The legacy of US Fed chairman Greenspan

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While it was not planned that way, it is perhaps appropriate that the trial of Enron's top two executives, Kenneth Lay and Jeffrey Skilling, for fraud and conspiracy, should have begun just one day before Alan Greenspan stepped down from his position as chairman of the US Federal Reserve Board.

More than any other single individual, Greenspan was responsible for creating the financial conditions that made possible the outright looting which has become synonymous with Enron. And though it is not listed in his official biography, Greenspan received the Enron Award for Public Service in 2001.

Yesterday, on his last day in office, Greenspan, together with the other members of the Federal Open Market Committee (FOMC), lifted the Fed's base rate a quarter point to 4.5 percent. The decision was not taken in order to contain too rapid economic growth—figures released last week showed the US economy expanded by only 1.1 percent in the December quarter, its lowest rate in three years. Rather, it represented a further payment in a kind of financial insurance policy.

After bringing down the Fed rate to a record low of 1 percent in the wake of the collapse of the sharemarket bubble and the recession of 2001, the FOMC has been steadily increasing it over the past two years in order to have some room to manoeuvre when the next global financial crisis strikes.

Greenspan retired from office to the plaudits of the representatives of finance capital. Lauded some years ago by journalist Bob Woodward as "The Maestro," he was recently hailed by former Fed vice-chairman Alan Blinder as "the greatest central banker who ever lived". His performance had been "impressive, encompassing and overwhelmingly beneficial—to the nation, to the institution, and to the practice of monetary policy".

Such praise, however, is not indicative of any real strength in the US economy—after all General Motors, once the world's largest industrial corporation, has just reported a loss of $8.6 billion. It is much more a reflection of the sentiments of the upper levels of the financial elite, who have benefited so directly from Greenspan's policies.

The modus operandi that characterised Greenspan's 19-year term as Fed chief was determined shortly after he took office. Confronted with the sharemarket crash of October 1987, when the Dow lost 22.6 percent of its value in a single day, Greenspan opened the financial spigots. Altogether, the central bank supplied $17 billion to the banking system, an amount equal to more than 25 percent of bank reserves and equivalent to 7 percent of the national money supply.

Greenspan issued a one sentence statement on the crisis: "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."

The intervention of October 1987, which resulted in a market revival, was to become the model for Greenspan's response to other financial crises.

In the early 1990s, the US economy was experiencing only sluggish growth following the recession of 1991-92. At the same time, however, stock market prices began to increase. By the middle of 1996 it had become clear that this rapid rise was not related to an expansion in the underlying economy but was assuming the character of a financial bubble, fuelled by the inflow of cash into financial markets.

At a meeting of the FOMC in September 1996 Greenspan recognised that "there is a stock market bubble at this point" and that it was "a problem that we should keep our eye on". No action was taken until December when, in a speech to the American Enterprise Institute, Greenspan made a veiled reference to the possibility of an asset bubble and the development of "irrational exuberance".

Because his remarks were directed to the recent financial history of Japan, their significance was largely lost on his immediate audience. However the response of the markets was swift. Stock prices fell sharply in Asia, followed by a drop of around 2 percent on Wall Street the following day.

Recounting these events, Australian journalist Peter Hartcher, described the political reaction as "poisonous". Senate Majority Leader Trent Lott when interviewed on Fox News Sunday intimated that he was "nervous" about the degree of independence exercised by the Fed—a hint of possible intervention.

The Clinton administration was no less displeased. Treasury Secretary Robert Rubin explained in a television interview that the "chairman was simply raising a question, not suggesting an answer" and that he was "just seeking to widen the intellectual debate over the level of the markets".

But, as statistics on stock market investments and their benefits reveal, this was no mere academic exercise. Powerful material interests were involved.

According to Hartcher: "The Fed's 1998 triennial Survey of Consumer Finances found that the wealthiest 1 percent of families owned almost half of all shares in the country and the top 5 percent owned three-quarters. The richest 20 percent owned an astonishing 96 percent, which meant that the other 80 percent of the population shared a mere 4 percent of all stock on issue. The result? The richest 1 percent of American families banked 42 percent of the market's gains between 1989 and 1997, and the wealthiest 10 percent took 86 percent" (Peter Hartcher, *Bubble Man*, pp. 28-29).

A tiny economic elite had a lot to lose from a fall in the market and much to gain from its continued rise and was therefore hostile to any action that would halt the share market spiral.

Having been brought into line, Greenspan changed tack and become a proselytiser for the "new economy". The upsurge in the stock market and in the economy in general represented a "once in a century phenomenon that will carry productivity trends nationally and globally to a new higher track," he told a Senate committee in July 1997.

Over the next three years, the market was fuelled by cuts in interest rates, first in response to the Asian economic crisis of 1997-98 and then in preparation for the possibility of Y2K computer problems. When the market eventually turned in March 2000, followed by the onset of recession in 2001, Greenspan's response was to cut rates still further.

The result has been the creation of a series of imbalances which threaten to set off a major crisis in the US and world economy. Fuelled by low interest rates, house prices have climbed, leading to the creation of a real estate bubble estimated to be around $5 trillion. The US balance of payments deficit is now more than 6 percent of GDP, requiring an inflow of foreign funds of around $2.5 billion per day. Household savings in the US are at a record low, with consumer debt at a record high.

Last month, the front cover of the *Economist* magazine featured a cartoon showing Greenspan handing over a lighted stick of dynamite in a relay race. The editorial, headlined "Danger time for America", warned that "the Fed's policies of the past decade look like having painful long-term costs". Present American prosperity was at least partly based "not on genuine gains in income, nor on high productivity growth, but on borrowing from the future".

These warnings were underscored by former US Treasury Secretary Lawrence Summers in a speech to the recent World Economic Forum summit meeting in Davos, in which he pointed to a dangerous degree of complacency about global economic imbalances. Indian finance minister Palaniappan Chidambaram added his voice to the criticism, blaming the US for creating an unstable world situation by excess consumption and insufficient savings. "The global imbalance issue is not being addressed by the country most responsible and this has serious consequences on developing countries like India," he said.

The critics were rebuked by US Treasury international affairs official Tim Adams, who pointed out that the US could quickly fix its balance of payments gap. However, if it did, there would be a sharp fall in consumer spending, slashing gross domestic product by as much as 6 percent, leading to a world depression from which no country would be immune. Furthermore, he continued, unless growth revived in the rest of the world, the present imbalances could set off a recession even without specific policy action in the United States.

In other words, as Greenspan leaves office, the policies with which he has been closely associated could well have helped create the conditions for a world recession, the scope and depth of which has not been seen in the post-war period.