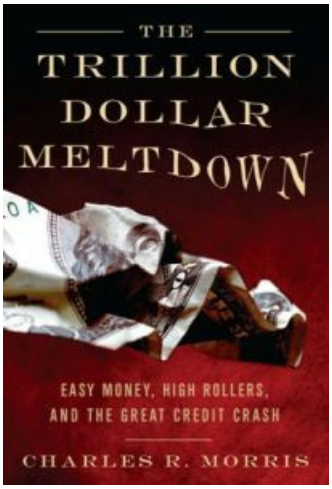

Book The Trillion Dollar Meltdown

Easy Money, High Rollers, and the Great Credit Crash

Charles R. Morris
Public Affairs, 2008
Listen now

- play
- pause

00:00
00:00

Recommendation

In this excellent, highly readable book, Charles R. Morris combines legal and financial experience with literary craft. No ideologue, no partisan and certainly no salesman, Morris traces the roots of the 2007-2008 mortgage securities crisis to its distant origins in the 1970s. He argues that policy missteps under the Nixon, Ford and Carter administrations, when Arthur Burns chaired the Federal Reserve, led to dollar debasement. He contends that the decline of America's currency and its business sector at that time led in turn to the Reagan administration's zeal for deregulation and Chicago-school economics. He details his belief that Alan Greenspan's policies took America from a relatively healthy financial status to a position perhaps as dire as in the late 1970s. Morris also reveals the privileges enjoyed by an out-of-control financial services system. *BooksInShort* found this to be a trenchant and provocative read.

Take-Aways

- The inflationary 1970s were a decade of fiscal misery for America.
- Arthur Burns chaired the Federal Reserve for much of the 1970s, presiding over 37 months of negative interest rates.
- Americans embraced deregulation and its early benefits with excessive zeal.
- Deregulation contributed to agency risk: Financial firms could make risky bets and reap profits if the bets paid, but leave the losses to be socialized if the bets failed.
- Excess reliance on questionable models has contributed to several financial crises since the 1980s.
- The year 1994 offered an uncanny precedent for the 2007 mortgage crisis.
- In the '70s and early '80s, Fed Chairman Volcker brought inflation under control by taking advantage of all instruments at his disposal.
- His actions offer a model for steps the Fed should be taking now.
- The U.S. financial sector shows no sign of admitting the full scope of the economy's current problems and no zeal for Volcker-like resolve.
- Failure to tackle these problems could result in a long, lingering financial malaise, like Japan's.

Summary

Two Roads and a Choice

In June 2007, two Bear Stearns hedge funds ran into trouble after a downgrade. The firm had to pay billions to assume the hedge funds' mortgage-backed securities holdings. Shortly, the contagion spread as banks worldwide took hefty write-offs. Central banks in North America and Europe opened the money spigot, to little avail. Even experts seemed to have no way of predicting how far the value of complex, mortgage-backed securities could fall – and how much damage their collapse would

cause throughout the financial system. History marked out two roads and gave policy makers a choice. Then-Federal Reserve Chairman Paul Volcker took the first road in the late 1970s and early 1980s when he courageously, forthrightly grappled with the challenge of wringing inflation out of the U.S. economy. He restored confidence in America's financial institutions. Japan took the second road after the collapse of its 1980s bubble. Japan did not admit its problems or deal with them straightforwardly. Instead, it concealed the problems, avoided responsibility and failed to take its medicine. As a result, Japan's financial sickness lingered for a long time. Indeed, its financial system still has not quite recovered. In the present mortgage crisis, America seems to be following the Japanese course.

Liberalism: In Dollar Terms

From 1973 to 1982, the U.S. registered dismal economic growth, high inflation and a collapsing currency. Its industries were uncompetitive in domestic and international markets. Oil exporters drove up prices, but only in dollar terms. Calculated in gold, the price of oil was rather stable. Foreigners bought up America's corporate crown jewels. This decade brought stagflation and the misery index, the sum of the inflation rate and the jobless rate. This happened for three reasons:

1. **Business failure** – Major U.S. businesses embraced anti-competitive market sharing arrangements throughout the 20th century. Such arrangements in the steel industry, for example, provided no incentives for technological innovation. Labor participated in the system for a share of the spoils. Instead of focusing on core businesses and learning to create more value in them, corporations diversified willy-nilly. They became unwieldy conglomerates. Business schools taught students how to administer large organizations bureaucratically. Executives knew little of the shop floor. U.S. firms were sitting ducks when Japanese and German competitors entered the market in the 1970s.
2. **Demographics** – The baby boomers were ready to go to work in the 1970s. They were young, unskilled, inexperienced and unproductive. With that kind of labor in abundance, wages fell. Cheap labor and expensive capital resulted in less investment.
3. **Bad economic management** – Inflation soared in the early '70s. Currency traders attacked the dollar. The standard defense would have been to increase interest rates, but that would have courted recession. Instead, President Richard Nixon reduced taxes, controlled wages and prices, and closed the gold window, effectively destroying the Bretton Woods system. Then-Federal Reserve Chair Arthur Burns increased the money supply. Growth surged; Nixon won re-election in 1972. But the long-term damage was severe. Floating the dollar while increasing the monetary supply led to a debasement of the currency. By the late '70s, inflation hit double digits, the dollar was tanking and economic output was falling. Faith in the government's ability to micromanage the economy faded. The time was ripe for a new ideology.

Wall Street Comes to Chicago

The new ideology, "Chicago-school" economics, which supported free markets, took America by storm. To some extent this was because pundits mistook correlation for causality. A 1978 reduction in the capital gains tax preceded a sharp increase in venture capital and investment, helping such startups as Apple, Compaq, FedEx and Sun Microsystems, among others. But did the tax cut lead to the investment boom? No. Most of the new capital came from tax-exempt pension funds, so the tax cut was irrelevant.

> "The American financial sector today is far more powerful than it was in the 1970s. And to date, its response to the looming crisis has been, overwhelmingly, to downplay and to conceal."

Another apparent but illusory confirmation of free-market ideology was the correlation between President Ronald Reagan's decontrol of oil prices and the subsequent fall in the price of gasoline. Analysis after the fact suggests that the fall in energy prices had more to do with an increase in energy efficiency throughout the economy – indeed, worldwide. Energy efficiency meant less demand for oil, even as political and economic stresses were breaking the OPEC cartel.

Paul Volcker and the Fed

Paul Volcker took the helm of the Fed in 1979. He knew that his job was to slash inflation and put the financial system in order. Monetarism, a theory developed by Chicago school economist Milton Friedman, said it was possible to control inflation simply by controlling the money supply. Volcker made a public commitment to monetarism. Did it work? Not really. In fact, the members of the Federal Reserve Open Market Committee were not even sure what the money supply was. New financial inventions made it hard to keep track of what was – and what was not – money. Volcker's announcement had strong PR value and he followed up by relentlessly, aggressively using every available lever to ratchet down inflation. Interest rates hit previously unimaginable heights. Recession was inevitable, but the U.S. accepted it as the price of recovery.

Mixed Policy Record

Presidents claim credit for good economic circumstances, but don't deserve as much as they take. Reagan believed in lowering taxes and deregulating markets. His economic legacy includes the boom in leveraged buyouts (wherein acquiring holding companies purchased and dismantled major corporations, selling off their component parts), which early on did a good job of cleaning the deadwood out of America's major corporations. After about 1985 though, LBO frenzy got out of hand and the market eventually collapsed. Reagan-era deregulation contributed to the savings and loan debacle, as entrepreneurs took advantage of deregulation to loot financial institutions and leave taxpayers on the hook. The era's lesson is that letting market forces exercise creative destruction does have some benefits, but deregulation also bears associated risks.

> "That is a path to turning a painful debacle into a decades-long tragedy."

Similarly, President Bill Clinton and his treasury secretary Richard Rubin claimed credit for an economic boom in the 1990s. However, the boom had more to do with demographics. Productivity increased because the inexperienced baby boomers of the 1970s had become seasoned practitioners of their professions and trades. They learned from Japan and took advantage of new technology. With military spending declining and Social Security tax surpluses building, a boom was more or less inevitable. Then the Clinton era gave us the dot-com bubble.

Bubbles

Three 1980s and 1990s crises – involving portfolio insurance, collateralized mortgage obligations and the Long Term Capital Management hedge fund – prefigured the crisis of 2007.

> "For connoisseurs of misery, the ten years from 1973 through 1982 are a feast of low points."

In 1987, complex financial models led to a stock market crash. The models underpinned so-called portfolio insurance. For a brief time, major investors could use these models to sell stock index futures as a way to hedge against a possible fall in their stock portfolios' value. But with most major institutional investors using the same models, the effect was not so much to protect as to magnify the impact of any market decline. In 1994, about a decade after the advent of complex mortgage-backed securities, their market crashed when the values the models had predicted proved unrealistic.

> "The real problem was that America had debased the currency."

Larry Fink and a team at First Boston invented the collateralized mortgage obligation (CMO) in 1983. They transformed ordinary mortgages into bond-like instruments with a menu of yields and risk alternatives. Wall Street ran with the innovation. Mathematicians designed extremely complicated variations. Some of the securities were high-quality, but they always left behind a residual, called "toxic waste." Some hedge fund investors specialized in high-return, high-risk, toxic waste securities. In 1994, a highly leveraged toxic waste hedge fund ran into trouble after the Fed hiked interest rates. The hedge fund's manager used models to calculate the prices for these illiquid securities, but the banks' models set different prices. When the manager attempted to sell some of these securities, no buyers emerged. In other words, regardless of what the models said, the market answered that the instruments were nearly worthless. Bear Stearns aggressively moved to seize the fund's assets, leading to a run that obliterated the fund and threw a wrench into the CMO market. The CMO market rout cost $55 billion and stalled the mortgage market for years.

> "Volcker broke inflation simply by clamping down very hard and very persistently, using every weapon at his disposal – interest rates, money supply, jawboning."

In the late 1990s, financial sophisticates at Long-Term Capital Management, a hedge fund established by the illustrious John Meriwether and his Nobel Laureate partners, Myron Scholes and Robert C. Merton, failed stupendously, putting the entire financial system at risk. The fund's elaborate models did not allow for correlations that became evident during crises in Asian, Latin American and Russian debt markets. More worrying, the hedge fund's investors included numerous major banks. Regulators had no idea how much risk LTCM's failure would pose to the financial system. The fund's partners had $100 billion in positions, but only $1 billion in equity.

> "It is a canon of Chicago-school economics that government resource allocations always reduce productivity. As a blanket proposition, that's evidently wrong."

These three crises began in market niches that were not on regulators' radar screens. They broke in an era when even America's most important financial regulator – Fed Chair Alan Greenspan – was antiregulation. Agency risk was high, because deregulation made it easy for financial-industry entrepreneurs to reap profits for themselves while making the public pay the losses.

A Flood of Dollars

Habitually, Greenspan responded to crisis by expanding the money supply. Traders began to refer to this predictable response as the "Greenspan put." He is largely to blame for the dire straits of America's financial system. He ignored the inflation in asset prices, evident in the stock market bubble of the 1990s and the subsequent real-estate bubble, the biggest real-estate bubble in world financial history. This real estate boom was not without benefits. Home ownership expanded, and members of racial minorities hitherto excluded from home ownership finally had a chance to achieve it. However, predatory lenders flourished. Brokers exploited the ignorance and inexperience of the most vulnerable buyers, saddling them with complex new mortgages that exposed them to unconscionable risks.

> "But the breadth of the current financial crash suggests that we've reached the point where it is market dogmatism that has become the problem."

At the debut of the Bretton Woods system, America, then a creditor nation, held most of the world's money. Now the U.S. is a debtor to peripheral countries, especially in Asia. These countries are beginning to shift their investments out of dollar-denominated securities. The dollar is losing its status as the world's reserve currency. This will result in an increase in U.S. interest rates and probably a sell-off of America's major corporations.

> "The 'wall of money' that has kept American markets afloat also created a global dollar tsunami that has left a waterlogged world in its wake."

It is possible to address these problems, but it would take the kind of decisive perseverance that Volcker exercised in the late 1970s and early 1980s. Regrettably, the U.S. financial sector shows no sign that anyone is willing to admit the full scope of the problems and take the kind of firm action necessary.

> "It's hard to imagine a worse outcome – the United States, the 'hyperpower,' a global leader in the efficiency of its markets and the productivity of its businesses and workers, hopelessly in hock to some of the world's most unsavory regimes."

Worship of the free market has cost America dearly. Financial entrepreneurs have despoiled workers. The rich are getting much richer and the poor are much poorer. The market system in health care has served Americans poorly. The U.S. has deregulated and privatized even those functions that government performs efficiently and cost-effectively. The U.S. created Sallie Mae to make education loans available, but then privatized it. Its CEO made a personal fortune, but students now struggle under a burden of debt. A much less costly government loan program exists and could expand tuition grants widely.

> "That's where a quarter-century of diligent sacrifice to the gods of the free market has brought us. It's a disgrace."

Irrational deregulatory zeal is also evident in proposals from President George Bush's administration to privatize Social Security, a plan that would place pensioners at risk but would put more profits in the pockets of Wall Street firms.

The financial-services industry's privileges and perquisites have led to exorbitant profits. These firms, uniquely, do not really face the risk of failure. Because their failure

might endanger the financial system itself, these financial service firms' losses are socialized. America must find a better way.

About the Author

Charles R. Morris, a lawyer and former banker, has published articles in numerous publications and has written 10 books.