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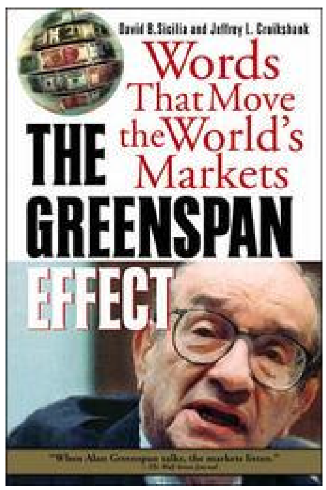
The Greenspan Effect

Words That Move the World's Markets



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Words that Lift Markets

1. The "Exceptional" Economy

Greenspan defines "exceptional" economy as characterized by strong growth and low inflation. Soaring prices in the stock market could be fueled by moderate long-term interest rates and expectations of investors that profit margins and earnings growth would hold steady or even increase further, in a relatively stable, low inflation environment.

Greenspan is baffled by an economy operating at high levels and drawing into employment less-experienced workers can still produce falling inflation rates. This suggests that the economy is on an unsustainable track. Unless aggregate demand increases more slowly and more in line with trends in the supply of labor and productivity, imbalances will emerge. When considerable momentum behind the expansion and labor market utilization rates are unusually high, there is a possibility that additional action might be called for to forestall excessive credit creation.

2. The "Oasis of Prosperity"

Domestic and foreign interests converge rather than diverge. With inflation no longer a threat, and with the rest of the world unable to get their economic houses back into order after months of stagnation, there is a greater threat of global recession. Greenspan believes that the United States cannot remain an "oasis of prosperity" unaffected by a world that is experiencing a greatly increased stress. Developments overseas contribute to holding down prices and aggregate demand in the U.S.A. in the face of strong domestic spending. As dislocations abroad mount, feeding back on the financial markets, restraint is likely to intensify.

3. The "Salutary" Sell-Off

Greenspan opines that within reasonable bounds, crashes can be salutary. When the economy operates with significant degree of inflationary excess, stock market crash neutralizes this excess. It is overoptimistic to assume that the dimension of any acceleration in productivity will be great enough to close, by itself, the gap between an excess of long-term demand for labor and its supply. It will take some time to judge the extent of a lasting improvement. When the economy draws down unused labor resources at an unsustainable pace, spurred in part by a wealth effect on demand, the market's net retrenchment of recent days will tend to damp that impetus, a development that should help to prolong business expansion.

4. The Wealth Effect

According to Greenspan, the steep uptrend in asset values has important effects on household behavior. As the bull market roars its way through, more and more householders would be drawn into the stock market. As a result, they would funnel more of their capital into equities. As they watch the value of their stocks climb on paper, they feel increasingly affluent and thus free to consume at higher levels. The wealth effect can be seen most clearly in the substantial decline in the measured personal saving rate.

Households should remember that what goes up comes down, and should diversify to protect a portion of its capital. A flattening of stock prices would likely slow the growth of spending that could lead to weakening of consumer demand. While asset values are very important to the economy and so must be monitored and assessed, they are not themselves a target of monetary policy. There is a need to react to changes in financial markets to sustain maximum growth of the economy.

The bull market helps to fuel economic growth, but, it carried within it the potential to spoil that growth. Just as the raging bull produces wealth effect, so a bear would produce a reverse wealth effect, one that could make the interest rate tinkering.

Words that Sink Markets

1. "Irrational Exuberance" in the Stock Markets

When Greenspan uses the words "irrational exuberance", he warns that the stocks are overvalued. Here are some words from Greenspan that can cause upheavals in the entire stock markets:

1. Stability of prices (low inflation) is essential to the stability of the economy.
2. It is extremely difficult to assess prices as a measure of value.
3. Sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earning assets.
4. Inflation lowers risk, lower risk boosts earnings.
5. Irrational exuberance can escalate asset values, which then subject to unexpected and prolonged contractions, similar to that of Japan over the past decade.
6. The monetary policy makers should take action in the face of irrational exuberance.

7. The central bankers need not be concerned if a collapsing financial asset bubble does not threaten to impair the real economy, its production, jobs, and price stability.
8. Despite the fact that sharp stock market break of 1987 had only few negative consequences for the economy, the complexity of the interactions of asset markets and the economy should not be underestimated.
9. Evaluating shifts in balance sheets must be an integral part of the development of monetary policy.
10. Asset values do affect the economy, and the monetary policy makers should pay attention and be prepared to act in relation to those values.

2. Battling Inflation

Greenspan suggests that when economy slows down to settle back toward a more sustainable pace, it is more of good rather than bad news. An economic running at a less sustainable pace would raise the specter of inflation, thereby increasing the probability of interest rate hike. Inflation imbalances would certainly threaten the stability and growth of the economy.

The monetary policy makers should be determined to hold the line on inflation by being vigilant to incipient inflation pressures.

3. Tight Labor Markets

If labor demand continues to outpace sustainable increase in supply, labor costs will surely escalate more rapidly. Tight labor markets or labor shortages would put upward pressure on wages which could easily translate into inflation. Thus, labor markets are seen by the financial markets as important key indicators of economic health.

4. Financial Contagion

Greenspan admits that no nation is insulated from the rapidly changing conditions overseas. Recent advances in telecommunications and computer technologies have linked markets around the world, and have made it much easier for crises to spill over from one country to another. The 1997 global financial crisis is a strong evidence that no economy is protected from disaster. The Russian financial crisis in 1999 made Latin America vulnerable, hitting the economy of Brazil the hardest.

A key linkage between U.S. and foreign financial markets that could transmit trouble is the fast increases in the net indebtedness of U.S. residents to foreigners. Should the sustainability of the buildup of foreign indebtedness come into question, value of the dollar may well decline, imparting pressures on prices in the United States.

Evidently, the weak economies of its international trading partners could depress the country's exports.

Remaking Financial Institutions

1. **Reforming Social Security**
   Greenspan stresses the point that enough resources must be set aside over a lifetime of work to fund the excess of consumption over claims on production a retiree may enjoy. There is also a need to eliminate federal budget deficit. One factor that argues for running sizable budget surpluses is to set aside resources to meet the retirement needs of the working population. The problem on under-funding of Social Security may be addressed through augmenting the domestic savings by greater private saving or surpluses in the rest of the government budget to ensure that there are enough overall saving to finance adequate productive capacity down the road to meet the consumption needs of both retirees and active workers.

   There should be an integration between the Social Security Commission and the political system. The interplay between the commission's deliberations and the parallel policy discussions in the White House and the Congress should be continuous to ensure political support for the final product.

2. **Merging Commercial and Investment Banking**
   The tools and strategies of commercial and investment banks increasingly overlap, blurring traditional distinctions between commercial and investment banks. Thus, modernization and restructuring of the financial system should be of high priority due to globalization, technological change, and market innovations. Wider affiliations between banks and other financial services providers should be allowed. This would be a major step in the modernization of the financial system – eliminating outdated restrictions.

3. **Reforming Federal Deposit Insurance**
   What is needed is a deposit insurance system whose status is unquestioned, so that the depositories can appropriately focus their attention on the extension and management of credit in the economy.

4. **Derivatives**
   Derivatives must be carefully managed and supervised. The market must be open to innovation and change, and the efforts to contain risk-taking should not stifle this direction. Risk-taking is a requirement of

economic progress and rising standard of living. Derivatives reduce risk as they allow risk to be distributed throughout the financial system.

The parties of the financial transactions are responsible for their own decisions. The fate of derivatives is best left in private hands. Regulation should only be used to adjust the balance of responsibilities between the parties involved. Greenspan advocates for more transparency and improved risk management through bilateral netting agreements and collateralization.

World Crisis Manager

1. The Asian Crisis

Technologically enabled connectedness creates new perils as market contagion can spread easily across borders. Greenspan suggests the following to ward off similar Asian crises in the future?

1. Countries like Korea and Thailand should curb excessive risk-taking in both the bank and non-bank sectors.
2. Emerging countries should be willing to subordinate “industrial policy” to market prices. The “policy loans” are bad in and of themselves; they are doubly bad when guaranteed by government.
3. Banks should be more disciplined about incurring interest-rate or liquidity risks by “lending long and funding short”.

2. The Crash of ‘87

Greenspan reiterates that the monetary policy has leaned in the direction of countering potential rise in inflation, while seeking to balance a monetary and financial environment compatible with sustainable economic growth. However, before taking actions, it is essential that there is a clear understanding of what happened during the crash. There should be a distinction separating self-correcting problems that can be addressed within existing regulatory frameworks from problems that require more fundamental, perhaps legislative solutions.

History teaches that central banks have a crucial role in responding to episodes of acute financial distress. In this situation, they should be ready to provide liquidity to the economy and financial markets.

What caused the 1987 clash or Black Monday in Wall Street? Greenspan sees a number of causes:

1. Stock prices were high, and this induced heavy selling.
2. The use of portfolio insurance by large institutional investors has contributed to the high level of share prices.
3. The situation was compounded by mostly unrelated factors, like the dramatic changes in computer and telecommunications

technology and unchanging human nature. New technologies allow an almost instantaneous involvement by all global players. The ripple effect is amplified by technology.

4. The avalanche then created its own problem. System capacity became a major influence on investor behavior. As investors recognized that the capacity of the system to execute trades was faltering, they sought to get out while they could.
5. At the same time, equity prices became disconnected from the price of their derivatives. Normally, arbitrage keeps the prices of derivative instruments in line with equities.

Price limits and other circuit breakers must be viewed as destabilizing, but they may be the lesser evil of all the solutions. When orders exceed execution capacity, the system will break down. The only question is whether it is better for it to take the form of a controlled disruption or leave the solution to a haphazard set of forces.

As a general principle, it is in the self interest of the exchanges and associations of market players to protect and enhance the integrity of their markets by correcting by themselves the problems experienced during the 1987 crash.

3. The Gulf War

Greenspan believes that economies all over the world suffer from a trickle down effect during conflicts and wars, like the Gulf War. Higher prices and correlated higher labor costs influence and spread outward from importing and exporting countries oil to those that are marginally involved in the industry. Another negative effect of wars is the uncertainties faced by consumers and producers resulting in withdrawal from their normal activities. This in turn, will result in drop in employment and decline of personal income weakening the purchasing power and retard consumer demand.

Businesses find it hard to secure funding as banks and other lenders tend to tighten the terms and conditions for supplying credit, and this restrains market activity.

A weaker dollar also is a cause for concern. It adds upward pressure to U.S. import prices, compounds the inflation impulse that stems from higher oil prices, and may put at risk the ready access to net inflows of foreign saving.

There is no policy initiative that can prevent the transfer of wealth and cut in standard of living due to higher prices for imported oil. The role of monetary policy is to provide the financial environment that is consistent with the nation's long-run economic objectives – to foster economic stability and sustainable growth.

Competing in the Global Economy

1. U.S. International Competitiveness

The ultimate test of the country's competitiveness is what is happening to the standard of living of our citizens over time. Knowledge and economic performance are inseparable. Knowledge spurs economic progress. American competitiveness in the world markets depends on its ability to keep developing and deploying new technologies. While U.S. is clearly unrivaled as a source of new ideas, Americans have been slow to convert their scientific and technological breakthroughs and new ideas into commercially viable products.

To remain competitive in the international arena, Greenspan suggests the following:

1. Stay in the "idea stream".
2. Meet and work with their overseas counterparts, especially in fields like banking.
3. Invest heavily in production facilities and ensure that they are technologically current.
4. Promote higher personal saving rates.
5. Deregulate and liberalize markets, and resist dabbling on the policy level, even in the critical realm of research and development.
6. Pursue sound fiscal policies on the federal level to avoid currency-driven disasters.
7. Keep banking system strong and liquid.
8. Broaden and deepen "human capital" by improving the educational system.
9. Focus on knowledge – expand it, share it, apply it.

2. Foreign Investment in the U.S.

The globalization and increased foreign investments offer many advantages in terms of increased competition; reduced costs of financial intermediation, benefiting both savers and borrowers; more efficient allocation of capital; and more rapid spread of innovation. Greenspan comments that increased foreign investment should not be feared as efforts to insulate the U.S. from the increasing forces of globalization could be very costly to the standard of living. But, continued efforts should be made to limit risks in international payments and securities settlements systems, and to protect investors by increasing international cooperation and coordination of supervision and regulation.

3. Economic Reform in Russia and Eastern Europe

There is a need to restructure the fundamentals of the former communist economies as Russian and Eastern bloc industries are not competitive because Marxist ideology views competition as destructive and Soviet planners placed too much faith in economies of scale. Greenspan recommends the following to reform the economies of Russia and the Eastern Europe:

1. Large amount of private capital and know-how will have to be mobilized.
2. Wisely designed commercial legal system should also be installed and implemented.
3. Government should resist the temptation to coin money – a short term fix that will lead to hyperinflation and more suffering for residents.
4. Markets will have to emerge to send signals, and enterprises will have to respond to those signals.
5. Russia must downsize its defense industry in the wake of the end of the Cold War.
6. Shut down obsolete and inefficient factories.
7. As "prices do not represent market values", there is a need to put emphasis on market pricing for inputs and outputs. Cost measures should be reviewed. The creation or importation of skilled cost accountants might help.
8. The people will have to become opportunity-driven, willing to live with disparities in income and wealth, and take risk taking as something to be rewarded.
9. Implement and abide by a strong contract law system.
10. Start with the basics starting with reforms to the banking systems that provide efficient, reliable payment systems, and that introduce sound credit judgment into the systems.
11. Develop an effective bond market to soak up the "overhang of liquidity" that has resulted from the excessive money creation in the past, and to provide a non-inflationary way to finance public-sector debt.
12. Minimize fiscal or trade imbalances and avoid "imprudent borrowing denominated in foreign currencies.

The greatest potential of the area making up the former Soviet Union is based largely on its vast endowment of resources. It has massive reserves of oil and gas and other minerals, fertile agricultural land, and has great human resources, particularly large cadre of scientist and engineers. However, Greenspan suggests that leaders in Russia and Eastern Europe should:

- Develop credible and comprehensive programs for a prompt movement to a market system, where resources can be guided by market signals.
- Educate their people about the difficulties of transition from a state-controlled to a market economy, and the need to modify attitudes toward competition, profit, and personal initiative, where necessary,

4. The Triumph of Capitalism

The collapse of the Soviet Union teaches why the free capitalist system works. The Soviet Union was not able to mold human responses while capitalism fits with the universal impulses "to work, save, invest and innovate". According to Greenspan, only free market systems exhibit the flexibility and robustness to accommodate human nature.

A "whole infrastructure of market institutions" is needed for the exchange of goods and services to occur smoothly.

Capitalism is winning the global economic contest because it generates wealth better than either partially planned or command economies. Centrally planned economic systems, such as that which existed in the Soviet Union, would have great difficulty in creating wealth and raising standard of living. Messiness, unevenness and relentless demand for high performance are intrinsic to open markets. As capitalism has evolved in our times, the unskilled, the uneducated, and the technologically illiterate are most vulnerable. The poor and the working class will see social welfare programs erode, but the whole will be stronger, richer, and freer.

Critical Investment

1. The American Education System

Greenspan asserts that higher education is an essential driving force behind the nation's economic health. As the computer has replaced the railroad as the symbol and reality of economic progress, the importance of education as an engine of economic growth has increased tremendously. The educational system, to be strong, should be persistently flexible and adaptable to respond to the constantly changing marketplace and economy.

Education is increasingly becoming a lifelong activity. Businesses are now looking for employees who are prepared to continue learning and who are prepared to continue learning and who recognize that maintaining their human capital will require persistent hard work and flexibility.

Competition is the necessary driving force toward delivering a superior product or service. We should not shy away from it. Greenspan believes that colleges and universities are being challenged to evaluate how new information technologies can best employed in their curricula and their delivery systems.

Greenspan strongly believes that as the conceptual share of the value added in our economic processes continues to grow, the ability to think abstractly will be increasingly important across a broad range of professions. Critical awareness and the abilities to hypothesize, to interpret, and to communicate are essential elements of successful innovation in a conceptual-based economy. The ability to think abstractly is fostered through exposure to philosophy, literature, music, art and languages. In the end, thinking requires intellectual balance, a synthesis of arts and sciences. To maintain this balance is the major challenge of the next millennium.

2. Consumer Saving, Credit, and Retirement

Saving creates wealth while consumption destroys wealth. Inadequate saving impairs the economic prospects in the long run. For a healthy economy, Greenspan pushes for higher rate of savings, and he believes that the market forces should solve this kind of problem. Interventions like subsidies enhance consumption at the expense of savings. The more people consume, the less they can invest. The smaller the investment in the capital stock, including technologies, and in labor force, the lower the overall productive capacity and the standard of living will be in the future.

An increase in the value of an individual's stock portfolio or his house has no direct effect on his measured income. If the individual raises his spending in response to the capital gain, saving falls. A booming stock market leads to falling rates of saving and increased consumption out of financial capital gains, and soaring real estate values combined with easy access to credit can also cause a fall in savings. Credit encourages consumption. However, there is no doubt that financial innovations in the credit industry improves consumer access to credit, helps the economy and stimulate flow of capital around the world. While the democratization of the credit markets is good, both the public and private market players should be vigilant to the risks of excess, both by lenders and by consumers.

Greenspan cites that the pending bulge of retirees accentuates the need to save more. Also, in the interest of intergenerational fairness, he argues for the piling up of surpluses in the social security trust funds.

Greenspan suggests that if households and business continue to save relatively little, then the federal government should compensate by achieving greater budget surplus.

3. Corporate Restructuring

What fuels restructuring? Greenspan cites the usual external suspects: exchange rate fluctuations (with special significance for exporters), technological change, structural economic shifts, and interest-rate and relative price movements. The changing face of American management and the continuing peculiarities in the U.S. tax system, which favors debt financing, also promote corporate restructuring.

Is corporate restructuring good or bad for the economy? Restructuring leads to a better mix of assets within companies and greater efficiencies in their use. This, in turn, is expected to produce marked increases in future productivity, and in the value of American business. The trend toward more ownership by managers and tighter control by other owners and creditors enhance operational efficiency.

Greenspan attests that restructuring is not a problem in need of a policy response. However, he believes that the greater use of debt makes the corporate sector more vulnerable to an economic downturn or a rise in interest rates. The financial stability of lenders, in turn, may also be affected.

Greenspan believes that it would not be wise to arbitrarily restrict corporate restructuring by allocating credit to specific uses through the tax system or through the regulation of financial institutions.

Greenspan favors the revision of the tax code to eliminate double taxation of corporate earnings, because this policy leads to higher than necessary levels of corporate debt.

4. Income Inequality

Greenspan welcomes a more careful and systematic investigation of wealth and income, but he is cautious against rushing to quick conclusions about income inequality. Over time, the relationship of economic growth, increases in standards of living, and the distribution of wealth has evolved differently in political and institutional settings.

On the research finding that demand for highly skilled technical workers is swiftly outpacing the supply, causing these workers' income levels to skyrocket, Greenspan reminds that the supply-demand gap is only one of the important indicators that should be reviewed.

Greenspan suggests that other relevant factors should be reviewed, such as, how private and public institutions may influence income inequality, and whether the growth of international trade has played an important role. The real challenge is to understand and evaluate standards of living, rather than just focusing on income levels.

Greenspan recommends a consistent monetary policy in which stable prices contribute to maximizing sustainable long-run economic growth. Such disciplined policies offer the best underpinnings for the identification of opportunities to channel growing knowledge, innovation, and capital investment into the creation of wealth that raises living standards as broadly as possible.

5. Small Business Finance

Businesses must have equity capital before they are considered viable candidates for debt financing. Equity acts as a sign of the creditworthiness of a business enterprise. The newer the firm is, the greater the importance of the equity base will be.

Most projections of the future banking structures call for substantial reduction in the number of American banks. Recent mergers resulted in the creation of nationwide banks and large financial service companies. The consolidations of the banking systems may help strengthen competitive community lending institutions, and in turn lead to more small business financing from this sector. The financial services industry has been transformed by recent innovations, with many positive results.

Greenspan believes that when the market participants discriminate, credit does not flow to its most profitable uses and the distribution of output is distorted. This results in higher costs, production of less real output and slower wealth accumulation. Discriminatory patterns in lending according to Greenspan, is the most disturbing potential roadblock.

Lenders should understand that failure to recognize the profitable opportunities represented by minority enterprises not only harms these firms, but also the lending institutions, and in the long run robs the broader economy of growth potential.

As large banks and finance institutions try mass market approaches to small business lending, the potential for inappropriate discrimination is diminished. Also, new intermediaries such as community development corporations, micro-business loan funds or multi-bank and investor loan pools are beginning to build expertise in specific areas of the small and minority business marketplace.

Greenspan also predicts that communication between small enterprises and lending institution will be much improved. The sharing of knowledge will bring about greater specialization and more funding sources geared to supporting and sustaining an ever-growing number of innovative new companies.

6. The Farm Economy

What prevents the agriculture industry from participating in the broad-based economic growth of the 1980's and 1990s?

1. As the potential for expansion of domestic demand is limited even in the strong economy, troubles and disruptions in other national economies, like weaknesses in Japan and other Asian countries, have direct effects on U.S. farming.
2. Exchange rates also influence the performance of domestic industries, including agriculture.

Greenspan believes the farm sector will profit from the future developments within the U.S. Advances in technology can help farms modernize and increase productivity resulting in lower costs. These developments will enable the farmers to compete in the world market. Modernization in agriculture will benefit the economy.

7. Mortgage Finance

Technological advances in the mortgage industry have resulted in lower costs for the providers which have led to lower costs for people seeking mortgages. The capacity to serve even greater numbers of customers in a more individualized plans, without suffering from service deterioration, has been the hallmark of the mortgage industry. Greenspan believes that this capacity will only grow in the future, as new technological innovations are brought to bear on the increasing levels of challenges of mortgage finance.

Greenspan is optimistic as of the future of mortgage banking despite the fact that changing demographics suggest that fewer new homes will be built and sold in the mid-term future.

The resiliency of the mortgage credit market highlights the value of having a diverse set of financial institutions and financial markets that serve a key sector of the economy, such as housing.

8. The Federal Budget Deficit

The deficit is a malignant force in the economy. It destroys the economic strength and deteriorates standard of living. Deficits are harmful because they pull resources away from private investment, thus reducing the growth of the capital stock.

Both productivity and higher taxes are not enough to resolve the basic long-term in the budgetary imbalance accounts. Discouraging risk-taking through excessive taxation of capital or repressive regulation will prevent emergence of high levels of investment, and will cause the level of savings to fall as real incomes stagnate.

Greenspan suggests some structural changes:

1. Sunset legislation, which would impose explicit termination dates on spending programs. Expiring programs that still have merit should be reauthorized.
2. Reevaluate the current services concept which assumes that no further congressional, judicial or bureaucratic actions will be taken to alter existing programs because the bias of such actions is toward more spending than less.
3. Support a constitutional amendment that stipulates that all revenue and expenditure initiatives require supermajorities to pass both houses of Congress.
4. In the short run, interest rates can be held down if the Federal Reserve accommodates the excess demand for funds through a more expansionary monetary policy. However, this will only bring greater inflation and economic instability.

Greenspan looks Toward the 21st Century

1. The "New" Economy

The future is expected to rest on the continuum from the past. Human nature appears immutable and ties the future to the past. The output of a free market economy and the notion of wealth creation reflect the value preferences of people. The economy is driven by human perception and human nature.

Foreign economies are likely to influence that of the United States, particularly in terms of the inflation rate.

When the degree of confidence in judging the future is high, discounted future values are also high – and so are the prices of equities.

An implication of high equity market values, relative to income and production, is an increased potential for instability. Overinvestment in short-lived assets that depreciate rapidly leads to a drop in domestic saving. So, there should be more caution.

The people's trust and enthusiasm compounded with inflation is likely to lead into a down cycle.

Greenspan sees capital investment as having the potential to magnify the instability of the economy because it leads to more efficient production processes, thus leads to downsizing and layoffs, just like what U.S. experienced in the early 1990s.

2. The Future of the Federal Reserve

The management of systemic risk is the job of the central banks. Individual banks should not be required to hold capital against the possibility of overall financial breakdown. The central banks offer a form of catastrophe insurance to banks against such events.

Any financial reform should be consistent with four basic objectives:

1. Continuing the safety and soundness of the banking system
2. Limiting systemic risk
3. Contributing to macroeconomic stability
4. Limiting the spread of both the moral hazard and the subsidy implicit in the federal safety net.

It is the responsibility of the Federal Reserve to maintain the stability of our overall financial system, including the interconnections between the domestic financial system and world financial markets.

Greenspan sees foreign crisis to threaten the domestic banking industry. The ability to respond quickly and decisively to any systemic threat depends on the experience and expertise of the central bank. The Federal Reserve must be directly involved in the supervision of banks of all sizes to carry out its systemic obligations. It also must be able to address the problems of large banks if one or more of their activities constitute a threat to the stability of the financial system.

3. The Future of the Banking System

Greenspan admits that technology promotes contagion across borders. The very efficiency that contributes so much to the global system also facilitates the transmission of financial disturbances effectively.

Greenspan identifies a number of critical tendencies toward disequilibrium and vicious cycles that will have to be addressed to head off crises and contagions in the future.

1. National economies that have already started down the road to high leverage and excessive risk-taking in both the bank and non-bank sectors will have to rein themselves in.
2. Emerging countries will have to be willing to subordinate "industrial policy" to market forces. Policy loans are bad as they foster misuse of resources, unprofitable expansions, losses and eventually loan defaults.
3. Banks with low-capital-asset ratios will have to be more disciplined about their risk-taking.
4. Banks will have to get off from their balance sheets the nonperforming loans to rid themselves of associated risk premiums.
5. Banks will need more regulation and supervision, both internally and externally.
6. Banks will have to cut back on short-term inter-bank funding, especially cross-border in foreign currencies.
7. Banks will have to be joined by other intermediaries.
8. Defaults and restructurings will have to be understood as part of the natural economic order.

As measure of objectivity and fairness is critical, Greenspan comments that it will entail courage, foresight, and selflessness to build and maintain the strong banking system of tomorrow.

4. The Future of Financial Services

Not all financial institutions will prosper, but many specialized providers of financial services will remain successful in the future because of their advantages in specific areas.

Technology is pushing the industry toward convergence. The well-managed smaller banks have nothing to fear from technology, globalization and deregulation. These banks will exist side by side with larger banks, often maintaining or increasing local market share. Technological change has facilitated this process by providing smaller banks with low-cost access to new products and services. However, technology can never fully displace the value of personal contact, the hallmark of community banking.

On structural level, there will be more pressure on Congress to allow merger of commercial and investment banks, as well as convergence of financial and non-financial institutions.

The critical challenge is to develop approaches to implementing umbrella supervision that are effective in limiting systemic risk without distorting economic incentives or being burdensome to banking organizations.

Only Congress can establish the ground rules to assure that competitive responses provide maximum net benefits to consumers and a fair and level playing field for all participants.

The regulators and the industry will continue to share fundamental goals – financial innovation, creative change, responsible risk-taking, and growth. The market forces will help the participants to get there.

5. Technology and the Future

For Greenspan, technology is a prime driver of the economy.

"Mass customization", the ability to tailor mass-produced products to meet the increasing consumer demand will be highly desirable.

Greenspan admits that the directions in which technological change will bring the U.S. and the rest of the world cannot be predicted precisely. As in the past, the economic institutions and the work force will strive to adjust, but it must be recognized that adjustment is not automatic. Any shift in the structure of the economy creates frictions and human stress. If the nation is able to boost investment in people, ideas, processes and machines, the economy can readily adapt to change and support ever-rising standards of living.

The Investor's Roadmap to Greenspan

Greenspan and the Future of the Stock Market

Greenspan believes that Internet stock mania is some type of hype that is more plus than minus. Internet stocks are an aspect of larger transformation due to technology.

Greenspan's personal portfolio is heavy with very conservative short-term Treasury bills. He does not invest aggressively in the bull economy that is in large part his creation. Greenspan may talk much about the bull market in the coming months, but it is doubtful that he will advocate drastic measures for the following reasons:

- Asset price inflation is difficult to judge.
- Strong interest rate actions would risk a crash.
- Greenspan does not like to interfere in free markets.

If the market falls it will have to fall a terrifyingly long way to erase the gains it has racked up since the 1987 crash. If that happens, Greenspan will most likely act decisively in the emergency to shore up the system.