Testimony highlights Greenspan's erratic course

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In delivering public testimony on US economic policy Federal Reserve Board chairman Alan Greenspan, supported by a generally uncritical mass media, strives to create the impression that whatever the difficulties of the moment there is nevertheless a steady hand at the wheel.

But a reading of his latest report, delivered to the Senate Banking Committee on Tuesday, and a study of the Fed's record, particularly over the past five years, tells a different story. Such an examination shows that US financial authorities are increasingly being buffeted by forces they do not fully comprehend, much less know how to control.

In his Senate testimony Greenspan indicated that while the slowdown in the US economy that began in mid-2000 had intensified over the rest of the year "perhaps even to the point of stalling around the turn of the year," it now seemed that "the exceptional weakness in a number of economic indicators" did not continue in January.

However, as Greenspan reported, at its meeting last month the Federal Open Market Committee, the body responsible for setting interest rates, nevertheless "retained its sense that the risks are weighted toward conditions that may generate economic weakness in the foreseeable future."

Asked directly if the US economy was in a recession, Greenspan replied: "At the moment we are not."

Greenspan devoted a considerable portion of his speech to the impact of new information technologies on the operation of the business cycle. These technologies, which allow greater supply-chain management and flexible manufacturing, enabled firms and business managers to make more informed decisions and respond more quickly to changes in the economic environment.

While this hastened adjustment was "generally beneficial," the process "does raise some warning flags". With the same information increasingly available to all, firms were acting in closer alignment with each other than in the past, "compressing changes into an even shorter time."

The effect of this increased synchronisation is that a crisis or loss of confidence in one area can be much more rapidly transmitted throughout the economy than in the past.

"While technology has quickened production adjustments," Greenspan told the Senate committee, "human nature remains unaltered. We respond to the heightened pace of change and its associated uncertainty in the same way we always have. We withdraw from action, postpone decisions, and generally hunker down until a renewed, more comprehensible basis for action emerges. In its extreme manifestation, many economic decision-makers not only become risk averse but also attempt to disengage from all risk. This precludes taking any initiative, because risk is inherent in every action. In the fall of 1998, for example, the desire for liquidity became so intense that financial markets seized up. Indeed, investors even tended to shun risk-free, previously issued Treasury securities in favour of highly liquid, recently issued Treasury securities.

"But even when decision-makers are only somewhat more risk averse, a process of retrenchment can occur. Thus, although prospective long-term returns on new high-tech investment may change little, increased uncertainty can induce a higher discount of those returns and, hence, a reduced willingness to commit liquid resources to illiquid fixed assets."

The collapse of Long Term Capital Management

It is significant that Greenspan recalled the experiences of September-October 1998 in the context of the signs of crisis which developed at the beginning of last month. When the billion dollar hedge fund Long Term Capital Management collapsed in September 1998, the Fed organised a $3 billion bailout and instituted a series of interest rate cuts in order to head off an emerging global financial crisis.

But the two interest rate cuts initiated by the Fed this January, each of 0.5 percentage points, were larger and delivered more rapidly than those at the end of 1998. It seems that Greenspan and other financial authorities feared that the sharp fall in stock markets at the start of the year could have led to a crisis of confidence at least on the scale of that which developed in the aftermath of the LTCM debacle.

The testimony was also significant in drawing attention to the fact, notwithstanding all the statements by Greenspan to the contrary, that the policies of the Fed are increasingly determined by movements in the stock market. When the Fed cut interest rates last month it made clear the decision was taken in order to bolster consumer spending and confidence—both of which it considers to be closely correlated with movements in the stock market.

In Greenspan's words, “changes in stock market wealth have become a more important determinant of shifts in consumer spending relative to changes in current household income than was the case just five to seven years ago.”

It was difficult, Greenspan noted, for “economic policy to deal with the abruptness of a break in confidence. There may not be a seamless transition from high to moderate to low confidence on the part of businesses, investors, and consumers. Looking back at recent cyclical episodes, we see that the change in attitudes has often been sudden. In earlier testimony, I likened this process to water backing up against a dam that is finally breached. The torrent carries with it most remnants of certainty and euphoria that built up in earlier periods.”

To the extent that a conscious policy is being pursued, it seems to be directed at trying to ensure the maintenance of consumer and business confidence via interest rate cuts to boost financial markets. In other words, to extend Greenspan's analogy of the dam, the Fed is moving from one leak to another, desperately trying to plug them.

Such a policy may avert a recession in the short-term but it is doing nothing to inspire confidence that the long-term structural imbalances in the US economy are being addressed.

As the *Financial Times* noted in its editorial on Wednesday: “A quick-fix recovery would assume that many of the trends of the past decade could simply continue in perpetuity. That would be mistaken. First, the share of profits in national income cannot rise indefinitely. Second, the private sector will not be able to continue indefinitely spending more than it earns. Third, investment returns will diminish as the capital stock accumulates. Fourth, foreign investors will at some point be unwilling to finance the huge US current account deficit.”

In other words, short-term action by the Fed to deal with immediate problems today—in particular sharp falls in equity markets—only creates the conditions for bigger problems tomorrow.

This is the lesson that emerges from an examination of its record over the recent period. In late 1998, Greenspan initiated a series of interest rate cuts aimed at boosting financial markets, despite having warned some two years earlier that Wall Street was showing signs of “irrational exuberance.”

The cuts in 1998 were followed by a further increase in liquidity in late 1999 in response to fears that Y2K problems could spark a recession. The result was the creation of a financial bubble as the Nasdaq index jumped by almost 250 percent from November 1998 to February 2000—an increase in value of around $3 trillion.

After lifting interest rates to try and control the stock market surge, Greenspan has now moved to cut them again in the hope that a rise in the stock market will boost consumer and business confidence.

So far the Fed's increasingly erratic, knee-jerk reactions have managed to avert a major crisis in the US economy. How long they will continue to do so is another question.