US stocks fall sharply after Greenspan warning

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19 February 2000

US stock markets fell heavily on Friday, reacting to the warning by Federal Reserve Board Chairman Alan Greenspan that US monetary authorities were prepared to raise interest rates repeatedly in the coming months, beginning with the upcoming meeting of the Fed's Open Market Committee March 21.

The Dow-Jones Industrial Average of 30 major industrial companies plunged nearly 300 points, at 3 percent not a disastrous drop in percentage terms, but one of the largest declines ever in dollar terms. Banking, oil and telecommunications companies were all hit hard. Friday's drop brings the cumulative decline since the market's all-time high January 14 to 11.8 percent. Another such day of trading would bring the Dow below the 10,000 mark for the first time in more than a year.

The decline was not confined to blue chip stocks. Broader averages were down by similar proportions. The Standard & Poor index of 500 stocks fell 3.0 percent, and the Russell 2000 index fell 2.2 percent. The NASDAQ index, heavily laden with high-technology stocks, fell 137 points, a decline of 3.0 percent.

On Thursday Greenspan gave his semiannual testimony to Congress, required under the Humphrey-Hawkins Law. He addressed the House Banking Committee, outlining the viewpoint of the US central bank on monetary policy. While describing current US economic conditions as the best in his lifetime, the Fed chairman warned that the financial boom on Wall Street could become the instrument of its own demise.

He cited what US economists term the “wealth effect”—the rapid increase in consumer spending by those enriched by the huge rise in the stock market. Fully one quarter of the increase in US Gross Domestic Product in recent years has come from this spending of stock market profits, which are reaped by a tiny fraction of the population.

This was dangerous, Greenspan testified, because it was “creating additional purchasing power for which no additional goods or services have yet been produced." Equally worrisome to the Fed was the fact that runaway market values were encouraging investors to borrow against the value of their unrealized market gains and plow these funds back into the market, further fueling financial speculation.

Up to the present, Greenspan declared, inflationary pressures had been offset by the flood of low-cost imports, which have kept prices relatively stable, and by the extremely modest pace of wage gains, which remain well below the rate of increase in productivity. But he warned that the US balance of trade deficit had reached unsustainable levels, and that the labor market was bound to tighten:

“While the pool of officially unemployed and those otherwise willing to work may continue to shrink, as it has persistently over the past seven years, there is an effective limit to new hiring, unless immigration is uncapped. At some point in the continuous reduction in the number of available workers willing to take jobs, short of the repeal of the law of supply and demand, wage increases must rise above even impressive gains in productivity. This would intensify inflationary pressures or squeeze profit margins, with either outcome capable of bringing our growing prosperity to an end.”

The day after Greenspan's remarks the Commerce Department reported that the US trade deficit for the whole of 1999 was a staggering $271.3 billion, 65 percent more than the previous record set in 1998, when the excess of US imports over exports was $164.3 billion. US trade deficits with Japan, China, Canada, Mexico and the European Union were all at record levels.

Although US exports rose by 2.7 percent during the year, this was dwarfed by the 12 percent rise in imports, which hit $1.23 trillion, including a 33 percent increase in the dollar value of oil imports. In merchandise alone, the

US trade deficit was over $350 billion, but was partly offset by net exports in the services sector.

Japan and China together accounted for more than half the total US trade deficit, with a record $73.9 billion deficit with Japan, up 15.5 percent, and a $68.7 billion deficit with China, up 14.6 percent. The US trade deficit with the European Union stood at $43.7 billion, with Canada at $32.1 billion, and with Mexico at $22.8 billion. Only a few years ago there was a surplus in US trade relations with the EU and Mexico.

Although Greenspan has occasionally commented on the inherent instability and irrationality of the stock market boom—most famously in his warning of "irrational exuberance" when the Dow Jones was at barely half its present level—Thursday was the first time that he indicated what an acceptable rate of increase for share prices would be. Non-inflationary growth required that household wealth, which includes the value of stocks and other financial assets, increased no faster than the overall rise in household incomes, he said.

Last year household wealth grew at twice the rate of household income, 11.3 percent compared to 5.5 percent, and stock market prices rose at an even faster rate. Any slowdown in the bull market to the level indicated by Greenspan would have potentially catastrophic consequences for speculators who have borrowed to the hilt in anticipation of continued double-digit gains.

Significantly, a long column in *BusinessWeek* magazine earlier this month, written by the magazine's economic editor Michael Mandel, warned that the current financial boom could turn rapidly into a collapse if the double-digit increases in the price of high-tech stocks slowed to as little as 5 percent.

Mandel wrote, "the strength of the tech sector is covering up growing vulnerabilities, including volatile consumer incomes, high debt levels, and increased dependence on foreign money. Once high-tech growth slows—as it almost inevitably will at some point—these weaknesses will feed on each other, setting the stage for a serious downturn." While such concerns might appear remote to Wall Street investors, he observed, "to many sober economic historians, the current situation is too reminiscent of the economic boom of the 1920s," prior to the crash which ushered in the Great Depression.

Unlike previous downturns in the post-World War II period, Mandel added, the social consequences of a sharp fall in the stock market would be quite serious. He wrote: "the income of workers has become much more tied to the ups and downs of the economy and the vicissitudes of the market.... That means labor earnings could actually drop sharply in the next slowdown, making the recession worse.

"There are also many more temporary workers who can be released quickly if times turn bad. Almost 3 percent of the workforce—more than 3 million people—is now employed by employment or temporary-help agencies, double the share at the end of the 1980s. An additional 10 percent of workers are either independent contractors or temporary workers directly hired by their companies."

In other words, some 15 million workers would find themselves thrown immediately on their own resources in the event of a serious financial shock.

The *BusinessWeek* editor also pointed to the growth of debt as a major destabilizing factor: "The typical household balance sheet is also far more vulnerable to a downturn than it used to be. Households now have 54 percent of their financial assets tied to the stock market, compared with 28 percent in 1989. Simultaneously, Americans have taken on far more debt. In particular, margin debt has risen by 62 percent, or almost $90 billion, over the past year alone, running well ahead of the gains in the market. And mortgage debt now equals 43 percent of the value of owner-occupied housing, compared with only 30 percent in 1985. So any significant slowdown in the economy may be accompanied by a wave of mortgage defaults."

As for belief that Greenspan and the Federal Reserve would be able to prevent any sharp break in the financial markets through interest rate cuts and the loosening of credit—as they did in September 1998 after the default by Russia and the collapse of a big Wall Street hedge fund, Long Term Capital Management—Mandel was not sanguine.

He wrote: "Because the economy has never gone through a tech-based recession before, it will be possible for monetary and fiscal policymakers to make big mistakes. The truth is that they still rely on the forecasting models that completely missed the strong growth and low inflation of the 1990s, and there is no reason to expect the models to do any better on the downside."