

SPECIAL REPORT

Sprott  **Asset Management**

MOVE OVER, ADAM SMITH: The Visible Hand of Uncle Sam

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Executive Summary

This report examines information indicating that the U.S. government has surreptitiously intervened in the American stock market. Important findings include the following:

- A statement by former presidential adviser George Stephanopoulos and credible British press reports appear to confirm suspicions that the United States has a so-called “Plunge Protection Team” whose primary responsibility is the prevention of destabilizing stock market declines. Comprising key government agencies, stock exchanges and large Wall Street firms, this informal group was apparently created in 1989 as an outgrowth of the President’s Working Group on Financial Markets. This revelation is significant because the government has never admitted to private-sector membership in the Working Group.
- The Plunge Protection Team is not merely concerned with the stability of the stock market. Speaking in 2001 as a correspondent for ABC’s “Good Morning America,” Stephanopoulos also revealed that at the time of the Long Term Capital Management crisis in 1998, the Federal Reserve directed large banks to prop up the currency markets. This was apparently done to diffuse a global currency crisis. We believe this crisis was rooted in the disorderly unwinding of the yen-carry trade, which resulted in the U.S. dollar plummeting against the Japanese currency.
- In response to the September 11 terrorist attacks, the Federal Reserve and large Wall Street firms prepared to support the main stock markets by buying shares if panic selling ensued. Multiple news reports indicate that investment banks and brokerage houses took concerted actions in the aftermath of the tragedy.
- Before the 2003 Iraq invasion, the U.S. and Japan reached an agreement to intervene in stock markets if a financial crisis occurred during the war. Though it was announced at a press conference by a Japanese government official, the U.S. never publicly acknowledged the accord.
- We believe the stability of domestic stock markets is considered by the U.S. government to be a matter of national security. Interventions are likely justified on the grounds that the health of the U.S. financial markets is integral to American preeminence and world stability. This conclusion flows from an extraordinary financial war game exercise conducted by the Council on Foreign Relations in 2000 and attended by key policy-makers. In this vein, an article in *Euromoney* magazine disclosed that simulation participants displayed a willingness to consider government intervention in the stock market in the event of a financial crisis.
- A 1989 *USA Today* story revealed that government regulators asked market participants to buy stocks in October 1989 to prevent another plunge. When these overtures proved ineffective, large brokerage firms appear to have intervened in the futures market to support the underlying index. In this regard, the recovery

was remarkably similar to the miraculous turnaround in equities the day following the 1987 crash.

- A 1989 *Wall Street Journal* op-ed piece written by former Federal Reserve governor Robert Heller may be the blueprint for the government's preferred method of equity market stabilization. Heller suggested that the central bank be empowered to stabilize plunging stock markets by purchasing stock index futures contracts. Such a move would force the underlying index to rise. Of note, a 1992 *New York Post* article quoted a former National Security Council economist as having confirmed that the government supported the stock market in 1987, 1989 and 1992. The article indicated that these interventions were conducted in the manner proposed by Heller.

Introduction

Most people probably assume that the U.S. stock market is free of government interference. It is acknowledged that the bond and currency markets are influenced by policy-makers, but equities are considered different territory altogether. Current mythology holds that share prices rise and fall on the basis of market forces alone.

Such sentiments appear to be seriously mistaken. A thorough examination of published information strongly suggests that since the October 1987 crash, the U.S. government has periodically intervened to prevent another destabilizing stock market fall. And as official rhetoric continues to toe the free market line, manipulation has become increasingly apparent.

Some of these interventions have apparently occurred with the active participation of selected investment banks and brokerage houses. In this regard, evidence from credible sources, including a former top adviser to President Clinton, appears to confirm the existence of a so-called “Plunge Protection Team” (PPT). This group is not simply the figment of creative imaginations, and we are not alone in this conclusion. Indeed, Todd Stein and Steven McIntyre of the *Texas Hedge Report* stated in 2004 that, “Almost every floor trader on the NYSE, NYMEX, CBOT and CME will admit to having seen the PPT in action in one form or another over the years.”¹

Much of the information is evidence of intent to intervene, rather than proof of manipulative activities themselves. This amounts to a distinction without a significant difference. That the government has given such serious consideration to supporting the stock market demonstrates its willingness to cross an important line, violating the traditional American belief in unfettered markets. It underscores the notion that the health and stability of the market represents an integral part of national security, thereby justifying government action when financial peril looms.

We would be remiss if we didn’t briefly discuss the material used to compile this report. Much of the information can be found in news articles from reputable sources. One in particular, John Crudele of the *New York Post*, is quoted repeatedly. This can be chalked up to him being the sole journalist who has consistently questioned whether the government has been intervening in the stock market. Despite the *New York Post*’s tabloid status, we consider Crudele to be one of the best financial reporters in the U.S. His coverage of serious issues related to the integrity of markets has been remarkable, given that his peers in the American business press have been strikingly silent.

We believe we can establish that the government has intervened in the stock market. What we cannot outline with any degree of certainty are many of the details, nuances, twists and turns of such activities. This is due to the utter lack of official disclosure of

¹ Steven McIntyre and Todd Stein, “Gold Manipulation is a Blessing,” *The Texas Hedge Report* (December 10, 2004): <http://www.safehaven.com/showarticle.cfm?id=2318&pv=1>. (McIntyre and Stein are referring to the New York Stock Exchange, the New York Mercantile Exchange, the Chicago Board of Trade and the Chicago Mercantile Exchange.)

market interventions. Accordingly, where decent evidence already exists, we have taken known information and added what we think to be reasonable conjecture. Understandably, though, questions outnumber answers on this topic.

We will not argue that in all cases government intervention in the stock market is wrong. There are certain instances, such as after a terrorist attack, when market stabilization could be deemed appropriate. Yet the government's unwillingness to disclose its activities has rendered it very difficult to have a debate on the merits of such a policy.

Tracing the Roots

As Bob Landis of Golden Sextant Advisors has observed, the stock market crash of 1987 “appears to be the origin of the contemporary stripe of market intervention.”² On Monday, October 19, 1987, the Dow Jones Industrial Average tumbled 508 points, to 1,738.³ But the rout did not end there. *Business Week* later noted that a

200-point rally on Tuesday morning had evaporated, and by 12:29 p.m. another wave of selling had battered the Dow back down to 1711. Many observers felt the market was on the verge of a free-fall. Another precipitous plunge could have laid waste to dozens of banks and securities firms, many of which were in far more perilous shape than had been revealed publicly. And that might have meant a financial apocalypse.⁴

Banks refused to extend credit to specialist brokerage firms responsible for market making on the New York Stock Exchange, and a noticeable absence of buyers threatened to spark a liquidity crisis.⁵ The financial and economic implications were dire.⁶

Yet the apocalypse never came. Accepted history holds that a steadfast Federal Reserve stemmed the panic by prudently providing liquidity to the banking system, which in turn worked to underpin the investment sector.⁷ It is no doubt true that the central

² Bob Landis, *Fiat's Reprieve: Saving the System, 1979–1987* (August 21, 2004):

<http://www.goldensextant.com/anchor55322>. See endnote 53. Landis is referring to interventions generally, although October 1987 also appears to be the first reasonably identifiable instance of stock market intervention.

³ Chris Welles, “Did Market-Rigging Save Wall Street?” *Business Week* (October 17, 1988).

⁴ *Ibid.*

⁵ James B. Stewart and Daniel Hertzberg, “Terrible Tuesday: How the Stock Market Almost Disintegrated A Day After the Crash – Credit Dried Up for Brokers And Especially Specialists Until Fed Came to Rescue – Most Perilous Day in 50 Years,” *The Wall Street Journal* (November 20, 1987).

⁶ Supporting this, the *Journal* account includes the following quote: “Tuesday was the most dangerous day we had in 50 years,” says Felix Rohatyn, a general partner in Lazard Frères & Co. “I think we came within an hour” of a disintegration of the stock market, he says. “The fact we didn’t have a meltdown doesn’t mean we didn’t have a breakdown. Chernobyl didn’t end the world, but it sure made a terrible mess.”

⁷ For instance, a 1997 *Washington Post* article states: “The Fed’s reaction to the 1987 market slide... is a case study in how to do it right. The Fed kept the markets going by flooding the banking system with reserves and stating publicly that it was ready to extend loans to important financial institutions, if needed.”

bank's actions in this regard proved helpful: A concise promise to fulfill its mandate as the lender of last resort,⁸ coupled with urgent communications to wary banks, ensured that a debilitating contraction of credit did not occur. Engaged both in the tangible endeavour of keeping the nation's payments and settlements systems running smoothly and the interrelated game of preserving confidence in the market, overt and conventional actions by the Fed played a role in rescuing stocks from possible oblivion.

But though it is rarely discussed nowadays, an altogether more intriguing suggestion soon emerged to explain the market's miraculous recovery the day after the 1987 crash. As *Wall Street Journal* reporters James B. Stewart and Daniel Hertzberg concluded in their Pulitzer Prize-winning article "Terrible Tuesday," only "the intervention of the Federal Reserve [to provide liquidity], the concerted announcement of corporate stock-buy-back programs, and the mysterious movement – and possible manipulation – of a little-used stock-index futures contract saved the markets from total meltdown."⁹

Stewart and Hertzberg combined a detailed reconstruction of that Tuesday's trading activity with extensive interviews of market participants to underscore the gravity of the situation. By approximately 12:30 p.m., trading in many large-capitalization stocks had all but ceased, and calls for the NYSE to close grew louder. Despite remarkable pressure, though, the exchange remained open. This proved a fortuitous decision, because as the paper recounted, a stunning recovery would soon commence:

In the space of about five or six minutes, the Major Market Index futures contract, the only viable surrogate for the Dow Jones Industrial Average and the only major index still trading, staged the most powerful rally in its history. The MMI rose on the Chicago Board of Trade from a discount of nearly 60 points to a premium of about 12 points. Because each point represents about five in the industrial average, the rally was the equivalent of a lightning-like 360-point rise in the Dow. Some believe that this extraordinary move set the stage for the salvation of the world's markets.

How it happened is a matter of much conjecture on Wall Street. Some attribute it to a mysterious burst of bullish sentiment that suddenly swept the markets. *Some knowledgeable traders have a different interpretation: They think that the MMI futures contract was deliberately manipulated by*

See Brett D. Fromson, "Plunge Protection Team," *The Washington Post* (February 23, 1997): <http://www.washingtonpost.com/wp-srv/business/longterm/blackm/plunge.htm>.

⁸ In a famous statement issued at 8:41 a.m. on Tuesday, October 20, 1987, Greenspan said that, "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." See Bob Woodward, "Crash of October 1987 Challenged Fed Chief," *The Washington Post* (November 13, 2000): <http://www.washingtonpost.com/ac2/wp-dyn/A1742-2000Nov11>. Excerpted from Bob Woodward, *Maestro: Greenspan's Fed and the American Boom*. Simon & Schuster, 2000.

⁹ James B. Stewart and Daniel Hertzberg, "Terrible Tuesday: How the Stock Market Almost Disintegrated A Day After the Crash – Credit Dried Up for Brokers And Especially Specialists Until Fed Came to Rescue – Most Perilous Day in 50 Years," *The Wall Street Journal* (November 20, 1987).

a few major firms as part of a desperate attempt to boost the Dow and save the markets.

According to this theory, the rally in the MMI futures contract was caused by a relatively small amount of concerted buying by one or more major firms at a time when it was so thinly traded that the orders had an enormous and disproportionate upward thrust. By forcing the futures contract to a premium to the underlying cash value of the index, the buyers of the futures could trigger immediate buying of the stocks in the index and selling of the futures by index arbitrageurs. Because so many of the MMI stocks are in the Dow, this would enable the NYSE to reopen many of these stocks at higher prices, leading to an upturn in this psychologically important index. At the very least, the buyers could flash a powerful bullish signal to the markets.¹⁰ [Emphasis added.]

Claims of manipulation seem to go beyond people's suspicions. Frank Veneroso, currently global markets strategist at Allianz Dresdner, has noted, "It is well known that many market participants claim to know of [a U.S. Treasury or Fed] intervention at the time of the stock market crash... in October 1987."¹¹

Even if the government did manipulate the market, it is difficult to argue that an intervention was wholly unjustified. Given the widespread panic and crippling losses among investors, even many doctrinaire free-market advocates might concede that a rescue of the financial system was defensible. Such a move, however, would epitomize an extraordinary measure. As a result, public admission would be imperative to maintain the integrity of markets. Otherwise, policy-makers would sense that they had a tool at their disposal with which to smooth markets that even slightly misbehaved.

1987 Redux

Less than two years after the crash, it appeared the market would disintegrate again. Friday, October 13, 1989, witnessed a 190-point drop in the Dow, and investors feared a devastating plunge reminiscent of Black Monday when the market reopened the following week.¹² A *USA Today* article examining what transpired set the scene:

The catalyst for the Friday plunge was word of the collapse of United Airlines' \$7.2 billion management takeover bid at 2:51 p.m. EDT. Many traders decided the United news was the last straw for a market grown rickety, tired and worried. Once the cascade of selling started, it continued virtually without letup until the 4 p.m. market close – and was made far worse by computerized program selling that hit in wave upon wave. The Dow's loss of 6.9% was the 12th-worst percentage drop in history.

¹⁰ Ibid.

¹¹ Frank Veneroso, "The Gold Conspiracy Question: GATA Provokes Interesting Responses from the Fed and Treasury" (January 29, 2000): <http://www.gata.org/veneroso.html>.

¹² Beth Belton, "Who Saved the Market?" *USA Today* (November 20, 1989).

Many eyes suddenly turned to Washington. Only the government, it seemed, was big enough to play the role of the market savior. And this time, unlike during the Crash of '87, Uncle Sam was ready to assume that role.

Treasury Secretary Nicholas Brady acknowledges that an unprecedented 48-hour whirlwind of meetings and phone calls took place that weekend, involving major stock, option and futures exchanges, brokerages, big institutional investors, the Federal Reserve, foreign central banks, the Securities and Exchange Commission and the Commodity Futures Trading Commission.¹³

While this was never publicly admitted, *USA Today* later revealed:

Privately, many people directly involved say regulators at government agencies and the stock exchanges phoned Wall Street firms and institutional investors over the weekend, asking or subtly suggesting that they buy stocks Monday while the “overhang” – sell orders left over from Friday and new sell orders made over the weekend – was absorbed.

In other words, maybe the biggest players couldn't initiate a rally Monday morning, but they could at least prevent another crash.¹⁴ [Emphasis added.]

Despite the weekend overtures to the private sector, the market did not find itself on sound footing when trading resumed on Monday. Stocks started to plunge again, and confidence among traders began evaporating. The crisis and subsequent resolution unfolded as follows:

From about 9:45 to 10:11, both stocks and futures markets seemed in total disarray. At 10:11, the Dow hit 2504.92, down 64.34 points from Friday's close. Many traders were terrorized, fearing a meltdown was imminent. “We expected it to go down 50 but when we saw it hit 60, the butterflies started. Nobody wanted to be a hero,” says W. Daniel Williams, head trader at Dillon, Read & Co.

Indeed, if money managers had been encouraged by regulators to buy stocks Monday, few were willing to step up.

Then, at 10:12, something happened. The market suddenly turned.

In Chicago, S&P index futures and options contracts began to rocket higher, as buyers poured in. A similar pattern emerged in the Major

¹³ Ibid.

¹⁴ Ibid.

Market Index futures contract, which represents 20 blue-chip stocks: Out of nowhere, buyers surfaced, and the MMI jumped.

Stocks soon followed the futures contracts, as optimism returned. By 10:15, the Dow was off 58 points. By 10:20, it was off just 24 points. By 10:23, it was up 4 points – a turnaround of 69 points in just 12 minutes. By 11 a.m. it was up 28 points. It fell back from there, but soon rallied again.

By 2 p.m. the Dow had a 36-point gain, by 3:30, 71 points. A final burst took it to its closing gain: 88 points.¹⁵

The parallels with 1987's Terrible Tuesday are clear. Once again, the aggressive purchase of index futures contracts seems to have rescued a dangerously faltering stock market. Indeed, on October 23, 1989, the *New York Post's* John Crudele would confirm that the rally in the MMI turned the Dow around. He spoke of

*brokerage firms that last week staged a concerted effort to manipulate the price of the Major Market Index – an index that trades on the Chicago Board of Trade and is made up of just 20 stock futures. By “buying the hell out of the MMI,” as one of my sources put it, these firms were able to push the similarly-constructed Dow Jones Industrial Average higher at minimum expense.*¹⁶ [Emphasis added.]

Come Heller High Water

The near repeat of a 1987-style plunge rekindled concerns about the market's stability. Weeks after the October close call, Robert Heller, who only months earlier had retired as a governor of the Federal Reserve, presented a dramatic proposal in a *Wall Street Journal* op-ed. Titled “Have Fed Support Stock Market, Too,” the piece suggested that the central bank be empowered with the responsibility to calm equity markets when cataclysmic plunges threatened.¹⁷ Downplaying the efficacy of circuit-breakers, Heller proposed a novel method to stabilize equity prices in the event of panic selling. He suggested:

The Fed's stock market role ought not to be very ambitious. It should seek only to maintain the functioning of markets – not to prop up the Dow Jones or New York Stock Exchange averages at a particular level. The Fed should guard against systemic risk, but not against the risks inherent in individual stocks. It would be inappropriate for the government or the

¹⁵ Ibid.

¹⁶ John Crudele, “Stock Recovery More like 1929 than 1987,” *Austin-American Statesman* (October 23, 1989).

¹⁷ Robert Heller, “Have Fed Support Stock Market, Too,” *The Wall Street Journal* (October 27, 1989). For a more complete discussion of Heller's article, see Robert Parenteau, “The Late 1990s U.S. Bubble: Financialization in the Extreme,” in *Financialization and the World Economy*, edited by Gerald Epstein of the Political Economy Research Institute (2005):

<http://www.umass.edu/peri/pdfs/epstein/Financialization/Financial.Parenteau.pdf>.

central bank to buy or sell IBM or General Motors shares. *Instead, the Fed could buy the broad market composites in the futures market. The increased demand would normalize trading and stabilize prices. Stabilizing the derivative markets would tend to stabilize the primary market.* The Fed would eliminate the cause of the potential panic rather than attempting to treat the symptom – the liquidity of the banks.¹⁸ [Emphasis added.]

Absent confirmation that the government was employing this strategy to rescue the market, Heller's proposal could be dismissed as theoretical. However, in a 1992 article, John Crudele quoted someone who maintained strong connections in the Republican Party as stating that the government intervened to support the stock market in 1987, 1989 and 1992:

Norman Bailey, who was a top economist with the government's National Security Council during the first Reagan Administration, says he has confirmed that Washington has given the stock market a helping hand at least once this year.

"People who know about it think it is a very intelligent way to keep the market from a meltdown," Bailey says.

Bailey says he has not only confirmed that the government assisted the market earlier this year, but also in 1987 and 1989.

Now a Washington-based consultant, Bailey says the Wall Street firms may not even know for whom they are buying the futures contracts. He says the explanation given to the brokerage firms is that the buying is for foreign clients, perhaps the central banks of other countries.¹⁹ [Emphasis added.]

Crudele also provided anecdotal evidence of possible interventions:

On July 28 [1992], for instance, Shearson Lehman aggressively purchased 1,000 stock index futures contracts when equity prices suddenly started sliding because of a news report that consumer confidence had plunged.

Traders in Chicago said the buying that followed by Shearson and other brokerage firms was so aggressive that it raised suspicions as to its intent. The Shearson purchases managed to stem the market's slide.

¹⁸ Ibid.

¹⁹ John Crudele, "Evidence Suggests Government Manipulating Stock Market," *Buffalo News* (September 1, 1992).

That day the Dow ended 51.87 points higher. Newspapers the next day said the bad news about the economy had made Wall Street believe that interest rates would decline again – a bullish move for stocks.

Similar suspicious trading has occurred for months, traders say. Just last Monday, for instance, when stock prices were sliding because of the weak dollar, traders say that nearly identical orders for several hundred Standard & Poor's 500 futures contracts were handled at the Chicago Mercantile Exchange by Shearson and Goldman Sachs.

With the two firms bidding against each other, the equities markets rallied temporarily before being overwhelmed by the weakness in the greenback. One trader in Chicago says unusual trading like that – without any basis in the fundamental outlook for the market – “has been happening fairly frequently.”²⁰

It is unclear where the money for such futures purchases came from, although in a 1995 article, John Crudele advanced a plausible explanation. Referring to the U.S. Exchange Stabilization Fund,²¹ he wrote, “Sources have told me that in the early 1990s it was secretly used to bail the stock market out of occasional lapses.”²² He further stated one source indicated “that the account used Wall Street firms as intermediaries and that Goldman [Sachs]... was used most often as a go-between.”²³ Crudele conceded that he could not confirm the allegations and, not surprisingly, that the Fed denied all of them.²⁴

They would issue a similar denial when queried by a U.S. congressman in the fall of 1998. According to an October 1999 report by Marshall Auerback of Veneroso Associates, Representative Ron Paul wrote both the Fed and Treasury, asking:

...has there ever been or does there currently exist a policy by the U.S. Treasury Department or Federal Reserve to intervene in the U.S. equity market through purchases of stocks or S&P futures, either directly for Treasury Department accounts such as the Exchange Stabilization Fund, for Federal Reserve accounts or by proxy – by having broker dealers purchase S&P500 futures when the stock market is threatening to crash on the understanding that they will be repaid for any subsequent losses

²⁰ Ibid.

²¹ According to the New York Federal Reserve, the ESF “was created and originally financed by the Gold Reserve Act of 1934 to contribute to exchange rate stability and counter disorderly conditions in the foreign exchange market.” See Federal Reserve Bank of New York, “Fed Point: Exchange Stabilization Fund” (June 2004): <http://www.ny.frb.org/aboutthefed/fedpoint/fed14.html>. The Secretary of the Treasury controls the ESF.

²² John Crudele, “Mexico Drains World’s Biggest Slush Fund,” *Rocky Mountain News* (February 12, 1995). Crudele refers to the fund as “the Currency (or Dollar) Stabilization Account,” but the official title is, in fact, the Exchange Stabilization Fund.

²³ Ibid.

²⁴ Ibid.

*through the Fed Open market operations or favored treatment at Treasury auctions?*²⁵ [Emphasis added.]

The report by Veneroso Associates stated that Fed Chairman Alan Greenspan responded:

*The Federal Reserve has never intervened in the U.S. equity market in any form, either in the equity market itself or in the futures market, for its own account, for the ESF, or for any other Treasury account. The Federal Reserve has never encouraged broker/dealers to purchase any stocks or stock futures contracts. The Federal Reserve has never had any “understandings” with any firms about compensating them in any manner for possible losses on such purchases.*²⁶ [Emphasis added.]

Marshall Auerback then analyzed the response, suggesting that Greenspan may have dodged the issue:

Apparently, a very direct response to a very direct question, which would appear to settle the issue once and for all. We discussed this response with a former Fed counsel and asked his opinion. He immediately pointed out that the answers given by Chairman Greenspan only referred to actions undertaken by the Federal Reserve, and not by any which may or may not have been taken by the Treasury. This may be proper, given that the very same question was posed to Treasury Secretary Rubin. However, the former Fed counsel did point out that some members of the Fed, notably Mr. Peter Fisher, “wore” both Treasury and NY Federal Reserve hats. Not only is Peter Fisher the number 2 man at the New York Fed under [William McDonough], *but he also has two vital roles which are carried out in his function as a member of the U.S. Treasury – namely, the management of the Exchange Stabilization Fund (ESF) and the manager of the foreign custody accounts held at the NY Fed.* Chairman Greenspan’s foregoing answer, according to the former Fed counsel, could be technically correct. But it does not elaborate on the ambiguous two-fold role played by Peter Fisher of the New York Federal Reserve, nor does it cover his Treasury related responsibilities as the manager of the ESF and custody accounts of foreign central banks held at the NY Fed. So the answer does not conclusively resolve the question of official intervention in the stock market.²⁷ [Emphasis in original.]

A more definitive answer would not be forthcoming from the Treasury. In contrast to Greenspan’s prompt response, they apparently took a full year to answer Ron Paul’s

²⁵ Marshall Auerback (Veneroso Associates), “The ‘Intervention Question’ Revisited,” October 15, 1999.

²⁶ Ibid.

²⁷ Ibid.

letter.²⁸ More importantly, the Treasury never directly addressed whether the department or the Exchange Stabilization Fund had intervened in the stock market.²⁹ In fact, Veneroso Associates would observe:

A former Fed counsel described this response as “an elaborate non answer to the question,” noting that the response speaks only to the role of the Federal Reserve, and not to the Treasury, nor the Exchange Stabilization Fund, nor the management of the foreign custody accounts in the NY Federal Reserve. *This, despite the fact that the respondent here is the Treasury, not the Federal Reserve.* It is a rambling philosophic response, which contrasts quite markedly with the more direct answer given by the Fed.

Thus, a question that could have been answered conclusively has instead raised even more doubts.³⁰ [Emphasis in original.]

A statement cited previously may shed some light on the situation. When John Crudele quoted Norman Bailey as confirming government stock market activity in 1987, 1989 and 1992, he also wrote that according to the former National Security Council economist, “the explanation given to the brokerage firms is that the buying is for foreign clients, perhaps the central banks of other countries.”³¹ Just who might have provided such an explanation? One person who could do it convincingly would be the New York Federal Reserve official in charge of the System Open Market Account.³² As Auerback notes, this official’s responsibilities include “the management of the Exchange Stabilization Fund (ESF) and... the foreign custody accounts held at the NY Fed.”³³ Recall Crudele’s information “that in the early 1990s [the ESF] was secretly used to bail the stock market out of occasional lapses.”³⁴ A reasonable scenario then unfolds: The person who placed the orders for futures contracts evidently told the firms that the buying was for foreign clients. This would have been believable, given one of the New York Fed official’s responsibilities. But such an explanation would have conveniently masked the true buyer, which likely was the Exchange Stabilization Fund.

A Treasury-Fed Split?

The Fed’s denial of stock market activity, combined with claims that the Treasury-controlled ESF did intervene, is intriguing when considered in the context of two 1995

²⁸ Ibid.

²⁹ Ibid. The Exchange Stabilization Fund, although under the control of the Secretary of the Treasury, is technically separate from the department.

³⁰ Ibid.

³¹ John Crudele, “Evidence Suggests Government Manipulating Stock Market,” *Buffalo News* (September 1, 1992).

³² Federal Reserve Board, “The Structure of the Federal Reserve System”: <http://www.federalreserve.gov/pubs/frseries/frseri2.htm>.

³³ Marshall Auerback (Veneroso Associates), “The ‘Intervention Question’ Revisited,” October 15, 1999. Published in *Gold Watch*, Veneroso Associates, January 5, 2000 (issue 01.01).

³⁴ John Crudele, “Mexico Drains World’s Biggest Slush Fund,” *Rocky Mountain News* (February 12, 1995).

Federal Open Market Committee transcripts. At the January 31 meeting, St. Louis Federal Reserve President Tom Melzer expressed concern about the Fed's proposed participation with the Treasury in the bailout of Mexico then under discussion. The Clinton administration had decided to use the ESF to fund the rescue when Congress refused to grant an appropriation. Melzer worried:

In effect, one could argue that we would be participating in an effort to subvert that will of the public, if you will. I do not want to be too dramatic in stating that. This could cause a re-evaluation of the institutional structure of the Fed in a very fundamental and broad way.³⁵

To which Greenspan cryptically, yet ominously, responded:

I seriously doubt that, Tom. I am really sensitive to the political system in this society. *The dangers politically at this stage and for the foreseeable future are not to the Federal Reserve but to the Treasury. The Treasury, for political reasons, is caught up in a lot of different things.*³⁶ [Emphasis added.]

At the March 28 meeting, FOMC members again expressed hesitation about the Fed's planned participation with the Treasury in the Mexican package. Once more, Greenspan attempted to alleviate any fears, but also noted:

*We have to be careful as to precisely how we get ourselves intertwined with the Treasury; that is a very crucial issue. In recent years I think we have widened the gap or increased the wedge between us and the Treasury.... In other words, we have gone to a market relationship and basically to an arms-length approach where feasible in an effort to make certain that we don't inadvertently get caught up in some of the Treasury initiatives that they want us to get involved in. Most of the time we say "no."*³⁷ [Emphasis added.]

These passages obviously suggest that by 1995 the Treasury was engaging in activities that Greenspan deemed politically dangerous and, accordingly, with which he was very reluctant to be associated. It is only logical that these actions had not been disclosed publicly by the time he made these two statements. Had they been public, the Treasury would have already suffered the consequences of the political dangers of which Greenspan spoke.

Greenspan revealed what looks to have been a major split between the central bank and the executive branch of government. He spoke of having "widened the gap" between the

³⁵ Federal Reserve, Transcript of Federal Open Market Committee meeting for January 31, 1995 (p. 136): www.federalreserve.gov/fomc/transcripts/1995/950201Meeting.pdf.

³⁶ Ibid.

³⁷ Federal Reserve, Transcript of Federal Open Market Committee meeting for March 28, 1995 (p. 6): <http://www.federalreserve.gov/FOMC/Transcripts/1995/950328Meeting.pdf>.

Fed and Treasury, taking their relationship to a market-based one. This “arm’s-length approach” was likely the Fed’s attempt to preserve its credibility if the Treasury’s initiatives resulted in a political storm. Whatever Treasury was up to sounds rather questionable, judging by Greenspan’s explicit statements about political dangers and also his implied worry that the central bank could “inadvertently get caught up in some of the Treasury initiatives that they want us to get involved in.” He seems to have fretted that even the appearance of the Fed’s participation in these activities could be politically toxic for a central bank that prides itself on independence. Precaution thus appears to have been the Fed’s approach when dealing with the Treasury. Of course, according to Greenspan, the Fed only said no to the Treasury *most* of the time, indirectly admitting that in at least *some* instances the central bank participated in the unspecified initiatives.

We do not know what these initiatives were and, indeed, Greenspan’s frustrating ambiguity suggests he was cognizant of the fact that his words were being recorded. So we are left to speculate. It’s a reasonable assumption that whatever the Treasury was doing was market-related. This likelihood is indicated by the Treasury’s apparent attempts to include the Fed in the initiatives. The central bank is not responsible for fiscal policy, so logically its only use to the Treasury would be to execute or participate in some market-related transactions. This is further corroborated by Greenspan’s comment that the Fed had moved to a “market relationship” where feasible with the Treasury. That statement suggests that the Fed had to conduct at least some of the initiatives on behalf of the Treasury.

At this point we return to the Exchange Stabilization Fund, which is controlled by the Treasury Secretary. According to the New York Fed’s website, “ESF operations are conducted through the Federal Reserve Bank of New York in its capacity as fiscal agent for the Treasury.”³⁸ As a result, it is easy to see how the Fed could become entangled in questionable Treasury initiatives.

Speaking of such endeavours, at the January 31, 1995, meeting the Federal Reserve’s general counsel revealed that the ESF conducted previously undisclosed gold swaps, and, while not spelling out the crucial details, a close reading of the transcript suggests they were recent transactions.³⁹ Six years later, in an apparent cover-up, that same lawyer would claim not to know of any such dealings.⁴⁰ But gold was probably not the only area in which the ESF dealt covertly. According to Greenspan, as of 1995 the Treasury was caught up in not one or a few, but “a lot of different things.” While only speculation, it is certainly possible that the Treasury used the ESF for stock market interventions that the central bank deemed unnecessary. If so, the Fed would logically have been concerned that its participation could draw criticism if such a scheme were revealed. Whatever the case, the 1995 FOMC transcripts suggest that the Clinton administration left office

³⁸ See Federal Reserve Bank of New York, “Fed Point: Exchange Stabilization Fund” (June 2004): <http://www.ny.frb.org/aboutthefed/fedpoint/fed14.html>.

³⁹ Federal Reserve, Transcript of Federal Open Market Committee meeting for January 31, 1995 (p. 69): www.federalreserve.gov/fomc/transcripts/1995/950201Meeting.pdf.

⁴⁰ See Joseph Rebello, “Top Fed Lawyer Says ’95 FOMC Transcript Misquoted Him,” *Dow Jones International News* (July 23, 2001).

having managed to keep politically dangerous revelations from leaking into the public domain.

Plumbing the Depths

Naturally, the 1987 market crash came as a shock to Americans. In response, President Reagan appointed a commission to study what caused the financial turbulence. Headed by future Treasury Secretary Nicholas Brady, then Chairman of Dillon Read and Co., the panel concluded in February 1988 that the catalyst for the crash was program trading by large market participants.⁴¹ Recommending greater coordination among the stock exchanges, as well as the use of circuit-breakers, the Brady commission's report did not satisfy the administration, which apparently disagreed with the call for more regulation.⁴²

In response, on March 18, 1988, Reagan issued Executive Order 12631, establishing a Working Group on Financial Markets.⁴³ The group would be composed of the Secretary of the Treasury and the Chairmen of the Federal Reserve, the Securities and Exchange Commission and the Commodity Futures Trading Commission.⁴⁴ According to the order, the main purpose for the Working Group was to “identify and consider the major issues raised by the numerous studies on the events in the financial markets surrounding October 19, 1987.”⁴⁵ In this regard, the executive order recognized “the goals of enhancing the integrity, efficiency, orderliness, and competitiveness of [the nation's] financial markets and maintaining investor confidence.”⁴⁶

But while the 1987 crash was its initial *raison d'être*, the Working Group's focus has evolved beyond that event. Americans heard little of the group following its report on the crash, but this would change with a widely circulated 1997 *Washington Post* article. Titled “Plunge Protection Team,” the story described the group's activities in the second Clinton administration as it prepared for the possibility of a severe market decline. After detailing a potential government response to a hypothetical plunge, the *Post* captured the urgency of the contingency planning:

These quiet meetings of the Working Group are the financial world's equivalent of the war room. The officials gather regularly to discuss options and review crisis scenarios because they know that the government's reaction to a crumbling stock market would have a critical impact on investor confidence around the world.

⁴¹ Christopher J. Neely, “The Federal Reserve Responds to Crises: September 11th Was Not the First,” *Federal Reserve Bank of St. Louis Review* (March 1, 2004).

⁴² “Probes of the Stock Market Crash, At-a-Glance,” *The Associated Press* (October 2, 1988).

⁴³ Executive Order 12631 – “Working Group on Financial Markets,” U.S. National Archives and Records Administration (March 18, 1988): <http://www.archives.gov/federal-register/codification/executive-order/12631.html>.

⁴⁴ *Ibid.*

⁴⁵ *Ibid.*

⁴⁶ *Ibid.*

“The government has a real role to play to make a 1987-style sudden market break less likely. That is an issue we all spent a lot of time thinking about and planning for,” said a former government official who attended Working Group meetings. “You go through lots of fire drills and scenarios. You make sure you have thought ahead of time of what kind of information you will need and what you have the legal authority to do.”⁴⁷

Quoting many current and former government officials anonymously, the article outlined the regulatory steps taken by government agencies to prevent a loss of confidence and liquidity in the event that a potentially destabilizing fall in equity prices occurred. In this regard, the *Post* noted:

The Working Group’s main goal, officials say, would be to keep the markets operating in the event of a sudden, stomach-churning plunge in stock prices – and to prevent a panicky run on banks, brokerage firms and mutual funds. Officials worry that if investors all tried to head for the exit at the same time, there wouldn’t be enough room – or in financial terms, liquidity – for them all to get through. In that event, the smoothly running global financial machine would begin to lock up.

This sort of liquidity crisis could imperil even healthy financial institutions that are temporarily short of cash or tradable assets such as U.S. Treasury securities. And worries about the financial strength of a major trader could cascade and cause other players to stop making payments to one another, in which case the system would seize up like an engine without oil. Even a temporary loss of liquidity would intensify financial pressure on already stressed institutions.⁴⁸

Following this story, the Working Group on Financial Markets became synonymous in the eyes of many with the term “Plunge Protection Team,” and vice versa. In fact, the *Post* article is apparently the first public reference to the PPT. Whether the paper invented this moniker or borrowed it from government officials is uncertain. What is clear is that ever since, suspicions have been raised considerably about whether the U.S. government stands ready to intervene in the stock market should a panic occur. This belief retains traction despite the story making no mention whatsoever of the Working Group conducting or even considering such interventions.

While we cannot be certain what prompted the Plunge Protection Team story of February 23, 1997, John Crudele offered a persuasive explanation in August 1996. In an article titled “Some Advice on How to Successfully Rig the Market,” he outlined steps that the

⁴⁷ Brett D. Fromson, “Plunge Protection Team,” *The Washington Post* (February 23, 1997): <http://www.washingtonpost.com/wp-srv/business/longterm/blackm/plunge.htm>.

⁴⁸ *Ibid.*

Clinton administration should take if it intended to prop up the stock market.⁴⁹ Among his recommendations, Crudele suggested the following:

Leak a story to your favorite puppet newspaper about how the government will “do all in its power to prevent problems in the stock market.”

That’ll work. Keep the statement vague and believable. And let the gullible press carry the message for you.⁵⁰

The fact that the *Washington Post*’s description of the Working Group came on the heels of a particularly candid remark by Alan Greenspan did nothing to dispel suspicions that the government stood ready to prevent a severe market decline. In a speech given in Leuven, Belgium, in January 1997, Greenspan repeated a statement he made in November 1996,⁵¹ declaring that

governments, including central banks, have been given certain responsibilities related to their banking and financial systems that must be balanced. *We have the responsibility to prevent major financial market disruptions through development and enforcement of prudent regulatory standards and, if necessary in rare circumstances, through direct intervention in market events.* But we also have the responsibility to ensure that private sector institutions have the capacity to take prudent and appropriate risks, even though such risks will sometimes result in unanticipated bank losses or even bank failures.⁵² [Emphasis added.]

He softened his emphasis upon “direct intervention in market events” by subsequently endorsing a central bank’s responsibility to allow the private sector to take potentially crippling risks. Nonetheless, this statement served as a significant declaration by the Fed. Greenspan laid claim to the central bank’s right to intervene in markets should emergency situations arise.

It is unlikely that the timing of Greenspan’s statement was random, and so it is worthwhile to consider the context in which the Fed chairman spoke. Clearly, Greenspan’s preoccupation for at least a few years had been his perception that the stock market was seriously overvalued and thus increasingly susceptible to a sharp decline. As Robert Parenteau, a strategist with RCM Dresdner, observed:

Since Greenspan’s first battle scars as Chairman of the Fed had been earned while trying to contain the potential damage of an overvalued

⁴⁹ John Crudele, “Some Advice On How To Successfully Rig The Market,” *St. Louis Post-Dispatch* (August 12, 1996).

⁵⁰ *Ibid.*

⁵¹ Remarks by Chairman Alan Greenspan at the Federation of Bankers Associations of Japan, Tokyo, Japan, Banking in the Global Marketplace (November 18, 1996): <http://www.federalreserve.gov/boarddocs/speeches/1996/19961118.htm>.

⁵² Remarks by Chairman Alan Greenspan at the Catholic University Leuven, Leuven, Belgium (January 14, 1997): <http://www.federalreserve.gov/boarddocs/speeches/1997/19970114.htm>.

equity market, it is not unreasonable to suspect his greatest fears lay with a replay of the October 1987 [meltdown]. Although a number of factors influenced the Fed's decision to begin tightening again by February 1994, it is quite clear from FOMC transcripts that containing what the Fed perceived to be an equity bubble at the time was one of its primary goals. This was not simply, as advertised at the time, a "pre-emptive strike" against inflation.⁵³

Parenteau then quotes from a March 1994 FOMC transcript in which Greenspan states, "When we moved on February 4th, I think our expectation was that we would prick the bubble in the equity markets."⁵⁴ Elaborating on this, the *Wall Street Journal* would later write:

By 1994, with the Dow nearing 4000, [Greenspan] asked researchers to dissect the popular explanations, such as the effect of globalization on profits, being floated on Wall Street. His staff was skeptical. "Bad science," and "Abby Joseph Cohen stories," the Fed staff called Wall Street's theories.

Throughout the mid-1990s, the staff prepared forecasts suggesting that the market would likely stop rising or suffer a 20% correction. Some of the economists told colleagues that they had personally gotten out of the market, and advised others to follow them into bonds.

Mr. Greenspan privately shared many of these doubts. When the Fed started raising interest rates at the beginning of 1994, the official explanation was that early signs of inflation were building. But behind the Fed's closed doors, Mr. Greenspan made clear that he was motivated by the stock market as well.

In February 1994, for instance, after the Fed made its first move to raise rates, the Dow dropped nearly 5% to about 3800. "We partially broke the back of an emerging speculation in equities," Mr. Greenspan contentedly told his colleagues in a conference call the afternoon of Feb. 28, according to transcripts. "We had a desirable effect."⁵⁵

Two years later, Greenspan's concern had clearly risen. The *Journal* article described the situation:

⁵³ Robert Parenteau, "The Late 1990s U.S. Bubble: Financialization in the Extreme" (p. 50–51), in *Financialization and the World Economy*, edited by Gerald Epstein of the Political Economy Research Institute (2005): <http://www.umass.edu/peri/pdfs/epstein/Financialization/Financial.Parenteau.pdf>. Note that Parenteau is speaking in a personal capacity.

⁵⁴ Federal Reserve, Transcript of Federal Open Market Committee meeting for March 22, 1994 (p. 41): <http://www.federalreserve.gov/fomc/transcripts/1994/940322Meeting.pdf>.

⁵⁵ Jacob M. Schlesinger, "Change Agent: How Alan Greenspan Finally Came to Terms With the Stock Market – As Investors Became More, Well, Exuberant, He Saw A Logic in Their Methods – Worried by a 'Wealth Effect,'" *The Wall Street Journal* (May 8, 2000).

On the morning of Dec. 3, 1996, having watched the Dow surge a dizzying 27% that year, Federal Reserve Board Chairman Alan Greenspan hosted a private meeting that became his own genteel version of the debate show “Crossfire.”

On one side was Abby Joseph Cohen, the belle of the bull market, who came from her post at Goldman, Sachs & Co. to defend investor sanity. She methodically gave Fed governors a list of reasons why underlying economic changes justified such lofty prices in the market.

On the other side were two Ivy League economists, Yale’s Robert Shiller and Harvard’s John Campbell, who painted a much gloomier picture, though they didn’t address Ms. Cohen’s comments directly. They illustrated their message of portent in 10 pages of handouts showing trends going back to 1872. The markets were destined, at best, to tread water, and possibly to crash, they warned.

As unusual as that meeting was, it didn’t compare to what would follow two days later. At a black-tie banquet at the Washington Hilton, Mr. Greenspan delivered a speech that would contain the most memorable utterances of his career: “How do we know when irrational exuberance has unduly escalated asset values? ...And how do we factor that assessment into monetary policy?”

Minutes after he spoke, stocks began tumbling in Tokyo, where the markets were open. That was followed by more carnage in Europe, then the U.S. Over the next few weeks, the Dow Jones Industrial Average slipped 4% from its then-record of 6400.⁵⁶

These declines would not last long. A February 13, 1997, *Washington Post* article by Brett Fromson, the same journalist who wrote the Plunge Protection Team story 10 days later, noted that, “The surging stock market reached a new high yesterday as a rally in technology stocks spread to other sectors and the public continued to pour money into mutual funds.”⁵⁷ Fromson also explained:

This latest sign of investor frenzy comes despite worries by Washington policymakers that the markets are being driven by what Federal Reserve Chairman Alan Greenspan, in a Dec. 5 speech, called “irrational exuberance.”

Greenspan has been worrying about the market’s level for at least a year. He discussed the speculative nature of the stock market Feb. 12, 1996, at a

⁵⁶ Ibid.

⁵⁷ Brett D. Fromson, “Stock Market Stays Hot, Officials Stay Concerned; Dow Rises 103 Points, to Another Record,” *The Washington Post* (February 13, 1997).

meeting of the President's Working Group on Financial Markets, basing his comments in part on an internal Federal Reserve study that showed prices to be notably high by historical measures, according to several participants at the meeting.⁵⁸

Later, he quoted a government official on Greenspan's views toward equity valuations:

“Obviously his concern must be pretty high if he finally said something in public,” one of the attendees at the meeting last February said. “If he was concerned enough to mention it at a working group meeting and the stock market has gone up 1,400 points, he is not less concerned now.”⁵⁹

The Plunge Protection Team article was not the last to hint at the government's resolve to protect the market. In 1998, Crudele described another apparently well-orchestrated leak, this time revolving around the activities of the aforementioned Peter Fisher:

The Federal Reserve is just dying to admit that it has been doing brilliant – but alas, questionable – things to keep the stock market bubble inflated. A *Wall Street Journal* article on Monday is the closest the Fed has ever come to making this admission, although the newspaper apparently didn't know what it was on to.

The *Journal* story was about the bailout of the hedge fund, Long-Term Capital Management, and how the Fed stepped in to save the day.⁶⁰

The story gets interesting in the seventh paragraph, when it starts talking about Peter Fisher, the 42-year-old No. 2 man at the New York Fed, whose “official” job is running the Fed's trading operation.

“In that capacity, Mr. Fisher is the Fed's eyes and ears on the inner workings of stock, bond and currency markets and is given a wide degree of latitude about deciding when certain events pose broader risks,” the article says.

“He begins most workdays at 5 a.m. by checking the status of overseas markets... and ends them 11 p.m. the same way. In between, Mr. Fisher SWAPS [Crudele's emphasis] intelligence and rumors with traders and dealers from his office in the Fed's 10th-floor executive suite that overlooks the trading floor he runs,” the piece continues.

⁵⁸ Ibid.

⁵⁹ Ibid.

⁶⁰ See Jacob M. Schlesinger, “Long-Term Capital Bailout Spotlights a Fed ‘Radical,’” *The Wall Street Journal* (November 2, 1998).

As I pointed out in a previous column, the market has done some strange things in the wee hours of the morning, especially between 5 a.m. and 7 a.m., which ultimately affect how equities do in the New York market.⁶¹

Crudele then asked of Fisher:

What exactly does he give to these traders and dealers he talks to at 5 a.m. in the morning? “Swaps,” which is the word the *Journal* reporter came away with, implies a give-and-take. What is Fisher, the second highest person in the New York Fed’s hierarchy giving to traders?

Just gossip? Or is Fisher giving away what Wall Street calls inside information.

And why are Fisher and the Fed concerned about the stock market? The Fed has jurisdiction over the dollar and, as an extension, bonds. It would be a big expansion of the Fed’s powers to suddenly have authority over stocks.

But since this nation’s economy has become so dependent on the stock market’s success, the Fed’s current interest in equities would not be surprising.

I asked to talk with Fisher. I said I wanted to know about his interest in the stock market and the swapping of information.

The Fed wouldn’t allow it. “I’m sorry but [we’re] not going to make Peter available,” said a spokesman in New York. “He’s kinda busy. I think the spotlight on him right now is a little too bright.”⁶²

Although it is unclear where he obtained the information, Crudele wrote in a February 2001 article that Fisher “has been described as the financial market’s ‘troubleshooter.’ He’s [known] as the fixer – the guy who controls a covert organization that’s been dubbed the ‘plunge protection team.’”⁶³ Weeks later, he would declare that the 1998 *Wall Street Journal* piece “missed the main point: Fisher wasn’t just innocently monitoring markets, he was manipulating them.”⁶⁴

⁶¹ John Crudele, “New York Fed Nearly Admits Rigging The Market,” *The New York Post* (November 6, 1998).

⁶² Ibid.

⁶³ John Crudele, “The Smart Money Wants No Part of This Market,” *The New York Post* (February 26, 2001).

⁶⁴ John Crudele, “This Guy Can Rescue Greenspan and Markets,” *The New York Post* (March 13, 2001).

The War Game People Played

Before the Nasdaq bubble burst, U.S. policy experts evidently recognized the broader economic risks associated with a crash of the high-tech-led stock market. As part of its Financial Vulnerabilities Project, the Council on Foreign Relations (a Washington-based think tank) conducted a financial war game in January 2000 designed to test decision-makers' responses to a confluence of financial, foreign policy and national security crises. According to project organizer Roger Kubarych, planning was initiated in the fall of 1999.⁶⁵ Dow Jones later described the simulation as follows:

Imagine if everything that could go wrong in the financial and geopolitical world did.

That's what the Council on Foreign Relations did in January, when it convened a group of 75 financial and political experts to play a War Game of the future.

This one didn't involve generals, superpowers and rogue nations. Rather, the key players were central bankers, Treasury secretaries and traders. But in simulating a collapse of the U.S. financial system, the New York-based group tapped into a new reality: that future threats to national security will be as much about economics and finance as they are about bombs and missiles.

The policy simulation presumed a 30% slide in the Dow Jones Industrial Average to 8,000 over a three-month period. That slide triggered an outflow of funds from stocks to Treasury bills, which are considered the ultimate safe-haven. The outflow of U.S. assets lowered the value of the dollar and put upward pressure on interest rates, and the Dow industrials sunk even further, to 6,000.⁶⁶

A book summarizing the findings of the project also made explicit the intersection of national security with economics. Writing in the foreword, Council president Leslie H. Gelb observed:

The major conclusion that flows from the work of Roger and his colleagues is this: *the most dangerous near-term threat to U.S. world leadership and thus to U.S. security, as well, would be a sharp decline in the U.S. securities markets. Such a decline would likely stun the U.S. economy at a time when the strength of our economy is critical to global*

⁶⁵ Roger M. Kubarych, *Stress Testing the System: Simulating the Global Consequences of the Next Financial Crisis*. New York: Council on Foreign Relations Press, 2001, p. xiii.

⁶⁶ Brian Blackstone, "Financial Focus To Attack Crisis – Threats to National Security Center on Economics As Much as on Missiles," Dow Jones Newswires. Published in *The Wall Street Journal*, July 19, 2000.

*prosperity, to the financial health and political stability of most nations, and ultimately to international security itself.*⁶⁷ [Emphasis added.]

Related to this, Frank Veneroso analyzed the significance of the unprecedented scenario:

*Such an extensive exercise at such a high level suggested that the U.S. Fed and Treasury recognized the potential for a disastrous stock market collapse. We were most struck by the open discussion of radical and unconventional measures to contain any stock market decline.*⁶⁸ [Emphasis added.]

A *Euromoney* magazine journalist who covered the simulation described the reaction of participants to a hypothetical plunge in the U.S. stock market. In doing so, he revealed one of the “radical and unconventional measures” they considered:

The U.S. financial regulators’ first concern is the state of the U.S. stock market. They wonder whether to intervene as the Hong Kong Monetary Authority did in 1998 and buy a proportion of the country’s stock market.

*“I doubt if we have the resources to stop this market adjustment,” says one wise participant. They decide to convene the president’s working group on financial markets.*⁶⁹ [Emphasis added.]

What’s important is not that the participants dismissed the efficacy of intervening in the stock market. We know from Robert Heller’s suggestion and subsequent events that this can be achieved via the aggressive purchase of stock index futures. Rather, the fact that this option would even be considered is reasonable evidence that stock market intervention is a line policy-makers are willing to cross if it means averting a catastrophic plunge in equities.

The dissemination of the Council’s findings stemming from the scenario followed a discernable pattern. As Robert Parenteau observed:

By July 2000, a review of the exercise was opened up to “serious professionals from the financial markets, business, and the foreign policy and national security communities.” Clearly, the CFR had designed a very thorough operation from start to finish, and an operation that was meant to be noticed by more than just the anonymous policy officials directly participating in the exercise.

⁶⁷ Roger M. Kubarych, *Stress Testing the System: Simulating the Global Consequences of the Next Financial Crisis*. New York: Council on Foreign Relations Press, 2001, p. ix.

⁶⁸ Frank Veneroso, “Gold: The Investment Case, the Commodity Case” (March 21, 2003): http://www.canarc.net/reports/Zurich_Paper32103P.doc.

⁶⁹ David Shirreff, “Crisis simulation – U.S. experts play at global meltdown,” *Euromoney* (March 2000). Quoted in Robert Parenteau, “The Economics of Euphoria: Financialization and the U.S. Bubble.” Prepared for the Political Economy Research Institute Conference On Financialization of the Global Economy. November 28, 2001: <http://www.umass.edu/peri/pdfs/parenteau.2.0.drft.pdf>.

One can almost conceptualize the entire CFR Financial Vulnerabilities Project as a grand fire drill or training exercise of sorts meant to informally clue various players into their appropriate roles, and to reassure them should a real fire in financial markets start to burn.⁷⁰

Despite the highly unusual nature of the simulation, not to mention the calibre of the people involved, it received virtually no press in the U.S., save for the Dow Jones article cited above and a story by John Crudele.⁷¹ This was notable, as journalists from Reuters, Bloomberg, the *Wall Street Journal*, CNN, the *Los Angeles Times*, the *New York Times*, *Business Week* and the *Chicago Tribune* attended but apparently did not write about the financial war game or its related discussion forums.⁷² In sum, notwithstanding the obvious newsworthiness of the affair, its existence and conclusions were not readily disclosed to members of the public.

September 11th Response

The terrorist attacks of September 11th threatened to cause a panic in financial markets. Not surprisingly, the government put plans in place in the aftermath of the tragedy to avert a disastrous plunge in equity prices. Officially, these involved steps designed to ensure liquidity in the banking system and confidence in the minds of investors. At no point did the authorities advertise the possibility of direct market intervention.

This was made clear when Richard Grasso, then chief executive of the New York Stock Exchange, was asked on national television whether the government would support the stock market. The following is the transcript of an exchange that occurred on CNN's "Larry King Live":

Caller: *...I want to ask you quickly about the plunge protection team, where the federal government might bail out the stock market. Where is the accountability in America? Should the federal government be doing this?*

L. King: Well let's ask Richard this, Richard, do you think so?

⁷⁰ Robert Parenteau, "The Economics of Euphoria: Financialization and the U.S. Bubble." Prepared for the Political Economy Research Institute Conference On Financialization of the Global Economy (November 28, 2001): <http://www.umass.edu/peri/pdfs/parenteau.2.0.drft.pdf>. See page 72. This was a draft paper, and Parenteau subsequently removed this quote from the final version.

⁷¹ Admittedly, the Dow Jones story did appear in the *Wall Street Journal*. However, it was authored by a reporter who evidently did not attend the event and, in any case, it was published months after the simulation.

⁷² The following is a list of the journalists who attended or participated. In parentheses is the page of Kubarych's book on which they are listed. Bloomberg: Caroline Baum (138) and Art Pine (186); *New York Times*: Floyd Norris (139); CNN: Kathryn Pilgrim (172); *Chicago Tribune*: Richard C. Longworth and James O'Shea (177); *Business Week*: Michael Mandel (184); Reuters: Caren Bohan (184); *Los Angeles Times*: Peter Gosselin (186); *Wall Street Journal*: Bernard Wysocki (172).

*Grasso: Well Larry, these markets are the freest and the most open on earth. And the federal government's role is not to stabilize by buying securities. The federal government's role as the Federal Reserve has indeed done is inject liquidity into the market system.*⁷³ [Emphasis added.]

A highly significant statement by a former top-level government official the day after the “Larry King Live” broadcast contradicts Grasso’s claim that the U.S. markets “are the freest and the most open on earth.” On September 17, 2001, ABC’s “Good Morning America” correspondent George Stephanopoulos addressed the actions taken by the government to ensure that equity prices did not plunge when trading resumed. According to a transcript we recently discovered, Stephanopoulos said the following:

Well, what I just want to talk about for a few minutes is the various efforts that are going on in public and behind the scenes by the Fed and other government officials to guard against a free-fall in the markets. You reported just a while ago that the Fed has lowered the overnight interest rates, will put about \$80 billion into the market. In addition, the SEC, the Securities and Exchange Commission, has relaxed the rules for companies on whether or not they can buy back their stock in case they start to fall.

And dozens of companies, including big companies like Intel and Cisco have announced that they would buy back their stock if necessary. Third, there will be some trading curbs in effect today. If the market drops by about 1,100 points, they will probably suspend trading for a while. *And perhaps most important, there's been – the Fed in 1989 created what is called a plunge protection team, which is the Federal Reserve, big major banks, representatives of the New York Stock Exchange and the other exchanges, and there – they have been meeting informally so far, and they have kind of an informal agreement among major banks to come in and start to buy stock if there appears to be a problem.*⁷⁴ [Emphasis added.]

London’s *Observer* newspaper reported similar information:

The U.S. Federal Reserve and Wall Street's powerful investment banks are preparing to spend billions of dollars to support the U.S. stock market, which opens this week for the first time since last Tuesday's terrorist attacks on New York and Washington.

A secretive committee – the Working Group on Financial Markets, dubbed “the plunge protection team” – includes bankers as well as representatives of the New York Stock Exchange, Nasdaq and the U.S.

⁷³ Transcript of CNN “Larry King Weekend.” “Special Edition: America’s New War.” September 16, 2001.

⁷⁴ Transcript of ABC News “Good Morning America. “Newscast: SEC relaxing rules to help stock exchanges; Banks agreeing to help if market gets in trouble.” September 17, 2001.

Treasury. It is ready to co-ordinate intervention by the Federal Reserve on an unprecedented scale.

The Fed, supported by the banks, will buy equities from mutual funds and other institutional sellers if there is evidence of panic selling in the wake of last week's carnage.

The authorities are determined to avert a worldwide slump in share prices like the crashes of 1987 or 1929. Investment banks and their broking subsidiaries are to block short-selling by speculators and hedge funds by making it hard for them to obtain prices on favourable terms.

“Everyone is eager to avoid ‘contagion,’ where prices fall rapidly as investors react lemming-like to a falling index,” said one banker.

In addition, U.S. regulators are prepared to ease rules that prevent companies from buying their own stock.

The “plunge protection team” was established by a special executive order issued by former President Ronald Reagan in 1989. It is known to include senior bankers at leading Wall Street institutions such as Merrill Lynch and Goldman Sachs. *It has acted before, in the early Nineties and during the 1998 LTCM hedge fund crisis.*⁷⁵ [Emphasis added.]

Another U.K. newspaper, the *Scotsman*, echoed this:

Concerted action is planned by Wall Street's most powerful investment banks and financial authorities to prevent a catastrophic collapse in share prices when U.S. stock markets resume trading today.

Over the weekend a group of top financiers from the world's largest and most powerful investment banks agreed to take concerted action to “underpin” the New York Stock Exchange and Nasdaq markets.

They are prepared to throw huge amounts of cash to prevent a run on the U.S. dollar and to prevent ...stock prices going into freefall.

The “Plunge Protection Team,” as it has been dubbed, comprises the heads of some of the most powerful global financial institutions and includes investment banks like Morgan Stanley, Citigate Group⁷⁶ and

⁷⁵ Richard Wachman and Jamie Doward, “Fed to Prop up Wall Street,” *The Observer* (September 16, 2001): <http://observer.guardian.co.uk/business/story/0,6903,552535,00.html>.

⁷⁶ This was probably an error. In all likelihood, it should be Citigroup, not Citigate. The former is a U.K. consulting company. Other articles mention Citigroup as an apparent member of the Plunge Protection Team.

Schroders Salomon Smith Barney,⁷⁷ and leading brokers such as Merrill Lynch and Goldman Sachs.

*The team also includes members of the Securities and Exchange Commission, Alan Greenspan's Federal Reserve Bank and NYSE chairman Richard Grasso.*⁷⁸ [Emphasis added.]

Similar to what the *Observer* reported, the *Scotsman* added that, "Other possible protection measures include purchases of equities held by mutual funds and other institutions if panic selling begins."⁷⁹

The *Guardian* newspaper was very specific as to some of the private-sector coordination that occurred, demonstrating that at a minimum the major investment banks and brokerage houses met together:

The scale of the damage inflicted on Wall Street appears to have prompted some unprecedented actions in the hours after the terrorists struck the twin towers.

At least six men, arguably among the most powerful non-governmental bankers in the world, put in place a pact to ensure that the global financial system was not ruptured.

They put a halt to any speculation or risky trades. They agreed to help each other (and their rivals) if anything failed to settle – or simply if the market just moved too fast. Unpaid bills would not be chased. They also agreed, of course, to help each other cope with the human cost, the search for missing staff.

*The six – Citigroup's Sandy Weill, William Harrison of JP Morgan Chase, Phil Purcell of Morgan Stanley, John Mack of Credit Suisse First Boston, John Thain of Goldman Sachs and David Komansky of Merrill Lynch – were joined by top bankers at Bear Sterns and Lehman Brothers.*⁸⁰ [Emphasis added.]

Whether any actual intervention occurred is not clear. However, the *Observer* noted weeks later:

⁷⁷ This is the European company resulting from the merger of Citigroup's "Salomon Smith Barney unit with Schroder Plc's investment banking business." See Citigroup press release, "Schroder Salomon Smith Barney Merger Completed" (May 01, 2000): <http://www.citigroup.com/citigroup/press/2000/000501a.htm>.

⁷⁸ Ian Watson and Andrew Turpin, "U.S. Banks Take Action to Prevent Wall Street Collapse," *The Scotsman* (September 17, 2001).

⁷⁹ *Ibid.*

⁸⁰ *The Guardian*, "This Crisis is Only Just Beginning" (September 15, 2001): <http://www.guardian.co.uk/september11/story/0,11209,601145,00.html>.

Analysts say the Working Group on Financial Markets, nicknamed the “Plunge Protection Team,” was extremely successful in helping coordinate a response across the markets when they reopened last Monday.

The team was set up in the late eighties by Ronald Reagan and came into its own in 1998 when it drew up an emergency response in the wake of the collapse of the giant hedge fund, Long Term Capital Management. In the past it has comprised Fed Chairman Alan Greenspan, U.S. Treasury Secretary Paul O’Neill, the heads of the various U.S. stock exchanges and the bosses of a handful of leading investment banks.

However, this time around no fewer than 35 individuals – including representatives of other central banks – are thought to have been in the team.

The challenge was to agree on how to react to the events. Harmony was in danger of being jeopardised when the members representing investment banks clashed with those representing the stock exchanges, who wanted an early resumption to trading. The banks, for their parts, were concerned that staff and infrastructure were too battered to resume in the same week as the attacks.

Eventually the investment banking lobby won the day and *when the markets did open on Monday there was an unprecedented level of co-operation between the financial institutions.* Short selling seems to have been kept to a minimum as the banks resisted the temptation to bet on the markets plunging.⁸¹ [Emphasis added.]

The significance of all this is difficult to overstate. Nowhere in government statements about the Working Group on Financial Markets or the *Washington Post* article detailing its activities is mention made of private-sector membership.⁸² Although the Working Group is supposed to consult with, among others, “major market participants to determine private sector solutions wherever possible,”⁸³ this is a far cry from the role described by the media reports cited above. They indicate that the banks were not simply consulted about issues, but instead played an integral role in implementing the agenda of the Plunge Protection Team. Along these lines, George Stephanopoulos claimed that the PPT had “kind of an informal agreement among major banks to come in and start to buy

⁸¹ *The Observer*, “Preventing the ‘Plunge,’” (September 23, 2001): <http://www.guardian.co.uk/wtccrash/story/0,1300,556432,00.html>.

⁸² Indeed, there is no mention of private-sector membership in a background of the Working Group provided by the U.S. Treasury in November 2003. See Department of the Treasury, “Statement By Treasury Secretary John Snow Following Today’s Meeting of the President’s Working Group on Financial Markets,” November 14, 2003.

⁸³ Executive Order 12631 – Working Group on Financial Markets, U.S. National Archives and Records Administration (March 18, 1988): http://www.archives.gov/federal_register/codification/executive_order/12631.html.

stock if there [appeared] to be a problem.”⁸⁴ So while many people exaggerated the revelations explicitly made in the 1997 *Washington Post* article, their suspicions were apparently correct after all.

Stephanopoulos was in a position to know, and it is this fact that separates his public statement about the Plunge Protection Team from all others. As noted in a biography:

Mr. Stephanopoulos served in the Clinton administration as the senior advisor to the president for policy and strategy. He was a key strategist in both Clinton presidential campaigns and was involved in the development of virtually all major policy initiatives during President Clinton’s first term in office.⁸⁵

Of note, Stephanopoulos states that the Federal Reserve created the PPT in 1989.⁸⁶ This is significant because it differs from the publicly known details about the Working Group on Financial Markets. As explained earlier, President Reagan created the Working Group in 1988. While a small detail on the surface, it tends to support what journalist Nelson Hultberg wrote in 2003, where he found a link between the PPT and the Robert Heller *Wall Street Journal* op-ed described earlier:

Bill King of the highly regarded King Report in New York tells us that the PPT sprang from an analysis written and presented by former Fed Governor Robert Heller in 1989. After his paper was published is when the PPT agenda was formalized.

King refers to his associate John Crudele’s writing on the subject of how the stock market was to be rigged.

“Heller had just left the Fed when he gave a speech suggesting that the central bank should step in and take direct action to keep the stock market from collapsing. The Fed had taken action before. It made sure there was enough liquidity during the crash of ’87 to keep the system going. It may have even strong-armed a few banks into propping up the market. And it has often lowered interest rates at opportune times.

“But Heller’s idea was different. He wanted a more direct approach, especially when the bond and currency markets were becoming uncontrollable... Heller believed that in an emergency, the Fed should start buying stock index futures contracts until it managed to pull stocks out of their nosedive. Essentially, whenever there is heavy buying of these

⁸⁴ Transcript of ABC News “Good Morning America.” “Newscast: SEC relaxing rules to help stock exchanges; Banks agreeing to help if market gets in trouble.” September 17, 2001.

⁸⁵ ABC Media Net, Biography of George Stephanopoulos:
<http://www.abcmedianet.com/shows03/news/correspondents/stephanopoulos.shtml>.

⁸⁶ Transcript of ABC News “Good Morning America.” “Newscast: SEC relaxing rules to help stock exchanges; Banks agreeing to help if market gets in trouble.” September 17, 2001.

futures contracts it causes the underlying stock market to rise. The futures contracts can be bought cheaply; they are highly leveraged so you can get more bang for your buck, and they eliminate the need for a rigger to purchase, say, all 30 stocks that make up the Dow. Heller explained that the process was simple. And it is. The trouble is, the government never has had authority to rig the stock market.” [email from Bill King, March 11, 2003 – kingreport@ramkingsec.com]

King, who at the time was running several equity trading desks in New York, goes on to say that it was during Q1 of 1990, as the Japan bubble was bursting, that massive S&P futures buying began to be used extensively by the trusted agents of the PPT, big “name” brokers in New York. During the crises of the late 90’s, this massive buying increased even more. By this time, many skeptics of such manipulation in the investment advisory business began to realize it was definitely taking place.⁸⁷ [Emphasis added.]

According to Hultberg, King says it was during the first quarter of 1990 “that massive S&P futures buying began to be used extensively by the trusted agents of the PPT.”⁸⁸ Along these lines, after September 11, the *Observer* stated that the PPT had previously acted in the early 1990s.⁸⁹ Furthermore, John Crudele wrote in a February 20, 1990, article that “the stock index futures markets were buzzing with rumors that Washington was putting pressure on big trading houses to give the market a lift.”⁹⁰ This was mere months after Heller’s proposal and thus may represent the effective entrenchment of market intervention in U.S government policy. The 1987 and 1989 rescues confirmed by former National Security Council economist Norman Bailey, by contrast, would appear to have been ad hoc activities. These likely were implemented with official approval, but not yet firmly instituted as the government’s typical response to a market plunge.

Stephanopoulos’s list of the Plunge Protection Team’s members coincides almost exactly with a statement made by an investment banking head days after September 11. Speaking on CNBC, John Mack, then chief executive of Credit Suisse First Boston, said the following:

The meeting yesterday was clear, number one concern of all the firms, of the New York Stock Exchange, of the Federal Reserve, the SEC, we need to pull together. We need to help each other. We need to especially help

⁸⁷ Nelson Hultberg, “Cornered Rats and the PPT” (March 26, 2003): http://www.gold-eagle.com/editorials_03/hultberg032603.html.

⁸⁸ Ibid.

⁸⁹ Richard Wachman and Jamie Doward, “Fed to Prop up Wall Street,” *The Observer* (September 16, 2001): <http://observer.guardian.co.uk/business/story/0,6903,552535,00.html>.

⁹⁰ John Crudele, “Don’t Bet on Greenspan as Forecaster,” *St. Louis Post-Dispatch* (February 20, 1990).

the families that have been affected and need to really stand very tall as Americans and help our country.⁹¹ [Emphasis added.]

A close comparison between this statement and the remarks of George Stephanopoulos on ABC is revealing. Stephanopoulos said the PPT included the “Federal Reserve, big major banks, representatives of the New York Stock Exchange and the other exchanges.”⁹² While not mentioning the PPT by name, John Mack reported that a meeting occurred after September 11 and apparently comprised “the firms... the New York Stock Exchange... the Federal Reserve, [and] the SEC.”⁹³ Other than the SEC,⁹⁴ the two lists are the same, suggesting that accidental leaks by the former presidential adviser and the CSFB chief executive have essentially confirmed the existence of a PPT that includes the private sector. Furthermore, the list provided by John Mack is exactly identical to one detailed by the *Scotsman* newspaper, where they claimed that the PPT includes firms as well as “members of the Securities and Exchange Commission, Alan Greenspan’s Federal Reserve Bank and NYSE chairman Richard Grasso.”⁹⁵

The fact that the publicly acknowledged Working Group and the unspoken PPT differ in their constitutions might explain a report from the U.S. General Accounting Office in 2000. It stated: “Agency officials involved with the Working Group were generally averse to any formalization of the group and said that it functions well as an informal coordinating body.”⁹⁶ As formalization would no doubt restrict the ability of the Working Group to grant status to the private sector, the reluctance of government officials to do so is not surprising. Instead, the government has apparently used the publicized Working Group as clever cover for the activities of the Plunge Protection Team. This possibility is supported by press reports cited previously in which the Working Group and the PPT are referred to interchangeably.

LTCM Revisited

The global financial system nearly came unglued when hedge fund Long Term Capital Management required a Fed-organized private-sector bailout to avert a failure that could

⁹¹ Transcript of CNBC “Squawk Box.” “Newscast: Squawk Box, 8:30 AM; today’s business news.” September 14, 2001. We originally discovered this interview with John Mack in a September 17, 2001, article entitled “Solidarity to Combat Adversity,” which appeared in the *Financial News*. However, there was a slight discrepancy over what the CSFB chief executive was reported to have said. Thus, we have used a transcript of the show itself rather than what appears to be close paraphrasing by the *Financial News*.

⁹² Transcript of ABC News “Good Morning America.” “Newscast: SEC relaxing rules to help stock exchanges; Banks agreeing to help if market gets in trouble.” September 17, 2001.

⁹³ Transcript of CNBC “Squawk Box.” “Newscast: Squawk Box, 8:30 AM; today’s business news.” September 14, 2001.

⁹⁴ It is doubtful that the SEC plays anywhere near as integral a role in the PPT as the Federal Reserve, exchanges and firms. Thus, Stephanopoulos’s exclusion is fairly immaterial.

⁹⁵ Ian Watson and Andrew Turpin, “U.S. Banks Take Action to Prevent Wall Street Collapse,” *The Scotsman* (September 17, 2001).

⁹⁶ United States General Accounting Office, “Financial Regulatory Coordination: The Role and Functioning of the President’s Working Group” (January 2000), p. 3:
<http://www.gao.gov/new.items/gg00046.pdf>.

have triggered widespread havoc in numerous financial markets. Leveraged many times its capital, LTCM came perilously close to collapse when currency and credit markets moved against the firm's trades. Concerned about the potential risk of global contagion, the Fed decided to step in.

A second look at the LTCM saga reveals greater intervention and coordination than previously thought.⁹⁷ Speaking about the Plunge Protection Team shortly after September 11, George Stephanopoulos went on to say the following:

*I don't know if you remember, but in 1998, there was a crisis called the long-term capital crisis. It was a major currency trader, and there was a global currency crisis. And they, at the guidance of the Fed, all of the banks got together when that started to collapse and propped up the currency markets. And they have plans in place to consider that if the stock markets start to fall.*⁹⁸ [Emphasis added.]

A review of markets at the time suggests that the "global currency crisis" referred to by Stephanopoulos⁹⁹ was rooted in the yen carry-trade. Popular among hedge funds and other speculators, the trade involved borrowing yen at extremely low rates of interest, selling it for another currency and investing the proceeds in higher-yielding debt instruments. For years, the large interest rate differentials between Japan and the United States allowed speculators to profit handsomely by borrowing yen and investing in U.S. Treasuries. In addition, the Bank for International Settlements noted: "The yen carry trade has reportedly been a fairly widespread strategy since the yen started its declining trend in the spring of 1995."¹⁰⁰

With the demise of LTCM, speculators short the yen and long the dollar via the carry-trade rushed to unwind their positions. Anecdotal evidence suggests that LTCM itself was caught on the wrong side of the trade,¹⁰¹ and it may have precipitated the cascade that would follow. As Stephanopoulos recounts, there was indeed a crisis in the currency markets. In two days, October 7 and 8, 1998, the dollar plummeted approximately 18% against the yen as dollar investments were liquidated. The Federal Reserve would later describe the situation as follows:

⁹⁷ This does not include credible reports of a large LTCM gold short position that may have been assumed by either investment banks or the government.

⁹⁸ Transcript of ABC News "Good Morning America." "Newscast: SEC relaxing rules to help stock exchanges; Banks agreeing to help if market gets in trouble." September 17, 2001.

⁹⁹ It should be noted that Stephanopoulos left the Clinton administration at the end of 1996. Thus, he was not in government for the LTCM rescue.

¹⁰⁰ Bank for International Settlements (Monetary and Economic Department), *BIS Quarterly Review: International Banking and Financial Market Developments*, p. 34 (March 1999): http://www.bis.org/publ/r_qt9902.pdf.

¹⁰¹ One press report stated: "...according to one dealer, there has been speculation that troubled hedge fund Long Term Capital Management unloaded \$10 billion of a \$35 billion dollar position." See "Dollar Stays Soft Vs Yen – Another Volatile Day Eyed," *Market News International* (October 8, 1998).

Although the dollar began the period at ¥136.50, it soon depreciated suddenly and sharply as hedge funds and other speculative accounts liquidated long dollar positions in an effort to reduce risk, deleverage balance sheets, and cover losses incurred in other markets. On October 7, the dollar-yen exchange rate fell 6.7 percent, from ¥133.90 to ¥120.55 – the largest percentage change in one day since 1974. Volatility in the exchange rate intensified during the following morning’s New York trading session, with the dollar falling to a low of ¥111.58 but then suddenly rebounding to a high of ¥123.40.¹⁰²

Given the dollar plunge that occurred in early October around the time of LTCM, Stephanopoulos’s remark provides the key insight into how the U.S. authorities apparently prevented a possible collapse of the world’s reserve currency. After the dollar sank to nearly 110 yen, the Fed likely instructed the large banks to actively buy the dollar against the yen and also to refrain from unwinding their own yen carry-trades. One thing seems clear: The U.S. government did not directly intervene in currency markets. Published transaction data shows no reference to Exchange Stabilization Fund dollar purchases in the fall of 1998.¹⁰³ Confirming this, the Federal Reserve later stated that, “The U.S. monetary authorities did not intervene in the foreign exchange markets during the quarter.”¹⁰⁴ Thus, the apparent inactivity of the U.S. government, combined with the dollar’s sudden recovery, would appear to corroborate Stephanopoulos’s claim that it was the major banks who took action to diffuse the crisis.

The dollar’s miraculous recovery, apparently thanks to large Wall Street firms, provides a rare glimpse into recent market interventions by the U.S. government. Rather than intervene directly in the markets themselves, the U.S. central bank evidently gave instructions to trusted surrogates who did the Fed’s bidding. Importantly, the Fed apparently did not merely provide instructions to each bank separately. Stephanopoulos stated that at the time of LTCM’s collapse, “all of the banks got together” to prop up the currency markets.” This was clearly a collaborative effort.

The LTCM revelation is also significant because it indicates that the Plunge Protection Team isn’t merely concerned with the stability of the stock market. Supporting this, a report cited earlier from the *Scotsman* newspaper stated that in the aftermath of September 11, the PPT would “also attempt to deflect any pressure on commodity markets.”¹⁰⁵

¹⁰² See Federal Reserve, “Treasury and Federal Reserve Foreign Exchange Operations,” *Federal Reserve Bulletin*, March 1999 (p. 178): <http://www.federalreserve.gov/pubs/bulletin/1999/0399forx.pdf>.

¹⁰³ See U.S. Treasury-Exchange Stabilization Fund (U.S. Intervention, 1993 – 2000): <http://www.treas.gov/offices/international-affairs/esf/history/Intervention93-00.shtml>.

¹⁰⁴ See Federal Reserve, “Treasury and Federal Reserve Foreign Exchange Operations,” *Federal Reserve Bulletin*, March 1999 (p. 178): <http://www.federalreserve.gov/pubs/bulletin/1999/0399forx.pdf>.

¹⁰⁵ Ian Watson and Andrew Turpin, “U.S. Banks Take Action to Prevent Wall Street Collapse,” *The Scotsman* (September 17, 2001). Observers of the gold market should not be surprised by the report that the PPT would “attempt to deflect any pressure on commodity markets.”

Taken together, these revelations demand a radical revision of prevailing beliefs about the current state of markets, not to mention the relationship between the private sector and the U.S. government. If major financial institutions are knowingly implementing government policy with regards to important markets, they have essentially become de facto agencies of the state. Just as importantly, the government's role has also changed markedly. Previously content not to intervene in certain spheres, now the Fed and Treasury apparently regard the stabilization of markets to be within their responsibilities.

The continuing silence of government officials about this expanded reach is easily explained. First, they no doubt recognize that an electorate supportive of free markets would frown upon market interventions. More pragmatically though, the government must also realize that to publicly acknowledge such activities would be to invite the greatest of moral hazard situations. To use a famous quote, the risks would be socialized while the rewards would remain privatized. Such a disconnect invites increasingly reckless speculation by investors who believe that the government stands ready to rescue them should crises arise.

Between Iraq and a Hard Place

The lead-up to the Iraq invasion stands as the most recent instance in which we can reasonably document planned U.S. government intervention in equity markets. On March 13, 2003, a Japanese news outlet reported the following:

Haruhiko Kuroda, adviser to Japanese Prime Minister Junichiro Koizumi's cabinet, will visit the United States from Thursday to discuss how to stabilize financial markets amid the crisis over Iraq.

During his three-day visit, Kuroda, former vice finance minister for international affairs, will meet with Federal Reserve Chairman Alan Greenspan, Treasury Undersecretary for International Affairs John Taylor and other U.S. officials.

They are expected to discuss monetary policy and measures to cope with possible stock market tumbles in the event of a war in Iraq.¹⁰⁶ [Emphasis added.]

Nearly a week later, Agence France-Presse relayed the outcome of Mr. Kuroda's trip to the United States:

Japan and the United States have agreed to cooperate to take action in financial markets if a crisis occurs, Chief Cabinet Secretary Yasuo Fukuda said Wednesday as a war in Iraq appeared just days away.

¹⁰⁶ "Japan to Send Cabinet Adviser Kuroda to U.S.," *Jiji Press* (March 13, 2003).

The agreement was reached when former vice minister of finance for international affairs Haruhiko Kuroda travelled to the United States last week to meet key economic figures, including Federal Reserve chairman Alan Greenspan.

“There was an agreement between Japan and the U.S. to take action cooperatively in foreign exchange, stocks and other markets if the markets face a crisis,” Fukuda told a news conference.¹⁰⁷ [Emphasis added.]

The *London Daily Telegraph* conveyed similar information, stating:

Finance officials in Washington and Tokyo yesterday agreed [on] a joint plan to intervene in currency and stock markets if the war in Iraq sparks a global financial crisis.

Following top level talks between the Federal Reserve chairman Alan Greenspan and Japan’s former finance minister Haruhiko Kuroda, each side is poised to step in should investors show signs of panicking.¹⁰⁸ [Emphasis added.]

The U.S. Treasury did not directly refute Fukuda’s statement that the two countries planned to “take action cooperatively in foreign exchange, stocks and other markets if the markets [faced] a crisis.” Nevertheless, speaking of the meetings between the former Japanese finance minister and Washington counterparts, a Treasury official stated that, “The discussions were routine and touched on a range of economic and financial issues.”¹⁰⁹ He further claimed: “The administration’s views on markets and interventions are well known and there has been no change in our view.”¹¹⁰ Once again, the government failed to acknowledge the interventionist reality.

Curiously, the agreement between Japan and the United States did not make the American press. Further, it coincided with speculation that markets were being fine-tuned in preparation for the invasion of Iraq. London’s *Evening Standard* newspaper referred to suspicious trading patterns:

Stock markets rallied last week because it looked as if war with Iraq was going to be postponed. Yesterday the markets rallied because it looked like the war was about to begin. The two reasons contradict each other.

¹⁰⁷ “States agree to cooperate to keep markets stable: Fukuda,” *Agence France-Presse* (March 19, 2003).

¹⁰⁸ Simon English, “America and Japan Poised to Intervene,” *Daily Telegraph* (March 19, 2003).

¹⁰⁹ “U.S. Treasury – Views on markets, intervention unchanged,” *Reuters News* (March 19, 2003). Excerpt published in Sean Corrigan, “He Really Shouldn’t Have Said That, Should He?” (March 21, 2003): <http://www.scoop.co.nz/stories/HL0303/S00181.htm>.

¹¹⁰ *Ibid.*

The explanations do not make sense unless the markets are being rigged.¹¹¹

It continued:

*The more astute watchers of markets say that the only explanation for what began last week and continued yesterday was a U.S. government-inspired support action to get markets where they wanted before the outbreak of hostilities.*¹¹² [Emphasis added.]

The View From Now

The road to Baghdad in March 2003 may represent the last planned stock market intervention that we can identify, but our suspicions linger on to the present day. Displaying markedly low volatility, the Dow hovers comfortably above the 10,000 mark. Yet with severe trade and budget deficits, rising interest rates and stubbornly high oil prices, the reasons to be bearish on U.S. equities are numerous. Strangely, the market has an uncanny ability to maintain its footing when serious declines threaten. Given the historical backdrop of U.S. government activity in the market, this curious trading activity is suspicious to say the least. Indeed, it is our belief that market intervention continues and has actually increased in intensity.

For a possible explanation of why this may be happening, we turn to a rather extraordinary article that appeared in the *Financial Times* in March 2002. After noting the public revelation that the Federal Open Market Committee considered unconventional policy measures at its January 2002 meeting to cope with a possible deflation,¹¹³ the story revealed that

a senior Fed official who attended the meeting said the reference to “unconventional means” was “commonly understood by academics.”

*The official, who asked not to be named, would not elaborate but mentioned “buying U.S. equities” as an example of such possible measures, and later said the Fed “could theoretically buy anything to pump money into the system” including “state and local debt, real estate and gold mines – any asset.”*¹¹⁴ [Emphasis added.]

¹¹¹ Anthony Hilton, “Plunge Protection and Rallying Shares,” *Evening Standard* (March 19, 2003): <http://www.thisislondon.com/news/business/articles/timid60605>.

¹¹² Ibid.

¹¹³ Federal Reserve, Minutes of the Federal Open Market Committee (January 29–30, 2002): <http://www.federalreserve.gov/fomc/minutes/20020130.htm>.

¹¹⁴ Peronet Despeignes, “Fed considered emergency measures to save economy,” *Financial Times* (March 25, 2002).

The Fed's aggressive easing of monetary policy after the tech bubble burst no doubt helped stave off a potential lapse into deflation. But the threat remains. As Myles Zyblock, Chief Institutional Strategist of RBC Capital Markets, recently commented:

Global policymakers are facing one of the most challenging backdrops in decades. The combination of excessive credit creation and extremely low inflation creates a potentially lethal mixture that, if left unchecked, could undermine the financial system and the economy. We need only to remind ourselves of the huge run-up in debt and the impact of its subsequent collapse on the economies of the U.S. in the 1930s and Japan in the 1990s to recognize the risks inherent in the present situation.

The U.S. lies at the heart of this new danger.... [T]otal debt (i.e., foreign, private and government) has risen 70 percentage points since the mid-1990s to about 307% of GDP – an all-time high! At the same time, inflation is hovering near a multi-decade low. A debilitating debt-deflation in this overleveraged economy is a possibility. The authorities have learned from the mistakes made by their predecessors and have embarked upon one of the most aggressive reflationary campaigns in post-war history in the hopes of producing strong tailwinds in order to thwart the risks.¹¹⁵

Many people have noted that the Federal Reserve Act does not explicitly permit the central bank to purchase equities.¹¹⁶ Nevertheless, the significance of the statement in the *Financial Times* article by the anonymous Fed official should not be downplayed. For an organization not prone to unauthorized leaking, it is reasonable to assume that, much like the 1997 *Washington Post* story about the Working Group on Financial Markets, this remark about “buying U.S. equities” was not made without regard to the consequences of such a disclosure. In other words, as David Tice of the Prudent Bear Fund observed in 2003: “It would be naïve in the extreme to assume that a central bank notorious for its supine treatment of markets would be insensitive to the effect the news of these [FOMC] deliberations would have on the equity market.”¹¹⁷ He continued by arguing that

any support lent to the market would likely remain covert providing that a sufficiently large critical mass of fund managers understood that there were support mechanisms at work in the market. The references to “unconventional measures” in the *FT* article help to create this “understanding.”

Such an implicit understanding on the part of these managers would facilitate their ability to trade on the back of periodic covert interventions,

¹¹⁵ Myles Zyblock (RBC Capital Markets), *Global Gold Outlook*, June 28, 2005, p. 17.

¹¹⁶ See, for example, Ted Wieseman (Morgan Stanley), “Debunking the Conspiracy Theory” (July 18, 2002): <http://www.morganstanley.com/GEFdata/digests/20020718-thu.html>.

¹¹⁷ David Tice, “When Central Bankers Become Asset Managers” (April 5, 2002): http://www.gold-eagle.com/gold_digest_02/tice040502.html.

thereby supporting government objectives. In these circumstances, policy makers would likely do nothing to disavow such a belief (and might in fact quietly encourage it), since the herding dynamics of these portfolio managers would enhance the authorities' objective of supporting the market. Only after this option has proved wanting would the authorities move to explicit intervention.

Why explicit? The public does not react to inferences and hidden coded messages by America's leading policy makers in the way in which a professional fund manager well attuned to the vagaries of the market would.¹¹⁸

Tice concluded by noting a worrisome implication of the *Financial Times* article:

The *FT* disclosure is particularly ironic given that just last week the Fed chairman again professed his belief in market forces as the best means of curtailing weaknesses in the corporate governance exposed by the collapse of Enron. An incredible statement coming from a man who has become synonymous with the perversion of the very free market forces he regularly extols. Has any other central banker ever had a put named after him? But Mr. Greenspan and his colleagues seem dead keen to establish moral hazard precedents as far as the eye can see, leaving the rest of us to deal with its exceptionally messy consequences when these "extraordinary measures" stop working.¹¹⁹

Conclusion

Given the available information, we do not believe there can be any doubt that the U.S. government has intervened to support the stock market. Too much credible information exists to deny this. Yet virtually no one ever mentions government intervention publicly, preferring instead to pretend as if such activities have never taken place and never would. It is time that market participants, the media and, most of all, the government, acknowledge what should be blatantly obvious to anyone who reviews the public record on the matter: These markets have been interfered with on numerous occasions. Our primary concern is that what apparently started as a stopgap measure may have morphed into a serious moral hazard situation, with market manipulation an endemic feature of the U.S. stock market.

We have not taken a position on the wisdom of intervention in this paper, largely because exceptional circumstances could argue for it. In many respects, for instance, the apparent rescue after the 1987 crash and the planned intervention in the wake of September 11 were very defensible. Administered in extremely small doses and with the most stringent safeguards and transparency, market stabilization could be justified.

¹¹⁸ Ibid.

¹¹⁹ Ibid.

But a policy enacted in secret and knowingly withheld from the body politic has created a huge disconnect between those knowledgeable about such activities and the majority of the public who have no clue whatsoever. There can be no doubt that the firms responsible for implementing government interventions enjoy an enviable position unavailable to other investors. Whether they have been indemnified against potential losses or simply made privy to non-public government policy, the major Wall Street firms evidently responsible for preventing plunges no longer must compete on anywhere near a level playing field. It is most unfair that the immensely powerful have been further ensconced in their perched positions and thus effectively insulated from the competitive market forces ostensibly present in our society.

In addition to creating a privileged class, the manipulation also has little democratic legitimacy in the sense that the citizenry has not given its consent. This has tangible ramifications. By not informing the public, successive U.S. administrations have employed a dangerous policy response that is subject to the worst possible abuse. In this regard, the line between national necessity and political expediency has no doubt been perilously blurred.

We can only urge people to see what the evidence indicates and debate what is and ought to be a very contentious matter. The time for such a public discussion is long overdue.

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