The Greenspan Warnings

November 22, 2005

By Nick Barisheff

As gold flirts with 20-year highs, we are hearing more from the 'gold bugs' or, as they are sometimes appropriately called, the 'doom-and-gloomers'. Appropriately, because a gold bug's current outlook for the future of traditional financial assets such as stocks, bonds and currencies is not optimistic, particularly in the US. A gold bug traces today's financial problems back to the removal of gold backing from global currencies; without such backing, there is no limit to the amount of money that politicians and the banking system can create. Monetary inflation inevitably leads to price inflation, and creates asset bubbles and excess debt that have historically led to financial collapses. However, pointing out these realities has earned gold bugs the label of doom-and-gloomers. For the most part, they are ignored by the ever-optimistic mainstream media and are relegated to offbeat websites and publications.

There is, however, a key spokesperson from the mainstream – Alan Greenspan, the most powerful financial person in the world today – whose voice cannot be ignored. On the surface he toes the party line and goes along with traditional optimism. But when you listen carefully to his words and read between the lines of his speeches, you will find another message. It is a message remarkably similar to that preached by the gold bugs, the doom-and-gloomers. In fact, if you dig deep below the surface, down to his root beliefs, you will discover that Mr. Greenspan is a closet gold bug.

That's right. Alan Greenspan is a gold bug. A doom-and-gloomer right up there with the best of them. On close review of some of his recent speeches it will become apparent that his comments on issues like the potential for a derivatives crisis, the potential drop in asset prices, the housing bubble, the coming social security crisis, oil supply risks, the rising budget deficit, rising long term interest rates and the record high current account deficit are the same issues that gold bugs are warning about. These speeches often go unreported by the mainstream media, or are buried on the back pages, but most importantly they have not been compiled into one comprehensive summary.

Although they are warnings, in some cases they are not clearly stated. For example, in reporting on Greenspan's August 26 speech at Jackson Hole, CNN said: "Federal Reserve Chairman Alan Greenspan issued a veiled warning Friday on the risks to the economy from trade and budget deficits — as well as the recent run-up in home prices.'

'Veiled warning' is an apt description. Greenspan has a talent for delivering veiled messages in general. As financial writer Doug Gnazzo says: 'This dude was born with a silver tongue able to joust with the best of them'. And from a recent Forbes article: 'His prophecies rivet everyone, even if no one can parse what he's saying. His wife, broadcaster Andrea Mitchell, jokes that he had to propose three times before she understood him.' Greenspan's vagueness has been noted so often it has earned its own name – Greenspeak.

So what has Greenspan actually said about the problems facing the US economy? A look at his words on each of the issues named above provides some important insights.

Derivatives Dangers

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Derivatives Dangers

In remarks to Congress in October, 1998:

"On occasion there will be mistakes made, as there were in LTCM and I will forecast without knowing who, what or where, that there will be many more. I would suspect there are potential disasters running into a very large number, in the hundreds."

In 1998, a hedge fund called Long Term Capital Management guessed wrong in the bond markets. LCTM was founded by two Nobel prizewinners, and had the who's who of both Wall Street and Washington on its board of directors. Because our global financial system is so intertwined, LTCM's losses of over $1.2 trillion of derivatives posed a risk so large that the whole global financial system could have collapsed had the Fed not intervened. In addition to LTCM, there have been the high-profile collapses of Orange County, Barings Bank and Enron, all thanks to derivatives losses. Greenspan believes there are hundreds of such potential disasters waiting to happen.

The risks are much higher now, since the total amount of over-the-counter derivatives has grown from about $70 trillion in 1998 to over $370 trillion today. There is a total of $89 trillion in US derivatives, of which three banks hold 95%; J.P. Morgan alone holds over $46 trillion.

Government-sponsored entities (GSE) such as Fannie Mae and Freddie Mac may now pose systemic risks. Between 2000 and 2003, Fannie Mae reported derivatives losses of $25 billion. With respect to the systemic risks posed by Fannie Mae and Freddie Mac Greenspan warned in February 2004:

"The Federal Reserve is concerned about the growth and scale of the GSEs' mortgage portfolios, which concentrate interest rate and prepayment risks at these two institutions."

The Potential Drop in Asset Values

Greenspan at a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming on August 26, 2005:

"This vast increase in the market value of asset claims [stocks, bonds, houses] is in part the indirect result of investors accepting lower compensation for risk. Such an increase in market value is too often viewed by market participants as structural and permanent But what they perceive as newly abundant liquidity can readily disappear . . . history has not dealt kindly with the aftermath of protracted periods of low risk premiums."

The long stretch of increasing stock, bond and real estate prices together with low interest rates has made investors feel secure and willing to accept lower returns. Since all markets are cyclical in nature, busts follow booms and prices tend to revert to their mean. As interest rates rise, stocks, bonds and real estate will all be negatively impacted and could result in painful declines.

Have a good look at the last sentence in his quote. You might have to read it a couple of times, but those words could have been uttered by the most ardent doom-and-gloomer. The words 'history has not dealt kindly with' imply difficult times ahead for assets, and this is one of the few unveiled warnings you'll hear from the grandmaster of spin.

The Housing Bubble

Greenspan at Jackson Hole on August 27, 2005:

‘Nearer term, the housing boom will inevitably simmer down. As part of that process, house turnover will decline from currently historic levels, while home price increases will slow and prices could even decrease. As a consequence, home equity extraction will ease and with it some of the strength in personal consumption expenditures.’

The housing boom will end, prices will level and could even fall. Either way, the consumer spending enabled by the refinancing boom will slow down. The current housing boom is a direct result of low interest rates and lax lending standards. Today, buyers can get low-cost, variable-rate mortgage loans for the full purchase price without having to document their income. As rates rise, many homeowners will be forced to convert their loans to a fixed rate at several points higher. As a consequence, many will no longer be able to afford the monthly payments and with no equity left, they will simply default. The increasing number of unsold homes could then lead to a collapse in prices. Once this happens, there will be a major impact on the economy as it loses its most important engine of growth.

The Coming Crisis in Social Security

Greenspan before the Committee on Financial Services, US House of Representatives, February 11, 2004:

‘The imbalance in the federal budgetary situation, unless addressed soon, will pose serious longer-term fiscal difficulties. Our demographics–especially the retirement of the baby-boom generation beginning in just a few years–mean that the ratio of workers to retirees will fall substantially. Without corrective action, this development will put substantial pressure on our ability in coming years to provide even minimal government services while maintaining entitlement benefits at their current level, without debilitating increases in tax rates. The longer we wait before addressing these imbalances, the more wrenching the fiscal adjustment ultimately will be.’

Greenspan in testimony before the House Budget Committee, March 2005:

“When you begin to do the arithmetic of what the rising debt level implied by the deficits tells you and add interest costs to that ever-rising debt at ever-higher interest rates, the system becomes fiscally destabilizing. What you end up with is probably a stagnant economic system.”

Greenspan before the Budget Committee, US Senate, April 21, 2005:

‘I fear that we may have already committed more physical resources to the baby-boom generation in its retirement years than our economy has the capacity to deliver.’

According to the 2004 Financial Report for the US Government, that year’s total Federal Budget Deficit exceeded $11 trillion for the year. Apart from the cash deficit of $412 billion, the balance was made up of unfunded Social Security and Medicare benefits. Since last year’s real deficit almost exceeds the entire US GNP, it is apparent why Greenspan says that more promises have been made to the baby-boom generation than the economy has the capacity to deliver. In the next few years, worker contributions to Social Security will fall far short of payments to retirees. There is no trust fund of accumulated contributions. Existing retirees were paid out of current contributions and the surplus was spent by various governments to fund general programs. Making up the shortfall will create serious challenges for the federal budget. It is estimated that unfunded Social Security liabilities now exceed $40 trillion. As these obligations fall due the only political choice the US government will have is to monetize these obligations, resulting in massive increases in monetary inflation and a resulting negative impact on the value of the US dollar.

Oil Supply Risks

Greenspan to the National Italian American Foundation, Washington, D.C., October 15, 2004:

' . . . the current situation reflects an increasing fear that existing reserves and productive crude oil capacity have become subject to potential geopolitical adversity. These anxieties patently are not frivolous given the stark realities evident in many areas of the world.'

Many industry experts predict that total world oil production will soon peak, even as demand continues to grow. The looming problem of peak oil is enough cause for concern, leading as it will to rising prices while existing supplies become insufficient to meet growing global demand. In addition, almost all remaining reserves are located in politically unstable areas such as the Middle East and former Russian provinces, making the possibility of supply disruptions even greater. The term 'geopolitical adversity' could also refer to plans by Iran to start an oil bourse in March 2006, and begin pricing its oil in euros. Hugo Chavez of Venezuela has stated that he will sell his oil in euros as well, and Russia's Vladimir Putin is considering doing the same. The negative impact to the US economy of rising prices and possible supply disruptions that the pricing of oil in euros would have will result in a major negative impact on the US dollar.

The Rising Budget Deficit

Greenspan before the Committee on Financial Services, US House of Representatives, July 20, 2005:

'Large deficits result in rising interest rates and ever-growing interest payments that augment deficits in future years. Unless that trend is reversed, at some point these deficits would cause the economy to stagnate or worse.'

Greenspan at Jackson Hole, August 27, 2005:

'Monetary policy, for example, cannot ignore the potential inflationary pressures inherent in our current fiscal outlook, especially those that could arise in meeting commitments to future retirees. However, I assume that these imbalances will be resolved before stark choices again confront us and that, if they are not, the Fed would resist any temptation to monetize future fiscal deficits. We had too much experience with the dangers of inflation in the 1970s to tolerate going through another bout of dispiriting stagflation. The consequences for both future workers and retirees could be daunting.'

The present budget is inflationary and the problems ahead will make it worse. In 2004 the US federal government's gross debt topped $7.4 trillion: that amounts to $25,000 for every man, woman and child in the country. If unfunded commitments to Social Security and Medicare are added in, the burden rises to $145,000 per person, or $350,000 per full-time worker. In his 2004 report, David Walker, Comptroller General of the United States, issued a very clear warning to the president, the senate and congress, reinforcing Greenspan's warning:

'Without reform, known demographic trends, rising health care costs, and projected growth in federal spending for Social Security, Medicare and Medicaid will result in massive fiscal pressures, that if not addressed, could cripple the economy, threaten our national security and adversely affect the quality of life of Americans in the future.'

Rising Long-Term Interest Rates

Greenspan at a banking conference in Germany, November 19, 2004:

'The fiscal issues that we face pose long-term challenges, but federal budget deficits could cause difficulties even in the relatively near term. Long-term interest rates reflect not only the balance between the current demand for, and current supply of, credit, they also incorporate markets' expectations of those balances in the future. As a consequence, should investors become significantly more doubtful that the Congress will take the necessary fiscal measures, an appreciable backup in long-term interest rates is possible as prospects for outsized federal demands on national saving become more apparent. Such a development could constrain investment and other interest-sensitive spending and thus undermine the private capital formation that is a key element in our economy's growth prospects.'

While the Federal Reserve sets short-term rates, the bond market sets long-term rates. As budget deficits increase, long-term interest rates, determined by the bond markets, are likely to rise. Higher debt-service costs will then further increase budget deficits. In addition, higher long-term rates will have a negative impact on corporate earnings, and lead to higher mortgage rates. This will ultimately lead to a slowdown in investment, faltering economy growth and a decline in both equities and real estate.

Greenspan went on to say:

'Rising interest rates have been advertised for so long and in so many places that anyone who hasn't appropriately hedged his position by now is desirous of losing money.'

The Record-High Current Account Deficit

Greenspan before the Committee on Financial Services, US House of Representatives, February 11, 2004:

'To date, the US current account deficit has been financed with little difficulty. . . investors evidently continue to perceive the United States as an excellent place to invest. Moreover, some governments have accumulated large amounts of dollar-denominated debt as a byproduct of resisting upward exchange rate adjustment. Nonetheless, given the already-substantial accumulation of dollar-denominated debt, foreign investors, both private and official, may become less willing to absorb ever-growing claims on US residents.'

Greenspan speaking to the European Banking Congress 2004, Frankfurt, Germany, November 19, 2004:

' net claims against residents of the United States cannot continue to increase forever in international portfolios at their recent pace. . .given the size of the US current account deficit, a diminished appetite for adding to dollar balances must occur at some point. The trade deficit cannot continue to increase forever at the recent pace."

In recent years the US has been able to convince foreign investors, both private and government, to hold its debt. The Current Account Deficit now stands at nearly 7% of GDP, the highest on record. Typically, when the deficits of third-world countries exceed 6% a collapse in the currency soon follows. It is unlikely that foreigners will be willing to accumulate US debt forever. At some point they will stop increasing their holdings and the US government will be forced to monetize the deficits. This will result in an increase in the money supply and higher inflation. Corporations and consumers may not be able to borrow on favourable terms, leading to a decline in economic growth and possibly a recession. If foreign debt-holders decide to start selling their US dollar holdings, a precipitous decline in the dollar could result.

These are but a few of the warnings – some veiled, some very clear – contained in the dozens of speeches made by Greenspan over the last several years. On close examination, it seems the only difference between a raging gold bug and the still-in-the-closet Greenspan is that a gold bug states that a crisis will happen, while Greenspan implies that a crisis might happen. But what else can he do? The most powerful man in the financial world can't yell 'Danger!' from the rooftops. Imagine the impact on the markets if the Chairman of the Federal Reserve were to issue dire warnings about the state of the economy. That kind of transparency doesn't go along with his job.

In trying to gauge Greenspan's words, you must also consider his past beliefs. Greenspan was an ardent gold bug and a true believer in the gold standard. Here are a few of the things he has said about gold over the years.

From a 1967 article entitled Gold and Economic Freedom
http://www.gold-eagle.com/greenspan041998.html:

'The abandonment of the gold standard made it possible for the welfare statists to use the banking system as a means to an unlimited expansion of credit. In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value. Deficit spending is simply a scheme for the 'hidden' confiscation of wealth. Gold stands in the way of this insidious process. It stands as a protector of property rights. If one grasps this, one has no difficulty in understanding the statists' antagonism toward the gold standard."

By any interpretation, these are the words of a true gold bug. 'In the absence of the gold standard, there is no way to protect savings from confiscation through inflation'. Could his words be any clearer? Could his pro-gold sentiment be any stronger? It could be argued that these words were written in 1968 and much has changed since then. However, as he recently autographed a copy of this article for Congressman Ron Paul, Paul asked him if still believed what he had written. Greenspan replied: 'I wouldn't change a word.'

In addition, here's what he said on December 19, 2002 when he spoke to the Economic Club of New York in New York City:

'In the two decades following the abandonment of the gold standard in 1933, the Consumer Price Index in the United States nearly doubled. And, in the four decades after that, prices quintupled. Monetary policy, unleashed from the constraint of domestic gold convertibility, had allowed a persistent over issuance of money. As recently as a decade ago, central bankers, having witnessed more than a half-century of chronic inflation, appeared to confirm that a fiat currency was inherently subject to excess.'

It will be interesting to see what Mr. Greenspan has to say once he retires in January 2006 and is free of the restraints his position places upon him. As events unfold, and he is writing his memoirs, he will be able to say, 'I told you so.' It may take some time before these events take place. In 1996 he gave what is probably his most famous warning:

'But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?"

Markets around the world fell 3-4%, and the US market fell 2% at the opening. The NASDAQ continued from 1,300 at the time of this speech to its peak of 5,049 on March 10, 2000 before plummeting 78% to 1,114 in October 2002. Today it is still more than 50% below its peak.

Given the devastating consequences many investors suffered when equity markets collapsed, it seems only prudent to take defensive action based on the warnings given by Greenspan himself.

One of the most effective ways of securing wealth in turbulent financial times is to ensure that investment portfolios are properly diversified and include an appropriate allocation to precious metals. Precious metals move in the opposite direction to financial assets, and act as portfolio insurance. In a recent study entitled Diversification with Gold, Silver and Platinum, Ibbotson Associates stated that an allocation of 7.1%, 12.5% or 15.7% for conservative, moderate and aggressive portfolios respectively could increase returns and reduce portfolio risks. They also concluded that precious metals, in bullion form, provided positive returns when they were needed the most. Bearing in mind the implications of Greenspan's warnings, an allocation considerably higher than the recommended Ibbotson allocations may very well be a prudent move.

__Nick Barisheff__ is the founder, president and CEO of BMG Group Inc., a company dedicated to providing investors with a secure, cost-effective, transparent way to purchase and hold physical bullion. BMG is an Associate Member of the London Bullion Market Association (LBMA) and an Associate Member of the Responsible Investment Association (RIA) as well signatory to the Six Principles of Responsible Investments (United Nations endorsed Principles for Responsible Investment – PRI).

Widely recognized as international bullion expert, Nick has written numerous articles on bullion and current market trends that have been published on various news and business websites. Nick has appeared on BNN, CBC, CNBC and Sun Media, and has been interviewed for countless articles by leading business publications across North America, Europe and Asia. His first book, $10,000 Gold: Why Gold's Inevitable Rise Is the Investor's Safe Haven, was published in the spring of 2013. Every investor who seeks the safety of sound money will benefit from Nick's insights into the portfolio-preserving power of gold. www.bmgbullion.com