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September 4, 2002
For immediate release

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Dealing with Asset Bubbles: the Fed's Changing Story and the Historical Record

Unlike his views on trade, taxes and government spending, Federal Reserve Chairman Alan Greenspan's ideas about asset markets and margin requirements appear to be a work in progress. During a September 1996 meeting of the Fed's Open Market Committee, Greenspan said, "I recognize there is a stock market bubble problem at this point" and asserted "I guarantee if you want to get rid of the bubble, whatever it is, [increasing margin requirements] will do it. My concern is that I am not sure what else [increasing margin requirements] will do."

But as the bubble expanded, margin debt soared and economists and market participants urged the Fed to use its margin authority, Chairman Greenspan changed his tune, insisting that margin adjustments do not affect stock values. Three months before the April 2000 NASDAQ crash, for example, he vowed, "there is no evidence to suggest" margin adjustments influence equity prices.

Now the chairman has come up with yet a different formulation. In an August 30 speech at the Federal Reserve Bank of Kansas City's annual central banking conference in Jackson Hole, Wyoming, he claimed, "it was very difficult to definitively identify a bubble [in U.S. equity markets] until after the fact." And Greenspan revised and extended his views on margin requirements, allowing that margin adjustments might be identified with stock-price movements after all – but only if investors interpret margin increases as a signal of upcoming interest rate hikes by the Fed. In such instances, said Greenspan, "it is the prospect of monetary policy action, not the margin increase, that should be viewed as the trigger" for changes in equity price levels.

In fact, the historical record suggests that margin adjustments may have more of an effect on stock prices than Chairman Greenspan previously acknowledged. In a June 2000 analysis the Financial Markets Center compared the growth rate of the S&P Composite Index, a broad group of stocks, for periods before and after each of the margin changes the Fed engineered between 1934 and 1974 (the last time the central bank altered the requirement). As Table 1 shows, **the growth in stock prices tended to slow down after a margin requirement hike (tightening) and pick up after a margin requirement cut (loosening) during the 3-month, 6-month and 12-month periods after margin adjustments.** Only the 1-month results were mixed: loosening had the predicted effect, but tightening appeared ineffective in the short-run.

Table 1: Average S&P Index Growth Rates Before and After Margin Requirement Changes

	1 month before	1 month after	3 months before	3 months after	6 months before	6 months after	12 mos. before	12 mos. after
Tightening	1.71%	2.79%	6.82%	5.37%	11.39%	10.03%	23.74%	19.24%
Loosening	-0.53%	1.18%	-1.13%	0.50%	-3.33%	2.67%	3.14%	5.69%

Though the available evidence is old and sparse, it does indicate that in eight of 13 cases ([click here for charts](#)), raising margin requirements was associated with a subsequent slowdown in the growth of stock prices. And in each of these eight instances, growth declined in a fairly measured fashion – not a calamitous collapse.

Moreover, a new update of that analysis counsels skepticism about Chairman Greenspan's recent claim that margin increases only appear to work effectively if seen as a harbinger of tighter monetary policy. In four of the eight previous instances in which margin increases were associated with stock-price slowdowns, the Fed raised interest rates as well. But in the other four cases, the central bank did not back up a margin adjustment with changes in monetary policy – and growth in equity prices moderated nonetheless (see Table 2).

Again, the evidence is old, sparse and far from definitive. But contrary to Chairman Greenspan's latest assertion, the record shows that on half the occasions when slowing stock-price growth mirrored higher margin requirements, investors had no obvious reason to think the Fed was contemplating parallel monetary policy actions. And, in fact, the central bank did not undertake such actions. While it seems unlikely that margin adjustments alone are capable of remedying all stock market imbalances, the Fed has not yet provided a convincing explanation for its decision to leave margin requirements untouched during one of the greatest asset bubbles in U.S. history.

Table 2: Margin Rule Tightenings & Monetary Policy Actions: 1934-present

Date of Margin Tightening	Amount of Margin Tightening	Trajectory of S&P Index Over Next 12 Months	Changes in Discount Rate Over Next 12 Months	Changes in Funds Rate Over Next 12 Months*
October 1, 1934	25-45 percent (Initial Requirement)	Rise	None	n/a
February 1, 1936	25-55 percent from 25-45 percent	Rise more slowly than during 12 months prior to tightening	None	n/a
April 1, 1936	55 percent from 25-55 percent	Rise more slowly than during 12 months prior to tightening	None	n/a
February 5, 1945	50 percent from 40 percent	Rise more rapidly than during 12 months prior to tightening	None	n/a
July 5, 1945	75 percent from 50 percent	Rise more rapidly than during 12 months prior to tightening	+50 bp (basis points)	n/a
January 21, 1946	100 percent from 75 percent	Decline	+50 bp	n/a
January 17, 1951	75 percent from 50 percent	Rise more slowly than during 12 months prior to tightening	None	n/a
January 4, 1955	60 percent from 50 percent	Rise more slowly than during 12 months prior to tightening	+100 bp	+100 bp
April 23, 1955	70 percent from 60 percent	Rise more slowly than during 12 months prior to tightening	+75 bp	+75bp
August 5, 1958	70 percent from 50 percent	Rise	+175bp	+200 bp
October 16, 1958	90 percent from 70 percent	Rise more rapidly than during 12 months prior to tightening	+150 bp	+225 bp
November 6, 1963	70 percent from 50 percent	Rise more slowly than during 12 months prior to tightening	None	None
June 8, 1968	80 percent from 70 percent	Rise more rapidly than during 12 months prior to tightening	+50 bp	+300 bp
November 24, 1972	65 percent from 55 percent	Decline	+300 bp	+500 bp

SOURCES: *Financial Markets Center; Federal Reserve System*

* Rounded off to increments of 25 basis points

For more information on margin debt and margin requirements, visit the Financial Markets Center main margin page at: http://www.fmcenter.org/fmc_superpage.asp?ID=223. In addition to data sets, statistical analyses and links, the page contains a [critical examination of the argument against employing margin adjustments](#) as a policy tool, [commentary by former House Banking Committee Chairman Henry Reuss](#), and [FMC proposals for instituting suitability requirements](#) for margin accounts and making the market for margin borrowing more transparent.

Greenspan on Margin Rules and Stock Prices

I recognize that there is a stock market bubble problem at this point and I agree with Governor Lindsey that this is a problem we should keep an eye on...We do have the possibility of raising major concerns by increasing margin requirements. I guarantee that if you want to get rid of the bubble, whatever it is, that will do it. My concern is that I am not sure what else it will do. (pages 30-31)

<http://www.federalreserve.gov/fomc/transcripts/1996/19960924Meeting.pdf>

There is no evidence to suggest margin requirements have an effect on the level of stock prices.

– Alan Greenspan, Remarks to the Economic Club of New York, January 14, 2000

Senator, as you comment quite correctly, the reason over the years that we have been reluctant to use the margin authority which we currently have is that all of the studies have suggested that the level of stock prices have nothing to do with margin requirements. That is, there is no evidence to suggest that changes in margin requirements up or down in years prior to 1974 when we did move them back and (inaudible), had any effect on prices.

– Alan Greenspan, confirmation hearing, Senate Banking Committee, January 26, 2000

http://www.fmcenter.org/fmc_superpage.asp?ID=290

The problem that I have had with the issue of moving our margins is not concern of what it would do to the marketplace, it's the evidence which suggests that it has very little impact on the price structure on the market or anything else.

– Alan Greenspan, Humphrey-Hawkins hearing, House Banking Committee, February 17, 2000

http://commdocs.house.gov/committees/bank/hba62930.000/hba62930_of.htm

[W]ould not [raising] margins be better? If the evidence indicated that raising margins would affect stock prices, then the answer in that hypothetical question would be yes. But the evidence that we have, going back a long period of time, is that margin requirements per se do not affect stock prices. They do affect borrowing patterns, and they affect the prudential safety of brokers and dealers and banks and others. But they don't affect stock prices.

– Alan Greenspan, Humphrey-Hawkins hearing, Senate Banking Committee, February 23, 2000

With regard to margin requirements, studies suggest that changes in such requirements have no appreciable and predictable effect on stock prices.

– Alan Greenspan, Letter to House Banking Committee Chairman Jim Leach, March 30, 2000

Some have asserted that the Federal Reserve can deflate a stock-price bubble--rather painlessly--by boosting margin requirements. The evidence suggests otherwise....The preponderance of research suggests that changes in margins are not an effective tool for reducing stock market volatility. It is possible that margin requirements inhibit very small investors whose access to other forms of credit is limited. If so, the only effect of raised margin requirements is to price out the very small investor without addressing the broader issue of stock price bubbles. If a change in margin requirements were taken by investors as a signal that the central bank would soon tighten monetary policy enough to burst a bubble, then there might be the appearance of a causal effect. But it is the prospect of monetary policy action, not the margin increase, that should be viewed as the trigger.

– Alan Greenspan, speech to Federal Reserve conference, August 30, 2002

<http://www.federalreserve.gov/boarddocs/speeches/2002/20020830/default.htm>