Derivatives Study Center

Challenge - May/June 2001, pp. 115-21

Maestro: Greenspan's Fed and the American Boom

by Randall Dodd

Maestro: Greenspan's Fed and the American Boom. By Bob Woodward. New York: Simon & Schuster, 2000. 272 pp. $25, cloth.

"Maestro" may be an odd choice of title for Woodward's hagiography on Alan Greenspan. While it captures the tone of the theme that Greenspan orchestrated the greatest economic expansion in modern U.S. history, it also resounds with a clank to Woodward's contrasting facts about how Greenspan nearly wrecked every moment of crisis in his career as chairman of the Federal Reserve Board (Fed).

This contrast is what makes the book a fascinating read: On one hand, the reader hears the author spin a yam intended to glorify his subject, and, on the other hand, the reader hears new insider accounts of the policy debates and negotiations that belie the yam and portray a Federal Reserve chairman responding to crises with consistently bad instincts and wrong-headed policy moves. It is two tales of a city. What saves Greenspan and the economy each time is the better advice of others, whom Greenspan wisely and sometimes reluctantly follows. Hence Woodward's account is not the normal heroic narrative.

This is not to say that Greenspan did nothing right in his performance as Federal Reserve chairman or that there was no merit in his actions even when they were imperfect. When he lowered the federal funds rate to 3 percent in the fall of 1992, it was the first time those rates had been so low since July 1963. This was truly a courageous policy decision that contributed greatly to spurring the economy onto a rapid pace of sustained recovery. Even if he can be faulted for acting late, he did ultimately act in a strong manner.

Greenspan's greatest accomplishment is in what he did not do. From the summer of 1994 until the end of the decade, he did not push the fed funds rate outside the range of 4.7-6 percent. Even though the pace of economic growth and job creation soared and the unemployment rate fell far past conventional non-accelerating inflation rate of unemployment (NAIRU) thresholds, he did not take the orthodox step of sharply tightening credit conditions. Woodward provides new and surprising accounts of how Greenspan employed his own intellectual acumen as well as institutional maneuvering to stave off pressure from the more orthodox inflation hawks. This approach resulted in only a moderately tight monetary policy that allowed the pace of U.S. economic growth to exceed its perceived bounds. Even if Greenspan can be faulted for tightening too much in 1994, he subsequently acted with very measured policy moves throughout the remainder of the decade as the U.S. economy entered uncharted territory.

The purpose of this review is primarily to delineate how Woodward managed this dual project. Woodward has done us a favor by conducting countless interviews with many of the principals involved in the making of monetary policy over the past thirteen years. He has assembled these interviews into a narrative that attempts to recreate the deliberations among the inner circle. In doing so, he has brought out new details about the discussions between top policymakers.

This reconstructed dialogue requires the reader to pay careful attention as Woodward shifts back and forth between statements that are strictly in quotation marks and similar-sounding statements that are in the interviewee's voice but are not within quotations and, thus, presumably are Woodward's own paraphrasing.

Woodward's "fly on the wall" perspective fails to place the deliberations in their larger macroeconomic context. This deficiency no doubt stems from Woodward's lack of knowledge of the economy. The narrative does, nonetheless, include enough references to the dates of meetings and other events that readers can reconnect the dialogue to their own memory or study of the period. While the book cannot be fairly described as containing extensive research, and certainly not exhaustive research, it does put a noticeable scratch across the entire surface.

Each chapter of the book represents a year of the Greenspan chairmanship. Of particular interest are those parts of the narrative that focus on the five major crisis events in the last thirteen years: the 1987 stock market crash, the recession that began in 1990, the response to the Mexican peso crisis that began in December 1994, the response to the East Asian financial crisis in 1997, and the response to the Long Term Capital Management financial crisis in 1998.

1987: Stock Market Tumble

The stock market crash of October 19, 1987, was the largest daily decline in the market in fifty years and was larger in percentage terms than the crash of October 29, 1929. Although many factors can be thought to have precipitated it, the largest single factor linked to its timing was the tightening of credit conditions by the Fed. From 1981 to 1986, the Fed had pursued a policy of lowering interest rates, and the stock market had rallied throughout that period. But, beginning in 1986, under the chairmanship of Paul Volcker and continuing when Greenspan took over in 1987, the Fed reversed course and raised the fed funds rate by 150 basis points in the twelve months preceding the crash. The higher interest rates snuffed out the rally and led to the dramatic fall in prices.

Leaving out this historical context, Woodward picks up the action on the day of the crash. After a drop on the previous Friday, the market falls dramatically on Monday morning. Greenspan is scheduled to fly to Dallas that afternoon to give a talk the next morning to the American Bankers Association. Despite the portentous plummet in prices, he sticks to his plans.

Upon arriving at the Dallas-Fort Worth airport, Greenspan discovers that the market has crashed-the Dow has fallen 508 points, or 22.6 percent. Instead of immediately returning to Washington, he continues on to the hotel. He is apprised of the pending dangers of bankruptcies and interrupted payments and settlements during phone calls with Fed Board members, as well as with the president of the New York Fed, Gerald Corrigan. Still he does not return.

He is awakened the next morning by Reagan's chief of staff, Howard Baker, who wants him to return to Washington, but Greenspan says that he wants to deliver the speech. Greenspan explains that his return ticket is not scheduled until that afternoon. Baker promises a military plane for an immediate return with secured communications. Greenspan argues that he should give the speech in order to send a signal that all is well. Corrigan and Fed vice chairman Manuel Johnson, weighing in on Baker's side, insist that Greenspan return to Washington immediately, arguing that to give a routine speech to a group of bankers in the midst of a crisis would signal that Greenspan is "out of touch with reality." Greenspan concedes and finally returns to Washington.

Upon arriving in Washington, the first step to address the crisis is to make a public announcement that will restore market confidence. Woodward describes how Greenspan orders the Fed's lawyers to draw up a lengthy and carefully crafted statement explaining the Fed's responsibilities in such circumstances. When Corrigan finds out what is being done, he cusses and says that what they need is a dear one-sentence statement to show that the Fed would be taking the right steps to ensure market liquidity. Greenspan concedes after making a one- or-two-word change to the statement that Corrigan has drafted. The statement is then made public and is well received in the markets.

The next step is to follow up the argument with phone calls to key market players. Woodward describes how Corrigan plans to call around and implicitly promise that the Fed will support the banks in making loans and in taking whatever action is necessary to ensure that payments are promptly made. Greenspan instead says it will be sufficient to call and remind banks to keep their customer relationships in mind when making lending decisions.

Meanwhile, Securities and Exchange Commission chairman David Ruder and New York Stock Exchange (NYSE) president John Phelan want President Reagan to exercise his authority and order a halt to trading on the NYSE. Greenspan strictly opposes the idea and argues that it would then be impossible to resume trading.

Would a halt in trading have been a disaster? Today, circuit breakers, which limit or completely stop trading once certain price limits are exceeded, are established policy tools that I believe successfully function to maintain market order and stability at stock exchanges and futures exchanges.

What is Woodward's conclusion? He declares Greenspan a master of the market for rescuing it from its own foibles. He paraphrases Howard Baker and Treasury Secretary James Baker as saying that the onesentence statement was brilliant and that they were lucky to have Greenspan at the Fed. Woodward goes on to opine, in what strikes the reader as a clear contradiction to his own narrative in the preceding chapter, that "Corrigan never figured the whole thing out."

Does Greenspan learn from his mistakes? We later read from Woodward that, in October 1989, when the stock market takes another serious dive, Greenspan hesitates again to issue a similar statement of the Fed's willingness to provide needed liquidity to the financial markets. Only when Vice Chairman Johnson takes matters into his own hands does the Fed issue such a statement. Greenspan criticizes Johnson afterward for acting too quickly.

1990: End of the Reagan Recovery

The next crisis faced by Greenspan was the 1990-1991 recession, which arose after the Fed tightened credit so sharply that it halted what was then the longest peacetime economic expansion in the U.S. economy. The Fed had eased for a few months following the October 1987 stock market crash, but soon commenced a new round of tightening. Beginning at 6.5 percent in May 1988, Greenspan's Fed pushed up the fed funds rate to 10 percent by March 1989.

Raising interest rates by 3.5 percent in less than a year amounted to going too far, too fast. By the time the Fed reversed policy in June 1989, home construction was falling fast, industrial production-one of the four key indicators of the business cycle-was also turning downward, and private-sector job growth -another key indicator-was less than 0.1 percent a month (having fallen from the 0.25-0.35 percent range). Although the Fed continued to lower rates, it did so very gradually, and the economy ceased growing and then turned down into a recession.

Without including this context in his book, Woodward describes how Greenspan pores carefully over the data in order to employ his allegedly brilliant forecasting skills. The reader cannot help but notice that, while Greenspan declares that the economy has bottomed out and is beginning to grow, the next page recounts how the economy took another "nosedive." Through Woodward's narrative we see how Greenspan fails to forecast the coming recession, then fails to recognize it once it arrives, and then incorrectly forecasts its end well before the economy returns to a period of sustained expansion.

Consider the following litany of errors: At the Federal Open Market Committee (FOMC) of August 21, 1990, the first meeting following the start of the recession in July, Greenspan declares that government "turmoil" has eliminated the role of fiscal policy and that the only hope for the economy is monetary policy. He then recommends that the Fed not lower interest rates. At the next FOMC meeting, Greenspan states his desire to reward the government for its deficit-reduction agreement by cutting the fed funds rate. He is opposed by others on the FOMC who point out that such a move amounts to a Fed intervention in the democratic process.

At the next FOMC meeting, held in November 1990, Woodward describes Greenspan as being focused on inflation and not the recession, even though the recession is now four months along. As a result of his particular bias, therefore, Greenspan recommends only a quarter-point decrease in the fed funds rate. The year ends with one more quarterpoint reduction in the fed funds rate, bringing that rate down to 7 percent-still higher than it was in the weeks following the October 1987 crash.

December 1994: Financial Crisis in Mexico

The next crisis faced by Greenspan arose after the devaluation of the Mexican peso in December 1994. Woodward once again fails to put the crisis in context. The peso crisis followed a year in which the Fed increased the fed funds rate from 3.0 percent to 5.5 percent-a hike of 83 percent. Higher interest rates pushed up the value of the dollar, which had risen in value by 15 percent in the first ten months of 1994, and that made it increasingly difficult for Mexico to maintain its fixed exchange rate for the dollar. This consequence forced Mexico either to raise interest rates and choke its own economic expansion or to risk capital outflows and a run on its currency. It settled on a poor mix of the two, which failed to stave off a devaluation. Once the crisis hit, it spread to other economies in Latin America in what became known as the "Tequila effect."

According to Woodward's account, Greenspan initially fails to recognize the seriousness of the financial crisis, opposing both the loan guarantees and, later, the loans that are proposed as a remedy for the crisis. Greenspan insists that the markets will correct themselves, and he considers the rescue loans a source of moral hazard. When the loans from the Exchange Stabilization Fund are proposed, Greenspan's first reaction is to tell Treasury Secretary Robert Rubin that the funds could not be used for such purposes. "You can't do that," Greenspan says. "Wayne [Senator Bennett of the Banking Committee] is wrong." Then, to make matters more difficult, Greenspan proposes further credit tightening-not a quarter but a half-point rise-at the next FOMC meeting in February. In the end, Treasury Secretary Rubin organizes the rescue effort that eventually succeeds in containing the financial crisis.

1997: Financial Crisis in East Asia

The Mexican peso crisis turned out to be just a practice session for the much larger financial crisis that swept through East Asia and other parts of the developing world starting in the summer of 1997.

In Woodward's narrative, both Greenspan and Rubin reject the use of the Exchange Stabilization Fund as a means for the United States to lead another rescue effort. They instead push the responsibility for managing the crisis onto the International Monetary Fund, but much responsibility still falls back onto the U.S. government. One task is to convince U.S. banks to roll over their loans in countries such as South Korea. Woodward describes Greenspan as being uncertain whether he or Rubin would make the calls to U.S. banks, and then quotes him as saying, "They [banks] can say no to him [Rubin]. They could not say no to me." And then, with no further explanation, Woodward follows up by describing how Rubin makes the calls, first to Citibank and then to the other banks. In the end, the banks make the loans, and a deeper economic crisis is averted. Having, by this time, clearly demonstrated his inability and unwillingness to perform in crises, Greenspan is evidently not called upon to play an active role in this crisis.

1998: The Failure of Long Term Capital Management

The next crisis followed the Russian debt moratorium, when the hedge fund Long Term Capital Management (LTCM) had to be rescued. The debt moratorium had sent a big chill through global bond markets, causing yields to spike. Soon liquidity was drying up in all but the major government bond markets that had become the target for investors' flight to quality. LTCM, which was long Russian bonds and short Treasury securities, and had other losing positions, became unable to meet its collateral calls and other payments and settlements requirements.

The failure of LTCM's enormous securities and derivatives portfolio would have had a larger impact on U.S. markets than the Russian debt moratorium did. The hedge fund had large open positions and many offsetting debt and derivatives positions with most of the major financial institutions. Woodward says that these firms "had money in LTCM," but what he does not describe is the tens of billions of dollars in repurchase agreements and over $1 trillion in derivatives that tied LTCM to these financial institutions. In this way, LTCM threatened the ability of the major U.S. banks and Wall Street broker-dealers to meet their payment and settlement obligations. The news of problems at LTCM froze up the markets in U.S. corporate bonds, U.S. mortgages, and U.S. dollar interest rate swaps.

Woodward explains that New York Fed president William J. McDonough "knew he was more of an activist than Greenspan, who would obviously prefer a free-market solution." Woodward's account of this crisis centers, in fact, on McDonough and his colleague, Peter Fisher. They analyze LTCM's books, evaluate the possible impact on the U.S. bond market, talk to the involved parties, and then organize a meeting in order to negotiate a solution. The solution consists of having sixteen financial institutions, major counterparties to LTCM, pitch in $3.6 billion in exchange for a 90 percent share of the ownership of LTCM. In the end, this capital infusion enables the hedge fund to avoid forced liquidation and, instead, to hold open its positions until they can be liquidated in an orderly and less costly fashion. As a result of this rescue, the markets begin trading again, and liquidity soon rises and credit spreads fall. In the end, the financial institutions recover their capital and their debt and derivatives interests in the hedge fund.

Despite the success of the rescue, Woodward says that Greenspan's reaction is negative. He is "unhappy," arguing that the meeting could have been held at a site other than the New York Fed. He criticizes McDonough for having risked the good name of the Fed by participating in the operation. In short, Greenspan thinks McDonough exercised bad judgment.

Bad judgment! If Greenspan's free markets had been left to their own devices, the likely crippling, and possible failure, of these key financial institutions would have interrupted the very foundation of the payments system for the U.S. economy, prevented U.S. corporations from raising new capital, and thwarted the average American from obtaining a home mortgage. The costs of that level of crisis, both to the government and to the overall economy, would have dwarfed that of the savings and loan failures of the 1980s. The cost to the government of coordinating the rescue was a few sandwiches and soft drinks-the $3.6 billion in fresh capital had all come from private sources.

Woodward does point out, however, that Greenspan kept his criticism internal and that he publicly backed McDonough. In the end, Greenspan's direct role was to follow up by proposing a quarter-point cut in the fed funds rate.

Ironically, given the facts surrounding these five most important moments in monetary policy over the past thirteen years, the reader can see that Greenspan is not the sage that Woodward and others credit him as being. Things have worked out well, in the end, and those in power at the end are credited with the successes-giving new meaning to the old maxim "Might makes right."

The glorification of Greenspan in works such as Maestro is alarming. It seems as if we need an economic leader whom we can trust, and if this leader does not exist, then it becomes necessary to fabricate him. The mantle of "maestro" and hosannas are laid upon this leader as tributes in the hope that the economy will deliver wealth and prosperity.

I fear that this worshipful praise drowns out criticism and that we are robbed of the benefits of conducting an open public debate over the course of economic policy. My hope is that a new book is forthcoming in which exhaustive, critical research is applied to Greenspan's conduct in governing monetary policy and financial market regulation since he became chairman in 1987.

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