# THE GREENSPAN PUT – AN INVESTMENT STRATEGY OR MORAL HAZARD?

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Can monetary policy interventions influence the convictions of market players concerning market prospects? Would it persuade market participants that they don't have to stress over large parts in market valuations? Would its effects be able to go past the impact of investors' beliefs on market fundamentals? Alan Greenspan, an American economist, served as the thirteenth chair of the Federal Reserve of the United States of America, from 1987-2006 (Alan Greenspan | Federal Reserve History, n.d.). In that capacity, he also served as the chair of the Federal Open Market Committee (FOMC), which is the principal committee formulating monetary policies pertaining to interest rates and money supply in the economy. He is widely known for his monetary policy interventions during the 1990s and 2000s under his chairmanship. Through his interventions, he made active efforts to strengthen the US economy by actively using federal rates to cut interest rates and counter deflation (Fleckenstein & Sheehan, 2008). Thus, creating an environment where investors were encouraged to take risks in the market.

Coined subsequent to the 1987 stock market crash, the Greenspan put is a type of a Fed put. The term "*put*" refers to a financial derivative that gives the holder of the instrument the right to sell an asset at a given price to a party on the other side (Poole, 2008). The put option can be exercised in times of declining asset prices to protect the holder from undergoing losses. When a crisis emerged during Greenspan's leadership, the stock market plunged higher than 20%, the Fed lowered the Funds rate, which resulted in a negative real yield. To avoid further deterioration, the Fed increased monetary liquidity and promoted risk-taking behaviours among investors in financial markets (Fleckenstein & Sheehan, 2008). While it seems to be a satisfactory short-term adjustment mechanism, it could pose problems in the long run if implemented in a continuous series of events. It was a necessary action at the time due to the fact that economic upswings tend to be slower while downswings more abrupt. Thus, it would've been natural to cut interest rates when a downturn was impending.

Equity investors can cushion themselves against losses caused by a fall in the value of their investment by buying put options. Thus, it would act as insurance, making the price of a put option the cost of buying such insurance. Many professionals in the financial industry believe that equity investors benefit from this down-side protection without incurring its total cost because of an implicit central bank back-stop guarantee against significant capital losses. This implicit back-stop guarantee is popularly referred to as the "*Greenspan Put*". The policy brought forth through the Greenspan Put was to lower interest rates when a slowdown was impending. The monetary easing through lower Fed rates would lead to higher borrowings by investors, further leading to higher investments in stocks and bonds and better liquidity. Higher investments would cause the emergence of a bullish market. However, as a Fed policy, this might not certainly be stable.

With a rise in liquidity, there would be the following rise in inflation. Who doesn't like a boom in the economy? But what might appear to be a boom could be a bubble. On the day of the 1987 stock market crash, also known as "*Black Monday*," all major US stock indices declined almost by 20% (Dahiya et al., 2017). The stock market in the United States fell precipitously before surging to new heights in the new millennium. The assets prices peaked to a little more



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than 1500 in August 2000 from its earlier 330 in August 1987, and the broad-based S&P index gained 360 per cent. This created an average growth of about 12% per annum (Miller et al., 2001). Based on historical comparisons, this boom in asset prices implied that either the risk premium had dropped, predicted dividend growth rates had raised, or that there was a bubble (Watson, 2014).

Shortly after the market crash of 1987, Alan Greenspan, the then chairman of the Federal Reserve, took to monetary policy implementation. The Fed implemented the policy propounded by the Greenspan Put, which later came to be termed as "*moral hazard*" (Bornstein & Lorenzoni, 2018). Investors perceive placed protection on asset prices as a result of the Fed's policy of supplying abundant liquidity. Investors increasingly anticipated the Fed to intervene in a crisis or downturn and inject money until the problem was fixed. Each time the Fed took the aforementioned steps, the impression became embedded in asset pricing in the form of higher valuations, smaller credit spreads, and excessive risk-taking.

### What did the Greenspan Put mean for Investors?

The introduction of the federal put by Chairperson Alan Greenspan held considerable significance for investors. Essentially a fed put is used to in the stock market to protect against a fall in the prices of stocks below a specified level, thereby insuring against losses. Thus, the Greenspan Put aimed to propagate the belief that the Federal Reserve would keep lowering interest rates, stepping in to help markets and market players in time of need (Kuepper, 2021). This is also closely tied to the idea of moral hazard that incentivizes investors to take risks in the stock market. When Alan Greenspan took over the Fed, the fed fund rate was approximately 10%. The first cut implemented by him came around after the 1987 stock market crash, sending across the message that the Fed would intervene in a similar way when crisis arose. The series of rate cuts continued for another 19 years in a similar fashion (Halbert, 2019).

Since the put works as a backstop guarantee, it can be helpful tool for hedging against price risks. This can in-turn helps investors mitigate losses. The series of policy interventions led to the formation of a bubble. It was evident that Greenspan and his Fed, along with facilitating bubbles, had made sure that speculators did not suffer to the extent they would have otherwise on the bursting of the bubble (Fleckenstein & Sheehan, 2008). This also created an environment for investors to take risks to a certain extent and trust the power of the Fed at the same time (which was elemental in encouraging risky investments).

## CONCLUSION

Joseph Stiglitz critiqued the put of privatising profits while socialising losses in the run-up to the 2008 financial crisis, and of generating a speculative bubble. The press began discussing the "*Bernanke Put*" in 2007 and early 2008, in which the then-chairman of the Federal Reserve Board, Ben Bernanke, continued to lower interest rates. The combination of rate cuts implemented by Greenspan and Bernanke has been widely blamed for encouraging excessive risk-taking in financial markets, which many believe was a catalyst contributing to the conditions that eventually contributed to the 2008 financial crisis. Nevertheless, the policy combinations by both the Chairmen made up for a necessary short term adjustments, and trickled benefits to investors even if a continuous series of it could be detrimental.

The Fed's continued efforts to soften the business cycle were exemplified by new quantitative easing measures. Declines in monetary growth measures after March 2011 evidently



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signal that there is in fact a limit to market manipulation. Overall, the Greenspan put ushered in an era where risk-taking was encouraged since it was assumed that the Fed would provide tacit insurance against severe market falls, much like a regular put option would.

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