FEDERAL RESERVE

Initiation by Fire

BY CHARLES GERENA

Alan Greenspan faced a stock market crash just two months after becoming Fed Chairman in August 1987. His response would reverberate over the next three years, and beyond

Walking down the marble hallways of the Eccles Building, Ben Bernanke follows in the footsteps of the previous Chairman of the Federal Reserve Board of Governors, Alan Greenspan. Bernanke's legendary predecessor is a tough act to follow, but it's easy to forget that Greenspan had big shoes to fill when he stepped into the Chairman role in August 1987.

Paul Volcker, with his 6-foot-7-inch stature and forceful personality, earned the respect of central bankers and financial markets around the world. From 1979 to 1987, Volcker took aim at the double-digit price growth plaguing the U.S. economy and wringed out excess dollars from the money supply, even if such actions had short-run recessionary consequences. His determination secured the public's confidence that the Fed would protect price stability, helping to reverse inflation expectations that had built up during the 1960s and '70s.

Like Volcker, Greenspan focused on inflation. He expressed this position several times during his July 1987 Senate confirmation hearing. In a response to one senator's question about what he thought appropriate targets for monetary policy should be, Greenspan noted that the Fed's primary goal is to "set an environment in which steady long-term maximum economic growth is feasible in our economy." In meeting that goal, the Fed needed to be very careful not to "allow the inflation genie out of the bottle, because that will clearly undercut that goal."

A week after taking office, Greenspan immediately acted against inflationary pressures. But his offensive would be put on hold after Black Monday, Oct. 19, 1987. The Dow Jones Industrial Average plummeted 508 points, or 23 percent. Greenspan's response would be a precursor to how the Fed would deal with a crisis of confidence in financial markets. It would also stir debate over how monetary policy should be conducted during a crisis and how much discretion a Fed Chairman should have in general.

President Ronald Reagan, right, watches as Vice President George Bush, left, swears in Alan Greenspan as the new Chairman of the Federal Reserve Board during a ceremony at the White House on Aug. 11, 1987.

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Into the Valley

The macroeconomic conditions that Greenspan inherited from Volcker were less volatile than what Volcker faced when he became Fed Chairman in 1979.

Year-to-year changes in the Consumer Price Index had reached a high of 11.3 percent after wildly fluctuating during the 1970s, while Fed credibility at keeping inflation stable had reached a low. Over the next few years, Volcker worked to reduce the amount of money and credit available and rebuild confidence in the Fed's inflation-fighting resolve, which eventually reduced people's expectations of future price increases.

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It wasn't going to be a cakewalk, though. Oil prices nearly doubled between 1986 and 1987, and the unemployment rate was falling. Neither factor alone would have automatically pushed up average price levels, since competitive pressures often prevent companies from passing along higher input costs, and there was only mixed evidence of resurging inflation at the time. Still, bond prices dropped and long-term interest rates on mortgages and other loans soared during the first half of 1987.

"There was some concern at the time that the economy was overheated, and some fear that inflation [was] drifting back up and the progress that Volcker had made in getting it down would prove to be temporary," recalls Benjamin Friedman, a Harvard University economist who has studied monetary and fiscal policy.

Meanwhile, fiscal policy wasn't doing much to assuage inflation fears. Tax cuts and increased government spending produced large federal budget deficits.

While Greenspan was widely considered to be the best choice, it was a tough job to replace "Tall Paul." Greenspan was an unknown quantity as a monetary policymaker in the eyes of central bankers and financial market participants overseas. While appointees to the Board of Governors were usually macroeconomists from the banking and securities industries, his understanding of the economy came from his work as a corporate consultant and a director on the boards of manufacturers like Alcoa and General Foods.

"He was a crackerjack domestic nonfinancial economist, intimately familiar with the data stream on the present and future prospects of the industrial sector in America. But [being Fed Chairman] was a financial job, with both national and international dimensions, and he would have some work to do to come up to speed," wrote David McClain in his 1988 book *Apocalypse on Wall Street*. McClain served as senior staff economist for the Council of Economic Advisers during the Carter administration.

While it honed Greenspan's ability to reach a consensus among people of differing viewpoints, his political experience counted against him as well. After serving as Richard Nixon's economic policy adviser during the 1968 presidential campaign, Greenspan advised Gerald Ford as chairman of the president's Council of Economic Advisers from 1974 to 1977. Later, he joined President Reagan's Economic Policy Advisory Board in 1981 and co-chaired his bipartisan commission on Social Security reform from 1981 to 1983.

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Given these Republican ties, plus the fact that six out of the seven members of the Board of Governors would be Reagan appointees, some people labeled Greenspan a political partisan who wouldn't have the gumption to tighten monetary policy if necessary. "Investors feared that Greenspan would not be the aggressive inflation fighter that Volcker had been and that he might look the other way rather than squelch inflationary pressures if that meant slowing the economy before the November 1988 presidential election," McClain notes.

Greenspan quickly disproved this perception when he took office on Aug. 11, 1987. At his first meeting of the Federal Open Market Committee, which includes the Board of Governors, the New York Fed president, and a rotating group of four other Reserve Bank presidents, the committee agreed to lean toward tightening policy between August and its next meeting on Sept. 22 if circumstances warranted it. This gave Greenspan a window of opportunity to use his authority in between FOMC meetings to initiate small adjustments in the federal funds rate, the interest that banks charge each other to lend reserves. On Sept. 3, the rate moved up a quarter of a point to a range of 6.75 percent to 7 percent.

The next day, Greenspan persuaded his fellow members of the Board of Governors to raise the discount rate half of a point to 6 percent, the first increase since April 1984. (In response, the funds rate rose again to 7.25 percent.) Changes in the discount rate — the interest that the Federal Reserve charges to lend reserves to banks — served as an important signal to financial markets about the Fed's policy intentions because changes in the funds rate weren't yet publicly announced.

Greenspan would soon prove his mettle in another way. A month later on Black Monday, Oct. 19, he would confront the central banker's historical problem as the provider of liquidity to the financial system facing a crisis. He would also demonstrate his willingness to loosen the Fed's grip on the money supply to mitigate threats to the financial system.

After the Fall

"A stock market crash can patently increase the credit risk involved in lending to certain borrowers," Greenspan would recall in his February 1988 congressional testimony about the Oct. 19 crash. "But there can be ... an exaggerated market reaction as well, based on little hard evidence, that builds on itself and ultimately affects borrowers whose creditworthiness has not been materially impaired by the drop in equity values. This irrational component of the demand for liquidity may reflect concerns that the crisis could affect the financial system or the economy more generally."

Greenspan compared this irrational flight to liquidity and safety with a run on a bank that is fundamentally sound. Before the existence of deposit insurance, bankers attempted to calm jittery depositors by putting cash in their front window. "In a sense, the Federal Reserve adopted a similar strategy after Oct. 19" to counteract market uncertainty, Greenspan noted.

Greenspan was en route to Dallas to speak at the American Bankers Association's annual convention when the Dow began to plummet. Upon landing, he rushed to his hotel and held a conference call with Vice Chairman Manuel Johnson, who was in charge of crisis management, and senior Fed officials. They discussed the seriousness of the situation — the Dow's decline was nearly twice as sharp as the 12 percent drop during the infamous crash of 1929, and financial markets would likely be in panic mode the next day.

On Tuesday morning, the group reconvened and agreed to issue a one-sentence statement in Greenspan's name before the markets opened: "The Federal Reserve, consistent with its responsibilities as the nation's central bank, affirmed today its readiness to serve as a source of liquidity to support the economic and financial system."

As Greenspan flew back to Washington — on a private jet sent by White House Chief of Staff Howard Baker — the Fed backed up that promise. That day and for the next two weeks, it made millions of dollars available to banks through its open market purchases. The purchases were significant and frequently made at an earlier time of the day than usual to assure markets that liquidity was available. (Later on, the Fed loaned reserves to banks through its discount window, which has historically served as the "lender of last resort.") As a result, excess reserves — funds set aside by banks above the amount required by the Fed and to clear debits to their accounts — rose 61 percent from $967 million on Oct. 21 to $1.6 billion on Nov. 4.

To make sure the additional liquidity in the banking system would reach the securities industry, Fed officials assured many in the banking industry that, despite the turmoil, the economy remained fundamentally sound. E. Gerald Corrigan, president of the New York Fed, spent several weeks calling Bankers Trust, Bank of New York, and other large banks to "encourage" them to lend to brokerage firms. Corrigan personally knew many of the biggest financial players because the New York Fed conducted the Federal Reserve's open market purchases.

He reminded bankers that it was their job to assess creditworthiness, not circle the wagons until the dust settled. Furthermore, it was in their interest to keep the financial system functioning. Greenspan also talked with financial market officials to calm them down.

This combination of gentle persuasion and reassurance was essential in the days following Black Monday. By midday on Tuesday, dozens of stocks that didn't attract any buyers stopped trading on the New York Stock Exchange, which was on the brink of closing itself. Meanwhile, the Chicago Board of Trade and the Chicago Mercantile Exchange halted trading in various futures contracts since there weren't enough stocks trading to set a price. Eventually, though, enough confidence and impetus to act built up to prompt someone to do something — several companies began repurchasing their stock while a number of Wall Street firms bought $60 million in futures contracts. That helped draw other buyers back into the stock market, sending the Dow up 102 points for the day.

The Fed closely monitored market developments for several days. Greenspan set up a crisis management center in his office with Johnson and other staffers who kept in touch with Corrigan in New York, other Reserve Bank presidents around the country, and market players worldwide.

Many credit these decisive actions for restoring confidence and preventing the stock market decline from affecting the banking system. For many people, Black Monday was just a bad day on Wall Street. In contrast, stock market crashes in March 1907 and October 1929 precipitated the failure of financial institutions and led to broader economic problems.

Even as the Fed did whatever it could to prevent financial gridlock — and, according to one report, contemplated more serious intervention such as directly lending to brokerage firms or guaranteeing payments between them — Greenspan didn't want to create unrealistic perceptions of the Fed's power.

"If you intervene too much, then you create expectations that you're controlling and shaping things," says Donald Kettl, a political science professor at the University of Pennsylvania and author of *Leadership at the Fed*. "Greenspan wasn't sure that he could do that, and he wasn't sure that the Fed should do that if it could." Such views, if proved wrong, would erode the Fed's credibility and make it harder to influence market behavior in the future. It would also create a moral hazard problem, whereupon investors factor Fed intervention into their risk assessments.

In addition to addressing the fear-induced demand for liquidity, Greenspan saw the need to counter risks to the nation's economic growth. In his semiannual testimony to the House Banking Committee on Feb. 23, 1988, he noted that the sudden loss in financial wealth and subsequent erosion of business and consumer confidence threatened to reduce spending.

So Greenspan persuaded his fellow members of the FOMC to lower their target for the federal funds rate from 7.50 percent just before Oct. 19 to a range of 6.75 percent to 6.88 percent by mid-November. Greenspan reduced the rate again to 6.5 percent in between the FOMC's meetings in January and February 1988.

The Fed's accommodative monetary policy for the five months following the October 1987 crash helped keep short-term interest rates from spiking as they had done in previous financial crises. However, it also "led to higher real economic growth in 1988 and 1989 than most experts had forecast," noted William Niskanen, who served on President Reagan's Council of Economic Advisers and is now chairman of the Cato Institute, in a recent paper on the Greenspan era. This forced the Fed to take decisive steps to remove excess liquidity from the economy and "deflate this demand bubble."

The federal funds rate increased nine times between March 1988 and March 1989, moving more than three percentage points to 9.75 percent. But it took some time to have the intended effect — the annual inflation rate inched upward from 3.6 percent in 1987 to 5.4 percent in 1990 before receding to 4.2 percent a year later.

The Fed's success came at a heavy price. Tighter monetary policy, coinciding with a reluctance to lend among some banks and anxiety over Iraq's invasion of Kuwait and the United States' military intervention, contributed to a recession that lasted from July 1990 to March 1991.

There is little doubt among macroeconomists that the yearlong string of increases in the funds rate was necessary to keep inflation in check. But some would argue that such corrective action wouldn't have been required if the Fed hadn't kept monetary policy so loose for so long after the crash.

Harvard's Benjamin Friedman agrees that the Fed tends to overreact to a financial crisis, but that's better than doing nothing, which is the mistake the Fed made after the 1929 crash. He offers the analogy of putting out a fire in a room. "You spray a lot of water on it [and] the next morning you've got some waterlogged furniture to deal with. ... That doesn't mean the smart thing to do would have been to stand back and watch the room burn."

Greenspan's Legacy

The Fed's response to the October 1987 crash would presage how it would cope with other threats to U.S. financial markets. A series of events added new stresses to financial markets 10 years after the crash. First, foreign investors fled currency and equity markets in East Asian countries in mid-1997. Then, Russia defaulted on its domestic debt and stopped making payments on its foreign debt in August 1998. The International Monetary Fund chose not to help the country like it helped Thailand and other countries.

Again, U.S. monetary policy focused on preventing these stresses from causing bigger problems — the Fed lowered the funds rate from 5.5 percent to 4.75 percent during the fall of 1998. "Easier money helped sustain the U.S. expansion — and prevent a global slump," wrote *Washington Post* columnist Robert Samuelson this past February in an editorial about Greenspan's legacy.

But a series of six rate increases occurred in 1999 and 2000, partly to pull liquidity back out of the economy and partly to address concerns about inflation that dated back to the mid-1990s. This tightening may have helped trip the 2001 recession.

Greenspan's approach to dealing with financial crises has raised a number of important questions. How responsive should the Fed be when faced with such a crisis — and how quickly should it revert to pre-crisis form? Also, how much leeway should the Fed Chairman be given to "fine-tune" policy?

This last question is not only relevant to how the Fed puts out financial fires, it also gets to the heart of the Fed's day-to-day policymaking. The Fed's effectiveness depends on its ability to communicate its intentions and manage inflation expectations.

Some would say that Greenspan mastered the art of managing expectations. It first came into play during the stock market crash and would help instill sufficient confidence in the Fed's inflation-fighting prowess to reduce volatility in prices and economic output during Greenspan's 18 years as Fed Chairman.

This is the legacy Greenspan has left Ben Bernanke. He and other FOMC members will take a hard look at setting an explicit inflation target. In the meantime, they will continue to use economic data and their best judgment to keep prices stable. **RF**

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