PARSING THE CHAIRMAN

On April 14, 2000, Mr. Greenspan returned to a favourite topic – the implications that the massive use of derivatives in the financial system has for the practice of central banking, risk management and the reactions of the markets in a financial crisis. FRB: Speech, Greenspan — Technology and financial services — April 14, 2000

It seems unlikely that he would emphasize the risks without having an underlying concern.

“During a financial crisis, risk aversion rises dramatically, and deliberate trading strategies are replaced by rising fear-induced disengagement from market activity. It is the general human experience that when confronted with uncertainty, whether in financial markets or in any other aspect of life, disengagement is the normal protective reaction. In markets that are net long, the most general case, disengagement brings falling prices. In the more extreme manifestation, the inability or unwillingness to differentiate among degrees of risk drives trading strategies to seek ever-more-liquid instruments that presumably would permit investors immediately to reverse decisions at minimum cost should that be required. As a consequence, even among riskless assets, such as U.S. Treasury securities, liquidity premiums rise sharply as investors seek the heavily traded “on-the-run” issues–a behavior that was so evident in the fall of 1998.”

Is he concerned that the “disengagement” (central banker-speak for “panic”) that erupted so violently in 1998 could reoccur? Why would he say that bankers and regulators “have chosen capital standards that by any stretch of the imagination cannot protect against all potential adverse loss outcomes.”

Does he feel that central bankers have the tools to manage such an hypothetical “disengagement”? And when will they act? He says, “making that choice may be the essence of central banking.”

A master of ambiguity, he leaves us breathless with wonder at his concluding comment. “I am sure that nostalgia for the relative automaticity of the gold standard will rise among those of us engaged to replace it.”

Gold? Where did that come from? Is his job to create a financial system totally freed from the constraints of the “barbarous metal”, and thus solely in the hands of politicians? Financial historians quake at the prospect.

Does his certainty that the old order will appear so much more comfortable portend imminent “disengagement”? The dramatic deterioration in credit spreads during February and March raise these questions to the level of a credible scenario.

Stay tuned.