CNBC TRANSCRIPT & VIDEO: Warren Buffett on Goldman Sachs and U.S. Economic Rebound

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Warren Buffett ***defended Goldman Sachs*** *as it faces SEC fraud accusations and talked about the* ***signs of "real strength" he's seeing in the U.S. economy*** *during a live interview in Omaha today, May 3, 2010 with* ***Becky Quick*** *on* ***CNBC's Squawk Box****.*

It was his first live TV appearance after ***answering shareholders' questions*** *for almost five hours at this weekend's Berkshire Hathaway annual meeting.*

Here are video clips and a transcript of their conversation.

BECKY QUICK: Our guest host for the next hour is Warren Buffett. He's the Berkshire Hathaway chairman and CEO. And, Mr. Buffet, thank you for joining us this morning.

WARREN BUFFETT: It's a real pleasure.

BECKY: Did you hear this conversation about Goldman Sachs?

BUFFETT: I did, yeah.

BECKY: Now, Goldman was obviously one of the huge headlines here this weekend. There are -- right now the SEC considering these charges. And a lot of concern about whether Goldman not only followed the letter of the law, but the spirit of the law. What do you think?

BUFFETT: Well, from everything I've seen of the Abacus transaction, which was the one the SEC put out the complaint on, I do not see a problem with that transaction. We're a bond insurer, ACA was a bond insurer, MBIA, FGIC, Ambac, and all those companies started out insuring municipal bonds and then the profit margins got squeezed in the municipal bonds and they started drifting over and insuring other structured deals and so on.

ACA had probably dozens of people analyzing bonds. Many of the reports don't even explain that they were bond insured, but that was their job. Their job was to look at credits and stick a proper premium on if they wanted to insure them. If they didn't know what the proper premium was, they should have skipped insuring them. And almost all of the bond insurers got in trouble during that period because they drifted over into areas where they really weren't that good.

BECKY: But the SEC complaint focuses on fraud and says in large part it's because Goldman, the SEC alleges, did not let on that John Paulson was on the short side, betting against this, and he was helping structure the deal.

BUFFETT: Becky, we had many deals presented to us. But, for example, there was a municipal bond deal that was presented to Berkshire. And 8 billion of municipal bonds and a Wall Street house came to us and they said, "We'd like you to insure these bonds." And we said, "We'll do it for $160 million." And you'll see that the state of California is a couple of hundred million and Texas is a billion. And when that firm came to us, it happened to be Lehman Brothers two years ago, and we were to insure these bonds for 10 years. There were four possibilities. Lehman had these bonds and was hedging them. Lehman had an opinion that municipal bonds were overpriced and they were shorting them. They had a customer on the bonds that was hedging them, or the customers were shorting them.

We didn't care. Our job was to decide whether to insure the bonds. I never asked who was on the other side of the transaction. Obviously, somebody is on the other side of the transaction. But if Ben Bernanke was on the other side of the transaction, I still would have insured the bonds. It was my job to figure out what I wanted to insure. And there's always somebody on the other side of the transaction. And John Paulson could have been on the other side of that transaction and we still would have insured the bonds.

On the other hand, if the premium was wrong, we wouldn't have insured the bonds. So a bond insurer runs the risk of loss when they insure bonds. It shouldn't make any difference to them who owns them, who is hedging them, who is shorting them. They should decide what the risk is and charge an appropriate premium. And ACA charged the wrong premium.

BECKY: Lloyd Blankfein went before senators last week and a lot of them made it sound like he had intentionally misled his customers, told them one thing and then acted another way.

BUFFETT: Well, I've been doing business with Goldman for 44 years. They have raised a lot of capital for us that enabled us to deploy a lot of people. They have been involved in more acquisitions than any other Wall Street firm by far in connection with Berkshire. We're a much larger company because of Goldman Sachs. And we trade with them.

Now, I don't hire them for investment advice or services. People do. They have got a big investment advisory business, but I don't pay them for that. What I do do is frequently is I trade with them. When I buy something from them, they may be selling it for a customer. They may be shorting it to me. You know, it's not their responsibility to manage my money. I could hire them to manage my money, if I want to. But I don't. And I often buy something from them that my guess is that they are shorting to me. But, you know, that's the name of the game.

BECKY: Melissa Lee mentioned that talk is growing that Lloyd Blankfein may end up losing his job over this. What do you think about how Lloyd Blankfein has performed?

BUFFETT: I think Lloyd Blankfein has done a great job of leading Goldman Sachs. I mean, I have known the people who run Goldman Sachs ever since Gus Levy, every one of them. And Goldman has had a history of picking first class people to run the business, people that are the sort of people that, you know, feel fine about having marry your daughter and people who are plenty smart about running a business.

BECKY: Some people would say you are defending Goldman Sachs because you have a major investment with them. You're talking your book. What do you say to them?

BUFFETT: Well, I'd say you're asking me the questions and I'm responding to your questions. But I am talking my belief. And we do have a major investment in them. And if you put $5 billion in a company, you ought to feel pretty good about it and we felt pretty good about it when we did it. And we feel pretty good about it now.

BECKY: Do you think Lloyd Blankfein should continue in his job?

BUFFETT: Absolutely. Absolutely. I'd rather have him running it than anybody else.

BECKY: Have you had conversations with him this, about the transaction, about the SEC complaint, about what he needs to be doing in response?

BUFFETT: Probably had three or four conversations, each one of them maybe five to ten minutes. He's bringing me up-to-date on some development. And he's asked me whether I've got any great ideas on this in terms of how to handle essentially what is a tsunami of press opinion. But I have had no conversation with him in any way about him stepping down. And if he asked me, which he hasn't, I would say by all means stay.

BECKY: You mentioned on Saturday that of the 40,000 expected shareholders, probably 39,900 of them did not understand this transaction or what was happening at Goldman. Do you think you were able to help them understand it this weekend?

BUFFETT: I have been told by a lot of them. I mean, I have literally had, dozens including some of our directors. And they said they had never heard the transaction explained. ABN AMRO actually is the one that ended up paying the dollars out. ABN AMRO, now part of Royal Bank of Scotland, they paid out 900 million, or close to it, and got paid -- they paid out because they were a credit guarantor of ACA. They took on that risk. We sometimes guarantee the credit of other people. ABN AMRO got -- it's in the SEC complaint, they got paid 17 basis points, that's about a million six, to guarantee 900 million of credit. If ACA hadn't gotten in trouble they would have pocketed a million six and felt like they made a good deal. But sometimes banks lose money guaranteeing credit and sometimes they don't. ABN AMRO lost that money. ACA originally lost the money because they rolled bond insurance on something they didn't understand very well.

But bear in mind, MBIA was writing insurance like that at the time. Ambac was writing insurance like that at the time. FSA was writing insurance like that at the time. And all of them lost money on it. I mean, the housing situation in February of 2008 looked a lot different than the housing situation a year earlier. And many people were wrong, including Fannie Mae, Freddie Mac, you know, companies with huge involvements with the society, managed by Congress essentially through an agency that had 200 people overseeing them. And they were the biggest losers of all. So a lot of people were wrong about housing.

BECKY: Do you think this is a situation where it's some big banks that made some bad bets and now it's sour grapes?

BUFFETT: Well, big banks made bad bets. And lots of people made bad bets. The American people made a bad bet on housing. I mean, you know, at the peak, housing was worth 22 billion and people thought housing could do nothing but go up. And everybody virtually believed it. I mean, I believed it, you know, people in my block believed it. Rating agencies believed it, Freddie and Fannie believed it, Congress believed it, Wall Street believed it, mortgage bankers believed it. Housing had kept going up and up and up, so they built these models in their minds. They might not have thought of them as models, but they basically didn't think housing prices could get cracked a lot. And when they did get cracked, a lot of people looked awfully foolish and a lot of people lost money.

BECKY: Do you think we have -- I guess the biggest problem with the Goldman situation with that back at Abacus deal is that the taxpayers eventually ended up paying for it because ABN AMRO may have made the bad bet but essentially at one point between that and ACA, it was soaked up by taxpayer dollars. And that's what has people so angry.

BUFFETT: Well, the biggest taxpayer loss apparently is Fannie and Freddie, and they were supervised by Congress. And as a matter of fact, they reported to Sarbanes and Oxley, of all the irony. So that's where the big money was lost. But banks can lose money on loans that are guaranteeing credits. They make decisions that sometimes are wrong initially and sometimes events make them wrong, as they turn out.

But this transaction was not unique in any way. A lot of people bet on the bullish side of housing. There weren't many people on the bearish side. And John Paulson was not regarded as a genius in 2007. But if John Paulson came to me with a deal today to insure, I would look at what I was being asked to insure, and if I thought I understood it, I would quote him a price and if he took it, he'd have an insurance policy. I don't worry about doing business with John Paulson.

BECKY: Okay. Joe, you have a question as well?

JOE KERNEN: Just listening to Warren. Hi, Warren, thank you for joining us today.

BUFFETT: Hi, Joe.

JOE: But listening to the way you explained it, the American -- really, we were all long on housing. And with the benefit of hindsight, to see the way it's been portrayed not only in the media, but I know you probably saw those Senate hearings. And you've been around a while, Warren. You know the ways of Washington. But when do you decide that Washington really is a bigger part of the problem than the problem itself? And where this -- you know, if you really beat up on Wall Street and not beat up on Goldman, beat up on capitalism and beat up on the free market, should we just write it off to, ah, that's just the politicians?

I have one here. Senator Kit Bond, maybe you can weigh in, too. They can eventually do some real damage, can't they, Warren? That was a travesty and a witch-hunt and an inquisition. Were you uncomfortable?

BUFFETT: Well, it wasn't anything unexpected. I mean when something goes wrong on a very, very major scale and lots of people participated in it. I mean the whole country was involved in essentially what turned out to be a fantasy. Now, we all believed it, we all want houses. And it was very easy to say if houses are going to go up every year, you better buy it this year because it will cost you more next year. And that became kind of a self-fulfilling mania for a while. Because housing became 22 trillion out of the American public's 50 to 60 trillion of wealth and it was the one that you can margin the most, borrow the most against, you know, when the crash came, it really had consequences and nobody likes to say, "It's my fault."

JOE: Guess we have to go to break, Beck. And then we'll continue along, I guess, some of this stuff, right?

BECKY: That's right. And we'll let Senator Bond jump in on that as well and get his response. We're going to sneak a quick break right now. But as Joe mentioned, we have a lot more to cover with Warren Buffett. We have got 45 more minutes. We're going to be talking about whether the consumer is back in full force, what he's seeing and other signs in the economy, plus we've got a run-down of the morning's top stories. So stay right here. "Squawk Box" will be right back.

[COMMERCIAL BREAK]

BECKY: We are back in Omaha. And we've been talking about what happened with the housing crisis, who was to blame, with Warren Buffett, who is the chairman and CEO of Berkshire Hathaway.

And, Warren, you were just getting ready to talk a little bit about who is to blame and whether the politicians were to blame as well. I thought maybe you could say that and we could bring Senator Bond in as well.

BUFFETT: Well, when there's a delusion, a mass delusion, you can say everybody is to blame. I mean, you can say I should have spotted it, you can say the feds should have spotted it, you can say the mortgage brokers should have, Wall Street should have spotted it and blown the whistle. I'm not sure if they had blown the whistle how much good it would have done. People were having so much fun. And it's a little bit like Cinderella at the ball. People may have some feeling that at midnight it's going to turn to pumpkin and mice, but it's so darn much fun, you know, when the wine is flowing and the guys get better looking all the time and the music sounds better and you think you'll leave at five of twelve and all of a sudden you look up and you see there are no clocks on the wall and bingo, you know. It does turn to pumpkins and mice.

BECKY: Go ahead.

BUFFETT: It's hard to blame the band. It's hard to blame the guy you're dancing with. There's plenty of blame to go around.

BECKY: And alcohol.

BUFFETT: There's no villain.

BECKY: Well, let's talk about what Washington is doing right now with financial regulatory reform. Are the issues that are on the table things that can prevent this from happening again?

BUFFETT: Well, they can't prevent bubbles from happening again. People do that. The human beings go to extreme and when your neighbor makes a lot of money doing something, you know, you feel like you ought to be doing the same thing, too. And they do feed on themselves periodically, whether it's the Internet boom. You have had it all. You had two bubbles, you know, 400 years ago. You had South Sea bubbles. So people will get delusionary from time to time.

And you might say it's the job of the government or the Fed to try to talk them down or something of the sort. It's not very effective. If people really see easy money being made by someone else that they think is dumber than they are, it gets very tempting to be out there trying to do it yourself.

So bubbles will happen again. What you want to try and do is contain the damage from them. And, you know, we did that after 1929. Now, after 1929, we decided that people buying stocks on 10 percent margin was dangerous for the economy and we passed a law that said the feds should set margin requirements. And then what did we do in 1982? We validated an S&P 500 contract which let people gamble in untold numbers on tiny margins, all the while maintaining 50 percent margins with the Fed. It was crazy. But we took -- we took the safety net of high -- of high margins away from the stock market and nobody said a word.

BECKY: So you're in favor of limiting some derivatives trading?

BUFFETT: I'm in favor of having leverage limited with organizations that can produce dangerous for the system. And I actually think leverage ought to be -- extreme leverage ought to be prevented for individuals speculating in the market. We decided that was dangerous back in 1934 and I still think it's dangerous and we totally negated the benefit of that legislation when we let the S&P 500 and the derivatives come in to the game bigtime.

I wrote a letter to Congressman Dingell in 1982, saying this would turn the market into more of a casino. And there were plenty of people that said, yeah, but it's more fun having a casino.

BECKY: The idea of limiting leverage for investment banks is a good one. But then when you have all of these off-balance sheet transactions, it's very difficult to know how what the real leverage is. How do you get your arms around it?

BUFFETT: They were terrible. I mean, the auditors failed, in my view, bigtime when they let, for example, SIVs, be set up, special investment vehicles, with the big banks. Citigroup had those by the tens of millions. And what were they trying to do? They were trying to get around the leverage restrictions that the banks normally had to follow and they were trying to pile up a little more earnings so they could report better quarterly earnings. So they stuck all this stuff off balance sheet and talked about liquidity puts and all that sort of thing. And that should be not only just a yellow light, that's a red light to auditors and should have been highlighted but it wasn't.

BECKY: But what in the current financial regulatory reform can prevent any of those things?

BUFFETT: Well, I haven't read 1500 and some pages. But I have the feeling from what I've read about it that Congress is going in the right direction. I do think -- I think that people that have the ability to attract money with an FDIC guarantee, so they feel it's a government guarantee, if you have the right to do that, there better be some pretty tough rules on what you can do once you gather that money from the public. Because you are getting it because you have a government guarantee.

BECKY: Senator Bond, you are one of the 100 people who will be voting on that financial regulatory reform. Do you think that the bill is the proper bill and that it will be able to prevent some of these extreme situations in the future.

SENATOR KIT BOND: Not yet, Becky. But, Mr. Buffett, I agree with you, we saw a situation where they all get better looking at closing time in the housing market, but the housing market was a team effort. The administrations, both Republican and Democrat and Congress, pushed for no down payment home loans, nonrecourse loans. That was an invitation for disaster. There were a few of us who fought against it unsuccessfully. But there are certain bad practices that really should be stopped.

And I think you're totally right. There needs to be regulation of liquidity. There needs to be regulation of some of these devices. And, you know, the computer game derivatives that are not based in reality I think deserve to be covered. But I know you have spoken out about the end users who are in the Heartland, where you and I live, who have to hedge their risk, whether they're farmers, manufacturers, transportation companies. How should we distinguish between the legitimate hedging activities in financial institutions and the gambling derivatives which you have decried in the past as weapons of mass destruction.

BUFFETT: In distinguishing, it's really tough. But it's a job that has to be done because you talk about end users. I read an article in Business Week a couple of weeks ago about Anheuser-Busch in your state of Missouri. They use them for hedging purposes. We're on the Burlington Northern Santa Fe right now. We use them for hedging purposes with diesel fuel. And to the extent that people like Anheuser-Busch or Burlington Northern, for example, have to put up a lot of collateral, that is money that is not being used in their own business. I mean, it's being deposited back in Wall Street. So I think it is very important to have something that makes sure that end users aren't put in the same category as casino operators.

SENATOR BOND: Well, I know you have utility. And I talked to a regional utility in my state that has $100 million in derivatives every day to hedge the cost over the energy input. And if they had to clear it, it would cost them a billion dollars.

[CROSS TALK]

BUFFETT: And sure, Senator. If they put the money up there, that money is not being used to build wind farms. And so there are hundreds of end users that have signed on to an appeal to make sure they aren't put in the same category as people who are just basically gambling on them, you have a way that you have got bear traps out there, but they don't catch rabbits.

SENATOR BOND: Sheila Bair just said that you shouldn't have -- you can't take derivatives out of FDIC-insured institutions without increasing their risk.

BECKY: Yes, Sheila Bair, over the weekend, I don't know if you have seen these comments yet, is saying exactly that. She does not want to see the banks not allowed to do derivatives because it will only drive the derivatives and risky business to other institutions that are less regulated. Do you agree with that or should the banks be limited in what they can do with derivatives?

BUFFETT: I don't really know the answer to that. I mean, certainly, banks can use derivatives in ways that makes sense for the society, just in terms of floating rate to fixed-rate loans. There are various ways of doing it that have a very proper business purpose. But I think if they are betting on the price at some variable 20 years from now -- when I took over GenRe, there was one derivator contract that lasted 100 years, and that meant for 100 years, no money changed hands, people put marks on it every three months and the trader got paid based on it and people got to report earnings based on it, and so it's hard for me to see that that is serving a wonderful social purpose.

BECKY: Charlie Munger has a much tougher view on derivatives. We heard from him earlier. He says that they should only be allowed on things like energies, commodities and currencies, I believe, or maybe metals. How do you pair up what you think with what he thinks?

BUFFETT: Well, Charlie is a little more Old Testament than I am. I've got a lot of Old Testament in me, too. But Charlie is right and I'm usually wrong. But I think that there can be proper uses of beyond the areas he named, but I would agree with Charlie that -- well, the S&P 500 contract is the ultimate derivative. I mean, it's a bet on an index and it trades by the billions of dollars on tiny margins and it isn't dealing with professional investors all the time. It's dealing with people that don't know a thing about stocks and bonds and are betting on whether the market is going to be higher 10 minutes later, an hour later. And it's really hard to imagine what the useful purpose is of dragging in people on tiny margins to gamble on what the stock market is going to do that day.

BECKY: We have much more to get with with Warren Buffett. We're going to talk more about the economy because Mr. Buffett, through his businesses, has seen a turn coming in the economy. We'll get the specifics on that and his read on the strength of the American consumer. "Squawk Box" will be right back.

This is part two of Becky Quick's interview with Warren Buffett on CNBC's Squawk Box, Monday, May 3, 2010.

BECKY: We are live in Omaha with Warren Buffett. We've been talking about a lot of the issues facing Wall Street, facing financial regulatory reform. But we have also been looking at the economy over the weekend here. Over the weekend, we got the chance to speak with Matt Rose who is the CEO of Burlington Northern Santa Fe. We're sitting on one of his rail cars right now. The railroad is one of the first that sees turns in the economy. They talk about the coal shipments moving as they see retailers ordering more or less.

And over the weekend, we got to speak with Mr. Rose to ask him what he is seeing right now in the railroads. Listen in.

MATT ROSE: We monitor 22 commodity groups across the railroad. Everything from iron, steel, metals, containers, coal, chemicals, automobiles. And if you look at last year, every one of those commodity groups were negative. If you look at last week, every one of those 22 were positive.

BECKY: That tells us a little bit about how far we've come in this economy. But, warren, you look at a lot of different factors in the economy. This is a particularly difficult time to try and figure out what's going on. Where do you think we stand right now in the economy?

BUFFETT: Well, actually, it may not be quite so difficult. A couple of months ago when we talked, I said we were seeing little bits of improvement here and there, but it was pretty spotty. In the last couple of months, in most of our basic businesses, we have seen real strength, so the economy has picked up I think a lot of strength in March and April. It won't be translated into huge changes in unemployment soon, but the economy is starting to move.

BECKY: Where do you see it? Which businesses?

BUFFETT: Well, we see it particularly in our businesses that supply other businesses across the spectrum. Now, IGCAR, we sell these small cutting tools that are used in big machine tools whether at Boeing or General Motors or heavy industry all over the world. And we have seen a really huge pickup in March, started in December. It was gradually improving just a little bit. And it really has taken off.

And we have a company that handles the distribution of electronic components down in Fort Worth. It sells all over to everybody in sight. It has been booming. I mean it's huge. We're glad we've got inventory because it's flying out the door. And that's going to thousands of customers all over. So there has been a real change in the last few months.

BECKY: This is more than just rebuilding inventories?

BUFFETT: Yeah, it is more. We can't rebuild our own inventories because it's moving so fast. No, it's much more. Nobody wants a big inventory of cutting tools or even electronic components because they are putting them into products right now. They are manufacturing right now. So there's a big pickup. I don't mean we're back to where we were three years ago or anything of the sort. But the economy is moving. Incidentally, that's what I would have expected in this world.

The American economy is an amazing engine of growth over time. And we may try to mess it up occasionally. And we go to excesses and we make mistakes and all of that. But if you look at the history of the country, I mean this country works. It's a mistake to bet against it.

BECKY: Is this a sharp "V" snapback recovery?

BUFFETT: It's a pretty big snapback. "V" conveys you get back to the top quickly. But it's a long way -- it's very different than some saucer-like thing that is very elongated. It's a real movement.

BECKY: Most of what you have mentioned, though, these businesses are industrial businesses. Do you see it in your consumer lines as well?

BUFFETT: We see it to a degree in consumer lines. I mean at NetJets, our jewelry business and all, those are coming back. People have regained confidence. They were paralyzed, you know, a little over a year ago. And our customers flying on NetJets, they still own the planes, they were still paying the monthly fee. They just weren't flying as much. They weren't buying jewelry.

All that, we're seeing a pickup in. It's not back to where it was, you know, two or three years ago, but behavior has really changed.

BECKY: We talked to Mohamed El-Erian and you know him.

BUFFETT: Yeah, sure.

BECKY: He's got a theory that PIMCO has been focusing on about the new normal, about consumers not going back to the same rate of spending. They have got a lot of debt they have taken on. Their house prices have not come back. Is that a fair and valid assessment of the economy as well? And how do you match that up with what you are talking about?

BUFFETT: Well, for years what you might call the normal was just leveraging up more and more, so it was getting to higher layers. I don't think that's going to happen. But consumers, you know, the ones that can handle like to spend. I mean we saw them this weekend at our furniture store, you know. In a week, we sold $35 million worth of goods. That's a lot of goods to move in Omaha, Nebraska in a week in a home furnishing store. We saw a lot of jewelry sales. The American public over time is going to spend money. What we don't want them to do is keep leveraging up like they did and everybody refy-ing houses and taking money out of their houses and using it to consume. I don't think you need to worry about the American consumer over time.

BECKY: Not worry about them over time. But you just mentioned that you don't think the unemployment picture is going to improve drastically any time soon.

BUFFETT: It takes a while. I mean we are net hiring people at Berkshire. Last year we were letting people go every month. I don't know toward the end of the year exactly the figures. Now, we're hiring people. But, you know, they talk about jobs. We have jobs when we have demand for our goods. We're not going to hire somebody to stand around. So the best jobs program is demand. And demand is coming back. And that means we hire people.

BECKY: Corporations were dealing with incredibly high productivity numbers where they were squeezing more and more out of their employees. Do you think businesses across America are in a position where they have to hire?

BUFFETT: Well, we have to hire sometimes. I mean when the Burlington is moving 173,000 carloads, they need more people than at 155. I hope it goes to 200,000 and we'll need a lot more. But that's happening at some of our businesses. Not all of our businesses, but some of our businesses.

But the unemployment rate comes down slower than the rate at which business improves. So it's going to take a while on that. And residential housing is still very poor. I mean our brick business, our insulation business, those businesses have not taken off because, as I said in the end report, there's an overhang of inventory in residential housing. I think that will be gone within a year.

BECKY: Senator Bond has a question as well. Senator.

SENATOR BOND: Thank you, Becky. Mr. Buffett, you talked about we're doing well lest somebody messes up. And you're right and I agree with you. There's basic strength in the economy. But I'm very worried that the small businesses are not hiring and growing. They are worried about taxes going up. They are worried about the interest rates. And I would appreciate your view on whether we are looking at paying much higher interest rates on the debt we're running up. We just saw that advisers are saying that governments that are running deficits are going to have to start paying higher interest rates.

When are the Chinese going to start demanding significantly higher interest rates on U.S. credit spreading high interest rates throughout the economy?

BUFFETT: It's certainly hard to imagine deficits like we have been running or other countries have been running being consistent with low interest rates over time. So, you know, if you could really run deficits of 10 percent on GDP and not have anything bad happen, people would have figured that out a long time ago. It's too much fun to do.

But there will be a price to be paid for the medicine that we used in order to break out of our panic situation, the huge deficits. And, you know, our Congress, but governments around the world are going to have to come to grips with how they bring down those deficits or people will get very afraid of lending money. Who wants to lend money to somebody that is going to follow a long-term policy of running deficits 10 percent? It's unsustainable over time.

And if you can borrow in your own money, what you have is you sowed the seeds of terrific inflation down the road. And if you borrow in other currency, eventually people quit lending you money.

SENATOR BOND: That message needs to go to the administration as well as Congress. I hope they will listen to you.

BECKY: I believe Melissa has a question as well. Melissa.

MELISSA LEE: Yeah. Mr. Buffett, I wanted to get back to the issue of Lloyd Blankfein, if we can for just a moment. I understand that you have confidence in him as a CEO. And he certainly has done a lot for shareholders during the financial crisis. But is it possible at this point in time in Goldman's history when it's soul-searching and trying to signal a culture change at the company that perhaps it would be best for the company to have a new CEO?

BUFFETT: You know, he's going through a tough period. But incidentally, Goldman Sachs, as I remember back around 1970, there was, you know, a big problem about Penn Central and the commercial paper and there was another problem when Gus Levy was in charge then. John Weinberg was in charge some years back when something connected with the Boesky Trading caused a problem with Goldman Sachs.

I mean you run a business for 140 years, you're going to have problems from time to time. But listen, I'm sure we've got problems at Berkshire. We have 260,000 people working for Berkshire. Can you imagine that, you know, we can have a city of 260,000 people and nobody is doing anything wrong?

MELISSA: Sure.

BUFFETT: All we hope is we find -- I think it would be a terrible mistake to do anything with Lloyd.

MELISSA: Well, it is interesting because he is the only financial company CEO to sort of have survived the financial crisis. You had said earlier to Becky that if Lloyd came to you, you'd say absolutely stay on. If Goldman's board came on and said we are thinking about replacing Lloyd, you would say no, keep him?

BUFFETT: I would disagree with them.

MELISSA: You would disagree with the board?

BUFFETT: I don't think Goldman's board has any notion of doing that. And, you know, when we put $5 billion into Goldman in September of 2008, which was not the easiest time to invest in anybody, we had been approached by the management of numerous other large financial institutions, including large investment banks and we turned them down.

MELISSA: Sure.

BUFFETT: So I felt the best about Goldman in terms of not only its business operation but in its risk control.

MELISSA: Some observers, Mr. Buffett, might compare this to your investment in Solomon in 1987 when you took a 12 percent stake. Is that fair? Because that certainly is going around the trading floors. There are comparisons of Goldman's structure versus Solomon's structure during the crisis in 1991.

BUFFETT: Well, in the case of Solomon, there was no question when I got called back there in August of 1991, there was no question something very wrong had been done, but it had been done by a bond trader. And then the top management did not report promptly at all the transgressions of this particular trader. And the real problem at Solomon was to essentially take away the stain that was on 8,000 people and place it properly on the stain of a bond trader that had broken a bunch of government rules.

But we knew exactly what happened. We found out exactly what he had done. He clearly had broken the rules. And we went down and presented all the evidence to the proper authorities. And we got rid of the guy and he went to jail for a short period of time. That's a different case than this.

JOE: Warren, the FT seems to think that Goldman at this point is making some moves to overhaul some of its practices as a precursor to a possible settlement. Do you think the SEC would like to settle? When you talk to Blankfein, has he asked you, do you think a settlement is the right move to make? Do you think it is?

BUFFETT: Well, sometimes it gets into a business decision regardless of how you feel about the merits of a case. But I have not talked to Lloyd about a settlement whatsoever. The SEC, historically, I think they'd like to settle most things rather than try them. But generally, in the judicial system, judges like you to settle rather than go to trial. So who knows how it will play out. But I do not see anything in the Abacus transaction -- and I have looked at it. I do not see anything in the Abacus transaction that would cause me to want to settle simply on the legal aspects of it. If it becomes a business decision, that's something for the board of directors of Goldman Sachs to figure out.

BECKY: Warren, over the weekend, you said if you had to bet your life on either higher inflation or lower inflation, you'd take higher inflation and potentially much higher.

BUFFETT: Yeah. We are following policies which will lead to inflation accelerating. There's no question about that. The question is whether we will change those policies before, you know -- you lit this fuse basically. And it's a long fuse. And you can change policies and, therefore, blow out this fuse that's going toward the dynamite. But if you don't, the dynamite -- it will get to the dynamite eventually. And countries that borrow larger and larger amounts of money in relation to their output, in their own currency, pretty soon -- at some point decide they don't want to pay it back with currency at the same purchasing powers. And the problem about inflation is it creates its own dynamic once it gets going. And we had that in late 1970s and it took Paul Volcker and a meat axe to stop it. And he was probably the most unpopular man in the United States for a period of time.

But we got to 15 percent or so interest rates for governments in a 21 percent prime rate. If Volcker hadn't come along, who knows what would have happened. So you don't want to play around with inflationary gain.

BECKY: But you were very much in support of the government taking the actions it did to stop and stem the financial crisis when it occurred. What have they done that you think has been too much? Or have they done anything?

BUFFETT: No, I think they went all in. And the American public needed to see they were going to go all in. When the whole world wants to deleverage, the only party that can leverage is the government. And the United States government did something perfectly proper. Whether they did it perfectly, nobody knows. But what became clear in the fall of 2008 is that the chairman of the fed and the secretary of the treasury and Sheila Bair at FDIC were willing to do extraordinary things to essentially prevent a panic. And they were the only ones that could do it. And I cheer them mightily for that. That was the medicine applied to a cardiac. And now we have to deal with the aftereffects of the medicine. We had unprecedented amounts of medicine so we may have unprecedented difficulties in weaning us away from the problems that result from that medicine.

BECKY: Jim Owens is the CEO of caterpillar. He has an Op Ed in today's "Wall Street Journal" where he lays out some of the things he thinks should happen to make sure America gets back on the right path. One of those is making sure we have a very strong and independent Federal Reserve. Another is that American companies should only be paying taxes on their American profits that they are kicking out. And that that would mean companies that have international operations could bring more back to the United States. Do you think that that is a good theory?

BUFFETT: Well, the second part of it, if you are talking about reducing taxes on corporations, which is what that is, you know, we have a huge gap between taxes and expenditures. And somehow that has to be narrowed. And it probably won't be narrowed by tax cuts. So I respect him enormously. And I know what he's talking about. But in the end, we are taxing 15 percent, not much more than 15 percent at GDP and we're spending 25 percent of GDP. That is not sustainable.

And the idea of cutting taxes on anyone or any entities from this level, you know, I mean I think that would be sending the wrong message about what we regard as the sanctity of our currency over time. If I were a bondholder in the United States and I saw that we were widening the gap by cutting taxes, that would bother me a great deal.

BECKY: If you -- I would say most people in this country realize taxes are going higher. But the debate is how much higher and who exactly is paying their share of the taxes.

BUFFETT: True.

BECKY: Is there a point where you get worried if taxes are raised to a certain level, whether that be against American corporations, whether that be taxes that are levied against the wealthiest Americans? Is there a point where you think there's a tipping point?

BUFFETT: Well, we have to eventually get the gap between expenditures and receipts down to maybe 2 percent of GDP. We can handle 2 percent of GDP and growth takes care of that over time, or 3 percent perhaps. But you can't have 10 or 12 percent.

And taxes, you know, everybody is going to scream. And if you cut expenditures, everybody is going to scream. And the question is whether Congress will have the will to do what needs to be done. And it won't be easy. I mean, you know, Russell Long said it, you know. Don't tax you, don't tax me, tax that fellow behind the tree. And that's the way we all feel.

But over time, we have been pretty responsible in this country. Since World War II, we came out with 120 percent debt to GDP. And we have brought that down into the 30s. I mean we were willing to keep our expenditures under control and tax. And we did exactly what is proper in the last two years, year and a half. We had to stem the panic. We had to restart the engine of America and we did. And now we've got to figure out what we do next.

BECKY: You mentioned two things, though. Also bringing down expenditures. And since that time, there have been a lot of new proposals that have either been put on the table or have actually passed and been put into action. Are those new expenditures going to get in the way of being fiscally responsible?

BUFFETT: Sure. You know, I mean it's easy to promise. And you can promise away the entire GDP, you know. But your promises don't grow more corn or turn out more automobiles. In the end, somehow like a family, like any kind of organization, you have to figure out a way so that your expenditures are in reasonable balance with your income.

And like I say, you can run a couple percent of GDP. But we have gone through a war of sorts, just like when we went through World War II. We ran up the debt enormously in World War II. Enormously. But we then followed the proper procedures after World War II to get it back in line with where it should be. We have to do the same thing after this economic war.

BECKY: Do you think we're on the right track?

BUFFETT: Well, I think it's just now is about the time to get started. I'd probably let the recovery go a little further. I'd want to be sure that we were gaining strength. And I would want the American public to feel we were gaining strength. I mean you need that to get the popular will. But it's something that has to be addressed soon.

BECKY: We are watching what happens when it's not addressed play out right now in Greece. There was an agreement over the weekend that the IMF and the EU will be stepping in to make those loans. It will come with some very strict austerity measures from the Greeks. But there are people today saying it still won't matter, it still won't be enough. The contagion will continue to spread and at the end of the day, this is just a Band-Aid on a problem that will continue to fester. What do you think?

BUFFETT: It's hard to tell. You have this unusual situation in the European Union where individual countries are sovereign in determining their budgets. They may get pressured by others, but they are sovereign in terms of their budgets but they can't print their own currency. We can print our own currency. We can always pay our debts in the United States as long as we borrow in dollars. We just keep printing more dollars. The Greeks can't do that or other members because they are tied to the euro, but they determine their own budget. It's going to be very interesting to see how this plays out because, you know, if you can sort of behave irresponsibly as one member and expect the other members to bail you out, that's an inducement, real inducement for everybody not to behave so well. So I don't know how it's going to come out in Europe.

BECKY: What about Portugal and Spain and even potentially Italy?

BUFFETT: Well, I don't know the countries involved. But you can say every member -- once one member sort of gets away with misbehaving to some degree in terms of their own budget and others bail them out, you know, that is the ultimate in moral hazard. That's what we talk about all the time in this country. And it's happening on a big scale in Europe. I don't know what will happen there. It's going to be an interesting movie to watch, but I don't know the ending.

BECKY: You have made bets on currencies in the past. How confident and comfortable would you feel with making a bet on the euro?

BUFFETT: I don't feel confident now in making a bet on any currency versus another, in other words, the euro, the pound, the yen, the dollar. I think all currencies are likely to lose value in terms of purchasing value. And if you are betting on one versus the other, you essentially are trying to guess which one will depreciate in value the most. But I don't like betting on the future purchasing power of any currency.

BECKY: You don't like betting on the future purchasing power of any currency. But would you say that the IMF and the EU have dealt with this properly to this point to try and jump in?

BUFFETT: I don't know how it's going to play out. They have to do something. And what they have to avoid is contagion and moral hazard. And who knows what's going on in the mind of bond investors all over the world. As we said here, when they see a situation where the credit defaults went to where they were went in Greece and all that, you know, predicting economic behavior gets very tough when you get into sort of uncharted territory like this. And like I say, I don't know the answer, so, therefore, I'm not making any bets.

BECKY: Warren, I'd like to play some sound from Charlie Munger. We spoke with him over the weekend. Charlie has a way of putting things.

BUFFETT: He does.

BECKY: To drive home points quite well. He talked a little bit about envy. He was talking about where the Street is headed, what can be done to try and bring the Street back into line. And I believe his comment -- again, I'm not sure if we have this right now in the control room. But this comment on envy that he had is one -- I'll read it to you if we can't find it. He said -- you have it right now? Let's play that soundbyte from Charlie Munger. And, Warren, you can listen in and see what he said.

CHARLIE MUNGER: Envy is a much more serious mischief-maker than greed.

BECKY: How so?

MUNGER: There's something in human nature that just can't stand even if you are making $5 million a year, that dumb bastard down the street is making 7.

BECKY: So those were his comments. He thinks envy is the biggest problem, not greed.

BUFFETT: Yeah. We saw a lot of that at Solomon. I mean you'd say how could a guy that's making 3 or $4 million a year be unhappy? And he's not unhappy until he finds the guy next to him who he thinks he's smarter than making a few dollars more. And as I always said, envy seems to me the silliest of the seven deadly sins. The other guy doesn't feel it. You just feel worse. You are sitting there with your stomach churning because you are envious. It doesn't make a lot sense.

I have always said, you know, if you are going to pick some sins from the seven deadly sins, go with gluttony and lust and you can have a hell of a weekend.

BECKY: But is there any way to legislate or regulate human emotions like that?

BUFFETT: No.

BECKY: Is there anything Washington can do?

BUFFETT: No, you can't do much. I tried on envy, various ways on compensation at Solomon. And I'm a failure at controlling envy. And you have to decide and you have to devise incentive systems for everybody that you work with.

And incidentally, that's one of the objections I have to the new bill on derivatives. I think it's a good thing overall, but I think that unless you change the incentives for the CEO and the directors of really large financial institutions, they have got all the upside and they don't have downside.

What director of any one of a half a dozen institutions we could name that have cost shareholders hundreds and hundreds and hundreds of billions of dollars who is really suffering financially? They may suffer in terms of losing prestige, but they are go away rich. The directors are still getting 200 or $300,000 a year. The CEO's still have their multiple houses and everything.

I would have something there if you run a large financial institution and you end up having to get saved by the U.S. Government, that you and your spouse are broke and that the directors pay a significant price themselves, not that drastic. And then you will change human behavior that way. You can change behavior by incentives, but you can't usually change behavior by sermons, although people try every Sunday.

BECKY: Do you have directors and officers insurance at Berkshire Hathaway?

BUFFETT: No. If Berkshire goes down, everybody goes down, and they should.

BECKY: Warren, just a final thought. Again, Goldman has been the biggest headline over the last several weeks. Where do you think we head next? What happens next at Goldman?

BUFFETT: Well, it's conceivable there's some settlement. There always is when two parties disagree on something like this. Otherwise, it plays out over a long period of time probably. You know, our Solomon -- Solomon took us nine months and four days. Nine months and four days. It felt like nine months and four days. Every day was painful. But it does play out over time.

BECKY: It does play out over time. Okay. Another question. One thing to take a look at is your thoughts on Moody's and the ratings agencies. You defended the ratings agencies or at least their business model over the weekend. Is this --

BUFFETT: Well, I said they have got a great business model. I mean they charge us a lot of money, and I can't negotiate it downward. I mean I can't say if Moody's and Standard & Poor's want to rate Berkshire or I need their rating, I can't go to them and say: How about doing it for 10 percent less or I'll go to XYZ? They have got me. So they have pricing strength. And it's a business that requires no capital whatsoever. So here is a business with zero capital in it that has great pricing power. That doesn't mean I defend all their actions or anything, but it does mean that they have a terrific business unless it, you know, gets changed in some way by legislation.

I think they made the same mistakes that everybody else made. I think they had a model in their mind and actually a model on paper that said residential real estate can't fall off a cliff. And once they have the wrong model, they have got the wrong answer. But they were no smarter and probably no more stupid than most of the American public. And people may feel that they should have been smarter. I mean that was their business.

BECKY: All right. Well, warren, we want to thank you very much for joining us today. We appreciate your time.

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