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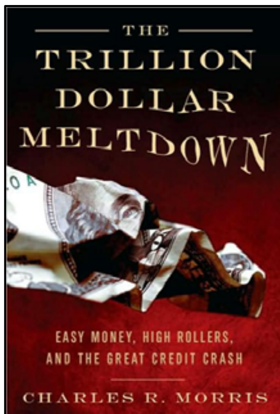

The Trillion Dollar Meltdown:

Easy Money, High Rollers, and the Great Credit Crash

Author: Charles R. Morris
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About the Author:
Charles R. Morris is the author of 10 books, including *The Cost of Good Intentions*, which was named one of the *New York Times*' Best Books of 1980. Morris is a lawyer and a former banker. He has written extensively on financial matters for *The New York Times, The Wall Street Journal,* and *The Atlantic Monthly.*

General Overview:
According to Charles R. Morris, we are living in the most reckless financial environment in recent history. The astronomical leverage at investment banks and their hedge fund and private equity clients virtually guarantees massive disruption in global markets. The crash, when it comes, will have no firebreaks. *The Trillion Dollar Meltdown* explains how we got to this point and what we need to do to prevent further damage.

*** *Please Note:*** This CapitolReader.com summary does ***not*** offer judgment or opinion on the book's content. The ideas, viewpoints and arguments are presented just as the book's ***author*** has intended.

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Introduction

As of 2008, the United States is facing the most serious economic crisis in generations. Decades of irresponsible lending practices, *laissez-faire* deregulation, and financial chicanery have brought the country to the brink of economic catastrophe. Put simply, 25 years of free-market zealotry have helped create the greatest credit bubble in history. A wrenching reckoning is all but inevitable.

The sub-prime crisis that has wrecked the housing market is only the tip of the iceberg. At the heart of the coming trillion-dollar meltdown are complex and esoteric financial instruments – derivatives, collateralized debt obligations, and credit default swaps – that were designed to mitigate risk, but have instead actually increased the likelihood of financial peril.

Global confidence in the United States is in grave jeopardy. U.S. policy makers have been trying to deny and conceal the extent of the crisis, but this approach will only exacerbate the problems we face. Americans are debt-ridden, hedge funds are leveraged to the hilt, and the Federal Reserve has been flooding the markets with interest rate cuts and printing money in the futile hope of postponing the inevitable. As a result, the dollar has sunk to historic lows, the seeds of inflation have been sown, and sovereign wealth funds from abroad are scooping up American assets at fire-sale prices.

The economic unwinding we are witnessing represents the collapse of a conservative ideological cycle dominated by an unbridled faith in the wisdom of free markets and an abhorrence of government regulation. Ironically, the orthodoxy associated with the highly libertarian Chicago School was instrumental in rescuing America from the excesses and stagnation associated with Keynesian School liberalism during the economic malaise of the late 1970s. At some point, however, when market orthodoxy devolves into dogmatism, the time comes for the pendulum to swing in the opposite direction.

The Death of Liberalism

"For connoisseurs of misery, the ten years from 1973 through 1982 are a feast of low points." During that period, economic growth was anemic, inflation was rampant, the dollar was in freefall, OPEC raised oil prices tenfold, and America's industrial heartland morphed into the Rust Belt. Terms like "stagflation" and "the Misery Index" entered the political lexicon because they captured just how desperate things seemed. There was no one cause, of course, but rather a perfect storm of factors (demographic, political, economic) that conspired to create the worst economic climate since the end of World War II. The Keynesian style of liberalism embodied by the Johnson administration (big government, central planning, and social engineering) reached its last hurrah with the Carter administration.

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Keynesian liberals believed in the wisdom of an *intelligentsia* that could manipulate the levers of government to achieve a desired result. By 1980, however, Keynesian liberalism had overreached with disastrous results. A new school of thought, associated with economist Milton Freedman, extolled the virtues of deregulation and the unfettered workings of the free-market. The election of Ronald Reagan in 1980 signified the end of Keynesian liberalism and the ascension of the Chicago School and their monetarist economic philosophy.

Wall Street Finds Religion

The Chicago School's economic philosophy mutated into a Theory of Everything: the notion that an unimpeded free-market will consistently produce optimum results. Free-market dogmatism, in other words, became the panacea to cure virtually every social ill, be it in healthcare, education, or crime.

Monetarism espoused by Milton Freedman held that inflation could be controlled by controlling the supply of money – i.e., if the amount of money in circulation grew at the same rate as the economy, prices would remain steady. In truth, "monetarism was in part a device to limit the purposeful meddling of central government."

When Ronald Reagan took office in 1980, interest rates were close to 20%, inflation was rampant, and the country was slipping into a recession. Fed Chairman Paul Volcker publicly embraced the monetarist strategy, but privately he was not a true believer. In fact, monetarism per se did not break the back of inflation, but rather Volcker's willingness to use every weapon available at his disposal. The emphasis on free markets and deregulation no doubt did much to revive American competitiveness, but it also contributed to the savings and loan scandals. Thus, the lesson was mixed: free-markets work, but "in raw markets, the scent of money deadens all other sensory and ethical organs."

The experience of the 1980s and 1990s only strengthened the faith conservatives had in free-markets and deregulation. In fact, free-market disciples ignored evidence that contradicted their beliefs, such as the implosion of the tech bubble or the fact that one of the biggest drivers of economic opportunity was a product created thanks to 40 years of government financed research and development – i.e. the Internet.

Bubble Land: Practice Runs

The dot-com bubble was a typical financial mania, but there were three other significant boom and bust cycles in the roughly 10 years prior to the collapse of Internet stocks. There was a big crash in residential mortgages in 1994, the stock market crash of 1987, and the 1998 crisis generated by a hedge fund called Long-Term Capital Management (LTCM). The power of desktop computing, an influx of mathematicians to Wall Street, and new investment instruments and technologies all played a major part in these financial roller coaster rides.

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Initially, many of these innovations produced economic efficiencies. However, "all the new technologies and strategies harbored dangerous flaws that tended to reveal themselves only at points of great stress." Even more elaborate and subtle variations on these instruments and practices are in place today. As a result, the stability of the world's economic system is far more precarious than most realize.

One of the financial instruments that plays a central role in the current economic climate is the collateralized mortgage obligation (CMO). Essentially, the CMO is a bundle of mortgages that have been sliced and diced according to certain criteria – risk and maturity, for instance – in order to meet the investment appetites of different classes of investors. That is, traditional mortgages tended to yield middling returns while offering moderate risk while CMOs, on the other hand, are instruments created to pay regular dividends like bonds, but with a variety of yields designed to suit the risk tolerance of various investment consumers.

The CMO was an innovative, important, and constructive contribution to the mortgage industry. However, the success of the initial CMO spawned ever more complex imitators. "The complexity of the instruments spiraled into absurdity." For instance, instead of slicing and dicing mortgages into three-tiered CMOs (the tiers are called "tranches" in financial parlance), the new more exotic CMOs featured 125 tranches. Few could fully understand and appreciate the risks of these complex instruments. Needless to say, disguising toxic waste (bad mortgages) became an art form. The toxic waste, however, could function like a time bomb, especially when sudden market events (such as a surprise Fed rate hike) threw "the CMO math into confusion."

Hedge funds are exclusive financial institutions that utilize leverage to generate spectacular returns. These firms specialize in managing risk by trying to exploit small advantages into fantastic returns. For instance, a hedge fund may be leveraged 10-to-1 or more in order to magnify miniscule margins into gargantuan returns. During periods of normal market activity, the mathematical models these firms rely on tend to function as expected. However, during market upheavals, the mathematical models can quickly break down. For example, in 1994, when the Fed raised interest rates by a half-point in a surprise move, it threw a monkey wrench in the models that valued the CMOs held by some hedge firms. Because these firms were highly leveraged, they were hit with margin calls from lenders, which demanded cash to compensate for the declining value of CMOs used as collateral. However, with no firm way of valuing the CMOs in question – and because there was no real market for these thinly traded exotic instruments – the value of these CMOs quickly plunged to zero.

Overnight, "the entire CMO market came to a screeching halt." Needless to say, an insolvent hedge fund that can't repay its lenders will send shudders through the financial system. Indeed, $55 billion in wealth evaporated during the CMO crash of 1994, which amounted to 5% of a trillion-dollar market. In fact, the havoc affected the mortgage

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industry for roughly three years. The crisis unfolding in 2007 and 2008 is a variation on this theme, but on a grander and more far-reaching scale.

Portfolio insurance is another instrument Wall Street introduced to serve the needs of their largest customers (i.e., pension and mutual funds). Portfolio insurance relied heavily on advanced mathematical methods (such as the Black-Scholes formula, which quantitized risk), derivatives, and computer trading programs. In fact, "the portfolio insurance that so enamored big investors was actually a futures-based hedging strategy." For example, in order to protect a portfolio against a broad market decline, an investment customer bought futures (the option to buy or sell stocks at a price for a specific future date), which would presumably offset market losses.

A strategy designed to mitigate risk for the individual customer actually exacerbated risk when it was adopted collectively. For instance, in the Fall of 1987, news that made investors nervous (tensions in the Middle East, a bigger than expected trade deficit, and a proposed tax on corporate takeovers) contributed to a market slide. Portfolio insurance programs executed by computer trading programs quickly overwhelmed the market. On Oct 19, 1987 – a day dubbed "Black Monday" – a panic in futures selling ensued as buyers evaporated. In effect, futures were like toxic waste; because there were no buyers, these futures became worthless. By the end of the week, stocks had lost roughly a quarter of their value, officials had seriously considered closing the exchanges, and half a trillion dollars in market value had evaporated. The lesson from Black Monday was clear: portfolio insurance "would work fine for a single firm, but if adopted by a whole market, it almost guarantees disaster."

Sometimes, it takes the smartest people to make the dumbest decisions. In 1998, a hedge fund run by mathematical whizzes, Long-Term Capital Management (LTCM), failed spectacularly, which led to a Fed-organized bailout. Once again, extreme leverage, computer trading, and mathematical modeling played a critical role in a financial unwinding. Regulators were stunned to learn that LTCM held stock market exposure in excess of $100 billion on an equity base of just $1 billion. The LTCM debacle raised a central question: how could such a small group of people borrow hundreds of billions of dollars from banks, yet neither the banks nor regulators had a clue as to what a firm like LTCM was up to?

Deregulation dogma and blind faith in the power of mathematical models to mitigate all risk were keys to the market meltdowns of the 1980s and 1990s, as well as the credit bubble building up in the next century. In sum, LTCM's meltdown contradicted the extreme *laissez-faire* conviction that market participants could and would police themselves. Instead, the Fed intervened to rescue LTCM because it feared the firm's failure would inflict heavy damage on other market participants. There is no better argument that markets need some oversight than the repeated necessity of the Fed coming to the rescue of private equity firms.

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A Wall of Money

The dot-com bubble exploded in 2000, which led the Fed to slash interest rates. After the horrific attacks of 9/11, the Fed cut rates even more. By 2003, the federal funds rate stood at 1%. Adjusted for inflation, the short-term interest rate was negative. "For bankers, in other words, money was free."

At this time, banks were embracing securitization – packaging loans into collateralized mortgage obligations (CMOs) and selling them to institutional investors. As a result, they had less incentive to ensure the credit worthiness of borrowers and more incentive to collect hefty fees by lending as much and as often as possible. In other words, lending was becoming a cost-free enterprise. It seemed like the dawn of a wonderful new era. After all, money was free, lending costless, and homeowners could continually spend more and more by tapping into home equity loans as housing prices kept appreciating.

A credit bubble was building, however, and all bubbles pop.

Former Fed Chairman Alan Greenspan bears much of the responsibility for allowing the credit bubble to expand. As one observer noted, "the function of the Federal Reserve is to take away the punch bowl just as the party is getting good." By keeping rates low for so long, even after economic growth had picked up considerably by 2004, Greenspan seems to have kept refilling the punchbowl even though the party was well under way. As a result, America's easy money led to asset inflation (in both share prices and real estate). One commentator described the Fed's record during this time frame as "unconscionable."

"The term Greenspan Put became commonplace around Wall Street in the early 2000s." It was understood that if things went sour, the Fed would cut rates, thereby creating cheap money, which would solve everyone's problems. The only snag, however, is that a loose monetary policy helped create the greatest real estate bubble in world history.

Between 2000 and 2005, the United States experienced a virtually unprecedented housing boom. In fact, during this period, housing prices appreciated by more than 50 percent. Houses, of course, are usually highly-leveraged investments, which makes their values hypersensitive to interest rates. As long as interest rates were on a downward trajectory, for instance, housing prices rose and homeowners could treat their homes as ATMs by refinancing.

But all booms breed excess. House-flippers, predatory lenders, and sub-prime mortgages were some of the major causes behind the breaking down in the credit markets. The rush to garner huge lending fees encouraged aggressive borrowers and predatory lending practices. Not surprisingly, however, "if loan originators have no stake in a borrower's continued solvency, the competition for fees will inevitably degrade the average quality of loans." Thus, it was only a matter of time before irresponsible borrowing and lending led to tighter lending practices and higher rates.

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As of 2007, the housing boom is over and the real estate industry is in dire shape. Experts forecast national real estate prices will decline by at least 10% and as much 30%. Foreclosures and delinquencies are devastating neighborhoods, lenders are facing bankruptcies, and credit is drying up.

The way low-quality sub-prime loans permeate the world's financial system poses devastating risks. Put simply, there is a lot of toxic waste out there, but the complexity of financial instruments makes it hard to discern who is holding it. Banks and investment firms are beginning to admit huge losses, but gargantuan write-offs are being revised upward as we speak. Losses at Citi, for instance, have even raised questions about the bank's capital adequacy, though at present, an emergency infusion from a Sovereign Wealth Fund based in Abu Dhabi has bought Citi some time.

It is clear there is a Great Unwinding underway, but there is not much the Fed can do at this point. The Fed kept the American markets afloat by printing an ocean of money, but a world awash with dollars has drowned the value of America's currency.

A Tsunami of Dollars

The Bretton Woods agreements following WWII established the dollar as the world's reserve currency. At that time, of course, the dollar was pegged to the price of gold, which ensured the dollar retained its value. When Richard Nixon eliminated the gold standard, however, the dollar plummeted. As economists note, a "reserve country cannot create liquidity in excess of world demand, even if that means accepting lower growth at home." What Nixon had done, of course, was flood the U.S with money to juice up the economy and ensure his reelection, but at the expense of undermining the world's monetary order.

Throughout most of the 20th century, the United States ran a trade surplus – the value of its exports exceeded the value of its imports. Beginning in the 1980s, however, America's position steadily reversed. By 2000, the account deficit exploded. Because the savings rate for Americans is virtually zero, the only way to finance the deficit is through foreign borrowing. Some suggest that America shouldn't worry about the $5 trillion in reserves piling up in foreign central banks, but the rapid decline of the dollar suggests otherwise. Indeed, the *Economist* has described the dollar's fall as "the biggest default in history."

The problem with the glut of dollars held by foreign creditors is this: foreign lenders, such as China, have financed our deficit, in part, so that American consumers can afford to buy their products. However, their trade flows are increasing with other partners. As this happens, holding dollars is less and less in their best interests. Concomitantly, if foreigners are no longer willing to make up the difference for our savings shortfall, then the Fed will have to raise interest rates to avert a complete currency rout, a bitter pill to swallow as the United States faces a recession. Of course, as the dollar declines, the

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price of oil and other imported commodities will rise. In short, America is in a vicious economic cycle with few good options.

Another problem, of course, with massive amounts of U.S. dollars piling up in foreign central banks is the fact that many billions – and in some cases trillions – of dollars are held by governments that are anti-democratic, repressive, and corrupt. It is a sobering situation when the world's only superpower finds itself indebted to some of the world's most unsavory regimes.

The Great Unwinding

We have reached a Ponzi stage in the credit cycle. The world's GDP has increased dramatically over the last quarter century, but it is nowhere near keeping pace with the explosion of global credit. Claims represented by complex financial instruments are many multiples higher than the total annual global GDP. The world's economy is extremely leveraged – the United States' economy in particular – and high leverage entails the potential for extreme volatility.

The most complex financial instruments – derivatives, credit default swaps, and collateralized debt obligation (CDO) – represent highly intangible assets. At the same time, the most exotic of these instruments are usually traded by only a small number of institutions (global banks, investment firms, and hedge funds). There is a lot of toxic waste embedded in this class of instruments and the consumers of these instruments are often leveraged to the hilt. In essence, a small cadre of institutions has "built a huge Yertle the Turtle-like unstable tower of debt by selling back and forth among themselves, booking profits, all along the way." This is where the Chicago School and its *laissez-faire* philosophy have taken us, to the brink of a Ponzi scheme poised for collapse.

Winners and Losers

American workers are more productive and harder working than virtually anywhere else in the industrialized world. They are not the best compensated, however. Indeed, one of the most striking developments in America over the last 25 years is the dramatic rise in economic inequality. It's not hard to gasp at the multi-million dollar packages earned by many CEOs. The spectacles at Enron, Worldcom, and Countrywide reveal, however, that all too often these executives have been looting their companies rather than creating value.

Conclusion

The Chicago School dogma is that government *is* the problem. In the decades following WWII, however, government leadership helped solve problems by tackling projects like public highways, waterways, and protecting the environment. "But now, after a quarter-century of chipping away at government, the domestic public sector in the United States has been impoverished and corrupted, and we are paying a price for it."

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We need to restore some balance between the public and private sectors. One of the first tasks, after we sort through the financial rubble, will be to regulate the financial industry in ways that reestablish transparency and integrity. Some of the steps we need to take will make credit more expensive, but finance should not be like Russian roulette.

We also need to address America's crisis in health care. America leads the world in advanced procedures, but we lag significantly in care that makes for sound social investment – prenatal care and preventive medicine. The payroll-based system of financing healthcare is clearly unraveling. It is imperative that government picks up some of the slack by defining a standard healthcare package. This will entail an expansion of government and higher taxes, but we cannot continue to shortchange public sector good like healthcare, education, and infrastructure.

According to the Chicago School, any spending on government inevitably reduces productivity. This thinking is wrong. The government lavished money on the Internet, for instance, and that investment has clearly paid huge dividends. The lessons of the last several decades are clear. Free markets are not always right. And government spending is not always bad. "Government spending, in short, is productive or not, depending on what it's spent on." We have reached the point where blind faith in free markets has become the problem. It is time for the pendulum to swing the other way.

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