Greenspan knew share market boom was a financial "bubble"

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When the US share market began its rapid climb from the mid-1990s, Federal Reserve Board (the Fed) Chairman Alan Greenspan maintained in his public statements that it was impossible to know whether the surge in equity values was really only a financial bubble. Moreover, he insisted, it was inconceivable that a handful of policymakers or anyone else could know more than "the market", which was the outcome of decisions taken by a myriad of investors.

Not only that, as the stock market expansion accelerated, Greenspan even provided a theory for the so-called "new economy" by pointing to the increases in productivity resulting from the new technologies. He even suggested that the rapid supply of real time information could eliminate some of the fluctuations of the business cycle. And he ruled out any action by the Fed, such as increasing the margin rate—the percentage of funds which investors had to lodge with brokerage houses in making their deals—to curb the escalation of share values.

Now it seems that privately the Fed chief and at least one, and possibly more, of the Fed governors held the opinion that the stock market escalation was a financial bubble, but chose to do nothing about it.

The evidence—the financial equivalent of a "smoking gun"—is provided in the transcripts of the Federal Open Market Committee (FOMC) meetings for 1996 released last month in line with the five-year delay rule. These show that more than two months before his now famous "irrational exuberance" speech of December 5, 1996, Greenspan had acknowledged that the rise in the stock market had assumed dangerous proportions.

The issue had first come up at the May 21 meeting of the FOMC as the committee considered the rapid change that appeared to have come over the US economy in the previous few months.

"The crucial issues at this stage," Greenspan told the meeting, "is the evaluation of the real side of the economy. The real side is being bolstered, as best anyone can judge at this stage, by the wealth effect. Not that many months ago, everyone was sitting around, here and elsewhere, and wondering what elements in the GDP [gross domestic product] were going to strengthen and sustain the recovery. We could not find it in residential construction. We could not find it in capital investment. The consumer was dead. The government had gone out of business. And clearly the export side was not doing anything."

Now the committee members were "sitting here and wondering what is going to moderate this expansion."

What had changed in just a few months was the stock market. The S&P 500 index was "going straight up in the charts" and it was "hard to buy that anything other than a wealth effect is driving the consumer."

"That gets us down to the question of how long all this will go on," Greenspan continued. "The stock market as best I can judge is high; it's not that there is a bubble in there; I am not sure we would know a bubble if we saw it, at least in advance."

While he had not yet characterised the market upsurge as a bubble, Greenspan did concede that if there were a series of adverse developments the market would come down "rather substantially and reverse the wealth effect". In other words, the stock market was already having a significant impact on the US economy.

Greenspan's remarks that day also pointed to another significant aspect of the "new economy" boom—the downward pressure on wages arising from workers' fear of losing their jobs.

"I go back to the issue that I raised about a year ago," Greenspan said, "namely that we seem to have created a level of job insecurity that has overwhelmed the pressures to increase wages. As I made the argument back then, the state of technology is creating a degree or sense of job obsolescence and fear that apparently ... has induced a tremendous shift away from increased wages and toward more job security."

The issue of the growing stock market bubble was next raised by then Fed Governor Larry Lindsey (now assistant to the president for economic policy) at the September 24 meeting of the FOMC.

Lindsey began his remarks by saying he would like to comment on the possibility that "our luck may be running out" and voiced his concerns about the state of financial markets. "What worries me ... is that our luck is about to run out in the financial markets because of what I would consider a gambler's curse: We have already won this long, let us keep the money on the table."

He pointed out that while profits were projected to grow at more than 11.5 percent per year over the next five years, the nominal growth of GDP was only 5.5 percent over the same period. Profits, he warned, would fall short of this 11.5 percent expectation.

"Excessive optimism is also necessary to justify current levels of IPO [initial public offerings] activity and valuations of highly speculative stocks. While it is not so large as to exert undue pressure on the real side of the US economy, this emerging bubble is nonetheless real."

While everyone enjoys an "economic party," he continued, "the long-term costs of a bubble to the economy and society are potentially great. They include a reduction in the long-term saving rate, a seemingly random distribution of wealth, and the diversion of financial human capital into the acquisition of wealth. As in the United States in the late 1920s and Japan in the late 1980s, the case for a central bank ultimately to burst that bubble becomes overwhelming. I think it is far better that we do so while the bubble still resembles surface froth and before the bubble carries the economy to stratospheric heights. Whenever we do it, it is going to be painful, however."

In the light of his subsequent repeated public comments that it was not possible to determine whether a bubble was in the process of formation, Greenspan's remarks at the September 24 meeting make interesting reading.

"I recognise that there is a stock market bubble problem at this point, and I agree with Governor Lindsey that this is a problem that we should keep an eye on."

Greenspan also recognised that while there were difficulties in dealing with a bubble and there was not a "simple set of monetary policy solutions" that could deflate it, the Fed was not completely powerless.

"We do have the possibility," he continued, "of raising major concerns by increasing margin requirements. I guarantee that if you want to get rid of the bubble, whatever it is, that will do it. My concern is that I am not sure what else it will do. But there are other ways that one can contemplate."

History shows that no action was taken. Ten weeks after the September meeting, by which time the Dow had risen another 10 percent, Greenspan did issue his warning of "irrational exuberance." Three and a half months later, when the Dow had risen by a further 7 percent, the Fed lifted interest rates by 0.25 percentage points. But such was the opposition that even this limited measure aroused that the Fed shelved any further action to try to collapse the bubble. Margin rates remained unchanged, as they have since 1974, and the "other ways" hinted at by Greenspan were not considered.

Powerful forces in financial and business circles were determined to ensure that the Fed took no action to end the "economic party" and bring a halt to the systematic looting which, over the next several years, was to bring them hundreds of billions of dollars.

Now the bubble has collapsed. The cost, however, is not being borne by those who promoted and benefited from it but by millions of ordinary working people who have seen their pension plans wiped out, their life savings destroyed and face the prospect of losing their livelihood.

But as the 1996 transcripts—in particular Lindsey's remarks about America in the late 1920s and Japan in the late 1980s—make clear, Greenspan and the Fed governors were fully aware there would be major consequences if no action were taken.