The Financial Tsunami and the Evolving Economic Crisis: Greenspan's Grand Design

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The Long-Term Greenspan Agenda

Seven years of Volcker monetary "shock therapy" had ignited a payments crisis across the Third World. Billions of dollars in recycled petrodollar debts loaned by major New York and London banks to finance oil imports after the oil price rises of the 1970's, suddenly became non-payable.

The stage was now set for the next phase in the Rockefeller financial deregulation agenda. It was to come in the form of a revolution in the very nature of what would be considered money—the Greenspan "New Finance" Revolution.

Many analysts of the Greenspan era focus on the wrong facet of his role, and assume he was primarily a public servant who made mistakes, but in the end always saved the day and the nation's economy and banks, through extraordinary feats of financial crisis management, winning the appellation, Maestro.1

Maestro serves the Money Trust

Alan Greenspan, as every Chairman of the Board of Governors of the Federal Reserve System was a carefully-picked institutionally loyal servant of the actual owners of the Federal Reserve: the network of private banks, insurance companies, investment banks which created the Fed and rushed in through an almost empty Congress the day before Christmas recess in December 1913. In *Lewis v. United States*, the United States Court of Appeals for the Ninth Circuit stated that "the Reserve Banks are not federal instrumentalities…but are independent, privately owned and locally controlled corporations." 2

Greenspan's entire tenure as Fed chairman was dedicated to advancing the interests of American world financial domination in a nation whose national economic base was largely destroyed in the years following 1971.

Greenspan knew who buttered his bread and loyally served what the US Congress in 1913 termed "the Money Trust," a cabal of financial leaders abusing their public trust to consolidate control over many industries.

Interestingly, many of the financial actors behind the 1913 creation of the Federal Reserve are pivotal in today's securitization revolution including Citibank, and J.P. Morgan. Both have share ownership of the key New York Federal Reserve Bank, the heart of the system.

Another little-known shareholder of the New York Fed is the Depository Trust Company (DTC), the largest central securities depository in the world. Based in New York, the DTC custodies more than 2.5 million US and non-US equity, corporate, and municipal debt securities issues from over 100 countries, valued at over $36 trillion. It and its affiliates handle over $1.5 quadrillion of securities transactions a year. That's not bad for a company that most people never heard of. The Depository Trust Company has a sole monopoly on such business in the USA. They simply bought up all other contenders. It suggests part of the reason New York was able for so long to dominate global financial markets, long after the American economy had become largely a hollowed-out "post-industrial" wasteland.

While free market purists and dogmatic followers of Greenspan's late friend, Ayn Rand, accuse the Fed Chairman of hands-on interventionism, in reality there is a common thread running through each major financial crisis of his 18 plus years as Fed chairman. He managed to use each successive financial crisis in his eighteen years as head of the world's most powerful financial institution to advance and consolidate the influence of US-centered finance over the global economy, almost always to the severe detriment of the economy and broad general welfare of the population.

In each case, be it the October 1987 stock crash, the 1997 Asia Crisis, the 1998 Russian state default and ensuing collapse of LTCM, to the refusal to make technical changes in Fed-controlled stock margin requirements to cool the dot.com stock bubble, to his encouragement of ARM variable rate mortgages (when he knew rates were at the bottom), Greenspan used the successive crises, most of which his widely-read commentaries and rate policies had spawned in the first place, to advance an agenda of globalization of risk and liberalization of market regulations to allow unhindered operation of the major financial institutions.

The Rolling Crises Game

This is the true significance of the crisis today unfolding in US and global capital markets. Greenspan's 18 year tenure can be described as rolling the financial markets from successive crises into ever larger ones, to accomplish the over-riding objectives of the Money Trust guiding the Greenspan agenda. Unanswered at this juncture is whether Greenspan's securitization revolution was a "bridge too far," spelling the end of the dollar and of dollar financial institutions' global dominance for decades or more to come.

Greenspan's adamant rejection of every attempt by Congress to impose some minimal regulation on OTC derivatives trading between banks; on margin requirements on buying stock on borrowed money; his repeated support for securitization of sub-prime low quality high-risk mortgage lending; his relentless decade-long push to weaken and finally repeal Glass-Steagall restrictions on banks owning investment banks and insurance companies; his support for the Bush radical tax cuts which exploded federal deficits after 2001; his support for the privatization of the Social Security Trust Fund in order to funnel those trillions of dollars cash flow into his cronies in Wall Street finance—all this was a well-planned execution of what some today call the securitization revolution, the creation of a world of New Finance where risk would be detached from banks and spread across the globe to the point no one could identify where real risk lay.

When he came in 1987 again to Washington, Alan Greenspan, the man hand-picked by Wall

Street and the big banks to implement their Grand Strategy was a Wall Street consultant whose clients numbered the influential J.P. Morgan Bank among others. Before taking the post as head of the Fed, Greenspan had also sat on the boards of some of the most powerful corporations in America, including Mobil Oil Corporation, Morgan Guaranty Trust Company and JP Morgan & Co. Inc. His first test would be the manipulation of stock markets using the then-new derivatives markets in October 1987.

The 1987 Greenspan paradigm

In October 1987 when Greenspan led a bailout of the stock market after the October 20 crash, by pumping huge infusions of liquidity to prop up stocks and engaging in behind-the scene manipulations of the market via Chicago stock index derivatives purchases backed quietly by Fed liquidity guarantees. Since that October 1987 event, the Fed has made abundantly clear to major market players that they were, to use Fed jargon, TBTF—Too Big To Fail. No worry if a bank risked tens of billions speculating in Thai baht or dot.com stocks on margin. If push came to liquidity shove, Greenspan made clear he was there to bail out his banking friends.

The October 1987 crash which saw the sharpest one day fall in the Dow Industrials in history—508 points—was exacerbated by new computer trading models based on the so-called Black-Sholes Option Pricing theory, stock share derivatives now being priced and traded just as hog belly futures had been before.

The 1987 crash made clear was that there was no real liquidity in the markets when it was needed. All fund managers tried to do the same thing at the same time: to sell short the stock index futures, in a futile attempt to hedge their stock positions.

According to Stephen Zarlenga, then a trader who was in the New York trading pits during the crisis days in 1987, "They created a huge discount in the futures market…The arbitrageurs who bought futures from them at a big discount, turned around and sold the underlying stocks, pushing the cash markets down, feeding the process and eventually driving the market into the ground."

Zarlenga continued, "Some of the biggest firms in Wall Street found they could not stop their pre-programmed computers from automatically engaging in this derivatives trading. According to private reports they had to unplug or cut the wiring to computers, or find other ways to cut off the electricity to them (there were rumors about fireman's axes from hallways being used), for they couldn't be switched off and were issuing orders directly to the exchange floors.

> "The New York Stock Exchange at one point on Monday and Tuesday seriously considered closing down entirely for a period of days or weeks and made this public…It was at this point…that Greenspan made an uncharacteristic announcement. He said in no uncertain terms that the Fed would make credit available to the brokerage community, as needed. This was a turning point, as Greenspan's recent appointment as Chairman of the Fed in mid 1987 had been one of the early reasons for the market's sell off." [3]

What was significant about the October 1987 one-day crash was not the size of the fall. It was the fact that the Fed, unannounced to the public, intervened through Greenspan's trusted New York bank cronies at J.P. Morgan and elsewhere on October 20 to manipulate a stock recovery through use of new financial instruments called derivatives.

The visible cause of the October 1987 market recovery was when the Chicago-based MMI future (Major Market Index) of NYSE blue chip stocks began to trade at a premium, midday Tuesday, at a time when one after another Dow stock had been closed down for trading.

The meltdown began to reverse. Arbitrageurs bought the underlying stocks, re-opening them, and sold the MMI futures at a premium. It was later found that only about 800 contracts bought in the MMI futures was sufficient to create the premium and start the recovery. Greenspan and his New York cronies had engineered a manipulated recovery using the same derivatives trading models in reverse. It was the dawn of the era of financial derivatives.

Historically, at least most were led to believe, the role of the Federal Reserve, the Comptroller of the Currency among others, was to act as independent supervisors of the largest banks to insure stability of the banking system and prevent a repeat of the bank panics of the 1930's, above all in the Fed's role as "lender of last resort."

Under the Greenspan regime, after October 1987 the Fed increasingly became the "lender of first resort," as the Fed widened the circle of financial institutions worthy of the Fed's rescue from banks directly—which was the mandated purview of Fed bank supervision—to the artificial support of stock markets as in 1987, to the bailout of hedge funds as in the case of the Long-Term Capital Management hedge fund solvency crisis in September 1998.

Greenspan's last legacy will be leaving the Fed and with it the American taxpayer with the role as Lender of Last Resort, to bail out the major banks and financial institutions, today's Money Trust, after the meltdown of his multi-trillion dollar mortgage securitization bubble.

By the time of repeal of Glass-Steagall in 1999, an event of historic importance that was buried in the financial back pages, the Greenspan Fed had made clear it would stand ready to rescue the most risky and dubious new ventures of the US financial community. The stage was set to launch the Greenspan securitization revolution.

It was not accidental, or ad hoc in any way. The Fed laissez faire policy towards supervision and bank regulation after 1987 was crucial to implement the broader Greenspan deregulation and financial securitization agenda he hinted at in his first October 1987 Congressional testimony.

On November 18, 1987, only three weeks after the October stock crash, Alan Greenspan told the US House of Representatives Committee on Banking, "…repeal of Glass-Steagall would provide significant public benefits consistent with a manageable increase in risk." 4

Greenspan would repeat this mantra until final repeal in 1999.

The support of the Greenspan Fed for unregulated treatment of financial derivatives after the 1987 crash was instrumental in the global explosion in nominal volumes of derivatives trading. The global derivatives market grew by 23,102% since 1987 to a staggering $370 trillion by end of 2006. The nominal volumes were incomprehensible.

Destroying Glass-Steagall restrictions

One of Greenspan's first acts as Chairman of the Fed was to call for repeal of the Glass-

Steagall Act, something which his old friends at J.P.Morgan and Citibank had ardently campaigned for. 5

Glass-Steagall, officially the Banking Act of 1933, introduced the separation of commercial banking from Wall Street investment banking and insurance. Glass-Steagall originally was intended to curb three major problems that led to the severity of the 1930's wave of bank failures and depression:

Banks were investing their own assets in securities with consequent risk to commercial and savings depositors in event of a stock crash. Unsound loans were made by the banks in order to artificially prop up the price of select securities or the financial position of companies in which a bank had invested its own assets. A bank's financial interest in the ownership, pricing, or distribution of securities inevitably tempted bank officials to press their banking customers into investing in securities which the bank itself was under pressure to sell. It was a colossal conflict of interest and invitation to fraud and abuse.

Banks that offered investment banking services and mutual funds were subject to conflicts of interest and other abuses, thereby resulting in harm to their customers, including borrowers, depositors, and correspondent banks. Similarly, today, with no more Glass-Steagall restraints, banks offering securitized mortgage obligations and similar products via wholly owned Special Purpose Vehicles they create to get the risk "off the bank books," are complicit in what likely will go down in history as the greatest financial swindle of all times—the sub-prime securitization fraud.

In his history of the Great Crash, economist John Kenneth Galbraith noted, "Congress was concerned that commercial banks in general and member banks of the Federal Reserve System in particular had both aggravated and been damaged by stock market decline partly because of their direct and indirect involvement in the trading and ownership of speculative securities.

"The legislative history of the Glass-Steagall Act," Galbraith continued, "shows that Congress also had in mind and repeatedly focused on the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments." Galbraith noted that "During 1929 one investment house, Goldman, Sachs & Company, organized and sold nearly a billion dollars' worth of securities in three interconnected investment trusts–Goldman Sachs Trading Corporation; Shenandoah Corporation; and Blue Ridge Corporation. All eventually depreciated virtually to nothing."

Operation Rollback

The major New York money-center banks had long had in mind the rollback of that 1933 Congressional restriction. And Alan Greenspan as Fed Chairman was their man. The major money-center US banks, led by Rockefeller's influential Chase Manhattan Bank and Sanford Weill's Citicorp, spent over one hundred hundreds million dollars lobbying and making campaign contributions to influential Congressmen to get deregulation of the Depression-era restrictions on banking and stock underwriting.

That repeal opened the floodgates to the securitization revolution after 2001.

Within two months of taking office, on October 6, 1987, just days before the greatest one-day crash on the New York Stock Exchange, Greenspan told Congress, that US banks, victimized by new technology and ”frozen” in a regulatory structure developed more than 50 years ago, were losing their competitive battle with other financial institutions and needed to obtain new powers to restore a balance: ”The basic products provided by banks – credit evaluation and diversification of risk – are less competitive than they were 10 years ago.”

At the time the *New York Times* noted that “Mr. Greenspan has long been far more favorably disposed toward deregulation of the banking system than was Paul A. Volcker, his predecessor at the Fed.” 6

That October 6, 1987 Greenspan testimony to Congress, his first as Chairman of the Fed, was of signal importance to understand the continuity of policy he was to implement right to the securitization revolution of recent years, the New Finance securitization revolution. Again quoting the *New York Times* account, “Mr. Greenspan, in decrying the loss of the banks’ competitive edge, pointed to what he said was a ‘too rigid’ regulatory structure that limited the availability to consumers of efficient service and hampered competition. But then he pointed to another development of ‘particular importance’ – the way advances in data processing and telecommunications technology had allowed others to usurp the traditional role of the banks as financial intermediaries. In other words, a bank’s main economic contribution – risking its money as loans based on its superior information about the creditworthiness of borrowers – is jeopardized.”

The *Times* quoted Greenspan on the challenge to modern banking posed by this technological change: ‘Extensive on-line data bases, powerful computation capacity and telecommunication facilities provide credit and market information almost instantaneously, allowing the lender to make its own analysis of creditworthiness and to develop and execute complex trading strategies to hedge against risk,’ Mr. Greenspan said. This, he added, resulted in permanent damage ‘to the competitiveness of depository institutions and will expand the competitive advantage of the market for securitized assets,’ such as commercial paper, mortgage pass-through securities and even automobile loans.”

He concluded, ‘Our experience so far suggests that the most effective insulation of a bank from affiliated financial or commercial activities is achieved through a holding-company structure.’ 7 In a bank holding company, the Federal Deposit Insurance fund, a pool of contributions to guarantee bank deposits up to $100,000 per account, would only apply to the core bank, not to the various subsidiary companies created to engage in exotic hedge fund or other off-the-balance-sheet activities. The upshot was that in a crisis such as the unraveling securitization meltdown, the ultimate Lender of Last Resort, the insurer of bank risk becomes the American public taxpayer.

It was a hard fight in Congress and lasted until final full legislative repeal under Clinton in 1999. Clinton presented the pen he used in November 1999 to sign the repeal act, the Gramm-Leach-Bliley Act, into law as a gift to Sanford Weill, the powerful chairman of Citicorp, a curious gesture for a Democratic President, to say the least.

The man who played the decisive role in moving Glass-Steagall repeal through Congress was Alan Greenspan. Testifying before the House Committee on Banking and Financial Services, February 11, 1999, Greenspan declared, “we support, as we have for many years, major revisions, such as those included in H.R. 10, to the Glass-Steagall Act and the Bank Holding Company Act to *remove the legislative barriers against the integration of banking, insurance, and securities activities*. There is virtual unanimity among all concerned–private and public alike–that these barriers should be removed. *The technologically driven proliferation of new financial products that enable risk unbundling have been increasingly combining the characteristics of banking, insurance, and securities products into single financial instruments*."

In his same 1999 testimony Greenspan made clear repeal meant less, not more regulation of the newly-allowed financial conglomerates, opening the floodgate to the current fiasco: "As we move into the twenty-first century, the remnants of nineteenth-century bank examination philosophies will fall by the wayside. Banks, of course, will still need to be supervised and regulated, in no small part because they are subject to the safety net. My point is, however, that the nature and extent of that effort need to become more consistent with market realities. Moreover, *affiliation with banks need not–indeed, should not–create bank-like regulation of affiliates of banks*." 8 (Italics mine—f.w.e.)

Breakup of bank holding companies with their inherent conflict of interest, which led tens of millions of Americans into joblessness and home foreclosures in the 1930's depression, was precisely why Congress passed Glass-Steagall in the first place.

'…strategies unimaginable a decade ago…'

The *New York Times* described the new financial world created by repeal of Glass-Steagall in a June 2007 profile of Goldman Sachs, just weeks prior to the eruption of the sub-prime crisis: "While Wall Street still mints money advising companies on mergers and taking them public, real money – staggering money – is made trading and investing capital through a global array of mind-bending products and strategies unimaginable a decade ago." They were referring to the securitization revolution.

The *Times* quoted Goldman Sachs chairman Lloyd Blankfein on the new financial securitization, hedge fund and derivatives world: "We've come full circle, because this is exactly what the Rothschilds or J. P. Morgan, the banker were doing in their heyday. What caused an aberration was the Glass-Steagall Act."9

Blankfein as most of Wall Street bankers and financial insiders saw the New Deal as an aberration, openly calling for return to the days J. P. Morgan and other tycoons of the 'Gilded Age' of abuses in the 1920's. Glass-Steagall, Blankfein's "aberration" was finally eliminated because of Bill Clinton. Goldman Sachs was a prime contributor to the Clinton campaign and even sent Clinton its chairman Robert Rubin in 1993, first as "economic czar" then in 1995 as Treasury Secretary. Today, another former Goldman Sachs chairman, Henry Paulson is again US Treasury Secretary under Republican Bush. Money power knows no party.

Robert Kuttner, co-founder of the Economic Policy Institute, testified before US Congressman Barney Frank's Committee on Banking and Financial Services in October 2007, evoking the specter of the Great Depression:

> "Since repeal of Glass Steagall in 1999, after more than a decade of de facto inroads, super-banks have been able to re-enact the same kinds of structural conflicts of interest that were endemic in the 1920s – lending to speculators, packaging and securitizing credits and then selling them off, wholesale or

> retail, and extracting fees at every step along the way. And, much of this paper is even more opaque to bank examiners than its counterparts were in the 1920s. Much of it isn't paper at all, and the whole process is supercharged by computers and automated formulas." 10

Dow Jones *Market Watch* commentator Thomas Kostigen, writing in the early weeks of the unraveling sub-prime crisis, remarked about the role of Glass-Steagall repeal in opening the floodgates to fraud, manipulation and the excesses of credit leverage in the expanding world of securitization:

> "Time was when banks and brokerages were separate entities, banned from uniting for fear of conflicts of interest, a financial meltdown, a monopoly on the markets, all of these things.
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> "In 1999, the law banning brokerages and banks from marrying one another — the Glass-Steagall Act of 1933 — was lifted, and voila, the financial supermarket has grown to be the places we know as Citigroup, UBS, Deutsche Bank, et al. But now that banks seemingly have stumbled over their bad mortgages, it's worth asking whether the fallout would be wreaking so much havoc on the rest of the financial markets had Glass-Steagall been kept in place.
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> "Diversity has always been the pathway to lowering risk. And Glass-Steagall kept diversity in place by separating the financial powers that be: banks and brokerages. Glass-Steagall was passed by Congress to prohibit banks from owning full-service brokerage firms and vice versa so investment banking activities, such as underwriting corporate or municipal securities, couldn't be called into question and also to insulate bank depositors from the risks of a stock market collapse such as the one that precipitated the Great Depression.
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> "But as banks increasingly encroached upon the securities business by offering discount trades and mutual funds, the securities industry cried foul. So in that telling year of 1999, the prohibition ended and financial giants swooped in. Citigroup led the way and others followed. We saw Smith Barney, Salomon Brothers, PaineWebber and lots of other well-known brokerage brands gobbled up.
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> "At brokerage firms there are supposed to be Chinese walls that separate investment banking from trading and research activities. These separations are supposed to prevent dealmakers from pressuring their colleague analysts to give better results to clients, all in the name of increasing their mutual bottom line.
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> "Well, we saw how well these walls held up during the heyday of the dot-com era when ridiculously high estimates were placed on corporations that happened to be underwritten by the same firm that was also trading its securities. When these walls were placed within their new bank homes, cracks appeared and — it looks ever so apparent — ignored.
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> "**No one really questioned the new fad of collateralizing bank mortgage debt into different types of financial instruments and selling them through a different arm of the same institution. They are now**…
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> "When banks are being scrutinized and subject to due diligence by third-party securities analysts more questions are raised than when the scrutiny is by people who share the same cafeteria. Besides, fees, deals and the like would all be subject to salesmanship, which means people would be hammering

> prices and questioning things much more to increase their own profit — not working together to increase their shared bonus pool.
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> "Glass-Steagall would have at least provided what the first of its names portends: transparency. And that is best accomplished when outsiders are peering in. When every one is on the inside looking out, they have the same view. That isn't good because then you can't see things coming (or falling) and everyone is subject to the roof caving in.
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> "Congress is now investigating the subprime mortgage debacle. Lawmakers are looking at tightening lending rules, holding secondary debt buyers responsible for abusive practices and, on a positive note, even bailing out some homeowners. These are Band-Aid measures, however, that **won't patch what's broken: the system of conflicts that arise when sellers, salesmen and evaluators are all on the same team**. 11 (emphasis mine–f.w.e.)

Greenspan's dot.com bubble and its consequences

Before the ink was dry on Bill Clinton's signature repealing Glass-Steagall, the Greenspan fed was fully engaged in hyping their next crisis—the deliberate creation of a stock bubble to rival that of 1929, a bubble which then, subsequently the Fed would pop just as deliberately.

The 1997 Asia financial crisis and the ensuing Russian state debt default of August 1998 created a sea-change in global capital flows to the advantage of the dollar. With Korea, Thailand, Indonesia and most emerging markets in flames following a coordinated, politically-motivated attack by a trio of US hedge funds, led by Soros' Quantum Fund, James Robertson's Jaguar and Tiger funds and Moore Capital Management, as well as, according to reports, the Connecticut-based LTCM hedge fund of John Merriweather.

The impact of the Asia crisis on the dollar was notable and suspiciously positive. Andrew Crockett, the General Manager of the Bank for International Settlements, the Basle-based organization of the world's leading central banks, noted that while the East Asian countries had run a combined current account deficit of $33 billion in 1996, as speculative hot money flowed in, "1998-1999, the current account swung to a surplus of $87 billion." By 2002 it had reached the impressive sum of $200 billion. Most of that surplus returned to the US in the form of Asian central bank purchases of US Treasury debt, in effect financing Washington policies, pushing US interest rates way down and fuelling an emerging New Economy, the NASDAQ dot.com New Economy IT boom. 12

During the extremes of the 1997-1998 Asia financial crises, Greenspan refused to act to ease the financial pressures until Asia had collapsed and Russia had defaulted in August 1998 on its sovereign debt and deflation had spread from region to region. Then, as he and the New York Fed stepped in to rescue the huge LTCM hedge fund that had become insolvent as a result of the Russia crisis, Greenspan made an unusually sharp cut in Fed Funds interest rates for the first time, by 0.50%. That was followed a few weeks later by a 0.25% cut. That gave the nascent dot.com NASDAQ IT bubble a nice little "shot of whiskey."

By late 1998, amid successive cuts in Fed interest rates and pumping in of ample liquidity, the US stock markets, led by the NASDAQ and NYSE, went asymptotic. In the single year 1999, as the New Economy bubble got into full-swing, a staggering $2.8 trillion increase in the value of equity shares owned by US households was registered. That was more than

25% of annual GDP, all in paper values.

Glass-Steagall restrictions on banks and investment banks promoting the stocks they had brought to market—the exact conflict of interest which prompted Glass-Steagall in 1933—those restraints were gone. Wall Street stock promoters were earning tens of millions in bonuses for fraudulently hyping Internet and other stocks such as WorldCom and Enron. It was the “Roaring 1920’s” all over again, but with an electronic computerized turbo charged kicker.

The incredible March 2000 speech

In March 2000, at the very peak of the dot.com stock mania, Alan Greenspan delivered an address to a Boston College Conference on the New Economy in which he repeated his by-then standard mantra in praise of the IT revolution and the impact on financial markets. In this speech he went even beyond previous praises of the IT stock bubble and its putative “wealth effect” on household spending which he claimed had kept the US economy growing robustly.

“In the last few years it has become increasingly clear that this business cycle differs in a very profound way from the many other cycles that have characterized post-World War II America,” Greenspan noted. “Not only has the expansion achieved record length, but it has done so with economic growth far stronger than expected.”

He went on, waxing almost poetic:

> “My remarks today will focus both on what is evidently the source of this spectacular performance–the revolution in information technology…When historians look back at the latter half of the 1990s a decade or two hence, I suspect that they will conclude we are now living through a pivotal period in American economic history…Those innovations, exemplified most recently by the multiplying uses of the Internet, have brought on a flood of startup firms, many of which claim to offer the chance to revolutionize and dominate large shares of the nation’s production and distribution system. And participants in capital markets, not comfortable dealing with discontinuous shifts in economic structure, are groping for the appropriate valuations of these companies. The exceptional stock price volatility of these newer firms and, in the view of some, their outsized valuations indicate the difficulty of divining the particular technologies and business models that will prevail in the decades ahead.”

Then the Maestro got to his real theme, the ability to spread risk by technology and the Internet, a harbinger of his thinking about the then infant securitization phenomenon:

> The impact of information technology has been keenly felt in the financial sector of the economy. Perhaps the most significant innovation has been the development of financial instruments that enable risk to be reallocated to the parties most willing and able to bear that risk. Many of the new financial products that have been created, with financial derivatives being the most notable, contribute economic value by unbundling risks and shifting them in a highly calibrated manner. Although these instruments cannot reduce the risk inherent in real assets, they can redistribute it in a way that induces more investment in real assets and, hence, engenders higher productivity and standards of living. Information technology has made possible the creation, valuation, and exchange of these complex financial products on a global basis…

> Historical evidence suggests that perhaps three to four cents out of every additional dollar of stock market wealth eventually is reflected in increased consumer purchases. The sharp rise in the amount of consumer outlays relative to disposable incomes in recent years, and the corresponding fall in the saving rate, is a reflection of this so-called wealth effect on household purchases. Moreover, higher stock prices, by lowering the cost of equity capital, have helped to support the boom in capital spending.
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> Outlays prompted by capital gains in equities and homes in excess of increases in income, as best we can judge, have added about 1 percentage point to annual growth of gross domestic purchases, on average, over the past half-decade. The additional growth in spending of recent years that has accompanied these wealth gains, as well as other supporting influences on the economy, appears to have been met in equal measure by increased net imports and by goods and services produced by the net increase in newly hired workers over and above the normal growth of the workforce, including a substantial net inflow of workers from abroad. 13

What is perhaps most incredible was the timing of Greenspan's euphoric paean to the benefits of the IT stock mania. He well knew that the impact of the six interest rate increases he had instigated in late 1999 were sooner or later going to chill the buying of stocks on borrowed money.

The dot-com bubble burst one week after the Greenspan speech. On March 10, 2000, the NASDAQ Composite index peaked at 5,048, more than double its value just a year before. On Monday, March 13 the NASDAX fell by an eye-catching 4%.

Then, from March 13, 2000 through to the market bottom, the market lost paper values worth nominally more than $5 trillions, as Greenspan's rate hikes brought a brutal end to a bubble he repeatedly claimed he could not confirm until after the fact. In dollar terms, the 1929 stock crash was peanuts by comparison with Greenspan's dot.com crash. Greenspan had raised interest rates six times by March, a fact which had a brutal chilling effect on the leveraged speculation in dot.com company stocks.

Stocks on margin: Regulation T

Again Greenspan had been present every step of the way to nurture the dot.com stock "irrational exuberance." When it was clear even to most ordinary members of Congress that stock prices were soaring out of control, and that banks and investment funds were borrowing tens of billions of credit to buy more stocks "on margin," a call went out for the Fed to exercise its power over stock margin buying requirements.

By February 2000, margin debt had hit $265.2 billion, up 45 percent in just four months. Much of the increase came from increased borrowing through online brokers and was being channeled into the NASDAQ New Economy stocks.

Under Regulation T, the Fed had the sole authority to set initial margin requirements for the purchase of stocks on credit, which had been at 50% since 1974.

If the stock market were to take a serious fall, margin calls would turn a mild downturn into a crash. Congress believed that this was what happened in 1929, when margin debt equaled 30 percent of the stock market's value. That was why it gave the Fed power to control initial margin requirements in the Securities Act of 1934.

The requirement had been as high as 100 percent, meaning that none of the purchase price could be borrowed. Since 1974, it had been unchanged, at 50 percent, allowing investors to borrow no more than half the purchase price of equities directly from their brokers. By 2000 this margin mechanism acted like gasoline poured on a raging bonfire.

Congressional hearings were held on the issue. Investment managers such Paul McCulley of the world's then-largest bond fund, PIMCO, told Congress, "The Fed should raise that minimum, and raise it now. Mr. Greenspan says "no," of course, because (1) he cannot find evidence of a relationship between changes in margin requirements and changes in the level of the stock market, and (2) because an increase in margin requirements would discriminate against small investors, whose only source of stock market credit is their margin account." 14

On the margin

But in the face of the obvious 1999-2000 US stock bubble, not only did Greenspan repeatedly refuse to change stock margin requirements, but also in the late 1990s, the Fed chairman actually began to talk in glowing terms about the New Economy, conceding that technology had helped increase productivity. He was consciously fuelling the market's "irrational exuberance."

Between June 1996 and June 2000, the Dow rose 93% and the NASDAQ rose 125%. The overall ratio of stock prices to corporate earnings reached record highs not seen since the days before the 1929 crash.

Then, in 1999, Greenspan initiated a series of interest rate hikes, when inflation was even slower than it was in 1996 and productivity was growing even faster. But by refusing to tie rate rises to a rise in margin requirements, which would clearly have signaled that the Fed was serious about cooling the speculative bubble in stocks, Greenspan impacted the economy with higher rates, evidently designed to increase unemployment and press labor costs lower to further raise corporate earnings, not to cool the stock buying frenzy of the New Economy. Accordingly, the stock market ignored it.

Influential observers, including financier George Soros and Stanley Fischer, deputy director at the International Monetary Fund, advocated that the Fed let the air out of the credit boom by raising margin requirements.

Greenspan refused this more sensible strategy. At his re-confirmation hearing before the US Senate Banking Committee in 1996, he said that he did not want to discriminate against individuals who were not wealthy and therefore needed to borrow in order to play the stock market (sic). As he well knew, the traders buying stocks on margin were mainly not poor and needy but professional traders out for a free lunch, which Greenspan well knew. Interesting, however, was that that was precisely the argument Greenspan would repeat for justifying his advocacy of lending to sub-prime poor credit persons, to let the poorer get in on the home ownership bonanza his policies after 2001 had created. 15

The stock market began to tumble in the first half of 2000, not because labor costs were rising, but because limits of investor credulity were finally reached. The financial press including the *Wall Street Journal*, which a year before was proclaiming dot.com executives as pioneers of the new economy, were now ridiculing the public for having believed that the stock of companies that would never make a profit could go up forever.

The New Economy, as one Wall Street Journal writer put it, now “looks like an old-fashioned credit bubble.” [16](#) In the second half of that year, American consumers whose debt-to-income ratios were at record highs, began to pull back. Christmas sales flopped, and by early January 2001 Greenspan reversed himself and lowered interest rates. In twelve successive rate cuts, the Greenspan Fed brought US Fed funds rates, rates that determined short-term and other interest rates in the economy, from 6% down to a post-war low of 1% by June 2003.

Greenspan held Fed rates to those historic lows, lows not seen for that length of time since the Great Depression, until June 30, 2004, when he began the first of what were to be fourteen successive rate increases before he left office in 2006. He took Fed funds rates from the low of 1% up to 4.5% in nineteen months. In the process, he killed the bubble that was laying the real estate golden egg.

In speech after speech the Fed chairman made clear that his ultra-easy money regime after January 2001 had as prime focus the encouragement of investing in home mortgage debt. The sub-prime phenomenon—something only possible in the era of asset securitization and Glass-Steagall repeal, combined with unregulated OTC derivatives trades—was the predictable result of deliberate Greenspan policy. The close scrutiny of the historical record makes that abundantly clear.

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Notes

1 Woodward, Bob, *Maestro: Alan Greenspan’s Fed and the American Economic Boom*, Nov 2000. Woodward’s book is an example of the charmed treatment Greenspan was accorded by the major media. Woodward’s boss at the Washington Post, Catharine Meyer Graham, daughter of the legendary Wall Street investment banker Andre Meyer, was an intimate Greenspan friend. The book can be seen as a calculated part of the Greenspan myth-creation by the influential circles of the financial establishment.

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3 Zarlenga, Stephen, *Observations from the Trading Floor During the 1987 Crash*, in http://www.monetary.org/1987%20crash.html.

4 Greenspan, Alan, Testimony before the Subcommittee on Financial Institutions Supervision, US House of Representatives, Nov. 18, 1987. http://fraser.stlouisfed.org/historicaldocs/ag/download/27759/Greenspan_19871118.pdf.

5 Hershey jr., Robert D., *Greenspan Backs New Bank Roles*, The New York Times, October 6, 1987.

6 Hershey, op.cit.

7 Ibid.

8 Greenspan, Alan, *Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking and Financial Services*, U.S. House of Representatives, February 11, 1999, in Federal Reserve Bulletin, April 1999.

9 Anderson, Jenny, *Goldman Runs Risks, Reaps Rewards*, The New York Times, June 10, 2007.

10 Kuttner, Robert, *Testimony of Robert Kuttner Before the Committee on Financial Services*, Rep. Barney Frank, Chairman, U.S. House of Representatives, Washington, D.C., October 2, 2007

11 Kostigen, Thomas, *Regulation game: Would Glass-Steagall save the day from credit woes?*, Dow Jones MarketWatch, Sept. 7, 2007, in http://www.marketwatch.com/news/story/would-glass-steagall-save-day-credit.

12 Engdahl, F. William, *Hunting Asian Tigers: Washington and the 1997-98 Asia Shock*, reprinted in http://www.jahrbuch2000.studien-von-zeitfragen.net/Weltfinanz/Hedge_Funds/hedge_funds.html.

13 Greenspan, Alan, *The revolution in information technologyBefore the Boston College Conference on the New Economy*, Boston, Massachusetts, March 6, 2000.

14 McCulley, Paul, *A Call For Fed Action: Hike Margin Requirements!*, testimony before The House Subcommittee on Domestic and International Monetary Policy on March 21, 2000.

15 Alan Greenspan as Fed chairman repeatedly asserted it was impossible to judge if a speculative bubble existed during the rise of such a bubble. In August 2002, after his clear strategy of Fed rate rises was obvious to market players, he reiterated this: "*We at the Federal Reserve considered a number of issues related to asset bubbles–that is, surges in prices of assets to unsustainable levels. As events evolved, we recognized that, despite our suspicions, it was very difficult to definitively identify a bubble until after the fact–that is, when its bursting confirmed its existence*.—Alan Greenspan Remarks by Chairman Alan Greenspan Economic volatility At a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming August 30, 2002.

16 Faux, Jeff, *The Politically Talented Mr. Greenspan*, Dissent Magazine, Spring 2001.

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