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June 20, 2010 David Warsh, Editor

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One Thing at a Time

Congressional negotiators are working overtime to reconcile various provisions of the House and Senate bills to overhaul financial regulation, hoping to send a final version to President Obama's desk before the July 4 weekend.

Thursday Senators on the panel voted 10-2 to kill a provision that would have made the Federal Reserve Bank of New York's president a White House appointment, requiring confirmation by the Senate, instead of a matter for the New York bank and the governors of the Federal Reserve Board, as it is now.

That led Jon Hilsenrath of *The Wall Street Journal* to write (subscription required), "[T]he Federal Reserve has emerged as likely to retain most of the power and independence Fed officials had feared they might lose."

Several details remain to be ironed out, Hilsenrath noted. The Senate bill would, for instance, exclude from voting commercial bankers, who traditionally dominate the FRBNY board. But the over-arching threats to its relative autonomy, including real-time Congressional audits by the Government Accountability Office of the Fed's decision-making, appear to have been turned aside.

Does that mean that appropriate bank reform will have been achieved? Hardly. There's broad agreement among experts that this year's bill tackles mainly the easy stuff.

Three related events last week bear witness to the vigor of the continuing debate. An overview by fifteen leading authorities on finance (led by Dartmouth's Kenneth French) appeared as *The Squam Lake Report: Fixing the Financial System*. The authors sought to loosely model their short book on the *The 9/11 Commission Report*.

So did Sebastian Mallaby's history of the hedge fund industry, *More Money than God: Hedge Funds and the Making of a New Elite*.

Meanwhile, the Project on Market Institutions and Financial Market Risk of the National Bureau of Economic Research met for two days in New York to hash over the latest thinking on the causes and consequences of the crisis.

Tim Harford
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Jon Hilsenrath
Greg Ip
Phil Izzo & Co
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Anatole Kaletsky
Zachary Karabell
Mickey Kaus
John Kay
Ezra Klein
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Peter Passell
Steven Pearlstein
Eduardo Porter
Virginia Postrel
Virginia Postrel
Catherine Rampell
Jonathan Rauch
Sudeep Reddy
Matt Ridley
Felix Salmon
Robert Samuelson
Noam Scheiber
Nelson Schwartz
Amity Shlaes
Gary Shilling
Allan Sloan
Paul Solman
Ira Stoll
James Surowiecki
Timothy Taylor
John Tierney
Maureen Tkacik
Nicholas Wapshott
David Wessel
Mark Whitehouse
Martin Wolf
Robert Wright

The Squam Lake Report by itself isn't going to change much. The idyllic New Hampshire resort was the setting of the famous stage play and film "On Golden Pond," and something of a fat pink cloud hangs over the report as well. Bickering is muted among its various market fundamentalists and financial engineers. With some notable exceptions – legislatively-mandated deferred compensation for executives; contingent convertible bonds to facilitate workouts – most of the measures they propose are being adopted into law (systemic regulation, consumer protection, exchanges and clearing houses). "Like the origins of the First World War, the causes of the Crisis will be debated by scholars for many years," the authors write. Let's hope that the backwards-looking approach embodied in regulatory overhaul legislation doesn't become a latter-day equivalent of the Treaty of Versailles.

Closer to the cutting edge were many of the papers at the NBER project, which is itself overseen by Mark Carey, of the Federal Reserve Board and three of the authors of the *Squam Report* (Anil Kashyap and Raghuram Rajan, of the University of Chicago; and René Stultz, of Ohio State University). These were the disagreements about what actually happened that the consensus study sought to submerge.

Perhaps the most surprising among them (by Nicola Gennaioli, of Pompeu Fabra University; Andrei Shleifer, of Harvard; and Robert Vishny, of the University of Chicago) broached the possibility that rapid financial innovation almost guarantees financial fragility, by playing to investors' cognitive limitations and bias toward hope.

The least surprising, by Gary Gorton and Andrew Metrick, both of Yale, argued that the essence of the crisis had been an old-fashioned banking run in the new-fangled "shadow" banking system and therefore preventable by new applications of time-tested means of preventing panic – an analysis that seems to be becoming widely accepted, by the Squam group, among others.

That leaves *More Money than God*, Mallaby's book about the rise of hedge funds, the newest and least understood of the industries that today rank with banks, brokers and insurance companies as the major elements of the financial system.

That these powerful and secretive organizations seem to have come out of nowhere in the last thirty years makes the former *Economist* and *Washington Post* journalist's origins story especially welcome, even if it often borders on authorized biography. That the *Squam Lake Report* authors thank Mallaby for his "ongoing guidance and support" (he directs the Maurice R. Greenberg Center for Geoeconomic Studies of the Council on Foreign Relations) indicates how close to the heart of the story is the question of the extent to which hedge funds are to be he included in the new

Matt Yglasias
Gregg Zachary

Various feeds

systemic regulation. Mallaby argues, plausibly, that hedge funds, as successors to the merchant banks of a half a century ago, the Dillon Reads, Goldman Sachs and Morgan Stanleys, have added to the stability of the system. More on this excellent book some other day.

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