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Did Washington Set the Stage For Current Business Turmoil?

Seeking Growth, Policy Makers Made Free Markets Freer, Shot Down Naysayers

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On an unseasonably warm February morning in 1987, three bank executives squared off against the Federal Reserve board in a crowded hearing room in Washington, D.C. Their mission was to persuade the Fed to start tearing down the half-century-old regulatory walls between the business of banking and the business of selling stocks and bonds.

[What's Wrong?]

Fourth in a series

Paul Volcker, the Fed's gruff chairman, was leery. He worried that easing the limits set by the Glass-Steagall Act of 1933 posed dangers: lenders recklessly lowering loan standards in pursuit of lucrative public offerings; banks marketing bad loans to an unsuspecting public.

Thomas Theobald, then vice chairman of Citicorp, countered that three "outside checks" on corporate misconduct had emerged since the financial shenanigans of the Roaring Twenties had led to Glass-Steagall. He cited "a very effective" Securities and Exchange Commission, knowledgeable investors, and "very sophisticated" rating agencies, according to a tape of the hearing.

Mr. Volcker remained hesitant, but most of his colleagues thought it was time to free the markets from the restraints of Glass-Steagall.

The erosion of that landmark law was one of many steps that added up to a free-market sweep of Washington over the past quarter-century. Policy makers transferred onto the shoulders of investors more of the responsibility for steering financial markets and policing wrongdoing. Republicans and Democrats joined forces to loosen federal control over crucial economic sectors. Along with banking, they unshackled telecommunications and energy.

WHAT'S WRONG?

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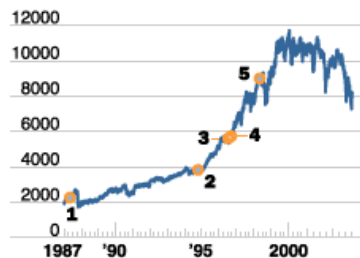
ON THE HOT SEAT

Scandal Scorecard⁵: From Adelphia to WorldCom, it's hard to keep the corporate scandals straight. Here's a rundown of who's who and what's next.

Printin

THE LAISSEZ-FAIRE ERA

Key Washington decisions as policy makers embraced deregulation and competition; Dow Jones Industrial Average monthly closes.



- 1 April 29, 1987** Fed begins easing Depression-era banking limits.
- 2 Oct. 1, 1994** SEC is forced to scale back inspections as Congress fights over funding.
- 3 Aug. 1, 1996** FCC releases rules designed to open local telecommunications markets to competition.
- 4 Sept. 24, 1996** Fed officials discuss popping the bubble but decline to act.
- 5 May 7, 1998** Fed, Treasury, SEC launch public fight to quash Commodity Futures Trading Commission study of new regulations for derivatives.

Source: WSJ Market Data Group

From the 1930s to the 1970s, Washington embraced an ever-greater role for the federal government. But the economic stagnation of the 1970s convinced politicians in both parties that the pendulum had swung too far. By the decade's end, Democrat Jimmy Carter launched the modern deregulation movement by freeing up the airline and trucking industries. His successor, Ronald Reagan, even more enthusiastically embraced the wisdom of markets over bureaucrats.

The reforms, the officials believed, would unleash innovation and raise living standards. Those good things did happen. Deregulation and low interest rates spurred a burst of technological investment that accelerated the growth of the economy and slashed the unemployment rate. But the savviest policy makers knew they were making a choice "between economic growth with associated potential instability, and a more civil ... way of life with a lower standard of living," as current Fed Chairman Alan Greenspan recently put it.

Now, with corporate corruption on the upswing and the stock market on the downswing, the trade-offs are all too apparent. Deciding not to meddle, the Fed let the stock-market bubble expand and pop to devastating effect. The Telecommunications Act of 1996 cleared the way for highfliers such as WorldCom Inc., which imploded after the biggest accounting fraud ever. The airline industry, having never really learned to cope with deregulation, slid into a series of slumps including a particularly devastating one now.

The decision in the 1990s not to regulate the arcane financial instruments known as over-the-counter derivatives made it tougher to uncover accounting tricks favored by Enron Corp. And it is now obvious that investors, and the stock analysts who advised them, weren't up to the task of making sure that corporate executives kept their priorities and books straight.

In short, it's clear in hindsight that the marketplace's own "checks," touted by Mr. Theobald 15 years ago, weren't enough to prevent the upheaval roiling the business world today.

Blame for business's recent troubles has been assigned to everyone from greedy executives to naive investors. But there were singular moments when Washington also made decisions with serious consequences. Here are five:

Chipping at Regulation

The morning that Mr. Volcker played host to Mr. Theobald and his fellow executives from **J.P. Morgan & Co.** and Bankers Trust New York Corp. was a bit of a landmark. It was only the third time in the secretive Fed's 74-year history that it had held a public hearing with outside witnesses.

UNSHACKLING THE MARKET

Banks diversified into underwriting¹
Five largest underwriters in 2002 vs. 1987:

FIVE LARGEST UNDERWRITERS, 2002 ²	MKT. SHARE
Citigroup/Salomon Smith Barney	13.0 %
Lehman Brothers	9.7
Credit Suisse First Boston	9.7
J.P. Morgan Chase	9.2
Morgan Stanley	7.4
■ Indicates commercial banks	
FIVE LARGEST UNDERWRITERS, 1987	MKT. SHARE
Salomon Brothers	15.3 %
First Boston Corp.	13.6
Goldman Sachs & Co.	12.7
Merrill Lynch Capital Markets	12.0
Morgan Stanley & Co.	11.0

¹Includes U.S. debt, equity and equity-related
²As of Oct. 14

Use of derivatives soared...

Total value of the market, in trillions



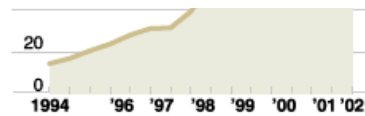
The bankers were seeking permission to sell certain securities. They weren't asking to sell stocks, just municipal bonds, commercial paper and securities backed by mortgages and credit-card receipts. Still, their pleas carried great symbolic value because they represented an assault on Glass-Steagall.

The triumvirate of bankers faced the five Fed governors across a large oval table, their lawyers and lobbyists watching from behind.

Mr. Volcker, the Fed chairman, brandished a copy of a 1934 letter to shareholders from the chairman of the National City Bank of New York, Citicorp's predecessor. In his rumbling voice, he read: "I personally believe the bank should be free from any connections, either directly or in any way, which might be taken by the public to indicate a relation with any investment banking house."

Why then, Mr. Volcker asked, was the lender back in Washington begging for permission to sell securities?

"The world has changed a hell of a lot," Mr. Theobald responded.



Note: Figures are for notional, or face value, of contracts outstanding, and include interest-rate swaps, cross-currency swaps, interest-rate options, credit-default swaps and equity derivatives.

And the telecom bubble expanded and popped
DJ Telecommunications stock index



Meanwhile, SEC cases surged while staff stayed flat
Staff vs. complaints and inquiries



Sources: Thomson Financial; International Swaps and Derivatives Association; WSJ Market Data Group; General Accounting Office



Paul Volcker

"But the law hasn't," Mr. Volcker barked. Citicorp was portraying its petition as so "innocuous," so "sensible," that "we don't have to worry a bit," Mr. Volcker complained. "But I guess I worry a little bit."

Having tamed double-digit inflation that plagued the late 1970s, the cigar-puffing Mr. Volcker was one of Washington's towering figures. A former undersecretary of the Treasury during the Nixon administration, he was appointed to his Fed post by President Carter. A Democrat, when it came to regulation, he was a pragmatic believer. But President Reagan had surrounded him on the Fed board with free-marketeters.

One of the Reagan appointees, Martha Seger, spoke up, challenging the logic of Glass-Steagall. "I don't think farm banks in Iowa or Michigan went under because they were underwriting or speculating in securities," she said.

"Thank you," Mr. Theobald interjected.

J.P. Morgan president Dennis Weatherstone explained that rapid market changes were putting banks at a "competitive disadvantage." Their clients were expecting new types of credit "they can readily get from our investment bank competitors," he said.

Nearly three months later, the Fed governors reconvened, this time in private, to vote. Though Mr. Volcker acknowledged the law was obsolete, he continued to fight. If a subsidiary was to be allowed to sell securities, it should have a name separate from the bank, he said. And in any case, he argued, it was the job of Congress to be making such important changes. The Fed's board approved the bankers' application 3-2, with Mr. Volcker voting against, according to minutes of the meeting.

That summer, the Reagan administration appointed Mr. Greenspan to succeed Mr. Volcker. The new chairman, a campaign adviser to Mr. Reagan in 1980, continued to chip away at the walls between banking and investment banking, and in 1997, banks were given permission to acquire securities firms outright. By the time Congress repealed Glass-Steagall in 1999, the law was pretty much obsolete anyway.

J.P. Morgan Chase & Co. and **Citigroup**, Citicorp's successor, were free to both lend money and underwrite securities for Enron, WorldCom and others, and they aggressively did so as they pushed to create diversified financial behemoths. But now the banks face questions about whether they extended risky loans in order to chase lucrative investment-banking deals with borrowers. J.P. Morgan said Wednesday that it was forced to take a charge in the third quarter of \$834 million for loans, largely to telecom and cable firms. Citigroup and J.P. Morgan also have been sued by WorldCom investors

alleging that they had a conflict of interest in lending money to the company and selling its bonds.

"The real problems have revolved around either bookkeeping or dodgy off-balance-sheet deals, all of which had nothing to do with the repeal of Glass-Steagall," says Mr. Theobald, now at a Chicago private-equity firm.

Mr. Volcker, 75, heads a global accounting-reform panel. He thinks the changes to Glass-Steagall, though inevitable, came without sufficient deliberation by policy makers. "Markets are absolutely indispensable," he says. "But I don't think they are God."

Starving the SEC

In May 1994, SEC Chairman Arthur Levitt told a congressional panel that he "would walk on hot coals" for a larger, more stable source of funds for his agency. Since the early 1980s, he told legislators, the value of public offerings had jumped nearly 1,800%, while the SEC staff had grown just 31%.

But Mr. Levitt's budget campaign faltered, thanks to a clash between two fiery lawmakers with very different ideas about the role of market regulators.



Arthur Levitt

Mr. Levitt's idea was to fund the SEC with fees paid by companies registering stock offerings. At the time, the SEC simply collected the fees and shipped the money -- an amount double the agency's annual budget -- off to the Treasury.

Mr. Levitt had an ally in Rep. John Dingell. The veteran Democrat had inherited his Detroit-area seat from his father, an ardent New Dealer who backed the creation of the SEC in 1934. The year before Mr. Levitt offered to do his coal walk, the younger Mr. Dingell had pushed a bill through the House that would have allowed the SEC to keep more of its fees. But it had stalled in the Senate.

This time, he tried an entirely different tack. Mr. Dingell persuaded the House to pass a bill cutting the SEC budget for 1995 to \$59 million from about \$270 million in 1994. He wanted senators to believe that unless the SEC was allowed to keep its fees, it would go belly up.

But Mr. Dingell hadn't factored Sen. Phil Gramm into his strategy. "Don't threaten me," the Texas Republican warned when asked about Mr. Dingell's ploy. "I may take you up on your offer."

A conservative economist with a deep skepticism of government, Mr. Gramm had spent the 1980s on the front lines of the war against federal spending. "Unless the waters are crimson with the blood of investors, I don't want you embarking on any regulatory flights of fancy," Mr. Gramm once told Mr. Levitt, according to a new book by Mr. Levitt.

Mr. Gramm thought self-funding would make the SEC too powerful. He dismissed the idea that it was starved for funds, writing to colleagues that with "a 145% growth in SEC funding since 1986," the SEC's budget "has grown faster than inflation, faster than the U.S. economy, faster even than the federal budget."

Throughout the summer, Messrs. Dingell and Gramm played parliamentary chicken with the SEC budget. The new fiscal year began Oct. 1 without full funding. At the SEC, Mr. Levitt curbed travel and scaled back inspections.

Ten days later, Congress put the agency back in business with an appropriation of \$297 million -- a 12% increase.

But Mr. Levitt and Mr. Dingell's victory was shallow and short-lived. Though the SEC had gotten more money, the self-funding notion was dead, leaving the agency at Congress's mercy. A month later, the Republicans won control over Congress, and Mr. Gramm took over the Senate committee setting SEC funding.

In 1995, Mr. Gramm won his committee's approval for a 20% funding reduction in the SEC's budget. Ultimately, he didn't have his way and the budget wasn't cut. Still, his counter-offensive changed the way Washington viewed Wall Street's overseer.

From fiscal 1995 to 1998, the SEC's work force and budget stayed about constant, adjusted only for inflation. In 1997, Mr. Levitt sarcastically noted to a House panel that SEC funding was below that of the Sportfish Restoration program, but lawmakers didn't nibble.

During those years, the number of corporate SEC filings grew 28%. Investor complaints rose 20%. The value of initial public offerings rose by a factor of 12. The agency cut back on reviewing financial filings, examining just 11.9% of the statements filed in 1998, down from 18.5% in 1995. It conducted its last thorough review of Enron's books in 1997.

It took the WorldCom bomb to revive Washington's backing of the SEC. In July, Congress authorized a 69% budget increase. But with the overall budget frozen in Congressional gridlock, the agency has only gotten a fraction of its new funding -- and may have to cut its expenses to pay for the new accounting oversight board Congress created.

Mr. Gramm, who is leaving the Senate to join the big Swiss investment bank UBS Warburg as a vice chairman, hasn't changed his mind. With self-funding, "you would lose accountability," he said recently.

Ramping Up Telecom

"How'd you like that telecom act?" a senator asked Reed Hundt, head of the Federal Communications Commission, shortly after it became law in early 1996.

"I've studied it a lot," Mr. Hundt said.



Reed Hundt

"Then you know we put everything in there," the senator said, laughing, and "then we put its opposite in." The Senator slapped Mr. Hundt on the shoulder and walked away, according to the former FCC chairman's memoirs.

In spirit, the sprawling Telecommunications Act of 1996 discarded the pro-regulation philosophy of the 1934 Communications Act, which had treated the telephone industry as a monopoly. Just as the breakup of **AT&T** Corp. had created competition in the long-distance business, the new act aimed to unshackle local markets, giving consumers cheaper phone, video and computer services.

But Congress worried that overnight deregulation would let the regional Bells smother new rivals. It instructed Mr. Hundt to spend six months writing a whole new web of rules governing the \$100 billion market.

At the FCC's aging eight-story headquarters near Georgetown, staffers spent months swapping complex economic models and arguing endlessly over the meaning of the word "cost." Lobbyists and telecom executives besieged the FCC with nearly 1,300 visits, phone calls and letters, as well as filings totaling 17,000 pages.

A wisecracking antitrust lawyer who went to prep school with Al Gore and law school with Bill Clinton, Mr. Hundt liked to joke that his appointment to the FCC was "just a coincidence. The truth is that I got the job because I have the same birthday as Alexander Graham Bell."

But Mr. Hundt, who believed that telecom needed a good shake-up to stir competition, had serious adversaries in Mr. Bell's namesakes. That spring, Bell Atlantic Corp., which serviced Washington, bused FCC staffers to its Baltimore switching facility to demonstrate the technical difficulties of opening its network to new competitors, a tour that included opening manhole covers to reveal the complex tangle of underground cables that would somehow have to be unbundled.

Long-distance carriers, meanwhile, encouraged Mr. Hundt to stand his ground so they could go head-to-head with the Bells and capture a piece of the big business of serving local customers. In June, Bernard Ebbers, president of long-distance provider WorldCom, spent two days prowling the FCC's halls making his case. The new rules, he wrote to Mr. Hundt, were "so important to WorldCom and the future of telecommunications competition."

On Aug. 8, 1996, the FCC released its 682-page "interconnection order" setting the rules for opening local markets and tilting the playing field toward telecom upstarts. Weeks later at a press conference, Mr. Ebbers announced WorldCom's \$14.4 billion acquisition of MFS Communications Co., an innovative Nebraska local service provider that had swallowed UUNet, an Internet pioneer. The acquisition, Mr. Ebbers said, had been "encouraged" by the new telecom law and the "absolutely fabulous" FCC rules.

It was precisely what Mr. Hundt had hoped for. "Within three years, there were 6,000 Internet providers, 250 new competing local telephone companies, a half-dozen new long-distance companies, dozens of new equipment vendors," he wrote in "You Say You Want a Revolution," published in 2000.

Yet opening the telecom market to competition turned out to be a painful process. In the past two years, telecom stock prices have plummeted. WorldCom's bankruptcy filing in July was only the most recent of two dozen by publicly traded telecom firms this year. Accounting scandals have bloomed at WorldCom, **Qwest Communications International Inc.**, Global Crossing Ltd., and Adelphia Communications Corp.

In the wake of the debacle, there has been plenty of finger pointing. The Bells insist that Mr. Hundt's rules made it too easy to enter the market, causing severe overcapacity. Announcing a round of 11,000 layoffs last month, Texas-based **SBC Communications** cited "regulations that force us to sell our product below cost." Telecom upstarts blame the Bells for sabotaging deregulation with yet-to-be-resolved court fights.

Mr. Hundt makes no apologies. Now a consultant at McKinsey & Co., he brandishes graphs showing how telecom's share of the economy has grown as consumer prices have plunged. "The 1996 telecom act produced the greatest consumer benefit of any law within a generation," he says. "I'm happy to claim whatever credit I can get."

The Fed: Party On

As Fed members took turns giving their assessments of the economy at their September 1996 meeting, most focused on their fears of impending inflation. Lawrence Lindsey, at 42 the board's youngest member, had something different on his mind: soaring stock prices.



Lawrence Lindsey

"Last night, one of the TV news magazines had a story about people who won the megabucks lotteries, millions of dollars -- and ruined their lives," he said, according to a transcript of the meeting. "The TV show reminded me that we have been having a string of what appears to be good luck. ... Our luck may be running out."

With the bull market shifting into high gear, and the Dow Jones Industrial Average poised to break 6000, Mr. Lindsey fretted that Wall Street had developed "a gambler's curse." He thought the Fed should consider reining in the market. Popping the bubble might have unpleasant effects on the economy, he acknowledged, but "I think it is far better that we do so while the bubble still resembles surface froth."

Most officials ignored Mr. Lindsey's views of what he called the "economic party." But after a coffee break, Mr. Greenspan agreed it was a problem "we should keep an eye on." Still, he worried aloud that the Fed's limited options for damping the market -- raising interest rates or making it harder for investors to borrow by raising margin requirements -- would cause a recession. The Fed didn't end up raising rates that day.

Partly encouraged by the Fed's inaction, the Dow kept marching upward. It crossed 6300 the day before the Fed reconvened on Nov. 13. By then, more members were concerned. Thomas Melzer, president of the Federal Reserve Bank of St. Louis, talked of "speculative excesses" and wondered if "by moving now, we might be able to avoid a bigger accident." Still, they left interest rates alone.

At an American Enterprise Institute dinner three weeks later, Mr. Greenspan used carefully chosen words to raise the question of whether "irrational exuberance" was boosting stock prices. Wall Street took note. With traders worried that the Fed would try to drive down shares, the Dow industrials fell 145 points before recovering some losses by the close. Investors bitterly complained that Mr. Greenspan had overstepped his role in criticizing the market.

A few board members congratulated Mr. Greenspan at the Fed's December meeting for taking some air out of the bubble. Mr. Lindsey, however, remained skeptical that a single speech would do the trick. "I think that ... 1997 is going to be a very good year for irrational exuberance," he said.

Mr. Greenspan replied, "I will make another speech." His colleagues laughed.



Alan Greenspan

The Fed never did openly target the stock market. And Mr. Greenspan never gave a speech forcefully declaring that he thought shares were overvalued. Though the Fed did end up raising rates -- once in 1997 and throughout 1999 and early 2000 -- the central bank explained the moves as an attempt to pre-empt inflation, not curb stocks. Mr. Greenspan's respect for market forces made him reticent about second-guessing investors, "many of whom are highly knowledgeable about the prospects for the specific companies," he said in 1999 at the Fed's retreat in Jackson Hole, Wyo.

When Mr. Greenspan returned to Jackson Hole this past August, the Dow had retreated some 3000 points, or 26%, from its January 2000 high of 11723. He defended his earlier decisions, arguing that pricking the bubble might have caused a recession. Meanwhile, the plunge in stock prices has contributed mightily to the current U.S. economic slump.

Mr. Lindsey left the Fed in early 1997 and, a year later, sold all of his personal stock holdings, he said in a 1999 speech. Now an economic adviser to President Bush, he says it's too early to tell whether leaving the bubble alone was the right choice: "Economic historians will be debating this issue for decades to come."

Bullying Brooksley Born

Meetings of the President's Working Group on Financial Markets, formed in the wake of the 1987 stock-market crash, were usually staid, scripted affairs.

Not so on April 21, 1998. A crowd of regulators watched in silence as Robert Rubin stared across the table in the Treasury Department's ornate conference room at Brooksley Born, head of the Commodity Futures Trading Commission. Mr. Rubin, President Clinton's venerated Treasury Secretary, curtly informed her that she had no right to pursue her plan to explore whether more regulation was needed of the market for over-the-counter derivatives.

Mr. Greenspan, sitting to Ms. Born's right, chimed in with a warning that she risked disrupting U.S. capital markets.

Messrs. Rubin and Greenspan were used to getting their way, but Ms. Born didn't flinch. The career litigator declared that, as head of an independent agency, she could go right ahead. "It was really unpleasant," says one attendee.

Ms. Born's thinking made her the odd person out among the others in the room. The value of the OTC derivatives market had grown fivefold to \$29 trillion in the six years since regulators had last considered regulating the financial instruments. They derive their value from price shifts in underlying assets, such as the interest on a bond, the value of a currency or the price of a barrel of oil. Multinational corporations, for example, use derivatives as a hedge, to protect themselves against sudden swings in the value of the dollar.



Brooksley Born

Mr. Rubin was a former co-chairman of **Goldman, Sachs & Co.** whose major political achievements included making Wall Street and business executives comfortable with Democrats and persuading President Clinton to balance the federal budget. He took seriously Wall Street's complaints that even the threat of regulation could void pending transactions. Mr. Greenspan believed that innovative derivatives were making the economy more efficient by providing companies with a hedge against financial fluctuations.

And yet Ms. Born worried that leaving derivatives unregulated also carried huge risks. Over-the-counter derivatives were traded directly between companies, away from regulated futures exchanges. Because they weren't subject to rules that applied to other securities, little was disclosed about the transactions. That made it easier for traders to take big risks, or fraudulently manipulate deals. Derivatives had contributed to some spectacular blowups, including the bankruptcy of Orange County, Calif., and the demise of 233-year-old Barings PLC, which went belly up in 1995 after a rogue trader lost \$1 billion in unauthorized derivatives trades.

In early May, Treasury and Fed officials circulated word to worried financial lobbyists that they had persuaded Ms. Born to back down. They were mistaken. Just days later, the CFTC released a "concept release" raising 75 questions about the way the OTC derivatives market was regulated. Treasury and the Fed received no advance notice.

The CFTC paper didn't propose new regulation. It just suggested that it might be needed. But that was enough to make Messrs. Rubin and Greenspan fear that the market would be destabilized if people read the paper to mean that derivatives had been sold illegally. Within hours, joined by SEC Chairman Levitt, they rushed out a statement saying they had "grave concerns" about the study.

Wall Street went into lobbying overdrive, as leading derivatives underwriters such as J.P. Morgan, heavy derivatives users like Enron, and nearly a dozen financial trade groups pleaded with the Fed and Treasury to stop Ms. Born. They then asked Congress to block the study.

In late July, Mr. Greenspan told the House Banking Committee that Ms. Born was trying to pick a fight with the capital markets. "If somebody says to me, 'I'm contemplating punching you in the nose,' I don't presume that that is a wholly neutral statement," he said.

Ms. Born, sitting at the table with Mr. Greenspan, said he had distorted her plan. She explained that she was merely asking, "Do you think you need a punch in the nose?"

"You don't intend to punch Dr. Greenspan in the nose, do you Ms. Born?" New York Democratic Rep. John LaFalce asked.

Even a financial meltdown that fall, triggered by bad derivatives bets made by the Long-Term Capital Management hedge fund, didn't help Ms. Born's cause. A month after the Fed brokered a bailout of LTCM, Congress passed a six-month moratorium on proposing or adopting derivatives regulation that lasted until Ms. Born's term expired. In late 2000, Congress passed a bill stating that OTC derivatives in most cases weren't subject to regulation.

Enron used derivatives to mask balance-sheet problems. Revelations that rival energy traders used derivatives for similar controversial transactions have prompted investors to lose confidence in the largely unregulated energy-trading sector, causing a loss of some \$200 billion in the market value of a dozen energy companies over the past year. Congress now is considering a bill to tighten oversight of energy derivatives.

Ms. Born, these days practicing law in Washington, says that if she had succeeded four years ago, regulators would have been more likely "to detect misuse of derivatives by entities such as Enron."

But Mr. Greenspan still believes in the value of an unregulated derivatives market. Those instruments, he said in a speech in September, "have effectively spread losses from defaults by Enron, Global Crossing" and others, cushioning the blow to the economy. "So far," he insisted, "so good."

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