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FLASHBACK

On the Spot: Stock Market's Frenzy Puts Fed's Greenspan in a Crucial Position

He Must Aid the Economy But Not Fuel Inflation; Is Tax Rise Now Possible? --- Reagan's Bipartisan Stance

By ALAN MURRAY

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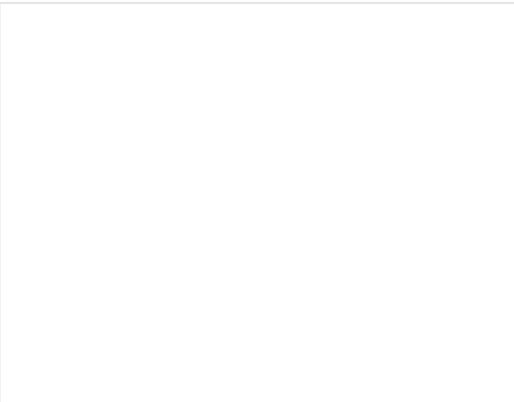
WASHINGTON -- The stock market's Monday collapse has put Federal Reserve Chairman Alan Greenspan on the front line in the fight to prevent a market panic from turning into a general economic slump.

Just a few days ago, Mr. Greenspan was under pressure from the financial markets to increase interest rates and prove his willingness to fight inflation. But by yesterday, the focus had changed dramatically. After Monday's unprecedented market crash, traders and analysts were calling on the central bank to ease credit to avoid recession.



"I think Greenspan is the only candidate for restoring the confidence of the markets," said Jerry Jordan, the chief economist at First Interstate Bank Corp. "It's the chairman of the Fed, when it comes down to it, who pulls the levers."

Whether Mr. Greenspan is up to that task remains to be seen. He tried to calm markets yesterday with a one-sentence statement signaling the Fed's switch from an anti-inflation to an anti-recession policy. It said: "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."

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The Federal Reserve quickly backed up its statement with action, driving the federal funds rate down to about 6 3/4% late in the day from more than 7 1/2% Monday. "I think that speaks for itself," said a senior administration official when asked if the Fed had eased credit. The federal funds rate, the interest rate banks charge on loans to each other, is a sensitive measure of the tightness of monetary policy.

The central bank's response seemed to soothe the worst fears troubling the markets. After swinging around wildly all yesterday, stocks ended higher. The Dow Jones Industrial Average ended with a record gain of more than 100 points -- a sharp contrast with its record 508-point plunge on Monday. And for the second day in a row, the bond market surged, largely fueled by money drained out of stocks. The higher bond prices meant lower interest rates, of course, because the two

move inversely to each other.

The Fed's statement "was the most calming thing that was said yesterday," said James E. Annable, the chief economist of the First National Bank of Chicago. "The Fed is aggressively creating liquidity in the market, and that's what you want now."

Although an adequate supply of funds in the market and the economy is important, the challenges facing the Fed over the coming weeks are immense. If the Fed doesn't do enough to bolster the economy, the stock-market collapse could quickly drag down other areas of the economy. And if the Fed primes the pump with too much money, it risks a collapse of the dollar and renewed fears of inflation.

"We know how to prevent economic downturns," says Benjamin Friedman, a Harvard economist. "But I'm not sure we know how to prevent them without causing inflation."

Mr. Greenspan, who had been scheduled to make a speech in Dallas yesterday, canceled it and rushed back to Washington. He spent much of the afternoon closeted with Treasury Secretary James Baker and White House Chief of Staff Howard Baker, discussing how the administration should respond to the market collapse.

But the administration's ability to respond is limited. Even White House officials acknowledge that public confidence in President Reagan has been severely eroded in recent months and won't easily be restored.

"The Bork defeat showed markets very clearly that President Reagan is a total lame duck who doesn't have the power to control events," one White House aide admits. "It's hard to see what Reagan can do, unless he can come up with something pretty dramatic."

Most analysts believe that a concerted effort by the president and Congress to attack the federal budget deficit could calm market fears. The president opened the door to such a grand compromise yesterday. In an announcement made after conferring with Mr. Greenspan and the two Mr. Bakers, the president abandoned his harsh anti-tax rhetoric and called for "bipartisan" negotiations with Congress.

Nevertheless, continued partisan squabbling leaves the outcome of any such talks in doubt. And meanwhile, the monkey is on Mr. Greenspan's back. "I think the response is going to have to come from the Federal Reserve," says Sen. Nancy Kassebaum, a Kansas Republican. "It's unfortunate. We let the Fed solve our inflation problem in the early 1980s. Now, we're going to be looking to the Fed again."

But it isn't clear just how much the Fed can do in the face of huge budget and trade imbalances, which require the U.S. to keep its interest rates high enough to finance the twin deficits. "People have been trying for years to tell Congress and the administration that eventually the budget deficit will put the Fed in a position where it doesn't have any options left," says former Fed Governor Lyle Gramley. "Well, it's there now. It's a no-win game."

In the efforts to restore market confidence, administration officials have emphasized that the economy's "fundamentals" remain sound. That was certainly true last week. Employment looked strong, inflation was low, and consumer spending and investment were holding up reasonably well.

But the market's nose dive could change those fundamentals substantially. In just a week, the market has wiped out -- on paper -- nearly a trillion dollars of wealth. Among those who were hard hit, that is likely to damp enthusiasm for spending money on houses, cars, furniture and appliances. And lower stock prices will hobble businesses trying to raise the money needed for capital investment.

More important, the plunge in stocks could produce a severe psychological effect.

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"Even if you're not directly affected, it may make you hesitant, cautious, pessimistic," says Thomas Juster, a University of Michigan economist and an expert in consumer spending. "If you were on the edge of making a decision to buy something, you are likely to say, 'Maybe I should wait and see where the dust settles.'"

And Harvard's Lawrence Summers notes that any businessman "thinking about starting a building project or ordering an expensive machine has to think to himself: 'Let's wait and see how things shake out.'"

To counter those forces, "the Fed should be easing," Mr. Summers says. The mistake made in 1929, many economists note, was that the central bank held its tight grip on credit for too long and thus turned market panic into depression.

"The next move on the part of the Fed should be a lowering of the discount rate, when the opportunity is right," agrees Irving Auerbach of Aubrey G. Langston & Co. Last month, the Fed raised its discount rate -- its rate on loans to member banks -- to 6% from 5 1/2%.

Fed Governor Wayne Angell acknowledged yesterday that the stock-market plunge could suggest the need for an easier Fed policy. "Declining stock markets tend to add to people's preferences for liquidity," Mr. Angell said. "That can move quite easily into a deflationary force. What's appropriate for us to do is make certain we supply the amount of money people may wish to hold in such an environment."

But an easier credit policy carries serious risks. With unemployment below 6% and many businesses operating near capacity, inflation could easily accelerate. Moreover, easier credit in the U.S. -- if not matched by easier monetary policies abroad -- could depress the dollar and threaten the administration's dollar-stabilization agreement with other industrialized countries.

"The effects of this decline in stock prices are going to be negative, and perhaps sizably so," Mr. Gramley says. "But if the Fed were to begin anticipating negative effects and start easing monetary policy, it risks being misunderstood and thus worsening the crisis of confidence. The Fed has to sit tight, let the smoke clear, assess what the damage is and then respond as conditions become more clear."

Harvard's Mr. Friedman contends that the stock-market drop could force the Fed to abandon efforts to defend the dollar. "The point is, the dollar is going to have to come down sooner or later," he argues. "To resist that in a climate in which the economy might be weak would be especially foolish."

Robert Hormats of Goldman, Sachs & Co. agrees. "I think we have gotten ourselves locked into a syndrome where everybody thinks that any fall in the dollar is a catastrophe," he says. "But it's not highly inflationary if the dollar falls a little bit in a controlled manner. In fact, with the stock market falling, that creates a deflationary climate, so a dollar drop would certainly not be inflationary."

Despite the pitfalls, Fed officials hope to negotiate the risky waters ahead without slowing growth or sparking inflation.

"When you go back through U.S. history, you find there are some kinds of market volatility that have less impact and some that have long-lasting effects," Governor Angell says. "Certainly, we've had stock-market movements that did not have deep or long-lasting effects on the real economy. That's our job -- to insulate the economy from these forces."

Ultimately, the Fed's ability to hold the economy together in coming months could depend on Mr. Greenspan's skill in instilling confidence in the markets. "We lost our great man at the Federal Reserve," says Mr. Jordan, referring to former Fed Chief Paul Volcker. "His was a purely judgmental monetary policy, but the truth is people trusted his judgment."

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Whether Mr. Greenspan can engender the same respect remains to be seen. "We have these twin fears that inflation is going out of control or that we are heading into recession," Mr. Jordan says. To allay those fears, Mr. Greenspan must walk a very narrow line, he adds. "Not too much, not too little, just the right amount."

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