

# Chapter 1

## Bamboozled

con·ta·gion [kuhn-tey-juhn] - *noun*

1. the communication of disease by direct or indirect contact.
2. a disease so communicated.
3. the medium by which a contagious disease is transmitted.
4. harmful or undesirable contact or influence.
5. the ready transmission or spread as of an idea or emotion from person to person: a contagion of fear.

**E**ach of the five preceding definitions of contagion could be appropriate to the current economic and societal circumstances occurring around the world. Although not exactly a disease, the greed, outsized consumerism, and virulent self-centeredness certainly appear to have devastating symptoms associated with them. The current illness is not transmitted directly by contact, but it certainly seems to have the capacity to spread broadly, especially through harmful or

undesirable contact. And it really was just an idea that spread, the idea that life is only about wealth accumulation and that men and women can be judged by some sort of bottom-line measurement system that ignores any sense of proper or ethical behavior in one's lifetime. People cared more about the ends than the means to reach those ends.

I don't remember who caught the greed bug first. I'm sure somewhere there were businesspeople who were rather unscrupulous and would sell any product for profit, usually on late night television. The politicians weren't far behind as it is difficult to be a politician without being ego-centric, which always seems to be one step away from unethical. I can still recall the first commercials I saw on television for lawyers offering their services to the recently injured. I remember when doctors and dentists became more interested in profits than patients. Everyone can name televangelists who were caught preaching the gospel more for profits than converts.

Of course, Wall Street has always been greedy. That is what they do. But, even on Wall Street things have deteriorated. Twenty years ago on Wall Street your word was your bond and the reputation of your firm was sacrosanct and to be protected at all times. You made money the old-fashioned way, by out-thinking and out-hustling your competitors and delivering a product or service to your clients that created real value for them.

Since then, trading and principal investing has turned Wall Street into a den of whores. There is no value in something other than what you can convince someone to pay for it. It is a reason to celebrate if you can mislead an investor and get him to pay more than what an asset or business is worth. If you can hide liabilities off the balance sheet and stick them with the customer, all the more reason for merriment.

But I don't want to give the impression that this current crisis started or ended on Wall Street. Wall Street could never have pulled this off on its own. Remember, this all began with an unsustainable housing boom and eventual housing market collapse. Home realtors pushed

their clients into ever-bigger homes based on phony high appraisals from non-independent appraisers with the money from mortgage brokers who fraudulently changed qualifying income amounts on mortgage applications, and all contributed to the dramatic boom in house prices. The commercial banks offered such aggressive terms for mortgages and knew full well they wouldn't sit on their balance sheet for long. Then the investment banks packaged these mortgages and sold them to unsuspecting institutional investors, such as pension funds and sovereign wealth funds. It may not have been ethical, but they paid the rating agencies hundreds of millions of dollars to rate much of this junk AAA. Even the dupes who ended up buying this junk were not without fault. They sought out the greater yield these investments returned, but the extent of their due diligence and credit analysis was to ask only about its credit rating. It leaves a lot of hours in the day to go golfing if your entire job consists of just investing in AAA securities with no further homework being done on the credit front.

But the real reason why this disaster was allowed to occur was that the U.S. government had been co-opted. None of this could have been accomplished without significant deregulation of the financial industry and the avoidance of previous regulation and of required supervision in many cases. It was the mantra of the American government for 30 years that less government and less regulation would lead to lower taxes and a stronger economy. Well, today, the United States has higher spending, higher taxes, more government, but a lot less regulation of the largest companies and banks.

Listen to your congressperson today say how surprised they are about the current crisis. Nothing could be further from the truth. They have been warned time and time again about this impending crisis, not only in home prices and in the mortgage market, but also about the high debt leverage of Fannie Mae and Freddie Mac as well as the entire commercial banking and investment banking and hedge fund industry. This crisis was no accident. It was just a matter of time until this

entire house of cards fell. Fannie Mae and Freddie Mac are the proper names of these large institutions that used to be abbreviations for their longer names, the Federal National Mortgage Association, for example, for Fannie Mae. They were put in business to buy existing mortgages from banks and to package them and to sell them as securities to investors, basically to turn mortgages into securities that looked more like traditional bonds.

So to understand the real reason why this occurred, you can't just stop at deregulation as an explanation. You have to ask why the deregulation was allowed to occur by our Congress and our President. The simple answer is that they were paid to deregulate industry. Our Congress and our President take billions of dollars each year from business and banks and Wall Street in the form of campaign contributions. They are by far the largest contributors to our national elections. Do you think a for-profit business would make a donation to a congressman unless they were getting something in return? John McCain admits taking money from the telecommunications companies that his committee regulates, but his defense is that it does not influence his voting. If this were true, it would certainly make the for-profit businesses that are handing him the money look awfully stupid for wasting their assets. No, just the opposite is true. A recent study on

[www.publiccampaign.org](http://www.publiccampaign.org) showed that for every one dollar in campaign contributions a typical American business makes, it gets back more than \$400 in tax benefits, tax deductions, and tax credits from the American government. Certainly a 400 to 1 return on your investment beats any of the alternative investments a company might have in its base operating business. And this does not measure the total benefit corporations receive from

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lobbying. In addition to tax benefits, generous lobbying corporations also receive help in protecting their domestic turf from foreign competitors, union busting with their workforces, price supports for their products, and taxpayer assistance in opening international markets.

Here is some evidence. Senator Charles Schumer, a Democrat from New York, has as his top 10 contributors the biggest financial institutions he is supposed to regulate on the Senate Banking Committee. The list of the top 10 campaign contributors to all of Congress include the National Association of Realtors, the Mortgage Bankers Association, the American Bankers Association, Fannie Mae and Freddie Mac, the investment banks and the hedge funds on Wall Street. It certainly sounds like every player in the current housing, mortgage, and banking crisis. In 2007 alone the securities and investment industry spent more than \$86 million on lobbying and the real estate lobby spent \$78 million. Tell me when the evidence becomes more than just simple coincidence.

Do you want further evidence? Name another problem facing America today and I can tell you the lobbying force that is preventing a commonsense solution that would benefit all Americans. Global warming? The coal lobby and the electric utility lobby. Gas prices? The oil and gas lobby. Pharmaceutical prices too high? The pharmaceutical industry lobby. Health care costs and coverage? The hospital corporation lobby and the HMO industry. War and defense spending? The defense industry lobby. Social Security and Medicare reform? The AARP. Education reform? The teachers union lobby.

Coincidence? I don't think so. Look at the facts of the current crisis. Banks and nonbanks were completely unregulated and were allowed to leverage themselves up and extend mortgage financing in the craziest amounts on the craziest terms to home buyers. There was no supervision of real estate agents and appraisers or mortgage brokers. Fannie Mae and Freddie Mac's supervision was so lax that they both utilized 120 to one debt to equity leverage to buy or guarantee half of all mortgages in the country, approximately \$5.2 trillion

worth. Is it a coincidence that Fannie Mae and Freddie Mac also spent hundreds of millions of dollars on lobbying and campaign donations to your Congress? Rating agencies' and investment banks' activities went completely unregulated as they packaged these mortgage securities and sold them worldwide. Hedge funds, some of the biggest contributors to your Congress and President, had no reporting requirements, no transparency, and no supervision as they helped grow the credit default swap market from a \$140 billion market 10 years ago to a \$65 trillion completely unregulated market today. AIG, a supposed insurance company, had \$420 billion of exposure in the credit default swaps market, an exposure that ultimately was their undoing.

As certain as the sun rises, as sure as the rain falls, as predictable as the tide, this financial crisis was guaranteed to happen. Not only has the U.S. government allowed deregulation at home, it has exported the idea worldwide as a solution to the world's economic problems. There is good regulation and bad regulation. In Peru and India, it can take six months and 850 bureaucratic steps for an entrepreneur to acquire a government license to start a new small business. Certainly this type of over-regulation is bad for an economy.

But what American advocates of deregulation failed to realize in promoting unregulated capitalism around the world is that you cannot have a free market without proper regulation. There can be no market without the rule of law. The reason capitalist free markets were slow to catch on in Africa and much of the rest of the developing world was not a problem of business, but one of government. The governments did not provide the essential rules and regulations and the rule of law necessary to conduct business effectively. Without the rule of law, contracts are not honored, fraudulent activity is not punished, and property rights are not protected. If you look at a map of the world, of the 160 countries on the planet with more than a million population, all are doing quite well economically, growing fairly well, with the exception of approximately 50 countries. All 50 of these countries share one

attribute—bad government. The corruption endemic in many Third World countries' governments means that individuals forming new businesses and building factories will face the constant fear that government representatives will someday steal their profits.

In one of the great ironies, rather than America exporting our model of good government to the world, it appears that America has imported some of the government corruption endemic to the Third World. As our government became more corrupt and more co-opted by corporate donations and lobbying, they regulated business less and business itself became threatened. Karl Marx said that the capitalists will manufacture the rope that hangs them. As Raghuram G. Rajan and Luigi Zingales said in their book of the same title (Rajan 2003), it's a matter of "Saving Capitalism from the Capitalists." It would be ideal if businesses operating in their own individual self-interest and profit-maximization does nothing but good for the planet. But this is not the case. Businesses pollute, cause global warming, cause conflicts over access to raw materials, rip off consumers, make false advertising claims, and put their workers in competition with the lowest wage workers around the world. Anyone who believes that corporations acting solely in their own self-interest to maximize profits in a world of no regulation will ensure a prosperous global economy, a healthy environment, and a stable world needs to go back to school and study externalities and collective action problems. Although governments should not do anything that the free market can do, there are enormous problems that cannot be solved by self-interested corporations in the free market and need government involvement. Perhaps one of the most important of these problems is the regulation of the market itself. Be wary every time a government official tells you that an industry has agreed to be regulated and that they have decided to regulate it themselves.

In this book I examine the evidence and try to gain a better understanding of how the United States got into this mess. I examine the housing price boom and collapse in detail because it was the primary

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cause of all of our current financial problems. But the primary focus of the book will be a look forward to try to describe how far-reaching this contagion might spread. The word contagion entered the lexicon of regulators of financial markets during the Asian meltdown in 1998, also known as the Asian flu in finance circles, and came to be popular in describing a crisis in one market that has the ability to mutate into others. I use a much broader definition of the term to not only include financial matters, but also government concerns such as corruption and societal

problems such as greed. Although I will not be accurate in all of my predictions, it is helpful to investors and businesspeople and concerned citizens to take this look forward as they are much more interested in what might occur in the future than what has happened in the past.

A question facing many homeowners today is: When will the current housing price decline cease? Unfortunately, I show that the country as of the end of 2008 is only approximately halfway into what is already a record housing price correction. A recession is spreading now in the United States, but I argue that it will become one of the deepest and longest in our nation's history. Already many European countries have entered recession and it will be some time yet until they return to positive economic growth. The United States and Europe drive global consumer demand for goods and products and so the other economies of the world, especially the emerging growth economies that specialize in manufacturing products for these markets and providing raw materials and commodities to them, will suffer. I cannot think of a single country on Earth that will be exempt from this economic downturn.

I describe what is happening on Wall Street and spend some time talking about the credit default swap market, that \$65 trillion completely unregulated market in which people can make bets on which company bankrupts next. I then turn around and demonstrate how problems on Wall Street and the freezing of credit worldwide can lead to serious problems on Main Street, in our own communities and in our own state and local governments.

An important question for investors is whether this is a temporary problem for the United States and the world or whether this is more permanent. The losses that have occurred in the housing market are permanent because no bank in the foreseeable future will be lending home buyers 10 times their annual income to buy a house as they have done in the past. If bank lending declines, the home prices have to follow. But it is also true that the problem extends further than just the housing price crash. The demographics of the United States are such that the baby boomers are just now starting to retire and this will represent a significant hit to our productive capacity and to our economic output. Just when the country starts to get over the housing collapse and the ensuing recession, demographically speaking, Americans will run into the baby boomer retirement, which will harm economic growth in the United States for decades.

In such a difficult crisis and terrible economic environment you can quickly see why cash is king. It is hard to come up with a list of good investment alternatives, but I do find a couple of interesting candidates. Similarly, there is not a long list of countries that I would recommend investing in, but there is at least one large one.

This analysis would not be complete without an understanding of the administration's plans to solve this crisis and a critique of their approach. Even after you stop the immediate bleeding of the financial institutions, you have to ask the question: What required reforms are necessary to the banking industry in general and to our government specifically? It makes no sense to talk about health care reform

or global warming or high pharmaceutical prices until big business is thrown out of our government. Until effective lobbying reform is enacted, this country is not going to be able to address any of the problems that Americans face. Remember, when these corrupt politicians were asked to come up with a plan to help the economy, they wanted to give \$700 billion of your money to the guys on Wall Street who caused the mess to begin with. The fact that many congresspeople and senators voted for this proposal even though their constituency e-mails and phone calls were 95 percent against the proposal makes you realize who they are really working for. I have some bad news for you, it isn't the American worker.

I conclude the book with a philosophical note as to what people in this country may have learned from this crisis. If the citizens survive it, it will make them stronger because everyone needs to do some serious introspection to determine if this country and this government and the their own lives are headed in the right direction. In a strange sense, it is good this crisis has happened. Americans never would have seen the error in their ways unless they were subjected to great pain and inconvenience. Now that they are feeling real pain with their jobs and homes threatened, only one final question remains:

Will they change?