Demetri Kofinas: What's up everybody? Welcome to another episode of Hidden Forces with me, Demetri Kofinas. Today we speak with writer, commentator, and chronicler of financial and economic history, Sebastian Mallaby. Sebastian is Paul A. Volcker senior fellow for international economics at the counsel on formed relations [00:00:30] and a contributing columnist for the Washington Post. His interests cover a wide variety of domestic and international issues including central banks, financial markets, and the intersection of economics and international relations. Some of his books include *More Money Than God*, *Hedge Funds*, and *The Making of a New Elite*, *The World's Banker*, and *The Man Who Knew: The Life and Times of Alan Greenspan*.

In this episode we take [00:01:00] a trip down Maiden Lane to the bond desk of the New York Fed and beyond to Constitution Avenue and to the headquarters of one of the most powerful constitutions ever devised, the Federal Reserve system. Our story begins in the early spring of 1926, during the Roaring 20's and follows the story of one man whose life and career paralleled, and in many ways defined, the evolution and transformation of the American economy. From the [00:01:30] depths of the Great Depression in the 1930s through the stagflation of the 1970s, the Tech Boom of the late 90’s and culminating, finally, in the financial crisis of 2008.

Alan Greenspan is one of the most consequential and, yet, least understood figures in American history. A Libertarian turned technocrat, a self-described side man who nevertheless managed to place himself front and center during one of the most crucial periods in the remaking [00:02:00] of American finance. From his early days in politics as an active supporter of Barry Goldwater to his later years as a fixture in the Ford administration and as an advisor to Ronald Reagan, Alan Greenspan's role in public policy long predates his almost 20-year tenure as chairman of the Federal Reserve.

That chairmanship lasted from the crisis of 1987 all the way through to the peak of the American housing market in [00:02:30] 2006. How responsible was he for the prosperity of the 1990s and how much is he to blame for the catastrophic financial meltdown of 2008? Most importantly, what can the story of Alan Greenspan, one brilliant, yet highly fallible human being teach us about the limits and the dangers of human intervention, foresight, and power?

As always, you can gain access to reading lists put together by me ahead [00:03:00] of every episode by vising the show's website at HiddenForces.io. Lastly, if you're listening to the show on iTunes or Android make sure to subscribe. If you like the show, write us a review. If you want a sneak peek into how the sausage is made or for special storylines told through pictures and questions then like us on Facebook and follow us on Twitter and Instagram at @hiddenforcespod. Now time for this week's conversation.

[00:03:30] So Sebastian, thank you so much for coming on today.

Sebastian Mallaby: Good to be with you.

Demetri Kofinas: Very excited to have you on. Very, very excited. I read ... As I was telling you, I read your entire book, really great. I want to cover all of it or as much of it as possible. I also want to try to get into the subject of central banking, in general, and outlooks and things like that. I want to start with Alan Greenspan and I want to start with these two myths that I think you expose in the book one of which is that Greenspan was incompetent [00:04:00] or that he didn't know. That's one myth that's perpetuated in the media that he didn't really understand or see the bubble that was forming or really be qualified to understand what it was.

We'll get into that, the wealth effect et cetera. Another myth is the idea that he was, that it was his stance on regulation and his lack of interest in regulating the banks and the financial system and not so much his monetary policy that was his biggest failure. Of course, the name of your book is [00:04:30] *The Man Who Knew,* which I think speaks to that idea that, in fact, he knew and he knew quite a great deal. As we learned from just reading his Ph.D. thesis which you read. In fact, you've gone through ... So why don't you tell us. You did a tremendous amount of reading. How many hours did you spend just you and Alan Greenspan together?

Sebastian Mallaby: I would go see him every week or two and spend a couple of hours with him. After about 70 hours of taped conversations I just quit counting because it seemed pointless after that. It was [00:05:00] essentially limitless access over five years.

Demetri Kofinas: Wow. In person was he more discernible that he is in his public musings?

Sebastian Mallaby: No. He would often meander and speak at length and not always on the point. He could be very lucid, actually intransigent in his writings when he was a younger man. He would be quite poignant. He was a student of Ayn Rand, the famous Russian Libertarian novelist. She had a real way with words, a way of going to the jugular in an argument. I think he picked [00:05:30] up some rhetorical techniques from that and he could at that point in his thirties, forties, and fifties be ... He had the skills of an op head columnist which is what he did part of the time. He wrote in the media. He commentated on TV and on the radio.

At that point he was pretty trenchant. I think with the passage of time he learned as a central banker that vagueness can be an asset because you don't want to give away what you're going to do.

Demetri Kofinas: That's something I want to talk to you about. That's the forward guidance innovation that he did. [00:06:00] This notion that you can control and influence rates without necessarily conducting open market operations. You can talk the rate down or talk it up. I think he innovated in that regard and he was certainly, I think, the most effective that we've known of. He had a celebrity status that he cultivated. The briefcase indicator, of course, that CNBC used. But what about this first myth, this notion that he didn't know. I think it's something that you've spoken about if I'm not mistaken. Where [00:06:30] do you think Greenspan stands on that and one thing we can even discuss is, and you cited in your book, that his speech before the American Synthetical Association in 1959 where he talked about asset bubbles, he talked essentially about the wealth effect and he talked essentially about home equity extraction, which I thought was remarkable. I mean I never thought the man was ignorant. I thought that and I was familiar with his comments on gold in the 1960s but that was, to me, even more significant.

Sebastian Mallaby: Right. I mean I think there is a view of the 2008 crisis which goes as follows. It says [00:07:00] we had a crisis because the guys in charge with Greenspan at the center were naive believers in the self-policing efficiency of financial markets. Because they had this naive belief that you just do laissez faire and it will be fine, of course the system blew up. They weren't trying to regulate it or think about it or worry about its instability. The biggest intellectual revelation in my five years of research on Greenspan was that he had been minutely obsessed with financial [00:07:30] instability going back to the 1950s, going back to when he was in his thirties.

The speech that you're talking about, the 1959 address to the American Statistical Association which was the forerunner of the American Economics Association which has famous meetings every year. That was really about the way that business cycles, which had conventionally been understood to be about the real economy overheating, factories produce too much, there's an inventory buildup. [00:08:00] There's this pile of stuff waiting to be sold and there's too much, so the factory stops suddenly making things and then people get laid off and that creates a recession. He said that's true but there's a way bigger effect on the business cycle which derives from financial markets.

When asset prices go up everybody's excited. Everybody goes out and invests. That investment drives growth. If it crashes the opposite happens. The crash from finance will have terrible effects on the real economy. He was very early [00:08:30] in thinking about that, writing about that. It shows that for this early point he was the man who knew. He was the man who understood that financial fragility could not be taken for granted and that if it went wrong it would be consequential.

Demetri Kofinas: That's interesting because when I was reading the book one of the things I noticed that I had not appreciated ... There's actually a very interesting arch in the thinking about inflation as it evolved over the 1950s, 1960s, 1970s. On the one side [00:09:00] there is the cost push, demand pull versus monetary policy argument, the evolution that happened with Milton Friedman and that whole idea and what drives inflation in the economy. The other one was, in my opinion, not necessarily was is or it sort of just happened, inflation was not thought of by central bankers or economists at large as having to deal with asset prices. They saw inflation entirely as a consumer price phenomenon. [00:09:30] When they referred to what I consider asset price inflation, or what I think now more broadly people consider asset price inflation, it sounds like what they were really talking about was financial stability.

That's how they referred to it. I think that's an interesting thing and so when Alan Greenspan was talking about asset price inflation to me do you feel that he understood? Even Greenspan in his writings and certainly in his public musings used that term about are we concerned about financial stability or do we focus on inflation? Did he [00:10:00] understand that? I think one area where I think this is poignant is because he gets a lot of credit in the 1990s for having spotted the change in productivity and the fact that CPI was misstating, overstating inflation because of productivity gains.

He was a strong advocate of reforming the way we measured CPI and hedonic pricing, for example. What I wonder about is did he not see that yes CPI [00:10:30] may be overstated, however, if you're going to expand monetary policy and if you're going to have globalization where you'll have excess savings coming in from abroad, driving down interest rates, and you've got extra savings driving down consumer costs which give people more money to spend, that's not going to go somewhere and it's not going to go into asset markets.

Even though he gets a lot of credit for having spotted that intellectually. Absolutely but how did that ... Didn't that just juice up asset prices [00:11:00] in the 90's and of course the 2000's are separate issue entirely. That's a convoluted way but I think you do understand where I'm going with it.

Sebastian Mallaby: Well this gets to the very big policy finding that comes out of my five years of research, in studying Greenspan one studies the tragedy of somebody who understood that asset price overshoots could be dangerous, that stock market bubbles could be dangerous. Yet, he was this man who knew but he was not the man who acted so this thing blew up in his face twice. Once when the Nasdaq bubble blew up in [00:11:30] 2000 and then a second time, of course, right after he retired with the subprime mortgage bubble. How do you get a man who understands financial instability and yet presides over these two disastrous bubbles?

I mean that's the central mystery that I think modern central bankers have yet to really grapple with. I go around the country these days and speak to the regional Fed banks and do stuff for their stuff and so forth. I always challenged to say look the last two business [00:12:00] cycles in the United States have come to an end because of asset price bubbles. The next one will probably follow the same pattern. What are you guys doing about it? They don't have a good answer.

Demetri Kofinas: They don't have a good answer.

Sebastian Mallaby: No. The answer they tend to give is well we'll try and fight it with regulation. If we see a bubble building up that's too much debt going on we'll give some guidance to the banks to lend a bit less. My point emerging from my research is that that was actually tried in the 2000's more than people realize and that Greenspan and the Fed tried [00:12:30] to cut down on Fannie and Freddie, the big housing lenders. They tried to do something about crazy subprime mortgages. It didn't work. Why didn't it work? Because in America you can always get around regulations. There's this huge chaotic alphabet soup of different regulatory bodies coming out of federal government. You can always forum shop from one to the next until you get your loophole where you can do some crazy stuff.

I don't think financial regulation will prevent the next blowup. If you want to prevent it you need [00:13:00] to be willing to raise interest rates even when inflation isn't that high. Right now in 2017 you've got Janet Yellen raising interest rates very, very cautiously at the Fed because she says inflation is still under control why should I raise any faster? The fact is that the stock market just had a huge run in in the first months after Trump's election. I think it's getting into bubble territory. If she carries on being super cautious about how far she raises interest rates, as you say, [00:13:30] the money that's coming into the economy, the credit that's being created, will end up in financial asset prices and that will end in tears.

Demetri Kofinas: I'm not surprised with what you say about central bankers. I had Allen Blender who you mentioned in your book on my old program. I asked him some poignant questions about monetary policy. I came to the same sort of conclusion. I think that's the conclusion that Alan Greenspan drew. Again, a young Alan Greenspan, to me, made a lot of sense. I think it's a conclusion he drew in his advocacy for [00:14:00] a commodity standard. I think that was his whole point, which was you can't trust individuals to manage interest rates. I think that is a fundamental issue because you talk about Fannie and Freddie. Fannie and Freddie had a lot of money to run advertisements in congressional districts.

In addition, Ben Bernanke was out on CNBC in 2005 or 2006 saying that he just didn't buy the premise that we were in housing bubble. Housing never, quote, never declines nationwide. I mean these are fallible people. We're all fallible. [00:14:30] I think that speaks to many of those issues. I also think we're in a different beast this time around with our financial mess. One of the ways I think of it sometimes is that or I ask the question to myself have we hit peak credit? Have we hit a place where the mechanism is broken?

Sebastian Mallaby: First of all let me just knit together what I think we've been both saying in the last few minutes which is to say that if it's the case that Alan Greenspan was the man who knew, it means that 2008 [00:15:00] crisis did not happen because he was dumb or ignorant. It happened because of something else. I'm going to insist on this point that modern policy makers need to grapple with what that something else was. I think that something was they will not agree to run monetary policy targeted partly at asset bubbles. If you only care about the price of eggs and you don't care about the price of nest eggs the nest eggs are going to go crazy. Right?

Demetri Kofinas: That's a great way to put it. That's a great way to put it.

Sebastian Mallaby: [00:15:30] I wanted to just wrap, underscore that point. On this thing about peak credit it's an intriguing idea. Clearly, I have a chart in the back of my book which shows how leverage in the US economy just balloons. It starts going up in the late 60's, it goes up gradually, gradually in the 80's and just takes off. In the 90's even more. Huge amounts of shadow banking debt and what have you.

Demetri Kofinas: Absolutely.

Sebastian Mallaby: Have we reached a peak? I think part of the answer has to do with what goes [00:16:00] on with the Trump regulation rethink. Whether something comes out of that which fundamentally loosens the constraints. Because I think the Dodd Frank reforms have scared banks, have clamped down on what they do, have caused them to spin off some of their prop trading to hold a lot more capital. All of that has constrained the growth of credit. If we have a different regulatory climate going forward which I think is not a done deal because I think Congress has shown plenty of scope [00:16:30] for burying Trump's proposals. If he gets some of what he talked about in the campaign, a fundamentally more deregulatory environment around credit creation, then we can see, I think, credit going up again.

Demetri Kofinas: Well I want to continue on that. Something else I'll say is I want to actually not finish your point which was why despite the fact that he was the man who knew, was he willing to precise over these asset bubbles and to conduct, I think, the first ... In the reading, for me, when I look at [00:17:00] his tenure he came in in 1987. He dealt with that crash, Black Monday. In addition, the crash the need to really assert himself as being someone that was credible on inflation in the manner that Paul Volcker was because it's important to remember that Greenspan was coming in when there was still strong fear and memory of the in stack inflation of the 1970s.

Of course, Volcker was this Old Testament fire and brimstone central banker curmudgeon. I mean I have a friend actually I was [00:17:30] speaking to yesterday about this. We were talking about this think about because I think Greenspan, he was a guy that he wanted to be liked, he liked the celebrity status. He didn't want to take the punch bowl away. He wanted to keep the party going but Volcker was just fine breaking it. He didn't just mind taking it away, he could crush it. He was the perfect guy for that period. I think in that sense he's earned his legend status. I think that, and I'd love to hear your thoughts on this. I think [00:18:00] my personal takeaway is that at the end of the day Greenspan knew what he knew and I think he knew deep down ... My sense is he knew deep down that what he was doing was precarious and I think he found himself in a situation where he had to keep doubling down and doubling down on interest rates.

I think that, for me what I saw, as the big turnaround was sometime around 1995-1996 with the irrational [00:18:30] exuberance speech and then with his ... That was where I feel like monetary policy changed. Before then you saw he raised rates when he came in, he dropped them a little bit again, he raised them again. Then there was that period where he dropped them and pretty much after that he never really raised interest rates again. Tell me about that period. Am I onto something there, 1995-96?

Sebastian Mallaby: Yeah, it's very gratifying when somebody's absorbed the book so well that they've exactly nailed it. There was that transition. I would say the key [00:19:00] time was right after the irrational exuberance speech. In late 1996 when he called the stock market he said it's a bit high. He questioned the level and then the market kind of dipped for a day and went up again. After that I think he just backed off and said, "it's not worth risking my reputation fighting the market. Technology and globalization have both caused price inflation to be very subdued. I'm just going to ride this party. I'm going to have low interest rates. There won't be inflations. That will be fine. [00:19:30] And if there's a stock market bubble I'll just say that's not my mandate, that's not what central banks are supposed to do and I'll just clean up after their bubble has burst.

In that point he was encouraged by the 1987 experience where Black Monday happened. The stock market was down 23 percent in one day and the Fed did some dramatic action, some dramatic loosening and basically cushioned the economy through that shock. He figured he could do that again and get away with it. I think you're right that after the mid 90's he was [00:20:00] essentially a dovish chairman. What's interesting is that he'd been a hawk earlier on and the key period to think about here which I think is actually relevant to ...

Demetri Kofinas: Earlier on you're saying 1970's and before?

Sebastian Mallaby: No. Sorry, I mean the period from when he took over the Fed in 1987 until the mid 90's. So basically roughly the first half or slightly less than half of his 18 year tenure. In this period George H.W. Bush and his team were really pushing him to cut interest rates [00:20:30] more aggressively and they got pretty down and dirty about this. Richard Diamond who was the Bush budget director would go around Washington trying to discredit Greenspan, to bully him into cutting interest rates. He would say stuff like, "Adam Greenspan, 65 years old, lives all by himself, calls his mother every day. Is this a bit creepy? Does it remind you of Alfred Hitchcock's movie Psycho?". There was real attempts to arm twist Greenspan into being friendlier to the White [00:21:00] House, cutting rates more.

Greenspan refused. He was a street fighter. When it came to political darts he could leak stories to the Wall Street Journal better than the administration could. He could make his opponents look dumb. He could go to Congress and lobby to get the Treasury's legislation blocked. He proved himself to be more of an adept political actor. My argument about Janet Yellen now is if Trump does attack the Fed in the next year or so, which I think is quite possible, she needs to be a street [00:21:30] fighter too. She needs to study the Greenspan model of how you push back.

Demetri Kofinas: Can she be? You think?

Sebastian Mallaby: In some ways it's tough because Greenspan, one of the things about him, was he was the last great bipartisan figure in Washington. He had very close ties amongst the Democrats and amongst ...

Demetri Kofinas: Well he got along better with the Clinton administration that any other administration, maybe.

Sebastian Mallaby: Yeah.

Demetri Kofinas: Certainly at the end of the second Bush administration was not a pretty period for him.

Sebastian Mallaby: Right. His better period was the Clinton administration and that speaks to your point. Although he was a Republican [00:22:00] he got along best with the Clinton team. In terms of his relationships on the hill in Congress that's where it was very balanced, which was a huge strength for him. He could speak to both sides and get legislation blocked by friends on both sides. It didn't matter how the midterm elections would go one year. If the other party got in fine, he could still pull strings. Janet Yellen is way more identified as a classic Democrat. In fact, a liberal Democrat. In fact, a Berkeley liberal Democrat.

Demetri Kofinas: Yeah.

Sebastian Mallaby: I think that restricts her ability to [00:22:30] fight political battles in Washington.

Demetri Kofinas: She's also the second academic at the Fed. Greenspan was, in fact, a businessman. Volcker was, although he had long served in government he was, of course, an economist at the Chase Bank if I remember correctly or the Rockefeller Bank.

Sebastian Mallaby: Just on this point I mean she did serve on the board of the Fed way back in the 90's then she was the president of the San Francisco Fed, so she's been around the top of the Fed including the politics of the top of the Fed for twenty [00:23:00] years. One shouldn't underestimate her ability in that sense. I think that Greenspan was an unusually canny political operator. One of the things I enjoyed unveiling in my book is the way that in his earlier years Greenspan would fight pitch battles with Henry Kissinger.

Demetri Kofinas: Right. I loved that part of the book.

Sebastian Mallaby: In the 1970's and Kissinger and he would go up against each other. One day there'd be a New York Times story saying basically if I paraphrased the headline Henry Kissinger acts [00:23:30] without understanding what the heck he's doing. Kissinger turned around to his deputy and said, "Where did the negative story in the New York Times come from?". The deputy said, "Alan Greenspan leaked that one to them". Kissinger goes oh okay. Kind of just like of course Greenspan would do that.

Demetri Kofinas: Was he ... That also speaks of something else which is that Greenspan was a passive aggressive person in terms of how he managed confrontation. He didn't like open confrontation but he really was committed to [00:24:00] achieving power, achieving status, achieving his objectives. He was clear about his goals and clear about how badly he wanted them. It is impressive. Of course Kissinger is Kissinger. There's something interesting about that when you write about it I do wonder to what extent was it ... It felt a little bit like Greenspan was little brother versus bigger brother. Kissinger who, at the end of the day, he didn't really see Greenspan as a threat, more as a nuisance.

What was that relationship [00:24:30] like? It doesn't seem ultimately that… because Kissinger was NSA Secretary of State at the same time. I mean he's a powerful figure and remains powerful.

Sebastian Mallaby: I tease my friend, Neil Ferguson, who's writing a two-volume biography of Kissinger. I say Neil, two volumes. I mean your guy, how long was he in power for? The answer is eight years. He was Secretary of State or National Security Advisor for eight years. Greenspan was chairman of the Fed for eighteen and a half years.

Demetri Kofinas: Yeah.

Sebastian Mallaby: I think [00:25:00] in the grand sweep of post war history Greenspan is, by far, the bigger figure because just by the length of time he was there if you add up the Fed period where the time when Greenspan was Gerald Ford's chairman of the council of economic advisors you get 21 years at the top of public life which is an extraordinary record.

Demetri Kofinas: Let's talk ... This is something I wanted to get to but we might as well just start to cover it now. There's such an interesting arch. I mean in terms of relationships for me the three most interesting of course there is [00:25:30] his relationship with Nixon, his relationship with Ford, his relationship showed some interesting back and forth with Reagan. I love, absolutely love, and I do want to ask you, did Greenspan tell you himself his conversation with Margaret Thatcher at that dinner where she asked him, "Excuse me, Mr. Chairman" or whatever it was at the time, "Why is it that we in Britain don't measure M3?". I love the fact that that was in the book because that is also ... That's such a hard money idea. Who [00:26:00] else would ask why don't we measure this particular monetary aggregate which captures more inflation. I'd love to hear your thoughts on that.

To me the three most interesting relationships in the book were his relationship to Kissinger, of course his relationship to Barbara Walters, which is such a stand in for his relationship at large with the press, at large with society, culture, and celebrity, and his ability to influence in so many different ways. I really, [00:26:30] for me I don't know that other people would necessarily feel this way, but I really like the stuff with Pat Buchanan because Pat Buchanan is such an interesting character. Of course, I think today a lot of people don't really know much about Pat Buchanan and what a really up- and-coming guy he was in the 1970’s and what an important role he played in the Nixon campaign.

Of course, Pat Buchanan, if I remember correctly, not from your book but you mentioned it somewhere else, he actually provided a bunch of documents for you. Those were in Pat Buchanan's basement, right? [00:27:00] Let's talk a little bit about that.

Sebastian Mallaby: Sure. There were a huge number of wonderful research breakthroughs that I had in these five years which is what made it so much fun. You mentioned the Margaret Thatcher conversation and the quick answer on that is that Greenspan remembers that conversation and told me about it but the key kicker came from Greenspan's ex-girlfriend who had gone to his apartment to wait for him to come back from a separate dinner and Greenspan showed up after this and counted with Margaret Thatcher kind of [00:27:30] grinning from ear to ear almost bubbly. She figured whoa he must have had an extra drink. What happened? Too much gin and tonic. Then she realized that he was intoxicated by having met this hard money political leader.

I think that was sort of the extra perspective from Greenspan's girlfriend is what turned that story into a winner.

Demetri Kofinas: That also really speaks into the kind of nerd and geek he was, too. I mean beyond all the other stuff at his court he really was a real geek about hard money, libertarian [00:28:00] ideas. He really, really, really loved that.

Sebastian Mallaby: Yeah. Another ex-girlfriend told me the story about how it was her birthday party and Greenspan showed up with the new copy of the US Statistical Abstract which had just come out that morning and commandeered the only nice chair in the apartment and basically sat there reading it while the party went on.

Demetri Kofinas: I remember that.

Sebastian Mallaby: He was that kind of guy. On Buchanan, this is another fantastic research breakthrough because Buchanan has two great things in his basement. There's a fantastic collection of guns ...

Demetri Kofinas: Guns.

Sebastian Mallaby: Antique [00:28:30] firearms. Speaks to the cultural conservative in him. Also there was the full set of Nixon campaign memos from 1967-1968 when Buchanan was the chief of staff speech writer figure. Buchanan very much was Greenspan's ally and saw to it that Greenspan was promoted. He gave me access to the entire set that he had of Greenspan's memos to Nixon and to the campaign, when in 67-68 [00:29:00] when Greenspan was acting as advisor on economics to Nixon. What's amazing about reading that set of memos is you start off with straight economic advice, then it becomes economic advice with a bit of politics. Then it becomes Greenspan by now is doing polling analysis for Nixon.

It becomes essentially just pure political nonsense. By the end it's gone beyond political nonsense and it's actually spin. He's saying, "Mr. Candidate, Mr. Nixon, I know you think the following [00:29:30] but it's not going to go over well with the voters, especially in the South, so you should maybe say something else". He's really message advisor.

Demetri Kofinas: And his advice on RFK and RFK's speech.

Sebastian Mallaby: That was amazing. Right after John Kennedy was shot, RFK, his brother who was, of course, the Democratic front runner in that campaign in 1968 made a memorable speech about his brother's death calling for unity amongst Americans in the wake of this tragedy. I'm sorry. [00:30:00] It was actually Martin Luther King's death. It was in the wake of Martin Luther King's death but he hearkened back to his brother's killing.

Demetri Kofinas: It's a beautiful speech. It's a very famous speech.

Sebastian Mallaby: That's right.

Demetri Kofinas: Back of a pickup truck if I member correctly. On some sort of ... He stood on top of a truck and gave that speech. Very moving speech.

Sebastian Mallaby: Yeah and he'd had no time to prepare it. He'd heard the news of Martin Luther King's killing on the way to this Indianapolis area and he got there and made this fantastic speech. Everybody was very moved and [00:30:30] some people attributed to the fact that Indianapolis did not experience race riots unlike many other inner cities to the fact that RFK had made this moving appeal for national unity. Greenspan's response in a memo which I got from Buchanan was quite shocking because essentially, he said RFK is being opportunistic and we shouldn't let him piggy back on liberal guilt and so forth.

He took a pretty nasty line [00:31:00] on RFK in that memo. What you see there is that I thought I was going to write the biography of one of the great post war financial statesman and Greenspan certainly was that. I also turned out to be writing the biography of a very deeply political figure, a deeply Machiavellian figure with a lust for power that I think he concealed to the world that was just really strong underneath.

Demetri Kofinas: You know, not so surprising. That was the thing I reflected after I read the book. I said [00:31:30] not surprising, how do you get to such a position? How do you stay for so long? At the end of the day we love the idea of electing people that are not politicians. If you're going to get elected you got to have strong political instincts and he certainly did. I like that you mention 68 because, again, we talked about the 1995-96 transition that I saw where I thought I saw a shift in his monetary, the way that he conducted monetary policy. Another thing I want to ask you, by the [00:32:00] way, I don't want to forget this, is to what extent do you think he really relied more on and the markets really responded more to his prognostication sent to the aura he created around himself as being the oracle and the maestro and less to actually whatever the bond desk was doing in New York with open market operations and the interest rate.

I think that's an interesting thing but that's a more technical question. I do want to go to it. This 1960's period, I think, was also equally significant to the 1990's period in terms of [00:32:30] the audience may not know this because we haven't talked about this in the book but of course Greenspan was a very successful businessman and he made a lot of money. In fact, he made enough money that he bought a really spiffy car that he would drive down the FDR drive, I think it was, in New York. He went through this period where he had a lot of financial success in the 50's and then the 1960s something happened with his introduction to Ayn Rand and his just almost he fell in love, in a way, with an ideological ...

He, [00:33:00] of course, went to NYU. He was, he already had strong beliefs that were non-Keynesians, pro-Austrian in a way. Certainly he was much more attuned to the business cycle but there was almost a, if you want to use the financial market analogy there was a peak, there was a boom, and he full indoctrination into objectivism. Of course, he wrote in the objectiveness newsletter and he was a fan and a supporter of Barry Goldwater. That changed rather rapidly. [00:33:30] You saw this flame out into ... I'm using this very highly quotations for lack of a better word, extremist ideas, and then you saw a quick pragmatic approach and, of course, Ayn Rand was one of a number of people in that movement that wasn't very happy about that.

That, to me, is very interesting. What do you think that was about? Was that ultimately, do you think ... well two things. One, do you think that because, of course, Alan Greenspan had that testimony to Congress where they asked him where you wrong. He goes I found a flaw in my model. [00:34:00] It was your ideology and he said everyone has an ideology. I just wondered did this man need to experience a visceral ideology at its core? Did he lust for this? A man who's so cerebral and so thoughtful, did he want to experience that sense of indoctrination? How did that transition happen between him being so ideological to becoming a quick pragmatist political?

Sebastian Mallaby: I think the Nixon campaign was key here. I mean he went into that as a libertarian idealist. [00:34:30] As I described, by the end, he was offering his very political advice. He'd figured out that purely offering libertarian memos were just going to be ignored. Nixon just wouldn't listen. If he wanted to be in the game he needed to moderate what he was telling and think okay ... he'd been a consultant in business. My client now is the Republican presidential candidate and what does the client want to hear? What will he actually act [00:35:00] on? Greenspan started to offer advice that was within the realm of what his client was going to be able to take on.

That was the transition to pragmatism and moderation which then I think Greenspan being a highly intelligent person was able to have two things going on in his head at once. The ideal system that he preferred which was still a gold standard, libertarian very small government vision. On the other hand, [00:35:30] the real world as he encountered it which required him to put that all aside and operate within the rules of the game.

Demetri Kofinas: You mentioned the gold standard. There's some interesting stuff in your book with respect to about how he approached the subject in the 1980's under the Reagan administration because, of course, many of Reagan's supporters were advocates of the gold standard. Was it Reagan that commissioned or encouraged the gold commission in the early 80's to take a look at restoring the gold standard? I think it was during that period, if [00:36:00] I'm not mistaken, that Alan Greenspan proposed this idea of gold bonds as a very ingenious and reasonable way to actually address the issue of transitioning back to gold.

Ultimately do you think that beyond simply the fact that once he became chairman he didn't want to have a gold standard obviously because he's in control of the interest rate, but do you think that philosophically he changed in that position?

Sebastian Mallaby: I do. I think there was a key transition which went as follows. It's a bit tricky to get across but [00:36:30] I'm going to give it my best shot here. Essentially what happened with the post second World War gold standard was that the theory was the dollar was linked to gold and other currencies were linked to the dollar and everybody had to avoid inflation because otherwise, if the US dollar has more inflation going on than the German Mark, then the exchange rate should adjust with the dollar getting weaker to compensate for that inflation difference. In a gold standard everything is pegged to each other so you can't adjust.

[00:37:00] Therefore, you've got to avoid inflation. That was the premise of the whole Bretton Woods post second world war system. What actually happened, starting with Lyndon Johnson and guns and butter and the Vietnam war and the great society spending programs, then continuing even more with Nixon, was that politicians in the United States ignored that constraint and printed money, created demand by having a budget deficit, bullied the Fed when it tried to raise [00:37:30] interest rates to offset that.

Demetri Kofinas: Like Arthur Burns.

Sebastian Mallaby: Yeah, and even before a bit under Mitchell when Lyndon Johnson in the famous episode I recount in my book, called the head of the Fed down to his ranch in Texas and he shows up. There's this big room in Texas, nobody's there, he's getting a bit nervous. In comes the massive, tall Lyndon Johnson. Starts pushing him around the room and saying boys are dying in Vietnam, you've got to cut interest rates, boys are dying in Vietnam, you don't even care. [00:38:00] That intimidation, if you look at what actually Fed policy did about six months after that. The Fed starts to get much looser and the 1960's inflation starts to pick up from 66 onwards.

That's where the gold standard can't work anymore. The gold standard only works if everybody controls inflation to the same extent. By 1971 when the dollar left the gold standard in the Nixon shock, Greenspan's view was [00:38:30] we can't stay on the gold standard because we've allowed the inflation and we can't kid ourselves. We need this adjustment in our exchange rate because we've had the inflation that requires it. Then he thought to himself okay if politicians are irresponsible, gold is nonfunctional. Therefore, we need responsible politicians.

But, this is the key thing, if the politicians aren't actually responsible, we don't need the gold constraint. [00:39:00] The necessary condition for gold to work actually made gold obsolete. That's the transition from a gold standard to what I would call a Ph.D. standard. A belief in expert policy makers needing to wade into the public square, win arguments, and persuade politicians to run moderate, sensible, macroeconomic policy. In some ways, Greenspan's life and career was a successful struggle to persuade the political classes, [00:39:30] to embrace that macroeconomic responsibility. It came to its finest fruition in the 1990's when the Fed was defacto independent. Clinton reduced the budget deficit and you got into this great moderation golden period for US economic performance and the Ph.D. standard triumphed.

Demetri Kofinas: That brings up another interesting question that I have which is to what extent were the 1990's and the great moderation [00:40:00] really not the result of

Alan Greenspan or the confidence he inspired, or his interest rate policy, but in fact the conditions of the global economy, the globalization that was going on and the ... Two things, globalization and technological innovation.

Sebastian Mallaby: Those were very important. Globalization meant that you had this army of workers in China and other developing countries producing things way more cheaply than that being the case in the US. [00:40:30] When you imported those goods from China you essentially had a fall in places, the sort of Wal-Mart effect. Of course, if you're the central bank that means inflation is lower and you can run interest rates lower and not worry about inflation. Technology was kind of a similar effect where because of the introduction of computers and so forth people could produce more in the same number of hours of work and that meant that even if their wages went up a bit their output was going up even more and so companies could afford to cut prices [00:41:00] and still make a profit because their workers had become more productive.

These two forces, globalization and technological change contributed a lot to the driving down of inflation through the 90's and to the stabilization around two percent. It's not the fully story. I mean I think you do also have to give credit to Volcker and Greenspan for bringing down expectations of inflation by just showing that the Fed would raise interest rates if inflation [00:41:30] showed any signs of looming it's head. That credibility of a central bank changed people's expectations and that was another important element in bringing down inflations.

Demetri Kofinas: It was the perfect storm. In fact, I do want to get to ask you some questions about Paul Volcker. By the way, did you ready William Greider's book in preparation for this at all?

Sebastian Mallaby: To be honest, I read bits of it. In some ways it was a great book. I don't know if you've read it.

Demetri Kofinas: I have. Yeah, I have read it.

Sebastian Mallaby: I found it sort of analytical lens through which he viewed the whole [00:42:00] story a bit off putting. Sort of a conspiracy thing about these guys are all secretive and so forth.

Demetri Kofinas: Well it's called *Secrets of the Temple*.

Sebastian Mallaby: Yeah, that's right. I know. I know. Yeah.

Demetri Kofinas: It was a long time ago when I read it. I read it a long time ago but it was, in fact, an important book for me because it was the first time that I had read any book that explained, for me, exactly how open market operations work and how the Federal Reserve controls interest rates. One of the things that I really love from the book are administration. [00:42:30] For me it was an eye-opening thing. It wasn't his Saturday night special. But I think, I don't remember when it was exactly that Volcker decided he was not going to target the interest rate and instead he was going to target the money supply.

I thought that was, for me, that was it seemed genius. I don't know that it necessarily was genius. Maybe it was just courageous, but to me it really gets to the heart of the issue that I think we have with interest rate policy [00:43:00] and why we have such a destabilizing monetary policy and system is because we do not allow the interest rate to fluctuate. I think what Volcker proved when he pegged the money supply or he put controlled focus on that variable instead of the price, which is the interest rate, is he said to bankers: "Hey listen. I'm not going to tell you that the interest rate's going to be ten percent because you're going to chase ten percent. You're going to move your interest rates upwards. I'm not going to tell you what it's going to be. I'm just going to tell you it's going to fluctuate based on daily notions of supply and demand".

[00:43:30] That put a risk premium into the market. The same type of risk premium that works in every other cost variable for producers except at the core which was credit. What do you think about that? What are your thoughts on the Volcker administration? What are your thoughts on that notion of losing volatility in the interest rate and how that affects stability in financial markets?

Sebastian Mallaby: I agree with you that putting risk into the market is a very healthy thing. I think the problem with forward guidance and it's modern [00:44:00] incarnation where you not only peg the short-term interest rate, you kind of guide people by what it will be in the future. That just makes life too cozy for people in financial markets and they end up taking more risk. This is the famous Hyman Minksy insight, which is that people have a fixed risk appetite in life and if you de-risk one aspect of their life, they're likely to seek more risk in some other fashion. In financial markets what that means is that if you take away [00:44:30] the risk in an unexpected shift in Fed interest rates, then financiers will take more leverage and increase their risk through that method.

You just incentivized more debt. In my view, the whole run up to 2008, the whole enormous carry trade on subprime assets that Lehman and so forth were doing, were fundamentally linked to the fact that the Fed not only hold the short term interest rate very low, making it tempting to borrow short very cheaply and then lend [00:45:00] long by buying longer term mortgage paper, but told the markets through forward guidance that that short term rate wasn't going to spike against them suddenly. That meant you could do that trade in enormous size. That meant that people were borrowing short enormously, lending long enormously, and that dragged down the long-term interest rate, dragged down the mortgage rates, incentivized all that crazy house building and so forth.

I think too much de-risking is a bad thing just like you say. I think, [00:45:30] on the other hand, that monetary targets as adopted by Volcker worked at the time but were not appetency. The reason is the debate about which monies apply for targeting, M3, M1, M2, M0.

Demetri Kofinas: And even beyond that because, of course, the entire shadow liquidity on the market is not represented in any of the monetary aggregates.

Sebastian Mallaby: Exactly.

Demetri Kofinas: How do you measure derivative contracts?

Sebastian Mallaby: Exactly.

Demetri Kofinas: The BIS's estimate was seven hundred billion right before the crash in 2008. [00:46:00] Where do you put that? I mean seven hundred trillion. Where do you measure those?

Sebastian Mallaby: Exactly. We don't have a good story about if you wanted to control supply of money what would be the ... How would you measure it? What the target would be.

Demetri Kofinas: And you have a central bank that was created in 1913 that is run off of a completely different financial, that was blueprinted off a completely different financial system than we have today.

Sebastian Mallaby: Yeah. I think one of the fascinating questions that raises about Greenspan's tenure is he came in 1987 and was pretty successful, as I've argued, fighting inflation, resisting [00:46:30] pressure from the George H.W. White House, completing the Volcker task of disinflation. Inflation, in fact, in 1990 was higher than four percent at one point. It wasn't something that you would take for granted that by the late 90's it would be stable at two. It seemed to be heading up again after Volcker's period and a lot of people thought, as you said, that Volcker was the formidable Old Testament prophet and Greenspan was this party loving person who wanted to be loved.

[00:47:00] Inflation going up and hitting four percent seemed to fit with that story and people expected to carry on going up. Greenspan did well in the first years to fight that expectation, drive inflation down, stabilize it. Then he should have pivoted and said okay what's the new challenge. We've stabilized inflation, what is the new challenge. The new challenge was clearly that shadow banking and general leverage in the system was exploding. That mega banks were merging with each other and getting bigger and bigger [00:47:30] and too big to fail.

That the inflation targeting doctrine that was emerging was turning a blind eye to asset prices. Those three things together, asset price bubbles combined with a lot of leverage, combined with too big to fail banks, called for a different intellectual approach or redefinition in what the Fed's mission and challenge really was. That's where Greenspan failed. He didn't redefine. He understood the case for a redefinition [00:48:00] better than most other people but he was the man who knew. He was not the man who acted.

Demetri Kofinas: How significant is it in that context of your comment right there that he supported and actively campaigned for a revamping of CPI? Not just stuff like hedonic pricing that I was mentioning but things like substitution bias. Did he really believe that the CPI was so significantly off that they needed to put a downward bias on inflation at the time?

Sebastian Mallaby: Well there was this famous debate, [00:48:30] at least to me, well striking debate, in 1996 when the Fed adopted a de facto inflation target. They didn't announce it publicly but you can read the transcripts of the FOMC, the interest rate setting committee's meeting. It's all there. There was this debate, actually between Janet Yellen interestingly, and Greenspan about if they targeted a certain level of inflation what should the level be. At one point, Yellen says to Greenspan, "what do you think the desirable [00:49:00] level of inflation would be?" Greenspan says, "Well I guess no inflation, zero, if you measured it properly". Yellen said, "Well we don't measure it properly so that means we should target two". The two percent target emerged from that random interchange and stuck slightly.

It wasn't totally that because also other countries had begun to adopt two percent targets. Two percent was in the air in the central banking priesthood already. In that discussion that's how it emerged. It was out of this point that you're making that they understood [00:49:30] inflation was mismeasured. I think that's the main way that the over statement of inflation in the official statistics played through into Greenspan's decisions.

Demetri Kofinas: Well it's also such an interesting ... It's a microcosm for me of, again, Greenspan was so cerebral and so quantitative. He was a data sleuth as you've said many times in the book. He loved data. He as a very early adopter of technology, a very early adopter of computers for the use of statistical [00:50:00] analysis and yet, at the end of the day they picked two percent because it just felt right. I mean it felt right, for lack of a better word. In some ways the same way that Hank Paulson and the crew in 2008 picked seven hundred billion dollars in the bailout because it was a big number. I think that speaks, again, to this other point which is these are human beings sitting at a board room deciding the price of money.

Which is, again, which makes [00:50:30] the personal aspects of the book, the evolution of Greenspan as an individual so interesting. I wanted to ask you something, and this is probably an appropriate time, what do you think was, if such a thing exists, or if it's a few things, the most significant influence in Greenspan's very early development up until perhaps the age of 18? What was the most significant thing that made him the man he is now? Or was it simply, as I feel based on your reading, [00:51:00] just his nature? The nature of his biology? The way that he was temperamentally? Or was it a more Freudian analysis. You obviously mentioned his father, his mother, he was raised by his immigrant Jewish grandparents. I'm curious about that.

Sebastian Mallaby: Yeah. I remember very clearly actually when I was just a few months or a year into the research having lunch with my great editor from Penguin Press, Scott Moyers, and saying you know Scott surely what we care about with Greenspan

[00:51:30] is when he becomes an economist. He's an adult, he's engaging in public debates, and all the childhood stuff. I know you're supposed to do that in biography but do we really need to go there? Scott said the one thing about childhood is it's the search for the deep roots of character. That proved actually to be very good advice because when I focused on his childhood I understood something which I think is relevant to how he conducted himself as chairman of the Fed.

The childhood thing [00:52:00] is essentially captured in this self-description that he has. He calls himself a side man and he persisted in calling himself a side man into his forties and fifties when he was a very rich person with a lot of power. He was not a side man whatsoever. But why did he think of himself as a guy off towards the side? It came from this period in his life where he left high school and didn't go to college initially and went and played in a jazz band. He was [00:52:30] the side guy, not the central brilliant improviser, but more the support saxophonist and trombonist. He thought of himself in the sideway ness. Again, where did it come from?

Well, the answer is that his father left his mother when Greenspan was just three years old or so.

Demetri Kofinas: That was very unusual for that time. That was probably a very shameful thing to acknowledge in the 1930's.

Sebastian Mallaby: Yeah, that's right. In fact, the late [00:53:00] 1920's. Greenspan was born in 1926. His father probably left his mom around 29. So Greenspan growing up from the age of three onwards was this child of a single mother.

Demetri Kofinas: And during the depression also.

Sebastian Mallaby: During the depression.

Demetri Kofinas: That was a destabilizing thing in itself.

Sebastian Mallaby: There is a literature on what that does to somebody if they have a single mother who never had other kids and never remarries. This woman's entire emotional life with no other person, no other husband, no other boyfriend, no [00:53:30] other child, is entirely focused on one perfect son. FDR's mother was a bit like that. FDR grew up as the single child of a single mother. What you get is this massive maternal focus, which in some ways is super supportive and you feel completely self-contained because you've had all this maternal affirmation. At the same time Greenspan's mother was a rather ambulant vivacious figure who was sharp at family parties [00:54:00] and leaned over the piano and sing beautifully in the manner of a haunting torch singer.

Greenspan felt he couldn't compete with that level of attractiveness and that level of performance. He always fell off to the side of the room with his charismatic mother whose love he depended on stealing the spotlight a bit. I think you can explain a lot of what

Greenspan did in his life from that sense that he's off towards the side. He's a bit insecure. He's shy, but he knows inside that he's great because his mother says he's great.

How [00:54:30] does he get the world to recognize the greatness which he can't just, being shy, he can't just walk into a room and charm everybody. They all think he's fantastic. He's not that guy. He's the guy who has to earn external markers of greatness through diligence, hard work, application and ambition. What did he do? First of all, he earned a lot of money, then he dated a lot of beautiful women, and then he accumulated a lot of political power. [00:55:00] This drive to be recognized and to be moved from the side to the spotlight I think is central to his personality.

Demetri Kofinas: Wow. You convinced me. That's interesting because I didn't necessarily feel that way when I read your book but hearing you say it now I really appreciate that. In that context of beautiful women he dated, of course, Barbara Walters. Barbara Walters was, and I've read her biography. I assume perhaps you have. I mean you might have interviewed her as well. I mean her biography is great [00:55:30] also. Very, very intriguing. She doesn't hold back at feels and she's really raw about it. It's interesting in that context of course Alan Greenspan spent more than forty years not married between his late twenties and his early seventies, right? He did, he did date around, which I think is interesting.

Perhaps that speaks to the whole Freudian notion of a doting mother. But, of course, he had a ten year relationship with Barbara Walters. A very long and it would seem by all accounts to have been very loving. Even though they were not married, even [00:56:00] perhaps they weren't even committed to each other there was a tenderness and I think it's captured in that moment that you describe at the convention in 1972 during the whole Ford dream ticket ... Not Ford dream ticket, I'm sorry.

Sebastian Mallaby: Yeah. 1980.

Demetri Kofinas: 1980, 80. Ford dream ticket stuff where she interviewed him. She grabbed him and of course that was Barbara Walters, right? I mean such an interesting thing. I really feel like that really, to me, also ... I lived in Washington. I had my television [00:56:30] show there before this. I've been around that culture and I know what that's like. They really were the quintessential Washington couple, it feels. Their careers came first. You saw that in that moment but you also saw that tenderness, I think, that you expressed. Let's talk a little bit about Barbara Walters because she's a tough cookie. She's something else in her own light. I'd love to talk about that relationship. What was that like? That was right in the prime of both of their lives and their careers.

Sebastian Mallaby: [00:57:00] Yeah. Greenspan went to rather fittingly, a tea dance at Vice President Rockefeller's official mansion in Washington.

Demetri Kofinas: Nelson.

Sebastian Mallaby: Yeah, that's right. Nelson Rockefeller, exactly. When Nelson Rockefeller was the Vice President and it was in this rather grand setting that Greenspan set eyes upon Barbara Walters who was, at the time, already regarded as the absolute queen of sex appeal on television news. [00:57:30] She was once questioned, Barbara in an interview, do you think that the networks use you as a sex symbol? She said I should hope so. She wasn't bashful about it. Greenspan approached her and danced. He was actually a very good dancer. Maybe fits with his roots as a musician on the circuit in his late teens. He persuaded her to accept his phone number and they got together after that.

They did date for about [00:58:00] a decade. I don't know if it was always close because I think that it was a very much a kind of alliance of powerful career minded individuals who found each other to be useful, likable, escorts to White House official events, to grand parties in New York. For Greenspan to show up with a beautiful, famous woman on his arm was good for [00:58:30] him and for her to show up with somebody who was a famous figure who'd been chairman of counsel of economic advisors for Ford who was a well-known commentator on TV, that was good for her. They had this alliance going on and I think neither of them were of a mind to decelerate their professional ambitions in order to get married or do something like that.

They were a couple but there were limits to that intimacy.

Demetri Kofinas: [00:59:00] That's interesting. Let's shift now. I want to ask you about everything we've discussed ... Separate from Alan Greenspan, of course Ben Bernanke was at the Fed when Greenspan was making these important decisions, and then he took over in 2006. Since then we had of course the financial crisis and now we have Janet Yellen who was also at the Fed. How do you see what has happened since Greenspan left office? [00:59:30] First in the context of his legacy and second, and more importantly I think, in terms of what we can expect for the next few years. What are we really looking at? What is the legacy there?

Sebastian Mallaby: I think that's a great question because I think it gets to a huge issue right now in the world which is the position of experts, generally. I mean central bank experts are exhibit A in the general faith that people use to put in technocratic specialists to make smart decisions. The populist politics [01:00:00] whether you're talking about Donald Trump and the US, or the Brexit vote in the United Kingdom. Populism has called in to question the reputation and credibility of all these experts including people like Greenspan. The cult of the expert was in some ways the cult of Alan Greenspan. He was the ultimate person who parlayed geekish control of numbers and understanding of the economy into being a household name with a massive amount of power.

He was the ultimate [01:00:30] empowered guru. I think what happened, to your question, after Greenspan left office was that the technocratic statist of the central bank that Greenspan had built up was inherited by Bernanke, inherited by Yellen, and they coasted on that. They inherited a Fed that held in huge high esteem that was factored facto independent could do what it wanted. They used that to react [01:01:00] very aggressively after the 2008 crisis began to create unbelievable amounts of money, expand the Fed's balance sheet by whatever it was six or seven times.

Demetri Kofinas: A remarkable, for you a historian and monetary policy. The fact of it's not officially. I'm familiar with some of your other previous work as well. That must be an incredible period to study.

Sebastian Mallaby: This is almost crystallized by this interchange between congressman Barney Frank and Ben Bernanke right [01:01:30] after Lehman went down when AIG the insurance company was about to go bust. Bernanke went up to the hill and told Barney Frank look these guys at AIG they need $85 billion to stabilize them otherwise the whole financial system's going down with them. Frank said, $85 billion have you got that much money. Bernanke said well I've got as much as I want. I just print it. I've got unlimited amounts.

Demetri Kofinas: I'm not familiar with that.

Sebastian Mallaby: That is a discussion that was being [01:02:00] reported in several different sources. I think Hank Paulson who was also in the meeting and was the treasury secretary at the time, told the writer of the New Yorker and it's come back in several different ways, different versions of this thing. But essentially that is part of the record now. It's been in several books. It's not being contested. I think Bernanke would have set it right if it had been wrong. Clearly that's what happened and clearly, it's true that when the central bank wants to create money there's no [01:02:30] actual limit on how much it can print. This is an extraordinary thing and you can see Barney Frank thinking $85 billion, how long would it take us to appropriate that through congressional committees and arguments and so forth. That's a huge thing.

The Fed can just click its fingers and there is the $85 billion. That was the ultimate high point of technocratic empowerment. I think I would argue made possible by the Fed that Greenspan had created.

Demetri Kofinas: The credibility.

Sebastian Mallaby: [01:03:00] The credibility around it and the sense that people would defer to it. Now what we're at is that eleven years after Greenspan left office that credibility has played itself a bit, and people are more willing to question the central bank and say did it go too far. I think the interesting thing in the next year or two is to see whether President Trump leads an attack on the Fed and calls them and says you're just an [01:03:30] elected technocrats and why should we defer to you. Whether he decides that it's in his interest to carry on the Greenspan model of difference to the Fed.

Demetri Kofinas: What do you think about this notion that we're in a balance sheet recession that's very similar to the Japanese and that no amount of monetary easing is going to get us out of it? What do you think of that?

Sebastian Mallaby: I think that was an important concern a couple of years ago. I think what you're seeing now is the Fed has raised interest rates [01:04:00] a couple of times since December and we're on a gradual tightening path and inflation is back around target and employment. The unemployment rate is 4.5 percent, which is way below the long run trend even if you look at a broader measure of unemployment, it's below the long run trend. The economy in the US has issues around the distribution of the income. There's a lot of inequity and that's a serious, serious issue. It does not have issues around macro performance in the sense [01:04:30] that unemployment is okay, inflation is not too low, growth is sort of okay for an economy which has got a very graying population. There's only so much growth you can expect.

Demetri Kofinas: Structural demographics issue there. I think also when you're touching on something that I think ... One of the ways I think about volatility and financial markets is I compare it to electoral volatility. I think as we've suppressed volatility in financial markets we have increased electoral volatility. That's where it's showing up. It's popping up [01:05:00] because that inequality that we've created in income distribution and wealth is showing up in populism. I think that's where that's coming from. I think and just saying to sort of bolster your point there. Do you see ... I'm not asking you to give a prediction but just to end it here ... Without holding your feet to the fire do you have any thoughts about what we might see in the next year, in the next two years, in the next three years, and what the likelihood of any of those scenarios [01:05:30] are?

Sebastian Mallaby: I think the concern is that the Fed is going to continue to raise interest rates because essentially the economy is operating at potential and growing a little bit faster than the Fed's estimate of what it could do on a sustained basis without generating inflation. The Fed's going to raise interest rates and that's going to support a strong dollar because when you have high interest rates money flows into the country because there are higher returns here and they flow out of places like Japan or Europe that seem more stagnant. A [01:06:00] strong dollar means, of course, that anybody in manufacturing in the US is going to get squeezed because you're less competitive against other manufacturing producers.

Precisely the voters in the swing states in the industrial Midwest who supported Trump, elected Trump, those guys are going to get hit by Fed tightening leading to a stronger dollar and Trump is not going to like that. I think he's going to be massively tempted to come after the Fed, blame the Fed for [01:06:30] wrecking his economic program, for creating a strong dollar that he hates, for being chicken little and thinking that you have to raise interest rates when growth is only around two percent. Surely it can be higher than that. Trump's official policy is it can be four percent which is, by the way, crazy, but that's what he says on his website.

Demetri Kofinas: Yeah, I agree with you. It's self-serving politically.

Sebastian Mallaby: I think where that all gets you to is that for the first time in a quarter of a century we could be back in a period where the White House is willing to beat up [01:07:00] the Fed and to have a fight with it. We haven't seen that since George H.W.

Bush in the early 1990's. To understand what that's going to look like in the next year or two you have to go back and study how it looked last time when it was George Bush versus Alan Greenspan.

Demetri Kofinas: It's so interesting and to end on that note I watched a presentation of sorts that Alan Greenspan recently gave at the American Enterprise Institute about five months ago. It seems that ... It's so interesting. First of all, he's still very lucid [01:07:30] as far as I can tell. I'm more inclined to take him at his word now obviously that he is not Fed chairman. I agree with him on this regard. I think some very smart people are talking about the issue of structural demographics and what role that's going to play. I don't think that's sufficiently discussed. That seems to be big on his mind and it seems that he is ... The word he keeps using is stagflation. I think that's a very interesting thing to note and I think he's onto something there.

Sebastian, [01:08:00] I really appreciate you coming on. I really enjoyed it. I enjoyed your book. I enjoyed this conversation. I found it very enlightening and I think we did a good job covering a lot of it.

Sebastian Mallaby: It's great to be with you. Thank you for having me.

Demetri Kofinas: That was my episode with Sebastian Mallaby. I want to thank Sebastian for being on my program. Today's episode was produced by me and edited by Stylianos Nicolaou. Sound engineering was Ignacio Lecumberri. For [01:08:30] more episodes you can check out our website at HiddenForces.io. Join the conversation on Facebook, Twitter, and Instagram at @HiddenForcesPod or send me an email. Thanks for listening. We'll see you next week.