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Dropping the Bonds
By PAUL KRUGMAN

In his July testimony to Congress on monetary policy, Alan Greenspan was cautious but - adjusting for his usual funereal demeanor - quite upbeat. ``Although the uncertainties of earlier this year are as yet not fully resolved,'' he declared, ``the U.S. economy appears to have withstood a set of blows. Not surprisingly the depressing effects of recent events linger. Nevertheless, the fundamentals are in place for a return to sustained healthy growth.''

O.K., I cheated: those quotations come from his testimony in July 2002, not July 2003. Needless to say, ``healthy growth'' failed to materialize. Undaunted, he said pretty much the same thing last week - and the result was to reinforce a huge sell-off in the bond market, which may undermine the very recovery he predicted.

I used to be a great admirer of Mr. Greenspan. But something has gone very wrong with the maestro.

His testimony last week was surprising on several counts. There is very little evidence in the data for a strong recovery ready to break out. As far as I can make out, Mr. Greenspan's optimism is entirely based on models predicting that tax cuts and low interest rates will get the economy moving. But that's what the models said last year, too: the report that accompanied his July 2002 testimony predicted an unemployment rate of 5.25 to 5.5 percent by late 2003 (the rate is now 6.4 percent). Maybe tax cuts mainly for the affluent aren't as effective as the models say.

Meanwhile, the boost from low interest rates seems to be evaporating. Mortgage rates did indeed fall briefly to historic lows, extending the home-buying and refinancing boom that has helped keep the economy's head above water. Since mid-June, however, rates have been climbing rapidly. This week rates on 30-year mortgages hit their highest level since January.

And Mr. Greenspan bears some of the responsibility. Until June, Fed officials had helped push down interest rates precisely by not being too optimistic - by indicating that they took concerns about deflation seriously, that they were not taking recovery for granted. Then they surprised markets with a small cut in the federal funds rate, a move that seemed to suggest that they were taking recovery for granted, after all. Mr. Greenspan's testimony reinforced that impression. Still, I would be prepared to forgive Mr. Greenspan's recent fumbles if it weren't for the huge fiscal damage he has inflicted on the republic in these past few years.

Let's not forget that back in 2001, Mr. Greenspan lent crucial political aid to the first Bush tax cut, arguing that such a cut was necessary to prevent, yes, excessive budget surpluses and too rapid a payoff of the federal government's debt. He should have known better - it wasn't hard, even then, to figure out that those huge projected surpluses were largely fantasy. But he tied himself in knots to find a way to give his political friends what they wanted.

He could have redeemed himself by changing his mind once record surpluses turned into record deficits, but he didn't. Mr. Greenspan still talks about the evils of deficits, but refuses to say the obvious: that if we are ever to balance the budget again, many of the Bush tax cuts will have to be reversed once the economy recovers. Instead, Mr. Greenspan offers platitudes about spending restraint: ``I would prefer to find the situation in which spending was constrained, the economy was growing and that tax cuts were capable of being initiated without creating fiscal problems." (``I would prefer a world in which Julia Roberts was calling me," Representative Brad Sherman replied, ``but that is unlikely to occur.") In short, the budget is in a mess, and Mr. Greenspan is one of the main culprits. And that, suggest some people I've talked to, may explain how he misjudged his recent testimony so badly.

Their theory goes like this: Mr. Greenspan must know that his legacy is in tatters - at the rate things are going, history will remember him not as the maestro of the new economy, but as an accomplice in America's descent into debt. For his own self-esteem, he has to believe that things will somehow turn out all right. Thus his sudden, destructive outbreak of optimism.

It's only a theory. What isn't a theory is that Mr. Greenspan has a lot to answer for.