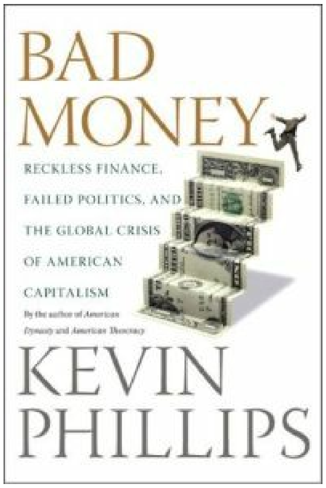


# Book Bad Money

## Reckless Finance, Failed Politics, and the Global Crisis of American Capitalism

Kevin Phillips
Viking, 2008
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## Recommendation

Many readers already admire Kevin Phillips's previous books, with their incisive analysis of U.S. politics. In this treatise, published just before the 2008 presidential election, his main concerns are the dangerous dominance of the financial sector in the U.S. economy and the fiscal implications of peak oil. Phillips covers many other hazards, from securitization to the real estate bubble. He provides historical background to explain modern financial circumstances, whacks both the Bush and Clinton administrations, and offers his take on everything from imperial England to the efficient market hypothesis. After he explains how and why the U.S. is teetering dangerously on the brink of disaster, *BooksInShort* is relieved to report that Phillips also offers some ideas about how it might rescue itself by going back to strong manufacturing, solid education and better regulations. This seems to be a fairly hasty overview of bad times, but the author can see beyond the immediate storm to the possibility of a brighter day.

## Take-Aways

- Finance has a disproportionate role in the U.S. economy.
- Excessive reliance on the financial sector has doomed past empires and threatens to doom the U.S. in the very near future.
- Blind faith in markets prompted reckless deregulation of the financial sector.
- Former Federal Reserve Chairman Alan Greenspan presided over a series of bubbles, and failed to address some real monetary and economic problems.
- Neither major U.S. political party is prepared to meet the challenges ahead.
- The dollar's links to oil are so strong that some experts refer to an "oil standard" in place of the old gold standard.
- Spain, Holland and Great Britain became imperial powers thanks to their energy sources, and faltered when they relied on finance to sustain their dominance.
- The U.S.'s 20th-century ascendancy depended largely on domestic oil reserves.
- Peak oil, perhaps reached in 2005, means that oil production is at its zenith and is unlikely to grow.
- A re-emphasis on wealth creation through manufacturing, education and political reform may allow the U.S. to step back from the brink of decline and recover.

## Summary

### Deceit and the Politicized Economy

The U.S. economy is weak and vulnerable, yet officials deny, obfuscate and understate the magnitude of the problems and the relationships among them. It is far from certain that the nation's politicians will be able to deal with the damage wrought by its policies on debt and oil. Underlying both issues is a far broader, more pressing concern: the metastasizing financial sector. This sector includes shadowy institutions that are able to create money, like banks, but that, unlike banks, are not subject to regulatory scrutiny. Proponents say that the financial sector's power made the economy more efficient and created wealth. That is nonsense. The growing dominance of finance in the U.S. political economy is a worrisome development. History demonstrates that when finance rises to such prominence, national decline is imminent – if not already under way.

## Summer Heat

Late summer historically has been the season of credit shortages, bank failures and financial disasters. In late summer 2007, the markets trembled over subprime mortgages. Credit froze and the trading of collateralized debt obligations slowed so dramatically it was no longer possible to value them by looking at prices as bid and asked. The government deficit was about $11 trillion; private debt neared $40 trillion. Total debt had multiplied four times in 10 years. The financial sector equaled more than a fifth of the U.S. GDP, while manufacturing was only a bit more than a tenth.

> "The most worrisome thing about the vulnerability of the U.S. economy circa [September] 2008 is the extent of official understatement and misstatement – the preference for minimizing how many problems there are and how interconnected they are."

Major financial institutions had slipped out of the regulatory constraints imposed after the 1929 market crash. They went beyond banking to engage in insurance, brokerage, real estate and other businesses. These institutions invented financial products whose risks no one really understood, but whose rewards enriched their traders and executives. Few acknowledged that this put the U.S. in a debt bubble, that finance's pre-eminence in the economy was a harbinger of decline, that the dollar depended for its backing (to the extent that it had backing) on oil produced and controlled by increasingly hostile entities, and that 2007's U.S. leaders could not cope with the these facts.

> "Outside the high towers of finance, the risks facing ordinary American households were growing."

In September 2007, George W. Bush's treasury secretary, Henry Paulson, told financial executives that unsound lending was to blame for recent financial instability, not "problems in the real economy." Spun in the media, his remarks implied that Main Street did not need to fret. Most Americans had no idea how profoundly the financial sector's problems would affect them. They were unaware that its share of GDP equaled the combined share of the seven Farm Belt states and the eight Mountain states. They did not know that the Financial Services Modernization Act of 1999 created new, dangerous financial system interdependencies by eliminating constraints and checks.

## A Short History of Debt

The start of the U.S.'s transition to being a society of debt started in the 1970s. In 1977, *TIME* wrote, "The Affluent Society has become the Credit Society." In subsequent years, financial deregulation and innovative products – like derivatives – allowed debt to swell tremendously, though gaps in official data make tracing its growth difficult. The most significant omission was private debt. The financial sector was in ascendance.

> "Adam Smith would have been amazed at the new financial services sector and its close interconnection with government, politics and power."

Margaret Thatcher and Ronald Reagan deliberately turned their economies away from the Keynesian economic orthodoxy that had prevailed since World War II. The Reagan years brought tax cuts, massive government deficits, the leveraged buyout boom, and the savings and loan crisis. White House free-market advocates promoted deregulation, but did not provide the needed oversight. The Federal Reserve arranged for a Saudi investor to rescue Citibank. Subsequently, it arranged a bailout for the junk bond sector. In the '90s, President Bill Clinton helped bring powerful people from the New York financial industry into the Democratic Party, where they became a crucial constituency.

> "Some opinion leaders in oil-producing nations believed that the invasion of Iraq mirrored a U.S. blueprint to pump and market large quantities of Iraqi oil...to break OPEC and drive down petroleum prices."

By September 11, 2001 – when terrorists took aim at the U.S.'s financial hub, Manhattan – the U.S. was running enormous current account deficits, purchasing abroad what it could no longer make competitively. A few observers saw the risk. One wrote, "Measured by its level of indebtedness, today's U.S. economy is the worst bubble economy in history." Meanwhile, foreigners poured money into U.S. markets, even as the Middle East and Asia began building large foreign currency reserves. These reserves later became a major concern. As U.S. worries grew about collateralized debt obligations, including mortgage-backed securities (whose value depended on increasingly undependable U.S. borrowers), foreign investors stepped back.

> "Petroleum-driven Anglo-American interest in the Persian Gulf goes back a long way. Denying that the motive is oil is often wise, though, and sometimes even necessary."

The failure of any major U.S. financial institution would have global repercussions. Fed and Treasury officials seemed to have no alternative but support and rescue. By the early 2000s, rumors circulated of a "Plunge Protection Team" created to prop up U.S. securities markets, like the President's Working Group on Financial Markets that Reagan established after the 1987 market crash. Such government support for financial services might have shocked Adam Smith, but old-fashioned mercantilists would have understood. To them, the goal of economic management was to maximize national wealth by any means necessary. In the U.S., this means supporting the value of financial assets, including homes.

> "Looking back a decade...a perverse incarnation of millennial utopianism crested in...'market triumphalism' – the belief that history was 'ending' because near perfection had been achieved through the enthronement of English-speaking democratic capitalism."

Home ownership is a cultural icon of English-speaking nations. It's no wonder that the 2008 real estate crisis hit hardest in countries with British roots. Former Federal Reserve Chair Alan Greenspan presided over a sequence of bubbles, but the real estate bubble was perhaps the most serious. As it grew, home equity loans let people tap the rising equity in their real estate. The deleveraging when the bubble deflated promised a severe, long-lived depression.

## Market Propaganda

Old-school Democrats like Harry Truman had little to do with the moneyed elite; Truman called them "bloodsuckers with offices in Wall Street." Even Republican Dwight D. Eisenhower did not support tax breaks for the rich and Richard Nixon set the tax rate on earned income at a lower percentage than the rate on unearned income (i.e., dividends and interests). He said, "Because speculators thrive on crises, they help to create them." However, Thatcher, Reagan and their disciples adhered to the Chicago School belief that markets were the most wise, efficient distributors of economic resources. The best thing the government could do for the economy was to step back and let the markets work without second-guessing. This ideology gave rise to deregulation, unrestricted financial innovation, the spread of speculation and the development of derivatives. The efficient market hypothesis said the market price was always, or almost always, the right price, because it comprised all the data available, including current facts and future probabilities.

> "Real estate slumps drag out longer than the nine-to-eighteen-month stock market declines associated with mild-to-middling recessions."

Until recently, the efficient market hypothesis was an article of faith, part of the economic religion that justified leaving hedge-fund traders, mortgage brokers, derivative engineers and investment bankers to their own devices. The government lived by the rule that the market is always right; it even manipulated statistics to make the rule seem truer than it was. When inflationary trends showed that cost-of-living adjustments (although expensive for the government), would lift retirees' nominal income to keep pace with inflation, the Bureau of Labor Statistics changed the way it calculated inflation. It emphasized items with falling prices over those with rising prices. It even tried using "hedonics," a calculation that said if a product's quality rose, its rise in price was not really a rise in price. Such adjustments let the government underreport inflation.

> "If banks are to be rescued because they are too big to fail, they must also become [like] a regulated public utility, too suitably behaved and too responsible to fail."

Economic faith in the efficient market hypothesis received considerable support from that old-time religion, the Pentecostal "prosperity gospel." The religion of the market resonated through the Republican Party's increasingly pivotal evangelical Christian base. Preachers of the prosperity gospel told their eager, often uneducated, blue-collar congregants that God wanted them to be rich, and would answer their prayers with prosperity.

## Asset-Backed Securities

Securitization was a form of financial engineering that packaged mortgages (good and bad ones, all in pieces), home equity loans and other debts into saleable securities. It let lenders reap fees from extending credit without taking on the risk of nonrepayment. U.S. financial institutions were responsible for most global issuance. Securitization essentially shifted risk from the financial institutions and companies most able to bear it to the middle-class citizens who were least able. U.S. borrowing rose in the '90s because real incomes stagnated or fell. Americans borrowed to stay even.

> "For both [political] parties, the bottom line is usually the same: the bottom line. Fund-raising. Money."

The remarkable thing about securitization is not its rapid, massive growth or incredible risks. The remarkable thing is that the institutions and experts running this business really did not understand what they were doing. No one knew what these securities were worth or how they would act in a crisis. Financial deregulation created institutions with complex, opaque interrelationships. They could create money outside the regulated banking system, with liquidity moving through unregulated, uncontrollable channels into the economy.

## The Coming Oil Shortage

Historically, energy resources have powered the emergence of empires. In the 17th century, the Dutch harnessed wind and water. In the late 18th century, coal was the key to Great Britain's power. In the 20th century, abundant domestic oil underpinned U.S. might. However, the modern U.S. has put itself seriously at risk with its dependence on foreign oil. The West's appetite for oil has long been the main driver of its Middle East policy. Great Britain invaded the neighborhood of Iraq in World War I and in 1941. The U.S. engineered a coup in Iraq in 1959 and, with Great Britain, invaded in 2003.

> "American financial capitalism...cavalierly ventured a multiple gamble: first, financializing a hitherto more diversified U.S. economy; second, using massive quantities of debt and leverage to do so; third, following up a stock market bubble with an even larger housing and mortgage credit bubble; fourth, roughly quadrupling U.S. credit-market to debt between 1987 and 2007...and fifth, consummating these events with a mixed performance of dishonesty, incompetence and quantitative negligence."

The world may be at or near the top of oil production or "peak oil." Some experts say production crested in 2005, leaving insufficient oil for growing global demand. The geopolitical implications of peak oil are already unfolding. National – and nationalistic – state oil companies in China, the Persian Gulf and Latin America are challenging U.S. dominance of the global market. Indeed, in many cases, they have avoided the market by arranging extra-market supply deals. Because U.S. power has long depended on access to oil, the struggle for oil is, in fact, a struggle for power.

The petroleum-exporting countries have substantial dollar reserves. They could attack the dollar, if they wished. In fact, they seem to have been shifting more of their reserves to the euro and away from the dollar. The fact that the dollar is weakening even as oil prices rise is telling. In the past, suppliers priced oil in dollars and invested their receipts in dollars, so oil and the dollar strengthened and weakened simultaneously. As a result, the oil standard has replaced the gold standard. So the dollar's weakening in the face of rising oil prices may be a symptom of a deeper, subtler realignment.

## Dodging the Issues

U.S. institutions seem as incapable of dealing with these challenges as were the leaders of other faded empires. The parties aggressively curry favor with financial interests. The muscular populism that characterized the Democratic Party is gone. Dynastic succession (Bush Republicans and Clinton Democrats) is troubling. So many vested interests connect these dynasties that real reform is almost unthinkable.

The pattern unfolding in the U.S. is similar to 17th-century Spain, 18th-century Holland and 20th-century Britain: The rise of finance occurred simultaneously with the erosion of real national power. This means American capitalism is in crisis. The faded empires of Spain, the Netherlands and the U.K. all relied, in the end, on finance to guarantee their power. Finance did not honor its guarantee. Under Greenspan, the U.S. inflated its currency and fueled bubbles with drastic economic consequences. The debt bubble is likely to be the most devastating to U.S. prestige and power. Global power is shifting to Asia. So, is there hope for the U.S.? A new commitment to manufacturing, education and sound, serious financial regulation may provide an opportunity for a second chance.

## About the Author

**Kevin Phillips** has been a political and economic commentator for more than three decades. A former White House strategist, he has been a regular contributor to *The Los Angeles Times* and National Public Radio. He has written for *Harper's* and *TIME,* and is the author of 10 books.

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