Fed’s 3 mandates: Price stability, jobs and ... Wall Street?

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February 26, 2016 – *The New York Times*

Suppose a visitor from the future comes and tells you these facts about the financial markets in the year 2030: The stock market has fallen sharply, as have the price of oil and investors’ expectations for interest rate increases over the next couple of years.

You would probably assume that the economy was heading down the tubes and in real trouble, quite possibly moving toward a recession.

A different visitor from the future arrives and tells you of this state of the world in 2035: The jobless rate is below 5 percent, and employers are hiring at a rapid clip and giving workers their biggest raises in years. Service industries that account for a large percentage of the economy are growing nicely, and consumers are spending money at a steady pace. Everything is just fine.

You’ve surely already guessed that both these descriptions apply to the United States in 2016, with big implications for businesses of all stripes and for the presidential election. But the tension — between a miserable few months in the financial markets and generally solid economic data — also exposes one of the thorniest questions with which policy makers at the Federal Reserve must grapple.

Should they believe market data or economic data? Bloomberg or FRED? That is, should they rely on the information that appears on the financial data terminals many Fed officials keep on their desks, or on economic indicators conveniently collected in the Federal Reserve Economic Data database?

If it’s market data, then Janet L. Yellen, the Fed’s chairwoman, and her colleagues should forestall any further interest rate increases indefinitely and perhaps reverse their quarter-point increase in December and entertain instead more radical easing measures. If it’s economic data, they should feel comfortable proceeding with pushing interest rates higher.

But beneath that question lies an even harder one. Can Ms. Yellen wean the economy off what is often called “the Greenspan put?” And should she?

The Greenspan put is the idea — much disputed within the halls of the Fed, but taken for granted in much of the financial world — that the central bank will forever stand willing to intervene to keep markets from falling too much. Greenspan is, of course, Alan Greenspan, the Fed chairman from 1987 to 2006, and a put is an options contract that insures against decline.

Perhaps most famously, in October 1987, the morning after the stock market crashed, the Fed offered this one-sentence statement: “The Federal Reserve, consistent with its responsibilities as the nation’s central bank, affirmed today its readiness to serve as a source of liquidity to support the economic and financial system.”

It did the trick. The market stabilized, and the United States economy kept growing for four more years. Eleven years later, when a crisis in emerging markets seemed to threaten the booming American economy, the Fed cut interest rates three times, successfully containing the damage. When the dot-com bubble was collapsing in 2001, it did the same, less successfully.

In each case, Fed officials argued that they were not focused on trying to prop up the market for its own sake, but were trying to keep the economy on an even keel despite market turmoil. When the stock market drops, Americans are less wealthy and so would be expected to spend less money, and capital is more expensive for businesses, which would tend to make them less inclined to invest.

While headlines tend to focus on the stock market during periods of turmoil, these episodes usually involve a lot more happening in the financial world beneath the surface, like the interest rates on riskier bonds spiking relative to those of safer bonds, and the drying up of credit availability. In effect, the Fed cut rates in these episodes not to try to bail out investors in the stock market, but to offset these effects for ordinary consumers and businesses.

That's the line you'll hear from Fed officials, anyway. The challenge is that, in practice, this behavior looks an awful lot like the Fed stepping in to bail out the stock market — so much so that financial markets tend to price in lower future interest rates whenever there is a drop in the stock market, as has happened in the early weeks of 2016.

The Fed started the year with signals that it would most likely raise its short-term interest rate target four times in 2016. After an approximately 10 percent drop in the Standard & Poor's 500-stock index — but steady economic data — futures markets now suggest only one rate rise is the most likely outcome. In other words, markets seem to believe that the Greenspan put has become the Yellen put.

It's not without basis, at least from historical analysis of the Fed's behavior. A 2011 study by Pamela Hall of the Swiss National Bank found that a model to describe Fed policy from 1987 to 2008 was more accurate when it included a reaction to asset declines than if it used purely economic indicators.

And to the degree that the Greenspan put is real, and continues, it raises difficult questions.

It might seem great to keep markets from falling too much, but that can create complacency and just encourage investors to take greater risk — creating much more damage when the bubble ultimately pops. This arguably is part of what happened in the 2008 financial crisis: that years of Greenspanian work to keep markets from plummeting had made the entire financial system brittle and overleveraged.

There's a simpler moral case against central banks propping up falling markets, which is that it implies a government entity using public resources to keep a predominantly wealthy investor class from losing money. The interests of Wall Street and Main Street don't always align.

There are some hints that the Yellen Fed is reluctant to react to the latest palpitations in markets. On Tuesday, the Fed vice chairman, Stanley Fischer, noted that there had been episodes in which markets tumbled but no broader slump ensued.

"If the recent financial market developments lead to a sustained tightening of financial conditions, they could signal a slowing in the global economy that could affect growth and inflation in the United States," Mr. Fischer said in a speech at an energy conference in Houston. "But we have seen similar periods of volatility in recent years — including in the second half of 2011 — that have left little visible imprint on the economy, and it is still early to judge the ramifications of the increased market volatility of the first seven weeks of 2016."

The challenge, as Mr. Fischer suggested, is to decide which type of market move this really is.

Is it more like mid-2007, when turmoil in financial markets was the early warning of a recession that wouldn't begin until the end of that year? Or is it more like 1998, when the Fed cut rates in response to market turmoil that never caused economic ripples on United States shores?

He and Ms. Yellen will show their conclusions through their actions — and in the process send a signal to Wall Street about whether, a decade after Mr. Greenspan left office, his approach to the job persists.