COVER STORY

Of Inhuman Bondage

The bond market has policymakers in its grip

BY AMY WALDMAN

STANLEY DRUCKENMILLER does not come across as a life-of-the-party kind of guy. He rarely gives interviews, but when he does the word "dour" is the inevitable modifier. One profile reported that he went to bed at 8:30 p.m. on weekends. But for Druckenmiller, a lack of color is no hindrance to being heard: When he talks—or bets—Congress listens.

The Manhattan-based protege of billionaire George Soros, Druckenmiller reportedly earned $700 million last year. He now manages Soros's money, as well as that of other gold-plated investors. Managing, for Druckenmiller, does not involve looking for good rates of return on bank deposits. It involves taking the millions of Soros or his clients, borrowing even more, and then making enormous bets on the direction of stock, bond, and currency markets worldwide. He is, in short, a speculator of leviathan proportions, part of a small elite of money managers with such large stakes in the markets that their decisions to buy or sell can move those markets.

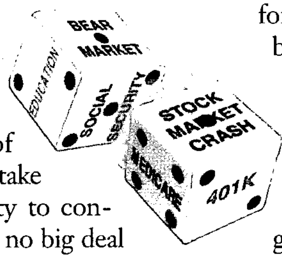
Or move Congress. After the Republicans took Congress in 1994, Druckenmiller wagered that the GOP would curb spending and force a balanced budget deal. For Druckenmiller, a bet was not a ten-spot with some friends; it meant buying millions of dollars in Treasury bonds. As James Glassman subsequently reported in *The Washington Post*, Druckenmiller speculated that the market would react favorably to a balanced budget deal, because as the government needed to borrow less, bonds would become rarer and thus more valuable. If the market bid up bonds in anticipation of that happening, he would make a killing.

His perfectly spun plan snagged on Bill Clinton, however, who resisted the Republican cuts and started warning of the dangers of a default because of the GOP refusal to raise the debt ceiling. The Republicans seemed poised to let a balanced budget deal slip away. So Druckenmiller began telling his Republican friends in Congress—and as a man who had given $250,000 to the Republican National Committee in 1994 he had a lot of friends—that the financial markets would tolerate any means to the end of balancing the budget, including a default. The cost of a "train wreck," Druckenmiller insisted, would be minor compared to the benefits of balancing the budget.

In September of 1995, Senator Pete Domenici (R-NM), the chairman of the Senate Budget Committee, flew to New York for a dinner at Seagram House with a dozen contributors, mostly large fund managers. Druckenmiller was among them. He told Domenici that the market would trade around a default if there were a balanced budget agreement. Domenici carried that message back to Capitol Hill. Newt Gingrich began broadcasting the same message, telling a meeting of the Public Securities Association—the bond industry trade group—that a balanced budget would be worth the price of a default. Druckenmiller and another big investor also bought a full page ad in *The Washington Post* that said, "let's not allow fears of temporary 'market instability' to serve as an excuse for equivocating on spending cuts ... If the markets believe the chaos will finally lead to decisive action, they will rise. If the markets believe decisive action will not be forthcoming, they will decline." In November, Druckenmiller took the same message to an ad hoc Republican hearing, where he testified.

To Congress, Druckenmiller was not just another private citizen giving his opinion: He became "the voice of the market"—so much so that when Alice Rivlin, then the director of the Office of Management and Budget, warned Congress of the devastating effects a default could have on the bond market, Domenici, fresh off the New York shuttle, publicly disputed her, authoritatively citing his contacts on Wall Street.

It apparently didn't trouble Domenici or Gingrich that Druckenmiller was hardly an objective sage offering wisdom; he was an investor who had bet gargantuan sums that a balanced budget deal would be reached. Druckenmiller had a stake in getting his way, and he was willing to push the Republicans to the brink of default—or even over the edge—to do it.



Druckenmiller didn't win his bet, of course, and he ended up selling off his big stake without reaping big profits. But his ability to convince congressional naifs that a default was no big deal is alarming nonetheless. Druckenmiller may be an extreme—perhaps the most extreme—example of how one speculator can unhinge the market for bonds (or stocks, or currencies, or futures, or wherever he chooses to lay his bets) and thus make Washington pay attention. But he is also representative: If you're looking for a metaphor for the power of money in American politics, or an explication of how private interest influences public policy, look no further than the bond market.

Bond Boors

In theory, of course, bonds are perfectly innocuous, simply a mechanism by which governments and businesses raise money. In return for cash, they issue bonds and pay bondholders interest for the use of their money. Eventually, the bond reaches maturity, which means that the government or corporation in question must repay the loan. Pretty staid stuff—which is why, until the early 1970s, bonds were the Dullsville of the financial world: a no-risk, conservative investment for the country club set. Bonds were bought, and they were held.

Today, they are traded at a frenzied pace, and their value can fluctuate over the course of a day or even an hour. It's a betting market, in which speculators wager on the market's direction. Arbitrage—buying and selling bonds simultaneously on the same or different markets, and profiting off the margins of difference—is where the real money is. The result is a relentlessly volatile market. And an influential one: The U.S. securities market may, in fact, be the most influential market in the world.

Because the bond market represents what financial journalist Steven Beckner calls "the interaction of government and the marketplace," its reach extends to the corridors of power in Washington—not just the Federal Reserve, but the White House and Congress as well. The bond market determines the cost of capital, for the government and much of the rest of the economy. The Fed controls short-term interest rates, but the bond market sets long-term rates. And mortgage rates, corporate borrowing, and other long-term loans all correspond to bond yields (specifically that of the benchmark 30-year Treasury bond). Those sectors of the economy in turn reverberate: Mortgage rates, for example, affect homeowners and homebuyers, who in turn influence the health of the construction industry, and so on. And the stock market now regularly follows the bond market's direction. So the Fed and the Treasury know they need to keep the bond market happy. In this relationship between government and the marketplace, the marketplace has the upper hand; all too often, the bond market is the tail that wags the dog in Washington.

This power can be difficult to grasp: The bond market is complicated, and even its most dramatic rallies tend to spark prose from *The New York Times* along the lines of, "Traders were exceptionally busy at their computer terminals." Tracking campaign contributions seems an easier way to document and fathom the influence of money in politics. But the relationship between policymakers and the bond market is ultimately more potent than that between PACs and politicians.

So while the names John Huang and Mochtar Riady now trip mellifluously off our tongues, what should really concern anyone worried about the influence of foreign money on American policy is the fact, recently reported by *The Wall Street Journal*, that foreign governments have purchased at least three fourths of all the new securities issued by the U.S. government over the last year. That means foreign countries own a significant portion of our debt—and that gives them a great deal of leverage over our economy.

To understand how, take December 11, 1996. That day, the bond market took its biggest one-day loss in five months. As they so often do, stocks followed: By mid-day, the Dow was down 129 points (it recovered to close 70 points down). Why? Because that morning, *The Wall Street Journal*'s "Heard on the Street" column had suggested that Japanese institutions might call a halt to their buying binge in the U.S. bond market. With fewer buyers, interest rates on bonds would rise, which would be bad for bond holders since the value of bonds drops as interest rates rise. The mere prospect of that happening—a prospect, mind you, supported by quite flimsy evidence—was enough to prompt a frenzied sell-off that sent the markets into a tailspin.

The Rumor Mill

The radical transformation of the bond market can be traced to three causes: inflation, deficit-spending, and technology. When inflation hit in the 1970s, bond holders learned the hard lesson that fixed-income investments meant little when the value of money wasn't fixed. They began demanding higher interest rates in anticipation of their bonds devaluing, and thus, interest rates began fluctuating with the value of money—or rather its anticipated value.

The 1970s left deep scars on the market, a psychological disorder that can only be called inflationphobia.

The 1980s brought profligate deficit-spending. And since a government that needs to borrow a lot also needs to issue a lot of bonds, the market was flooded. That meant that bonds were again devalued—the more bonds in circulation, the less they're worth. But the more bonds in the market, the larger the market becomes—and in the 1980s, it was becoming very large indeed.

The evolution of technology that made possible the almost instantaneous trading of large volumes also expanded the market. And the development of computer-driven complex mathematical models greased the way for arbitrage and speculation. All of this made bonds sexy—Tom Wolfe, Tom Hanks sexy—and more profitable. It made the bond market, with its daily fluctuations and massive buying and selling, more like the stock market. Over the last 15 years—and especially in the last five—commerce in Treasury securities has become the ultimate capitalist bazaar.

To grasp the change, consider the arc of William Gross's career. He got into bonds in 1971. His first job was as a "coupon clipper": His company bought bonds and kept them in a vault; he would go into the vault and clip interest coupons off the bonds so the coupons could be mailed into the Treasury.

He may as well have been in plastics for as much resemblance as that market bore to today's. Gross now heads Pacific Investment Management Company, which he founded, in Newport Beach, California. The financial press calls him a "bond guru," and it's easy to see why. His company manages close to $90 billion. Most of its clients, such as the pension fund of IBM, tend to be institutional investors, which means he spends his time trying get a safe rate of return in a volatile market. Gross alone trades $100 million a day. He has also become something once unthinkable for a bond manager: a pundit. He is regularly quoted by the press, and is a frequent guest on the financial TV talk shows whose explosion has paralleled the market's—the all-day CNBC, CNN's "Moneyline," and now CNN's new financial network.

Needless to say, Gross isn't clipping coupons anymore. In fact, he's not handling paper at all: In the netherworld of today's bond market, everything is done electronically. There is no central locus, a la the stock exchange; just thousands of brokers and dealers nationwide buying or selling from their offices or company floors. Po Bronson perfectly captures the surreal intangibility in his novel *Bombardiers*, when he has his protagonist, a bond salesman, suddenly realize that although he sells millions of dollars worth of bonds a day, he has never laid eyes on an actual bond.

Bond traders negotiate prices and interest rates based on expectations of what will happen in the economy. Brokers and analysts and research divisions and economists evaluate, instead of a corporation's product and prospects, economic conditions and indicators to set prices and give a "story" for why the person on the other end of the transaction should buy bonds. (Most traders subscribe to multiple analysis services, and "shop" for the story—the interpretation of the numbers—that supports the transaction they're trying to make.)

The market now runs 24 hours a day, seven days a week; Gross stops tracking it—reluctantly—only when he has to sleep. He is watching the skies—or actually the screens—to calibrate the strength or weakness of the economy, and most of all for signs of inflation.

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Whenever new data on payroll figures, or purchasing orders, or consumer spending is released, the market goes into paroxysms, as traders sell or buy madly in anticipation of an interest rate hike or cut. If traders anticipate higher inflation, they either demand higher interest when they buy bonds or they simply sell bonds. The result: Yields rise; bond values fall.

Bond traders abhor signs of economic growth or lower unemployment, which they believe portend inflation. "I'm hoping in a perverted type of way that the economy is weak. It implies inflation will be low down the road," Gross says, adding sweetly, "We are the ghouls of the financial world, because we thrive on bad news."

They don't just thrive on bad news—they help create it. In mid-1990, for example, sluggish growth was prompting worries about an impending recession (in fact, one was just getting underway, although that wasn't known at the time). Then, in August, Saddam Hussein invaded Kuwait, and oil prices temporarily spiked up. The inflationary threat wasn't real—it didn't take a PhD in geopolitics to realize that the Saudis, who desperately needed American help, had every reason to pump enough oil to keep our economy from being wrecked. But the bond market didn't care. It panicked, sending yields up above 9 percent. That only slowed the economy more—exacerbating the recession. An even more sluggish economy didn't bother the bond market nearly as much as it did the rest of us—especially those who lost jobs and income during the recession's protracted duration.

If fear of inflation drives the bond market, keeping the bond market happy drives Washington. So when the market tanked during that oil inflation scare in 1990, the Federal Reserve, which should have been lowering rates in August and September in order to short-circuit the recession, instead did nothing during that crucial period, thus giving the recession even more time to put down deep roots. The Fed acts similarly in healthier times: When the economy heats up, and a nervous bond markets pushes long term rates up in response, the Fed will move to keep inflation on a short leash by raising short-term rates. The dictate that growth must be contained well below 3 percent leaves us with less money to invest in research and development or Social Security or crumbling schools or deteriorating sewers. The corollary, that unemployment must be maintained above 5.6 percent lest fuller employment translate into wage inflation, now more often translates into stagnating wages, as well as a lot of people without work.

Over the past year or so, of course, the markets and Fed have grudgingly come to tolerate unemployment of about 5.4 percent, only because there hasn't been a corresponding rise in inflation. Which tells us something: That the fear of inflation unjustly protects Wall Street while punishing Main Street is a truism. But increasingly, it's also an absurdity—because more and more, the inflation paranoia seems wrong-headed. There's no sign of inflation on the horizon, and there hasn't been for the past five years. Over that period, inflation has averaged below 3 percent (and, if the Consumer Price Index is as off as Michael Boskin claims, it's been even lower). The great irony is that the only real inflation in the economy now is in the financial markets; bond prices, for example, have been increasing by 20 to 30 percent a year over the last few years, thanks largely to the fall in interest rates prompted by Clinton's deficit-cutting.

Economists are beginning to question whether the old paradigms of business cycles and NAIRU (nonaccelerating inflation rate of unemployment) still apply. Even William Gross says that we're actually experiencing *dis*inflation—that the globalization of labor and capital, and the productivity increases due to technology, now have more effect on inflation than the rate of growth or unemployment do. Not only that, he says, but this disinflationary trend is "a bond investor's best friend."

Try telling that to the market, which, as Gross concedes, continues to look through a "rear view mirror." Like the tides, the market rises and falls on each new trickle of data, but its analysis of that data is more junk science than exact.

"Good evening. An ugly day in the bond market," CNN's "Moneyline" began on June 7, 1996. "Inflation fears hammer[ed] bonds and sen[t] long-term interest rates sharply higher. The catalyst: a much stronger than expected report on jobs, the government reporting the economy added 348,000 new jobs in May, twice what most economists expected." On the floor of the Chicago Board of Trade, "Moneyline" reported, traders had re-priced Treasury securities to account for what they called a "now certain interest rate hike" by the Fed that summer. One bond futures trader said, "You can't ignore this data . . . it's above average . . . The Fed has to look at it. They can't ignore it."

But ignore it they did. The Federal Reserve didn't raise interest rates at its next meeting, or the one after that, because it recognized that there was no real threat of inflation. And it was probably basing that decision in part on data also released June 7—data showing that the unemployment rate had *risen* to 5.6 percent. But where the Fed weighed all the evidence, the bond market focused on the payroll figure, sending interest rates to a four-week high.

As anyone who has ever read tea leaves knows, you tend to see what you're looking for. Bond traders do the same. Reflex drives many to assume inflation is on the way. And calculation drives others to perpetuate that belief: Some members of the market—including, probably, that Chicago futures trader—make heavily leveraged bets that there will be a sell-off, then try to stir up fears of an interest rate hike in order to capitalize on their prophecy.

"In a sense, imagined inflation is more firmly embedded in the economy than real inflation," *Institutional Investor* wrote last May. "Greenspan knows only too well that the longer it takes to cure this pessimistic psychology, the longer the economy will have to endure boom-bust cycles before true price stability and higher real growth can be achieved." Greenspan may not think that healthy consumer spending this Christmas is going to trigger inflation, but he has to speak and act in response to wild gyrations in a bond market that thinks it does. He has to keep the market's confidence.

In the face of imagined inflation, Greenspan is powerless—and so are rational souls like Gross. Gross says he will often respond to economic indicators based not on what he thinks the numbers say, but on what he thinks the rest of the market will think they say. "You don't want to stand in front of 100-mile-an-hour freight train"—a bond market selling madly because it thinks inflation is coming, he says. "You have to be cognizant of what the market thinks rather than what you think. It's best to step aside and let the market have its way." Until the market's mind is changed, in other words, the wild swings will continue, and policy will continue to be held hostage to phantom fears.

Deficit Vultures

The hostage takers, so to speak, call themselves "bond vigilantes," in reference to the discipline bond traders exert on economies: The globalization of capital markets means that if they are dissatisfied with a government's monetary or fiscal policies, if inflation is too high or the money supply too loose or the currency too low, they can simply sell—thus driving bond prices down—and take their money to another market—Germany, say, or Japan.

The fear of inflation can be called bond vigilantes' Carter doctrine—and the fear of government spending their Reagan doctrine. As they learned in the 1980s, more borrowing means more bonds, driving bond prices down. And a growing deficit holds the threat that the Fed could inflate the money supply to bring the deficit under control. So the bond market has made a balanced budget into Washington's Holy Grail. This shaped Bill Clinton's early decision to abandon an investment plan in favor of deficit reduction. And it continues to shape what happens—or doesn't—in Washington.

In 1994, for example, Bill Gross noted on "Moneyline" that Clinton had lost popularity with the bond market because "I think there's ... a fear that Clinton may have a little bit more of a New Democrat than a conservative Democrat image to him, and the programs of health care and crime-related bills have influenced, to some extent, these higher rates. We would prefer, as bond vigilantes, to have lower deficits and less spending on the part of the government." The words were a warning to Clinton: Embark on a major social policy initiative at your peril.

No one can deny that deficit reduction is important, or that these fiscal disciplinarians have helped bring spending under control, or that Clinton's success at cutting the deficit has been good for the economy. If we get entitlement reform, it may be largely because of pressure from the bond market. But if any effort that requires real spending—from investing in infrastructure to providing health care for the young—will be vetoed by the bond market, and thus by the Treasury and the President's economic advisors, the power of government to act as an agent of change will be severely constrained. Hoping that the government will put out some real money to help employ welfare mothers? You're probably hoping in vain—not only because conservatives are ideologically opposed, but because Bill Clinton understands the bond market's power all too well.

The bond market's evolution is a parable for how the financial interests of a relatively small group of people—large investors, traders, money managers—have come to bear disproportionate weight in our political process. These people are part of the "one percent"—the thin sliver at the top of our economic stratum where wealth, income, and financial assets have been concentrating since the 1980s. The bond market's influence shows how much political power is concentrating there too.

So while Stanley Druckenmiller lost his bet last year, he will be ready to wager again as Congress once more contemplates a balanced budget amendment. And, just to be sure he'll have the GOP majority's ear, he recently gave another $250,000 to the RNC. Of course, he doesn't really need to give: His ability to destabilize the market is enough to ensure that attention will be paid—by Robert Rubin and Bill Clinton as well as Newt Gingrich and Pete Domenici. That's the real money-in-politics scandal of our time. ●

Teachers' Pets

Forget Capitol Hill—it's the state houses that are doing business with teachers' unions

By Dante Chinni

HALF-TRUTHS CAN BE DANGEROUS things, especially in the hands of a politician. Witness this little harangue on education reform near the end of Bob Dole's nomination acceptance speech in San Diego:

> "The teachers' unions nominated Bill Clinton in 1992; they are funding his reelection now; and they, his most reliable supporters, know he will maintain the status quo," Dole told conventioneers. "[W]hen I am president, I will disregard [their] political power, for the sake of the parents, the children, the schools, and the nation." The unions are killing the education patient and bankrupting the education business, he said.

It was a perfect political half-truth, a simple diagnosis of a real problem with a magic bullet answer: a president willing to stare down the unions. Even those who didn't agree with Dole's final solution—a school voucher system—heard something sensible in his words. Many agreed that teacher unions get in the way of reform and that Washington needs to do something to limit their power.

The problem is, Dole had it wrong and his half-truth draws attention away from the real issue.

It is true that teacher unions and their unwavering support of archaic tenure and certification systems all too often are roadblocks to reform. But any effort to ease the influence of the unions cannot begin in Washington. Despite their well-known national organizations, teacher unions are creatures of the states, governed by state laws that establish licensing procedures and guarantee tenure. Those laws, established long before our lawsuit-crazed era, were designed to protect teachers from political pressures and capricious firings. Today, however, they often serve as a shield for inferior teachers, and they stay on the books because of union money that goes not to the White House, but to the state houses. "Where the teacher unions are most powerful is the state level," says Jay Butler, spokesman for the National School Boards Association. "They want to be where the power is—where the real bread-and-butter issues are decided."

The numbers bear Butler out. According to the latest FEC figures, the American Federation of Teachers' PAC gave $1.29 million to federal campaigns between January 1995 and September 1996. That's not chump change. But the AFT's New York affiliate, the New York State United Teachers, spent nearly as much on its state races in just 10 months, $1.2 million from January to October 1996. And while the nationally focused AFT gave almost exclusively to Democrats, the NYSUT took a more bipartisan approach, giving 52 percent to Democrats and 34 percent to Republicans, with the remainder going to non-partisan groups.

Teacher union spending is not always so evenly split at the state level, but there are usually a number of key Republicans with their hands in the pot. In the states, the "laboratories of democracy," party affiliation and ideological differences are often less important than they are in Washington, and big money—the politician's best friend—is harder to find. Those state-level realities make it easier for unions to get control of state legislatures and kill efforts to reform teacher laws. Changing those laws, while not a panacea in the fight to make schools better, is surely a key element. To understand why, just sit down with a local school board member.

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