— Introduction —

I'm a very unlikely author of any book, much less one about economic theory. I live in a quiet, small town, working in the construction trade, designing and building houses, and renovations to houses. My town is very old, incorporated in 1637. It was the second Pilgrim settlement in North America; they came here when the best farmland around Plymouth Bay was taken. The sense of history here gives you a different feeling as you're going about the business of living. The feeling that what you do matters, especially as a builder. All these years later, there is still only one traffic light in town. And, the streets are filled with very old houses, each with centuries of stories to tell. Not long ago, I stopped to look at a tiny little Cape near my house that I had never really noticed. Set on an acre of trees and gardens, the house has a pastoral setting so commonplace here you forget to take in the charm. Antique houses here have dateboards. This one was built in 1716. I paused to wonder how on earth this modest house could still exist.

The answer is generations of families who cared enough about that charm to pass it on to the next generation. The absence of those values is what bothers me most about what we are all about today. Nine out of every ten houses built here since the 70's are large, boxy colonials. They're not particularly charming and they all look pretty much the same. That is, except for those built since 1995, which look like they're on steroids. It's no longer about charm, it's about wholesale square footage.

It's through this lens I observed the crumbling of our economy. There were, in fact, clues that things were coming apart at the seams. But, the financial wizards told us the "fundamentals of the economy were sound." That litany of false confidence was repeated *ad nauseum* as pieces of the economy continued to fragment. It turns out the whole crazy thing had been operating beyond the bounds of sanity for quite some time, and we watched in subdued despair as our 401Ks were chopped in half for the second time in ten years. But, the most shocking thing of all was the surprise expressed by those in power.

Anyone paying attention could see the concentration of wealth and power at the highest levels, the enormous executive salaries and such. But, that's another world, far removed from our everyday lives. We knew the deficit was out of control and has been for quite some time. We knew Social Security was in trouble. And, there was this persistent noise about "subprime," like the last fly of summer that won't go away. Meanwhile, we saw a correction in home prices, and although this affected many of us, the correction was to be expected.

We **didn't** know that at the highest levels of corporate America, there were business models that wouldn't pass muster in a lemonade stand. Fundamentals? The fundamentals are where we will sift through the rubble of the economy looking for our valuables.

If this was done with knowledge and forethought, "they" are guilty of greed and criminal fraud on a massive scale. It's almost worse if they did this unwittingly. It's no more comforting to think that the "experts," the titans of finance and industry to whom we've entrusted our economic well-being, are merely moronic.

As an unrepentant news junkie, I began to sift through that rubble. What I found astounded me. As it turns out, anyone with the common sense God granted animal crackers could have seen the truth that inexplicably eluded some of the world's smartest people. It was all there for anyone to see.

I never consciously set about to write a book. But there was a story here that I felt compelled to tell. At some point, right at about 10,000 words, I realized I was writing a book.

Here follows my disclaimer. I am not a financial expert. The facts and numbers in this book are the result of my sitting at the kitchen table for hundreds of hours, pouring over reams of internet information. I do not have a research staff. Mostly, I tried to verify the facts, figures, and concepts by cross-referencing, and by seeing them published in multiple places.

Because of the timely nature of the subject, the writing was done in relatively few months, by me sitting at that same kitchen table pounding on the laptop with my two index fingers. Most of the other fingers refused to cooperate, although I convinced my right thumb to operate the space bar now and again.

Wherever possible, when I used more than a few words from something I read, I credited the author. My understanding is that "fair use" copyright laws grant that much. I am eternally grateful to all those web bloggers and editorialists out there who post information you tend not to see in print, or hear in prime-time media.

I am a simple man. I don't pretend to be an economist. My understanding of the complex financial world is average at best. In fact, I'm so simple I tend not to get in much trouble. Usually, I buy things only when I can afford to pay cash. When I borrow money, I make sure I can service that debt even in the harshest of times. Call me crazy.

If I misinterpreted some of the finer points, I beg forgiveness in advance. But, I don't think I'm wrong about the bigger picture I'm presenting. In fact, I challenge the smartest economic minds out there to tell me I am. Believe me, I would love to be wrong. It's no fun at all to be right about this stuff.

Doug Friesen
April 1, 2009

— Chapter One —

The Entitlement Era

> *"It came with a speed and ferocity that left men dazed. The bottom simply fell out of the market...The streets were crammed with a mixed crowd — agonized little speculators,.. sold-out traders... inquisitive individuals and tourists seeking... a closer view of the national catastrophe...Where was it going to end?"*
> — Account of the 1929 stock market crash in the New York Times

Chronology of a Crash

The economic crisis of 2008, although years in the making, started officially on Monday, March 10. It began very quietly, and it started with rumors. The word "on the street" (Wall Street) was that venerable investment bank, Bear Stearns, was having liquidity problems and was unable to cover losses in their mortgage securities. CEO Alan Schwartz, and Executive Committee Chairman Ace Greenberg, called the rumors "ridiculous." After all, they had almost $18 billion dollars to the good on their balance sheets.

By Wednesday, the rumors grew to a fever pitch. The stock, which had been trading at a low of $60, considered by some top stock analysts to be a "risky but good" buy at that price, dropped 50% to $30. A visibly shaken Alan Schwartz appeared on CNBC to calm the markets. His appearance had the opposite effect. It started a classic run on the bank,

and by Friday, it was clear that without some type of intervention, Bear Stearns would be unable to open for business on Monday.

It was a sharp lesson in the value of confidence in the markets. Without it, rumors, unfounded or not, can destroy a company in days. It was also a sharp lesson for the Federal Reserve (Fed), who realized they would either become the lender of last resort, or allow the collapse of a Wall Street giant, creating major repercussions throughout the system, and causing untold damage.

During a series of tense weekend meetings, the decision was made for a backdoor bailout. Because it was an investment bank, not a regular commercial bank, (a bank whose primary business is providing financial services tocompanies), the Fed could not give money directly to Bear Stearns. Instead, the Fed gave $30 billion to JP Morgan Chase to "acquire" Bear Stearns in a shotgun marriage. By the weekend, Bear Stearns employees, who owned a big chunk of the company stock, were hoping to get at least $20 for their shares. The grim reality was revealed Sunday evening with the devastating announcement that Bear Stearns had been acquired by JP Morgan Chase for $2 a share.

When the Fed reviewed the Bear Stearns books, they found billions in hidden losses in "structured investments" like mortgage securities. More profoundly, they found Bear Stearns held over $20 trillion in "derivative" futures and options, a shockingly risky position that far outstripped their ability to cover even a tiny fraction of these contracts.

In May 2008, with the Bear Stearns rescue fading from the front pages, Federal Reserve Chairman Ben Bernanke called the subprime mortgage crisis "contained." Bernanke and many others anxious to return to "business as usual" clearly ignored warning signs throughout the summer of similar trouble at Fannie Mae and Freddie Mac, the two giant quasi-government mortgage companies. On September 7th, Treasury Secretary Henry Paulson finally announced the next rescue, the single most expensive government rescue in history. The Government agreed to spend $200 billion to restore confidence in Fannie Mae and Freddie Mac, whose stock had plunged 90% in a few months.

All of this government support for private institutions was beyond troubling to Paulson, a deeply conservative "free marketer." It represented what conservatives call a "moral hazard, " the worst possible breach of the very principle that defines free markets: the principle that self-preservation will cause even the boldest of players to step back from the brink of excessive risk. But, the markets were truly rattled. If huge companies like Fannie and Freddie could drop so easily, then no company was safe. The Fed had to choose between the "moral hazard," and an uncontrollable systemic failure among interconnected and interdependent worldwide super-banks. Nobody wanted that on their resume.

The events of September 2008 unfolded like a slow motion train wreck. At first, the crash of some of Wall Street's biggest investment houses seemed cataclysmic enough, but the momentum of what came behind it caused devastation to the economy unimaginable just a few short weeks before.

Lehman Brothers was the next casualty, and they fell for all the same reasons: too many highly-leveraged positions in subprime lending and other high-risk investments. Potential buyers, including Korea Development Bank, Barclays, and Bank of America, had walked for one reason: the Fed would not guarantee losses on the deal. Paulson and Bernanke had "bailout fatigue," and they felt they had already gone too far with Bear Stearns, and with Fannie and Freddie. They had warned Lehman CEO Dick Fuld before, and now they aimed to restore some discipline to the markets. On Sunday September 14th, they made the "tough love" announcement that Lehman, an investment bank that predates the Civil War and survived the Great Depression, would be allowed to fail. Lehman's bankruptcy filing listed $613 billion in debt, making it 15 times larger than the largest bankruptcy filing ever, World Com in 2002.

On the same day, Wall Street giant Merrill Lynch agreed to be acquired by Bank of America. This, on the heels of Merrill Lynch losing an average of $52 million a day for an entire year, on now-toxic mortgage investments. Paulson issued a statement that the American people should remain confident in the "soundness and resilience of the American financial system." Some Wall Street columnists breathed a

sigh of relief Sunday night and submitted Monday morning columns saying the worst was over; the toxins had been purged from the system.

On Monday, September 15th, the world awoke to quite a different reality. We were not even breathing the same air. This is the day the world realized the systemic failure Paulson and Bernanke so feared had, in fact, occurred. Overnight, stocks in Asia and Europe had gone into freefall. Throughout the day, US stocks plummeted, with the biggest one-day point drop since 9/11. Credit markets froze solid on fears that no company or institution anywhere constituted a safe place to park money. My God, even some money market funds were in trouble!

By mid-week, AIG, one of the largest insurance companies in the world, was also suffering liquidity hell following its credit rating downgrade. Unwilling lenders would not save AIG from insolvency. Because AIG held default insurance (Credit Default Swaps) worth hundreds of billions of dollars on thousands of companies, their failure could trigger a cascade of further damage. The Fed quickly injected $85 billion to prevent a nuclear meltdown.

The week of September 21st, Wall Street's only two remaining investment banks, Goldman Sachs and Morgan Stanley, were forced to become "commercial banks" to make cash infusions from the Fed easier. It was the end of the era of Wall Street investment banks; they were all now regular commercial banks.

A bailout plan to restart the stalled economy was batted around Congress and presented to the public in a prime-time address by President Bush. It was met with resounding negativity by Bush's own party, and especially by the public. Very few were buying the notion that we had to throw money at rich people to avert an impending "apocalypse." The very same President Bush, standing at the very same podium, had invoked similar urgency to convince us we needed to invade Iraq five years earlier.

On Thursday September 25th, 119 years to the day after its founding, Washington Mutual, the nation's largest savings and loan, was seized by the FDIC for bankruptcy liquidation. The FDIC sold Washington Mutual's banking assets to JP Morgan Chase for pennies on the dollar, after Washington Mutual's stock price had tumbled 98% and depositors had withdrawn $16.7 billion in ten days.

Wachovia, once one of the most conservative banks in the US, was approaching insolvency and was in talks to be acquired by Citigroup. Wachovia ended up going with Wells Fargo, but Citigroup itself became the poster child for "banks too big to succeed," and later needed two massive bailouts. Meanwhile, Bank of America was reeling from shock after acquiring Merrill Lynch and having a close look at the books. Another cash infusion to Bank of America. Are we getting dizzy yet?

Through the weekend of September 27th-28th, Paulson and Bernanke met with congressional leaders to hammer out the "mother of all bailout plans." The message by Paulson

was clear: "If you do not act now, there will not be an economy on Monday." On Monday, the "economy" answered: Paulson, Bernanke and Congress are out of ammo and have lost control of the situation. The Dow dropped 777 points, the largest one-day point drop ever. Still, just to keep the present reality of a Dow languishing around 8,000 in perspective, the Dow was still well above 10,000 points.

October and November featured a worldwide banking collapse, and even the failure of an entire country, Iceland. Collapsing mortgage securities and the resulting credit crunch worked through the international banking system like a pig through a python. The depth of the sell-off was such that by year's end, the S&P index featured as many stocks that had fallen by at least 90% as ones that had risen at all. As miserable as all this seems, at a 50% drop (considerably more than any single year during the Great Depression), we were doing better than almost any other industrialized country, where most stock markets were down well over 50%.

Entitlement Rules

> *"Don't go around saying the world owes you a living.*
> *The world owes you nothing. It was here first." - Mark Twain*

Our free market system, even with its inherent greed and excess, was the model of dynamic wealth creation. Every stock market in the world wanted to be more like the US, and even Communist countries like China adopted the US model. In "bull" markets, the energy was infectious. In "bear" markets, corrections, and recessions, the momentum of free capital markets eventually cleaned out failing and underperforming companies, clearing the way for new growth. Even in the worst of times, the desire for wealth would always fuel human ingenuity to find a way to prosperity again.

Now, each new day dawns with new "all-time lows," new cutbacks, new drastic measures. The wholesale system collapse we are currently experiencing may or may not be worse than the Great Depression; that comparison has yet to play out. That we are even contemplating the comparison is testament to how far we've fallen. We are left to question the integrity of everything. In these stormy seas there is no holding ground to anchor in, no place from where we can start over. The collapse seems so deep, so bottomless, with potentially more shocks to come, one starts to envision some sort of Mad Max world. How did this all fly apart so easily; what really happened to cripple this giant?

We have spent most of the last two decades living through two booms: dot-com and now housing, both created easy wealth that disappeared even more easily. This can't be just a coincidence, there's got to be a trend here. Looking for the free lunch, we just can't accept a plodding path to prosperity. The bumper sticker for the age of entitlement is "I want instant gratification and I want it now!" And we don't seem to care how we get there, either. If we would have cared, this whole crazy thing would have set off alarms long before it did.

We might like to blame the whole thing on evil geniuses in ivory towers doing wicked things with their wicked money. There's probably more than a little truth to that, but it's a bit too easy. It lets us off the hook for any personal responsibility for what has happened. And, among the many admirable traits in short supply recently, personal responsibility is right up there.

Self-Esteem Run Amok

> *"Too many people overvalue what they are not, and undervalue what they are."* — Malcolm S. Forbes

The so-called "entitlement generation" is officially defined as "those born between 1979 and 1994, who believe they are owed certain rights and benefits without further justification." It's unclear how these dates came to define a generation, but it is clear that such a generation does exist. The rallying cry goes something like this: "We're entitled to have everything work for us, and if it doesn't, someone else is to blame."

We've all seen it: the biggest homes, coolest cars, best schools, the most stuff. Articles abound on how to deal with the "entitlement generation" in schools, colleges and workplaces. How did this happen?

Anthony Robinson, writer and speaker on spiritual matters, ponders this question in a May 2007 weekly on-line column, *Speaking of Faith*: "How has this pervasive sense of entitlement come to pass? Is it self-esteem run amok? Is it the emphasis on 'rights' in speech and thought? Is entitlement a corollary of affluence or a consequence of consumerism? Does it owe to being the world's sole superpower? Whatever the cause, this much seems true: Entitlement is the handmaiden of the ego, the sign of a neglected, malnourished soul. Entitlement signals a

rejection of the very DNA of America. Our national genetic code, at least at one time, was patterned on respect for the common man and woman. It was sequenced by a belief in the dignity of human life that's not the consequence of having, but of being. In the end, it's the entitled who, however rich, are truly poor. Instead of knowing life as a gift, life turns into something that's taken for granted — or worse, begrudged. That's real poverty, and no sense of entitlement can alleviate it."

I'm OK, You're OK

> *"What others think of us would be of little moment did it not, when known, so deeply tinge what we think of ourselves."*
> — Lucius Annaeus Seneca, 4 B.C.

If the 70s self-help book *I'm OK, You're OK* were written today, it might be called "I'm entitled, you're entitled." Somehow many of us, even those born before 1979, have come to believe we qualify for "the good life" whether we have earned it or not. Across the entire economic spectrum, there has been an excess of consumption and borrowing, with not enough production and saving. There was simply no way to use credit indefinitely, especially when most of the borrowing took place on the strength of home equity, which turned out to be mostly phony wealth. With traditional forms of saving at or below zero, consumers will now be forced to contract their lifestyles, and have already begun to

do so. The July to September 2008 quarter saw the largest drop in consumer spending in 28 years. When 70% of the economy depends on consumer spending, it cannot absorb these imbalances without a profound recession.

Throughout history, America has witnessed the creation of the most dynamic economy in the modern world. Then something happened. Several decades ago, Americans stopped building wealth and started building debt. We stopped manufacturing things of value and became an economy that spins on the strength of consumption instead of production. Every generation has been taught to expect an improvement in lifestyle. Over the last 20 years, our personal consumption has risen at roughly the same rate as our personal savings have fallen, about half a percent per year. This is the first American era where consumers bought lifestyle improvement on the credit plan. Although economic models vary slightly, most show America currently has around a 0% savings rate, down from 12% in 1980. Meanwhile, the total household debt has skyrocketed from $4.4 trillion to somewhere between $9 and 10 trillion in just the last ten years. As a nation, we have a lot more "stuff" than any previous generation, and we are completely broke.

Lifestyles Out of Control

> *"This would have been a big year for Darwin,*
> *if he had been fit enough to survive this long."* — Grant Bartley

At certain points in history, like the period following World War II, debt, both public and private, has been wisely used to finance important economic growth. This current round of indebtedness seems to have served few purposes other than instant gratification. Easy credit, aggressive marketing and predatory lending… these are not the cause of our consumer credit crisis. These factors are merely symptomatic of a much larger problem. Several decades of stagnating or falling real wages have somehow coincided with an expectation of an increasingly material lifestyle.

The middle class family of the 1950s and 60s, even the 70s and 80s, grew up in a modest house of perhaps 1200-1500 square feet, sharing one bathroom and one car. It was normal for several kids to share a room. Since then, a 2400 sq. foot house with four bedrooms became the norm even while family size was decreasing. The "McMansion" syndrome spread across the country. In many areas, almost every new house built in the last decade was in the 4,000-6,000 square foot range, and houses much larger than that were commonplace. A car for each driver is a must, as well as a house filled with expensive gadgets and toys. This new lifestyle expectation took place not because we could afford it, but because that's what we expected to

have. Those who profit from extending credit were happy to fill the void between "want" and "have." The end result of this credit binge was that by the end of 2008, one in every 171 houses in the US was in foreclosure.

In the midst of living fantasy lives we can't afford, we haven't been alarmed by government spending out of control. We haven't even paid attention. The same mindset that won't sacrifice current desires for future savings misses the contradiction between borrowing money from China to grow government spending while cutting taxes. The wake-up call will be the worst financial hangover experienced by any generation since WWII and the Great Depression. The fallout from consumers amassing huge debts for non-essential consumer goods, houses they can't afford, and government's inability to spend within its means will be unprecedented. And, it will inevitably fall upon on financially conservative taxpayers who were un-cool enough to live within their means. They will be the only ones with money left to bail out the hopelessly irresponsible.

In an interview on National Public Radio (NPR), Parker Palmer, a Quaker writer and theologian, speaks of "repossessing virtue" in light of the economic meltdown: "At some level, most of us knew [the economic crash] was coming. Who doesn't know that a society where the rich get richer, while the poor get poorer, is a society that will someday have to pay the piper? Who doesn't know that a society that encourages us to live beyond our means and

refuses to regulate greed is one in which our avarice will come back to bite us? Who doesn't know that at every level of life, from personal to global to cosmic, what goes around comes around? The problem is not that we don't possess a capacity to know these things... The problem is that the knowledge we need, like the seismic shifts that create eruptions, originates underground. It comes from a place within us deeper than our intellects."