Economic Policy Institute

Briefing Paper

1730 Rhode Island Ave., NW • #200 • Washington, DC 20036 • 202/775-8810

A REPORT CARD ON THE GREENSPAN FED

By Gary Dymski, Gerald Epstein,
James Galbraith, and Robert Pollin

It is more than four years since Alan Greenspan became Chair of the Board of Governors of the Federal Reserve System. How well has the Federal Reserve conducted monetary policy under his stewardship?

Assessing the performance of Greenspan's Fed is of major importance, The economy is mired in a recession which has already lasted longer than virtually all post-war downturns. And with fiscal policy placed in a political straight jacket by the budget deficit, the Federal Reserve's monetary policy has become the only tool of macroeconomic policy available to the U.S. economy. Indeed, Alan Greenspan himself has argued against using anti-recessionary fiscal policy. Thus, he has squarely placed the responsibility for managing the nation's macroeconomy on his own Federal Reserve.

Does the Greenspan record inspire confidence that the Federal Reserve, under his leadership, should be entrusted with this enormous power at this critical juncture? Unfortunately, the answer must be no. For though the Greenspan Fed deserves an A for meeting its first major challenge -- the stock market crash of 1987 -- it has earned a flunking grade for handling its most recent urgent tasks: first avoiding, and then fighting, the current recession. The verdict on the Greenspan Fed's recent policy must be: too little, too late.

This is not a personal question. The problem lies not in the man, but in his beliefs and in the policies to which they lead. Unfortunately, Alan Greenspan is now a prisoner of his own reputation as an inflation-fighter, and this fact is itself a barrier to the pro-growth monetary policy that the country needs. Given who he is and

what he stands for, Chairman Greenspan's useful period of service has, in our judgment, simply come to an end.

To be sure, the enormous uncertainties facing economists and policymakers must be taken into account in assessing any policy. Yet, in the end, these uncertainties do not vindicate the Greenspan Fed. For the Fed's costly policy is not simply due to forecasting errors, which have been all too common among economists and policymakers these days. The problem, rather, has been the policy choices the Fed made in light of these uncertainties. This Federal Reserve focused on fighting the last war -- the war against inflation. It has therefore lacked the flexibility of mind and purpose to fight the current and very real one that we all face: recession. This fixation with fighting the last war has led the Federal Reserve -- both through misreading warning signs and through deliberate policy -- to pursue much less expansionary policy than the economy needs if it is to resume strong and stable economic growth.

First, the Fed's perceptions of the economy were filtered through inflation fighting glasses, which led the Federal Reserve to misinterpret or ignore important economic warning signs in three areas: fiscal drag at the federal and state and local levels; continued weakness in real estate; and significant problems in the financial sector.

These three problems led the Fed to underestimate the monetary stimulus that would be required for recovery and to overestimate the stimulus implied by its own monetary policy. For example, a close look at the record of deliberations shows that the Federal Reserve ignored the emerging problems at the state and local levels, and therefore failed to see the fiscal drag exerted by the need to balance budgets at these levels of government. In addition, the Federal Reserve tended to discount the importance of falling prices of real estate and vacancies in office buildings, and an overhang of unsold houses in assessing the chances of recovery. Finally, the Fed discounted the important effects of the debt overhang which built up in the 1980s and have reduced the speed and altered the channels through which monetary policy can work. This led the Fed to underestimate the importance of declining rates of growth of M2 and bank credit to businesses, and therefore to fail to realize that its monetary policy was less potent than previously believed.

Alan Greenspan finally acknowledged his own errors, specifically with respect to the debt overhang, in his Congressional testimony of last December 18. Abandoning the optimistic forecasts to which he had clung for over one year, he stated that "by late summer, the growing propensity of households to pare debt and businesses to reduce leverage was a signal that the balance sheet restraints. .. had indeed taken hold, working against the normal forces of economic growth." Greenspan attempted to rationalize his misreading of the financial system -- over which, after all, he presides as senior regulator -- claiming that "I am not sure there is any way I know of analytically that we could have forecast" the depths of the problems in the financial system. However, these problems had been building throughout the 1980s, and their likely consequences were hardly a mystery to anyone who was willing to examine the situation objectively.

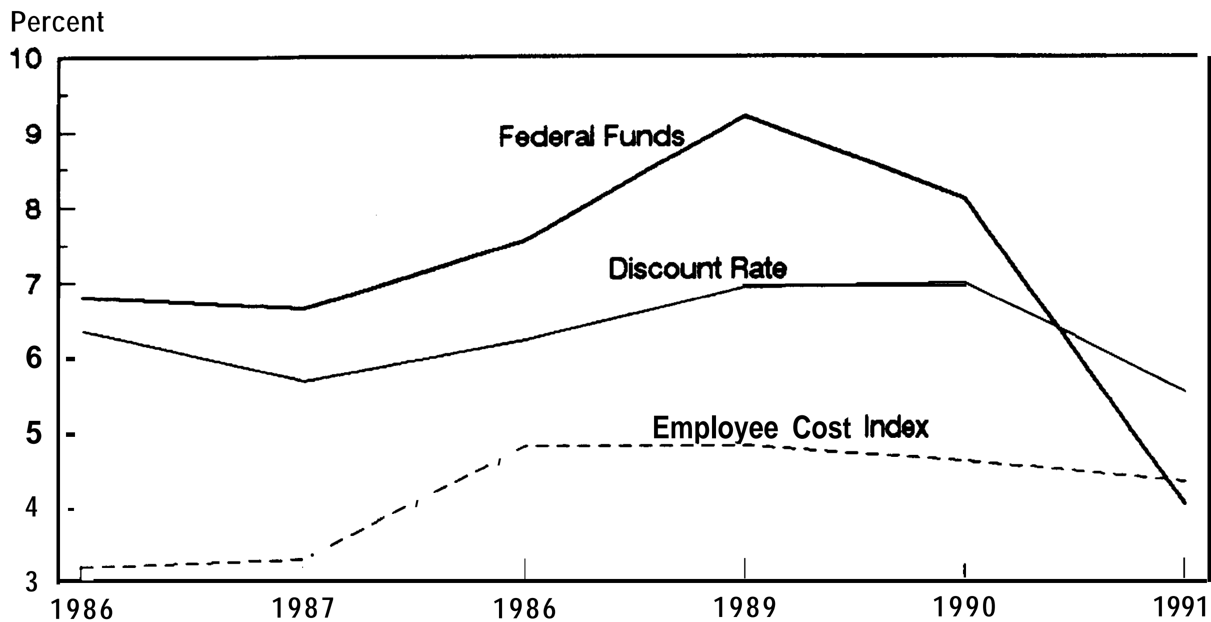
Greenspan's misreading of the financial market had far-reaching consequences. Choosing to fight the last war against inflation, the Federal Reserve opted for gradualism, even as the recession unfolded. Thus, the Fed dropped the Federal Funds rate in quarter point increments, a speed which minimized the effectiveness of their impact. The reason for such slow policy implementation is clear: as a careful analysis of the record indicates, given the range of forecasts and the uncertainties associated with them, the Federal Reserve's policy was virtually always on the side of caution and restraint. Why? Because, at every juncture, faced with choosing between a higher risk of recession or a higher risk that inflation would not continue to fall, the Federal Reserve chose the higher risk of recession.

Most telling were the deliberations in 1990, at a time when the Federal Reserve was forecasting extremely slow growth for the year. In that context, the Federal Reserve still chose to maintain a steady course, rather than loosen in order to expand the economy in line with the growth of potential real GDP. Again, in the summer and fall of 1991, the Fed was still focused on inflation, despite the fact that, as we now know, the recession was already one year old.

In short, given all the uncertainties plaguing our economy, Greenspan's Federal Reserve, like any Federal Reserve, made policy to some extent by throwing dice. But -- and this is the key point -- the Fed chose to play with dice that were loaded to fight inflation rather than recession.

The data support our evaluation of the Greenspan Fed's anti-recession performance. As Figure 1 shows, the Federal Reserve has been quick to respond to the threat of cost-push inflation with higher rates as employee costs go up, but slow to lower the discount rate and federal funds rate as the growth in demand and employee costs fall. The result is a slow response to the recession by the Federal Reserve.

Figure 1
Employee Cost Index, Federal Funds, and the Discount Rate, 19864 991

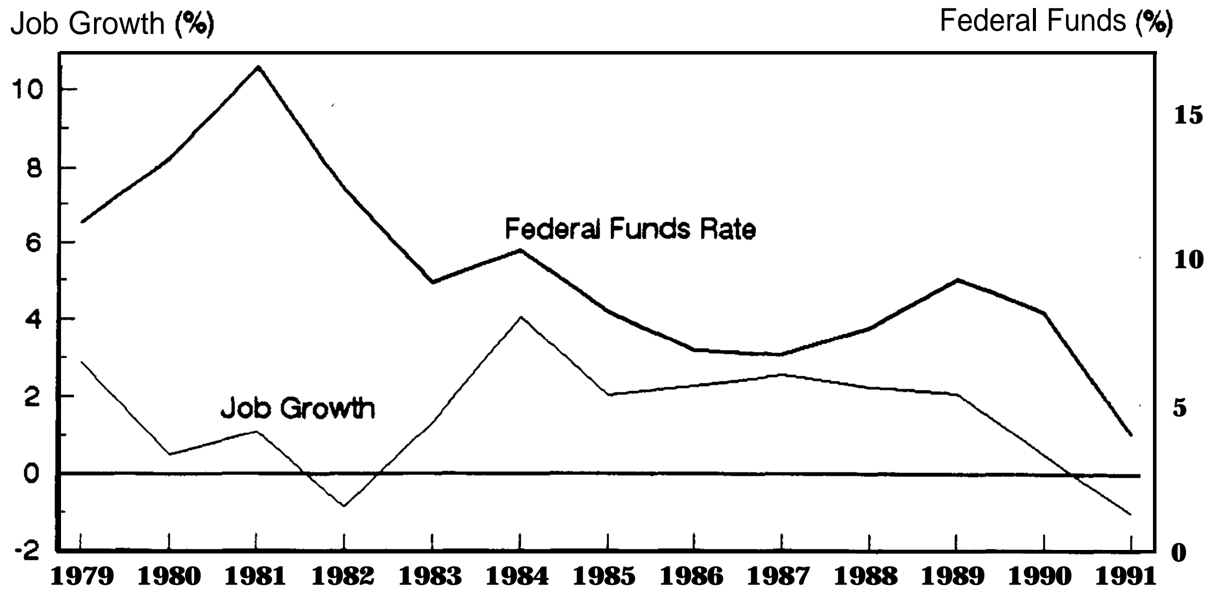


Sources: Economic Report of the President and Council of Economic Advisors.

As Figure 2 shows, the Federal Reserve was slow to respond with cuts in the Federal Funds rate as job growth slowed between 1987 and 1989. This tight monetary policy set the stage for the decline in employment **that** followed in 1990 and 1991.

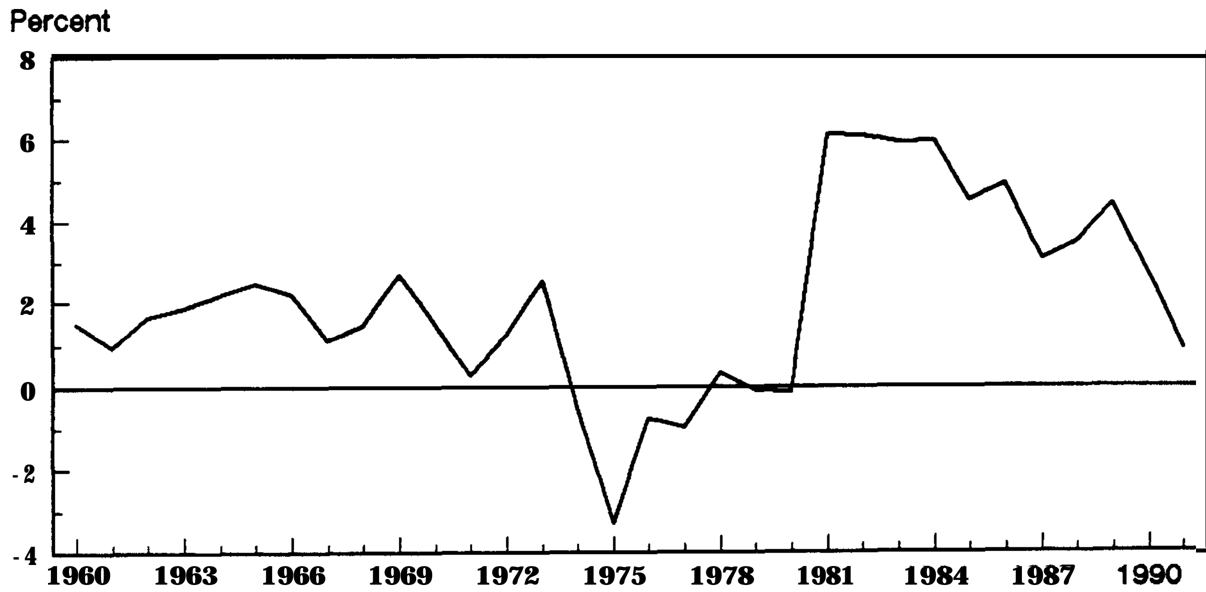
Figure 3 indicates that while the real funds rate (the federal funds rate minus inflation) has come down since 1989, and is below its level in the **1980s,** it still is not low by historical standards. **As** Figure 4 shows, real corporate bond rates measured by AAA rates also remain high by historical standards.

Figure 2
Job Growth and the Federal Funds Rate, 1979-1991



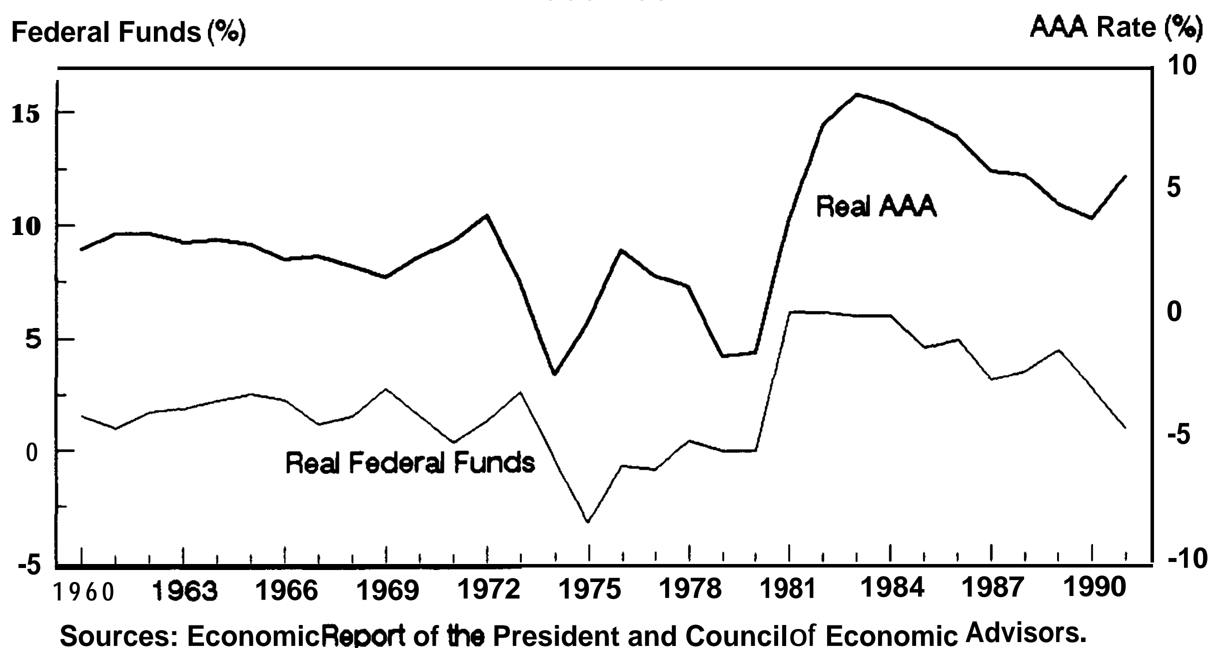
Sources: Economic Report of the President and Council of Economic Advisors.

Figure 3
The Real Federal Funds Rate, 1960-1991



sources: Economic Report of the President and Council of Economic Advisors.

Figure 4
The Real Federal Funds and AAA Rate,
1960-I 991



Sources: Economic Report of the President and Council of Economic Advisors.

The result of this bias toward inflation fighting was a monetary policy which, despite a greater than average fall in short-term interest rates, has been less expansionary than usual by other measures. Short-term interest rates have come down in smaller steps and the cuts have been spread out over a longer period of time than in other post war recessions. Real interest rates remain higher than in most 0 ther post-war recessions. Further, the rate of growth of important monetary aggregates -- M2, domestic credit, and bank lending -- has been extremely low by historical standards. For example, in November 1991, bank lending was only 0.2 percent above the levels of July 1990, while it had advanced 11 percent during corresponding periods of previous cycles. M2 has declined during most of the recession. Meanwhile, the growth of real credit to non-federal borrowers has fallen drama tically during the recession.

While monetary stimulus has been painfully tentative, other economic factors call out for a more aggressive policy than usual. Fiscal policy has been significantly less expansionary than in other post-war recessions, when the federal fiscal stimulus averaged almost 1 percent of GDP. This time there has been no federal fiscal stimulus. On top of that, fiscal problems at the state and local levels are generating a significant fiscal drag on the economy. Moreover, the unusually slow growth in domestic credit described above indicates that credit is not expanding as rapidly per unit of monetary policy stimulus as is usually the case.

Other factors also suggest the need for a greater-than-usual dose of expansionary policies. One is that consumer confidence is unusually low. Another is that, according to many estimates, 50 percent of the effect of monetary policy comes through increases in exports resulting from a depreciating dollar. And, with our major trading partners experiencing slow growth or recession, the stimulus from this channel of monetary policy is likely to slow in the near future.

With the Fed's dramatic December reduction of the discount rate by a full percentage point, one might argue that, finally, Greenspan and the Fed have come to understand the true dangers of recession, and are now willing to assume responsibility for ending the recession. However, soon after their dramatic change in policy, Greenspan and the Federal Reserve threw their commitment to ending the recession into doubt. Recent increases in long-term interest rates associated with statements by Alan Greenspan and other Federal Reserve officials and the continued large spread between long and short-term interest rates suggest that the Greenspan Fed has a severe credibility problem. This has reduced the effectiveness of the expansionary policy that the Fed has undertaken, and is likely to plague the Federal Reserve as a recession fighter in the months to come.

The credibility problem is this: Greenspan and his Fed have made reducing inflation and inflationary expectations their top priority. The markets know this means that the Federal Reserve will raise short-term interest rates if there is any sign of an uptick in inflation. This policy has undoubtedly had the effect of lowering the inflation premium present in both short- and long-term interest rates. But it has at the same time increased another premium in long-term interest rates: the "tight money" premium. The tight money premium exists because the market is concerned

that, in the future, the Fed will raise short-term rates. As a result, while short-term interest rates and inflation expectations have fallen, long-term rates have not fallen by nearly as much. Investors fear that the Federal Reserve will raise interest rates in the near future.

Recent events provide strong evidence for this interpretation. When the Federal Reserve announced in December that *it* perceived that the economy was weak and was therefore reducing the discount rate by one point, long-term rates fell dramatically. If the markets had been concerned about future inflation, long-term rates would have risen when the Fed reduced the discount rate. Similarly, in early January, when Alan Greenspan presented testimony that he believed there probably would be no further need for rate cuts, long-term rates began to *rise.* Again, one would have expected long-term rates to fall had investors been primarily concerned with future inflation.

Thus, it is not inflation that the market fears, but the Greenspan Feds anti-inflation bias. The market knows that the Federal Reserve under Greenspan's leadership is an inflation fighter. What the market needs in order to bring about an adequate decline in real interest rates is a Federal Reserve committed to overall economic stability.

The need for a credible recession fighting Federal Reserve is made all the more important by the severe constraints facing fiscal policy. If the Federal Reserve wants fiscal policy to play no role in fighting the recession, as Greenspan has insisted in his recent public pronouncements, then it must unequivocally assume the responsibility it wants to reserve for itself: the responsibility of stabilizing the U.S. economy.

It may be that Alan Greenspan can convince the markets that he and his Fed will do everything it takes to bring the U.S. economy out of recession and into the range of growth consistent with the trend growth of potential GDP. However, it is not clear that Greenspan *wants* to increase his credibility as a recession fighter. His past behavior gives little evidence that he does.

Effective policy requires a new Federal Reserve Chairman, one who is known to be committed to economic stability -- including price stability -- rather than one with a bias in favor of fighting inflation to the detriment of economic growth.

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