Introduction

Okay, you got this far, which means you already know something important: that you don't know enough about the financial toxic waste Wall Street has foisted upon us. Sure, you've heard there are piles of bad mortgages taken out by people who couldn't afford them. You've also heard that all of us, consumers and bankers alike, are too deeply in debt and that it's time to tighten our belts. But you suspect that's not really the entire story. It isn't.

Like most of us, you are praying that the stimulus package and the Wall Street bailouts will resurrect the economy (although you're probably dubious about helping wealthy bankers, and furious with their bloated bonuses). You're also worried that as the economy crashes your hopes and dreams for our country—like universal health care or alternative energy investments or renewed support for public education—are slipping out of reach. And you no doubt fear the country will be crushed under the mountain of debt that we are accumulating. It's all a muddle, and you'd like some straight answers. Same here.

After the housing bubble burst in 2007, I realized I didn't know enough about modern high finance. The last economics textbook I cracked open devoted 544 pages to the production of goods and services, and only one page to banking and finance. It couldn't explain why our economy was collapsing and why we had to give all that money to Wall Street to avoid an even worse collapse. I no longer felt like an informed citizen. It was time to figure some of it out and share it with my fellow ignoramuses.

I turned to the experts, the way we're supposed to. I studied the analyses of the bankers, investment analysts, scholars, and reporters who are trying to explain this mess or propose solutions to it. But too many experts are wearing ideological blinders. Many of these insiders formed the cheerleading chorus when all was rosy and billions were being made on Wall Street. Almost all promoted our bright new financial-services economy as the way forward

for America. And they considered anyone who questioned it to be an inconsequential whiner or a radical kook. What's more, most insiders seemed unable even to ask whether the new wave of "financial engineering" contributed to or harmed our society. Instead, their understanding was: "If it makes that much money, it *must* be good, useful, and productive."

It's very hard from the inside to question market fundamentalism. We have been told for decades that private-sector financial markets are, by definition, the most efficient way to allocate capital. And if they aren't working efficiently, it must mean government has interfered and messed them up. This faith-based thinking has pervaded all of our established institutions and financial reporting. It's even taught in our grade schools.

In this book, I come at the economic crisis from outside the usual professions. I aim to answer some very basic questions and share what I've learned in a way that will allow others to understand it too. As we investigate the nitty-gritty of the crisis, we'll also make sure to keep a big-picture perspective. This crisis is a good thirty years in the making, and we won't solve anything if "solutions" don't address the underlying issues.

To maintain our citizenship in a world dominated by imploding economies, we all need some basic financial literacy. I mean, take a look around you: We are teetering on the edge of a vast economic depression. The experts helped us get here. You want to let them write all the critiques as well?

For the past few years, I've had a morbid curiosity about exotic financial instruments, especially collateralized debt obligations (CDOs)—those highly profitable new financial products that supposedly made housing more affordable to marginal buyers and generated vast sums for the financial sector at almost no risk for investors. (To keep the terms straight, there's a glossary in back. I'll also be explaining the guts of CDOs in chapter 6.) Wall Streeters and their cheerleaders in the media told us that these

CDOs were part of a wave of great new products from American financial institutions that were making our country strong and rich. As we ceased to be a manufacturing giant, we were becoming the great engine of global financial innovation, spewing forth these wondrous new inventions. In fact, these new financial instruments, the envy of the world, were said to be much more profitable than making cars or steel or refrigerators. And they produced high-paying jobs, which in turn helped increase our overall standard of living—especially in Manhattan!

It was really hard to understand how these instruments worked. I kept imagining something like a financial iPod—an elegant new device that gave people something they really wanted (or thought they had to have), and in return earned profits galore for those who produced it. But as I read more about my imaginary CDO-iPod, I soon realized that there was something fundamentally different about a financial product and a consumer product: namely, when a financial product screws up, the entire world economy could collapse.

As of this writing, several trillion dollars' worth of value—something close to half of all the world's financial wealth—has disappeared from the global economy due to, or facilitated in large part by, fundamentally flawed CDO products.[1] Our government is bailing out Wall Street firms and has taken over Fannie Mae and Freddie Mac, two companies at the heart of our mortgage system. Lehman Brothers has gone into liquidation, Merrill Lynch's bull has been gored by the Bank of America, and now Bank of America is in serious trouble. Along the way, the largest insurance company in the world, AIG, is essentially owned by the taxpayer, and Citigroup is not far behind. Meanwhile, banks are doing precious little lending, and the economic system is spiraling down with unemployment rising rapidly well into 2009. And the government has been forced to spend nearly $1 trillion on financial bailouts and another $787 billion on a public stimulus package to keep the economy from tumbling into the abyss.

These innovative financial products also are polluting local

treasuries around the globe. The town of Narvik, located at the northern tip of Norway, invested its reserve funds in supposedly supersafe CDOs: It lost $65 million. Five Wisconsin school districts invested $35 million and borrowed $165 million more to purchase AA-rated securities called "synthetic" CDOs. Not only are they now on the verge of losing their entire investment, but they also owe $200 million. That's some financial product!

As with other defective products, there's a recall underway—the largest product recall in history. These financial instruments, which sliced and diced mortgages into securities sold and resold all over the world, have grown so toxic that they have to be carefully removed from the balance sheets of banks, investment houses, brokerages, insurance firms, and other financial entities. (I can't help picturing bank examiners fully encapsulated in white hazmat suits and air packs, using large tweezers to pluck the toxic products from the banks' books.) In fact, these financial hazards are turning out to be so toxic that the Bush administration, in November 2008, gave up trying to remove them and instead partially nationalized key portions of the banking system, while also providing tens of billions to other key financial institutions. Imagine that—a product so toxic that the virulently free-market Bush White House adopted socialist policies!

But this product recall is like no other. Rather than being reeled back in by their corporate producers owing to their faulty design, the federal government at first decided to use at least 700 billion of our tax dollars to buy the products from the ailing banks. (Nomi Prins calculates that as of February 2010, Wall Street is still the recipient of $8.6 trillion in various government bailout subsidies, even after the well-publicized TARP repayments.) Then they decided that instead of buying up the toxic waste, they would loan billions of dollars to the polluted financial companies to get them, in turn, to lend money to businesses and consumers again. (Meanwhile, the Federal Reserve was quietly insuring the toxic assets, which may cost us hundreds of billions of dollars more down the road.) Now the Obama administration

is again taking up the plan to remove these hazardous assets from the banks, which could end up requiring several *trillion* dollars on top of the money already put into this mess. Meanwhile, Wall Street's finest awarded themselves $18.4 billion in bonuses for a job well done during the worst financial crash since the Great Depression, *after* their banks went on the federal dole.

Compare this to the failure of a more tangible product like an iPod. Let's imagine that a major electrical problem was discovered that caused iPods to burst into flames (the way some laptop-computer batteries made by Sony actually have done[2]). If the cost of the recall and the threat of legal action were enough to totally sink Apple, Inc.—which is pretty unlikely—about $90 billion (as of this writing) would evaporate as the company's stock crashed to zero. That's spare change compared to a CDO going haywire. As we are learning day by day, the demise of faulty financial products can ignite a vast economic firestorm.

Another tremendous difference between a CDO financial instrument and an iPod is that, as of this writing, no one on earth really knows how much a given CDO is worth. As a result, banks, investment houses, and insurance companies—which are loaded with these products—are struggling to figure out whether or not they are solvent. And since they know that they don't know, they also know that *others* don't know. They don't trust each other, and investors don't trust them. Unlike the iPod, with its "suggested retail" sticker price, the value of many CDOs often can be estimated only through complex computer models. And no one trusts the models either. Hence a great freeze in the credit and loans our system relies upon.

How could this alleged pillar of our nation's grand financial future be so "opaque"? How is it possible that this shady instrument might damage the entire world economy? And how come so few of us have any idea how it works? Writers and policy makers are talking a good game about how people took loans they couldn't afford, and how these were put in mortgage securities that have crashed in value, and that these mysterious CDOs

somehow have caused the housing market to tank (or is it the other way around?). You hear them use the word *tranche* (the French word for "slice") with intimate familiarity as if it were a new type of croissant. But if you listen carefully, you can sense that they have only the vaguest understanding of how these new financial instruments work . . . and don't work.

And how many policy makers and analysts are willing to step back and look at what we've really become? Our nation has entrusted trillions of dollars of investment and debt to the creators and distributors of these indecipherable instruments. We've written rules, or eliminated rules, or failed to write rules that have encouraged the creation of wildly complex and (at one time) wildly profitable financial arrangements that turned out to be lethal. We've allowed a new global shadow banking system to exist totally beyond the control of any regulatory body. We've given the swashbuckling, gambling, high-risk alpha males and females of finance the keys to our economy and they've crashed it.

We have put our collective livelihoods at risk, and for what? Why have tens of thousands of our very best minds spent their energies dreaming up new money-making-money instruments that may be at best socially neutral and at worst disastrous? At this perilous moment for our planet, why are so many talented people spending their days playing this extremely risky game of fantasy finance?

I've tried to keep an open mind about the social utility of CDOs and other newfangled financial instruments—and the tens of thousands of truly bright people who make, sell, and profit by them. But the evidence just keeps mounting that much of the financial sector, as currently constructed, is basically a drain on our resources. Commentators everywhere point to the unproductive deployment of talent in financial engineering when we really need more minds engineering clean energy alternatives, among other things. They also are quick to slam Wall Street for its greed as if this were a freshly observed quality. Since when has greed been a sin on Wall Street or in capitalism as a whole? In fact, it's

supposed to be the very best motivator for creating efficiency in a market economy. Didn't Adam Smith long ago suggest that by narrowly pursuing our individual interests, society prospers?

And prosper it did. The financial sector, up until the 2008 crash, was one of the fastest growing sectors of the economy, generating approximately 20 percent of our gross domestic product. It also accounted for 27.4 percent of all corporate profits.[3] Finance grew as manufacturing declined, thereby dominating the real economy. According to the Bureau of Labor Statistics, in 1940 there were 7.1 manufacturing jobs for every job in the financial service industries. The ratio increased to 7.7 in 1950. Then the slide started, as you can see in chart 1. By November 2008, *there were only 1.6 manufacturing jobs per financial services job.* Until the current meltdown, the financial industry produced almost 10 percent of all the wages and salaries in the country, up from 5 percent in 1975. In a few years, provided that the system doesn't collapse entirely, the finance sector is going to be larger than the manufacturing economy.

When we hear that these financial institutions are too big to fail, unfortunately it's because they are. As of 2008, Citigroup,

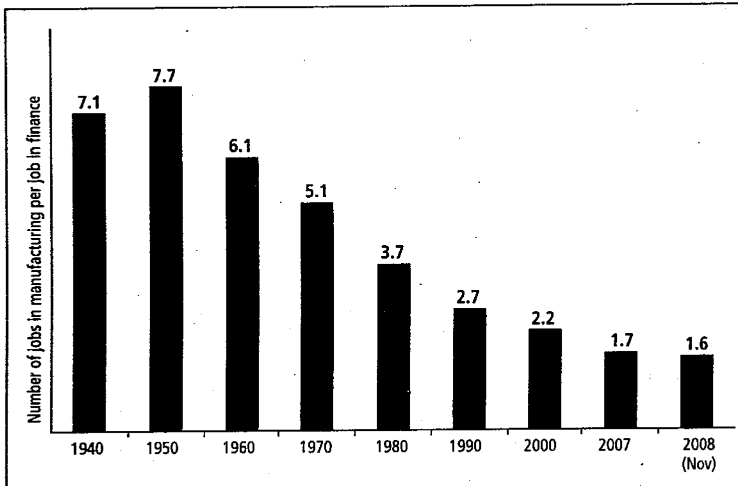

Chart 1. U.S. Job Ratio: Manufacturing to Finance Bureau of Labor Statistics

Bank of America, JPMorgan Chase, and AIG had revenues of over $100 billion each. Goldman Sachs and Morgan Stanley were not far behind, each with approximately $80 billion in revenues.[4] If all of them were to fail simultaneously, then all of us, as distant as we might think we are from the day-to-day operations of Wall Street, would be staring at another Great Depression.

I'm worried that Wall Street wizards have used exotic financial instruments to set up a vast game of fantasy finance . . . betting with other people's money. Is it possible that a handful of bankers and traders are making huge sums of very real money by creating, buying, and selling financial products that add little to the real economy? Is this like fantasy baseball leagues where prizes are won based on stats derived from the real game of baseball?

There are at least a couple of very obvious differences: In fantasy baseball, a few dollars exchange hands at the end of the season and no one would dare claim that make-believe baseball improves real Major League Baseball. In fantasy finance, trillions of dollars change hands and, until recently, our financial leaders—Alan Greenspan, Robert Rubin, and the like—claimed that the game actually helped to improve the real-world economy. Unfortunately for us, they were mistaken.

To be sure, fantasy finance is very real. We taxpayers are being asked to pay several trillion dollars in order to save our economy from collapse by bailing out Wall Street in large part because of their latest and greatest products—CDOs, credit default swaps, and their unholy spawn, "synthetic" CDOs. We are also paying with our jobs. The official unemployment rate was 9.7 percent in March 2010 and the broader jobless rate (the U6 rate measured by the Bureau of Labor Statistics) was at 16.9 percent. Public-sector workers, from teachers to firemen, are under assault as state and local tax revenues plummet. I'm sure all of us at risk would like to know a bit more about these financial instruments and how they are wrecking our economy.

And then there's the subprime-mortgage puzzle. The financial media has all but concluded that the crash was caused by risky

mortgages taken out by poor people and deadbeats who couldn't afford them, and issued by reckless lenders who should have known better. About $1.3 trillion worth of such mortgages are out there. Of that, about $300 billion are in default or nearly so (divided equally between the subprime and Alt-A mortgages, the two riskiest types). Please, can someone explain how that amount, about 2 percent of household net worth, could devastate the world's financial system? To date, the taxpayer has put up about $2 trillion in bank bailouts and loan guarantees. Why didn't that take care of the problem long ago? Like some perverse modern-day miracle of fishes and loaves, how did $300 billion of bad debt multiply into trillions of dollars in financial toxic waste? Poor people did all that?

In this book I go after these questions—and I hope the answers will tell us a good deal about our economic woes and what to do about them. At the very least, I hope to contribute modestly to our collective financial literacy.

In short, if I can understand this crap, so can you.