

AN UNCONVENTIONAL PERSPECTIVE ON THE GREENSPAN RECORD

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On his nomination as chairman of the Federal Reserve Board, Ben Bernanke stated, “My first priority will be to maintain continuity with the policies and policy strategies established during the Greenspan years.” For that statement to provide much information, however, it is useful to understand the record of the Greenspan years.

The Greenspan Record

The most important summary statistic of this record is that the *trend* rate of increase of aggregate demand—measured by nominal final sales to domestic purchasers—from 1987/III through 2006/I was 5.4 percent a year. This increase in demand reflected an increase of real final sales to domestic purchasers of 3 percent a year and an average inflation rate of 2.4 percent. Thus, during the Greenspan era, the trend rate of increase in demand was only slightly too high to meet a 2 percent inflation target. From my perspective this was the appropriate trend rate of increase in demand during this period.

The variation around this trend, displayed in Figure 1, provides valuable additional information about “the policies and policy strategies established during the Greenspan years.” Although the standard deviation of demand around this trend was only 1.3 percent, this variation had significant effects on asset prices and the real economy, and most of this variation was a consequence of the Fed’s response to financial crises.

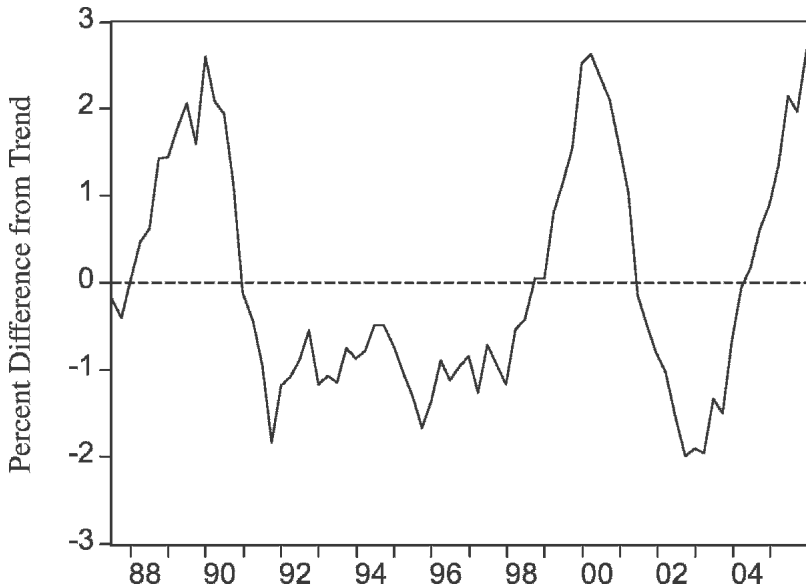
The Fed’s Response to Financial Crises

The Fed’s characteristic response to a financial crisis during this period was to put a lot of money in the market quickly and then slowly

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FIGURE 1
NOMINAL FINAL SALES TO DOMESTIC PURCHASERS



take it out. The first unusually large increase in demand was clearly a consequence of the Fed's response to the large decline in U.S. equity prices in October 1987, only two months after Greenspan's confirmation. This response led to higher real economic growth in 1988 and 1989 than most experts had forecast. In turn, Fed tightening to deflate this demand bubble was the primary cause of the shallow recession of 1991.

The second unusually large increase in demand was clearly a consequence of the Fed's response to a series of foreign and domestic financial crises beginning with the Asian crisis in 1997, sustained by the collapse of Long Term Capital Management and the Russian default in 1998, and ending with the Brazilian devaluation and the anticipated Y2K crisis in 1999. The Fed's easy money policy led to a bubble in aggregate demand that was nearly synchronous with the equity bubble, and Fed tightening to deflate the demand bubble contributed to the sharp reduction in equity prices and the shallow recession of 2001.

It is less clear what triggered the third large increase in demand. Some have suggested that the September 11, 2001, crisis led to this increase, but this view is implausible because demand did not begin

to increase rapidly until 18 months later. In any case, the recent increase in demand is too high—a 7.4 percent annual rate over the past two years (2004/I–2006/I)—to maintain Bernanke’s apparent inflation target of 1 to 2 percent. As a result, the general inflation rate increased to 3.1 percent during 2005. One of Bernanke’s first major challenges will be to reduce the increase in demand to a sustainable 4 to 5 percent range without another recession.

Some Policy Lessons

The major lesson from Figure 1 is that most of the variation in demand has been triggered by the Fed’s response to financial crises. A second lesson is that the Fed seems to overreact. A reasonable standard by which to judge the Fed’s response to a financial crisis would be to avoid a *decline* in the growth of aggregate demand relative to the target path. Instead, the Fed has let demand increase relative to the target path. A third lesson is that the deflation of the demand bubbles caused by overreacting to financial crises led to the two shallow recessions during the Greenspan years.

Institutional Problems

Some of the more important institutional problems that the Bernanke Fed should address are whether and how much to respond to a financial crisis. For example, the Fed did not respond to the Mexican financial crisis in the winter of 1985, but did respond to the several financial crises during the Greenspan era. The conventional perspective on this issue is that the Fed faces a tradeoff between avoiding the potential near-term contagion effects of a financial crisis and the longer-term problem of moral hazard and that the Fed is biased in favor of reducing the near-term contagion effects. The record of the Greenspan years suggests that there is another potential long-term cost of responding to a financial crisis—the increased probability of a recession caused by deflating the demand bubble caused by the Fed’s overreaction to a crisis.

Conclusion

I do not mean to imply that the Fed should never respond to a financial crisis. My objective is to induce more analysis about how to minimize the combined effects of a financial crisis and the Fed’s response to it on the Fed’s primary mission: to maintain a steady increase in aggregate demand consistent with a low target rate of inflation.