The known unknowns, unknown unknowns, and John Locke

John Roskam reviews

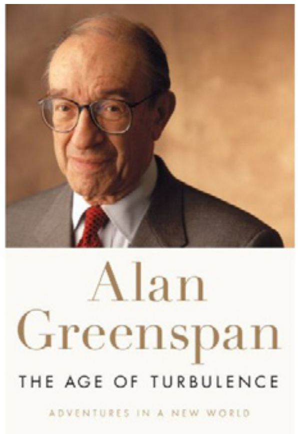
The Age of Turbulence: Adventures in a New World

by Alan Greenspan
(Penguin, 2007, 544 pages)

Alan Greenspan's memoir covers a vast array of issues, including his dealings with various US Presidents, his opinions on the American health and education systems, and his predictions for the future of China. But perhaps what's more interesting than these topics is Greenspan's analysis of what we know and don't know.

In the same way as the community expects the health profession to alleviate every ailment, there is the demand that central bankers regulate the economy to provide for steady growth and prevent every boom and bust. But as Greenspan explains this isn't possible. In 1987 ten weeks after he started as chairman of the Federal Reserve stockmarkets around the world plunged. On October 19, 1987 the Dow Jones fell by twenty-two percent. What happened is a lesson in behavioural economics which Greenspan nicely explains.

> [T]he theory of efficient markets cannot explain stock-market crashes... What new piece of information surfaced between the market's close at the end of the previous trading day and its close on October 19? I am aware of none. As prices careened downward on that day, human nature, in the form of unreasoning fear, took hold, and investors sought relief from pain by unloading their positions regardless of whether it made financial sense.



The difficulty of 'managing' the economy is that 'the economy' is nothing more than millions of individual decisions made daily by individuals. To manage this complex interaction is impossible—which, of course, is Hayek's great insight. Individuals like investors in the stock-market are liable to emotion. 'Perhaps someday investors will be able to gauge when markets veer from the rational and turn irrational. But I doubt it. Inbred human propensities to swing from euphoria to fear and back again seem permanent: generations of experience do not appear to have tempered those propensities.'

While we don't know what will move the stock-market, we can be more certain about what will make economies grow and what will improve people's living standards. And Greenspan thanks Adam Smith for these insights. Smith, together with John Locke, and Joseph Schumpeter are the stars of the book. Each gets their portrait on the photos pages (opposite photos of Arthur Burns who was Greenspan's faculty mentor at Columbia University, and Ayn Rand).

Greenspan summarises the wisdom of *The Wealth of Nations* as follows: economic growth in a country is determined by **1)** the degree of domestic competition, and the extent to which that economy is open to trade and integrated with the rest of the world, **2)** the quality of country's institutions, and **3)** the success of its policymakers in implementing the measures necessary for macroeconomic stability. (However Greenspan's interpretation of Smith in point three might be some special pleading on behalf of the world's central bankers. It would be more accurate to conceive of point three as an injunction from Smith to policymakers to do little more than not interfere in the operation of the free market.)

John Locke is important because as Greenspan stresses without an individual's right to 'life, liberty and estate' there is minimal incentive to material improvement.

For Greenspan if there is any one single thing that drives economic development it is property rights. 'My experience leads me to consider state-enforced property rights as the key growth-enhancing institution... People generally do not exert the effort to accumulate the capital necessary for economic growth unless they can own it.'

Secure property rights allow individuals and corporations to make the sort of continual investment necessary to keep up with competitors and the changes wrought by technological change. And this is the relevance of Schumpeter. It is impossible to gain the benefits of 'creative destruction' without property rights.

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