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LARRY KUDLOW, host:

Tonight, on a special edition of THE KUDLOW REPORT live from Washington, DC, former Treasury Secretary Henry Paulson talks to us about his new book, "On the Brink: Inside the Race to Stop the Collapse of the Global Financial System." We will talk to a free market man who engaged in perhaps the most systemic government intervention in US financial history. Did it work? Were there other options? Why is there a populist political backlash against the bailouts? And is the long-term American economic future better or worse? Mr. Paulson will give us some straight talk on what he was thinking and how it all turned out. This is a first government source account, inside account, straight from the horse's mouth. Fasten your seat belts, everybody, THE KUDLOW REPORT begins right now.

Good evening, everyone. I'm Larry Kudlow. Welcome to a special edition of THE KUDLOW report. We are live from Washington, DC. And, yes, we still believe free market capitalism is the best path to prosperity.

Tonight, we're going to have some great fun. We talk to the man who was at the center of the worst worldwide financial crisis since the Great Depression. That man is, of course, former Treasury Secretary and former Goldman Sachs chairman Henry Paulson. His much awaited memoir, "On The Brink: Inside the Race to Stop the Collapse of the Global Financial System," just hit bookstores today, and it is climbing the Amazon list very rapidly. It is a first-person account of what Mr. Paulson and others thought was impending financial Armageddon, peering into the abyss with major financial companies failing left and right. All that in the autumn of 2008, a little more than year ago.

TEXT:

Financial Wreckage

Bear Stearns - Mar. 30:
Acquired by JPMorgan Chase

IndyMac - Jul. 11:
Taken over by FDIC

Fannie/Freddie - Sept. 15:
Taken over by federal govt

Merrill Lynch - Sept. 15:
Acquired by Bank of America

Lehman Bros - Sept. 15:
Files for bankruptcy

AIG - Sept. 16:
NY Fed extends \$85B loan

Washington Mutual - Sept. 25:
Acquired by JPMorgan Chase

Wachovia - Sept. 29:
FDIC announces Acquisition by Citigroup

KUDLOW: But today as the system is healing, populist anger from the left and the right rails against the rescue mission and the bailouts. The Republican Party has turned against its former Treasury secretary. My question is, why is this? And finally, can the free market system survive all of this. Tonight, we learn about Mr. Paulson's thinking behind all those decisions, taken in response to the financial crisis, and, ultimately, in the pursuit of long-run American prosperity. Here with me now in Washington, DC, the former Treasury man Henry Paulson.

Hank, thank you very much for doing this.

Mr. HENRY PAULSON: Larry, great to be here.

KUDLOW: First of all, let me say just as someone who read the manuscripts, they were Xeroxed for me, it was one hell of a book. I just want to say that. I loved it, I couldn't put it down. I read it in the course of three or four days.

Now, let me ask you this. You were here in this very spot in the spring of 2007. We interviewed.

Mr. PAULSON: Yeah.

KUDLOW: And the first stirrings of the crisis began more from reports about subprime mortgage failures and some bank issues. A month or two later, you had the BNP Paribas crisis, which triggered in France. OK. Then you take this narrative down to 2008. Let me ask you this: In '07, you said it was containable.

Mr. PAULSON: Right.

KUDLOW: You were still an optimist on the economy. You were still an optimist on the financial system's health. Why wasn't it containable?

Mr. PAULSON: Larry, you know, one of the things that I recount in the book is, you know, the very first major meeting I had with President Bush, I asked for the topic to be about what I thought was the likelihood of having a credit crisis. And he asked me, he said, 'Hank, what would--well, what would cause it,' and I said, 'I don't know, and we--it's almost impossible to guess. Who would have guessed that the Russians would default and that would cause a crisis in '98? But after the fact, it will be obvious. There's just a lot of dry tinder out there and I'm not sure what's going to light the spark.' Now, why did we say it's contained? And I think...

KUDLOW: You said it, Mr. Bernanke said it, a lot of people said it.

Mr. PAULSON: Yeah. And I think...

KUDLOW: And then I said it after you said it.

Mr. PAULSON: I know it. I know it. And you're an optimist.

KUDLOW: I am an optimist.

Mr. PAULSON: Now, in terms of why I thought it was contained was, first of all, I was talking about subprime and we made the mistake of just simply

saying the subprime was not big in relation to, you know, a \$13-, \$14 trillion US economy. And what was really going on is we were talking about housing overall, and, you know, since World War II, housing, residential home prices had generally gone up. And mortgages were just considered to be very safe investments. And so the kind of decline we saw was something that was not envisioned in any kind of model. It wasn't anything that many people that were close to it--you know, after the fact, it all seems obvious to all of us. But the--and so when you had the kind of decline we saw in housing prices, that changed the behavior of those who, you know, of homeowners. And also the other thing you and I were talking about before the show is just this--all of this complexity.

KUDLOW: Mm-hmm.

Mr. PAULSON: And so when...

KUDLOW: These crazy bonds, collateralized debt obligations, credit defaults, what--mortgage-backed securities that were rated triple-A by a bunch of goofy raters that didn't know what they were talking about.

Mr. PAULSON: Yeah. And the level of complexity, OK, made--so when housing the prices declined, all kinds of complex products became suspect because people said, 'Who understands them.'

KUDLOW: All right. So look, let's shift the narrative now. You maybe saw the first sparks of problems back in 2007. Let's call it midyear, to the argument's sake.

Mr. PAULSON: Right.

KUDLOW: Switch it to six or nine months later. March of 2008, Bear Stearns faces a run on the bank. You got to close, them and you sell them to JPMorgan. And as you note in your book, March to September 2008, probably the most extraordinary thing in the history of American finance, eight major financial firms failed, and that doesn't include putting Merrill Lynch inside the Bank of America. In a sense, Merrill would have been nine. And I think we may have a full screen on what the eight were, if we put those things up. But leaving that aside, here, Bear Stearns, IndyMac, Fannie, Freddie, Merrill Lynch acquired by Bank of America. Let's switch to page two on this. We've got to get--AIG's got to come up on there. There's Lehman, AIG. And let's not forget, by the way, Washington Mutual--WaMu--Wachovia and somewheres in there, did I mention IndyMac. That was in there as well. Now...

Mr. PAULSON: And now what you had also happening was...

KUDLOW: That was an incredible jump shift. Incredible in the space of nine months to a year we had a total collapse of all these huge institutions. And yet it seems to come as a great surprise.

Mr. PAULSON: And that's--and that's the US alone because you had--if you look from September through the first part of October, we had six European nations have to come in and rescue a whole series of banks.

KUDLOW: But why? What happened? You had this, in effect, a rolling run on the bank. That's really what you had.

Mr. PAULSON: Right. Yeah.

KUDLOW: You can define it and make it complex...

Mr. PAULSON: Yeah.

KUDLOW: ...but basically you had a run on the bank--investors, depositors--for liabilities that were insured. Open market trading funds and all the rest of it...

Mr. PAULSON: Yeah.

KUDLOW: ...just took off. And all of a sudden you're in this incredible crisis. The credit markets freeze. You couldn't even have bank-to-bank, interbank trading. Money market fund went down, let's not forget that, whatever it was called, the reserve primary fund, that was another.

Mr. PAULSON: Right.

KUDLOW: What happened? Some--there's got to be some rational explanation to get from the middle of those seven into the autumn of '08.

Mr. PAULSON: Well, what you need to understand is what had happened before even the middle of '07, which is you'd had these excesses had been building up for some times. You'd had a--we had been overstimulating housing. So if you look at the combined weight of all of our policies in the US government...

KUDLOW: Wait. It's HUD-backed, unaffordable mortgage loans, Fannie and Freddie?

Mr. PAULSON: What you have--yeah, yeah, Fannie and Freddie, the FHA, various state programs.

KUDLOW: Community Reinvestment Act.

Mr. PAULSON: You know, mortgage interest deduction. I'm not saying of them were...

KUDLOW: Zero capital gains tax on home sales.

Mr. PAULSON: That's right. And so you had--so you had all of this going on, and then you had even more basic than this, you had these big global economic imbalances, structural imbalances, which stem from the fact that we, as a country, save not enough, both as a government and individually. Overreliant on debt. And so this--so you had these big structural imbalances. We have a tax system that penalizes savings and it really rewards consumption.

KUDLOW: Right.

Mr. PAULSON: And so you had these huge capital flows, global capital flows raining down through the banks. And so it was something--economists would talk about this, and they would talk about it, and I remember someone even using this term that was, you know, "stable disequilibrium," you know...

KUDLOW: Yeah.

Mr. PAULSON: ...the oxymoron, almost. But--so you had these excesses and then you have, in 2007...

KUDLOW: Right. Before we get to those, though, I want to say...

Mr. PAULSON: Yeah.

KUDLOW: ...Hank, you were effusive in your praise of Ben Bernanke.

Mr. PAULSON: That's right.

KUDLOW: Effusive.

Mr. PAULSON: Right.

KUDLOW: In a number of pages. You call him the most brilliant guy, he's a nice man.

Mr. PAULSON: Yeah.

KUDLOW: He shows up on time for meetings. As I recall, you like that, too. But so many of us believe that the Fed's ultra-easy money, with Greenspan running the Fed in the early part of the decade, and Bernanke as intellectual co-pilot, ultra-easy money, ultra-low interest rates, negative real interest rates helped the housing bubble, the commodity bubble. And you know, as a former Wall Street veteran, you throw negative real interest rates at Wall Street traders looking for yield to please customers and whatever, that's like throwing blood into the water for sharks. And so they just took those--and then I want to ask you, that it comes around--what goes around, comes around. After the Fed finally figures out that they were too easy and the inflation rate started rising to 5 or 6 percent, then they tightened the screws from pillar to post. And if you look at a chart, real interest rates were 4 or 5, 6 percent by the time we got to '07, '08. So they pumped the money in, they bubbled out the asset prices, then they clamped down on them with a huge liquidity squeeze. Why aren't you more critical of the rock 'n' roll monetary policy?

Mr. PAULSON: Because what I looked at, and this was--this was my view of the world, my view of the world was inflation was very low globally, there was--the world was awash in excess liquidity, and you saw--so, in this world, investors were reaching for risk and mispricing it. But to get to your basic question...

KUDLOW: How easy to misprice when the Fed has mispriced its own monetary policy?

Mr. PAULSON: Well, when the world's lost--but if you--but to get to your basic question, because--which I think is critical when you say why did you get this chain of bank failures suddenly, you had--remember, the crisis hit in the late July-August period of 2007. So before we got to Bear Stearns, this had been going on for some time. And the--it was taking its toll. And I think that given some of that accounting conventions and so on, the losses weren't realized.

KUDLOW: Something happened, Hank. Here's the thing that I'm--I don't want to dwell on this. I mean, your book, your narrative is...

Mr. PAULSON: Yeah.

KUDLOW: ...this was financial Armageddon, peering into the abyss.

Mr. PAULSON: Right.

KUDLOW: And you know what, I don't--I don't disagree. I think you're right. I'm not sure we need to talk about why the rest of the public today doesn't

understand that. But I'll come back to that. But it seems like when these big banks, brokers, mortgage lenders, let's not forget Countrywide went down...

Mr. PAULSON: Yeah.

KUDLOW: ...something happened between Bear Stearns and, I don't know, Merrill Lynch, something happened so the system turned off. What was the event that happened?

Mr. PAULSON: Well, I would say that, but first of all...

KUDLOW: Turned a downturn into a catastrophe?

Mr. PAULSON: Well, first of all, again, this had been building up for a long time. These institutions were--there was a--I think they didn't adequately understand the need for liquidity cushions. There was a lot of focus on capital, which is important, but I think they didn't have adequate liquidity. I think it was a complexity of products. But again, they were--I was aware from August of 2007 right up through that period, how severe the problem was.

KUDLOW: Well, I'm not blaming you.

Mr. PAULSON: No, no.

KUDLOW: There's no perfect foresight in this game. I'm not blaming you.

Mr. PAULSON: No. But I was just saying...

KUDLOW: Nobody blames you.

Mr. PAULSON: No, I wasn't...

KUDLOW: The question is, though, in terms of how this thing hit...

Mr. PAULSON: No, I was--I was saying...

KUDLOW: ...what was it? We wake up in the fall of '08, Hank, and it's a total catastrophe.

Mr. PAULSON: See, I was--well, here's the point, I think.

KUDLOW: Something must have happened.

Mr. PAULSON: But here's the point I'm trying to make, which is I think--see, I saw it hitting in August of 2007, and it was beneath the surface. So it was building and building and the system was becoming more and more fragile.

KUDLOW: And you're still going to defend the Fed during this period?

Mr. PAULSON: And it was hard. We were working, yeah, with the Fed, during that period, we were working jointly with the Fed trying to get institutions to raise capital and trying to get them to raise capital while they still could raise some. And I was calling up bankers and saying, I don't know of a single CEO of a major bank or any bank who's ever got in trouble by having too much capital, raising capital. But they viewed it as a sign of weakness.

KUDLOW: All right. We're going to take a break here.

Mr. PAULSON: Yeah.

KUDLOW: I understand that. And I agree with, by the way, the capital issue, and I think that's a key part of this solution. All I'll say is this: Wouldn't it be nice to have a steadier monetary policy that didn't go on, let's take real interest rates. I mean, the inflation rate went to 5 percent for awhile, then it went back down, then it went to 6 percent for awhile in 2006 to 2008. They blew their targets. Wouldn't it be nice to have a central bank and policy that didn't fluctuate from a negative 4 percent real rate to a positive 4 or 5 percent real rate? Because I submit that that was an ocean that drowned--first it created the waters and then took the water out. This was a liquidity squeeze of the first magnitude. First, they pumped it up, then they deflated it. That's got to be part of the issue here.

Mr. PAULSON: Well, I have looked--I'm not trying to debate it. I just looked at, from my perspective and from a banker's perspective, I saw huge complexity, much of it unwarranted. I saw--and I saw big capital flows stemming from imbalances, and with the world awash in that kind of liquidity from the capital flows, and low inflation around the world. So that was, you got it from me, not an economist, not a monetary economist but a banker. And when we were working to put out the fire, you know, I could not have had better partners.

KUDLOW: Well, we'll get to the putting out the fire part. We're going to take a full break. We have Mr. Paulson here for the entire hour. We're going to talk about mark to market accounting, where he's totally going to disagree with me. We're going to talk about the role of the dollar. We're going to talk about Lehman, we're going to talk about AIG. We're going to ask the former secretary whether he, in fact, put a gun to Ken Lewis' head to buy Merrill Lynch. Of course, this is a dramatic book. Somebody's got to figure out the causes of this thing so we can somehow try to prevent it in the future. Coming up, we'll even talk about some of the individual players. I'm Larry Kudlow. Treasury man Henry Paulson. It's a great honor and a pleasure. It's a great read, folks, by the way. You got to go online, buy it, Amazon, bookstores, whatever. Hell of a read. You're watching CNBC, first in business worldwide.

Announcer: You're watching THE KUDLOW REPORT on CNBC. First in business worldwide.

(Announcements)

Announcer: Live from Washington with former Treasury Secretary Henry Paulson, a special edition of THE KUDLOW REPORT.

KUDLOW: All right. We are live with Hank Paulson, talking about his brand-new book. It really is the first inside government account, what I call straight from the horse's mouth.

Hank, thank you. You honor us by this, and it was a terrific book. We're talking about what it was that changed from '07 to '08, the end of '08, when the absolute crisis really started to crash in around us.

I want to ask you about one, and you can disagree with me on this, mark to market accounting. A lot of people, in fact Steve Forbes, the editor-in-chief and publisher of Forbes magazine, he's got another editorial about the subject in this week's Forbes. And he said when the Financial Accounting Standards Board reinstated mark to market accounting, that these banks had to mark to a nonexistent market, that they moved away from cash flow accounting, that the

FASB changes, it hadn't been changed since the 1930s. This happened in the middle of 2007. And it just seems a peculiar coincidence that by 2008, as banks had to report terrible earnings because they were marking down their assets as much as 80 percent, this helps trigger the lack of confidence, the run on the banks, and the credit freeze-up.

Mr. PAULSON: Yeah, Larry, I disagree very strongly, and I know that reasonable people disagree on this. But having run an investment bank, I don't know how to do it if we didn't have the discipline of knowing that every asset had to be marked because I wouldn't know how to do it if you had a different book in terms of what the security is worth from what you would actually--actually paid for it originally. If you had it--the way I think about it is that there is a marvelous discipline about having to say every day what is this...

KUDLOW: Even if there is no real market bid?

Mr. PAULSON: Well, I've got to say...

KUDLOW: Because the opposite is cash flow accounting, right?

Mr. PAULSON: Well...

KUDLOW: They were servicing 70 percent of these bad, toxic loans.

Mr. PAULSON: You can have cash flow accounting, but if something is worth--I would say there's no perfect accounting system. None.

KUDLOW: Hm.

Mr. PAULSON: But to be able to--I just spent too much time in the financial services industry, worked with banks all around the world, looked at what it's like when accounting goes awry and you use historical accounting, and you use that to hide and cover up losses. And the thing that I knew for certain in this--and actually I believe that if there had been more rigid adherence to mark to market accounting, maybe the excesses wouldn't have built up to the point that they built up to, and at least the problem--the problem that I was dealing with in the first part of the crisis was to get banks to recognize losses and raise capital.

KUDLOW: But with respect, at the time--now I'm going to switch to early March of 2009.

Mr. PAULSON: Right.

KUDLOW: And Democratic Congressman Paul Kanjorski and Barney Frank--and you speak very well of Barney Frank in the book.

Mr. PAULSON: Yeah.

KUDLOW: Those two guys really pushed FASB to change mark to market and go back to cash flow accounting.

Mr. PAULSON: Yeah.

KUDLOW: And that was the almost to the day the absolute bottom in the stock market.

Mr. PAULSON: I...

KUDLOW: Is that just a coincidence?

Mr. PAULSON: You know, it is a coincidence.

KUDLOW: It is a coincidence?

Mr. PAULSON: It is a coincidence. If it were--if it were 72 degrees...

KUDLOW: To the day.

Mr. PAULSON: If it was 72 degrees that day, that would--that would have as much to do with it.

KUDLOW: All right. A coincidence.

Mr. PAULSON: I've got to tell you, though, one thing I feel strongly is that politicians should not interfere with accounting. I mean, that is, to me...

KUDLOW: Well, maybe, maybe, you know what? Maybe war is too important to be left to the generals.

Mr. PAULSON: I think...

KUDLOW: Maybe...

Mr. PAULSON: But...

KUDLOW: Maybe this is too important to be left to the accountants.

Mr. PAULSON: Account...

KUDLOW: Because they took a long-run view. The banks are going to get out of this in the long run.

Mr. PAULSON: Yeah, the long...

KUDLOW: Maybe.

Mr. PAULSON: I still remember going up to the Hill and having meetings where I would say--where I had a number of congressmen say, 'The banks in my district don't have a problem, they don't have losses, they've just got problems with this mark to market accounting.' And--or--and I felt like saying, 'Do you know what you've just said to me? You've just said they've got losses, but they want to hide them.' And you know...

KUDLOW: Well, some people think there are different ways--look...

Mr. PAULSON: Yeah.

KUDLOW: ...if you're servicing the loan, even though it's temporary value, you know, you have the--if its temporary value comes down, but you're servicing the loan, why is that a bad loan?

Mr. PAULSON: Well...

KUDLOW: And by the way, it works in reverse. During the bubble, those loans were overvalued because of mark to marketing accounting and...

Mr. PAULSON: Can I just say...

KUDLOW: ...everybody got fat and happy.

Mr. PAULSON: I'll just say one other thing. I would look at things where a bank would have it on its balance sheet in one place and, you know, a historical value, and they'd be trading the same loans, you know, in the broker deal...

KUDLOW: Well, I agree with that.

Mr. PAULSON: ...for...

KUDLOW: That's a--yes.

Mr. PAULSON: ...60, 70 cents on the dollar.

KUDLOW: No, no, that part I agree with.

Mr. PAULSON: OK.

KUDLOW: It's got to be consistent and transparent.

Mr. PAULSON: Now, I do agree that, in the middle of a crisis, where there is no liquidity...

KUDLOW: Right.

Mr. PAULSON: ...OK, where there is no liquidity, that mark to market accounting could be an accelerator.

KUDLOW: Ah. It's a small concession.

Mr. PAULSON: But...

KUDLOW: My first concession from you this evening.

Mr. PAULSON: But there is no system that is perfect.

KUDLOW: Yeah.

Mr. PAULSON: And I believe that with mark to market accounting, we would not--we would've been less likely to get to the problem to begin with.

KUDLOW: Right.

Mr. PAULSON: Recognize losses or...

KUDLOW: One other one, before the break. One--I don't mean to be abrupt, but so many things to talk about.

Mr. PAULSON: Yeah, yeah.

KUDLOW: I need you for three hours, but only have you for this hour. Fannie and Freddie taken over by the government into so-called "conservatorships."

Mr. PAULSON: Right.

KUDLOW: Then, bang, Lehman Brothers goes down into bankruptcy.

Mr. PAULSON: Right.

KUDLOW: Then, bang, AIG is essentially rescued or bailed out...

Mr. PAULSON: Right, right.

KUDLOW: ...whatever we're going to call it. A lot of people think that those conflicting signals of policy helped create the credit freeze-up. A lot of--you--with this, with this, with this.

Mr. PAULSON: Yeah.

KUDLOW: I'm going to wait till the next segment to talk to you about TARP and going from toxic asset buys to capital buys.

Mr. PAULSON: Right, right.

KUDLOW: But on this point, you saved Fannie and Freddie, "saved" is a relative term, but they didn't go under.

Mr. PAULSON: Right.

KUDLOW: Lehman went under, AIG was saved, and people said, 'Huh? We don't know who's next.'

Mr. PAULSON: Well, let me explain. First of all, I haven't heard the sane argument yet how stabilizing Fannie and Freddie led to the crisis. In other words, when the thing that I...

KUDLOW: Well, only in relation to letting Lehman go down, sir.

Mr. PAULSON: Well...

KUDLOW: That's what I'm saying.

Mr. PAULSON: Without...

KUDLOW: Mix--this is what you call mixed signals.

Mr. PAULSON: OK. I would--I would say this, with Fannie and Freddie, I viewed that as the most important step. There were \$5.4 trillion of securities out there.

KUDLOW: Mm-hmm.

Mr. PAULSON: That is huge. If those organizations had become really unstable or done down, we would've had an absolute disaster. So part of the story in the book is I tell--is a race to get that done.

KUDLOW: Mm-hmm.

Mr. PAULSON: Which was not easy before Lehman was announcing his earnings. Now, I was naively hopeful for a short time that maybe that would be such a positive--it--for the world to know those were stable, it would've staved off the Lehman. Now, in terms of the mixed signals...

KUDLOW: You say--great. You think if the world knew that Fannie and Freddie were stable, that would've stopped the run on Lehman?

Mr. PAULSON: Yeah. I was hopeful.

KUDLOW: Work me through that.

Mr. PAULSON: Well, I was hopeful...

KUDLOW: I'm not sure I understand that one.

Mr. PAULSON: ...because what would...(unintelligible)...if you saw, when you look at \$5.4 trillion in securities held all over the world, if you find they're stable and the credit spreads shrink, that creates a value on everyone's balance sheet. They're no longer worried about will mortgage financing be available. I mean, that was a--that was--it's not stabilizing to know that Fannie and Freddie have come unglued.

KUDLOW: Right.

Mr. PAULSON: OK, but...

KUDLOW: May not be so stabilizing to know they're permanent wards of the state.

Mr. PAULSON: No, but I don't like--and they shouldn't be. The step we took was to be a time out and to show everyone the current structure wouldn't work, is greatly flawed, and needs to be changed.

KUDLOW: Well, nobody disagrees with you there. What I'm saying is there is this sort of...

Mr. PAULSON: Now, but listen, but now let's get to your...

KUDLOW: ...up and down policy thing.

Mr. PAULSON: Now let's get to your basic question. There was not--we did not have all the authorities we needed. So we raced--we worked with Congress and it got just in the nick of time, the authorities we need Fannie and Freddie from going down, OK? We had--Bear Stearns was quite interesting for us because with Bear Stearns, we had a buyer.

KUDLOW: Right.

Mr. PAULSON: The best buyer in the world because you had a...

KUDLOW: JP.

Mr. PAULSON: You had JPMorgan, strong credit, a CEO that was decisive and had the confidence of his board and so was able to do a deal. But going into that weekend, we knew that Bear Stearns had already started to unravel, the run had begun, and that if we didn't leave that first weekend with a deal with JPMorgan where they agreed to guarantee the trading book, during dependency of the shareholder vote, this company was going to disintegrate. So what we learned that weekend, we knew it theoretically beforehand, but what we learned the weekend was when you have someone that's an investment bank with a capital and a liquidity issue, that we didn't have the authorities to deal with it in government. And so, at that time, we didn't--and...

KUDLOW: But to the rest of the world watching this, including all these big financial institutions and hedge funds and private equity funds we're putting

liquidity in and taking liquidity out of the market...

Mr. PAULSON: Yeah.

KUDLOW: ...would it have been better after you completed the Bear Stearns action, which was March of 2008, to lay down a clear policy line about who's going to win and who's going to lose and how?

Mr. PAULSON: Well...

KUDLOW: Would that have been better to do that?

Mr. PAULSON: ...I don't know...

KUDLOW: Because it got very ad hoc in September, October.

Mr. PAULSON: Well, we were doing--let me say this. I look at it--we were doing this until we got there with TARP, we were--we were--we were late all the way along, as we tried to put out the fire, but the policy line, we didn't change policies. The facts changed. So, for instance, we did everything we could to save Bear Stearns. We stabilized Fannie and Freddie, put them into conservatorship, and with Lehman, we would have loved to have done--been able to present--prevent that failure. But in Lehman, you didn't have a buyer to fill the capital hole.

KUDLOW: I understand.

Mr. PAULSON: ...OK.

KUDLOW: I'm not criticizing the Lehman decision.

Mr. PAULSON: So I'm...

KUDLOW: I'm just saying it was like some were up, some won and some lost.

Mr. PAULSON: See, the perception, there was only one that--where we were unable to save and that was Lehman.

KUDLOW: All right.

Mr. PAULSON: And what--so the inconsistency and what people miss, there were--there were two issues with Lehman, OK? We didn't have a buyer to fill the capital hole and guarantee the trading book during...

KUDLOW: I understand.

Mr. PAULSON: ...which--and the Fed didn't have the power to do that.

KUDLOW: And the British regulators wouldn't sign off on it.

Mr. PAULSON: And we--and--yeah. So we didn't have that, number one. And then number two, if there had been someone, there still would've been a challenge, given the size of the capital hole, for the Fed to make the same loan it made for Bear Stearns, that would be secure to the satisfaction.

KUDLOW: I understand.

Mr. PAULSON: Because--but that's--but that's one of the things that worked with the private sector.

KUDLOW: All right. We can take break. We're going to come back. I want to talk about the AIG bailout. I want to talk about trading partners with AIG such as Goldman Sachs. I want to talk about the populist revolt against TARP and bailout nation. And we're going to talk about some of the individuals that Mr. Paulson dealt with, including Barack Obama and John McCain and, of course, President George W. Bush during this fateful period. Staring down the abyss, I agree with that. The question is, did we get it right? Stay with us. We'll be right back. I'm Larry Kudlow.

(Announcements)

Announcer: Live from Washington with former Treasury Secretary Henry Paulson, a special edition of THE KUDLOW REPORT.

KUDLOW: All right, welcome back, everybody. I'm live with former Treasury man Hank Paulson. He was at the very center of the financial crisis, writes about it in great detail in his brand-new excellent book called "On the Brink." Out today, rising up the Amazon.com list.

All right. TARP is a hated word politically. Bailouts, hated politically. Populism from the left and the right. And AIG, a three letter dirty word, hated politically. I'd like to zero in on that. First of all, what can you tell us?

Mr. PAULSON: Well, let me start with TARP being hated; and, in some ways, I think it's good because we, as a country, don't like bailouts.

KUDLOW: Ah.

Mr. PAULSON: And the president said it in the State of the Union.

KUDLOW: Right.

Mr. PAULSON: He said Republicans, Democrats, all of us. And you know, I hate it. I hated the things I had to do. It was just much better than the alternative, which was Armageddon, as you said. And the--I remember looking at a poll once and--which put it all in perspective for me. I said--it said 93 percent of the people in the US were against the bailouts. I was trying to figure out who the other 7 percent were. And it said--but 60 percent were against torture.

KUDLOW: Ah.

Mr. PAULSON: So that put it--that put it all in perspective. And the...

KUDLOW: But Rasmussen says, if you pay down your TARP bill, Rasmussen's poll show, then people say you're OK as a bank.

Mr. PAULSON: Well, I would say this, I believe that we're going to get--you know, we designed these programs so--to maximize the likelihood we get it all back. We're going to get everything we put back in the banks with a nice profit. And I think--although we've got to look at it over a five-year horizon, I think people are going to be surprised on the upside...

KUDLOW: Mm-hmm.

Mr. PAULSON: ...in terms of getting the--getting either all of it back or most of it back and--if you look at everything, and that includes some of the

money for the--for actual spending programs as opposed to investment programs.

KUDLOW: Were you aware of this AIG brouhaha--it's like the story that refuses to die. All right, we bailed out AIG, but then comes the second wave of the story, that the AIG trading partners were bailed out 100 cents on the dollar, including your old firm Goldman Sachs. And this has created another furor, and it's created a furor around Tim Geithner. Were you aware that the New York Fed was trying to prevent full disclosure on the amount that the Goldman Sachs type trading partners got in the AIG bailout? Had you heard anything about that?

Mr. PAULSON: Larry, I had heard absolutely nothing about it, but--well, when I say that, which is I had heard nothing about it, the--I want to...

KUDLOW: On the secrecy, the nondisclosure.

Mr. PAULSON: Oh, absolutely. And I had had not only had I heard nothing about disclosure, but I had no involvement in the decisions related to how to deal with the counterparties and how to pay them.

KUDLOW: The 100 cents on the dollar payout.

Mr. PAULSON: Right.

KUDLOW: You were not--that was not--you were not part of that decision?

Mr. PAULSON: Not at all.

KUDLOW: You were in the center of every decision at the time.

Mr. PAULSON: But I want to come back, first of all, because I want to just say how strongly how much I support the Fed's action, how necessary it was and...

KUDLOW: For secrecy over this...

Mr. PAULSON: No.

KUDLOW: ...for this cover-up?

Mr. PAULSON: In terms of bailing--in terms of the rescue of AIG.

KUDLOW: Oh.

Mr. PAULSON: And that loan, and I'll tell you the thing that I--the other thing I just feel very strongly about is having worked with the people I worked with there and knowing what their motives were.

KUDLOW: At the New York Fed.

Mr. PAULSON: At the New York Fed.

KUDLOW: But they made a huge blunder, Hank.

Mr. PAULSON: Well, I...

KUDLOW: They never should've allowed this secrecy cover-up thing to get out of the bag.

Mr. PAULSON: I will say this. I'm for transparency.

KUDLOW: Right.

Mr. PAULSON: But I will say this, I know these people, I know what their motives are, I know how hard they are working to save the system. I know their professionalism, I know their integrity, so I am not going to second guess. I will be the last person to second guess what they did.

KUDLOW: All right. But you are second guessing the decision to pay Goldman Sachs and others 100 cents on the dollar.

Mr. PAULSON: Of course. I'm not...

KUDLOW: And then what kind of trouble would Goldman had been in if they hadn't received that?

Mr. PAULSON: Look...

KUDLOW: This is one of the key issues here. Have we--did we rescue Goldman through the back door?

Mr. PAULSON: I would say very clearly that when we--when we--when AIG was rescued, that AIG was rescued to prevent a meltdown of the system, that this company, if it had gone down, would've taken everyone down. And as I look at it and when I've said I can just tell you what I'm--I believe in the very strongest way that was the Fed's motive, that was all of our motives at the time the loan was made, that the last thing on my mind was any counterparty's exposure or claim.

KUDLOW: All right.

Mr. PAULSON: I knew--counterparties...

KUDLOW: Who the heck did then? Who did that?

Mr. PAULSON: I do. It was--the--once the loan was made, OK, once the loan was made, it was the Fed's job to...

KUDLOW: Mm.

Mr. PAULSON: ...to administer the loan. We were--we were all very busy. I was very busy doing other things.

KUDLOW: I understand that. The world was going to hell in a handbasket.

Mr. PAULSON: And I--but I mean, I got to...

KUDLOW: But this stuff comes back at you down the road.

Mr. PAULSON: But I got to tell you something, there was an awful lot going on; and, again, what the Fed did, I will never second guess. And, in terms of the decisions they made, I'm totally confident, knowing them, they made--any decision they made in the best interest of this--of this system and the country.

KUDLOW: All right, strong support. I still think the Fed made a big mistake on this, but whatever.

We're going to come back with Hank Paulson. I want to talk about President George W. Bush's role. I want to talk about John McCain and Barack Obama, two people that Mr. Paulson had a lot to do with in the late fall of 2008. And then, yeah, we're going to talk about Tim Geithner. He's the Treasury man everyone loves to hate, but maybe Geithner has better stuff than we know about. We'll be right back. I'm Larry Kudlow.

(Announcements)

Announcer: Live from Washington with former Treasury Secretary Henry Paulson, a special edition of THE KUDLOW REPORT.

KUDLOW: All right, welcome back. We're talking about Hank Paulson's new book, "On the Brink." It's a terrific read. Really the first and only inside government account; I call it straight from the horse's mouth. During this fateful period, the Armageddon period--by the way, I agree with you, we were looking into the abyss. I don't doubt that. That's your basic narrative. I think you're right. On the other hand, you spent a lot of time with--on the phone with Barack Obama and John McCain. My reading of these, you felt that Obama was much more measured and helpful, and you did not think that way about Mr. McCain.

Mr. PAULSON: Larry, there was no doubt that I had easier conversations with, you know, Senator Obama at the time than with Senator McCain. But both men supported the TARP legislation ultimately.

KUDLOW: In the end.

Mr. PAULSON: And both supported the--neither came out against the rescues; and, as I look back on that, and as I looked at it in the time, I've always been very grateful for John McCain for taking that position. Because, as he fell behind in the polls, it would've been very easy to play the populist card, and if he had we would've been defenseless and we'd have 25 percent...

KUDLOW: But reading...

Mr. PAULSON: ...unemployment.

KUDLOW: I...

Mr. PAULSON: And so as I look at it, it was a--you know, it was--we were very fortunate, and--because the crisis came at the very worst time, because it came six weeks before an election.

KUDLOW: Right.

Mr. PAULSON: And so everyone, at the Hill, both candidates, they've got to go through this with one eye on the polls, and, of course, anything that even looked--would've smacked of a bailout is--was going to be very unpopular because, you know, in our system, if a--risk takers are supposed to bear the responsibility for their losses, no one--the idea of having public assistance for any institution, let alone a bank with private profit is, and it should be, an anathema.

KUDLOW: I understand. I understand.

Mr. PAULSON: And so this was going on.

KUDLOW: I got to go to lightning. I got to go lightning. You're too good.

No, you're too good for--you're just too good.

Mr. PAULSON: OK.

KUDLOW: I got to go to George W. Bush.

Mr. PAULSON: Right.

KUDLOW: You speak highly of Bush. Now, one of Bush's speechwriters wrote a book and said he was completely disengaged in the financial bailout, that you made all the decisions. In your book, you repeatedly are briefing him on the phone or in person, and he has to sign off on your major decisions, half of which, on the bailout stuff, he didn't want to sign off on, but he did because he felt it was for the good of the country. Am I giving an accurate reading?

Mr. PAULSON: You're giving an accurate reading, and I'll tell you, it's a very accurate reading, because we had--I didn't keep notes--I've got a good memory--and a lot of people do. There were--there were--there were good notes--notes in the White House, and good records. And the--and I would say that it was--from day one...

KUDLOW: Mm-hmm.

Mr. PAULSON: ...this is a man who was very engaged. We spoke frequently. Every major decision was reviewed with him. He understood the politics and the markets when this collision--in the book, as I said, is a collision between markets and politics.

KUDLOW: Mm-hmm.

Mr. PAULSON: And he was the one that always said, 'This may not always look good. This is going to be ugly.'

KUDLOW: Right.

Mr. PAULSON: 'We're going to have to hold our nose,' or what have you, 'but we are not going to let a lack of doing the right thing here hurt the American people and the economy.'

KUDLOW: I got to hard out. He said, real quick, real quick, one word answer. He said, 'In order to save the free market system we have to suspend it.' Do you agree with that?

Mr. PAULSON: Yeah.

KUDLOW: All right, we're going to leave it there.

Mr. PAULSON: Yeah. Yeah.

KUDLOW: Hang on. Much more coming with Secretary Hank Paulson. I'm going to talk about some more political figures--Nancy Pelosi, Tim Geithner--and also spiritual guidance during the darkest period of the night.

(Announcements)

Announcer: Live from Washington with former Treasury Secretary Henry Paulson, a special edition of THE KUDLOW REPORT.

KUDLOW: All right, we've got a brief lightning round left with Hank Paulson,

former Treasury man, on his book, "On the Brink," a very good read. Just one thing I want to get out of the way. A lot of people took umbrage when you, quote, "bowed down" to House Speaker Nancy Pelosi. In your book, you do suggest she wasn't all that helpful to your process of getting TARP through, but can you give us a quick comment?

Mr. PAULSON: Well, no, I thought she was helpful, and I thought it was pretty clear she was. You know, the--I needed to work with the--with the leaders on the Hill, and if Nancy hadn't been as supportive as she was, we never would've got it through. And I tell the story in the book of that night, September 27th, a Saturday, when we negotiated it. And I think she just all the way along, but there she played a key role in bringing people together and getting it done and said the American people expect this.

KUDLOW: Was it because you kissed her hand, or just she wanted to do it for the good of America?

Mr. PAULSON: Well, she wanted to do it for the good of America.

KUDLOW: No, I--say no more.

Mr. PAULSON: She--the leaders do...

KUDLOW: Say no more.

Mr. PAULSON: The leadership. But I'll tell you, it's...

KUDLOW: No! Say no more. I got to ask you this.

Mr. PAULSON: OK.

KUDLOW: I don't want to get out.

Mr. PAULSON: OK.

KUDLOW: Because I'm a spiritual person and so are you, and so are our wives. You sought spiritual guidance during the worst part of this.

Mr. PAULSON: Yes.

KUDLOW: Tell me about that.

Mr. PAULSON: Well, I--prayer is an important part of my life, and I continually prayed for humility and, you know, strength, stamina, wisdom...

KUDLOW: We don't know everything, do we? We just, as humans, we don't...

Mr. PAULSON: ...judge...

KUDLOW: ...we don't know everything.

Mr. PAULSON: ...judgment. Yes. And it was--it was--it was very important.

KUDLOW: And your wife read scripture to you at one point on the phone?

Mr. PAULSON: Oh, yes, yes, that was--one day--she read scripture to me at more than one point.

KUDLOW: Did it work? Did it work for you in the next meeting?

Mr. PAULSON: It sure helped, because it was--I--it was a verse that was very meaningful to both of us in dealing with fear.

KUDLOW: Boy, there's a lesson. There is a lesson for all of us in and out of government, a little scripture will help.

That's it. We're going to run out of time. Many thanks to former Secretary Treasury Hank Paulson. It's a hell of a book. I want everybody to go and join us, "On the Brink." And there was a brink, folks, and he has written a brilliant account.

Coming up, my last thought.

(Announcements)

KUDLOW: There can be little doubt that Hank Paulson's basic narrative that we were totally on the edge, on the brink, on the abyss was the key point. That's why you should all buy the book, "On the Brink."

I'm Larry Kudlow. See you tomorrow night.