The Federal Reserve's Balancing Act in 1990

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1. Introduction

This paper is part of my project to come up with an English reading textbook about some aspects of the U.S. economy, the biggest and most fascinating country in the world. To be sure, there has to be a limit to how authentic this paper can be since I set out to do the task as a teacher of English, not an economist with a proper educational background. Despite hesitation and difficulty, I feel it worth my while embarking on the job since it gives me some insight about economics-related technical terms in English.

In the course of this writing, several terms caught my attention. The usual shortened form for the Federal Reserve Board is the "Fed," not the "FRB," which is a preferred abbreviation in Japan. Easy as it may sound, two oft-used terms for describing the Fed's move in monetary policy are "easing" and "tightening." The most important monetary tool for easing and tightening is the federal funds rate, not the discount rate. The Fed sets a target for the former by influencing the supply of excess reserves that affiliated banks use for overnight lending and borrowing among themselves to meet their reserve requirements. The latter one is the interest rate at which commercial banks borrow from one of 12 Federal Reserve Banks in their respective districts, which rarely happens. Thus the discount rate is said to be "largely symbolic."

The 1990-91 recession, the ninth postwar one, was largely a result of three factors: the lingering effects of the past structural excesses, some constraints placed on the Federal Reserve's monetary policy, and the oil crisis triggered by Iraq's invasion of Kuwait. Together they limited Federal Reserve Board Chairman Alan Greenspan's latitude in monetary policy. How finely he balanced fighting inflation and securing a sustainable economic growth will be discussed in the following four sections with a primary focus on the Fed's easing moves.

2. The Debt Binge of the 1980s

During nearly eight years of growth since 1982, the U.S. economy accumulated huge excesses in building construction, service-sector capacity, and borrowing. Here are some numbers to give you some idea of how excessive they were. Housing starts posted a year-on-year increase of 60.3% in 1983, and private construction spending surged 75.4% from 1982 to 1989. Employment in service industries increased 27.6% in the 1980s. Especially noteworthy were the finance, insurance and real estate sectors, which all together posted a leap of 29.2% in employment. In that decade, mortgage debt for commercial properties multiplied threefold while that for one- to four-family houses swelled at about half the pace.(1) Double-digit growth was the norm for business and consumer debt from 1984 to 1988. That was when the U.S. was enjoying a property boom. But then came the bursting of the bubble that caused bankruptcies, both business and personal, leaving behind massive vacant office space and dreadful debt. Vacancy rates in some major cities reached more than 20%. As commercial real estate developers failed, their problem loans hurt lenders.

Bankers were already mired in a savings and loan debacle. Savings and loans are cooperative associations, either chartered by the federal government or states, to make mortgage loans on their local real estate market. They were originally kept away from risky investments, and their interest rates for depositors were capped. Other financial institutions including commercial banks paid higher rates and began to attract depositors away from S&Ls in the 1970s. In 1980, Congress removed the cap and raised the ceiling on insured deposits to $100,000. Accordingly the S&Ls offered better rates to attract deposits. Moreover, Congress passed a legislation to allow them to issue commercial loans and to make direct investment in real estate developments in 1982. Many of their loans and investments, though higher-paying, were risky and unwise and eventually failed. With the collateral depreciated amid bursting of real estate bubbles, 205 S&Ls became insolvent in 1988 alone.(2) In the following year, the federal government set up the Resolution Trust Corporation, a liquidation agency to dispose of bankrupt thrifts' bad loans.

Worse yet, banks had to improve their capital positions as required by the BIS agreement at a Group of Ten meeting in July 1988. Thus they tightened their lending policy, making it harder for small businesses to secure loans. And a credit crunch developed as economic conditions deteriorated toward the end of 1990. What's more, with homeownership rates around 64%,(3) erosion of home values ate into consumer spending. According to the forecasting firm Laurence H. Meyer & Associates, every dollar lost in housing value translates into a reduction of 10 ¢ in consumer spending in two and a half years. Personal consumption expenditures grew a mere 1.8% in 1990. That was down 0.9% from the previous year. They even contracted in 1991. Most affected was spending on durable goods, which showed a drop of 6.6%.(4) Big Three auto makers saw their sales slipping despite their increased incentives. The result was large declines in corporate profits. Business executives called for further Fed easing.

3. Monetary Policy Constraints

Going into 1990, the Federal Reserve Board found its maneuvering room limited by some developments that it had no control over. First, ever-increasing inflationary pressures in the service sector were getting out of hand despite the central bank's continued anti-inflation efforts. In fact, medical care costs jumped 9.3% for 1990.[5] Monetary tightening from 1988 to early 1989 dampened demand for manufacturing goods while curbing goods inflation. The weak demand diminished factory output by 0.5% in 1990. Consequently, a 5.1% decline in corporate profits after tax for 1989 was followed by a 0.3% climb in unemployment rate in 1990. The Fed's nightmare was a scenario of rising wages in the service-producing sector fueling inflation.

The Federal Reserve moved cautiously in easing monetary policy. It made six quarter-point cuts in the federal funds rate, the charge on overnight interbank loans, during a six-month period since June 1989, though such a gradual approach became a source of criticism from Wall Street. The sixth reduction in December 1989 brought in an 8.25% short-term rate, which was still too high for a slower economy. In early 1990, the U.S. economy temporarily showed a few signs of expansion thanks to the past rate cuts. At the same time, inflation worries intensified with the consumer price index posting annual gains of 8.5% in the first quarter of 1990. Particularly worrisome was soaring service inflation led by large price hikes in medical care and education costs.

The second development that limited the Fed's capacity was a sudden rise in long-term interest rates for fear of inflation and rising Japanese interest rates. Here the Japanese side of the story sheds intriguing light on how a nation's central bank should act. As part of its move to tackle the problem of inflation, the Bank of Japan shifted its monetary policy to tightening in May 1989 after about eight years of easing that brought about Japan's real estate and stock market bubbles. It raised the discount rate on commercial bills from 2.5% to 6% over a 15-month period to mid-1990, expressing its concern that soaring labor costs and higher oil prices would cause inflation. The pace of the hikes was surprisingly steep considering the length of the previous easing phase. The lowest rate of 2.5% lasted 27 months from February 1987 to May 1989. It certainly contributed to boosting domestic demand and helped Bush's bid for Presidency but left an irreparable scar on the Japanese economy. The central bank's easing was largely influenced by the government that felt pressured to meet the U.S. demand to import more goods and influence Japanese institutional investors to continue purchasing U.S. Treasuries.[6]

Britain was the largest net purchaser of U.S. securities, but the U.S. bought about half as much of British securities in return, establishing a two-way flow of money. The second biggest purchaser was Japan, whose securities hardly attracted investors from the U.S., creating a one-way flow of Japan's trade surplus money back to the States.

Now Washington worried that the Bank of Japan's rate hike binge would lure Japanese investors away from

U.S. securities. Reflecting this fear as well as that of inflation, yields on 30-year Treasury bonds, the basis for determining other long-term interest rates, soared from 7.85% in late December 1989 to 9% in early May 1990. Meanwhile, no matter what bashing it invited, the Fed waited almost seven months until July 1990. Then it introduced its next rate cut, but its volume was still limited to a quarter point in the wake of rising prices for services. The immediate response from Fed-watchers was that Fed Chairman Alan Greenspan whose term was to end in about one year gave in to the Bush Administration's pressure to stimulate the flagging economy. He justified the new funds rate of 8% by referring to commercial banks' cautious lending approach that had been squeezing M2, a measure of the money supply of currency, checking accounts, and some savings. Calling the quarter-point cut simply technical, Greenspan tried to maintain the Fed's independence and played down the possibility of continual further easing.

The third constraint on the Fed was a federal budget deficit. The Reagan Administration (1981-89) carried out large tax cuts and, while increasing defense spending, tried to make relentless cuts in social programs. President Reagan turned to the supply-side school for ideas to form his economic policy and stressed the need for small government — more tax cuts and less regulatory programs. Reaganomics created 20 million new jobs, but the cost was a snowballing federal deficit. Contrary to the contention of the supply siders like Arthur Laffer who introduced the Laffer Curve, an analytical tool to illustrate how high tax rates could reduce government revenue, Reagan's cuts in personal tax rates did not lead to enough increases in tax revenues from other sources. Moreover, his budget policy to reduce civilian spending failed because of congressional resistance. Government spending persistently increased during the Reagan Administration and eventually became a main culprit for the deficit.[(7)] Consequently, gross federal debt tripled in the 1980s. The budget deficit for fiscal year 1990 reached an alarming level of $221 billion with the volume of federal debt swelling to 55.9% of GDP.[(8)] This certainly made George Bush's election campaign promise of "no new taxes" difficult to keep.

Massive government bonds issued to finance the deficit had to provide high yields to attract overseas buyers. This fact along with inflation fear drove up long-term interest rates. On the other hand, since the economy began to go south, the federal funds rate had been falling a quarter point a clip. That meant lower short-term interest rates. The problem here was that this easing took place during the period of Japan's rising discount rates between May 1989 and August 1990. The result was a widening spread between short-term and long-term rates. This dimmed the Fed's further easing as well as the Administration's hope for new private investment.

4. The Oil Shock of August 1990

The 1990 oil shock, though not a main cause, triggered the 1990-91 recession. Higher oil prices fueled inflation worries, and there was no denying that an already weakening U.S. economy could go into recession if inflation accelerated.

On August 2, 1990, Iraqi troops marched into Kuwait to achieve Saddam Hussein's ambitious goal of annexing Kuwait and thereby expanding its hegemony in the Persian Gulf region. The annexation would enable Iraq to control 20% of the world's proven crude-oil reserves. The invasion immediately sent world oil prices surging from $20 to $28 a barrel.(9)

Fed economists knew that double-digit percent jumps in commodities price index had been recorded right after the 1973 and the 1979 oil price shock.(10) So they were worried that they had virtually no option for tightening because of the staggering economy. During the 1970s oil crises, the Fed resorted to easier money policy only to find rampant inflation. Thus this time they were determined not to make the same mistake.

Soaring oil prices were also a big concern for Japan and West Germany, but their economies were growing at more than a double pace in inflation-adjusted terms. They could afford to slow their expansion a little with higher interest rates were commodities prices to rise sharply. Or they could resort to an export drive to make up for higher prices of imported oil. As it turned out, they chose to raise their interest rates. That initially undermined the value of the dollar relative to the yen and deutsche mark, sending rates on long-term Treasury bonds upward. Japan maintained the rate of 6%, the highest since December 1981, between August 1990 and July 1991. The Bundesbank's rate on Lombard borrowing rose half a point to 8.5% in November 1990, one month after the unification of West and East Germany.

5. A Soft Landing

A jump in overseas interest rates was a big threat to the U.S. government and Congress since Treasury bond yields could continue a steady climb without matching Fed tightening to fight inflation and defend a strong dollar. Despite some fluctuations, however, the dollar generally stayed firm. The gulf crisis came at the worst moment for concluding a deal to reduce a federal budget deficit. One big-ticket item on the reduction list was defense spending. However, with the U.S. sending troops to the Middle East for military action, any hint of a defense cut was a no-no. On the revenue side, increases in energy taxes had been under discussion. Support for such a measure was increasingly losing ground in the face of the oil crisis. Thus Greenspan's hopes for a helpful budget deficit package were dashed. Under these unstable circumstances, he chose the option of standing still, which not only raised the risk of recession but increased that of losing his job.

Much to Greenspan's relief, Congress passed a set of bills aimed at budget deficit reduction on October 27. Two days later, the Federal Reserve cut its funds rate a quarter point to 7.75%. And another quarter point cut was carried out in November. The next one, the fourth quarter-point cut for 1990, came on December 7, 40 days before the outbreak of the Gulf War. The Fed's easing moves were prompted by an ever rising unemployment rate, which climbed to a three-year high of 5.9% in November. The business outlook was gloomy as people were cutting spending. In the face of an imminent military confrontation in the Mideast, companies had started slashing workforce to prepare for a worsening economic situation. Reflecting the Fed's anxiety about weak domestic demand, the federal fund rate was cut another quarter point to 7% on December 19. This easing move was also prompted by a decline in nonenergy inflation.

As a result of a U.N. trade embargo on Iraq and Kuwait, some 3.8 million barrels of oil was lost daily from the world market. However, OPEC's key player Saudi and other members promptly increased their production to compensate for the lost exports that equaled 10% of what the industrial world needed. Lining up support from allies and taking a strong stance against Saddam, President Bush took military action and attained an overwhelming victory in driving the Iraqi troops out of Kuwait. The shooting war that started on January 16, 1991, ended so quickly and decisively that oil prices instantly fell below $20 a barrel, subduing the fear of inflation. That gave the Fed more latitude to cut higher short-term rates, which continued to fall a quarter percentage point to 6.75% in January. On February 1, the central bank made an operative move to bring down the federal funds rate by half a percentage point to 6.25%. The Federal Reserve Board's continued easing helped debt-burdened households and businesses as well as the debt-ridden financial system. That marked the end of the 1990-91 recession.

Greenspan's cautious and wise moves aimed at a "soft landing" contributed to making this eight-month long recession one of the shallowest on record and paved the way for an economic recovery that was destined to become the basis for a decade long expansion. His gradualist monetary policy often met with an angry reaction from the Bush Administration while receiving praise from foreign investors for defending the dollar. Under Washington's pressure to cut interest rates, the Fed maintained its long-term policy of containing inflation by sticking to a series of gradual rate cuts.

［Notes］

(1) Source: Board of Governors of the Federal Reserve System.

(2) See *The New York Times 1998 Almanac*, p. 343.

(3) See *Statistical Abstract of the United States 1997*, p. 725.

(4) Source: Department of Commerce, Bureau of Economic Analysis.

(5) Source: Department of Labor, Bureau of Labor Statistics.

(6) For further details, see Kitsukawa 1998, pp. 80-86.

(7) See Lindsey 1990.

(8) Source: Department of the Treasury, and Office of Management and Budget.

(9) For further details, see Nakaya 2001.

(10) Source: Department of Labor, Bureau of Labor Statistics.

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[Abstract]

The Federal Reserve's Balancing Act in 1990

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This paper is an attempt to come up with appropriate reading material about the American economy, the most energetic and industrially advanced country in the world that will continue to grow driven by market incentives. The main focus is on how the Federal Reserve Board reacted to pressures for easing monetary policy while holding the line on inflation to ensure a soft landing of the U.S. economy in 1990. That's when the United States was becoming the world's largest debtor. The chief cause for its massive budget deficits was the government debt binge of the 1980s that fueled inflation fears. The Fed was delayed by some unavoidable constraints in switching from neutral to easing its monetary policy. The delay slowed the economy to a crawl, and the 1990 oil shock triggered the onset of a full-fledged recession. Discussion in this paper centers on how finely the Fed chairman balanced fighting inflation and securing a sustainable economic growth of about 2.5% under these difficult circumstances in 1990.