Greenspan's warning: confidence appears normal until the moment it is breached

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US Federal Reserve Board chairman Alan Greenspan has issued his clearest warning to date that the Wall Street stock market bubble could collapse with major repercussions for the entire economy.

In an address to the annual gathering of central bankers at Jackson Hole Wyoming last week, Greenspan centred his remarks on the "challenges" confronting the formulation of monetary policy under conditions where rising asset prices increasingly impact on the wider economy.

"As the value of assets and liabilities have risen relative to income," he told the symposium, "we have been confronted with the potential for our economies to exhibit larger and perhaps more abrupt responses to changes in factors affecting the balance sheets of households and businesses. As a result, our analytic tools are going to have to increasingly focus on changes in asset values and resulting balance sheet variations if we are going to understand these important economic forces. Central bankers, in particular, are going to have to be able to ascertain how changes in the balance sheets of economic actors influence real economic activity, and, hence, affect appropriate macroeconomic policies."

The implication of these remarks is that whereas in the past the stock market tended to follow and reflect broad trends in the economy, a reversal is now taking place as the level of economic activity is directly affected by the stock market and expectations of the future movement in equity values.

But with stock market valuations dependent on the assessment of risk factors, this means that central bankers and other economic authorities are increasingly groping in the dark when it comes to making an assessment of future economic trends and deciding on the appropriate policy.

As Greenspan put it: "Even our most sophisticated analytic techniques have difficulty dealing with the interactions among time preference, risk aversion, and uncertainty and with the implications of those interactions for the risk premiums that are embedded in asset prices. It is our failure to anticipate changes in this discounting process that much of our inability to accurately forecast economic events lies."

Greenspan pointed to the events of last October when US financial markets were gripped by a major crisis following the Russian debt default and the collapse of the US hedge fund Long Term Capital Management. As subsequent investigation revealed, the roots of the LTCM collapse were not that it acted as a "rogue trader" engaging in highly risk operations. Rather, its investment strategy, like those of much larger banks and financial institutions, was based on a series of financial models which assumed that interest rate spreads in different markets would return to their historical norm. The crisis erupted when that failed to take place.

"Modern quantitative approaches to risk measurement and risk management," Greenspan noted, "take as their starting point historical experience with market price fluctuations, which is statistically summarized in probability distributions. We live in what is, for the most part, a stable economic system, where market imbalances that produce unusual outcomes almost always give rise to continuous and inevitable moves back toward long-run equilibrium. However, the violence of the responses to what seemed to be relatively mild imbalances in Southeast Asia in 1997 and throughout the global economy in August and September of 1998 has illustrated yet again that adjustments in asset markets can be discontinuous, especially when investors hold highly leveraged positions and when views about long-term equilibria are not firmly held.

"Enough investors usually adopt strategies that take account of longer-run tendencies to foster the propensity for convergence toward equilibrium. But from time to time, this process has broken down as investors suffer an abrupt collapse of comprehension of, and confidence in, future economic events. It is almost as though, like a dam under mounting water pressure, confidence appears normal until the moment it is breached."

Greenspan, of course, is an avowed opponent of Marxism and its philosophical outlook, dialectical materialism. But as all students of that philosophy will recognise, he has described the onset of a crisis in the terms employed by Marx. Everything continues as it did before until a small quantitative change gives rise to a qualitative transformation.

The Fed chief went on to acknowledge that neither he nor any other financial authorities have the means for predicting when the next crisis will erupt.

"History tells us that sharp reversals in confidence happen abruptly, most often with little advance notice. These reversals can be self-reinforcing processes that can compress sizable adjustments in a very short period of time. ... We can readily describe this process, but, to date, economists have been unable to anticipate sharp reversals in confidence. Collapsing confidence is generally described as a bursting bubble, an event incontrovertibly evident only in retrospect."

One of the factors which could give rise to a collapse of confidence is the realisation that future profit earnings have been overestimated as a result of the practice of issuing stock options to executives as part of their "salary packages." According to Greenspan, calculations by the Fed show that failure to properly account for such options has led to the overstatement of profits by "one to two percentage points annually during the past five years."

Other reports suggest the figure may be much higher. An editorial entitled "Wrong way to pluck the goose", published in the *Financial Times* of August 21, noted that with the increasing prevalence of options their impact on profit rates could not be ignored.

"A study by the London broker, Smithers and Co, earlier this year suggested that the real cost of option schemes for the largest US companies in 1998 was about 50 percent of declared profits. The value of all outstanding options has now exceeded $1000 billion, almost equal to a fifth of US federal debt."

The Levy Institute Forecasting Center has also focused on stock options in its August monthly report. In a press release headed "Profits 'reek of accounting mischief'" the institute noted that while "optimistic expectations" about where the economy is going are largely based on perceptions of recent economic performance "little is what it seems these days."

According to the report, while reported profits surged in the second quarter this result contrasted strongly with national income accounts, which indicated "only a modest year-over-year profits gain and no improvement in profits margins." With the market mania generating pressure on companies to show increased profits there was pressure to indulge in "unorthodox accounting" to achieve the desired results.

While profit margins may widen a little in the current quarter, the institute's director of forecasting, David A. Levy warned that an "intense margin contraction" will probably be underway by the first quarter of 2000 with the "downside potential" for next year rated as "severe."

A decline in profits is not the only possible trigger for a sudden drop in the share market. A decline could also be set off by a drop in the value of the US dollar in international markets as a result of the widening trade deficit, further interest rate rises, or major losses by investment houses which wrongly anticipate shifts in the financial markets.

And as Greenspan's address to bankers' symposium made clear, a collapse in share values could have a major impact on the wider economy. According to the Fed's own estimates the share market is now 40 percent over valued. If the market were to lose the rises of the past two years, this would mean a loss of share value of $10.8 trillion, equivalent to around 125 percent of the GDP. A decline of this order would affect millions of American families with estimates that households have on average money assets equal to two years after-tax income directly or indirectly dependent on the stock market.