KEVIN PHILLIPS

From *Bad Money*

The severe recession that hit the American economy in 2008 presented policymakers with daily challenges: saving banks, bailing out automobile companies, aiding foreclosed homeowners. The news was punctuated with talk of unemployment, stimulus, deflation, fear of inflation, executive compensation, and debt, debt, debt. Noted commentator Kevin Phillips, who has taken on some of the big issues of the twentieth century, turns our focus here to the causes of the economic crisis that transformed the American economy. If we understand how it happened, maybe it won't happen again. "The great credit bubble" had been building up for quite a while, Phillips notes. He traces how one problem led to the next and the next. He indicts the nation's reliance on the financial industry as a replacement for the old manufacturing economy.

For centuries, the importance of harvesttime in the affairs of men made August and September months notorious for declarations of war, crop failures, and, eventually, bank crises. . . .

By the twenty-first century, of course, farm calendars no longer guided major events in North America or Europe, save for well-attended fairs and festivals or the pleasure of buying raspberries, peaches, sweet corn, and cider at roadside stands. However, in the United States, a new economic seasonality—the high point in late spring and summer of new and existing home sales—helped set the time frame for the financial markets' 2007 mortgage and credit spasms. Falling prices fanned concern that housing's giddy five-year buoyancy had created a bubble, indeed one already starting to pop; concern crystallized into panic, at least in the mass media and the financial markets, when June and July data dashed any lingering hopes for a sales and price rebound.

Nearly a year earlier, very different public concerns—a quagmire in Iraq, and Republican sexual scandals and attendant moral hypocrisies—had taken over the 2006 midterm elections, returning control of Congress to the Democrats after twelve Republican years. Worry about soon-to-be-inadequate world oil supplies and the mountainous U.S. buildup of public and private debt, particularly home mortgages, were merely clouds

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on the horizon—perils, but not ones determining how people voted ... yet.

That changed in mid-2007. Surging gasoline demand as springtime put motorists back on the road had focused May attentions on oil prices. Now roiling financial markets took global center stage, spooked by home foreclosure data, several hedge fund problems, and ominous projections of further foreclosures and price declines to come. As the days passed, fear spread—from subprime mortgages to the collateralized debt obligations (CDOs) into which asset loans had been opaquely repackaged. In August, apprehensions also stalled leveraged buyouts for want of funds, made banks unwilling to loan to one another, and froze the normal activity in commercial paper and other suddenly hard-to-value situations and product innovations. The impact was worldwide. From London to Tokyo, credit market after credit market froze toward illiquidity. Buyers sat on their hands, kept inactive by too little information about the new products' enigmatic content and wary of undisclosed risk. The once-sought-after CDOs could no longer be valued or "marked to market," or even marked to model, the next resort, but only, as skeptics remarked, marked to make-believe, a poisonous perception. Investors heard talk of the possible deleveraging of the global credit bubble—the privately feared "great unwind." Recession and deflation might be just over the hill. Other financial shivers—trembling municipal bonds, money market funds, and plain vanilla stocks—added to the worst August market chills since the mobilizations of 1914 had shut down bourses on both sides of the Atlantic. (The New York Stock Exchange, closed on July 31, 1914, did not resume full trading for four months.)

The 2007 crisis quickly revealed watershed characteristics. The great credit bubble, over two decades in its shaping, had since the 1980s been kept aloft and generally expanding by uplifts of monetary expansion from the U.S. Federal Reserve and other central banks. Having taken so long to form, cycle watchers thought, it would take years, not months, to unwind and deleverage. Proximate and wobbly currency and petroleum situations might add their own domino effects. Nor was the process assured of a happy ending through the wave of a central bank magic wand. Not unless, as the old adage says, God once again took particular care of fools, drunks, and the United States of America.

... [F]ar-reaching economic and political events and consequences began to unfold in midsummer's melee—developments that at least in part followed the direction that many specialists had foreseen—regarding U.S. housing prices, credit-bubble risk, the instability of so many financial

innovations never crisis-tested, the ever-more-apparent inadequacy of global oil production, the related vulnerability of the dollar, and, behind it all, the false assurance of American "imperial" hubris. The administration of George W. Bush, rarely known for strategic grasp, miscued again in the early days of the crisis. Statements by the president, the secretary of the treasury, and the chairman of the Federal Reserve Board that the low-quality-mortgage meltdown would be short-lived and safely contained were disproved almost overnight. The principal catalysts of marketplace panic were some $500 billion of collateralized debt obligations seen to be tainted by subprime mortgages: "Ninja" loans, so called because unqualified borrowers had "no income, no job or assets." The CDOs quickly spread wider destruction than had been rumored for the vaunted weapons never found in Iraq (investor Warren Buffett, in 2003, had prophetically nominated derivatives as the "weapons of mass destruction" especially to be feared).

History does seem to repeat itself, if only in outline or rhyme. Unfortunately, vague memories of past financial bubbles almost never suffice to inoculate a people or nation against repeating an earlier generation's mistakes. Despite highly cautioning precedents, the U.S. financial services circa 2007, swollen to an unprecedented and unstable 21 percent of gross domestic product, had laid down a national and international playing field no more controllable than the earlier venues of the Gilded Age and the Roaring Twenties. Technology, quantitative mathematics, and leverage allowed more to go wrong more quickly, and with much greater global reach. Twenty-first-century risk turned out to be spread and distributed in a negative rather than positive way.

Aggravating matters, America's sprawling financial debtscape of 2007—some $11 trillion in federal, state, and local obligations, plus a towering private issuance of $37 trillion (mostly financial, corporate, and mortgage)—had attained most of that size and clutter over the two previous frenetic decades. When Alan Greenspan had taken up the eagle feathers of Federal Reserve Board chieftainship in 1987, public and private debt in the United States had totaled $10.5 trillion. By 2006, following his departure, total credit market debt had quadrupled to $43 trillion. The best-publicized part of the surge, in various forms of mortgage borrowing, came when the Fed, anxious to stimulate the weakened post-9/11 economy, dropped the key overnight interest rate, already low, several times more to an ultrastimulative 1 percent in July 2003. In the abstract, this mortgage bet was plausible; in its multiyear government and private implementation, though, the mistakes and abuses are still surfacing.

Huge sums were involved. Debt in record quantities had been piled

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on top of the trillions still extant from the binges of the eighties and nineties, so that by 2007 the nation's overseers watched a U.S. economy in which public and private indebtedness was three times bigger than that year's gross domestic product. This ratio topped the prior record, set during the years after the stock market crash of 1929. However, in contrast to the 1920s and 1930s, when manufacturing retained its overwhelming primacy despite the economy's temporary froth of stockmarket and financial ballyhoo, the eighties and nineties brought a much deeper transformation. Goods production lost the two-to-one edge in GDP it had enjoyed in the seventies. In 2005, on the cusp of Greenspan's retirement, financial services—the new übercategory spanning finance, insurance, and real estate—far exceeded other sectors, totaling over one-fifth of GDP against manufacturing's gaunt, shrunken 12 percent. During the two previous decades (and only marginally stalled by the early 1990s debt bailouts), the baton of economic leadership had been passed.

In the new century, a burgeoning debt and credit complex—vendors of credit cards, issuers of mortgages and bonds, architects of asset-backed securities and structured investment vehicles—occupied the leading edge. The behemoth financial conglomerates, Citigroup, JPMorgan Chase, et al., were liberated in 1999 for the first time since the 1930s to marshal banking, insurance, securities, and real estate under a single, vaulting institutional roof. Hedge funds, the bold boutiques, had multiplied from just a couple of hundred in the early 1990s to roughly ten thousand in mid-2007, deploying over $1.8 trillion in assets. Like digital buccaneers, and hardly more restrained than their seventeenth-century predecessors, they arbitraged the nooks and crannies of global finance, capturing even more return on capital than casino operators made from one-armed bandits and unfavorable gaming-table odds.

As the mortgage markets seized up in mid-2007, shrewd players understood the virginity of the terrain. Jack Malvey, the chief global fixed-income strategist for Lehman Brothers, explained: "This is what we would characterize as the first correction of the neo-credit market. We've never had a correction with these types of institutions and these types of instruments." Others distilled the doubts about hedge funds themselves—the exotic quantitative mathematics, the obscure language of fixed-leg features and two-step binomial trees, and the humongous bank loans needed for the fifteen- or twenty-to-one leverage that alchemized mere decimal points into financial Olympic gold medals.

New products often turned out to have Achilles' heels, like the misbehaving index arbitrage of so-called program insurance, the derivative innovation widely blamed for the 1987 crash, and the junk bonds derogated

after their inventor went to jail. In 2007, the failures were multiple: besides the CDO and exotic mortage embarrassments, hedge funds' mathematical vulnerabilities included too many copycats doing the same thing, as well as an inability to deal with anarchic, almost random, volatility. . . . Some future congressional investigating committee would have a field day. Mathematically, what was theoretically impossible often manages to occur anyway. But the hedgies were big players, first-tier customers of first-tier lenders, and their bets sometimes accounted for as much as half the daily trading volume on the New York exchanges.

The average American, with other things to worry about, had little inkling of the financial sector's gargantuan size and clout or its resemblance to a laboratory of digital wagering. . . .

Many insiders, of course, had sensed for months, even years, what was coming. The valuation of U.S. homebuilders' stocks hit a zenith in 2005, pulled down thereafter by sagging new-home demand and slowing price appreciation. New mortgage borrowing by households peaked in the third quarter of 2005, and had declined by 45 percent a year later. Building permit applications topped out in late 2005. The index of real estate investment trusts crested in 2006. California was already a patchwork quilt of cut-rate sales and unraveling prices. Housing foreclosures were setting national records during the last quarter of 2006 and the first quarter of 2007, even though the April–May–June peak-season disaster got the page 1 headlines.

By September 2007, the Mortgage Lender Implode-O-Meter—real enough, and easily found on the Internet—listed 150 U.S. mortgage lenders as having gone out of business or stopped making certain loans since December 2006, including American Home Mortgage and Ameriquest, once the nation's largest subprime lender. Even in late winter and spring, several dozen had already closed their doors. In May and June, endangered hedge funds also came to light. By late July and August, the bond and credit markets should not have been surprised. On the other hand, neither should markets have been surprised nine decades earlier when war came in August 1914. But they were. British bonds (consols) did not plunge until July 27, 1914, just days before. If markets are not always rational, the same is true of their willingness to anticipate bad news. . . .

Huge stakes also drove the intense politics. In the United States, the UK, Canada, and Australia, your-home-is-your-castle nations where ownership reaches the 70 percent level, housing-centered crises are usually the ones that cut deepest into middle-class well-being. The explanation is simple. By some hypotheses, an informal, broadly defined "housing sector" of the U.S. economy—mortgage finance, construction, furnishings,

lumber, and related industries—might represent a 25 percent share of the national gross domestic product, enough to include several million vulnerable jobs on top of the frightening blow to the national psyche's sense of well-being and stability.

And on top of that, between 2001 and 2006, an unprecedented number of Americans used their homes as ATMs, turning huge chunks of residential equity into borrowed, but spendable, cash. Harvard economist Martin Feldstein, a former Republican chairman of the White House Council of Economic Advisers, calculated in 2007 that over "the past five years, the value of U.S. home mortgage debt has increased by nearly $3 trillion. In 2004 alone, it increased by almost $1 trillion." He went on: "Net mortgage borrowing that year *not* used [my italics] for the purchase of new homes amounted to nearly $600 billion, or almost 7 percent of disposable personal income." In short, borrowing against homes enabled stressed consumers to keep consuming. . . .

. . . I've given this book the title *Bad Money*, and part of the explanation is caught up in what I think of as the malfeasance of "money," including lax oversight of the financial sector by Washington past and present. These failures laid the foundation for both of this volume's main concerns: first, the deadly interplay of financial sector growth and debt hubris with a hot-wired American housing crash; and second, the intertwined vulnerability of U.S. oil supremacy and the embattled, targeted dollar. Should both perils impact the U.S. financial markets simultaneously, as August 2007 hinted, the word "crisis" might prove to be an inadequate description.

In recent decades, many book titles and names for television programs have placed hot, flavorful adjectives—"old," "new," "easy," "dirty," "mad," "smart," and "dumb"—in front of greed's best-loved noun, "money." The pairing for this volume, *Bad Money*, is not intended to evoke nineteenth-century robber barons, twentieth-century salad oil swindlers, or twenty-first-century Enron architects. For now, that is too parochial. The reason for applying a negative characterization is historical and institutional, with a deep bow to the inherent vulnerability of human nature exposed to pecuniary temptation, witnessed today on an unprecedented scale. Money is "bad," in the historical sense, when a leading world economic power passing its zenith—before the United States, think Hapsburg Spain, the maritime Dutch Republic (when New York was New Amsterdam), and imperial Britain just before World War I—lets itself luxuriate in finance at the expense of harvesting, manufacturing, or transporting things. Doing so has marked each nation's global decline. *To institutionalize the dominance of minimally regulated finance at this stage of U.S. history is a bad idea.*

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"Bad" in the systemic sense further applies to letting a financial elite elevate, expand, and entrench itself as a country's GNP- and profits-dominating sector, as has been done in the United States over the last quarter century. Doing this so hurriedly has wound up institutionalizing runaway public and private debt, gross speculative biases, tenfold and twentyfold leveraged gambling, unchecked and barely regulated "product" innovation, and a tendency toward periodic panics and instability. In such a short time frame, though, finance could probably not have consolidated and entrenched in a meeker or more civic-minded fashion. Former Federal Reserve chairman Alan Greenspan has openly stipulated, now that he is again a private citizen free to speak, what most people know well: that manic boom and bubble periods bring the weakness of human nature to the fore. As for the financial sector's behavior in such circumstances, surely there must be some applicable variation of Lord Acton's famous thesis about the greater the power, the greater the abuse and corruption.

It's also "bad" to promote an overbearing financialization of America's economy and culture, lesser versions of which in both U.S. and world history have led to extremes of income and wealth polarization, a culture of money worship, and overt philosophic embrace of speculation and wide-open markets. Minimally bridled finance, extraordinarily rewarding to the top 1 or 2 percent of the population possessing capital, skills, and education, indulges all of these tendencies. Bridling that sector was possible in 1933, when Franklin D. Roosevelt orated about throwing the money changers out of the temple. To a degree, at least, he did. Tossing political and governmental nets around the giant, cyberspatial King Kong who prowls early-twenty-first-century Manhattan (or, for that matter, the City of London financial district) represents an entirely different magnitude of challenge. . . .

The crisis is no longer in the future, but upon us. The debacle started in August [2007], when collateralized debt obligations, built in part around bad debt and distributed globally by Wall Street, began making a slow train wreck relating to weak sections of the U.S. mortgage market into a crisis of top American banks and of the global credit markets. The crux, beyond unsafe mortgage lending, was the recklessness of the speculative mind-set that lay at the heart of Anglo-American finance in an era when the rest of the world was beginning to look for capitalism more rooted and conscious of its responsibilities. . . .

There is no better distillation of the harm inflicted—and probably yet to be inflicted—than that of hedge fund manager Richard Bookstaber in his 2007 volume, *A Demon of Our Own Design: Markets, Hedge Funds, and*

the Perils of Financial Innovation. His underlying point is that even though financial strategists can keep dreaming up new instruments, it's not a good idea to do so, because each innovation adds layers of increasing complexity, tight coupling, and risk. By way of comparison, "consider the progress of other products and services over the past century. From the structural design of buildings and bridges, to the operation of oil refineries or power plants, to the safety of automobiles and airplanes, we learned our lessons. In contrast, financial markets have seen a tremendous amount of engineering in the past 30 years, but the result has been more frequent and severe breakdowns. . . . The integration of the financial markets into a global whole, ubiquitous and timely market information, the array of options and other derivative instruments—have exaggerated the pace of activity and the complexity of financial instruments that makes crises inevitable."

Countertrends toward realism and greater regulation may well become excessive and overreach, much like the market excesses and Anglo-American hubris they now challenge. But it is well to understand the provocation offered by the blind-to-human-nature, history-ends-with-us millennial capitalism. . . . My summation is that American financial capitalism, at a pivotal period in the nation's history, 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 debt between 1987 and 2007, a scale of excess that historically unwinds; and fifth, consummating these events with a mixed performance of dishonesty, incompetence, and quantitative negligence.

How fully the complicit politicians will investigate the culpable regulators and financial architects remains to be seen. But there will be many further market events, energy and climate problems, books, essays, congressional hearings, and political campaigns to guide us.

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