

# Fed Defends Stock 'Bubble' Performance

Greenspan Attempts To Restore His Image

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Responding to criticism that it helped create and sustain the stock market "bubble" of the late 1990s, the Federal Reserve Board has recently launched a vigorous defense, arguing that it was better to have boomed and busted than never to have boomed at all.

The campaign represents a determined effort by Fed Chairman Alan Greenspan to restore the luster to his reputation as the maestro of global economic policy that has recently been tarnished by the worst stock market crash in 30 years and an economic slowdown that has still not run its course. Greenspan, 76, is widely expected to step down when his fourth four-year term as chairman expires in 2004.

More recently, there have been questions about whether the Greenspan Fed has been ignoring another possible bubble -- this one in house prices -- that may be about to burst.

The Fed's defense is waged in the arcane locution of macroeconomics, infused with free-market ideology and reflective of the sometimes narrow viewpoint of central bankers. But essentially it boils down to this: The economic dangers involved in trying to pop a stock market bubble are greater than the risks of letting the bubble pop on its own and then lowering interest rates to try to limit the economic damage after it does.

Fed officials acknowledge that some individuals and companies may now be worse off because of the boom and bust in stock prices. But overall, they contend, the substantial social and economic benefits of the long boom of the 1990s -- low unemployment, rising incomes, a boom in innovation and productivity -- far outweigh the temporary economic pain caused by the bust.

"In my view, somehow preventing the boom in stock prices between 1995 and 2000, if it could have been done, would have throttled a great deal of technological progress and sustainable growth in productivity and output," said the Fed's newest member, Ben Bernanke, in one of eight recent speeches by Fed governors on the subject.

Alan S. Blinder, a Princeton University economist who stepped down as the Fed's vice chairman in 1996, agreed.

"To those who say the Fed failed to prevent this catastrophe I say, 'What catastrophe?' " said Blinder, co-author of "The Fabulous Decade," a book about the 1990s economy. "As far as I can see, the damage to

the real economy and to the financial system has been somewhere between little and none."

Still, even Greenspan acknowledged in a speech last week that the final judgment on the Fed's handling of the bubble will have to wait until all the financial damage has been tallied and the economy has fully recovered.

"It is too soon to judge the final outcome of the strategy that we adopted," he told the Economic Club of New York.

## A Tarnished Legacy?

Most of the criticism of the Fed's bubble policies has come from Wall Street, where the vaporization of \$7 trillion in market value has been keenly felt, as well as in the columns of a number of influential newspapers, magazines and newsletters, where Fed-bashing is a long-established sport.

"Pure and simple, save for the Fed, the stock market bubble could never have reached the monstrous dimensions it did, and its bursting would never have caused such a widespread and profound misery as it has," wrote Alan Abelson, whose weekly column in Barron's is read religiously on Wall Street. "The Fed wasn't just relaxed through the better part of the '90s -- it was out to lunch."

"If anyone had the legal, moral and intellectual authority to prick the bubble, it was Alan Greenspan," John Cassidy wrote last year in his book, "Dot.con," reprising earlier critiques published in the New Yorker.

Journalistic criticism has come both from the left (Nation columnist William Greider accused Greenspan of "gross duplicity and monumental error") and the right (the Economist and the Financial Times, which headlined a recent editorial "Mr. Greenspan's Tarnished Legacy").

"He seeded it, accommodated it, celebrated it and defended it from those who believed they saw it turn into a bubble," declared Jim Grant, publisher of a bearish investment newsletter easily given to Fed bashing. "It was a terrifically costly lapse of judgment."

Grant's big complaint is that after giving a prescient warning about Wall Street's "irrational exuberance" in 1996, Greenspan gave in too quickly and instead launched into an enthusiastic embrace of the "new economy" and the productivity revolution that lay behind it.

"He was a greater seducer than any of the big-money analysts," said Grant. "Instead of doing what central bankers are supposed to do, which was take away the punch bowl, he was busy spiking it."

Of all the critiques of the Fed's bubble policy, perhaps the most serious and sustained has come from Stephen Cecchetti, a former research director of the Federal Reserve Bank of New York and now a

professor at Ohio State University.

Cechetti argues that the Fed should have begun to "lean against the bubble" by raising interest rates in 1998, as soon as the economic dangers had passed from the Asian financial crisis and the near-collapse of giant hedge fund Long-Term Capital Management, the combination that had required the Fed to pump money into the financial system. A series of rate increases at that point, supported by warnings, would have sent a clear signal to investors that the economic assumptions underlying stock valuations were in question.

"To the extent that bubbles arise from unrealistic expectations of future economic growth, interest-rate increases that moderate current levels of growth can put a brake on them," he wrote recently.

Greenspan, who only two years ago was lauded for having delivered the best economy in a generation, has clearly been stung by such criticism. Associates say he decided to respond with a series of speeches designed not simply to stimulate a debate about the bubble but, more broadly, about the role of monetary policy and financial regulation at a time when financial markets have become a powerful, sometimes destabilizing force in the global economy.

The opening salvo was delivered at the Fed's annual economics summer camp at Jackson Hole, Wyo., in August. There, Greenspan argued that it would have been the height of arrogance and folly for a bunch of government officials to substitute their judgment about the appropriate level of stock prices for that of millions of investors interacting in an open market.

Furthermore, while bubbles may be easy to identify after they've popped, it's a lot harder when you're in the middle of one, Greenspan asserted -- particularly at a time when a new technology, the Internet, appeared to hold out the very real promise of huge returns to investors.

Finally, Greenspan speculated that even if the Fed had determined to burst the bubble, investor sentiment was so bullish that it would have required an increase in interest rates so swift and so sharp that it almost surely would have thrown the economy into precisely the deep recession that pricking it was supposed to avoid.

"Is there some policy that can at least limit the size of the bubble and hence its destructive fallout?" Greenspan asked. "The answer appears to be no. . . . The notion that a well-timed incremental tightening could have been calibrated to prevent the late 1990s bubble is almost surely an illusion."

Critics wasted no time in characterizing the Jackson Hole speech as disingenuous and evasive.

Some noted that as far back as February 1996, minutes of Fed meetings quoted the chairman as acknowledging there was a "stock market bubble problem at this moment," but he had turned aside a suggestion that the Fed try to let the air out of it either by raising interest rates or by raising margin requirements -- the amount of their own money investors must put up to borrow more to buy stock.

Others dismissed Greenspan's exaggerated deference to free markets, noting that the Fed routinely substitutes its judgment for the market's on the basis of uncertain information, including every time it raises and lowers interest rates in an effort to fine-tune the economy's performance.

A number of Fed governors have since acknowledged that they were well aware a bubble existed by the time the dot-com craze was in full swing. But one reason they backed off from trying to do anything about it was that earlier attempts to use monetary policy or the bully pulpit to restrain the bull market had little, if any, impact. That was the case back in 1994, when the market easily shrugged off a series of rate increases. And it was true after Greenspan's "irrational exuberance" warning in 1996.

In fact, the steepest increase in the Nasdaq composite index -- when it soared from 2500 to 5000 in eight months -- occurred in the period *after* the Fed began raising interest rates in June 1999 and *after* Greenspan began to use congressional testimony to warn anew about stock prices that had become "unwarranted" and "euphoric."

Summing up the Fed's defense last week, Greenspan said he still believes the wiser course was to have let the stock market work out its own imbalances, stepping in only after the bubble had burst with lower interest rates to help cushion the fall and avert long-term damage to the economy.

History may also be on his side. The one time in its history that the Fed set out explicitly to pop a stock market bubble was in 1929, when it raised interest rates by 2.5 percentage points over 20 months.

According to Bernanke, the consensus among economists is that it was the effect of this harsh monetary policy on the economy -- not the impact of the stock market crash -- that set in motion the chain of events that led to the Great Depression.

## The Great Deregulator

While much of the criticism about the Fed and the bubble revolves around its monetary policy, there is an equally fierce disagreement about whether the central bank's enthusiastic embrace of deregulation in the 1990s opened the door for banks and Wall Street firms to engage in questionable financing schemes that contributed to the bubble and were used to mislead and defraud investors. Many of these financing arrangements involved Fed-supervised banks using complex new securities traded on markets that the Fed insisted remain beyond the reach of other federal regulators.

Greenspan's Fed has been aggressive in defending the deregulatory paradigm. In recent speeches, Fed officials have said it was the new powers granted to banks under deregulation, and the emergence of unregulated markets in "derivatives" and "credit swaps" and "asset-based securities," that allowed the U.S. economy to withstand the shock of a stock market crash and the collapse of the telecom industry without a financial crisis.

"These increasingly complex financial instruments have especially contributed, particularly over the past couple of stressful years, to the development of a far more flexible, efficient and resilient financial system than existed just a quarter-century ago," Greenspan said in a speech last month to the Council of Foreign Relations.

In the same speech, Greenspan cited Enron Corp., WorldCom Inc. and Global Crossing Ltd. not as regulatory failures that contributed to a bubble, but as success stories that prove the wisdom of deregulation.

Taking the somewhat narrow view of the bank regulator, Greenspan noted that despite the rash of corporate failures and write-off of tens of billions of dollars in bad corporate loans, no major bank has been threatened with failure.

Greenspan went so far as to assert that it was the role of central bankers to create an environment in which banks and investors are encouraged to take the risks that lead to breakthroughs in innovation and productivity, even if that same environment is also conducive to investment bubbles and imprudent lending.

"We have responsibility to ensure that the regulatory framework permits private-sector institutions to take prudent and appropriate risk, even though such risks will sometimes result in unanticipated bank losses or even bank failures," he told the Washington audience.

Such arguments strike some critics as perverse.

"It is hardly comforting to learn that deregulation helped the banks strengthen their balance sheets by allowing them to operate unethically, take risks they should not have taken and then pass them on to unsuspecting investors," said D. Quinn Mills, a professor at Harvard Business School who has just published a book on the bubble. "For the Fed to claim credit for all the benefits of deregulation while denying any responsibility for the negatives is, frankly, quite outrageous."

## A New Bubble?

Even as the debate over the stock market bubble continues, another is just beginning, this one over house prices.

Nationally, house prices were growing at the annual rate of about 8 percent through much of 2001, while in some metropolitan areas, such as Washington, the average annual percentage increases were as high as the mid-teens. Such increases were two and three times those in household income, leading some analysts to argue that investors who had once poured their savings into the stock market had now decided they could get better, or at least more secure, returns by investing in new and bigger homes.

Lending support to that notion were the Fed's own figures on household wealth, which show an acceleration in the growth of mortgage debt beginning in 2001. By the end of 2001, mortgage debt burden as a percentage of disposable household income had reached its highest level in more than 20 years.

A number of critics, including Ed Yardeni, an economist and chief investment strategist at Prudential Securities, blame the Fed for helping to create and fuel what they characterize as a housing bubble. Keeping interest rates at their lowest level in decades, they argue, had the effect of pushing house prices even higher while encouraging households to allow their debt to grow faster than their incomes or their wealth.

But Fed officials have repeatedly declared that there is no housing bubble worthy of the name.

"We've looked at the bubble question and concluded it's most unlikely," Greenspan testified at a congressional hearing in July, noting that the housing market by that time had already begun to cool. "We see no evidence of it."

Indeed, rather than expressing concern about the increase in mortgage debt levels, Greenspan and his colleagues have applauded the boom in mortgage refinancings that allowed millions of homeowners to "cash out" on some of the equity value of their homes. Consumers have used much of that money to continue spending on new cars, furniture and other goods right through the recession, Fed officials argue, helping to smooth out the business cycle and make it one of the mildest in memory.

By contrast, Mervyn King, the new governor of the Bank of England, used a speech last month to warn that the British economy had become overly reliant on consumer spending propped up by increases in housing values that reached nearly 30 percent in the past year.

"Even the optimistic Mr. Micawber would realize that this cannot continue indefinitely," King said, referring to Charles Dickens's character in "David Copperfield."

But King went on to acknowledge that he wasn't sure whether the central bank should try to prick the bubble before it burst, or give it a chance to deflate on its own.