Steve Glines

Roosting Chickens

In 1978 I had the opportunity to buy a house in Cambridge Massachusetts for about $75,000. I turned it down because had I bought it, after paying $10,000 up front for a down payment my mortgage would be $300 a month more than I had been paying to rent the house. If I bought the house I would get a negative return on my investment. Real estate has been immune from that logic for most of my lifetime because of the almost universal belief that all real estate appreciates quickly. The house was sold and I had to move. I drive by it occasionally and realize that at the peek of the real estate boom that ramshackle house could have sold for $900,000.

The problem is that someone did buy that house for a price nearer $900,000 than the $75,000 I had been offered. For the last 50 years the expectation that real estate will appreciate has been proved more or less true. Unless incomes grow at least at the same rate as the price of housing eventually the average person cannot purchase the average home. My guess is that that line was crossed somewhere in the mid 1990's. Unfortunately bankers, brokers and consumers all assumed that the party would continue forever, that there would always be a greater fool willing to pay just a little bit more but as the prices rose relative to our incomes the number of fools willing to pay absurd prices approached the vanishing point.

Banks recognized the problem they were facing. When a depositor places money in a bank it is a liability. To turn that liability into an asset it must be invested which for a bank means loaning the money out. Because that money is then returned to the bank in the form of a new deposit or liability, it must be loaned out again. Without limits the amount of money "created" could approach infinity. To prevent that from happening a "reserve" of about 20% is held back. This reserve requirement is adjusted by the Federal Reserve Bank to speed up or slow down the economy as it effects the creation of money, it's a multiplier effect. As the Real Estate market began running out of new suckers, banks began running out of new places to put their money. The banks return on investment began to falter; the rise in the price of Real Estate

began to falter. The first part of the Real Estate Bubble was at an end, the second part was just about to begin.

We have become a very short sighted society. Executives are rewarded for what results they got last quarter and their vision rarely extends beyond the next. The "future" has been foreshortened to not much beyond this fiscal year. A mortgage is a 30 year investment, a deposited liability is now. The question became one of how to turn all that liability into high paying short term loans. Some financial genius with an HP-35 calculator realized that the adjustable rate mortgage, or ARM, was a perfect vehicle to keep the good times rolling.

An ARM is based on the notion that a security can be sold based on the cash flow over the life of a loan while low payments at the start mean more people can afford the payments at least initially. For example a loan can have very low payments for the first 24 payments then those payments rise over time with a huge balloon payment at the end. If the bank resells the the loan while the payments are low and still in good standing then the bank is off the hook. A loan priced at 2% then 6% then 25% could average, over the life of the loan as 7%. This financial genius figured the bank could have it both ways:

1. By charging a very low interest rate (or low repayment rate) initially, a lot more people could qualify for loans and since, so the theory went, most people refinance (in 3 years for example on a 30 year note) before the high payments kick in the security was safe. In theory someone could continually refinance a house with an ARM every couple of years forever.
2. Since the sale price of the security is based on the cash flow over the life of the security, 30 years, the bank could bundle thousands of these loans and sell them as "tranches" to large investment banks as well as Fanny Mae and Freddy Mac. Banks typically mix good, bad and mediocre loans in a tranche and sell these to the highest bidder. They need to sell tranches to prevent buyers from cherry picking only the best loans leaving the bank with the trash. We'll see in a moment what Freddy, Fanny and the investment banks did with these securities that made the situation worse.

The availability of cheep loans jumpstarted the Real Estate market as new

"greater fools" flowed into the housing market. Hundreds of thousands of jobs were created as millions of dollars worth of new housing was built. The monster fed on itself as deposits flowed into the banks and unstable loans flowed out.

Greed has no limits. Fanny, Freddie and the investment banks were not happy holding five year notes, much less 10, 15 or 30 year notes. To make these assets liquid, to create even more money, these institutions created "Asset Backed Securities." An Asset Backed Security is created when an investment bank merges all it's "tranches" together then splits them into different grades of investment bonds. A new "tranche" of, for example, $100 million worth of mortgages (at present value) is bundled together and bonds created that represent some percent of the total. These ABS's were then sold on the open market creating new cash, new liabilities. The problem is that in a declining market no one knows what these asset backed securities are worth because they don't know what the underlying mortgages are worth. It's a Ponzi scheme, it works only while there is a greater fool willing to buy whatever is being sold.

Again! Unfortunately bankers, brokers and consumers all assumed that the party would continue forever, that there would always be a greater fool willing to pay just a little bit more but as prices rose the number of fools willing to pay idiotic prices approached the vanishing point. Suddenly all those 2, 3, and 5 year ARMS began to come due. A 2% interest rate became, 4% and 4% became 6, 7 or 8%. A mortgage payment of $1000 became $2000 and promised to go to $4000. The greater fools could not refinance their mortgages and the prices began to fall. The monster fed on itself.

Remember that money you deposited in a bank back at the beginning of this story? Let's say you deposited $100. Given the 20% reserve requirement the bank was able to loan out $80, then $64 then $51.20 …. This creates a total of about $450 in new deposits and about $350 in new loans. If some of those loans go sour then the bank has to either find more money to maintain the reserve requirements or stop making loans while those loans that are still good are paid back.

The way banks find more money is to either sell the assets they have or

get new deposits. Here's the problem: No one is willing to buy these "assets." Even Fanny and Freddy have suffered terminal indigestion, having purchased enough ABS junk bonds and toxic mortgages that they had to be taken over and resuscitated by the U.S. Government. That leaves option number two: wait until existing loans mature and are paid back. The cash coming in from maturing loans fills the bank's vault until the reserve requirements are met. In the mean time they don't have any money to loan out. That is where we find ourselves right now but that's only half of the story.

It gets worse. We live in a world where we finance everything. No one pays cash for their homes or cars or washing machines. Likewise companies finance as much of their operations as they can get away with. Every automobile dealership finances their inventory and look inside any store and you will see nothing but bank owned inventory, fixtures and infrastructure. Most companies as well as most individuals are "leveraged" to the max. On paper this looks great: Grow with other people's money. What happened when all this toxic debt began clogging the market is that the whole house of cards started falling. It's already begun and like the twin towers once the collapse starts no one knows if it can be stopped.

The cards at the top of the pyramid are crumbling: General Motors has tapped out its last $2 billion line of credit. Once that's spent it will have to live on its cash flow, something it hasn't been able to do for the better part of a decade. GMAC, GM's finance arm and a big player in the toxic security market, announced it could no longer finance the inventory of its dealers and almost immediately the largest GM dealership in the US went bankrupt sending thousands of employees to the unemployment lines.

All five of the of the largest investment banks, creators of those toxic Asset Backed Securities, have, one way or another, gone out of business so has the largest insurance company in America, a major buyer of the ABS junk. We may celebrate the demise of incompetence but historically these same investment banks were instrumental in the creation of most of America's largest companies. In the future it will be foreign investment banks, Chinese, Russian, Arab and European that will dictate the

direction America's economy will go. Almost unnoticed was the largest bank failure in American history when Washington Mutual discovered that it could not raise enough cash to meet its commitments. Then Wachovia, who's next? This is just the tip of the iceberg.

So the Federal Government is going to bail out the financial system by buying $700+ billion in bogus, toxic, ABS, "derivative" securities. With luck it will work but please note that the Feds aren't buying the original mortgages, heavens no, they might have some value, rather the Feds are buying the Asset backed Securities created by the now defunct Investment Banks. If (and only if) the Real Estate market "recovers" and somehow still greater fools are found will those ABS ever have value.

If $700 billion is the size of the problem we would be very lucky. $700 billion is only about half the size of the annual Federal Budget, that's manageable. Fortunately only a small portion of those questionable mortgages were converted into ABS's, the vast majority of those loans are still on the books of banks and Freddy and Fanny as assets. If the sale price of these assets continue to decline they will poison the balance sheets of more and more banks and cause many to fail. If you don't like a $700 billion bailout you'll love the price tag if this bailout doesn't work. It's something like $100 trillion or about half of the mortgages out there.

It might be interesting to stop for a moment and look at how and why we got here. We know greed got us here but it was greed at every level, from the most petty real-estate salesman through Wall St. to the Congress and the President of the United States. Greed has many forms and in politics is often disguised as altruistic actions. We want all sorts of services from our government but none of us want to pay for these services. No problem we'll charge it and leave the debt to another generation. Our national debt, money we have borrowed to run the national government, has grown from $2 Trillion in 1980 to $10 Trillion today. Historically our debt has been eliminated by monetary inflation. Inflation is a hidden tax shared evenly across the country. Let's take a look at the last 100 years.

In 1900 the average person earned $300 a year. In 2005 the average person earned over $40,000 per year. Of course in 1900 the average person didn't have the costly amenities we have today like indoor

plumbing and electricity but still the majority of the difference in incomes between 1900 and 2005 is inflation. Inflation is defined as an increase in the amount of money in circulation relative to the goods and services available for sale. It sounds simple and concrete but is really nebulous because as we saw banks can create money simply by making loans.

Economists have a name for different kinds of money much like Eskimos have names for different kinds of snow. Hard currency is called M0, M0 plus bank deposits are M1, M1 plus medium term deposits (like CD's and savings accounts) are called M2 and M2 plus the longest term deposits (like 2 year treasury notes) are called M3. Most of us treat our real estate investments as part of our personal M3 although most economists don't count it. In the past we have treated real estate as money since we could always go to the bank and get a loan based on the value of our houses. I would also argue that our 401K plans are also part of our personal M3 since we can dip into them on occasion too. The point of this exercise is that we measure our economy and our salary in money terms measured in dollars but that term has different meanings depending on context. A dollar means different things depending on when and where it's used so talking about inflation around economists is as slippery as an eel but a change in incomes from $300 to $40,000 speaks for itself.

What happened at the beginning of the Great Depression was almost the same thing that's happening today. When deposits aren't reinvested, new money isn't created and when money is transferred from M3 to M2 (by loan defaults or by paying off loans faster then new loans are made) then to M1 and cash (as confidence in longer term securities dwindles) the combined money supply shrinks. So long as all those ARM's are not being refinanced the money supply will shrink. When the money supply shrinks prices fall. At the height of the Depression the average price level actually declined, we had deflation.

When Roosevelt came into office the new thinking in economics was to stimulate the economy by increasing the money supply. It did so by purchasing all the bonds issued during the First World War and by buying gold at the, then, unheard of price of $35 an ounce. The national

debt was "monetized." Still it took the demands of the Second World War to put the malaise of the Great Depression behind us, monetary policy wasn't enough. Fortunately for us a combination of aggressive monetary expansion and an incredibly fast growing economy put the debt of the Second World War behind us very quickly. The cost of Vietnam was different.

There is an old saying that "you can't have both guns and butter" and during both world wars there were shortages and rationing. Vietnam was different. For the first time in history politicians tried to have it both ways. President Johnson's "Great Society" combined with a booming post-war economy and a festering and expensive war in Vietnam lead to a relatively massive national debt. The solution the Federal Reserve choose to solve the problem was to monetize the debt to pay for it with "fiat," invented, money. Of course this lead the wild inflation of the Nixon and Ford and Jimmy Carter years but it solved the problem of the debt. It got rid of it. It also stimulated the economy and the 1980's were golden years.

This magic potion was not lost on Ronald Reagan who doubled the national debt as well as the size of the federal budget and managed to bankrupt the Soviet Union in an arms race Russia realized they could not win. Unfortunately Reagan also appointed Allan Greenspan to head the Federal Reserve.

Alan Greenspan did two things that made free market economists drool in delight. He attacked inflation with a vengeance by raising interest rates sky high. This made investments in America look very attractive while at the same time removing money (that mysterious M3) from the system. He was so effective in removing money that he caused the recession of 1988-89 which cost George H.W. Bush the presidency and forced President Clinton to create budgets with a surplus. Regains debt could not be paid for with inflation so Clinton had to arrange to pay for it with taxes. Fortunately the end of the cold war reduced the need for military spending. We had a peace dividend and the economy grew and grew and grew. The economy grew because there were more goods and services available to buy since the capacity of our economy to manufacture goods for human consumption rather than military

consumption grew. The good times came to an end with George W. Bush.

George thought he could do old Ronald Regain one, maybe two better. After nine-eleven George conjured up the most expensive war in American history. If Regain only doubled the national debt from $2 trillion to $4 trillion, George managed to double it again from $4 trillion to $8 trillion through a combination of tax cuts and uncontrolled spending. Contrary to their political doctrine Republicans have been unable to restrain themselves when it comes to spending your money. With the financial rescue plan in place it is not unreasonable to expect the final bill to push our national debt well over $10 trillion.

So how are we going to solve this problem? This is a ~$30,000 problem for every man woman and child in the US, it's the cost of a low end luxury car or a year at a middle of the road private college. It is "doable" if any of us really thought that would be the end of it but it would destroy the hopes of retirement for the current generation and hobble the start of the next. Even if we did pay it off in a static economy would it have any effect? Who do we owe this money to anyway?

In the aggregate we owe it to ourselves but the devil is in the details. When Ross Periot sold Electronic Data Systems to General Motors for a couple of billion Dollars he put his money in U.S. Government bonds, he bought part of our national debt. When he ran for President and paid for his campaign "with his own money" he actually paid for it with interest on those bonds. We actually paid for his campaign with that portion of our taxes that pays the interest on the national debt. It's the very rich of the world, rich individuals, rich corporations and rich countries like Dubai and China that own the promissory notes of the United States. If we default, and default we must, it will be a massive transfer of wealth from the rich to the poor.

Why must we default? Simple, we must default because there is historical precedent for it and in the end there is no other way. Trickle down economics never worked. The rich don't spend the way you and I do. They invest, they create more money, and they create additional claims on our national productive capacity. They own or have a lean on

the means of production and they demand their due. Eventually the economy grinds to a halt as it becomes tied up in servicing its own debt.

I'm not inventing economic theory here, just observing the patterns of history that have been observed in every society since man began recording history. In our own era it has been called long economic wave or *Kondratieff Wave* after a Soviet era economist who first described a 50-80 year wave of economic growth and contraction in the modern era. Nilolai Kondratieff observed the expansion and contraction of economies and described it as a cycle of strong economic growth followed by a period of debt repudiation and commodity price collapse. The price collapse is a result of the contraction of the money supply brought on by debt repudiation or default.

In earlier times what economists now call the Kondratieff wave was observed as "goldsmith crisises." Vilfredo Pareto, an economist and early contemporary of Kondratieff was able to isolate data showing signs of long economic waves going back into Roman times. It appears that in societies lasting long enough to observe their internal economics institutionalize their debt repudiation. For example in the Old Testament there is the observation of the "Jubilee Cycle" every 49 years, a feature of which is the forgiveness of debts.

There are many ways to default on the national debt. The most obvious way and the least likely to take place is to simply repudiate the debt, just announce that we will no longer honor the debt. The second way is through monetary inflation. The Federal Reserve adjusts the money supply by buying or selling debt instruments like Treasury Notes. When the Feds buy notes they introduce money into the system, when they sell securities they remove money from the system. What do you think will happen when $700 billion in cash is spent buying up defaulted mortgages and "toxic" securities? A lot of money will be introduced into the system and according to classical (or neo-classical if you like) economic theory one of two things will happen. If there is pent up demand (i.e. if there are people who could qualify to buy a house but can't because of the mortgage crisis) then the economy will boom as money changes hands again at an accelerating pace. This is called a simple increase in the velocity of money if any of you reading this are

economists. If, however, the economy is saturated, if there are no more "greater fools" out there then this sudden increase in the money supply will cause nothing but inflation. This is good!

Why is this good? For one it reignites the housing market as outrageously expensive houses become relatively cheaper. It also allows us to pay down the national debt with inflated dollars. It's a game of musical chairs where those who hold enormous wealth on paper are least likely to end up with a seat at the table. Still inflation is a hidden tax on all of us that history has shown to be a universal but, ultimately, welcome leveler.