Alan Greenspan: Capitalising reputation

Remarks by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, at the 2004 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Georgia, (via satellite), 16 April 2004.

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Recent transgressions in financial markets have underscored the fact that one can hardly overstate the importance of reputation in a market economy. To be sure, a market economy requires a structure of formal rules - for example, a law of contracts, bankruptcy statutes, a code of shareholder rights. But rules cannot substitute for character. In virtually all transactions, whether with customers or with colleagues, we rely on the word of those with whom we do business. If we could not do so, goods and services could not be exchanged efficiently. The trillions of dollars of assets that are priced and traded daily in our financial markets before legal confirmation illustrate the critical role of trust. Even when followed to the letter, rules guide only a few of the day-to-day decisions required of business and financial managers. The rest are governed by whatever personal code of values that managers bring to the table.

Market transactions are inhibited if we cannot trust the reliability of counterparties' information. The ability to rely on the word of a stranger is integral to any sophisticated economy. A reputation for honest dealings within a business or financial corporation is critical for effective corporate governance. Even more important is the way outsiders view the corporation itself. The reputation of a corporation is an exceptionally important market value that in principle is capitalized on a balance sheet as goodwill.

Reputation and trust were valued assets in freewheeling nineteenth-century America. Throughout much of that century, laissez-faire reigned, and caveat emptor was the prevailing prescription for guarding against wide-open trading practices. A reputation for honest dealing was thus particularly valued. Even those inclined to be less than scrupulous in their private dealings had to adhere to a more ethical standard in their market transactions, or they risked being driven out of business.

To be sure, the history of business is strewn with Fisks, Goulds, and numerous others treading on, or over, the edge of legality. But they were a distinct minority. If the situation had been otherwise, the United States at the end of the nineteenth century would never have been poised to displace Great Britain as the world's leading economy.

Reputation was especially important to early U.S. bankers. It is not by chance that many bankers in the nineteenth century could effectively issue non-interest-bearing liabilities in the form of currency. They worked hard to develop and maintain a reputation that their word was their bond. For these institutions to succeed and prosper, people had to trust their promise to redeem banknotes in specie. The notion that "wildcat banking" was rampant before the Civil War is an exaggeration. Certainly, crooks existed in banking as in every business. Some banks that issued currency made redemption inconvenient, if not impossible. But these banks were fly-by-night operators and rarely endured beyond the first swindle.

In fact, most bankers, especially on Wall Street, competed vigorously for reputation. Those who had a history of redeeming their banknotes in specie, at par, were able to issue substantial quantities, effectively financing their balance sheets with zero-interest debt. J.P. Morgan marshaled immense power on Wall Street in large part because of his widespread reputation for fulfilling his promises.

Over the past half century, the American public has embraced the protections of the myriad federal agencies that have largely substituted government financial guarantees and implied certifications of integrity for business reputation. As a consequence, the market value of trust so prominent in the nineteenth century seemed unnecessary and by the 1990s appeared to have faded to a fraction of its earlier level.

Presumably, we are better protected and, accordingly, better off as a consequence of these governmental protections. But corporate scandals of recent years have clearly shown that the plethora of laws of the past century have not eliminated the less-savory side of human behavior.

We should not be surprised then to see a re-emergence of the market value placed on trust and personal reputation in business practice. After the revelations of corporate malfeasance, the market punished the stock prices of those corporations whose behaviors had cast doubt on the reliability of their reputations. Recent allegations on Wall Street of breaches of trust or even legality, if true, could begin to undermine the very basis on which the world's greatest financial markets thrive. Guilty parties should be expeditiously punished. Some practices and rules have outlived their usefulness and require updating. But in so doing we need to be careful not to undermine the paradigm that has so effectively governed voluntary trade. Rewriting rules that have served us well is fraught with the possibility for collateral damage.

I hope and anticipate that trust and integrity again will be amply rewarded in the marketplace as they were in earlier generations. There is no better antidote for the business and financial transgressions of recent years.