achieve a satisfactory economic performance" (U.S. Senate 2003, 10, 11). The desperate Maestro also let slip—and the media breathlessly reported—that at its June meeting the FOMC had discussed at some length the possibility of utilizing "alternative" methods of reducing interest rates, including the purchase of longer-term securities, but the committee had concluded that it was

“unlikely” that these unconventional measures would be necessary. So it was a short jump from Governor Bernanke’s theoretical ruminations about cures for potential deflation to Chairman Greenspan’s reference to them as “alternative” practical policies in a prospective but supposedly “remote” war against deflation.

If we look more closely at Greenspan’s testimony, we find that in his cynical attempt to manipulate markets he has profoundly contradicted himself. While he was pointing to the “remote” probability of deflation with one hand, he was encouraging the housing bubble with the other. Thus, he noted “a solid advance in the value of the owner-occupied housing stock,” noting “changes in technology and mortgage markets that have dramatically transformed accumulated home equity from a very illiquid asset into one that is now an integral part of households’ ongoing balance-sheet management and spending decisions” (qtd. in Campbell 2003). In plain English, this statement means that the ready availability of cheap mortgages via Internet shopping has fueled consumption spending as people cash out some of the gains realized in the ever-expanding housing bubble.

Unfortunately for Greenspan, the media and the markets have finally begun to catch on to his verbal legerdemain and are no longer diverted by his invocation of the specter of deflation. Greenspan hoped to stimulate investment spending and economic recovery by solemnly talking up the threat of prospective deflation and the Fed’s determination to fight it and thus by duping the markets into expectations of aggressive rate cutting. The Fed then proceeded to disappoint market expectations by reducing the federal funds rate by a measly one-quarter of a point in June. Hence, the strategy backfired, and, as one journalist noted in late August, “Greenspan now finds himself the subject of derision and doubt in the bond market. Investors, stung by the wide swings in bond prices over the past few months, blame Greenspan and the Fed for misleading the markets about the threat of deflation and the central bank’s likely response to it” (Miller 2003). Even some regional Federal Reserve Banks, such as the relatively “hard money” St. Louis and Cleveland Feds, sought to disassociate themselves subtly from Greenspan’s deflation hysteria by attempting to distinguish between benign and malignant deflation.³

By the end of September 2003, the yield on ten-year Treasury bonds and the rate on conventional mortgages had risen by nearly one percentage point, indicating spreading anticipations of future inflation as the Fed continued to expand the money supply rapidly to get the economy back on track.⁴ Indeed, one perceptive journalist, Ian Campbell, pinpointed the real and present danger to the economy: unrestrained money creation to maintain low interest rates in the face of an exploding federal budget deficit. Wrote Campbell:

The danger, to our mind, is that Greenspan’s “solid advance” is not solid at all. It is all based on flooding the markets with liquidity, forcing down

3. See, for example, Federal Reserve Bank of Cleveland 2003 as well as Bullard and Hokayem 2003.

4. For current monetary and interest-rate data, see the Federal Reserve Bank of St. Louis’s *Monetary Trends*, available at <http://www.research.stlouisfed.org>.

mortgage rates to indecently low levels, cutting rates on savings deposits, encouraging the creation of more and more debt—while friend George racks up the government debt—and encouraging spending based on extracting equity from an asset, housing, whose price is inflating recklessly and which subsequently, like the equity market is likely to fall.

Conclusion

Thus, we have yet another in a string of performances by the Master of Illusion that has flopped badly and should have disqualified him from consideration for another term. Unfortunately, Greenspan's departure from the stage would not be cause for unalloyed joy among proponents of sound money, for although his personal style may be uniquely irritating and egregious, his inflationary "conduct" and "performance" are ultimately determined by the monopolistic structure of the institution he heads. In other words, because the Fed possesses a legal monopoly to create money, the chairman always faces overwhelming incentives to employ his position and power to benefit the constituencies that directly or indirectly enable the continuation of the Fed's "independence" or monopoly power. These constituencies include, in roughly descending order of importance, the incumbent administration, Congress, banks and other financial firms, and the capital-goods and consumer-durable-goods sectors of the U.S. economy dominated by large corporations and unions. The one thing that all these disparate groups agree and thrive on is "cheap money"—the cheaper the better. So it is no surprise that the Fed chairman, whoever that individual happens to be and whatever his style, strives more or less successfully to deliver a low-interest-rate policy, employing any argument that is plausible and ready to hand in order to deny or downplay that policy's inflationary consequences.

Finally, consider again the conduct of Governor Bernanke, a low-key and straightforward academic who has done some very respectable work in macroeconomic history and has in the past been rumored to be Greenspan's heir apparent. Although Bernanke's manner could not be more different than Greenspan's, this highly trained technical economist, since joining the governing body of the Fed, has expressed views more and more indistinguishable from the untutored Maestro's intuitive and ad hoc effusions. In January 2004, although conceding to the growing chorus of anti-inflationary critics that the Fed's interest-rate policy was "unusually accommodative in historical terms" for the then-current stage of the business cycle, Bernanke maintained: "That accommodation is justified, I believe, by the current very low level of inflation, and by the productivity gains and the weakness in the labor markets, both of which suggest that inflation is likely to remain subdued" (qtd. in Uchitelle 2004). Thus, it is likely that, with or without Greenspan as Fed chairman, the long-run prospect for the U.S. economy is a persistent war against the phantom of deflation waged by misleading rhetoric and cheap money. This policy runs the serious risk of re-creating the financial and real-investment bubbles of the late 1990s, rekindling the smoldering embers of consumer-price inflation, and eventually precipitating global investors' full-blown flight from the U.S. dollar.

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Acknowledgment: This article is a revised version of an address given at the Conference on Prosperity, War, and Depression, Mises Institute Supporters Summit, October 24–25, 2003.