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Should the Fed Raise Margin Requirements?

By Bruce Bartlett

On March 21, the Federal Reserve raised both the federal funds rate (the interest rate banks charge each other on loans) and the discount rate (the interest rate the Fed charges banks) by another 25 basis points (1/4th of 1 percent). In the wake of this latest increase, growing numbers of economists and politicians are starting to question the Fed's action. They are asking why farmers, small businesses and home buyers must be punished when the Fed's principal target appears to be the stock market. They are urging the Fed to raise margin requirements (the maximum percent of an investment that can be made with funds investors borrow from their brokers) instead of raising interest rates.

Combating the Wealth Effect. On many occasions, Federal Reserve Chairman Alan Greenspan has warned about the so-called wealth effect. According to this theory, as the stock market rises and people become wealthier, they increase their consumption:

- A common estimate is that a $1 increase in wealth translates into 4 cents of additional consumption.
- Using this rule of thumb suggests that last year's $2.8 trillion increase in the value of equity shares owned by households raised their consumption by $110 billion, an amount equal to 1.2 percentage points of the increase in the gross domestic product (GDP) in 1999.

Therefore, restraining the growth of the stock market is key to the Fed's strategy of slowing economic growth to a sustainable pace that does not risk overheating and hence inflation. But as interest rates rise, the minimum rates of return investors require for all investments throughout the economy also rise. As investors find that planned investments will no longer yield an adequate rate of return, they channel their funds into the one place where returns are still high: the stock market. In this way, ironically, the Fed's efforts to check the stock market's rise have exactly the opposite effect, heating the stock market up instead of cooling it off.

Growth of Margin Debt. At the same time, Greenspan has indicated concern about the rising level of margin debt, which has skyrocketed since October. In February margin debt hit $265.2 billion, up 45 percent in just four months. Anecdotal evidence suggests that much of this increase comes from increased borrowing through online brokers and is being channeled into the high-flying NASDAQ. As long as that market continues to reach record highs, everyone wins. Investors achieve higher profits by leveraging their investments, while online brokers make much of their profit making margin loans.

Initial Margin Requirements — Percent of Total Value Required to Purchase Stock

10/15/34	45%	1/16/58	50%
2/1/36	55%	8/5/58	70%
11/1/37	40%	10/16/58	90%
2/5/45	50%	7/28/60	70%
7/5/45	75%	7/10/62	90%
1/21/46	100%	11/6/63	70%
2/1/47	75%	6/8/68	80%
3/30/49	50%	5/6/70	65%
1/17/51	75%	12/6/71	55%
2/20/53	50%	11/24/72	65%
1/14/55	60%	1/3/74	50%
4/23/55	70%		

Of course, if the market were to take a serious tumble, margin calls could turn a mild downturn into a crash. Congress believed that this was what happened in 1929, when margin debt equaled 30 percent of the stock market's value. That is why it gave the Fed power to control initial margin requirements in the Securities Act of 1934. As the table shows, since that time margin requirements have been changed 23 times. The requirement has been as high as 100 percent, meaning that none of the purchase price could be borrowed. Since 1974, it has been unchanged, at 50 percent, allowing investors to borrow no more than half the purchase price of equities directly from their brokers.

What Does Increasing Margin Requirements Accomplish? Historically, the Fed has raised margin

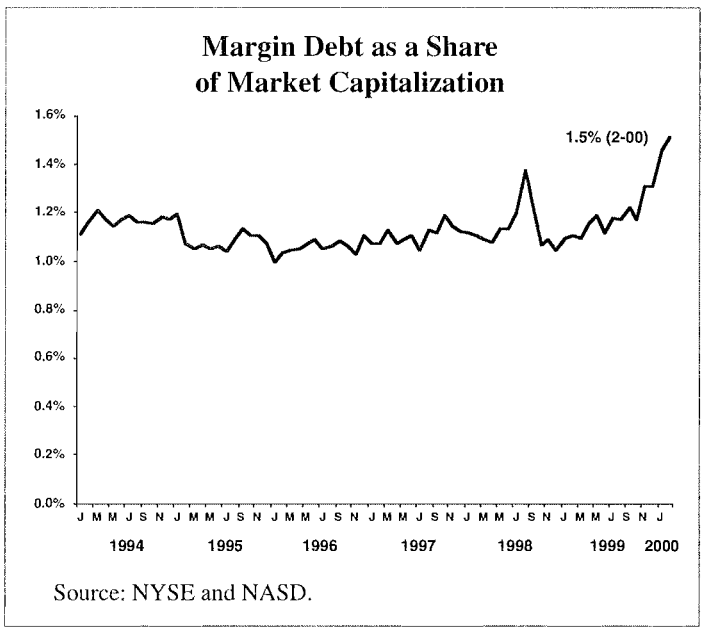
Dallas Headquarters: 12655 N. Central Expy., Suite 720 • Dallas, TX 75243-1739 • 972-386-6272 • Fax: 972-386-0924 • E-Mail: ncpa@public-policy.org
Washington Office: Metropolitan Square • 655 15th Street N.W., Suite 375 • Washington, D.C. 20005 • 202-628-6671 • Fax 202-628-6474 • E-Mail: ncpa@his.com

For more information: Julie Hillrichs or Sean Tuffnell in Dallas at 972/386-6272 or Joan Kirby in Washington at 202/628-6671

requirements to curb stock market volatility rather than overall growth of the market. Yet considerable research shows that margin requirements have no impact on volatility. The latest research, by Fed economist Paul Kupiec, concludes "there is no substantial body of scientific evidence that supports the hypothesis that margin requirements can be systematically altered to manage the volatility in stock markets."

Nevertheless, advocates of higher margin requirements, such as economist Robert Shiller of Yale, argue that they are an significant weapon in the Fed's arsenal. He feels that higher margin requirements can be an important signal that the Fed is serious about cooling an overheated market.

There are a number of problems with this theory. First, there is no evidence that increases in the stock market portend increases in inflation. As a December 1996 study by the Federal Reserve Bank of St. Louis concluded, "The pace of increase in stock prices is not itself inflationary, nor are stock prices particularly useful in helping to gauge inflation trends." Indeed, during the 1970s inflation was associated with a stock market that was falling, not rising.



Second, the Fed's record of taking "direct action" to reduce stock prices it considers are too high does not inspire confidence. Economist Timothy Cogley of the Federal Reserve Bank of San Francisco recently looked at the Fed's actions in the late 1920s, when it both raised interest rates and sought to directly curb funds flowing into the stock market. Although it succeeded in doing so, it contributed to the onset of the Great Depression, in Cogley's view. "The lesson of the Great Depression is not about the dangers of allowing a speculative bubble to develop unabated," he concluded, "but about the difficulty of identifying speculative bubbles and about the risks associated with aggressive actions."

Another analogy might be the failure of the Fed's efforts to curb consumer credit in 1980, which brought on a brief but severe recession that year. Although the credit controls were not especially onerous, they had a dramatic effect on consumer confidence. Thus even symbolic gestures, such as raising margin requirements, can sometimes have consequences far out of proportion to their intended impact.

Finally, it is important to note that changes in financial markets will blunt the effectiveness of higher margin requirements. San Francisco Fed economist Simon Kwan points out that unlike in 1934, investors now may leverage themselves through options and financial futures. Also, investors can borrow against home equity and from other sources to purchase stocks regardless of margin requirements.

Kwan further notes that despite the recent run-up in margin debt, it is still quite low as a share of market capitalization. As the figure shows, in February it was just 1.5 percent of the market value of the New York Stock Exchange and the NASDAQ combined. Moreover, his statistical tests indicate that margin debt tends to rise in response to an increase in the stock market, not the other way around. Thus rather than the market going up because of increased margin borrowing, margin borrowing increases because the market goes up.

Conclusion. The idea that the Fed should target the stock market and raise margin requirements is flawed. Although there are risks associated with a stock market bubble, should one in fact exist, the risks associated with market tampering by the Fed are even greater.

Bruce Bartlett is a Senior Fellow at the National Center for Policy Analysis.