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listening**in**

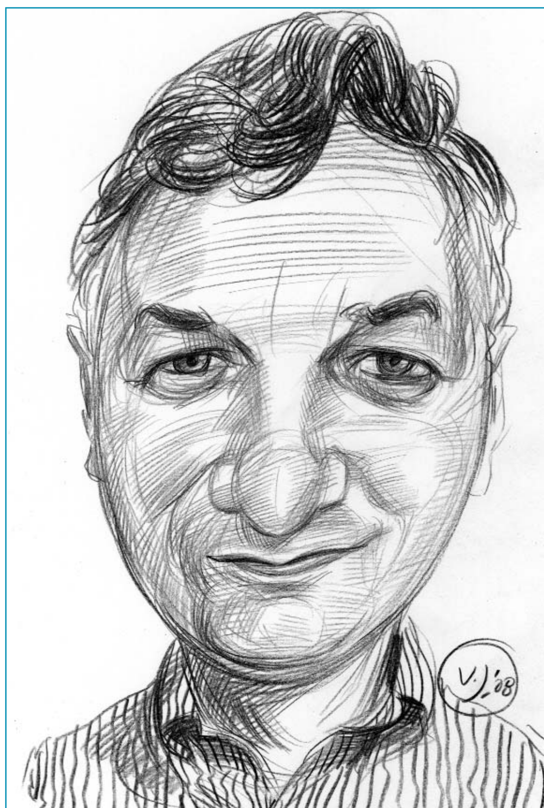
Fed Needs A Grinch

Bernanke Ill-Suited For Cleaning Up Aftermath Of Greenspan's Mess

***Frederick J. Sheehan**, it is safe to say, is a man on a mission. It started well before the turn of this century, when the genial and erudite Bostonian, a former director of asset allocation services at **John Hancock Financial Services**, started obsessively collecting newspaper clippings. There were just too many disconnects between the day-to-day realities he was observing in the economy and the markets and proclamations coming out of the mouth of the generally acclaimed "maestro" running the Federal Reserve. Once he started digging a little deeper, Fred also started uncovering large discrepancies between what **Alan Greenspan** said in different times and places. The more Fred researched, the more he became convinced that Greenspan understood the risks of the bubble economy he was fostering, but, says Fred, was putting his own personal interests ahead of the public good.*

Fred has turned his research into two books, the just-published, Panderer To Power, *and* Greenspan's Bubbles, *which he co-authored with **Bill Fleckenstein**.*

*The tragedy now, Fred says, is that Greenspan's successor, **Ben Bernanke**, who looks likely to be confirmed for a second term in January, really doesn't understand the risks he's running by trying to inflate the economy out of Greenspan's mess. Fred's advice to Ben: "Just go." Mine: Listen, and learn.*
KMW



I see you've now appointed yourself scourge not just of Alan Greenspan, but of his successor, recently posting quite a diatribe on your website, aucontrarian.com. [See page 4].
Yes, well, I want to stay current. **Ben Bernanke** needs to be worked over, I think.

His all-but-certain confirmation by the Senate and *Time's* "Person of the Year" honors don't change your mind?
Not a chance. I think, when we look back, this will be seen as *Time's* most perspicacious person of the year award – for reasons that would baffle *Time* today.
And, as with most awards in all fields today, I am reminded of **T. K. Whipple**: "Whenever numerous people speak of a renaissance, you

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Victor Juhasz
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can be sure an era is dying. It is a law of literary history that these spectacular outbursts which look as if they are ushering in a new epoch are in truth ushering out an old one."

I'm afraid the reality is that Bernanke really isn't getting it. He doesn't know what's going on and yet it seems to be hands off because he saved us from a Great Depression last fall, so let's stick with the guy. But he may be even more clueless than Greenspan was.

Actually, one of the planks in the case you built against Greenspan in your book is that he really *wasn't* as clueless as some of his critics would have it –

Right. My sense is that Greenspan pretty much had some idea of what was happening but, well, he saw fit to make sure that nobody else did. And everybody went along with that. That's one of the things, when people talk about, "Let's blame it all on Greenspan." Well, no. People didn't *have* to quote everything he said on the front page, as if it were gospel. They could have treated his ridiculous statements the way they treated **Dan Quayle**'s ridiculous statements – and he would have been out of town just as quickly. But, whether it was the press or other economists, they just went along with Greenspan's charade.

"When the question comes up, 'Well, how did Greenspan pull the wool over everyone's eyes all those years?' The answer is that it's the way people think: They *don't* think."

You document an appalling number of occasions in your book when Greenspan was allowed to get away with blatantly contradicting his own earlier statements. How long have you been hoarding newspaper clippings?

I have been saving articles for years and years, collecting quotes in newspaper articles that are just ridiculous compared to what is actually happening. I'm doing the same thing now, by the way, because it is simply ridiculous what people are saying, when if you just read what's happening, the economy is *not* coming out of recession.

Before we get too deeply into this, let's explain a little bit about where Fred Sheehan comes from. You start your book, after all, delving into Mr. Greenspan's childhood.

I did not play the clarinet or the saxophone. And *I* didn't go to high school with **Henry Kissinger**.

So far, it sounds like you might have had the better youth –

Well, I'm from south of Boston. From there, I went to the Naval Academy; after the Navy, I went to Columbia Business School and then I worked in the treasury department at **J.C. Penney**, where I worked on the pension plan and did some acquisition work. Then I moved back up to Boston and went to work for **John Hancock**, where I stayed into 2005, mostly providing asset management and investment policy services for institutional pension plans.

In other words, you actually have practical asset management industry experience.

At least I hope so. I tried to, maybe that's what I should say.

Your experience is grounded in doing more than merely pontificating about it?

Well, one of things that you learn in a job like that, working with trustees of pension plans – of all different types, corporate, municipal, union, it didn't matter – year after year, is how little influence I actually ever had. From one year to the next, they wouldn't remember a thing that I had said. They, for the most part, just stayed with their 60/40 stock/bond mix, no matter what their circumstances or cash flow. I could try to show them, for instance, things like runaway pension obligations that they were going to have to pay, but only on rare occasions, I found, did trustees even understand what I was trying to tell them about such things. Now, maybe that was for good reason –

Are you dissing all trustees?
No, I'm saying maybe I didn't make myself clear enough. But that experience has also influenced how I look at why people often don't understand, say, what Greenspan or Bernanke are really saying. It is simply that they receive an avalanche of information that pretty much is the same, pretty much spoken almost in a jargon that is repeated over and over. It's very difficult for most people to hear anything other than the clichés that are repeated over and over. When the question comes up, "Well, how did Greenspan pull the wool over everyone's eyes all those years?" The answer is that it's the way people think: They *don't* think.

You mean it's like on those old Charlie Brown animated TV specials when the teacher starts talking and all you hear is Whaah-Whaah-Whaah?
Yes, yes. I think that's what happened to most people when Greenspan gave testimony or speeches. It was common to say nobody understood what he was saying, and if you read any one speech, he talked in circles. But you could make out sometimes that this was a significant point that he was making here – and that is what went into the headlines. But nobody really *read* his speeches or really *read* into the testimony, other than to extract the headlines that they apparently thought people wanted to hear. Things like, "Greenspan says, you should be taking out a variable rate mortgage"; that was the headline. I saved that front page of the *Wall Street Journal* and that headline was probably about as far as most people read before they went to their broker and said, "I want a variable rate mortgage." After all, "Greenspan said it." Who was going to argue with that man?

I guess on some level everyone wants an avuncular uncle to tell them what to do, so they don't have to do the homework and make the hard decisions for themselves.

Yes. All the more, I think, the more complicated things have become. As I wrote, the financial decisions that people are confronted with today simply didn't exist 40 years ago. Most people didn't know what stocks or bonds were back then. They saved money and they had a passbook savings account. Maybe they had a life insurance policy. But once we went on to the roller coaster of inflation in the '70s, a lot of people understood belatedly that they had to do something different if they were going to preserve their net worth or, at least their sanity. So they become exposed to stocks a little, but mostly to CDs and money market funds in the 1980s and then to buying stocks in the 1990s – not really understanding the stock market, but sort of being swept along into it out of necessity.

Reaching for returns —
Exactly. Again, early in this century, when interest rates went down to 1%, people started taking risks that they didn't understand and, again, today, with the Fed driving interest rates down to zero people are being forced to take on risk that they either don't understand or they they don't want to take, but they see no other choice. The investment landscape has changed tremendously and it's not a slight to say it's beyond the capacity of most people to play this mostly Fed-induced roller coaster game, because it's very complicated.

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"IN THE NAME OF GOD, GO!"

Fed Chairman Ben Bernanke is Time Magazine's "Man of the Year. But not in Fred Sheehan's book. On December 3, 2009 the Senate Banking Committee held a hearing to vote on his nomination to serve a second term as Federal Reserve chairman. Chairman Bernanke's first four-year term began on Feb. 1, 2006. He was nominated by President Obama to serve a second term as chairman in Aug. 2009. Fred offered this speech, gratis, to any senator who would have liked children to recite this denunciation in classrooms 300 years from now, but alas got no takers. *[Note: Bracketed comments were not intended for the senator's remarks. Time allotted for each senator to speak is short and the attention span of listeners is even shorter. Bracketed comments were background information.*].

Chairman Bernanke, you are the chief regulator of the U.S. banking system. You have more authority than other agencies over the entire U.S. financial system. Specifically, the Federal Reserve directly supervises U.S. bank *holding* companies.

I make this precise definition of your authority because I anticipate a disingenuous distinction you are likely to make. That is, "Senator, the Federal Reserve only has authority over the bank holding companies, not over the banks. Banks are regulated by the Comptroller of the Currency or the Federal Deposit Insurance Corporation."

As you well know Chairman Bernanke, that is a false distinction. A bank owned by a holding company is, obviously, a part of the holding company. You can investigate practices and loans of banks by investigating your holding companies. If you reply, "investigating banks from the holding company level does not give a clear picture of the risks taken by banks" – then why didn't you do anything about it? Since 2007, the government has put $45 *billion* – not million – dollars into Citigroup, alone. If you did not think the Comptroller of the Currency and the Federal Deposit Insurance Corporation were doing an adequate job, it was your duty to tell this committee.

But, I do not think you were capable of warning us. This is an important reason you should not be Federal Reserve chairman: you do not understand banking. I want to review some of what the nation's head bank regulator should have known by the end of 2006. You had been chairman 11 months, having replaced Alan Greenspan on February 1, 2006.

The Federal Deposit Insurance Commission (FDIC) reported that construction loans, land development loans, and direct mortgages held by commercial banks had grown 87% from December 31, 2000 to June 30, 2006: from $1.6 trillion to $3 trillion: three trillion dollars of mortgages, construction and land development loans sat on the banking systems' books. [These are direct loans. This does not include mortgage securities on bank books: another $1 trillion.]

The growth alone would have alerted a curious mind. Such a mind would have sought a measurement of the quality of those loans. Some information that was readily available to you:

The median price for an existing, single-family house in California rose from $237,060 in 2000 to $542,720 in 2005.

How could Californians buy houses? You answered the question yourself in a November 2006 speech: "In 1994, fewer than 5 percent of mortgage originations were in the subprime market, but by 2005 about 20 percent of new mortgage loans were subprime." You thought this was a good thing. In the same speech, you also said with approval: "[T]he expansion of subprime lending has contributed importantly to the substantial increase in the overall use of mortgage credit. From 1995 to 2004, the share of households with mortgage debt increased 17 percent, and in the lowest income quintile, the share of households with mortgage debt rose 53 percent." Mr. Chairman, how could you say this with approval? [If Bernanke claims he gave a warning during this speech, this is correct. He advised "greater financial literacy" for "borrowers with lower incomes and education levels."]

From other public statements, you thought the banking system was in great shape. In June 2006, you told an International Monetary Fund conference: "[O]ur banks are well capitalized and willing to lend." Since you as Federal Reserve chairman did not grasp the insatiable appetite of your bankers to lend, you did not understand the capital was insufficient.

By the time you spoke to the IMF, daily newspapers had already reported that lenders were rounding up pools of illegal aliens who had bought blocks of houses, and criminals who ran mortgage rackets. The latter group did not need to be rounded up since they were already in prison. [See *Denver Post*, July 14, 2005: Colorado banks lured illegal aliens into loans that were insured by the federal government. "They didn't even have to come up with any money. They just moved in" and some immediately defaulted, moaned the local District Attorney. Also, see *Denver Post*, January 7, 2007, "Four People Plead Guilty in Mortgage Fraud Conspiracy," Prisoners had received 100% loans for houses with inflated house prices.]

We know the carnage in the mortgage market since then. Yet, in October 2007, you told a group of central bankers and economists you did not know if there *had been* a housing bubble. [John Cassidy, "Anatomy of a Meltdown," *New Yorker*, December 1, 2008]

Another blot on your record is the leverage throughout the financial system. Again, I anticipate your denial: that you only hold authority over the banking system. But, you hold the only position that can ration credit, so can substantially influence stability in our financial system.

Let me remind you of the machinery you control: The Federal Reserve adds or subtracts money to the economy. You do this by adding or subtracting dollars held by the commercial banks. You also set limits on how much credit the banks can extend to the economy. You have options to restrict lending. Most often the Federal Reserve has done so by setting reserve ratios. But more directly, you are the country's leading bank regulator. From my own study of bank balance sheets – both their growth and deteriorating quality since you became chairman – I conclude, once again, that you do not understand banking. [As stage prop, senator could slap a stack of bank quarterly reports held by intern.]

Anticipating one of your smirky, pompous rebuttals, don't tell me: "I remind you, senator, that we live in a global economy with a global financial system. The Federal Reserve does not have as much control as you claim." Such specious arguments might close debate with an ambitious, non-inquisitive, Ivy League economic student. I am talking about reality: you have more control over money than the other central banks combined. The dollar is still the world's reserve currency, despite your prolific printing efforts to debase it. As the world's reserve currency, at least until you destroy the dollar's status, it is only the United States that can print money in any quantity it so desires.

I will return, now, to the consequences of credit produced by the Federal Reserve. When Bear Stearns and Lehman Brothers had leveraged the balance sheet by over 30:1, it was the accommodating policies of the Federal Reserve that allowed them to borrow that much money. It was the accommodating policies of the Federal Reserve that permitted banks to offload mortgages to non-banks, such as Fannie Mae and Freddie Mac. This permitted the banks to constantly offer more mortgages, of poorer and poorer quality, confident that they could immediately sell them. This was the greatest relay operation since Tinkers-to-Evers-to-Chance. [Particularly appropriate if delivered by Senator Bunning.] You stated the banks were well capitalized. You probably believed this, since you do not understand banking.

Chairman Bernanke, you may claim you had no authority over investment banks, but the credit they leveraged originated in your banking system. This is also true for non-bank mortgage lenders such as New Century: every dollar it borrowed – so that it might finance new mortgage loans – was first lent from the banking system. This permitted New Century to make $56 *billion* in mortgage loans during 2005. By 2006, New Century was making loans on which the borrowers immediately defaulted. The carnage is strewn across the country.

You also showed no signs of understanding the consequences of your banks lending to private-equity firms. We can approximate this growth by looking at leveraged loans: that is, loans to finance buyouts. These were often companies that private equity firms leveraged with large amounts of debt.

In 2006, the year you became chairman, you had all the information you needed to know trouble was ahead. The Comptroller of the Currency issued a report in October 2006 that credit risk rose for 5% of the banks making leveraged loans in 2005 and had increased for 69% of banks in 2006. Bank loans to finance leveraged syndicated deals rose from $200 billion in 2005 to $360 billion in 2006 to $570 billion in the *first half* of 2007. Many of the companies bought were so leveraged they could not meet interest payments a few months after the buyout.

Yet, you stood by. Do not tell me the Federal Reserve has no authority over where banks lend – you not only can persuade but you have precedent – In 1980, when Paul Volcker was chairman, the Federal Reserve restricted bank credit used for acquisitions. Instead, the government-subsidized credit you were producing was going straight into the hands of stupid, greedy, malevolent bankers [senator chooses one – 'greedy' seems to be in vogue] and private-equity firms.

You did not have to guess at the irresponsibility and low motives of your bankers. In March 2007, a *Wall Street Journal* reporter told the world: "Hedge-fund managers, buyout artists, and bankers get paid for short-term performance. *The long-term consequences of their actions are, conveniently, someone else's problem. People inside the big banks.... Don't want to get caught missing the next big deal. Their banks, and their own bonuses, might suffer. So they ply ahead."* [Note on italics: delivered with passion.]

What were the consequences? According to Moody's, acquired companies have been "crippled." In the next few months, many of these companies must refinance the debt loaded onto their balance sheets. Many will not be able to borrow. They will be forced into bankruptcy, and possibly, into liquidation. The unemployment rate is a reflection of your truancy, Chairman Bernanke.

[Circuit City was forced to liquidate. Mervyn's Department Store – liquidated. Linen's 'n Things – vaporized. Those jobs are gone. Many other very large employers, such as Clear Channel Communications and Harrah's Entertainment are in bankruptcy court. The list is long and growing. Some will make it, some will not.]

The banks that made these loans, too, have been crippled. They wrote off $3.8 billion of leveraged loans in 2007 and another $54.4 billion in 2008. 2009 promises to be a bonanza. It is the taxpayers who are paying for the banks' ineptitude. It was your job to stop it.

Instead, you are behaving like Oedipus when he understood his act of perversion. But, instead of gouging your eyes out, you drove interest rates to zero. Zero! The backbone of America, those who saved prudently and asked the government for nothing, cannot earn enough interest to buy Spam. The insurance companies, another backbone to prudent households in our country, cannot earn enough interest to pay policy-holders: they are being forced to either buy riskier assets and hope for the best, or, join Circuit City in liquidation. Community banks, one more source of stability, are being driven out of business because you have saved and subsidized the megabanks that should have been liquidated and that can now prey on smaller non-subsidized banks.

This is your legacy, Mr. Chairman. As is the derivative mess. I agree that your predecessor has much to answer for here. But look at the record since you acquired power: The nominal value of derivative contracts held by U.S. *commercial* banks leapt from $33 trillion at the end of 1998 to $101 trillion at the end of 2005, about the time Mr. Greenspan left office. This was roughly a 17% annual increase. By June 30, 2007, seventeen months into your chairmanship, the nominal value had risen another 50% - to $153 trillion.

Most importantly – and this may be the greatest deficiency in your magnificently woeful record – credit derivatives rose from $14 trillion to $42 trillion from January 2006 to June 30, 2007. The inability of banks to honor these contracts led to the bailout of Goldman Sachs, AIG and who knows what else. At least, that is what every American with a pulse believes, and will continue to believe, since you so desperately try to avoid an audit. This is a black eye on the face of the United States. Americans believe you have protected the worst financial manipulators while unemployment and disillusionment rise.

Mr. Chairman, it is time to give the American people hope that they are represented in Washington. It is also time to give them hope the Federal Reserve chairman knows what he's doing! Your notice for dismissal was written over 300 years ago, when Oliver Cromwell scolded the Long Parliament: "You have sat here too long for any good you have been doing. Depart, I say, and let us have done with you. In the name of God, go!"

Even on institutional boards, you said, you found eyes glazing over quickly?
Yes, and there's another complicating factor with institutions – ERISA, the law that makes trustees responsible for acting prudently and so forth.

Beware the law of unintended consequences.
Yes, so they almost all hire consultants. The consultants come up with these nice looking boxes in magenta and yellow and other colors and they run through mathematical calculations of the risks that they're taking in the portfolio. But all consultants pretty much do the same thing; no consultant wants to be out saying you should be 100% in cash, so all of the institutional plans wind up doing the same thing, which is why so many colleges and endowments wound up doing the **Harvard** and **Yale** thing over the past few years.

At precisely the wrong time.
Sure, because they move very, very slowly. Twenty and twenty-five years ago, when Harvard and Yale started doing what they were doing, they were the outliers and they could generate some very nice returns over time – because they were the outliers. By the time everybody else in the herd slowly moved into doing it, there was no outlier gain to be had anymore, and they all got killed.

No mystery there.
Yet **David Swensen** has taken heat for it, even though I'm pretty sure that he warned in recent years, "Look, you can't all be doing this; it doesn't work that way."

Almost by definition, by the time something shows up on the consultants' radar screens, its useful life is all but over.
Well, I shouldn't say all of them, but none of the ones I ever dealt with would never go out on a limb. They would never do anything other than the consensus. There may be some consultants who actually do think for themselves but, for the most part, the ones I saw when I was working at Hancock were just showing the same thing to everybody. So everybody wound up with the same investment policy.

And here we sit, with pension liabilities in many plans far outstripping assets.
You know, one advantage we had at Hancock was that we had actuaries who would look at future liabilities for the pension plans. Our actuaries would show the skyrocketing payments that would have to be made on pensions in 10, 15, 20 years. I'd show that to the plans' trustees and they couldn't believe it. But they really didn't do anything; they'd just give another increase the next time the union asked for one in contract negotiations. I'm sure that at this point they are even less able to pay those future benefits.

What seems painless at the point of promise, might not be when it comes due.
And we're coming to that. We've seen it in some places already. We're generally coming to that in the next five years or so, where some states and large cities just won't be able to pay pensions they've promised.

You're talking public sector pensions, now?
Well, corporations just go out of business.

Which throws their obligations, albeit in shrunken form, on the back of the public sector, in the form of the Pension Benefit Guaranty Corp., for all it's worth. And, ultimately, on all of the rest of us taxpayers.
Yes. The PBGC, with every other government agency that's supporting some payment, is on the verge of either defaulting or begging on Obama's doorstep for another few $100 billion.

In other words, it's a fine mess we've gotten ourselves into. And your contention is that Greenspan as Pied Piper led the way, because no one really questioned his authority to lead?
What I started tracking back in the 1990s, well before I left Hancock even, were the disconnects between what I was reading in the papers about what Greenspan was saying and what was really happening in the economy. Secondarily, I also started noting differences between what was reported in the short articles published on Greenspan's speeches and what he actually said in the transcripts, where his statements often would be highly qualified.

How about a for instance?
A statement that caught everybody's attention would be about us going through a productivity change that may be the greatest this century or the greatest ever – that was good for headlines. But then in the next paragraph, or maybe in footnote 6, he would say, of course, studies done by the Federal Reserve between 1953 and whenever blah, blah, blah, show that these sorts of gains have been seen before, so we can't *prove* this is the greatest ever.

Footnotes? In speeches?
Yes, I don't think I've ever seen footnotes in speeches, other than his, but he is quite fond of them. And his footnotes could be very interesting, the way that he would sometimes make an absolute statement and then insert a footnote, citing some study or another by two economists out in Kansas City that didn't support his statement at all.

In other words, he was conceding, *sotto voce*, that the evidence at hand totally contradicted what he was asserting, but asserting it anyway?
Yes. And he got away with it. He still, in a sense, gets away with it because people don't match up the statements he's making now with what he said and what he *did*. For instance, when he came out recently and talked about the "too big too fail" problem with the banks, he certainly didn't go as far as **Paul Volcker** did in suggesting separating commercial banks from the casinos. But Greenspan did say that, maybe we should be separating them into different categories by function. And his counsel was generally respectfully received. What struck me was that no one pointed out, in covering his remarks, that no one individual did more than Greenspan did to enable the banks to get too big to fail in the first place. He was the nation's chief bank regulator over the whole period when Glass-Steagall was dismantled, financial deregulation was perfected and securitization and derivatives flourished. Yet he goes and gives a speech about what to do about too big to fail banks and no one says a peep about the enormous role he played in creating those *institutions* – you can't really call them *banks* anymore.

The word implies so many things that just don't apply to the Citis and Morgans of the world. Have you seen, by the way, the photo of the "2BIG2FAIL" vanity license plate on the Dealbreaker blog? On a Cayenne Turbo from a Greenwich dealership, it pretty much defines chutzpah.
That sounds too good to be true, but a lot of hard to believe things turn out to be so these days. Did you see the **Alice Schroeder** piece on **Bloomberg** recently about **Goldman Sachs** people arming themselves with pistols? I imagine, if they're doing that, they've received threats.

I can't imagine they haven't. But I can't imagine most Wall Street types using a gun, either. Maybe the threats are from disgruntled New York bartenders and wait staff whose tips will be way down because Goldman put the kibosh on holiday parties.
Did you see there actually was a memo saying that individuals employed by Goldman weren't to throw their own parties, either?

Right. Here's your obscene bonus, but don't throw a celebration and share the wealth because that wouldn't look good.
Kind of defeats the whole trickle down theory, doesn't it? You just have to keep it. Can't spend it on anything ostentatious. You can't throw parties, can't buy a fancy boat.

It's not the sort of thing I'm losing sleep over. But getting back to Greenspan, a lot of people have cited the influence of Ayn Rand on the young Alan Greenspan to explain his hands-off approach to financial regulation. But if I've read you correctly, you don't think Rand's objectivist philosophy had much to do with it.
Greenspan doesn't have a philosophical bone in his body. He used her the same way that he used everybody else.

You write that Rand recognized that about Greenspan early on, yet she didn't banish him from her inner circle.
He was walking in and saying things like, "I think that I exist but I don't know for sure; actually, I can't say with certainty that anything exists." I mean, who wouldn't want to throw him out the door?

But she didn't, right? That boggles the mind because she evidently was quite ruthless about throwing others out.
I don't know why, but her No. 2, **Nathaniel Branden**, for some reason decided he wanted to convert Greenspan, so they went to a lot of lunches together. Branden wrote about this in his autobiography. Apparently Greenspan rarely wanted to talk about philosophy at these lunches. He wanted to talk about the destructive capacity of the Federal Reserve system back in the 1950s. Now, Greenspan had been under the tutelage of **Arthur Burns** at Columbia University a few years before that, and Burns had gone on to run the Council of Economic Advisers by then. So in that sense, I can see how Greenspan would have been attuned to what was happening in Washington and at the Federal Reserve. But otherwise, it would seem strange that a young economist just starting out was spending so much time looking at the problems of the Fed. Then again, that he was taken

in by Ayn Rand still surprises me. She lined up her followers up at her gatherings according to where she had them in her pecking order and Greenspan used to sit up as No. 5 or No. 6. How he got there, I don't know. What I thought was interesting in Branden's autobiography was that he sort of asks himself, looking back, I wonder to what extent Greenspan was aware of Ayn's opinions. Branden says that Greenspan rarely voiced his feelings about anything of a personal nature and that his language tended to be detached and passive. He adds that when the group was discussing the Rand's *Atlas Shrugged* manuscript, Greenspan's contributions were meager. Complementing Ayn on some passage he might say, "On reading this, one tends to feel exhilarated." Exactly the sort of superficiality that he brought to the Fed and also why I said I don't think he even really understood what Rand's philosophy was. He didn't care. He was meeting people in Rand's salon who could be helpful later on; the point was to endear himself to the group. It seems to me that Greenspan had long cultivated the ability to flatter people. There don't seem to be enemies of Alan Greenspan among those who have worked with him.

That tends to speak well of someone —

Well, there are plenty of people who have told me that they knew him when he was an economist on Wall Street and couldn't stand him, but that's different. I'm talking now about people who worked with him, say, at the Council of Economic Advisers or at the Federal Reserve. Those staffs, from what I've been told, say he was just a really nice man. He knows how to flatter people. So I imagine he flattered Ayn Rand and, from what I've read, she needed flattering, especially into the 1960s, after she had written *Atlas Shrugged*, and it seems as if she was not really sure of herself anymore. He is certainly a man who knew how to flatter people. But that's simply a guess.

Could be. For a bookish type, Greenspan certainly made himself felt in New York social circles.

Yes, he was a regular on the society pages and in "Notes on Fashion" in the *New York Times*, which were probably invaluable to him, both for the publicity and for rubbing elbows with the people he was with almost every night. People like **Martin Anderson**, the Hoover Institution Fellow who has been active in GOP campaigns since acting as director of research for Nixon's 1968 campaign. There's a story in my book about Anderson, who was a sort of fringe follower of Rand, not part of her inner group. Greenspan got to know him through Rand and Anderson may or may not have been instrumental in Greenspan getting involved in the Nixon presidential campaign of '68. But he was certainly instrumental in Greenspan getting involved in the Reagan campaigns in '76 and in 1980. Anderson was running Reagan's economics research operation, and he pulled Greenspan in near the top, so he was really important to Greenspan's leap into the future.

What was it about Greenspan that so impressed Anderson, do you have any idea?

Well, I have a story in my book in which Anderson recounts working in the White House in the early 1980s, while Greenspan still had his consulting business back in New York. I don't have the quote right here, but what Anderson said, basically, was that it was extraordinary, every time I was in the White House, walking down a corridor, there was Alan Greenspan, either sitting in somebody's office or sitting outside somebody's office, waiting to talk to them.

Greenspan was maneuvering, obviously, for some position, probably Fed Chairman or maybe Treasury Secretary, and he was letting his own consulting firm fall apart, from what I've heard. I've also read a couple of pieces in which people claim that the White House told him to disassociate himself from **Townsend-Greenspan** in 1987. At any rate, there was virtually nothing left of it when he was named to the Fed; the only things that could be sold were the furniture and the computers. Greenspan had been spending so much time on the campaign trail for himself.

I've heard pretty much that same thing. His record as an economic consultant isn't remembered as awe-inspiring, either.

I've actually heard conflicting views on that. The positive story is that Greenspan knew numbers. He could tell you freight car loadings, and he knew how many pounds of lead were being mined in Utah or things like that, all of this data, he was tremendous at. The negative stories go along the lines that Greenspan had lots of numbers, but they were always wrong, and always came off of the top of his head. Two different people have told me about being in different meetings with Greenspan, in different decades, in which he's talking about inflation will be X% and GDP will be Y% and so forth, when somebody asks, could you give us your

backup for those numbers? And Greenspan says, "Oh, I mailed that to you last week," and that's the last they ever heard of them.

"The check is in the mail."
Right. The other, probably bigger problem people have told me about having with Greenspan the consultant was that he was never right. "Whatever he told us, with all his data, it never came out that way."

Well, consider that Townsend-Greenspan was a pioneer in the econometric data field, back in the days when it was a feat just to collect it, much less make sense of it.
My understanding, from a couple of the biographies I've read of him, is that Greenspan got into econometrics early, because he started working at the Conference Board, which was actually doing most of the early data collection, while he got his masters degree at NYU. So he got a headstart on other consulting economists in the 1950s in putting together a lot of data that others simply weren't using yet. He probably did impress some people, at least early on, by coming in to meetings with data they couldn't find in the newspapers. On the other hand, someone told me of sitting in on a meeting with Greenspan as a young analyst in the mid-'60s. He recalled Greenspan sweeping into the room with several associates, sitting down with his slicked back black hair and big black glasses, and speaking softly, but very fast, and totally dominating the room with his mastery of the data, even though he wasn't yet a big name. The guy who tells me the story remembers having to scribble furiously to keep up, and he saved the notes. The only thing was, he laughs today, that nothing Greenspan forecast that day turned out the way he predicted it would.

You recount instance after instance in your book of Greenspan's forecasts going awry. So clearly forecasting ability didn't power his career. But your book also demonstrates that he's probably the best politician the economics profession has ever produced —
Yes. **Bill Seidman**, who was an aide to **President Ford** at that point, interviewed Greenspan about the possibility of becoming chairman of the Council of Economic Advisors. This isn't an exact quote, but what Seidman said was, "Well, Greenspan said that he wasn't a politician, but he surprised us; he was the best politician of all." And he was.

What I'm still not sure of, after reading your book, is whether you think Greenspan understood that there was a massive buildup in credit going on in the economy, largely outside of the Fed's direct control, during his reign? Did he willfully ignore it or was he really Mr. Magoo, as Bill Fleckenstein, co-author of your prior book, dubbed him?
I lay out what Greenspan did and didn't do in my book, and I think the evidence is there in the wreckage he left us with. His motives can only be inferred. But on that score, the evidence I've seen from the earliest days of his career always seemed to be that he did what he thought was in the best interest of Alan Greenspan. Everything he has done, from the very beginning, has been to build himself up, to put himself on top, whether socially, financially or politically.

Okay, but you cite a whole slew of his speeches and statements before Congress and at FMOC meetings over the years to show that even though he long maintained publicly that the Fed could not — and should not — try to recognize and pop bubbles proactively, he sang a decidedly different tune in private FMOC discussions in 1996.
It was in a 1996 FOMC meeting, as I recall, that he said, "We can pop this bubble. I can raise margin requirements. I guarantee you that that would pop the bubble." That was that September. In December '96, he gave his "Irrational Exuberance" speech.

And the market swooned, albeit only briefly. But all I ever recall hearing him saying in public was nonsense about having no effective tools to use counter speculation — that raising margin wouldn't work.
That was a bit later. I believe he went on record saying that during his reconfirmation hearings in January of 2000. Sen. **Charles Schumer** was a little concerned about the internet bubble by then and asked him about raising margin requirements. That's when Greenspan said, "We have looked into it. We've had lots of discussion about that and it simply wouldn't do any good." There was no rebuttal at the hearings, but I've tried researching this every which way in the FOMC meeting transcripts and I can find no discussion of margin requirements at any FOMC meetings after Greenspan's boast back in 1996 that he could pop the bubble with them. So maybe the Fed was discussing them via semaphore, but they weren't talking about them at FOMC meetings. Now, there was one

study, posted on the Fed's website in 1997, but if it was read by any of the FOMC members, it was never discussed at their meetings.
Anyway, possibly concocting his story on the fly, Greenspan spun himself as an ardent populist in the forum Sen. Schumer provided, insisting that margin requirements would only hurt little investors, because large institutions would find ways to evade them – and so would not effectively change market behavior. The irony is that only two days before Greenspan was testifying, the **New York Mercantile Exchange**, which knew a thing or two about markets, had seen fit to raise its own margin requirements on heating oil, effective immediately, by 80%.

In a literal sense, Greenspan was correct, margin was just a tiny fraction of the leverage. Nonetheless, as a statement, at that point, it could have been quite powerful, psychologically.
That's what **Henry Kaufman** said. "When you raise margin requirements, you express concern that is telegraphed to the market at large. You express concern about speculation, and the inappropriate use of credit and risks that it may expose to the financial system."

But that would have required Greenspan to play the heavy—
Exactly. If you look back to his early career, Greenspan said a number of things that make it obvious that he understood the problems of a bubble. He had talked about it with a *Fortune* reporter back in 1959, when he said that ever since the Fed had been established there has been artificial liquidity in our financial system. To quote the reporter's distillation of their conversation, "Once the Federal Reserve was set up, Greenspan reasons, the money supply never really got short. With one eye necessarily cocked towards politics, the Fed has always maintained a more than adequate money supply, even when speculative booms threaten."
I mean, he understood that and it's pretty clear that he knew the consequences of it. But when it was inconvenient to talk about it, he stopped talking about it. He gave his "Irrational Exuberance" speech in December '96, which really wasn't much of a warning. He was more like Hamlet; we know that when a bubble has risen to a certain level it's dangerous. He was acting and reacting more to what people were thinking rather than to what was happening in the markets. But I can't tell you what Greenspan was thinking.

Just what he did —
Right. At the next FOMC meeting, which was **Larry Lindsey**'s last meeting, he said to Greenspan, "I think we're in for a lot of irrational exuberance," talking about the bank loan market, as well as the stock market and bond market. Greenspan replied, "Well, maybe I should give another speech" and Lindsey retorted, "I wouldn't wait too long." I think those were the last words out of Larry Lindsey at the FOMC. He was gone before the next meeting. Greenspan did mention a couple of more times, in February 1997, once to the House and once to the Senate, that there's a potential problem of a stock market bubble. But **Sen. Phil Gramm,** for one, said, "I would disagree with you. I would say that not only are stocks not overpriced, they're underpriced." And I don't think that Greenspan ever mentioned a bubble again, either in the FOMC or certainly in public until June 1999, when he gave testimony before Congress and said, "We can't see an asset bubble." That was new. That was out of nowhere. But it then became the Greenspan doctrine. The notion had been floating around in academia for who knows how long, but it hadn't been part of the Fed's tool kit. They had always watched product prices, first and foremost, but hadn't dismissed asset prices as meaningless; as not worth monitoring. In fact, **Jerry Jordan**, the Cleveland Fed president, in FOMC meeting after meeting in '97 and '98, had said that what we're looking at, as far as price is much too narrow; we're just looking at product prices. We have an asset bubble right now; it's growing. **Michael Prell**, the Fed's director of research, was a staffer who must have really unnerved Greenspan. In meeting after meeting, he'd talk about this huge asset bubble. Once he pulled out the South Sea prospectus and said we're beyond the South Sea bubble at this point. But Greenspan just shut the door on all that talk at the FOMC – that was at a meeting prior to his testimony before Congress that "I've given this a lot of thought and we cannot detect a bubble; all we can do is clean it up after it's blown apart." And the other FOMC members didn't talk about the asset bubble in subsequent meetings.

You've read all those transcripts. How do you explain the iron grip Greenspan exerted over the other FOMC members?
One thing that is striking, reading through them, is the etiquette. It probably makes it difficult to have a real discussion. There wasn't one real argument in the 10 years of transcripts that

I read. Maybe even the protocol of referring to each other as Mr. Jordan and Mr. Chairman and so on inhibited real give and take. Jerry Jordan was one of the few who would even bring up certain topics. **Cathy Minehan**, the Boston Fed president, was another one who would often disagree with Greenspan, but disagreement was as far as it went. Greenspan would speak and nothing else was spoken after that. The disagreement was squashed. When you read the next transcript, everything was back to where it was at the end of the previous meeting, with Greenspan in full charge. The discussion never moved anywhere that Greenspan didn't want it to go. There were even a couple of occasions during his tenure when the FOMC members went to the meetings to find that Greenspan had already had the staff prepare the communiqué to be released at its end, complete wit the rate cuts he was confident the committee would make.

So Greenspan controlled the agenda and the staff and the rest was window dressing? Hadn't there been more dissension on the FOMC under some of his predecessors?
Yes. There was a lot of disorder, for instance, under Paul Volcker, especially after some of the FOMC members were replaced after Ronald Reagan was elected. The early years of his term, between 1979 and '82, were Volcker's golden years, when he was able to contain money. After that, as the terms of FOMC members started expiring, the new Administration started replacing them with looser money people. So by the time Greenspan came up for confirmation as Fed Chairman in 1987, there was not a single FOMC member left who had been on the board in 1980 and they were all looser money people. I haven't looked at the transcripts from back then. But I did talk to somebody who spent some time at the New York Fed and who has looked at those transcripts. He told me that there was actual arguing in those days and that at one point Volcker said, "Well, wait a second, I'm still in charge here!" But there was none of that when Greenspan was chairman. Which in a way is surprising because Volcker's a much more formidable figure than Greenspan, at least physically.

No one will ever describe Greenspan as a towering figure—
Yet he clearly had his ways. I remember a story about him getting very upset when **Janet Yellen**, who at the time was a Board member (now the San Francisco Fed president), approached a staffer to ask where some numbers Greenspan was using came from. He didn't want other governors talking to the staff and possibly upsetting their calculations. So, yes, he really did exert control over the Board. Geography helped him, too, I think. The presidents of some of the regional Fed banks tended to voice more dissent, but they only flew to Washington for meetings every six weeks or so, tending to blunt their effectiveness. The same thing is happening today, I suspect, when some of the regional Fed chiefs grumble about the zero interest rate policy. Bernanke can pretty much ignore them.

Let's talk a little about credit swaps and derivatives. Greenspan thought they were the greatest things since sliced bread —
I'll never forget, it was only a couple of months before **Lehman Brothers** when I saw him on CNBC talking about, "Well yes, we have seen problems with some derivatives, but the one remarkable innovation that we have had is credit default swaps so we have to be thankful for this wonderful innovation." If there were four people left in the country who weren't terrified of credit default swaps at that point, that was a lot, but he still thought they were wonderful.

That begs the question of whether he or his successor have learned anything from what has happened. At least Greenspan has admitted that he was wrong to believe that the private sector would regulate itself.
In a way. I mean, his admission was a typical Greenspan thing. I've never seen him really admit doing anything wrong in his life, which is probably why he couldn't admit that he may have mis-estimated the bubble. When he made that confession, first of all, it was the model he blamed – he's always blaming models – he said it was his fault but he was blaming it on the others, the bankers weren't acting in their own self-interest to maximize profit or whatever he said, and they were willing to run their own institutions into the ground, which wasn't the behavior that he had modeled.

Bankers behaving badly came as quite a surprise to him, evidently —
But not to the surprise of a lot of other people who had been watching this thing building up for years and warning that they were running those institutions into the ground. But then he made what seems to be his confession – there must have been a reason for it; I just haven't figured it out yet.

Well, it deflected some political heat. His

successor, meanwhile, continues to grapple with the mess Greenspan bequeathed to him — and looks to be trying to solve it by blowing a bubble of his own, though he should know better.

He should. I'm not sure what Bernanke does know. But if you made a schematic of what happened to Greenspan with the housing/credit bubble and what is going on now with the government spending /credit bubble, it would look the same. At some point, it's going to pop and the damage will probably be larger and worse than what happened in 2007 and 2008. But the Federal Reserve Chairman certainly is unaware of it, or if he is aware of it, he's not saying anything about it. I think he actually *believes* in what he's doing, as opposed to Greenspan, whom I think made accommodations in his different speeches as time went on to fit the current circumstances. But Bernanke, I think, is a true believer in his Ph.D. thesis and that nothing has changed much since then.

In other words, go for the stimulus.

Yes, although it's all so abstract, there's nothing specific about it. It's not as though we can look to any point in history and be able to run a regression analysis of some macroeconomic model to see if this is or isn't working. There's nothing along those lines. It seems as though the other economists who support his spending just say well, you have to spend more. If we're running a $2 trillion deficit, let's run a $5 trillion deficit because that would certainly get us out of this problem. The thing is, debt never enters into Bernanke's scholarly writings. I read his essays on the Great Depression, and it seemed to me, as a non-economist, that the way he would just pick some variables and exclude others wasn't good science. But I know he considers himself a scientist. Yet the debt pileup of the 1920s was never a consideration. He did mention debt *once* in one of his essays, but it simply is not something that he considers. And since he doesn't pay attention to debt, he can add as much as he wants and it fits into his model.

Debt is just the flip side of credit, and when credit is what fuels the economy, why *should* he worry about it?

Well, because when the debt, and the carrying charges on the debt, are growing faster than the economy, it's ultimately unsustainable and destabilizing. The Federal Reserve does control money, and it is able to set limits on credit growth, though it seldom does. Even when, for instance, Lehman Brothers or **Bear Stearns** were leveraged up over 30-to-1, that credit had to come from the banking system, which is something that the Federal Reserve does control. It was the same with all of the huge subprime lenders – the ones that were not also banks – the only way they were funded were from banks that had those wholesale lines of credit so that they could make subprime loans.

Don't forget, a roaring securitization market had a whole lot to do with creating tons of that malodorous debt—

True, but again, it had to get its start in the commercial banking system, which the Federal Reserve *does* have control over. I mean Bernanke et al are correct in saying that they cannot direct *where* money is lent, but they can say where money *cannot* be lent, as a regulator. It's something that they generally do not do. Although Paul Volcker, when he was Fed Chairman, stopped the banks from lending for mergers back in 1980. So there is precedent.

All we need is a Fed Chairman actually willing to take away the punch bowl, you're saying?

Yes. He is really the only one in a position to control credit, but he doesn't want to. He knows what is going to happen if this credit bubble implodes. If this so-called "new normal" really deleverages, the next new normal is going to be much smaller than the one we have right now.

The reality is that without leverage, this economy doesn't grow.

Right, and it has required much more leverage in the recent years to produce a given unit of GDP growth than it used to. If you look at the ratio of GDP growth to the amount of credit created from the 1920s up until 1980, it averaged about $1.20 to $1.40 of credit for every $1 of GDP growth. In the mid '80s, it went up to about $4 of credit to every $1 of GDP growth. Then in the '90s it sort of normalized back to about $2. But then after 2000, it went up to 4-to-1 and in some recent years to as much as 7-to-1.

That sounds like the real flip side of Greenspan's productivity miracle.

It's amazing what you can do when you exclude debt from all of your calculations and presentations. It was the same thing when Greenspan was talking about Americans getting wealthier. In 2003, he gave a speech about how the economy was improving and he expected much greater improvements because of how much

wealthier households were. Well, the wealth he was looking at was the figure that the Federal Reserve produces every quarter in their Flow of Funds Report for housing and stock market wealth – and, of course, house prices were going up. What he wasn't looking at was at how much debt they they were acquiring. But household debt was going up very fast. Unfortunately, Greenspan and Bernanke are not the only economists to make that mistake. As a group, economists don't look at balance sheets and don't seem to look at debt. They seem to ignore it.

So do you have any advice to Bernanke, assuming he doesn't follow your injunction to "just go"?
That's what he really should do. He's failed at everything. Leading up to the crisis, he didn't see anything coming; he didn't understand what was happening. In the summer of 2007, I was told, somebody had to explain to him what a CDO was and what a SIV was, and he never really seems to have understood, even through 2008. He's made so many contradictory statements when I've watched him give testimony about why they let Lehman Brothers go and why they saved Goldman, **AIG**, and so forth. Either he was so dumbfounded by it all that he still can't make sense of it or he is being economical with the truth, one of the two. Either way, he should definitely go. I think it's even more important at this point to see the provision of the financial reform bill go through that says the Fed is to be audited so that we can find out what they've really been doing.

Well, Rep. Ron Paul did get his pet cause through the House last week. But the Senate is likely to be a tougher nut. The argument is that regular monetary policy audits would make the Fed all too vulnerable to political meddling.
But the reality is, as Greenspan said back in 1959, that the Fed has never really been independent. He understood that when he told the *Fortune* reporter that there's been artificial liquidity in our financial system ever since the Fed was set up, because they've always had one eye on politics. The Fed couldn't be compromised any more than it already has been.

But back to Bernanke. He doesn't show any signs of leaving voluntarily, and odds are he'll be confirmed by the Senate, so what should he be doing?
Focusing on derivatives and credit default swaps, for starters, where nothing has been done, and the potential problems are getting worse. Maybe Bernanke is afraid to do something. But there are no dollar reserves currently required against any derivatives, by the way.

Perhaps he's afraid to step on Congress' toes and so is waiting to see what it does. But the lobbyists have Congress so tied up in knots that meaningful financial reform is a nonstarter there.
They wouldn't dare touch that. There's no way that they're going to touch derivatives. That's a huge moneymaker for financial services companies. Derivatives are safe, until there's another blowup, and I don't know if they'll even do anything then. You probably saw the other week that Treasury Secretary **Timothy Geithner** said that it was not credit default swaps that led us to rescue Goldman and AIG and to pay off Goldman's credit default swaps, which seems– well, I don't believe him. But assuming it is true, why do we need a Goldman Sachs or a Morgan Stanley? Why do we need any of the "too big to fails" which converted into commercial banks? Why allow of them? They don't hold deposits. They're just a blight on the nation's conscience at this point.

We do need a commercial banking system. But if it weren't for the outstanding derivatives and credit default swaps – because I have no idea what's really out there, and what could happen with them –I'd just say to let the "too big to fail" investment banks go right now. Just drop all of the guarantees and let the banks that manage themselves well get the business, instead of protecting these big monstrosities so that they can get bigger and bigger and drive out of business the banks that try to manage themselves well.

The thing is, the too big to fails are taking out an insurance policy, of sorts, against being broken up as long as they manage to pump out those indecipherable transactions by the bucketful.
When you look at it, though, the notional value of all these obligations that are being created, in relation to the world's GDP is just getting so huge that they will topple over at some point. We can keep trying to hold that day off, which might be a good thing. I don't really want to see what happens when it all topples over. But they're doing nothing to correct it. I don't know that they even could. The interrelationships and cross promises in the derivatives world are mind-bending.

I've said before that it might require

something like a force majeure, on a global basis, to sort things out.
That might be the best solution. I've been told that what they've done with some of the credit default swaps in which there were many multiples of swaps written above the actual value of outstanding debt – and where the swaps were required to settle in the debt itself – what happened was that someone from the NY Fed sat down in a room with all the parties and gave everyone pads and pencils on which to write down all their holdings. Then they started crossing out different holdings they had with each other until they got down to a manageable amount and then they settled the credit default swaps. So maybe the Fed just has to get all the banks in the world to sit down in a room and see how many sways they can possibly just settle and let a certain amount of them just be pushed off the gangplank to keep the system as a whole from imploding.
Again, I have no idea where the exposures are now. But interest rate swap volume has been exploding over the last few months, especially on Treasuries of five years or longer. It makes sense to me that people would want to be protecting themselves from rates increasing on five-year or longer Treasuries. But do the banks that are selling these swaps have anything set aside to backup these commitments when interest rates do rise?
Meanwhile, the Benanke Fed has been talking about it being so important for it to be involved in setting bank regulations and be the regulator. Well, I'd be very interested to know if the Fed has done anything to even look at this, if they've even talked to the banks about the surge in interest rate swaps. "Hey, what is this? Look at all these interest rate swap contracts you're writing."

And it's no mystery that interest rate swap activity has been surging—
Not to anyone who reads the BIS reports. They had gone way up in the June 30 report, and the text attributed most of the increase to five-year and longer Treasury interest rate swaps.

You're just a worrywart. I'm sure whoever is writing those swaps is convinced they'll *never* have to pay out.
Yes. And if it turns out that they're wrong, I'm *sure* they could pay, without threatening their solvency again.

Of course. *Surely*, they're hedged.
And *surely*, the Federal Reserve, as their regulator has looked at the adequacy of their hedges. Well, *maybe*. But if past is prologue, they aren't even aware of it. I recount the story in my book of how, in the immediate aftermath of the Long Term Capital Management implosion, Greenspan was just astounded that no one knew who LTCM's counterparties were. Well, he was right to have been astounded, they *should* have known more then. But there's nothing I've seen in the intervening years that makes me think that the Federal Reserve is any more on top of the latest problem. They seem to spend most of their time trying to defend their turf. They haven't done anything about derivatives. There are still no reserve requirements on them at all. Meanwhile, to deal with the 2007-08 crisis, they've blown massive holes in accounting standards, and from what I've read, there's already been some sort of an accounting change for when commercial loans start going bad that will mitigate the immediate losses to commercial banks. So this is a case of looking ahead to the next catastrophe, already hiding the damage before it even hits.

You could call that proactive regulation, I guess. I'd be derelict if I didn't solicit your views about troubles brewing in the muni market, given the way your earlier piece [w@w 9/28/2009] went viral —
Things are happening now on a small scale where there are municipalities that have gone into bankruptcy and where it looks as though rates are rising for states to be able to borrow. The next big thing, though, will be a major default – there just are so many candidates. The State Treasurer of Massachusetts has said, "We're just one step from California." I've seen statements that New York is one payment away from a real mess. They are only able to sustain themselves as long as they have a willing bond market. Once one of them defaults, it is probably going to be a big problem across the board. Not that the others will lose access immediately, but the trend will be toward higher yields and then they'll all be looking at the federal government for a bailout.

Were all the states just living as far beyond their means as their citizens?
The problem with state expenses was that the amount of spending that went on over the last decade or so just increased enormously. Now, at the same time, the states and municipalities were also were receiving so much more in revenues, whether it was from taxes on real estate or on income or on capital gains, and yet they

still weren't able to keep within budget. I have heard again and again about different municipalities that were paying operating expenses out of bond issues that were supposed to be for capital projects. So they've not been entirely forthright already. Once they really run into trouble, with tax revenues dropping and expenses still shooting up, both because of pension costs and operating expenses, it's not going to be pretty.

As a rule of thumb, there's been so much building by towns, nonprofit foundations, endowments and so forth over the last few years that that they have increased their maintenance expenses by about 30%. Those new buildings are there, now, so they have to be maintained. Most of them were financed with bonds. The only other thing they could do would be default and not keep the places up. The commitments for pensions were made long ago. I suppose they can shut down the schools and tell all the fire departments and police to go home, but it is going to be a terrible problem.

It already is, with state tax revenues falling like a rock.

Exactly. A lot of states' tax revenues have now fallen by double digits compared to last year, and expenses up big while revenues are going down means that they are going to have to go to the bond market to be able to pay their bills – or just not pay. Illinois already is about $4.5 billion behind in payments to suppliers. And the trend is national; it's practically everywhere. The only states that seem to have been prudent were prudent for a reason, which was that they couldn't look at the world through rose tinted glasses. Michigan was very stringent in how much it was spending over the past few years. But now it's doing as badly as states that were spending like mad, because its revenues have dropped so much. Teachers' and municipal pensions are a problem everywhere, because the promised benefits were allowed to grow so much, and it's often the towns, not the states, that have to pay.

The bottom line is that munis these days can be a minefield?

Yes. But on the other hand, they might also be an opportunity for, say, people like those who were willing to sift through tranches of CDOs when everybody was dumping them. If somebody is willing to read through all of the documents, and from what I understand from municipal bond managers – people who really try to do a good job – it's nearly impossible to read through the documentation for every issue, it *is* possible to find value in some issues. But even good managers do wind up relying to some degree on S&P and Moody's at least for some preliminary research on munis.

Amazing isn't, it? Despite everything.

I know, I know. But beyond the fact that there's always the potential for a general sell-off in munis, the thing you have to remember is that there really are no two bonds that are exactly the same. There are rules of thumb, like general obligation bonds being safer than revenue bonds because you have the first call on revenues and the infinite taxation powers, supposedly, of a state or city. But even within the revenue category, some revenue bonds are safer than others. Ones backed by water revenues, for instance, are safer because people tend to pay their water bills. Another example was the MAC bonds that New York City issued back in 1975 when they were on the brink of default. They were not general obligation bonds, they were revenue bonds, backed by sales tax revenue, but they were first in line to receive sales tax revenues – and since they were revenue bonds, they yielded 10%, while NYC GOs yielded 8%. So if somebody spent a little time, and I'm sure some did, they realized that those were a bargain. I have a feeling that the same thing is going to happen for somebody who has the time and expertise to be able to read through the documents for different bonds and find out value in some, even when as a whole, municipal bonds get jettisoned. What I've found is that nobody pays very careful attention to municipal bonds, which can create real opportunity if you are smart and careful.

Which is a perfect holiday note on which to end. Thanks, Fred.

W@W Interviewee Research Disclosure: Frederick Sheehan is author of "Pander to Power, the untold Story of How Alan Greenspan Enriched Wall Street and Left a Legacy of Recession" (McGraw Hill, 2009) and co-author (with William A. Fleckenstein of "Greenspan's Bubbles, The Age of Ignorance at the Federal Reserve," (McGraw-Hill, 2008). Fred is a former director of asset allocation services at John Hancock Financial Services, whose market analysis has been published in Marc Faber's Gloom, Boom & Doom Report, and on the web in Whiskey & Gunpowder and the Prudent Bear, as well as on his on blog, aucontrarian.com. This interview was initiated by Welling@Weeden and contains the current opinions of the interviewee; such opinions are subject to change without notice. This interview and all information and opinions discussed herein is being distributed for informational purposes only and should not be considered as investment advice or as a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but is not guaranteed. In addition, forecasts, estimates and certain information contained herein are based upon proprietary research and should not be interpreted as investment advice, or as an offer or solicitation for the purchase or sale of any financial instrument. No part of this interview may be reproduced in any form, or referred to in any other publication, without express written permission of Welling@Weeden. Past performance is no guarantee of future results.

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