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Blind Faith in the Fed

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Ten years ago this January, stock prices increased in nine of the first 10 trading days of the month. Over the entire month, the market rose an astonishing 13 percent -- a fitting beginning for the second leg of the greatest bull market in history.

Stock prices have tripled in the past decade, and investors have prospered by viewing any downturn in the market as a buying opportunity. When stock prices declined substantially -- in October 1987, August 1990, March 1994 and again this past July -- investors scooped up bargains.

Sustained economic growth without inflation is the favorite explanation for the market boom. But the ultimate guarantor of the "buy on dips" trading rule is the Federal Reserve. Confidence that the Fed will prevent price declines from threatening the integrity of the financial sector is the hidden prop for the current euphoria.

Oct. 20, 1987, the day after the infamous crash, was the Fed's finest hour. Invoking Walter Bagehot's 1873 dictum to act as "lender of last resort," Alan Greenspan allowed unlimited borrowing by banks from the Fed. This prevented panic withdrawals from banks and brokerages. Without that single-minded commitment, the financial system would have been irreparably damaged.

Success like that carries a price. The market seriously overestimates the Fed's power. If the central bank's responsibility to shore up the financial system conflicts with fighting inflation, it will be caught in a bind. The problem is that the Fed has only one tool -- liquidity, its willingness to provide credit to the financial system. Tinkering with the money supply or adjusting interest rates amounts to the same policy instrument. And if the central bank must raise interest rates to restrain emerging inflation, it will be unable to lend freely to avoid the consequences of collapsing stock prices.

Mr. Greenspan's cryptic concern about "irrational exuberance" is best understood within this framework. We are at a point in the business cycle that normally anticipates tightening by the

Fed to control inflation. Stock prices do not reflect that possibility because inflation has been surprisingly restrained. But if and when inflation emerges, the Fed will tighten, sending stock prices into a tailspin.

Inflation, though, does not disappear overnight. Under these circumstances, the Fed would have to commit to a sustained period of reduced liquidity. It could not act exclusively as lender of last resort. And when investors recognize the Fed's problem, the Big Bubble could burst, leading to a renewed downturn.

Sound far-fetched? Perhaps, but look at the Japanese experience during the late 80's and early 90's. Stock prices doubled and then fell by two-thirds. It could happen here too.

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