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FOMC ALERT

OCTOBER 3, 2000

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MERCHANTS OF RISK: THE FED DRAWS A LINE

For 20 years, large financial firms waged a relentless campaign to dismantle the regulatory system that had governed their industry since the New Deal. Over time, politicians of virtually every stripe rallied to their cause. Editorials in the *Times* and the *Post* blended seamlessly with Q&A sheets in their press packets. Citicorp merged with Travelers. Regulators resolved their turf battles. Securities and insurance accepted banks' version of Glass-Steagall repeal. And then, poof, no more "Depression-era banking law."

Except for one small detail.

Thanks to a handful of unreconstructed lawmakers, the new Gramm-Leach-Bliley Act maintains, albeit tenuously, a legal wall between banking and commerce – the bedrock legacy of 1930s financial reform and an enduring historical judgment against the giant combinations that controlled America's economy at the turn of the 20th century. Now, like winners in many successful campaigns before them, the victors of Washington's financial decontrol struggle are attempting to reinterpret the terms of their triumph – in this case, by taking down the wall.

Surprisingly, the biggest obstacle to their efforts has turned out to be the Federal Reserve. In a striking reversal

of the *bon temps roulez* spirit that has characterized Alan Greenspan's approach to financial regulation, the central bank is taking a relatively tough line on the merchant banking powers that Gramm-Leach-Bliley (GLB) bestowed on financial holding companies. As it plays out, the battle over those powers promises to shape the values, priorities and economic outcomes that define the country's new financial framework.

Historically, merchant banking conjured up images of Europe's royal

families of finance, who lorded over the traded economy and geopolitics of previous centuries by bankrolling everything from the Crimean War (Rothschilds) to the Louisiana Purchase (Barings). Chronicling these dynasties, Joseph Wechsberg observes that they operated "in the twilight zone between politics and economics," occupying the space that central banks and ministries of finance would later assume.

In contemporary America, merchant banking connotes a much more mundane mix of financial activities,

(cont. on page 2)

MERCHANT BANKING POWERS

BEFORE GLB	AFTER GLB
<p><i>Permissible Investments for Bank Holding Companies</i></p> <ul style="list-style-type: none"> • Small Business Investment Companies (through Small Business Investment Act) • Foreign nonfinancial companies (through Edge Act) • Domestic nonfinancial companies (through Bank Holding Company Act) <p><i>Permissible Investments for State-Chartered Banks</i></p> <ul style="list-style-type: none"> • Varies with state law 	<p><i>Permissible Investments for Financial Holding Companies</i></p> <ul style="list-style-type: none"> • Any company <p><i>Permissible Investments for Bank Holding Companies</i></p> <ul style="list-style-type: none"> • Unchanged <p><i>Permissible Investments for State-Chartered Banks</i></p> <ul style="list-style-type: none"> • Unchanged
<p><i>Major Restrictions & Requirements</i></p> <ul style="list-style-type: none"> • BHCA - authorized holdings cannot exceed 5 percent of voting shares or 25 percent of total shares in any portfolio company • Substantial restrictions on ownership and management rights under each separate authority 	<p><i>Major Restrictions & Requirements (FHCs)</i></p> <ul style="list-style-type: none"> • May own 100 percent of any company but total holdings cannot exceed \$6 billion or 30% of Tier 1 capital without Fed approval • Investments can only be held for 10 years (15 years if through private equity fund) • Restricted participation in "routine management" of portfolio companies • Detailed record-keeping required
<p><i>Capital Requirements</i></p> <ul style="list-style-type: none"> • 8 percent on all holdings 	<p><i>Capital Requirements</i></p> <ul style="list-style-type: none"> • 50 percent on all holdings

FOMC ALERT

FOMC Alert is published by the Financial Markets Center, an independent, nonprofit institute that provides research and education resources to grassroots groups, unions, policymakers and journalists interested in the Federal Reserve System and financial markets.

Through its work, the Center seeks to promote democratic values, accountable public institutions and improved living standards for ordinary citizens.

In addition to publishing the *Alert*, the Center produces periodic reports on issues in monetary policy and financial regulation. It also conducts educational workshops and conferences.

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Merchants of Risk *(cont.)*

the most prominent of which is taking ownership positions in privately held companies. Within the banking industry, high-profile merchant banking has remained primarily the province of a few large holding companies that went to the trouble of using the limited equity investing authority available to them through the Edge Act, the Small Business Investment Act and the 1956 Bank Holding Company Act.

Altogether, the banking industry accounts for nearly ten percent of the \$400 billion private equity market, approximately one-third of which involves venture capital investments in start-up and early-stage firms. The remaining two-thirds includes leveraged buyouts and investments in middle-market companies.

According to the Fed, the ten largest players control 90 percent of all private equity investments held by the banking sector. Despite the restrictions imposed on their merchant banking operations, these firms doubled the size of their combined private equity holdings between 1994 and 1999 – in many cases reaping exuberant earnings. In recent years, analysts say, banks like Chase Manhattan, Citigroup and FleetBoston have earned 30 to 40 percent returns on their venture capital portfolios.

Unsurprisingly, then, the companies that fought hardest for passage of GLB discreetly eyed expanded merchant banking powers as the new law's crown jewel – something a civilian observer never would have guessed by following the national media's bored coverage of financial deregulation.* In the unscrutinized ebb and flow of congressional deal making, the circumspect champions of merchant banking authority mostly got what

they wanted. GLB removed old limits on equity ownership and, with only a few sketchy conditions, authorized financial holding companies – the new, under-one-roof corporate form for banking, insurance, securities and other activities – to control 100 percent of any type of firm, commercial or financial.

As a product of energetic horse-trading, however, these GLB provisions stacked layers of murk atop an underlying contradiction. Though GLB's architects insisted that banking and commerce remain separate, the merchant banking powers they approved inevitably bring the two closer together.

GLB restricts financial holding companies (FHCs) from "routinely managing" companies in their merchant banking portfolios. But it doesn't explain the meaning of that elusive term. GLB expressly permits FHCs with a securities affiliate to conduct merchant banking activities. But the law doesn't define securities affiliate or merchant banking. Nor does the law clarify its inscrutable mandate "to protect depository institutions." Instead, it leaves all the defining to the regulators.

On March 17, the Fed stepped into this breach with two proposed rules. The first, issued jointly with the Treasury Department, spelled out various restrictions on FHC involvement in managing the affairs of its merchant bank's portfolio companies. It also put a cumulative dollar limit (\$6 billion) on investments an FHC may hold in its merchant-bank portfolio and specific time limits on the retention of each asset. The second rule, based on Fed research into current industry practices, required FHCs to guard against

* A Lexis-Nexis search of major U.S. newspapers yields only a handful of instances in which the term "merchant banking" appeared in articles mentioning "Glass-Steagall" or "financial modernization" between January 1995 and GLB's enactment in November 1999.

investment losses by setting aside 50 cents of capital for every dollar of their merchant banking assets – a six-fold increase over the pre-GLB requirement.

Both rules gave FHCs ample room to throw their weight around. Despite restrictions on participating in “routine management,” for example, an FHC may still name senior officers and directors of its portfolio companies – including directors who are employees of the FHC itself. Moreover, an FHC can require portfolio companies to obtain its approval for actions “outside the ordinary course of business,” such as business plan changes. In June, Governor Laurence Meyer, the central bank’s point man on merchant banking issues, told Congress that the new \$6 billion caps on merchant bank holdings were “really thresholds,” since the rule allows an FHC to exceed this limit with the Fed’s approval.

Despite these features, the Fed’s rules sparked a carefully orchestrated firestorm of protest from the financial industry. Steve Bartlett, president of the Financial Services Roundtable and a former Texas congressman, denounced the rules as a “a disaster for the economy, a disaster for Gramm-Leach-Bliley and a disaster for the banking industry.” The Bank Private Equity Coalition, an alliance of five megafirms heavily involved in merchant banking and the drafting of Glass-Steagall repeal measures, pronounced itself “shocked and disheartened” by the Fed’s actions.

Even the central bank’s own Federal Advisory Council – the elite group of banking industry representatives that meets with the Board of Governors each quarter – took the unusual step of filing a sharply critical response to the rules. Indeed, of 137 public comments submitted to the Fed by parties ranging from the Swiss embassy to the development lender Shorebank, only one – from the Independent Community Bankers of America – endorsed the central bank’s approach.

According to industry sources, Chase Manhattan took the lead in organizing opposition to the rules. Like its cohorts, Chase had a fairly straightforward goal – toppling the obstacles to *kieretsu*-style finance. But the big banks skillfully meshed their agenda with a broader spectrum of complaints. And they benefited from trade groups – notably Bartlett’s Financial Services Roundtable – competing to

energize and broaden their membership with GLB policy issues.

Grievances rained down on the Fed. Small businesses advocates predicted that raising bank capital requirements to 50 percent on SBIC holdings would stop the flow of capital to Main Street. State-chartered banks griped that the higher capital standard would push them out of the private equity market (a huge percentage of the Fed’s comment letters came from state-chartered banks in Massachusetts, one of the few states with a grandfathered law that permits such investments by its banks). Securities firms grumbled that the Fed’s portfolio size limit would block their path to commercial banking – GLB’s fabled “two-way street.”

More revealing than the substance of these complaints was the petulance and high-handedness with which they were conveyed, particularly by the nation’s biggest banks. In a blustery comment letter, Bank of America assured the Fed that its “draconian” capital requirement “would have been defeated” if proposed during congressional deliberation over GLB “or the banking industry would have withdrawn its support.” Wells Fargo – perhaps the Fed’s most vociferous critic – complained that “financial holding companies shouldn’t be forced to centralize record keeping.” Chase Manhattan insisted that FHCs *should* enjoy the prerogative of routinely managing their portfolio companies (Chase Capital Partners, the bank’s venture finance unit, currently holds board seats in more than 560 firms).

As the industry campaign reached critical mass, its supporters in the House and Senate held a pair of hearings designed to ramp up pressure on the Fed. Big banks used the forum to publicize their complaints and associate themselves with fellow witnesses from sympathetic organizations like the National Black Chamber of Commerce. Members scolded the Fed for allegedly running roughshod over congressional intent. And a third of the Senate Banking Committee followed up with a blunt letter warning the Fed to change direction.

Despite their organizing prowess and powerful sense of pique, the companies seeking totally unrestricted merchant banking powers have lacked one important weapon: a persuasive argument. None of their lobbying has shown convincingly why American capital users would benefit from a bigger FHC presence in private equity markets or why regulators should simply let the attendant safety and soundness concerns sort themselves out.

From a demand-side perspective, promising start-up and early-stage companies have hardly wanted for capital in recent years. Without any assistance from GLB, money has gushed into high technology and other preferred sectors through private equity partnerships that funnel investments for pension funds, endowments and other institutional investors. As Paul Gompers and Josh Lerner of Harvard

(cont. on page 4)

ONLINE RESOURCES

Check out www.fmcenter.org for:

- A detailed summary of the Fed’s merchant banking rules by Mary Jo Parrino
- Exclusive weekly profiles of the financial holding company industry
- News, analysis and links on financial modernization

Merchants of Risk *(cont.)*

Business School have noted in their research, private equity markets remain vulnerable to volatile capital flows. But it's not at all clear that FHCs would steady those flows by expanding their merchant banking activities.

In less-sexy sectors of the economy the biggest capital challenge facing new, young and mid-sized companies is the financial industry consolidation that has left megabanks in the driver's seat while winnowing the ranks of independent institutions that do relationship-based finance in local markets. Small business investment companies were established to help bridge such gaps and the Fed would not jeopardize its overall regulatory strategy by restoring the previous eight percent capital requirement for SBIC investments. But even if the merchant banking rules remain unchanged, the additional capital required to back all existing SBIC investments would amount to only four-tenths of one percent of commercial banking equity at yearend 1999.

At another level, encouraging big FHCs to enter private equity markets could have unintended effects on innovation and business development. As an industry, commercial banks (the dominant firm in virtually all FHCs to date) have seldom been associated with visionary thinking. In the world of private equity finance, Sequoia Capital symbolizes success for betting its money on the cluttered trailer that became Yahoo! In the world of big banking, BankAmerica bulldozing its way through another acquisition passes for a creative act. If a nation were building its financial system from scratch, which of the two would it choose to help long-shot entrepreneurs nurture the pioneering business in their garage?

Over on the capital markets' supply side, taxpayers' exposure to financial failure surely justifies a cautious approach to merchant banking powers. Investors demand high returns in private equity deals precisely because their risks multiply in the course of making long-term, illiquid investments in new or troubled companies. According to the Fed, between one-quarter to one-third of all venture capital investments over the past four decades have resulted in absolute losses. And neither losses nor gains from merchant banking tend to be orderly or predictable.

Chase Manhattan offers a prime example of these roller-coaster possibilities. In 1999, Chase Capital Partners realized huge returns on its tech-rich portfolio and generated more than a quarter of its parent firm's operating earnings. But during the second quarter of 2000, the parent company's earnings dropped precipitously compared to its year-before performance, despite rising profits in most of its commercial banking activities. The reason: a 51 percent earnings plunge in its venture capital unit. If FHCs like Chase become even more

reliant on merchant banking revenues in the future, their earnings could grow even more volatile, particularly during periods of market turmoil.

Big banks generally appreciate the magnitude of these risks and, pre-GLB, voluntarily set aside substantial capital to cover potential merchant banking losses. However, says Fed Governor Meyer, "the underlying methodologies banks use to allocate internal capital aren't that sophisticated and don't allow banks to make distinctions" between the riskiness of individual investments. Thus the need for tough supervisory capital requirements – and for greater skepticism about banks' internal risk-management systems replacing regulatory oversight.

Indeed, the troubling implications of no-holds-barred merchant banking don't stop at the firm level. Multiplied many times over, a busy bundle of stock ownership and credit creation like Chase looks a lot like the universal-bank/cross-shareholding systems that have fostered economic stagnation in other parts of the world. In addition, this model of finance poses the potential for rampant conflicts and self-dealing.

Example: an FHC has a chance to finance a competitor of a company in which it has significant ownership. Will the credit decision be based solely on the borrower's creditworthiness or on other factors? Example: as an FHC holds more equity in portfolio companies, its affiliated analysts come under pressure to tailor buy/sell recommendations that run counter to the FHC's actions for its own account. Will the analysts resist heroically or help their bank make even more money at the expense of its clients? Example: in the event of bankruptcy, an FHC stands last in line to collect on outstanding loans to a company in which it holds an equity stake. Will the bank face the music or throw good credit after bad to prop up the firm?

All these considerations notwithstanding, the Fed has found itself quite isolated on the subject of merchant banking powers. Congressional Democrats and Republicans have flailed at the central bank's rules like a regulatory piñata. House Banking Committee Chairman Jim Leach, a key defender of the Fed and banking-commerce separation, has purposely steered clear of the debate. Though the lame duck Treasury Department has publicly supported the Fed, other executive agencies – the SBA, the FDIC – have joined the piling on.

The Fed's isolation may result from nothing more complicated than the absence of a natural constituency for financial safety and soundness. Or the central bank may have chosen not to spend its abundant political capital on such an inside-baseball dispute. But the

(cont. on page 7)

United States Senate

Dear Governor Meyer,

On behalf of the Securities and Financial Institutions Subcommittees of the Senate Committee on Banking Housing and Urban Affairs, thank you for appearing as a witness on June 13 to discuss the Board's Interim and Proposed regulations concerning merchant banking activities.

Your testimony was helpful in clarifying your intent to consider carefully the views of members of Congress, the financial services industry and other interested parties concerning your proposed regulations. Your assurances that the Board's goal is to encourage Financial Holding companies (FHCs), bank holding companies and banks to engage in innovative and progressive private equity investment activities while preserving the safety and soundness of the financial services system is welcome.

As the Board considers issuance of final rules we strongly urge that several factors be considered. One is the overwhelming opposition to all or parts of the proposal from the public comments which you have received. Our understanding is that of 92 comment letters which you have received, only one was fully supportive. The others were either neutral or largely in opposition.

If the public comment exercise is to have relevance, this fact needs to be addressed. Second, we heard what we believe to be very persuasive testimony at our hearing that bank holding companies and banks themselves through Small Business Investment Companies (SBICs) and other statutory authorities, have engaged effectively and safely in a range of merchant banking activities for many years. This experience was corroborated by the Small Business Administration's (SBA) report indicating that since 1978, SBIC's only experienced one year in which they experienced net losses in principal. Third, and very importantly from our perspective, is to bear in mind the careful attention which Congress gave to the merchant banking provisions as the Gramm-Leach-Bliley Act (GLB) was being considered.

The manner in which merchant banking activities may be conducted by FHC is quite specifically defined in the act. We therefore take strong exception to several provisions of the proposed rules which, in our judgement, go beyond the intent of the legislation as agreed to by the Congress.

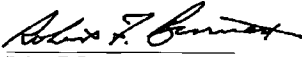
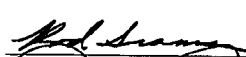
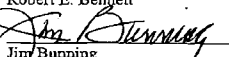
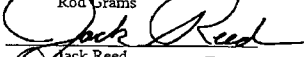

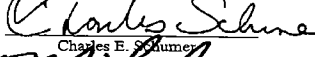


We are particularly concerned about the 50% capital imposition on merchant banking activities. The Congress addressed capital adequacy issues with great specificity in the Federal Deposit Insurance Improvement Act (FDICIA). The Congress is not unmindful of this issue, however, there is no provision in GLB which requires new rules providing specific additional levels of capital for merchant banking. We note that the blunt 50% capital provision applies to all merchant banking activities wherever conducted. This approach to capital adequacy is in stark contrast to recent regulatory efforts by the Fed and other federal regulators encouraging financial institutions to develop risk management models which can assess capital and loan loss reserves according to a more carefully considered approach to managing risk. We note with interest the recently released Federal Reserve Supervisory Letter on merchant banking activities which states in part:

"The potential risks and returns of equity investment and merchant banking activities exceed those of many more traditional banking activities. Consequently, organizations substantially engaged in these activities should have strong capital positions, with capital backing these businesses that is well above their current minimum regulatory requirements for traditional banking activities. They should also have robust internal methods for allocating capital that fully reflect the risks inherent in these activities."

It seems to us that an inflexible 50% capital requirement will discourage both merchant banking participation and refinement of existing capital allocation models based on risk. Additionally, we have yet to hear a compelling justification for applying a mandatory cap on merchant banking activities. In fact, it has been suggested that the \$6 billion investment cap may harm safety and soundness by limiting diversification and by limiting the competitive options of Financial Holding Companies that choose to compete in this market.

In addition to the concerns expressed in this letter, your testimony and the testimony of industry participants raised other concerns about the proposed regulations which are addressed in the enclosed questions to which we would appreciate your written response.

Thank you for your cooperation.

 Robert E. Bennett	 Rod Grams
 Jim Bunning	 Jack Reed
 Chuck Hagel	 Charles E. Schumer
 John Edwards	 Mike Crapo

Robert Bennett (R-UT)
 Chairman, Subcommittee
 on Financial Institutions
 1995-2000 Financial Industry
 Contributions: \$520,930
 Contributions from Chase and
 Wells Fargo
 1995-2000: \$17,550
 1999-2000: -\$2,000

Rod Grams (R-MN)
 Chairman, Subcommittee
 on Securities
 1995-2000 Financial Industry
 Contributions: \$581,040
 Contributions from Chase and
 Wells Fargo
 1995-2000: \$29,400
 1999-2000: \$13,900

Jim Bunning (R-KY)
 Vice Chairman, Subcommittee
 on Securities
 1995-2000 Financial Industry
 Contributions: \$691,818
 Contributions from Chase and
 Wells Fargo
 1995-2000: \$ 4,000
 1999-2000: none

Chuck Hagel (R-NE)
 Vice Chairman, Subcommittee
 on Financial Institutions
 1995-2000 Financial Industry
 Contributions: \$806,744
 Contributions from Chase and
 Wells Fargo
 1995-2000: \$20,150
 1999-2000: none

John Edwards (D-NC)
 1995-2000 Financial Industry
 Contributions \$153,300
 Contributions from Chase and
 Wells Fargo
 1995-2000: none
 1999-2000: none

Jack Reed (D-RI)
 1995-2000 Financial Industry
 Contributions: \$702,305
 Contributions from Chase and
 Wells Fargo
 1995-2000: \$11,750
 1999-2000: \$ 3,000

Charles Schumer (D-NY)
 1995-2000 Financial Industry
 Contributions: \$2,749,653
 Contributions from Chase and
 Wells Fargo
 1995-2000: \$16,150
 1999-2000: \$ 5,000

Mike Crapo (R-ID)
 1995-2000 Financial Industry
 Contributions: \$188,389
 Contributions from Chase and
 Wells Fargo
 1995-2000: \$1,250
 1999-2000: none

MERCHANT BANKING EIGHT
 1995-2000 Financial Industry
 Contributions: \$6,394,179
 Contributions from Chase and
 Wells Fargo
 1995-2000: \$100,250
 1999-2000: \$ 19,900

SOURCE: Center for Responsive
 Politics

NOTES: Contributions for 1995-
 2000 include donations made to
 individuals for House of
 Representatives campaigns prior to
 their running for Senate.
 Contribution totals for Chase and
 Wells Fargo include donations by
 (respectively) Chemical Bank and
 Norwest Corporation, the
 institutions' major acquisitions
 during the survey period.

THE MERCHANT BANKING EIGHT

Several weeks after testifying to two subcommittees of the Senate Banking Committee, Fed Governor Laurence Meyer received a letter from eight senators admonishing the Fed for its stance on merchant banking and demanding a more lenient approach.

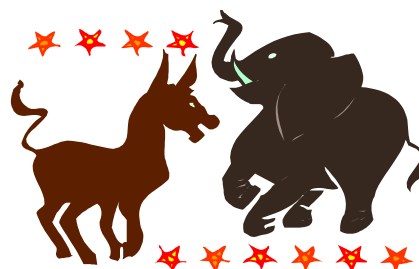
Other members of Congress also weighed in on the Fed's proposed rule with comment letters and verbal volleys that focused on small-business finance or the investment powers of state-chartered banks (Massachusetts Senator John Kerry had the dubious distinction of sending separate complaints on both subjects). But only the Merchant Banking Eight have so wholeheartedly aligned themselves with the grievances of Chase, Wells Fargo and the largest financial conglomerates.

Members of the MB8 range from Wall Street's man in Washington (New York Democrat Charles Schumer) to

several senators who haven't betrayed much previous interest in the fine points of financial regulation. Only one of the group is standing for re-election this year – Senator Rod Grams (R-MN), who accounts for fully two-thirds of all Chase and Wells Fargo contributions to the Eight during the 2000 electoral cycle (though based in San Francisco, Wells became the largest financial firm in Grams' state when it acquired Norwest Corporation in 1999.)

Traditionally, the nation's editorial pages have risen to the Fed's defense at the slightest hint of politicians meddling in the central bank's arcane affairs. But ten short years after media elites flagellated themselves for blowing the story of S&L deregulation, editorial writers – like their colleagues in the business section – have remained uniformly silent on this episode of "Fed-bashing."

Jim Lehrer
 c/o Commission on Presidential Debates
 1200 New Hampshire Avenue NW
 Washington, DC 20036



Dear Mr. Lehrer:

Congratulations on being selected to moderate this year’s presidential debates. According to the sponsor, these debates will allow “a more open and free-floating exchange of views than in past years.” We hope the exchange also will inform voters about key areas of presidential decision-making that got short shrift in previous debates.

For example, this year’s election marks a watershed in terms of voter understanding about the key role of the Federal Reserve in managing the nation’s economy and shaping the governing choices of a president. Never before has the central bank occupied such a prominent place in the public eye. Writing from the campaign trail, the *Washington Post’s* David Broder recently noted, “many of the voters I met are aware of the one constant through this whole period [of economic expansion]: the stunningly adept performance of the Federal Reserve Board.” Even the timing of the presidential debates seems to reflect this phenomenon: the first encounter will take place the same day the Fed conducts its last interest rate-setting meeting before the election.

No other decision a president makes will have a bigger impact on citizens’ economic well-being than the appointments he makes to the central bank’s leadership and the relationship he tailors with the Fed. But most voters don’t have a clue how future presidents would act in this area because reporters seldom ask. You have a unique opportunity to bridge this gap by posing the following kinds of questions to Vice President Gore and Governor Bush.

- ★ Earlier today, the Federal Reserve’s Open Market Committee decided to leave interest rates at their current level. But between June 1999 and May of this year, the central bank raised rates six times out of concern that the economy was expanding too fast. Do you share the view of some Fed officials that the economy has a so-called speed limit – such as four percent GDP growth – that should not be exceeded? If you don’t share this view, how would your administration promote more growth and rising incomes without being thwarted by Fed decisions to raise interest rates?
- ★ During the past ten years, the U.S. has seen its net foreign debt rise to \$1.4 trillion, equaling 16 percent of our gross domestic product. Are you concerned about America’s growing reliance on foreign credit to finance consumption and investment? If so, what will your administration do about it?
- ★ Since the financial turmoil that swept Asia, Russia and Latin America in 1997 and 1998, many proposals have been put

Federal Funds Rate Changes: 16-Month Period Prior to Presidential Elections

Election Cycle	Nominal Federal Funds Rate ¹	Change in Nominal Funds Rate	Real Federal Funds Rate ²	Change in Real Funds Rate	Number of FOMC Policy Changes ³
Jun-99	4.76		2.80		
Oct-00	6.50	1.74	3.30(e)	0.50(e)	6
Jun-95	6.00		2.96		
Oct-96	5.24	-0.76	2.25	-0.71	3
Jun-91	5.90		1.21		
Oct-92	3.10	-2.80	-0.18	-1.39	9
Jun-87	6.73		2.89		
Oct-88	8.30	1.57	4.04	1.15	8
Jun-83	8.98		6.51		
Oct-84	9.99	1.01	5.72	-0.79	8
Jun-79	10.29		-0.79		
Oct-80	12.81	2.52	0.18	0.97	20
Jun-75	5.55		-3.63		
Oct-76	5.02	-0.53	-0.44	3.19	8
Jun-71	4.91		0.53		
Oct-72	5.04	0.13	1.86	1.33	13
Jun-67	3.98		1.14		
Oct-68	5.91	1.93	1.16	0.02	na
Jun-63	2.99		1.67		
Oct-64	3.36	0.37	2.16	0.49	na
Jun-59	3.39		2.70		
Oct-60	2.47	-0.92	1.11	-1.59	na
Jun-55	1.64		2.49		
Oct-56	2.96	1.32	0.39	-2.10	na

SOURCES: Board of Governors, Federal Reserve System; Federal Reserve Bank of New York; Bureau of Labor Statistics

¹ Average monthly effective federal funds rate.

² Monthly effective funds rate adjusted for year-over-year CPI. CPI for October 2000 based on mid-point of Federal Reserve inflation forecast for Q4 2000.

³ Changes recorded in this column include upward and downward adjustments of both specific targets and ranges.

forward for strengthening the international financial systems in order to prevent future crises. But no significant changes have been made on the basis of those proposals. How would your administration safeguard the global system against wild swings in currency values and sudden investor stampedes that can impoverish millions of people overnight?

- ★ Some economists and central bank officials say the Fed would do a better job of managing the economy if its obligation to promote maximum employment was eliminated from the Federal Reserve Act, leaving low inflation or zero inflation as the central bank's sole statutory goal. Do you agree and would your administration support such a change? If not, why not?
- ★ Under Alan Greenspan's leadership, the Federal Reserve challenged many economists' belief that inflation would spiral out of control if unemployment fell below six percent. As a result, the country has enjoyed unemployment rates below 4.5 percent for the past 20 months with very low inflation, growing productivity, rising real wages and slightly less income inequality. Do you believe that this evidence refutes the notion of a "non-accelerating inflation rate of unemployment" (NAIRU) and, if so, would you appoint individuals to the Federal Reserve Board who agree with you?
- ★ Two of the seven seats at the Fed's Board of Governors have been vacant for more than a year. Last August, President Clinton nominated Carol Parry to fill one of the seats but the Senate Banking Committee has refused to hold confirmation hearings, apparently because of its chairman's opposition to fair lending laws. Earlier, the president considered naming investment banker Felix Rohatyn and economist Alicia Munnell to the Board but backed away in the face of financial industry and partisan opposition. What kinds of qualities will you look for in your appointees to the Board of Governors – including their views on fair lending laws – and how will you defend them against the informal veto power of industry interests and senators who disagree with their views?
- ★ Both of you have praised Alan Greenspan's performance as Fed chairman. But if he serves out his current term, Mr. Greenspan will remain in charge of the central bank until the middle of the last year of your first term as president. Given the importance of this position in helping a president implement the economic program he ran on, do you agree with the idea of synchronizing the Fed chairman's term with the president's, so that newly elected presidents can appoint – or reappoint – their own Fed chairs?

Sincerely,
FINANCIAL MARKETS CENTER

Merchants of Risk *(cont.)*

lack of support may best be explained by a third factor – the Fed's own habits of deregulatory rhetoric and action.

Weaned on Alan Greenspan's laissez-faire preachments, the financial industry might be excused for forgetting that central bankers are supposed to be cautious, dyspeptic types who fret over things nobody else worries about. For better or worse, central bankers of all ideologies traditionally have bridled at "reckless, booming anarchy" – banking historian Bray Hammond's famous putdown of the Jacksonian economy and its wildcat banks.

Under Greenspan's leadership, the Fed substantially raised its comfort level with reckless and anarchic, publicly embracing the cause of unrestricted financial liberalization around the globe. Now that it's counseling mild restraint, the central bank has a big reeducation project on its hands, explaining to friends and foes how a little liberalization can go a long way – and sometimes too far.

So far, the central bank has stuck to its guns. In May, Greenspan stoutly defended the agency's merchant banking rules, warning that periods of prolonged prosperity can spawn

ruinously bad equity investments by banks as well as dumb loans. Speaking to a group of banking executives on September 22, Board of Governors General Counsel J. Virgil Mattingly said the Fed is contemplating "minor" changes at most in the rules.

Mattingly and company are expected to release the central bank's final word on merchant banking late this year. If it stands by its preliminary rules as calmly as it challenged the orthodoxy of a six percent "natural" rate of unemployment, the Greenspan Fed may prove itself the rare central bank capable of genuine independence. ■

The following excerpt from Capital Flows Monitor examines the U.S. international investment position at yearend 1999. The complete Monitor (six pages) is available at www.fmcenter.org or in hard copy, upon request.

The U.S. International Investment Position

During 1999 and the first two quarters of 2000, the U.S. sank deeper into net debtor status as foreign inflows cascaded into American financial markets under the spur of rising U.S. interest rates. Even though U.S. direct investment abroad rose by record amounts in 1999, net new foreign direct investment in the U.S. was nearly twice as large. Foreign capital also poured into U.S. debt markets, where foreign investors now hold more than one-third of outstanding government debt and nearly one-fifth of outstanding corporate bonds. According to just-released international transactions data, foreign ownership of U.S. assets grew three times more rapidly than did U.S. ownership of foreign assets during the second quarter of 2000.

These developments mark the continuation of a long-term decline in the U.S. international investment position. Since 1970, the U.S. current account – the record of net exports and imports of goods, services, income and transfers – has registered a surplus in only eight years. Not since 1975 has the trade balance (the current account's largest component) been in surplus. Foreign lending to finance these deficits has mounted steadily, with foreign ownership of U.S. assets rising on a historical cost basis from \$291.1 billion in 1976 to \$6.97 trillion at year-end 1999. If foreign direct investment in U.S. enterprises is measured by market value rather than current cost, the 1999 value of foreign-owned U.S. assets totaled \$8.65 trillion.

Because inflows of capital have surpassed outflows, the U.S. international investment position has sharply reversed course. In 1976, the U.S. position was positive – the market value of U.S.-held foreign assets exceeded the value of foreign-held assets in the U.S. By 1989, the U.S. position turned negative; by year-end 1999, the market value of U.S. assets owned by foreign residents topped the current cost of foreign assets held by U.S. residents by \$1.47 trillion.

Components of the investment position

The components of the U.S. international investment position (see table) provide a more comprehensive view of the sources and uses of capital flows to and from the U.S. They also illuminate the differences in investment patterns within U.S. and foreign sectors.

Direct investment. U.S. direct investment abroad rose at a record level of \$150.9 billion in 1999. Combined with a 14 percent increase in the market value of owners' existing equity, these new holdings pushed up the value of outstanding U.S. direct investment by \$442 billion or 20.3 percent.

Even though three countries account for nearly two-fifths of outstanding assets, U.S. direct investment abroad remains somewhat diffuse geographically. The United Kingdom leads the pack with 18.8 percent of outstanding U.S. direct investment, followed by Canada (9.9 percent) and the Netherlands (9.4 percent). In addition, seven countries – Switzerland, Germany, Japan, Bermuda, France, Brazil and Mexico – claim a combined 27 percent of the total outstanding, with individual shares ranging from 4.5 to three percent. The remaining 35 percent is split between scores of nations, none of which accounts for more than three percent of the total.

By contrast, sources of foreign direct investment in the U.S. tend to be far more concentrated. Eight countries – the United Kingdom (18.6 percent), Japan (15.1 percent), the Netherlands (13.2 percent), Germany (11.3 percent), Canada (8.1 percent), France (7.8 percent), Switzerland (5.6 percent), and Luxembourg (5.6 percent) – account for 85.4 percent of the total. Indeed, the aggregate value of these eight countries' direct investment in the U.S. (\$2.4 trillion) nearly equals all U.S. direct investment in other countries (\$2.6 trillion).

Just as new U.S. direct investment abroad attained record volumes in 1999, so did net foreign direct investment in the U.S. The difference was that foreign inflows (\$275.5 billion) were almost two times larger than U.S. outflows (\$150.9 billion). Rising U.S. stock prices – amplified in some cases by dollar appreciation – drove up foreign owners' equity in existing direct investments by 15.3 percent. All in all, the combination of soaring net inflows, booming stock valuations and favorable exchange rate movements boosted the value of outstanding foreign direct investment in America by \$609.7 billion, or 28 percent.

Portfolio investment. Despite exchange rate depreciation in euro-denominated issues, a general run-up in prices renewed

U.S. investors' interest in foreign equities during 1999. Resurgent prices raised the value of U.S.-held Latin American stocks by 65 percent and provided substantial gains on investments in Asia's emerging markets. Still, price appreciation did not trigger a wholesale turn to foreign equities on the scale of the mid-1990s or completely allay the cautionary lessons of the emerging market crises that followed. In 1999, net purchases accounted for just one-fifth of the total increase in the value of U.S. investors' foreign stock portfolios and the bulk of these additional U.S. holdings were concentrated in Japan and Europe.

While holdings of foreign government bonds do not make up a large share of total U.S. international investments, the opposite holds true for foreign ownership of U.S. assets. Despite their net sale of Treasuries (-\$20.5 billion) in 1999, foreign private investors, like foreign official institutions, continue to hold substantial amounts of Treasury obligations. Altogether, foreign public and private investors owned 35 percent of outstanding U.S. government debt at year-end 1999, with Japanese investors

(\$321 billion) holding 11.4 percent of outstanding issues and U.K. investors (\$238.9 billion) 6.5 percent.

Foreign private and official investors also responded to changes in the market for Treasury debt by shifting to U.S. agency securities. And they invested heavily in high-grade corporate bonds. Despite valuation adjustments of -\$71.2 billion due to price and exchange rate depreciation, foreign private investors made net purchases of \$232.8 billion in corporate and agency issues in 1999. According to the Federal Reserve's Flow of Funds Accounts, these investors held \$343.8 billion of agency paper at year-end (8.8 percent of total outstanding issues) and \$818 billion of U.S. corporate bonds (18 percent of total outstandings). Here, too, investors in the U.K. (\$535.8 billion) and Japan (\$120.4 billion) claim the major share (a combined 62 percent) of foreign holdings of these securities.

Foreign holdings of U.S. stocks have tended to lag investments in either government or corporate bonds and 1999 was no exception. However, the roaring U.S. equity market continued to benefit foreign investors as well as

(cont. on page 11)

SELECTED COMPONENTS OF U.S. INTERNATIONAL INVESTMENT POSITION, YEAR-END 1998-1999
(\$US BILLIONS)

	1998	1999	Change: 1998-1999		
			Financial Flows	Valuation Adjustments	Total Change
US-owned assets abroad	6,045.5	7,173.4	430.2	697.6	1,127.8
US government assets	232.8	220.6	-11.5	-0.6	-12.1
Official reserve assets	146.0	136.4	-8.7	-0.8	-9.6
Other assets	86.8	84.2	-2.8	0.2	-2.5
US private assets	5,812.8	6,952.7	441.7	698.3	1,140.0
Direct investment abroad	2,173.5	2,615.5	150.9	291.1	442.0
Foreign securities	2,052.9	2,583.4	128.6	401.9	530.5
Bonds	576.7	556.7	14.2	-34.2	-20.0
Corporate stocks	1,476.2	2,026.6	114.4	436.1	550.5
Non-bank claims	565.5	643.7	92.3	-14.0	78.3
Claims reported by banks	1,020.8	1,110.1	69.9	19.4	89.2
Foreign-owned assets in the US	7,453.2	8,647.1	753.6	440.3	1,193.8
Foreign official assets	837.7	869.3	42.9	-11.2	31.6
US government securities	620.3	628.9	32.5	-23.9	8.6
Other assets	217.4	240.4	10.3	12.7	23.0
Other foreign-held assets	6,615.5	7,777.7	710.7	451.5	1,162.2
Direct investment	2,191.0	2,800.7	275.5	334.2	609.7
US Treasury securities	729.7	660.7	-20.5	-48.6	-69.0
Other U.S. securities	2,012.4	2,509.3	331.5	165.4	496.9
Bonds	902.2	1,063.7	232.8	-71.2	161.6
Corporate stocks	1,110.3	1,445.6	98.7	236.6	335.3
US non-bank liabilities	438.0	473.8	34.3	1.6	35.9
US liabilities reported by banks	1,016.1	1,082.5	67.4	-1.1	66.3
US currency	228.3	250.7	22.4	0.0	22.4

SOURCE: US Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*.

NOTE: 1999 figures are preliminary. Valuation adjustments include changes in prices, exchange rates, coverage, statistical discrepancies, and other adjustments to the value of assets. Direct investment is at market value. Numbers may not add up due to rounding

Millionaires Making Policy



Speaking at the Federal Reserve's annual Jackson Hole conference on August 25, Chairman Alan Greenspan noted "considerable unease" among some citizens "about the way markets distribute wealth." Nevertheless, Greenspan and his colleagues have been served very well by these distributional mechanisms. According to recently released financial disclosure statements, the five members of the Fed's Board of Governors saw their aggregate net worth jump by 17 to 20 percent during the course of 1999.

The financial disclosures filed by Fed governors report the value of each income-producing asset in their portfolio within eight broad dollar ranges (for example \$1,001 to \$15,000), not specific amounts. The top category among these ranges tends

to mask rather than reveal total net worth – "over \$1 million" could mean \$1,000,001 or it could mean \$40 million. In addition, the reports do not disclose non-income producing assets, such as homes, held by the governors or their family members.

Still, the disclosures provide a fascinating look at the financial lives of America's most powerful economic policymakers. For example:

- During 1999, the combined low-end net worth of the Fed's five governors rose from \$16.3 million to \$19.0 million. Their aggregate high-end net worth jumped from \$33.6 million to \$40.3 million.
- Each Fed governor is a millionaire several times over – even without spousal assets being included in their net worth. Though they

preside over an economy with soaring household debt levels, none of the governors reported a penny in liabilities in 1999.

- Claiming that he wants to avoid the appearance of a conflict of interest, Chairman Alan Greenspan keeps most of his holdings in Treasury bills, not stocks. At the end of 1999, the chairman's net worth stood between \$4.3 million and \$9.3 million. During the course of the year, he and his wife reaped

Board of Governors Financial Disclosures: 1999

[+/- percent changes from 1998 in parentheses]

	Roger W. Ferguson, Jr.	Edward M. Gramlich	Alan Greenspan	Edward W. Kelley, Jr.*	Lawrence H. Meyer
Value of Assets					
High (a)	\$5,951,001 (+25%)	\$4,485,001 (+18%)	\$9,285,000 (+6%)	\$16,666,000 (+21%)	\$3,905,001 (+53%)
Low	\$2,988,057 (+24%)	\$2,579,029 (+18%)	\$4,328,036 (-4%)	\$ 7,021,191 (+30%)	\$2,132,044 (+15%)
Biggest Asset	Vanguard 500 Index Fund (> \$1 million)	College Retirement Equities Fund Account (> \$1 million)	Treasury bills and GE stock (spouse) (\$500,001-\$1 million)	Deposit in Tax Exempt Money Market Trust, Chase Bank of Texas (\$500,001-\$1 million)	College Retirement Equities Fund (> \$1 million)
Income from Assets & Misc. (b)					
High	\$365,100 (-9%)	\$2,256,900 (+65%)	\$742,114 (+12%)	\$1,031,515 (-45%)	\$1,297,942 (+19%)
Low	\$117,634 (+5%)	\$ 302,222 (+10%)	\$336,757 (+15%)	\$ 384,015 (-38%)	\$108,678 (+8%)
Notes	Holdings in the tobacco-free Concert Social Awareness Fund make Ferguson and his wife, SEC official Annette Nazareth, the only social investors in this group.	Does Gramlich vibrate to Warren Buffett's market jitters? The governor sold an emerging market India fund and bought Berkshire-Hathaway.	Still very liquid. The chairman is a big depositor in the Fed's credit union and heavily invested in T-bills. He reports that his spouse received "union wages" for appearing on <i>Celebrity Jeopardy</i> .	Substantial inherited wealth. Active trader who sold chunk of Time Warner stock and invested aggressively in mini bonds. Wife holds stock valued at \$50-100k in Fannie Mae, with which the Fed has feuded.	Sold holdings in emerging market mutual fund and bought GE stock. Receive \$50,000 a year from Stifel Financial Corp. for shares in St. Louis forecasting firm he founded.

SOURCE: Executive Branch Personnel Public Financial Disclosure Reports

* Governor Kelley also holds additional assets in and collects additional income from his share of a \$6 million estate.

(a) Actual value of assets may be higher than range shown for Governors Ferguson, Gramlich and Meyer because at least one asset is valued at over \$1,000,000."

(b) Includes honoraria, royalties, partnership income, etc. but not salaries.

Disclosure statements list all income-producing assets and all non-salary income for Federal Reserve governors and their immediate family. Asset values are reported in the following dollar ranges: \$0-1,000; \$1,001-\$15,000; \$15,001-\$50,000; \$50,001-\$100,000; \$100,001-\$250,000; \$250,001-\$500,000; \$500,001-\$1,000,000; over \$1,000,000.

Income is reported in the following dollar ranges: \$0-\$200; \$201-\$1,000; \$1,001-\$2,500; \$2,501-\$5,000; \$5,001-\$15,000; \$15,001-\$50,000; \$50,001-\$100,000; \$100,001-\$1,000,000; over \$1,000,000.

between \$337,000 and \$742,000 in income from their assets and honoraria.

- Holdings in TIAA-CREF, the giant education-sector retirement fund, supply the single biggest chunk of wealth for Governors Edward Gramlich and Lawrence Meyer, both of whom held teaching positions before coming to the Fed. Among all the governors, Meyer realized the biggest gain in net worth during 1999 while Gramlich booked the biggest increase in annual income from his financial holdings.
- Governor Edward W. Kelley, Jr. (who arrived at the Fed after a

successful career in business) remains head-and-shoulders the wealthiest Board member and his 33-page disclosure statement (plus a 26-page attachment) outweighed the other governors' filings combined. Kelley's inventory of assets ranges from stocks (including a \$100,000-\$250,000 investment in the financial software company Intuit) to real estate to partnership interests in a Connecticut business that specializes in leveraged buyouts of manufacturing firms.

All in all, the disclosures paint a picture of institutional leadership that remains strikingly homogenous in at least one key respect. In light of that

homogeneity, citizens are entitled to wonder how the prism of personal wealth may affect the governors' view of the economy and influence Fed policy decisions. ■

ONLINE DISCLOSURE

For detailed information on the governors' assets and income, check out Schedule A of their disclosure forms, available online only at www.fmcenter.org. The Center's web site also contains an analysis of the governors' 1998 reports as well as a 1998-1999 summary comparison.

Capital Flows (cont.)

domestic shareholders. By year-end, foreign investors' stockholdings totaled \$1.4 trillion, or 7.7 percent of outstanding U.S. corporate equities. Slightly more than half of this foreign ownership is concentrated in four countries: the U.K. (\$407.9 billion), Canada (\$128.8 billion), the Netherlands (\$103.9 billion) and Japan (\$103.9 billion).

Assessing the policy landscape

The dominant role of the dollar in international trade and finance continues to compel other countries to export goods and services to the U.S. in order to earn greenbacks needed for building up foreign exchange reserves, paying down external debt and buying imports from third countries. Because a large share of these dollar earnings are invested in U.S. financial assets, persistent foreign inflows tend to push up the value of the dollar relative to other currencies. This dynamic constrains the volume of U.S. exports by raising their cost relative to goods and services priced in other currencies while reducing the cost of imports for U.S. buyers.

While the dollar's role as the key international currency helps explain the persistence of U.S. external debt, interest rate differentials were also a

decisive factor in 1999. With interest rates rising more rapidly in the U.S. than in other major currency areas, an inflow of capital seeking higher returns ensured steady appreciation of the dollar, especially against the euro.

Though it explained its actions entirely in terms of domestic economic considerations, the Federal Reserve's decision to raise interest rates repeatedly in 1999 clearly reflected the growing complexity of managing international financial stability in an era of mammoth, unrestricted capital flows. For better or worse, various policy considerations (such as global investors' response to Treasury's debt buydown) and market dynamics (such as the rising volume of cross-border transactions driven by hedge funds and bank trading programs seeking to cash in on interest rate differentials) suggest that developments in the U.S. external position play an increasingly formative part in domestic monetary policy calculations.

In 1999 and the first half of 2000, the Fed's incremental monetary tightening managed to maintain interest rate differentials favoring dollar-denominated investments while letting some of the air out of inflated U.S. asset prices without triggering large losses or sustained market

turmoil. While these policy actions effectively prolonged the foreign financing of America's consumption boom, they did so at the cost of increasing U.S. external debt. The question is: how long can this go on?

Total foreign holdings of U.S. financial assets (\$8.65 trillion) now equal 24.8 percent of total financial assets of U.S. households and non-profit organizations (\$34.81 trillion). More tellingly, the net external debt of the U.S. equaled 15.9 percent of GDP at year-end 1999 – down slightly from the previous year, but more than 16 times greater than the comparable ratio a decade ago.

Variations of this magnitude do not warrant complacency. Familiar assumptions about the relationship between balance-of-payments positions and economic growth have become less certain as debtors thrive and creditors falter – at year-end 1999, economically shell-shocked Japan's net creditor position was 63.9 percent of GDP while the robust United Kingdom's net debtor position was 65 percent of GDP. But even these developments lend no certainty to the proposition that domestic economic growth can be sustained by continuously taking on more external debt.

— Jane D'Arista

INTEREST RATES & ELECTIONS: UPDATE

Average and Median Federal Funds Rate Changes: 16-Month Period Prior to Presidential Elections

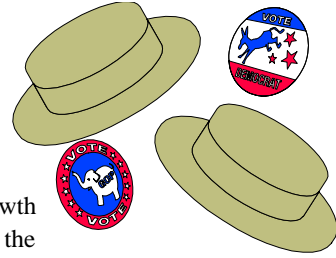
	Nominal Funds Rate	Real Funds Rate
Average Change: 1955/56 – 1995/96	.35	.05
Median Change: 1955/56 – 1995/96	.37	.02
Change: 1999-2000	1.74	.50(e)

(e) Based on mid-point of Federal Reserve inflation forecast for Q4 2000.

If the FOMC holds its benchmark federal funds rate steady on October 3, the 2000 presidential election cycle will go down as the third most-aggressive Fed tightening of the 12 most recent quadrennial periods. During the 16 months leading up to this year's election, the rise in the funds rate has been five times greater in nominal terms than the average change over comparable periods from 1955-56 to 1995-1996. In projected real terms, it's been ten times greater.

By all accounts (including the Fed's second and third quarter reports on regional conditions), economic growth has begun to slow in the wake of rising interest rates. Though the economy generally remains robust, Democratic partisans may detect an ominous pattern. During the past half-century, the only two pre-election Fed tightenings to surpass this cycle's rate hikes helped set the stage for Republican victories against incumbent Democratic administrations – Jimmy Carter's in 1980 and Hubert Humphrey's in 1968. If the most Fed-friendly administration in modern presidential history meets a similar fate, the rate hikes of 1999-2000 will set new standards for political-monetary irony.

For more on this story, turn to page 6.



NEXT EDITION

The next edition of FOMC Alert will be a year-end double issue published between the FOMC's November 15 and December 19 meetings.

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