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The Greenspan Myth

By Donald L. Luskin

"What would the Maestro do?" As nervous markets hang on every word of Federal Reserve Chairman Ben Bernanke, trying to divine whether he will lower interest rates in response to the current turmoil in credit markets, comparisons to his illustrious predecessor Alan Greenspan are inevitable.

Such comparisons can also be invidious, and shouldn't influence what Mr. Bernanke does now. Mr. Greenspan is fondly remembered for his role in stewarding markets through the stock crash of 1987, the Long Term Capital Management crisis of 1998, the collapse of the tech bubble in early 2001, and the aftermath of the terrorist attacks of September 2001. Today he enjoys a reputation for having moved swiftly and decisively -- "pre-emptively" it is often said now -- to help the markets out of those crises.

But the truth is quite different. Mr. Greenspan is fortunate indeed to be remembered as such a decisive leader, because in fact his reactions to some of those crises were quite tardy, and were seen by most market participants at the time as being too little, too late.

Let's look at the Long Term Capital Management crisis of 1998, an event in many ways analogous to today's situation. Then the markets were thrown into turmoil by emerging market currency devaluations and Russia's default on its sovereign debt, much as markets have recently been rocked by defaults in subprime mortgages. As a consequence, then as now, the solvency of hedge funds and the investment banks that sponsored them were threatened.

By the time LTCM had collapsed -- and had to be bailed out by a private consortium of banks brought together by the New York Fed's William McDonough, not Mr. Greenspan -- the S&P 500 had already fallen by almost 20%, and staged a modest recovery from there. Mr. Greenspan had done precisely nothing with interest rates.

The Federal Open Market Committee made a 25 basis-point rate cut the day after the LTCM bailout was announced in late September. Markets were not impressed. Credit markets remained frozen much as they have been in the current crisis, and stocks fell to new lows over the first 10 days of October.

Laurence Meyer, a Federal Reserve Board governor at the time, recalls in his 2004 book, *A Term at the Fed*, that "Rather than calming the markets, the small size of the rate cut raised doubts that the Fed appreciated the severity of the problem . . . Greenspan was now under attack."

In mid-October, Mr. Greenspan cut rates another 25 basis points in a surprise inter-meeting move. According to Bob Woodward in his Greenspan biography *Maestro*, Mr. Greenspan was reluctant to make that move but was pressured by Mr. McDonough and then Fed Vice Chairman Alice Rivlin.

By the end of 1998 there was another 25 basis-point cut at a regular FOMC meeting, the market turmoil passed and Mr. Greenspan ended up on the cover of *Time* as chairman of the "Committee to Save the World." That's how he's remembered today.

Mr. Greenspan is also remembered for cutting interest rates aggressively as the tech bubble burst in early 2001, starting on Jan. 3 with a surprise inter-meeting cut of 50 basis points. In his book, Mr. Meyer writes that Mr. Greenspan "had decided that the Fed should be seen making a deliberately anticipatory move -- one that would not be viewed as a late response to a rapidly deteriorating situation."

Alan Greenspan got his wish in terms of how history would remember him, but the reality is that the economy had already rolled over. By the time Mr. Greenspan made his "anticipatory" cut, the S&P 500 had already fallen almost 16% from its highs the previous September.

And when the cut was announced, the relief in the markets was fleeting. Stocks stabilized for several weeks, but fell to new lows in mid-February. They were destined to fall nearly an additional 40% from there, despite no less than 11 more rate cuts -- with even more to come after stocks bottomed in late 2002. So much for "anticipatory."

Mr. Greenspan indeed did cut rates quickly in the aftermath of the stock crash of 1987 and the terrorist attacks of September 2001. That's because both those extraordinary and highly public events were seen by the Fed as being very likely to depress overall economic activity, not because distressed markets themselves needed to be bailed out.

To help the markets in those crises, the Fed opened its checkbook to provide the liquidity necessary for transactions to clear and credit to endure despite the chaos. That's precisely what Mr. Bernanke has already done in the present turmoil, both through a very high volume of ordinary open market transactions and a liberalized discount-window lending policy.

In that sense, Mr. Bernanke has already acted more pre-emptively than Mr. Greenspan did in 1998, and similarly to the way Mr. Greenspan did in 1987 and September 2001. And he has done so despite the fact that, judging by the stock market's sturdy performance through the current turmoil -- now down only about 5% from all-time highs -- today's crisis is less threatening than those earlier ones.

It's noteworthy that the enormous volume of Fed open-market operations in the fed funds markets over the last month has been completed at the current rate target of 5.25%. This suggests that no lower rate is required to meet the needs of the banking system. And the discount window has scarcely been used at all, which suggests that the system is not in quite the state of distress that has been advertised.

So why would Mr. Bernanke cut the fed funds rate, unless he became convinced that the overall economy was highly likely to be damaged by the present market turmoil? That was the call Mr. Greenspan made quickly after the 1987 crash and the 2001 attacks, and slowly in 1998 and early 2001. Where's the evidence to support Mr. Bernanke making such a call today? Almost all the evidence is that the economy is remarkably robust, credit crisis or no credit crisis, housing slowdown or no housing slowdown.

Yes, we've had one disappointing jobs report. But with jobs at a level historically regarded as "full employment," must we hurry to cut rates? By historical standards, rates are already low. Since the 1970s, no easing cycle, and no recession, has ever begun when the real funds rate was as low as it is today.

Yet Mr. Bernanke remains under tremendous pressure from markets to cut rates. The prices observed in short-term fixed-income and interest-rate futures markets clearly imply that the markets expect a cut -- and the balance of pundit commentary is calling for one.

If the principled case can be made that a robust economy is significantly at risk, then Mr. Bernanke should do what the markets and the pundits demand -- provided that he sees a rate cut as consistent with his mission to preserve price stability.

But the idea that he must act immediately, in order to be seen as a worthy successor to the "Maestro," is unfair to Mr. Bernanke and too generous to Mr. Greenspan. The current Fed chief deserves our admiration for having acted quickly and appropriately so far, and resisted the temptation to over-react.

Mr. Luskin is chief investment officer of Trend Macrolytics LLC.