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The Deregulator

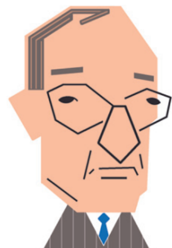
A Less-Visible Role For the Fed Chief: Freeing Up Markets

Greenspan Blessed Mergers And Blocked Regulation; Using the 1800s as a Model

Is Modern Finance Too Risky?

By Greg Ip

WASHINGTON—As Alan Greenspan approaches his last year as chairman of the Federal Reserve Board, he continues to draw praise for his most visible job: steering the economy by raising and lowering interest rates. But behind the scenes, the 78-year-old economist has had a big impact on American life in an entirely different role: pushing the government to stay out of financial markets.



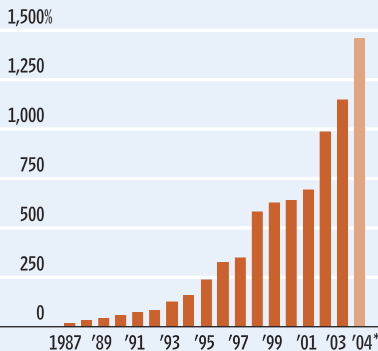
GREENSPAN'S LEGACY
Second of Two Articles

Consider what happened in 2002, when Democratic Sen. Dianne Feinstein proposed new rules to govern how traders buy and sell contracts to deliver energy through financial instruments known as derivatives. Her move came after Enron Corp. and others helped send electricity prices soaring in California by manipulating that market. When she telephoned Mr. Greenspan for support, he declined, telling her the proposal threatened the multitrillion dollar derivatives industry, which he considers an important stabilizing force that diffuses financial risk.

Mr. Greenspan persuaded other Bush-appointed regulators to join him in a critical letter that Sen. Feinstein's opponents wielded as a weapon on the Senate floor. The bill was narrowly defeated on a procedural motion. Sen. Feinstein reintroduced the proposal a number of times and at least twice Mr. Greenspan rallied fellow regulators to oppose it. "I believe it would have passed without his opposition," Sen. Feinstein says.

An Invisible Hand

Derivatives, which Alan Greenspan sees as a key economic stablizer, have soared as a percentage of U.S. gross domestic product.



Note: Chart shows the notional value of interest rate, currency and credit derivatives as a percentage of U.S. gross domestic product

Sources: International Swaps & Derivatives Association; Commerce Department *First half

In addition to thwarting the post-Enron impulse to regulate derivatives, Mr. Greenspan has helped remove Depression-era barriers between the banking and securities industries and has blessed mergers creating banking behemoths. He has implored regulators to keep their hands off hedge funds and other markets that are replacing banks as financiers of American business. Although the Fed is a major bank regulator, it has become a less intrusive one under Mr. Greenspan.

Behind this advocacy is a passionate belief that freely functioning financial markets are better than government regulators—and even central bankers—at protecting the economy from booms and busts. Mr. Greenspan once read that a B-2 "stealth" bomber would crash without a computer that continuously adjusted its wing flaps. In conversations, he compares markets to the B-2's computer: They continuously redistribute risk so the economy can absorb shocks.

The result is a paradoxical position for one of the world's most influential civil servants: He would prefer that the state play virtually no role in the economy. His ideal is the pre-Civil War period when the federal government was so invisible it didn't even issue a national currency.

In reality, Mr. Greenspan sometimes tailors that radical position to suit the demands of his job—such as dealing with the near-collapse of hedge fund Long Term Capital Management—as well as the political requirements of surviving in Washington. But, on balance, his views have been powerfully influential in deregulating markets at a crucial time in their history when they are increasing in size, complexity, and the number of ways in which they interact with everyday people. With Mr. Greenspan's term set to end in January 2006, an important question is whether his successor will carry on this less visible role.

Critics say his hands-off regulatory philosophy has made the Fed a less effective watchdog, citing complicity by Fed-regulated banks in recent corporate scandals. His intellectual opponents also argue that some regulation is necessary to moderate the risks inherent in modern finance.

Mr. Greenspan first articulated many of his views in the 1960s when he was part of the intellectual circle surrounding libertarian philosopher Ayn Rand. If businesses were solely responsible for their own reputation, he said at the time, they would do whatever necessary to maintain it or ultimately fail.

"It is in the self-interest of every businessman to have a reputation for honest dealings and a quality product," he wrote in Ms. Rand's "Objectivist" newsletter in 1963. Regulation, he said, undermines this "superlatively moral system" by replacing competition for reputation with force. "At the bottom of the endless pile of paper work which characterizes all regulation lies a gun."

His language has moderated but he still admires the laissez-faire capitalism of the mid-19th century. At that time, competition, not regulation, kept financial markets honest. Banks, for example, issued their own currency whose value fluctuated with the issuer's reputation.

Mr. Greenspan believes the 19th-century economy was inherently stable because of the gold standard, a system in which currencies were exchanged for fixed amounts of gold both within the U.S. and across international borders. Countries that borrowed too much would hear from anxious foreign lenders demanding to be repaid in gold. To prevent that, banks would raise interest rates, encouraging lenders to stay put. Borrowing, which was now more expensive, would abate.

In Mr. Greenspan's view, this self-correcting economy was undermined by

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cumulative government intrusions. The first was the creation of a national currency and national banking system in 1863 whose flaws, he believes, contributed to periodic financial panics in following decades.

In 1913, the very organization in which he made his name, the Federal Reserve, was created. As the lender of last resort, the Fed could prop up failing banks, reducing the incentive for bankers and businessmen to act prudently. Market discipline weakened further when the government created federal deposit insurance in 1933, making depositors less concerned about the reputation of the bank to which they entrusted their money. That was compounded when the U.S. went off the gold standard in 1933.

Alan Greenspan

"A kind of vicious circle of government replacement of market oversight [was] clearly set in motion," he said in a May 2001 speech.

Mr. Greenspan has a complicated way of reconciling his job with his economic theories. In an ideal world, he believes, there would be a gold standard and no central bank. But the end of the gold standard and creation of the Fed weakened market discipline. That created a need for government intervention the Fed chairman must do his best to fulfill.

Few things are more important to Mr. Greenspan than keeping the government's hands off financial markets. Former Treasury Secretary Robert Rubin, among others, used to argue to Mr. Greenspan that governments should sometimes use regulation to moderate risks that stem from the complexity of modern markets. Mr. Greenspan was willing to tolerate occasional hiccups to encourage innovations that allow markets to operate more efficiently.

To those in the Rubin Treasury, this clash became known as the "wooden tennis rackets" debate. Mr. Rubin's notion, that governments should constrain markets, "was like saying tennis was a better game with wooden rackets," says Lawrence Summers, president of Harvard University and previously Mr. Rubin's deputy and successor at the Treasury. Mr. Greenspan would prefer rackets made with advanced alloys that delivered better shots even if they were occasionally wild.

Mr. Greenspan has long disparaged government-imposed limits on mergers. He came to the Fed an avowed opponent of the 1933 Glass-Steagall Act that established barriers between the banking and securities industries. The act was inspired by the belief that bank stock speculation helped cause the 1929 stock market crash and Great Depression; subsequent study casts doubt on this. The act split J.P. Morgan & Co. into two firms whose successors today are J.P. Morgan Chase & Co. and Morgan Stanley. Mr. Greenspan, as a director of J.P. Morgan in 1984, played a part in publishing that bank's anti-Glass-Steagall treatise, according to a book by historian Ron Chernow.

The Fed took its first step toward undoing Glass-Steagall in 1987, a few months before Mr. Greenspan's arrival. It further loosened restrictions in 1996. Two years later it precipitated the act's demise by approving the merger of Citicorp, parent of the U.S.'s second-largest bank, and Travelers Group, a major insurance underwriter and securities dealer.

The Fed's approval was conditional on Citigroup Inc.—the merged company—later divesting businesses not permitted. But Citigroup correctly bet the law would change. The merger prodded Congress to repeal the remaining barriers a year later.

"Greenspan pushed the envelope," says Kenneth Guenther, retired president of the Independent Community Bankers of America, a small-bank trade group that at the time unsuccessfully sued the Fed for pre-empting Congress.

Though Mr. Greenspan usually defers to his staff about regulatory matters, their recommendations have tended to track his laissez-faire approach. In his tenure, the Fed has approved the merger of every bank-holding company that has come before it except two. By contrast, his predecessor, Paul Volcker, scotched 10 mergers in an eight-year term. The U.S. now has three banking conglomerates with assets exceeding $1 trillion—Citigroup, J.P. Morgan Chase and Bank of America Corp.

Critics say these mergers concentrate financial risk too heavily in a few institutions. Mr. Greenspan argues that deregulation also produced a more stable financial system.

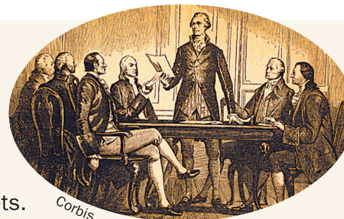
His favorite example comes from the telecommunications sector. Telecom companies borrowed almost $1 trillion between 1998 and 2001, but while many failed, no major financial institution collapsed as a result. Stock and bondholders lost money but banks that arranged the financing used innovative methods to spread their risk. Some sold pieces of loans to other institutions, underwrote bond offerings or bought hedges in the new market for "credit derivatives," insurance policies against companies defaulting.

"Even the largest corporate defaults in history—WorldCom and Enron—and the largest sovereign default in history—Argentina—have not significantly impaired the capital of any major U.S. financial intermediary," Mr. Greenspan said in a speech last month. Banks in the 1980s and early 1990s, by contrast, were crippled by bad loans to developing countries and real-estate developers. The resulting credit crunch hobbled the economy.

When markets give way to crisis, Mr. Greenspan has reluctantly given way to government intervention. In December 1997, the Treasury wanted banks to roll

Market Forces

Key moments in the history of intervention in U.S. financial markets.



Corbis

Alexander Hamilton, *as Secretary of the Treasury, presents the Constitution of the new Federal Bank to the Cabinet members.*

1791 Alexander Hamilton starts the first Bank of the United States. Dissolved in 1811.

1816 Second Bank of the United States chartered. Charter lapses in 1836

1863 National Bank Act, national currency issued

1907 Financial panic ends with intervention organized by J. Pierpont Morgan

1913 Federal Reserve formed

1933 Federal deposit insurance introduced

1933 Glass-Steagall Act bars combinations of banks, securities companies

1972 Financial derivatives first traded in Chicago futures markets

1978 States begin to allow interstate banking

1980 Monetary Control Act deregulates interest rates

1981 Over-the-counter derivatives are born with first currency "swap"

1987 Fed gives banks permission to sell bonds

1987 Fed slashes interest rates after stock-market crash

1995 Treasury, Fed bail out Mexico

1996 Fed significantly increases banks' ability to deal in securities

1998 Fed arranges rescue of Long Term Capital Management

1999 Glass-Steagall fully repealed

2000 Deregulated status of most derivatives entrenched in law

2001 Enron collapses

2004 SEC votes to register hedge funds

Source: WSJ research

over loans to South Korea to avert a global financial panic. Mr. Greenspan went along but told Treasury officials he wouldn't call the commercial banks himself, according to people involved in the effort. He argued it was inappropriate for a regulator to influence banks' lending practices. Instead, Mr. Rubin and then-New York Fed President William McDonough made the calls.

Mr. McDonough says in an interview that as a former commercial banker, he could convey to the banks that restructuring the loans was in their own best interest.

A bigger test came several months later, when the near-failure of hedge fund Long Term Capital Management threatened to halt trading in U.S. debt markets. Again, Mr. McDonough took the lead and brokered a buyout of the fund by its private creditors, including several Fed-regulated banks. While Mr. McDonough says he kept Mr. Greenspan informed, he didn't ask the Fed chief for approval. Testifying to Congress, Mr. Greenspan called the rescue one of "those rare occasions when otherwise highly effective markets seize up and ad hoc responses were required."

The LTCM debacle was an embarrassment to the Fed—which regulated some of the hedge fund's largest creditors—but Mr. Greenspan didn't think it suggested the Fed needed to significantly beef up its oversight operations. "If we had to meet the standards that people think exist, we would have five times as many examiners," he said at a Fed meeting that September, transcripts show. "We would examine them to death, and they would not have any breathing room." The Fed didn't take public disciplinary action against LTCM's lenders.

Congress was more worried about the economic risks inherent in hedge funds than the adequacy of the Fed's regulatory operations. In 1998, it asked the President's Working Group on Financial Markets, which included Mr. Greenspan and Mr. Rubin, to suggest how—if at all—to regulate hedge funds and "leverage," large financial bets made with borrowed money.

Mr. Rubin was open to increased regulatory oversight, say people involved in the process. Mr. Greenspan was not. He asked why government officials earning $80,000 or $100,000 would be any more likely to spot overly risky hedge-fund activities than the Wall Street experts, earning millions of dollars, who ran them, recalls Gary Gensler, the Treasury official who coordinated the group. Mr. Greenspan refused to endorse the most intrusive of the group's recommendations: expanding oversight over brokerage firms' unregulated affiliates.

Mr. Greenspan has also been skeptical of the value of the Fed's many consumer-protection rules. The only vote he has lost on the seven-member Federal Reserve Board was a 4-3 decision in 1995 that required banks to change the way they calculate savings-deposit rates. Some on the board felt the way the rate was calculated was misleading to the public. Weeks later, after banks protested the cost of the change, the board voted unanimously to suspend its action and the proposal didn't take effect.

In some ways, Mr. Greenspan has become less hostile to these kinds of rules. For example, he now sees some benefit to Fed-enforced laws that compel banks to do business in poor communities.

Although banks have been implicated in recent financial scandals, the Fed has often been slow to take decisive action. Critics note that it was private litigants and Senate investigators who first brought to light evidence that Citigroup and J.P. Morgan Chase helped Enron hide its true financial state from shareholders. Both were eventually charged by the Securities and Exchange Commission and reached settlements with the SEC, Manhattan District Attorney and the Fed. Neither admitted or denied wrongdoing.

The Fed "has changed its approach from being a cop on the beat to being a consultant at the elbow of major financial institutions," charges Tom Schlesinger, director of the Financial Markets Center, an often-critical Fed watchdog.

The Fed's defenders say its main job is to ensure the soundness of the financial system, not to sniff out fraud. On that score, they note that the banking system has remained strong amid recent economic upheavals. The Fed has also revamped its supervisory procedures and has levied three of its four largest-ever penalties in the last year.

Last year, SEC Chairman William Donaldson put hedge-fund regulation at the top of the regulatory agenda by proposing hedge funds register with his agency. The SEC wanted routine access to information and the right to examine hedge funds' operations to search for fraudulent behavior.

Mr. Greenspan, who worked with Mr. Donaldson on Wall Street in the 1960s, became one of his leading opponents. He told senators last July that hedge funds provide essential market liquidity, meaning they are often willing to buy when everyone else is selling. Registration would scare them away, "to the significant detriment of our economy," while doing little to stop fraud, he said.

Mr. Greenspan's opposition was manna to Mr. Donaldson's opponents. "With due deference to Chairman Greenspan and the tough job that he has, I cannot think of a time when he has been so clear," Paul Atkins, one of Mr. Donaldson's four fellow SEC commissioners, declared during the agency's debate last month.

In an interview, Mr. Donaldson suggests he and Mr. Greenspan simply have different priorities. "I think it's a legitimate argument that they do provide liquidity," he says. But "how much fraud are you willing to tolerate for liquidity? And if you asked me that, I'd say, zero."

On this rare occasion, Mr. Greenspan's side lost. The SEC voted 3-2 for Mr. Donaldson's proposal. But business groups hope to overturn the SEC's move and are mulling an appeal to Mr. Greenspan for written support.

—Kate Kelly contributed to this article.