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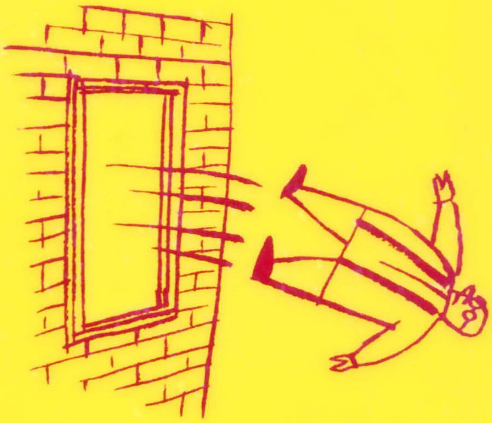
THE TWO TRILLION DOLLAR MELTDOWN

The *New York Times* Bestseller



EASY MONEY, HIGH ROLLERS AND THE GREAT CREDIT CRASH

Charles R. [illegible]

PRAISE FOR THE PREVIOUS EDITION OF
THE TWO TRILLION DOLLAR MELTDOWN

A *New York Times* bestseller
A *Wall Street Journal* bestseller

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—Floyd Norris, *New York Times Book Review*

"[*The Trillion Dollar Meltdown*] is an absolutely excellent narrative of the horror that we have in the credit markets right now. It's a wonderful explanation of how it happened and why it's so rotten, and why it will take a long time to unwind."
—Paul Steiger, editor-in-chief, ProPublica, and former managing editor, *The Wall Street Journal*

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"Morris, a former banker, [earned] rock-solid status as a predictor of the crash. He homes in on the complexity and the paradoxical unpredictability of these financial instruments, which were supposed to manage risk and ended up magnifying it."
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"Morris provides a comprehensive and jargon-free description of the hideously complex financial securities that have brought the credit system to collapse. It is a remarkable story."
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"Amid the hyperbole, several financial-scare books stand out for their high credibility and low hysteria. *The Trillion Dollar Meltdown* by Charles R. Morris ... avoid[s] the wild predictions of mass economic destruction, instead giving thoughtful, if alarming, histories and analyses of how we got into the mess we're in today."

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"Charles Morris, author of *The Trillion Dollar Meltdown*, isn't one for sugarcoating. His analysis is dour and grim, but certainly not dull. And when read against a backdrop of an ever-weaker economy, increasingly anxious economists, and a stream of gloomy predictions, it can be downright scary. Morris serves up a sharp, thought-provoking historical wrap-up of the U.S. economy and its markets, along with clear scrutiny of today's economic woes."

—*USA Today*

"My favorite single book account [of the subprime crisis]."

—Business & Economics Correspondent
Adam Davidson, NPR's "Planet Money"

"Millions of words have been written about the ongoing financial disaster largely caused by the subprime mortgage mess. But the most concise and easiest to understand handbook on the issue is almost certainly Charles R. Morris' *The Trillion Dollar Meltdown: Easy Money, High Rollers, and the Great Credit Crash.*"

—Robert Bryce, *The Texas Observer*

"[A] masterful and sobering book."

—Commonweal

"To better understand how the world economy has been pushed to the brink and what the post-crash political/economic environment might eventually look like, this book provides both insight and a possible peek into our future."

—Larry Cox, *Tucson Citizen*

"Will provide some important background that will help decipher the meaning behind today's gloomy financial headlines. For those who wonder 'Why?', here's a place to get some answers!"

—*Watsonville (CA) Register-Pajaronian*

THE TWO TRILLION DOLLAR MELTDOWN

EASY MONEY, HIGH ROLLERS AND THE GREAT CREDIT CRASH

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For Charlie-chan

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FOREWORD TO THE PAPERBACK EDITION

Sometime in October 2008, markets finally "got it." The world was stuck in a vicious credit crunch and teetering on the brink of a frightening recession. Stock markets plunged everywhere, currencies whipsawed violently, interbank lending seized up. Governments poured out trillions in loans, equity infusions, and bailouts, while credit markets stayed obstinately stuck on "Closed." The U.S. Federal Reserve Bank, in an unprecedented, and unilateral, expansion of its powers, pumped out $1.1 trillion in new lending in about six weeks—to banks, broker-dealers, a big insurer, commercial paper issuers, and money market funds.

A $700 billion bank bailout bill was rammed through the American Congress on the promise that it would get at "the root cause" of the crisis by buying up toxic assets from banks' books. European governments, led by Great Britain, trumped the American bailout with the much more focused strategem of equity infusions directly into the banks. Treasury Secretary Henry Paulson, a former president of Goldman Sachs and arch-antagonist of interventional government, was grudgingly forced to follow suit, only to find the queue of petitioners lengthening by the day—not just banks, but insurance companies, state governments, and automobile companies. There was even talk of lending to hedge funds.

For the first time, finance ministers realized how deeply the lethal new financial instruments from America had penetrated global investment portfolios; and how far their own banks, especially in Europe, had gone in emulating the American giants. Europe's hope that it could "de-couple" its economy from America's vanished, as the continent slid toward negative growth. The petrostates—Russia, Venezuela, Iran, and the Arab states—who had linked their spending to the infinite gluttony of the American consumer, stared into the abyss. Even economies—like those of Korea, Taiwan, and Brazil—that had maintained strong reserves and mostly sound practices were staggered in the gusts. Iceland, which had taken a riskier path, went bankrupt.

The global crisis, however, was indeed made in America, despite the sins of its imitators and fellow travelers. At its core, it was a crisis of the classic "Argentinean" variety—a debt-fed party, marked by a consumer binge on imported goods, and the strutting of an ostentatious new class of super-rich, who had invented nothing and built nothing, except intricate chains of paper claims that duller people mistook for wealth. This was the same America, of course, that had preached the strait-laced "Washington consensus"—increase savings, balance budgets, run trade surpluses—in the wake of the Latin American and Asian crises of the 1980s and 1990s.

This new edition of the book goes to press in the early months of Year Two of the Great Credit Crunch. Since the first edition was completed in November 2007, when the crash was still in its early stages, a brief summary of Year One is in order.

From today's perspective, the late spring of 2007 seems like a different era. American financial markets were unusually sunny; consumer spending was growing strongly; the market for investment-grade credit was booming; and the premiums demanded to invest in riskier forms of debt were at an all-time low. The S&P 500 jumped more than 9 percent just from March through May.

A first seismic quiver came in mid-June when it was disclosed that two Bear Stearns mortgage hedge funds could not meet margin calls. A Moody's downgrade had reduced the value of certain of their investment-grade "subprime" mortgage-based bonds. The fund sold some of its bonds to raise money, but most of the rest, it turned out, were not salable at any price. The value of all subprime-related debt tumbled. The experience was frightening, but cooler heads reminded the world that subprime mortgages were a small market and the problem was "contained."

Then subprime-related problems began to pop up all around the world. A $900 million London hedge fund closed its door. There was a run on a big London mortgage lender. German and Swiss banks announced large writeoffs. In August, the

Federal Reserve and the European Central Bank flooded their economies with fresh money.

Alarming new revelations poured out. Big banks, especially Citigroup, it seemed, held hundreds of billions of long-term loans in mysterious off-balance sheet entities called SIVs that they financed in the short-term commercial paper market. The shock of the disclosure brought interbank lending to a grinding halt. On top of that, banks were sitting on hundreds of billions in "bridge loan" commitments to finance highly-leveraged private equity company buyouts. But the banks had assumed that they would be able to sell off those loans into the same markets that were now choking on subprime paper. Banks tried to back out of the deals. Legal papers flew.

The Federal Reserve rode to the rescue, with an aggressive cut in the base short-term lending rate in September and another in October. Hosannahs were sung to Ben S. Bernanke—then newly installed as Fed chairman—the stock market leaped, and credit markets jittered back to life.

The losses disclosed in the October bank earnings releases were shocking—some $20 billion in asset writedowns, with about half of them at Merrill Lynch and Citi—but the markets actually rose in relief that the bad news was finally out. Relief turned to horror just days later, when both Merrill and Citi acknowledged that they had grossly underestimated their losses. Even more alarming, in November, Gary Crittenden, the Citigroup CFO, told analysts that he did not know how to value the complex new instruments at the heart of Citi's problems.

The October fiasco set the pattern for subsequent quarters. The losses at the major banks kept growing, as did uncertainty about the real value of bank assets. CEOs were fired, often expensively. (Stan O'Neal, ousted as CEO of Merrill, was paid more than $200 million from 2006 through the fall of 2007.) Federal Reserve interventions were ever more extreme. In December, the Fed tried to re-liquefy banks by exchanging Treasuries for some of their riskier credit instruments. Through the spring, it steadily expanded the instruments it would accept as collateral and the range of financial companies it would lend to, but the effects of its successive interventions steadily dwindled. Nervous markets continually teetered on the edge of panic.

The first big bank to topple was Bear Stearns, in March 2008. Like all the investment banks, its trading books were highly leveraged and dependent on short-term financing. As doubts grew about the value of its large and opaque mortgage portfolio (it could be valued only by Bear's internal models) lenders finally refused to roll over its credit lines. Bankruptcy was avoided only by a forced merger with JP Morgan.

The dominos kept falling. Countrywide Financial, the biggest American mortgage lender, was rescued by Bank of America in May. In August, shockingly, Fannie Mae and Freddie Mac, the giant mortgage lenders with some $5 trillion in home loans, were taken over by the government.

Next on the chopping block was Lehman Bros., which had long been suspected of excessively optimistic financial statements. Lehman was bigger than Bear, but arguably in worse shape, and Paulson and Bernanke had long been pressing it to bring in more equity. But the longtime Lehman CEO, Richard Fuld, delayed and delayed until he was finally forced to ask for government help. Paulson decided to draw a line in the sand. With no merger prospects, Lehman filed for bankruptcy on September 15.

The same weekend that Lehman was allowed to go down, the insurance giant AIG, which ran a high-risk trading operation out of its central office, petitioned the Fed for a large "temporary" loan and was summarily rejected—it was not even a bank. But AIG was the guarantor on $300 billion of American mortgage-backed CDOs held by European banks, worth at best fifty cents on the dollar. Those guarantees would fail if AIG did, forcing European banks to write off some $150 billion in assets. Finance ministry telephone lines crackled, and on Monday night, Paulson capitulated, with an $85 billion loan (which has now grown to $123 billion) on very harsh terms.

Merrill saw the handwriting on the wall and executed a quick midnight elopement with Bank of America. That week, both Morgan Stanley and the once-invincible Goldman Sachs petitioned the Fed to convert to full Federal Reserve Bank status, trading their relative freedom from regulation for the assurance of quick aid in a crisis.

The Lehman failure, however, was a watershed. Not even Paulson or Bernanke suspected how deeply its securities were marbled through the world financial system. Money market mutual funds are a major source of short-term liquidity to banks, and one of the biggest of them all, the Reserve Fund—with $65 billion in Lehman paper—announced that it had "broken the buck." It could not return the sacrosanct $1 a share to investors. All money market funds immediately pulled back their bank lines, triggering a global liquidity crisis.

As panic spread through world markets, Paulson and Bernanke announced their $700 billion bailout plan, at that stage nothing more than a semi-hatched three-page memo. Almost all European governments, led by Great Britain's prime minister, Gordon Brown, came into the markets in force. By November, there was a scarcely a major bank on the continent that had not received a large infusion of taxpayer cash, while the list of American banks with the federal government as their partner was growing almost by the day.

Yet as of this writing, the sickening stock market downdrafts continue, and credit markets remain semicatatonic. The gut-freezing comprehension is finally taking hold that this is not really, at the end of the day, just a banking phenomenon. America's problems, and therefore the world's, go much deeper than that.

Some simple math tells the story. Starting in the late 1990s, the share of personal consumption in GDP grew from a long-term average of about 66 percent all the way to 72 percent in early 2007—the highest level ever, anywhere. At the same time our trade deficit grew from about 1.3 percent of GDP in the mid-1990s to an average of 4.8 percent of GDP in the 2000s. The increase in spending was mostly fueled by borrowing, mostly against houses.

From 2000 through 2007, home equity withdrawals for personal consumption, making payments on credit cards and other consumer debt, and refurbishing homes totaled about $2.8 trillion, a huge swathe of economic activity. All together, it was equal to about 4 percent of disposable personal incomes. With the collapse of home prices, of course, that finance has all but disappeared.

The flood of credit was pumped out by a brand-new credit turbine—the "shadow banking system," hedge funds, investment banks, off-balance-sheet conduits, and the like. By early 2007, according to the Federal Reserve Bank of New York, the shadow banks' lending book was bigger than the entire traditional banking sector. (They didn't lend directly to homeowners, but bought up loans in huge volumes from mortgage-banker intermediaries.)

The current bailouts perpetuate a standard misconception of the credit bubble—that we have a *liquidity* problem, rather than a *solvency* problem. It's a crucial distinction. A couple of examples illustrate the difference.

Before the development of grain futures markets in the 1870s, American farmers had limited access to capital, and merchants took great risk in buying grain and shipping it overseas. But once future deliveries could be sold for cash, a fire hose of investment poured into new grain-belt "factory farms," and turned America into a Saudi Arabia of food. Farmers and grain merchants had a *liquidity* problem that was brilliantly solved by financial markets.

Now consider the famous, if possibly legendary, tulip bulb mania in seventeenth-century Holland. As bulb prices skyrocketed, traders took massive risks leveraging up their bulb holdings until someone realized that tulip bulbs are, after all, just a kind of onion. Prices collapsed almost overnight. No amount of lending could have restored the old tulip bulb prices, since onions, at bottom, aren't worth much. The story of the tulip bulbs is a parable of *insolvency*, not illiquidity. And today's housing debt problems, unfortunately, look rather like tulip bulbs.

Over the long term, the appreciation in home prices is about 1 percent a year faster than the rate of inflation, roughly tracking the growth in real incomes. But from 2000 through 2006, when inflation was quite low, major-market home prices jumped by more than 14 percent a year—the fastest prolonged price increase ever—although without any obvious demographic reason. It both attracted, and was prompted by, a flood of finance that made it very easy to buy homes at low interest rates with little or no money down.

Buy a home with 5 percent down, watch it appreciate at 10 percent net of interest costs for three years, and you've recovered your equity investment sevenfold. Buy it at 1 percent down, which was fairly standard, and you've made more than thirty times your equity. In America's efficient capital markets, home values quickly jumped to reflect the present value of the potential capital gains, rather than a steady-state price that a homebuyer could finance from current income on normal lending terms.

Super-efficient financiers allowed you to tap into the new fountains of housing credit without even buying or selling a house—just leverage up the house you already owned. Banks were happy to send you a large bolus of cash for a claim on your home's unrealized value. It was the same as selling a tulip bulb future.

It is impossible to exaggerate the sheer idiocy of the financial machinery of the 2000s. To start with, leverage is extremely high—in the shadow banking world, often as much as 100 to 1. Moreover, the favored instruments, such as collateralized debt obligations (CDOs), are highly illiquid, or hard to sell in a pinch. Even worse, the preferred method for financing positions is in overnight and other short-term money markets, so there are horrendous asset-liability mismatches. Then those highly leveraged, illiquid, short-term–funded CDOs and similar securities are built from securities that themselves carry a high risk of default, primarily sub-prime and so-called "Alt-A," or undocumented, mortgages. Finally, a new class of arcane credit derivatives, completely outside the purview of regulators, ensures that almost all bank portfolios are "tightly coupled" as engineers say, so failures in any part of the system will quickly propagate through the rest. An evil genie could not have designed a structure more prone to disaster.

The focus on high-risk mortgages is especially revealing. Easy money policies at the Fed pushed the yield on prime mortgages so low that banks couldn't build fee-generating CDOs with the kind of yield investors were looking for. So they focused on riskier and riskier loans, even competing to buy up subprime lenders to ensure a flow of product. By 2006, high-risk mortgages accounted for about 40 percent of all mortgage originations. Similar phenomena occurred on a somewhat smaller scale in highly leveraged corporate takeovers, commercial real estate, and auto loans—all of them, to a greater or lesser degree, the financial equivalent of tulip bulb futures.

If the scale of the irresponsibility is staggering, it was in pursuit of equally staggering profits. Data compiled by the Commerce Department show that the financial sector claimed 41 percent of all corporate profits in 2007. The irresponsibility of the financial sector was matched by that of its regulators. The reason that all developed nations regulate their financial sectors is precisely because very highly leveraged players can make huge profits by risking other people's money. When their risks turn out badly, however, the costs tend to fall back to the public, as amply demonstrated by the events of the last several months. Uniquely, the United States adopted a pronounced hands-off attitude toward the financial sector throughout the 2000s, ensuring that taxpayers would eventually reap the whirlwind.

In the first edition of this book, I estimated that the losses to the banking and other investment sectors would be at least $1 trillion, specifying that if the deleveraging is disorderly, the losses could be double or triple that amount. We now seem to be in the midst of a disorderly deleveraging. The highly leveraged players in the shadow banking world, like the hedge funds, are caught in a forced deleveraging as banks pull their margin lending lines and insist on greater collateral against high-risk positions. Deleveraging feeds panic as forced sales drive down prices.

Just through October 2008, large publicly-traded financial institutions reported nearly $700 billion in losses. That number, of course, excludes losses in hedge funds, pension funds, and other investors that must be at least as large. Since the Paulson/Bernanke bailout plan implicitly assumes a continuing stream of bank losses on roughly the same scale for the foreseeable future, the likely losses are now $2 trillion or even more. Indeed, the actual or committed public cash infusions to the banks, including toxic assets "temporarily" absorbed by the Federal Reserve, the multiple bailouts, and the Paulson/Bernanke plan are now—by themselves— close to $2 trillion.

There are reports that cash-hoarding at banks is obstructing normal financing for payrolls and inventories at healthy companies. That is a classic liquidity problem, and the government's equity infusions into banks will be helpful in easing it. But the government can't arrest the fall in housing prices and other misvalued assets until they return to levels consistent with the cash flow and incomes of their borrowers. By most estimates, housing prices still have 10–20 percent more to fall, and the same arithmetic is at work in high-risk corporate bonds, leveraged loans, and commercial mortgages. Solvency issues, that is, still dominate.

The sad reality is that there is no easy way out. For about a decade now, we have had a false prosperity based on a huge water-wheel of money, fueling a debt-financed, import-driven consumer binge. Personal savings rates have dropped to zero, and the world is flooded with dollars. The new dollar-lakes from the Paulson/Bernanke rescue efforts just put us deeper underwater.

Now it's time that we take the same harsh measures we have long preached to other countries. Re-energizing consumer borrowing and spending with cheap money is exactly the wrong prescription. Consumption has to fall, by at least 4–5 percent of GDP, and the money has to be shifted to savings and investment. The hypertrophied financial sector has to shrink drastically. And we have to run down the huge overhang of dollar-based debt by producing more than we buy for the first time in a long time—in effect, by working harder and living poorer.

America is a resilient country, and will prosper again. But the shifts are of such a scale that they cannot be accomplished without a tough recession—and the sooner we get it over with the better. The precedent most on point is Paul Volcker's achievement in reversing skyrocketing consumer prices in the wake of the Great Inflation of the 1970s. It required engineering one of the nastiest recessions on record in 1979–1981, but cleared the ground for twenty years of solid growth. The alternative is a Japanese-style stagnation that could stretch on for a decade or more. By piling on yet more trillions in foreign claims on the United States, the Paulson/Bernanke therapies are making the ultimate tab grow higher.

Unfortunately, there may be no way to repair the damage to America's greatest financial asset of all—the global trust in our financial markets, which have long been a magnet for world capital flows.

The German finance minister, Peer Steinbrück, recently forecast that the American crisis is the beginning of the end of its status as the world's financial superpower. The United States, he said, "is the clear origin and focal point of the crisis . . . spreading through the world like a poisonous oil spill."

He's right on both counts, and it's a shame. During the years of American financial supremacy, dating from the Marshall Plan days, it has been a force for much good, although prone to periodic episodes of irresponsibility. The last decade, however, may rank as the most destructive of all, and both America and the world will pay the price for a long time to come.

I wrote this book to tell the story of the credit crisis as briefly and crisply as I can. I walk the reader through the instruments involved, how they work, and how they are abused. I untangle—as far as possible—what the outstandings are, why they are shaky, and build up to the probable loss scenarios and unwinding scenarios I just described.

In the first two chapters, I recreate the context for the 2000s credit bubble. A long cycle of liberal government-centric policy-making led to the Great Inflation of the 1970s, the failed attempts at price controls, and Paul Volcker's great success in arresting the collapse.

The watershed presidential election of 1980 brought free-market "Chicago School" ideology to Washington, and with it financial deregulation and, in the domestic arena, a steady trimming back of the power of centralized government. The scorched-earth reconstruction of our bloated post-war "old-boy" big-company corporate establishment in the first half of the 1980s was an essential precondition for the restoration of American competitiveness and the "Goldilocks" economy of the 1990s.

The prolonged financial boom, however, carried the seeds of its own destruction. In Chapter 3, I trace three critical developments of the 1980s and the 1990s—the birth of "structured finance," the great expansion of derivatives markets, and the mathematization of trading—that flowed together to create the great credit bubble. Chapter 4 delves further into the arithmetic, the instruments, and the mechanics of the credit bubble, and the crucial enabling role of monetary authorities, especially in America. Chapter 5 focuses on the debasement of the dollar, the huge dollar assets accumulated by some of the world's most unsavory governments, the rise of "Sovereign Wealth Funds," and the humiliations of selling off the family jewels to pay the interest on our past excesses. Finally, in Chapter 6, "The Great Unwinding," I pull together the instruments at risk, lay out the numbers involved, and play through likely unwinding scenarios.

In Chapter 7, I assess some of the broader financial and macroeconomic trends that fed into the bubble, while finally, in Chapter 8, I examine some of the policy responses available to Barack Obama's new administration.

I've always been impressed with a cyclical theory of American politics associated with the senior Arthur Schlesinger—that the political/economic consensus tends to swing between liberal and conservative cycles in roughly twenty-five to thirty-year arcs. In the early days of a cycle the new ways of thinking are like a fresh breeze that blows away the mythologies of the past. Inevitably, through a kind of Gresham's law of incumbency, breezes become doldrums, and leaders get trapped in mythologies of their own. Liberal cycles inevitably succumb to the corruptions of power, conservative cycles to the corruptions of money.

The current conservative, free-market, cycle that commenced with the Reagan presidency, with all its achievements, seems to have long since foundered in the oily seas of