

THE ASPEN INSTITUTE

IN CONVERSATION WITH ALAN GREENSPAN

SATURDAY, JULY 4, 2009

1 PROCEEDINGS

2 (Tape starts abruptly.)

3 MR. ISAACSON: -- of the Federal Reserve, a great
4 jazz musician who used to play saxophone at the Roosevelt
5 Hotel in New Orleans. Alan Greenspan is our guest today.
6 Thank you very much.

7 (Applause)

8 MR. GREENSPAN: I did bring my horn, it's
9 backstage --

10 MR. ISAACSON: Right. Between you and Bill
11 Clinton, we always have these problems. As the week goes
12 on, people want to play saxophone as opposed to talk.
13 Instead, we're going to make you talk about the financial
14 crisis and maybe we can start it as a narrative, because I
15 would love to start at the very beginning with what caused
16 the housing bubble.

17 MR. GREENSPAN: There are about 20 explanations
18 of the housing bubble. I happen to think that only one is
19 correct. And the reason I suggest that is that something
20 very extraordinary happened with the fall of the Soviet
21 Union. Let me give you a rather longer answer here,
22 because I think it's relevant to this whole issue.

1 With the decline -- the collapse of the Berlin
2 Wall, an economic room that was observed behind the iron
3 curtain, the whole notion of central planning which had
4 been very pervasive throughout this then third world, fell
5 into very rapid but quiet disrepute.

6 And there was a major shift in the now
7 developing nations from various forms of central planning
8 to one form or another of market planning, mainly for
9 China. And the results were spectacular. I mean in
10 India, China, Indonesia, in fact over a whole array, all
11 were subject to major reforms towards opening up their
12 markets to the globe.

13 This created a huge increase not only in world
14 GDP, but very especially in the developing world. They,
15 meaning the developing world, did not have the
16 infrastructure or the capabilities or interest, really, of
17 consuming much of that huge increase in income. And we
18 had, what economists call, a major increase in x anti-
19 savings intentions over x anti-investment.

20 In short, short term -- I mean, shortening this
21 notion, there was a huge excess of savings in the system -
22 -

1 MR. ISAACSON: So that drives down interest
2 rates.

3 MR. GREENSPAN: It drives down long-term
4 interest rates.

5 MR. ISAACSON: Okay.

6 MR. GREENSPAN: Short-term interest rates are
7 largely in the control of the central banks.

8 MR. ISAACSON: Yeah.

9 MR. GREENSPAN: And for many years, they also
10 indirectly controlled long-term interest rates, but that
11 stopped at the beginning of this decade. And it stopped,
12 as you can see, the convergence of long-term rates,
13 especially mortgage rates. And in the United States it's
14 the 30-year fixed rate mortgage.

15 Long-term interest rates throughout the world
16 converged, and by 2006 there wasn't a single major country
17 with a few exceptions that did not have long-term interest
18 rates and inflation in single digits -- first time ever.
19 What the central banks experienced was that we no longer
20 controlled the long end of the market.

21 But what the data show, in the United States
22 very specifically, is that housing prices are directly

1 related to the mortgage rate with an 11-month lag.

2 MR. ISAACSON: So long-term interest rates
3 getting lower meant housing prices went up.

4 MR. GREENSPAN: And they did. And the fact is
5 that the mortgage rates began to decline, or long-term
6 interest rates in United States began to decline well
7 before short-term rates declined in this country. And you
8 could actually see the housing boom developing here as it
9 was developing in two dozen other countries at exactly the
10 same time.

11 MR. ISAACSON: But it was clear it was
12 unsustainable after a while.

13 MR. GREENSPAN: It was clear it was
14 unsustainable largely because what was occurring in the
15 United States was an extraordinary rise in home ownership.
16 We had all household formation in, say, 2004-2005 and I
17 think maybe 2006. All of household formation moved into
18 owner-occupied, mainly single family owners.

19 MR. ISAACSON: But you are very good at looking
20 at data. And you see all that -- it's clearly
21 unsustainable. Shouldn't or couldn't the Fed leaned
22 against that and in there some way you could have tamped

1 down long-term interest rates?

2 MR. GREENSPAN: There is no way we could have
3 tamped down long-term interest rates. But we could have
4 raised short-term rates to 20, 30, 40 percent, and we
5 would have crushed the economy and we would have crushed
6 the housing boom in the United States.

7 MR. ISAACSON: Well, Dean Baker earlier this
8 week said that you really could have found some way to
9 lean against what was clearly a bubble, and which you've
10 just described that you knew was a bubble.

11 MR. GREENSPAN: Look, there is not a single
12 instance in economic history in which central banks leaned
13 against a bubble and succeeded. We actually didn't try
14 that in the dot-com bubble. But we did -- in retrospect,
15 we were raising rates -- that happened, say, in 1994, and
16 we raised rates by 3, 4 percentage points, federal funds
17 rate went up very sharply. The incipient stock market
18 boom of the previous year flattened out --

19 MR. ISAACSON: Right. And you also called it a
20 rational exuberance and that helped taper it a bit, right?

21 MR. GREENSPAN: No.

22 MR. ISAACSON: No?

1 MR. GREENSPAN: I mean for one day.

2 MR. ISAACSON: Oh, okay.

3 (Laughter)

4 MR. GREENSPAN: And mainly --

5 MR. ISAACSON: A memorable day, yeah.

6 (Laughter)

7 MR. GREENSPAN: -- mainly in Tokyo.

8 (Laughter)

9 MR. ISAACSON: Oh, okay. Now wait, correct my
10 facts if I'm wrong, but let me just generalize it. I
11 think about \$6 trillion of this mortgages were
12 securitized; securitized in a way that I couldn't figure
13 out. If I were buying a securitized debt obligation that
14 was a mortgage in some Citibank fund, I couldn't figure
15 out.

16 In fact, I'm not even sure if the Citibank risk
17 committee could figure out the risk of these securitized
18 mortgages. Was that a contributing factor? Was that a
19 mess, and should we have stopped securitizing of
20 mortgages?

21 MR. GREENSPAN: I'm sorry I never did finish
22 your previous to previous questions.

1 MR. ISAACSON: I'm sorry. Right, go ahead.

2 Okay.

3 MR. GREENSPAN: We in 1994 drove short-term
4 rates up very sharply, and we stabilized the stock market.
5 As soon as we stopped stock prices took off again, and we
6 did that twice. And we concluded that what was happening
7 is that unless monetary policy crushed the economy and
8 profitability, that the equilibrium Dow Jones industrial
9 average went up.

10 Because the people were saying if all of this
11 tightening didn't tilt the economy down, it must be in far
12 better shape than we thought. So the question here about
13 the notion that we can somehow incrementally tighten
14 monetary policy and diffuse a bubble of any sort is
15 without any statistical foundation. It's one of those
16 extraordinary conventional wisdoms for which there is no
17 evidence.

18 MR. ISAACSON: Well, let me push on that one
19 before we go to securitize, which is if you know there is
20 a bubble -- you're just telling me you knew there was --
21 you say you knew there was a bubble, there is nothing you
22 should have or could have done?

1 MR. GREENSPAN: In fact, what -- you may recall
2 that we argued at the Fed in 1999 and 2000 that we knew we
3 were dealing with a bubble, but the only way that we could
4 scheme as a policy matter was essentially to try to
5 ameliorate the aftermath. And indeed that is what we did,
6 and I thought very successfully.

7 And the recession in the year 2000-2001 was the
8 shallowest in the post-World War II period. The problem
9 basically is that when you got into the housing boom, I
10 myself remember very succinctly that of course we never
11 had a decline in housing prices in the United States since
12 the 1930s.

13 And Australia and the United Kingdom had gone
14 through the same sort of thing and had minor declines in
15 house prices and then they stabilized. It was the general
16 view of all of the housing experts with whom we dealt that
17 there was going to be downside pressure on prices, but it
18 was going to be very modest.

19 And indeed our view is that the impact of the
20 housing boom would be handled in a very -- manner similar
21 to what we did with monetary policy in 2000-2001.

22 MR. ISAACSON: Yeah, that was reasonable because

1 every -- most people other than Dean Baker, let's say, I
2 mean most people said that that was the case. But had you
3 known, in retrospect, that it was going to be this bad,
4 was there anything you could have done?

5 MR. GREENSPAN: I don't think so. In other
6 words, we would be caught in the following problem. We
7 knew from our experience with the dot-com boom that fairly
8 significant tightening of policy did not curb a euphoria
9 which builds up and builds up. And indeed, all of our
10 actual experience with the dot-com boom was that our
11 tightening was counterproductive.

12 So that our basic view was that essentially we
13 would largely function in a very -- in a manner quite
14 similar to what basically we did in the dot-com boom.

15 MR. ISAACSON: Should we have allowed it to
16 become securitized as these consumer products both for
17 ourselves and around the world if it was this dangerous,
18 this stuff?

19 MR. GREENSPAN: Well, securitization per se is
20 actually a very effective monetary mechanism, because
21 remember what securitization was all about. And the
22 original securitizer was Fannie Mae, actually, when Fannie

1 Mae was doing the things -- what it's supposed to do.

2 MR. ISAACSON: You still don't reassure me that
3 you said that, but okay.

4 MR. GREENSPAN: The major problem that banking
5 has always had since time immemorial is that you can't --
6 you cannot make a profit in banking except with a very
7 high leverage. And very high leverage means that
8 periodically you run into banking crises which is dotted
9 throughout our history.

10 The problem is that when you got heavy leverage
11 there is no way a bank can get out of it until
12 securitization showed up. What securitization does is it
13 takes -- it allows the banks to make the loans. But then
14 instead of putting it on its balance sheet which are very
15 highly leveraged, it combines them into securities and
16 sells them in the market.

17 And the conventional wisdom, which indeed was
18 the case for many years, was those securities in that risk
19 would be purchased by pension funds, mutual funds, and a
20 whole variety of other types of institutions which were
21 not highly leveraged, and therefore of a less systemic
22 risk than the banks were.

1 So what basically we were dealing with was a
2 situation in which securitization was obviously very
3 useful in taking the risk off. And indeed as we saw that
4 securitization, initially we thought it was valuable.
5 Because as we were confronted with this dilemma of whether
6 we try to find some way to diffuse the expansion or reduce
7 the risk, if we incidentally had tried to tighten in a
8 very significant manner, I will assure you the political
9 system would have gone berserk.

10 MR. ISAACSON: "Political" meaning the second
11 Bush administration and the Congress?

12 MR. GREENSPAN: Congress of the United States.
13 You know, the Federal Reserve is independent legally, but
14 only up to a point. And there is always the question of
15 if we had deliberately knocked the economy down on the
16 grounds that we were addressing the housing bubble, the
17 implications, I think, are beyond comprehension. So --

18 MR. ISAACSON: Didn't you do that to the elder
19 George Bush? Couldn't you've done it to the younger
20 George Bush?

21 (Laughter)

22 MR. GREENSPAN: Well, the elder George Bush said

1 things which I am saddened by. Because remember, monetary
2 policy did not affect the level of GDP in a negative way
3 in the year of the election and that's when it's -- the
4 growth rate of GDP in 1988, as I recall, was pretty
5 impressive.

6 MR. ISAACSON: But getting back to the
7 securitized debt obligations that you say financial
8 institutions bought, you --

9 MR. GREENSPAN: And this is very interesting.
10 Well, let me see if I can carry it through because I think
11 you are at a critical point here. The basic problem that
12 in retrospect we can see, because we didn't have the data
13 right in real time, was that the subprime market which was
14 a deteriorating market, but a very small market.

15 The size of the subprime market in the United
16 States is actually not large. But what happened was --
17 and I might add there is not a single subprime mortgage,
18 indeed any mortgage of any significance that's held
19 outside United States other than a securitized one. So
20 what happened is, the securitizers, the Wall Street firms
21 started to securitize the subprime mortgages.

22 But they put them at a much higher interest rate

1 than it would be normal for mortgage securitization. And
2 this is right at the time when delinquencies and
3 foreclosures of subprime mortgages were actually going
4 down. And the rest of the world thought it was a steal.

5 MR. ISAACSON: But so did our banks.

6 MR. GREENSPAN: They did too, but the answer is
7 yes, but --

8 MR. ISAACSON: And they were wrong.

9 MR. GREENSPAN: They sure were.

10 MR. ISAACSON: Yeah.

11 MR. GREENSPAN: But look, the reason I am
12 raising this issue is I am trying to say that we expanded
13 the market far greater than it otherwise would have been,
14 were it a wholly domestic operation. And what -- as I
15 observed it, as the pressures occurred on the securitizers
16 for more paper because Europe, especially, was just dying
17 for this stuff.

18 And so that the securitizers put pressures on
19 the underwriters and the lenders who, I understand, they
20 had a lot of fly-by-night operations in there.

21 MR. ISAACSON: Yeah. But you said both here in
22 the past and in other places that risk managers at

1 financial institutions and pension funds was -- and banks
2 and investment banks were sufficiently sensitive to the
3 problems and risks of default, that they were going to
4 protect against it because that was their job. Were you
5 right?

6 MR. GREENSPAN: No.

7 MR. ISAACSON: Okay, good. You were wrong.

8 MR. GREENSPAN: I was wrong.

9 MR. ISAACSON: Okay.

10 MR. GREENSPAN: Look, for 60 years I depended
11 upon the self-interest of all of these financial people to
12 essentially protect the shareholders. And for 60 years it
13 was an unqualified success, if I may put it that way. I
14 could not believe, in retrospect, some of the practices
15 that were done. And as I said publicly, I was shocked
16 into disbelief, which is a fact.

17 MR. ISAACSON: Why did that happen? Is it
18 because investment banks became publicly traded companies,
19 because of the incentive structure for these leaders of
20 these investment banks to make huge sums of money and not
21 worry if they crashed?

22 MR. GREENSPAN: Yeah. The answer is, in

1 retrospect, yes. There's a very interesting story here.
2 In 1970, the New York Stock Exchange changed the rules
3 that numbers no longer had to be partnership solely, and
4 could incorporate.

5 MR. ISAACSON: You're talking about investment
6 banks --

7 MR. GREENSPAN: Yeah, in other words --

8 MR. ISAACSON: -- or banks?

9 MR. GREENSPAN: No, investment banks.

10 MR. ISAACSON: The investment banks.

11 MR. GREENSPAN: Okay. Commercial banks could
12 always incorporate. In the climate prior to that, since I
13 was working in Wall Street at the time, I knew all these
14 people. The Morgan Stanleys and the Goldman Sachses of
15 this world and the Bear Stearnses and the Lehmans wouldn't
16 lend you a nickel overnight, because they were
17 partnerships and the individual partners was subject to
18 unlimited liability of the firm. And they were
19 extraordinarily cautious.

20 MR. ISAACSON: Wait. So you're saying when it
21 was their money they were cautious, but when it was my
22 money they weren't?

1 (Laughter)

2 MR. GREENSPAN: Well, remember what happens when
3 these things go into incorporations. It's not you it's
4 the taxpayers' money.

5 MR. ISAACSON: Oh, sorry. Well, I consider
6 myself --

7 MR. GREENSPAN: Are you a taxpayer?

8 MR. ISAACSON: Yes.

9 (Laughter)

10 MR. ISAACSON: Very much so.

11 MR. GREENSPAN: I'm glad. Yeah. The problem is
12 this that if you're dealing in a partnership, if there are
13 losses, it's yours. If you're a corporation with limited
14 liability, you could only lose your stake in the firm, but
15 there is no call on your other assets and the like. And I
16 always was terribly concerned that when you had incentives
17 break down, the weirdest things occurred.

18 And I think that what a number of these -- a
19 number of these major players in the investment banks lost
20 a huge amount of money. But not -- there was no claim on
21 any of their other assets.

22 MR. ISAACSON: In other words, their own

1 personal houses and property were not at risk even though
2 somebody who may have invested their life savings was?

3 MR. GREENSPAN: Yeah. So basically what it is
4 in the first instance is that you -- in a partnership the
5 losses and the profits go to the partners one way or the
6 other. In a corporation, especially in today's world, the
7 losses tend now to get socialized and the profits are
8 privatized. So then what you have is an incentive to take
9 very large risks because --

10 MR. ISAACSON: Again the incentive structure at
11 these Morgan Stanleys add to that by saying you take a
12 huge risk and you succeed, you're wealthy beyond your
13 wildest dreams; and if you fail, hey, you know, you get a
14 smaller bonus?

15 MR. GREENSPAN: That is caused by the
16 incorporation issue.

17 MR. ISAACSON: Yeah.

18 MR. GREENSPAN: No, this is one -- see, I wonder
19 the things that in -- I was appalled by, because I didn't
20 -- I didn't see it in the detail that -- you could only
21 see in the later months of this whole process. I mean
22 going to 30 times leverage is not to say the least.

1 But if -- I always had the impression that these
2 people knew exactly what they were doing with respect to
3 funding their short-term liabilities. And indeed, the
4 evidence was that that was indeed the case. It turns out
5 that it wasn't. That's one of the things that I found
6 very dispiriting.

7 MR. ISAACSON: Do you think there was also
8 massive fraud in pushing out these mortgages?

9 MR. GREENSPAN: Some. I don't know how much,
10 but as I've always been concerned about is that we have on
11 the books and we've had them for years, fraud statutes
12 which essentially basically say that misrepresentation is
13 fraud and that's a felony. And I've said that we need
14 much greater enforcement of existing statutes.

15 MR. ISAACSON: But do you think enforcement was
16 bad?

17 MR. GREENSPAN: It was inadequate.

18 MR. ISAACSON: Okay.

19 MR. GREENSPAN: And it was clearly inadequate
20 because there were so many -- there was so much evidence
21 in the tail end, remember when I mentioned that when the
22 Europeans -- and then even Fannie and Freddie were major

1 buyers of subprime securitized loans. They put very great
2 pressure on the securitizers and then the underwriters to
3 just get peoples' signatures on loans.

4 And I think -- but I don't know personally,
5 obviously -- that there was a lot of misrepresentation.
6 But that's an issue of legal question, because as you
7 know, the way a sentence can be phrased or the type can
8 get small -- that there was willful misrepresentation I'm
9 reasonably sure. Whether it was a legal misrepresentation
10 I really don't know other than obviously --

11 MR. ISAACSON: But what this whole toxics do of
12 everything starting from the willful misrepresented
13 perhaps mortgage, to securitizing it, to big banks that
14 then leverage themselves 30 times on what is clearly
15 starting to look like it might be a housing bubble.
16 Shouldn't somebody have blown the whistle and said stop
17 this?

18 MR. GREENSPAN: And do what?

19 MR. ISAACSON: Say you can't leverage yourself
20 30 times?

21 MR. GREENSPAN: The law, the banking law
22 basically said -- for example, take the 30 times. The 30

1 times are only in the investment houses. But in 2006, the
2 Federal Deposit Insurance Corporation, which is the
3 overseer of all banks -- you know, it's the ultimate
4 insurer of all banks -- commented in its -- I think the
5 second quarter report -- that more than 99 percent of
6 insured institutions met or exceeded the highest capital
7 regulatory requirements or to the highest capital
8 requirements of all of the regulators.

9 In other words, the official position of those
10 whose job it was to monitor the level of capital were
11 saying we've never had it this good. A year later, the
12 crisis began. So that it's hard to realize, in
13 retrospect, the state view. It was a universal view which
14 went across the Office of the Comptroller of the Currency
15 which is the biggest regulator of the banks.

16 MR. ISAACSON: Right.

17 MR. GREENSPAN: It was true at the Fed. It was
18 true everywhere else. And I will tell you we at the
19 Federal Reserve had more Ph.D.s, first grade economists of
20 any organization I have ever been associated with. There
21 were no whistleblowers in there. Were there people who
22 were saying that there is a low probability -- real

1 problems? There always are. If you have 10,000 people
2 making forecasts, I will guarantee you're going to get
3 four or five who look extremely appreciative --

4 MR. ISAACSON: Okay. But wait, I'm going to ask
5 a very simple question. Every one or almost every one of
6 these Ph.D. economists was just totally wrong. How do we
7 fix that?

8 MR. GREENSPAN: You can't.

9 MR. ISAACSON: Okay.

10 MR. GREENSPAN: It's human nature.

11 MR. ISAACSON: Okay.

12 MR. GREENSPAN: And you can't fix it largely
13 because for other reasons -- internally, you know, I'm
14 just talking about the United States.

15 MR. ISAACSON: Yeah.

16 MR. GREENSPAN: This is replicated all over the
17 world. I mean the housing boom if you pluck the booms of
18 a two dozen countries, they all look the same and the
19 United States actually was below the median. We weren't
20 the worst of it, by any means. But the behavior of all of
21 the regulatory agencies throughout the world were similar.

22 We had, for example, what is called the Basel

1 Committee which is the international group of regulators
2 which set up international standards, promulgated them in
3 2006, and within a year they were wholly outmoded.

4 MR. ISAACSON: Right.

5 MR. GREENSPAN: So this isn't an idiosyncratic
6 issue. This is a -- I mean there is a fascinating
7 history, and I think you have to go back and say why does
8 the world work this way.

9 MR. ISAACSON: Why are there bubbles?

10 MR. GREENSPAN: Why are there or aren't?

11 MR. ISAACSON: Why are there -- I mean why does
12 the world work this way?

13 MR. GREENSPAN: Well, bubbles invariably occur
14 when you've had protracted periods of prosperity, low
15 inflation, and low long-term interest rates. And --

16 MR. ISAACSON: That's what we had.

17 MR. GREENSPAN: -- that's exactly what we had --

18 MR. ISAACSON: So we should have known there was
19 a bubble?

20 MR. GREENSPAN: Well, we certainly knew that
21 risk was being increasingly under-priced.

22 MR. ISAACSON: By the big investment banks that

1 had become incorporated where they had the incentive to
2 risk it.

3 MR. GREENSPAN: No, it wasn't only they. It's
4 appearing throughout the whole structure.

5 MR. ISAACSON: Okay.

6 MR. GREENSPAN: It's insurance companies, it's
7 individuals -- I mean this is not any single institution.
8 You see this pattern of pricing going all the way back. I
9 mean I just recently reread a book on the 1907 crash that
10 I hadn't read for 50 years. And I'm saying to myself, oh
11 my God. With the exception of the names, the names of the
12 institutions, you could just sit and --

13 MR. ISAACSON: Get the law to finance --

14 MR. GREENSPAN: No, no, no. This is a book
15 written --

16 MR. ISAACSON: Okay. I was going to give it --
17 shout out to a friend who wrote a book, but I guess I
18 can't. And some of these institutions, though, became too
19 big to fail. Is that a problem to have institutions too-
20 big-to-fail and should we have let them -- well, go ahead.

21 MR. GREENSPAN: I think it's the most dangerous
22 problem that we've got. And the reason I think is that --

1 let's remember what finance is all about. The basic
2 purpose of finance is to marshal the savings of a society
3 and direct it into the most profitable fiscal investments
4 that is those investments which increase rates of output
5 per hour, and therefore, standards of living.

6 And what we've got to do is to remember that
7 what finance does is take the niches out of the market.
8 In other words, where they see inefficiencies finance goes
9 in and adjusts the process so that you get the maximum use
10 of your savings. Now, the problem basically with too big
11 to fail is by definition you will be supporting, either by
12 government funds or others, institutions which are
13 inefficient by their very nature. In other words --

14 MR. ISAACSON: And you'll encourage them to
15 take risks knowing that they aren't going to be allowed to
16 fail?

17 MR. GREENSPAN: Well, yeah, exactly. And -- but
18 another thing is important is you know that -- let's put
19 it this way. If the government in any way indicates that
20 we will not allow you to fail, then private sector
21 investments will be willing to lend you money at a much
22 lower rate.

1 MR. ISAACSON: Take more of a risk, yeah, too --
2 with a lower price on it?

3 MR. GREENSPAN: No. Well, actually there is no
4 -- no, they will lend the too-big-to-fail institutions
5 money at significantly lower rates than they would, for
6 example, lend money to their smaller competitors.

7 MR. ISAACSON: So should we stop there being
8 banks that are too big to fail?

9 MR. GREENSPAN: Yes.

10 MR. ISAACSON: Okay.

11 MR. GREENSPAN: And the question essentially is,
12 as my former colleague and very good friend, the governor
13 of the Bank of England, said the other day, if they are
14 too big to fail, they shouldn't exist essentially.

15 MR. ISAACSON: Okay. So that would be a nice
16 going-forward lesson out of this.

17 MR. GREENSPAN: Well, I think -- now that it's
18 going forward, but that's not where we're going. We're
19 going --

20 MR. ISAACSON: Correct. That's what I was about
21 to say.

22 MR. GREENSPAN: Well, we're not. And I think

1 that if -- what happens if you support these zombie
2 institutions and don't let them fail as they should? You
3 reduce the standard of living of the whole society.

4 MR. ISAACSON: So we should have let Lehman
5 fail?

6 MR. GREENSPAN: No. By that time --

7 MR. ISAACSON: Oh, it's too late.

8 MR. GREENSPAN: By that time it was too late.

9 MR. ISAACSON: Okay.

10 MR. GREENSPAN: In other words, the basic
11 problem with what the individual regulators had to
12 confront in Lehman was they didn't know it was going to
13 fail till about 48 hours before. And there were rumors,
14 but -- had they gone in and looked at the firm in great
15 detail when these early rumors went up, they would have
16 precipitated the crash because you have the Feds going in
17 --

18 MR. ISAACSON: I would have taken my money out,
19 yeah.

20 MR. GREENSPAN: Yeah. The comptroller of
21 currency is going in or SEC is going in. The problem
22 basically is that they had 48 hours, but they would have

1 needed 3 weeks to vet the Lehman balance sheet to know
2 what the consequences of a Lehman default would be, and
3 they didn't have that time. And the choice was you either
4 acted or you didn't act. There was not a third
5 alternative.

6 MR. ISAACSON: And so it's a mistake in some
7 ways to let them fail to use the shorthand?

8 MR. GREENSPAN: In --

9 MR. ISAACSON: In retrospect.

10 MR. GREENSPAN: In retrospect it was.

11 MR. ISAACSON: Okay.

12 MR. GREENSPAN: Nobody disagrees with that. The
13 question is, the coin they tossed, which is effectively what
14 they had to do, came up in the wrong place.

15 MR. ISAACSON: Should we be bailing out General
16 Motors, to change the subject slightly?

17 MR. GREENSPAN: No.

18 MR. ISAACSON: No?

19 MR. GREENSPAN: No.

20 MR. ISAACSON: And I take it that means we
21 shouldn't be bailing out Chrysler either?

22 MR. GREENSPAN: I'll -- when the original

1 Chrysler bailout came out many, many years ago, I was up
2 to testify and I -- and they asked me, do I think the
3 bailout will work? And I said, "Yes, and that's the
4 problem."

5 MR. ISAACSON: Ah, yes, right.

6 MR. GREENSPAN: Because it's a precedential
7 issue which is exactly what I mentioned before. If you do
8 that, you begin to misuse the capital of society. In
9 other words, you don't get the effective use of savings.
10 You're using part of the nation's savings to support the
11 obsolescent, less productive parts of the economy. If you
12 do that in general, you end up with the Soviet Union.

13 MR. ISAACSON: I've been obviously a bit out of
14 my depth asking you questions about economics. So I'm
15 going to switch to physics.

16 (Laughter)

17 MR. ISAACSON: In which we're both out of our
18 depth, but I've proven it on a public stage.

19 MR. GREENSPAN: (Off mike.)

20 MR. ISAACSON: Thank you. There is a principle
21 in quantum physics that there's just an inherent
22 uncertainty in the way the Good Lord created the universe.

1 And that we can never truly know everything --

2 MR. GREENSPAN: With certainty.

3 MR. ISAACSON: -- with certainty and
4 predictability, and that nothing is strictly causality or
5 predictability. That's basic premise of quantum physics.
6 Is that a basic premise of economics?

7 MR. GREENSPAN: Very much so. It's an
8 interesting analogy. Incidentally that was a terrific
9 book and I don't care what anybody says.

10 MR. ISAACSON: Okay.

11 (Laughter)

12 MR. ISAACSON: Thank you.

13 MR. GREENSPAN: The -- you know, remember that
14 there is still an interesting endeavor on the part of
15 economists who try to do what Einstein did, was instead of
16 merely trying to get a whole set of physical relationships
17 and demonstrate that while you don't know them
18 specifically in exact concrete sequence of cause and
19 effect, you can with a probabilistic notion.

20 Kanes (phonetic) tried to do that with the
21 Einstein effect. In other words, Einstein as you've --
22 wrote continuously failed in the field theory adaptation

1 for years after the relativity theory. And what he was
2 trying to do was to get a global concept which fit all of
3 the facts and he probably got at the point 99.99 --

4 MR. ISAACSON: Right.

5 MR. GREENSPAN: -- but he failed in the end.
6 What Kanes did was to try to make this general, fairly
7 simple view which has a cause and effect system which was
8 embraced by the economics profession for quite a number of
9 years. And then it started to breakdown in the same sense
10 that is happening in the physics world.

11 MR. ISAACSON: Right.

12 MR. GREENSPAN: And what now actually most
13 economics is econometrics, which is essentially a model-
14 building with cause and effect, but with probabilistic
15 aspects in a way that is not dissimilar.

16 MR. ISAACSON: Econometrics and quantum
17 mechanics seem incredibly similar.

18 MR. GREENSPAN: They are similar in the approach
19 --

20 MR. ISAACSON: Right.

21 MR. GREENSPAN: -- and their view of what is
22 cause and effect. But we don't go as far as the physical

1 sciences go because we don't have an uncertainty principle
2 and all these other very sophisticated things.

3 MR. ISAACSON: Maybe you could use an
4 uncertainty principle. No, I'm kidding.

5 MR. GREENSPAN: Yeah, the principle is that we
6 are all uncertain.

7 (Laughter)

8 MR. ISAACSON: Two quick questions before I go
9 to the audience. The huge deficits we're building up,
10 does that mean we're really at risk for inflation?

11 MR. GREENSPAN: Yes, depending on how we handle
12 it. First of all, the short-term problem is still
13 deflation.

14 MR. ISAACSON: Right, okay.

15 MR. GREENSPAN: There is a very significant
16 amount of excess capacity in the world, and the
17 statistical data with probabilistic characteristics does
18 suggest that we still have a way to go in the rate of
19 inflation flowing. But what the data also show is that
20 when you have a huge build up in Central Banks' balance
21 sheets and what economics call the monetary base, that
22 depending on how the demand falls into place, but history

1 says that there's a 3-1/2 year lag between the onset of
2 very sharp increases in the monetary base, which is what
3 we've had, and inflation.

4 So that's still -- the major changes that came
5 out of a crisis following mid-September 2008 will not
6 impact until 2012. And here the issue is strictly the
7 monetary question, which is the reason incidentally all of
8 the monetary authorities are acutely aware that they've
9 got to rein in that stuff. The big problem is that we've
10 got these huge, unbelievable deficits in the United States
11 which, if anything, I think are underestimated. And I
12 think they are underestimated largely because the major
13 culprit here is not the stimulus moneys, it's Medicare.
14 We have funded Medicare officially at about half of the
15 benefit levels out in 2030.

16 MR. ISAACSON: So that's basically a hidden
17 deficit.

18 MR. GREENSPAN: It's -- well, the hidden -- no
19 that's the actual (inaudible). The hidden deficit is
20 essentially that the trustees in 2006 of the Medicare fund
21 arbitrarily made a decision that the rate of growth of
22 Medicare spending, which is about 2 percentage points a

1 year more than the GDP could not go on indefinitely,
2 because it would become a 110 percent of the GDP. They
3 arbitrarily slowed it down in the forecast to 1 percent,
4 and that's a very questionable decision because the
5 actions have not been taken.

6 And when you're dealing with numbers of this
7 size, we are violating a principle that existed in this
8 country for generations, have the level of debt in --
9 federal debt in this country never get close enough to any
10 perceived seeping or borrowing capacity. We've always had
11 a huge buffer --

12 MR. ISAACSON: Right.

13 MR. GREENSPAN: -- between the actual debt and
14 what the ultimate borrowing capacity was. I think we're
15 getting precariously close.

16 MR. ISAACSON: Especially if China gets a little
17 worried about lending us?

18 MR. GREENSPAN: That would be one of the
19 symptoms.

20 MR. ISAACSON: Yeah.

21 MR. GREENSPAN: But the real problem essentially
22 is that if we build up the way we are currently building

1 up, we get to a level where the Central Bank becomes
2 pressured to finance the excess of these --

3 MR. ISAACSON: Right.

4 MR. GREENSPAN: -- issuances and that creates a
5 much larger monetary base, and the reason why the fiscal
6 authorities are creating major problems for the monetary
7 authorities who have to rein it in, but would not be able
8 to if the deficit remains at that level.

9 MR. ISAACSON: And final point, grant me the
10 premise, if you would, that we really ought to stop
11 dumping carbon into the atmosphere for all sorts of
12 reasons, mainly climate change. Is the cap-and-trade bill
13 a good idea?

14 MR. GREENSPAN: I think the cap-and-trade bill
15 is not a good idea because it is essentially a carbon tax
16 which is a good idea, but it tries to obscure the fact
17 over the costs. Cap-and-trade is a problem for two
18 reasons. One, what history shows is a remarkably stable
19 relationship between carbon emissions or greenhouse gases
20 and GDP, and this is true for the United States, it's true
21 for the world, and the rate of decline is fairly steady.
22 And it's essentially the result of technology, which means

1 we find ways of taking carbon essentially, in many cases
2 energy costs out of the system. But we've never found the
3 way to put the cart before the horse, in other words, put
4 a cap on it, say this is where it's going. But we now
5 mandate that it goes down here.

6 MR. ISAACSON: But if we put a price on carbon,
7 will it go down more quickly?

8 MR. GREENSPAN: If we put a price on carbon,
9 will it go down quickly? It's exactly what happens all
10 the time. What I'm fearful about politically is that if
11 we set or try to meet some of the goals that are now
12 conventionally being employed for the cap, everyone thinks
13 it's going to be the other guy who is going to run in to
14 problems.

15 MR. ISAACSON: Right.

16 MR. GREENSPAN: But you cannot reduce the cap
17 unless, one, you have the technology there to do it, or
18 two, you're willing to get a reduction in production and
19 employment. There is no third way, and the notion that
20 somehow you put a cap on you will galvanize investment
21 automatically has no historical precedent which I'm aware
22 which applies globally or to the United States as a whole.

1 And I would say that the trade issue is okay,
2 but it too has a problem that what we now find is the
3 price of emission permits fluctuates all over the place.
4 And if you are going to build an electric plant which has
5 a 30-year life, you need to have some notion of what the
6 costs are. And if you don't know what the cost of your
7 carbon emissions is, because it's fluctuating all over the
8 place, you're much less inclined to build the plant.

9 What a carbon tax does is basically makes it
10 very explicit, and it's exactly the same as cap-and-trade.
11 Indeed, I would even argue that what we should have been
12 doing for quite a long time is have a very high gasoline
13 tax, because most of our carbon emissions over the years,
14 or most of our energy --

15 MR. ISAACSON: Global carbon -- yeah.

16 MR. GREENSPAN: -- was basically, you know, 9
17 million barrels a day of motor gasoline, but we also had
18 other 2.5 million barrels of diesel for these big
19 operations

20 MR. ISAACSON: Yeah.

21 MR. GREENSPAN: -- and those are huge emission to
22 --

1 MR. ISAACSON: So a pure gasoline tax would have
2 been predictable, transparent, understandable, we could
3 have --

4 MR. GREENSPAN: And also it doesn't have the
5 downside of what a carbon tax does.

6 MR. ISAACSON: Right.

7 MR. GREENSPAN: Carbon tax does make you non-
8 competitive abroad, gasoline tax does not.

9 MR. ISAACSON: Okay. Questions please. Yes,
10 sir, just shout it out to our --

11 SPEAKER: Thank you.

12 MR. ISAACSON: Yeah.

13 SPEAKER: Thank you. Mr. Chairman, let's -- I
14 think we should stop looking backwards, and perhaps look
15 forwards, and tap your mind and your experience for how we
16 get out of this, the predicament that we're in. And
17 specifically we seem to have a substantial decline in
18 consumer demand over the past year or so.

19 MR. GREENSPAN: You're talking about U.S. or --

20 SPEAKER: Yes, precisely. And at the same time
21 we have built a financial superstructure, and an economy
22 based on consumer demand, maybe 70 percent of the economy.

1 Is that going to come back, and if so how? And if not to
2 levels that once were, how do we change the superstructure
3 to adapt to a lower consumer demand economy?

4 MR. GREENSPAN: Well, the obverse of that is
5 obviously what's happening to the savings rate, because
6 what we're seeing now is a very significant rise in the
7 savings rate, which means that consumptions are moving up
8 far more slowly than income is moving up, and it's
9 probably got a way to go. There is some credible evidence
10 that the fairly significant weakness in consumption
11 expenditures in United States is flattening out. Motor
12 vehicle sales have flattened out.

13 But you can't have a significant decline in
14 employment and consumer incomes that are implicit in that
15 without a significant downward pressure on consumption.
16 And I do think that we are fortunate in the sense that
17 capital goods market seem to be flattening. We can't go
18 any lower in home building, so --

19 MR. ISAACSON: And that means housing prices
20 will start to rise, right?

21 MR. GREENSPAN: What do you have in mind?

22 (Laughter)

1 MR. ISAACSON: Well, my supply and demand says
2 that we aren't producing any more supply. Aren't we
3 seeing the green shoots of housing price stabilization?

4 MR. GREENSPAN: Well, yeah, the data that came
5 out last week are frankly encouraging for the first time.
6 And as I've argued for a couple of years now, I don't see
7 how this financial crisis can come to an end until house
8 prices in the United States stabilize.

9 And if we can take another 5 percentage points
10 decline without macroeconomic effects, but there is a very
11 large amount of mortgage issuance of so-called
12 conventional confirming mortgages, the type that are
13 bought by Fannie and Freddie, or securitized by Fannie and
14 Freddie, you can't basically get a 10 percent decline from
15 here without -- dig in to the 20 percent margin that those
16 -- homes purchased with conventional mortgages in say 2005
17 and 2006 was incidentally -- were 8 million. That 8
18 million homeowners are now very close to being underwater.

19 MR. ISAACSON: Right.

20 MR. GREENSPAN: And if prices fall significantly
21 from here, you're going to get a major acceleration in
22 those underwater and therefore the foreclosures. And this

1 will be negative for consumer spending as well. So a very
2 critical component and partial answer to your question is
3 really what happens to home prices at this stage.

4 MR. ISAACSON: Is there anything we can do to
5 keep home prices stabilized? I mean, I thought of one
6 weird idea which is immigration would help this country.

7 MR. GREENSPAN: Yeah, that's exactly my point.

8 MR. ISAACSON: Oh, okay.

9 MR. GREENSPAN: Skilled immigration especially.

10 MR. ISAACSON: Well, yeah.

11 MR. GREENSPAN: But the chances of that
12 occurring -- you and I maybe the two people in this
13 country who believe that's a good idea.

14 MR. ISAACSON: It is a good idea.

15 MR. GREENSPAN: It is a good idea.

16 MR. ISAACSON: Okay.

17 (Laughter)

18 MR. ISAACSON: And now this room believes it.
19 Yes, right there.

20 MR. GREENSPAN: And that's a --

21 MR. ISAACSON: Both of you get -- yeah, start
22 with you, and then we'll -- yeah.

1 MR. GREENSPAN: -- we didn't say -- but the
2 reason is that immigrants become households --

3 MR. ISAACSON: Yeah.

4 MR. GREENSPAN: -- buy homes, and they absorb the
5 excess supply of homes over high (phonetic) in the market,
6 which is what's causing the prices to go down. And the
7 numbers are very interesting, you know, we have to knock
8 off maybe 600,000 units of excess single family supply.
9 And you know, if we took H-1Bs and we really expanded
10 them, as I was arguing yesterday --

11 MR. ISAACSON: H-1Bs are skilled immigrants,
12 correct. Yeah.

13 MR. GREENSPAN: Yeah. This was a panel from
14 yesterday.

15 MR. ISAACSON: Right.

16 MR. GREENSPAN: But --

17 MR. ISAACSON: And we could take the panel from
18 the day before and solve the Israeli settlement issue by
19 combining all three, right?

20 (Laughter)

21 MR. GREENSPAN: I like it, I like it.

22 MR. ISAACSON: And Red Mountain (phonetic)

1 prices could go back up and we'd all be happy, right?

2 Yes, ma'am.

3 SPEAKER: I'd love to hear your thoughts on the
4 hedge fund industry, and its role in this current crisis,
5 and what you might think about future regulation of hedge
6 funds?

7 MR. GREENSPAN: I'm sorry, I didn't quite get
8 that.

9 MR. ISAACSON: What do you think of the hedge
10 fund contribution, I think it was, to the crisis? And
11 what would you think of future different type of
12 regulation of the hedge fund industry? Did I get that
13 right? Yeah.

14 MR. GREENSPAN: Yeah, well, first of all, let me
15 say that there is -- the hedge funds came through this
16 crisis without any systemic problems that I'm aware of.
17 We may find later on that there are. But the only major
18 liquidation was Amaranth, which was liquidated with \$6
19 billion and didn't have any secondary affects.

20 And before you even think about the regulation
21 of hedge funds, let's remember that in the issue of the
22 viable financial system you need institutions in there who

1 are essentially seeking above average rates of return, and
2 the very investments that they make do create -- they will
3 only get an above average rate of return if there is an
4 inefficiency in finance, meaning there is an inefficiency
5 in the way the economic system is functioning.

6 If they succeed in profiting, they put the
7 capital into that -- invested, into that inefficiency, and
8 largely eliminate it. So hedge funds, and indeed all
9 institutions of that nature, by seeking above normal
10 profit, it's not in their interest to get rid of the
11 (inaudible), but that's what happens.

12 They are -- they've turned out to be a very
13 effective and crucial institution for modern economic
14 structures. And if they -- if regulation would do
15 something that would be helpful to the system, I would say
16 why not. But it's not clear to me how you regulate hedge
17 funds effectively. I mean, getting them to register does
18 nothing except they sign a few documents.

19 The problem is that you can't say -- well, you
20 can oversee their risks. Well, the balance sheet of the
21 hedge fund published for the close of business, say, a
22 Thursday will not look -- may not look anything like what

1 it looked like on Monday at noon. They keep changing all
2 the time. And there seems to be some view that regulators
3 can oversee what the hedge funds are doing seeing their
4 strategies and saying this is risky. I've been in the
5 business since 1948. I know about as much as anybody
6 about exactly what that is all about.

7 You stick me in front of a screen watching the
8 transactions of a specific hedge fund, I'll have all the
9 help I need, I will not have a clue or I wouldn't catch
10 half the subtleties. And there's a belief out there that
11 there are people who can do these things. There may --
12 they may be, but I have never met any of them.

13 MR. ISAACSON: Yes, ma'am, there. And then --
14 yeah.

15 SPEAKER: First of all, thank you for your
16 profound contributions to understanding the financial and
17 economic world over the years. You actually just began to
18 address what my question was. You talked about the
19 limitations of modeling to explain economic uncertainty.

20 To what extent do you think the failure or the
21 actual inability of the quants and others to measure
22 investment risk contributed to the current mess? And do

1 you see any hope for improvement in those methods in the
2 future?

3 MR. GREENSPAN: That's a good question. We
4 developed by say 3 or 4 years ago globally an
5 extraordinarily sophisticated risk measurement and risk
6 avoidance system throughout all the financial
7 institutions. The process began in the 1950s, with the
8 University of Chicago, Harry Markowitz's insight into
9 portfolio diversification.

10 And the whole development in essentially the
11 academic community spawned innumerable Nobel Awards in
12 economics for people who added to the concept, so that by
13 2007 we had as probably mathematically sophisticated a
14 system of measuring and avoiding risks as you can imagine.

15 The difficulty was that the data that they
16 fitted to the system were the last 20 years, and what one
17 should be doing with a risk system where you're trying to
18 avoid is losses and default is to pick those periods when
19 you've had losses and defaults and fit those data to your
20 mathematical system, which is the most sensible thing to
21 do, and which was not done.

22 Some institutions did, and they did better than

1 others. But it was really quite remarkable that the
2 people who were sufficiently sophisticated to employ,
3 construct, and use these systems didn't know enough
4 economics to realize that what they were fitting the
5 system to was a period of euphoria and you didn't want
6 that. What you really want to fit it to is a period of
7 fear.

8 MR. ISAACSON: If you take those models and you
9 put a 130 years of data in, so you include the 1890 panics
10 and all, do those models work?

11 MR. GREENSPAN: Oh, no, they won't work, but
12 they replicate the risks under the conditions of what the
13 data that you have. In other words, what the models
14 showed was that the risks in that 20 period were very low.

15 MR. ISAACSON: Okay.

16 MR. GREENSPAN: And indeed they were. But you
17 don't want to know that. What you want to know is
18 essentially what happens in a period when euphoria
19 switches to fear, a phenomenon incidentally which is
20 common to human nature going all the way back, and can
21 never be forecast.

22 The result of that is you want to have a type of

1 regulatory system which doesn't require you to forecast,
2 but essentially in companies, fits the data to -- or fits
3 the risk system to the data that you're concerned about.
4 And in general, what I think will solve a good deal of the
5 problems that we have now is just very significantly
6 raising the level of capital requirements for financial
7 institutions.

8 MR. ISAACSON: So they have more cushion?

9 MR. GREENSPAN: They have more cushion; it will
10 reduce the level of lending and it will reduce the level
11 of economic growth, but it also will reduce the volatility
12 of the system and that's a tradeoff.

13 MR. ISAACSON: Right. Yes, ma'am.

14 SPEAKER: One thing that we can't forecast is
15 aging and your glaring statement about the fact that
16 Medicare was arbitrarily slowed down was a wakeup call to
17 me.

18 MR. GREENSPAN: The forecast was.

19 MR. ISAACSON: Yeah, yeah.

20 SPEAKER: Forecast, okay, forecast. Now, as we
21 look at the overall picture of the environment with the
22 effect of carbon, with the potential increase of cancer

1 risk, and those expenses affecting the Medicare budget and
2 the withdrawal of funds, what do you foresee that
3 inevitable aging factor as baby boomers enter this crisis
4 of health care and what can we do about that?

5 MR. GREENSPAN: Well, I remember in 1983 we had
6 a National Commission on Social Security and medicare
7 reform. The first meeting of the commission, as I recall
8 it, was to recognize that the problem with Medicare was
9 extraordinarily difficult because we knew, one, that we
10 had the baby boomers retiring in an environment in which
11 medical technology was very difficult to forecast.

12 Social security is easy. It's a defined
13 benefits program that's cast. And so the great wisdom of
14 that commission was to say we don't know how to address
15 that, we won't do it; and besides, we have 25 years before
16 they start to retire, we'll get it done by then. We
17 didn't.

18 The problems that prevented are obvious today in
19 the sense that when you have a third-party payment system
20 which is subsidized, you have no real choice but to do
21 some form of rationing. Now, we rationed medical care in
22 this country. We don't call it that. But when, for

1 example, MRIs originally came on the scene, there was far
2 greater demand for the use of MRIs than physically could
3 be met.

4 It was the physicians who essentially decided at
5 that point who did what and when, and it worked. And
6 there is no choice. But we are so politically sensitive
7 to the word that anything that resembles it, we veer away
8 from. The basic problem as Peter Orszag, who is the OMB
9 director, and is probably the most knowledgeable person on
10 the economics of Medicare and medicine in this country, I
11 mean, he demonstrated very interestingly that the
12 adjusting for the quality of care that the United States
13 has remarkable differences.

14 If you look -- put up a map of states with
15 respect to the degree of cost adjusted for quality, it
16 varies hugely.

17 MR. ISAACSON: Right.

18 MR. GREENSPAN: You know, the Mayo Clinic for
19 example, comes out with a very low cost and very high
20 quality. And I won't mention the others -- the -- all of
21 the institutions -- major institutions throughout the
22 country which don't. The answer apparently is largely in

1 the degree of use of physical facilities that we are
2 clearly over-testing in their cost-benefit analysis sense.
3 And what the Mayo Clinic and others have succeeded in
4 doing is to find a way to reduce the testing costs without
5 in any significant way undermining their medical
6 efficiency, and that's the direction we've got to go.

7 MR. ISAACSON: Let me go to Pierre John
8 (phonetic) --

9 MR. GREENSPAN: I just want --

10 MR. ISAACSON: Yeah.

11 MR. GREENSPAN: What that is, that is rationing.
12 We're doing less than we could otherwise need to do.

13 MR. ISAACSON: Which is inevitable?

14 MR. GREENSPAN: It's inevitable.

15 MR. ISAACSON: Yeah.

16 MR. GREENSPAN: If you have the subsidies, and
17 the third-party payments, there's no way out.

18 MR. ISAACSON: John?

19 MR. JOHN: I wanted to ask, we hear a lot about
20 China and other countries. To what extent do other
21 countries' decisions, fiscal and monetary decisions,
22 impact our own ability to manage our way out of the

1 crisis, and how effective have we been, let's say in the
2 last year, in dealing with those countries?

3 MR. GREENSPAN: Well, I think we learned in the
4 immediate aftermath of the Lehman default when within
5 matters of days that trade credits froze up and the global
6 trading system collapsed. If you look across the spectrum
7 everything fell at the same time. All export markets went
8 down about the same. We are in a global economy, and so
9 that what China does, what Russia does, what Brazil does
10 affects us to a greater extent than never before. And
11 indeed, when I was first in the business of economic
12 forecasting back in the 1950s, we never had to be terribly
13 concerned about what was going on in the rest of the world
14 because essentially you could forecast United States as a
15 unit, and indeed with the other countries who had to look
16 at us to see what we were doing to know what was going to
17 happen to them.

18 That is no longer the case. We are fully
19 integrated and we are in a fully global system. And one
20 of the things that I didn't mention, but I think is
21 relevant here, is our global system -- our trading system
22 is essentially a laissez-faire system. There is an

1 international version of the invisible hand running it,
2 and that was subscribed to by the G-20 several weeks ago
3 where everybody agreed we would maintain free trade.

4 We have to be very careful in recognizing that
5 if we want the benefits of free trade, which incidentally
6 is what essentially took hundreds of millions of people
7 out of poverty in the last decade worldwide, especially in
8 China and India, if we want to keep that system going, and
9 still be competitive in the United States, we're going to
10 have to construct our regulatory system so that we don't
11 restrict our capability of creating ever-increasing gross
12 and output per hour.

13 And this is one of the reasons incidentally I'm
14 so concerned about the too-big-to-fail thing. I think
15 that makes us internationally noncompetitive and
16 politically forces us into a protectionist mode, and that
17 I think would be extraordinarily dangerous.

18 MR. ISAACSON: And real quickly on the too-big-
19 to-fail thing, that is sort of a new regulation or
20 something that would be needed to say we won't allow banks
21 to get that big. Is that right or am I misinterpreting?

22 MR. GREENSPAN: Well, I think what essentially

1 is involved is, you do one of two things; you either as I
2 -- the existing -- your proposed regulations, which I
3 think make some sense if you're going to do this, is you
4 make capital requirements rise with some measure of size
5 or systemic --

6 MR. ISAACSON: Which basically taxes you if you
7 become too big --

8 MR. GREENSPAN: Yeah, absolutely.

9 MR. ISAACSON: -- so therefore you don't become
10 too big.

11 MR. GREENSPAN: I'm concerned that it's so
12 difficult to measure what that tax should be that we've
13 got to find a way to scale back these operations.

14 MR. ISAACSON: Okay. Yeah, right here. I'm
15 sorry, I got the hand first. Yeah.

16 SPEAKER: I appreciate your perspective on too-
17 big-to-fail as it relates to GM and manufacturing. But
18 map the too-big-to-fail view towards the bailout of AIG
19 and the U.S. government's investment in Citibank.

20 MR. GREENSPAN: Well, up until the actual
21 bailout of Fannie and Freddie, the official position of
22 the United States government was that there is no such

1 thing as too-big-to-fail. And indeed I used to be asked
2 in the Congress for years, do I think that Fannie and
3 Freddie are supported by the full faith and credit of the
4 United States government, and I said no.

5 And the reason I said no is that was the law of
6 the land, and a government official cannot say that the
7 government will fail to basically enforce the law. So we
8 didn't have this issue in a governmental sense until very
9 recently. And I think we have to come to grips with it
10 very quickly, because if it gets embedded in the system,
11 there are going to be an awful lot of institutions which
12 are going to be designated systemically strategic.

13 MR. ISAACSON: AIG, he asked about.

14 MR. GREENSPAN: You know, well --

15 SPEAKER: Is that what's happened with AIG?

16 MR. GREENSPAN: Yeah.

17 MR. ISAACSON: Yeah.

18 MR. GREENSPAN: Well, no, AIG is gradually
19 dismantling at this stage.

20 MR. ISAACSON: It is being allowed to fail
21 slowly is what you are saying?

22 MR. GREENSPAN: Well, being allowed to

1 liquidate.

2 MR. ISAACSON: Liquidate slowly.

3 MR. GREENSPAN: But the problem is that there's
4 this general view if you know that's going to happen and
5 you're a creditor, you're going to feel a lot more secure,
6 and you don't want that to be the case. You want people
7 to be at risk --

8 MR. ISAACSON: Right.

9 MR. GREENSPAN: -- so that the cutting edge
10 technologies displace obsolescent physical capacity.
11 That's the competitive process, that's what works, and
12 that's what finance helps happen.

13 MR. ISAACSON: Right. And we'd have a lot of
14 new car companies, had we not bailed out the old ones
15 probably is what you're saying?

16 MR. GREENSPAN: Just remember that General
17 Motors and Chrysler essentially ran into trouble because
18 they could not sell their cars to the American public.

19 MR. ISAACSON: Yeah, that's a bad -- let me go
20 to the back because I have been prejudiced to the front.
21 Yes, sir, way back there. Stand up, yeah. In the blue,
22 yeah.

1 SPEAKER: I was curious if you felt that we
2 could see ourselves in a pickle between having to raise
3 interest rates on treasury bills for funding the country
4 and the cost of servicing that debt in the future?

5 MR. GREENSPAN: Well, there are sort of the
6 answers implicit in the question. The answer is clearly
7 if you merely take what the proposed -- or I should say
8 what the forecast deficit is, and what the issuance of
9 treasury securities of all types are without getting into
10 the sort of abstruse mathematics of this, but in a very
11 general way, an economy can only absorb a certain amount
12 of -- or it creates a certain amount of savings plus the
13 amount of savings you can borrow from abroad, which is our
14 current account deficit, and that amount of savings must
15 fill the requirements of the society.

16 And when you have the first time caller, which
17 is the federal government, meaning they have the first
18 draft on the funds, if they -- if that amount is much too
19 large, then you have the demand in the private sector
20 exceeding the residual supply of savings, and that drives
21 real interest rates higher, enough to snuff out the demand
22 in the private sector which means that capital investment

1 goes down, housing that's crushed, and the like.

2 So the way the numbers read today, that's the
3 type of problem we have. And unless, as I written in
4 several places, we stretch out these -- this whole
5 program, as you cannot basically have the very large
6 fiscal requirements that we had before the election
7 coupled with the additional requirements with new
8 priorities of the current administration, you just
9 automatically cannot fit that into the sum of our fairly
10 modest private savings, and as well as our current account
11 deficit.

12 Something has got to give, and the simplest way
13 to do it is basically to take the timetable and to stretch
14 it out. And I think that inevitably something has got to
15 happen, and I must say to his credit, the language I'm
16 hearing from the president, I find quite encouraging in
17 this regard in the last several weeks actually.

18 MR. ISAACSON: Mr. Chairman, thank you very
19 much. Appreciate it.

20 (Appause)

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