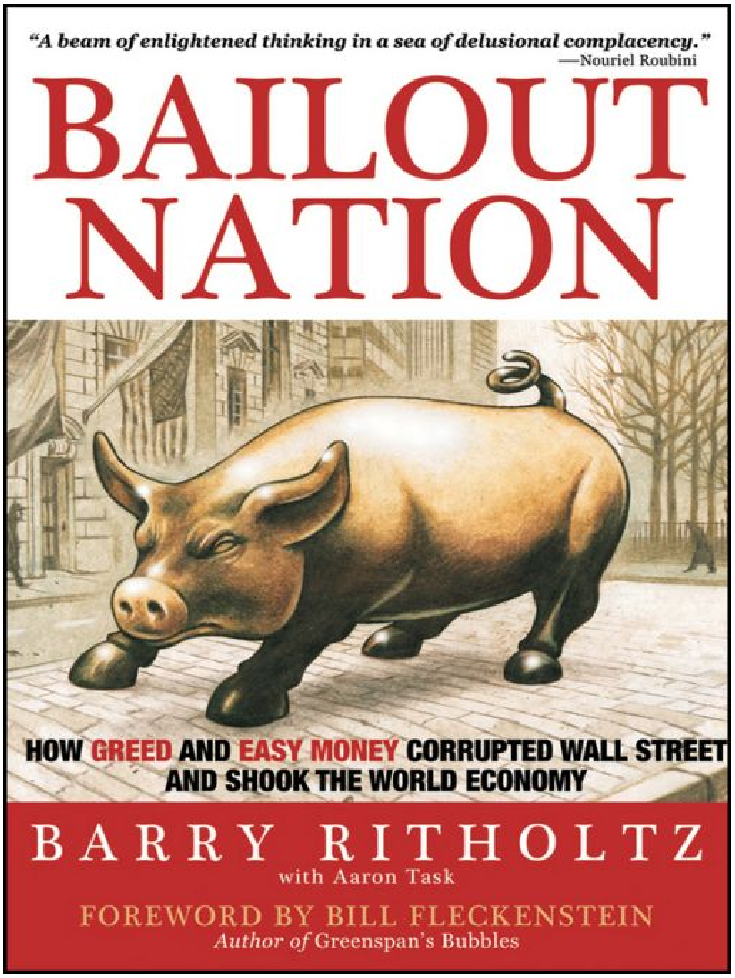
"A beam of enlightened thinking in a sea of delusional complacency."
—Nouriel Roubini

# BAILOUT NATION

## HOW GREED AND EASY MONEY CORRUPTED WALL STREET AND SHOOK THE WORLD ECONOMY

BARRY RITHOLTZ
with Aaron Task

FOREWORD BY BILL FLECKENSTEIN
*Author of* Greenspan's Bubbles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## Praise for *Bailout Nation*

"The greatest economic calamity in a generation has now swept from Wall Street through Main Street, to Iceland, Europe, and beyond. Barry Ritholtz not only saw the financial tidal wave coming, but tried to warn us before it hit, when few believed anything like it could happen. Now that clean-up is at hand, who better to explain what went wrong? Read this book: when Barry Ritholtz speaks, as the saying goes, attention must be paid."

—Jeff Matthews Author, *Pilgrimage to Warren Buffett's Omaha*

"This thrilling page-turner is really a doctoral thesis in disguise on the history of financial debacles and the inner workings of the global financial system and modern economics. Barry is truly one of Wall Street's important thinkers and rising stars. Bravo Barry!"

—Jeffrey A. Hirsch Editor-in-Chief, *Stock Trader's Almanac*

"Barry Ritholtz, long known to readers of *The Big Picture* for telling it like it is, does exactly that in Bailout Nation. With sparkling clarity and his inimitable brashness, Barry names names and tells you where to look for the bodies who are profiting from the unprecedented $8 trillion government bailout."

—Michelle Leder Author, *Financial Fine Print* and *Footnoted*

“Part history lesson, part social commentary, part in-depth analysis, *Bailout Nation* serves up a riveting indictment of the age of hubris and excess.”

—Michael Panzner Financial Armageddon

“As Wall Street wizards were turning into welfare kings, Barry Ritholtz was there to chronicle every new outrage on his blog, *The Big Picture*. Now he’s focused on the really Big Picture—how we got into this mess—with his great new book, *Bailout Nation*.”

—Jesse Eisinger Portfolio

“Barry Ritholtz crystallizes the absurdity of the bailouts and why America’s addiction to them is doomed to fail. This should be required reading for every future politician with a conscience.”

—Herb Greenberg former journalist, CNBC, Marketwatch, and now director of GreebergMeritz Research & Analytics

“Barry Ritholtz is leading the first wave of critical analysts who are trying to make sense of the past year beyond the official explanations. He not only illustrates the conflicts and contradiction in current economic leaders and policies, but suggests some solutions and even opportunities in this sea of global financial misery. I’m already looking forward to volume two.”

—Christopher Whalen Institutional Risk Analytics

“*Bailout Nation* provides a timely review and analysis of the issues and problems that led to and are evidenced in the present financial turmoil. These forensics are much needed today."

—David Kotok Cumberland Advisors

"Barry Ritholtz has a one-two combination punch of insight and skepticism that leaves financiers, bankers and politicians out cold on the floor. This is pungent and funny required reading about the current crisis."

—Dr. Paul Kedrosky
Infectious Greed
Partner, Ventures West VC

# Bailout Nation

*How Greed and Easy Money Corrupted Wall Street and Shook the World Economy*

Barry Ritholtz
with
Aaron Task

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*To Wendy,*
*who has bailed me out of more than a few jams*

# Foreword

**D**o you find yourself wondering: *How did we get here?* How did the United States of America get into such a predicament whereby in one year, 2008, the financial system nearly vaporized, the stock market crashed, real estate tanked, and major corporations were being bailed out (or begging to be) on a regular basis. How did our great country, a bastion of capitalism, devolve into a Bailout Nation where the gains were privatized but the losses were socialized?

This terrific book by Barry Ritholtz will explain to you how this sorry state of affairs came to pass. By reading it you will come to understand how we got here, which is a necessary prerequisite for understanding how to navigate the future.

The primary reason that I wrote *Greenspan's Bubbles: The Age of Ignorance at the Federal Reserve* (McGraw-Hill, 2008) was so that when the U.S. credit/housing bubble inevitably burst, people would understand why such enormous financial and economic problems were occurring, seemingly erupting out of nowhere. But they didn't erupt out of nowhere; these problems were created over time by the monetary policies of the Federal Reserve, specifically the targeting of interest rates and the Fed's ongoing refusal to recognize the flaws in this approach.

Although nearly everything that has transpired since my book was published in February 2008 I had expected to occur, I was still shocked by the total collapse of so many major financial firms, such as Bear Stearns, Countrywide Financial, Fannie Mae, and Freddie Mac in such a short amount of time.

But that is what happens to highly leveraged financial entities when significant portions of their underlying assets are found to be essentially worthless. The mind-set of deregulation that was championed by Federal Reserve Chairman Alan Greenspan in the wake of the Long-Term Capital Management (LTCM) bailout in 1998 is partially responsible for the massive overleveraging of nearly the entire financial system in the United States.

That Wall Street bailout (which led to the notion of the "Greenspan put") set the stage for what we are witnessing today in the United States (and in the United Kingdom), with the prudent being forced to bail out the reckless. As Barry notes, "The parallels between what doomed LTCM in 1998 and what forced Wall Street to run to Washington for a handout in 2008 are all there."

The United States has abandoned its capitalist roots, and the country has morphed into a Bailout Nation; now almost any large entity that finds itself in trouble feels the government (taxpayers really) should provide financial support. Similarly, homeowners who overextended themselves also feel that they too should be rescued from their mistakes.

Barry weaves together the problems created by the Federal Reserve's interest rate targeting policies with the determination on the government's part to thwart the "creative destruction" aspect of capitalism. We have now arrived at a juncture where our government seems to embrace free markets only when they deliver the results it wants. If they don't, an attempt is made to alter the outcome, leading to unintended consequences down the road, which often are more severe than the original problem.

Ritholtz also names the villains in this tragedy—the rogues' gallery of politicians and officials who screwed up big time—and demonstrates what they did to make the problem either bigger or worse. He also shows how each bailout throughout modern history has impacted what happens in the future—for example, why Chrysler should have been allowed to fend for itself in 1980, and the impact that has on future bailouts.

This book is the history of how the United States evolved from a rugged, independent nation to a soft Bailout Nation, one in which too few question why we ask the taxpayers "to allow financial firms to self-regulate, but then pony up trillions to bail them out."

However much we dislike the predicament we are in, the only way it can be remedied is if people learn in some detail what has transpired and so, armed with knowledge, demand change. Reading this book will prepare you to be able to do just that.

BILL FLECKENSTEIN *March 2009*

# Acknowledgments

**A**ll books are collaborative efforts, and *Bailout Nation* was more so than most. There were many people whose contributions were crucial to getting this project off the ground, and keeping it going when things started to falter.

Over the course of the past year, I wrote this book while working in an asset management firm, heading a research shop, all the while running a very active blog. This book was possible only thanks to the many helping hands involved.

Much of the book was written in real time, and early versions of parts of this appeared on *The Big Picture* (www.ritholtz.com). I would post ideas a few hundred words at a time, and readers would critique, poke, and prod my thought process along. These brave souls have my everlasting gratitude. Many of the insights, quotes, obscure references, and artworks within the book come courtesy of them.

There were many professional journalists and writers who selflessly shared sources, ideas, and insights with me. In particular, Dan Gross, Jesse Eisinger, Randall Forsyth, and Herb Greenberg all greatly impacted my process. If there are any parallels between my book and Dan's, it's because we batted more than a few ideas off of each other. Special thanks go to Thomas Donlan of *Barron's*, who took my disjointed ramblings in *A Memo Found in the Street* ("Dear D.C.") and turned them into a concise thing of beauty.

Numerous other authors were helpful with the process of writing a book, as well as influencing my own research and writing. I owe special thanks to Nouriel Roubini, Bill Fleckenstein, and Michael Panzner for advice and comfort.

Various fund managers and analysts generously shared their insights, most notably Doug Kass, James Bianco, Scott Frew, Chris Whalen, and David Kotok.

I grew up in a household where stocks and real estate were fodder for dinner-table conversations. My now-retired mother was a successful real estate agent, and used to regale us with dark tales of corruption and criminality in the real estate business (especially about C1 and C2). Her subversive view of the industry she worked in definitely rubbed off on me. (Thanks, Mom!)

The artwork in the book came to me courtesy of a few fantastic artists: John Sherffius of the *Boulder Daily Camera* is the creator of the fabulous jacket illustration to *Bailout Nation*. His political cartoons are also at the beginning of each of the five parts of the book. His dry wit and deft pen strokes communicate more with one picture that I can with thousands of words. J. C. Champredonde is the wicked mind behind the investment banks as casinos illustrations. You will find his work toward the end of the casino capitalism chapter and on the Web at www.stereohell.com. His art perfectly captures the past decade of casino capitalism. Jess Bachman of WallStats.com did amazing work on the Anatomy of a Crisis. R. J. Matson lent us a cartoon—corporate welfare.

Special thanks also go to Bill McBride of Calculated Risk for his informative real estate charts, and to Ron Griess of The Chart Store for the historical market charts.

Few writers particularly enjoy being edited. I was fortunate at TheStreet.com to work with Aaron Task—a rare editor who genuinely makes your work better (as opposed to merely different). When McGraw-Hill first approached me about doing this book (more about them later), I knew without question who I was willing to entrust my words to. Aaron's contributions, organization, and constant urgings

forward are the prime reason this book got to the publisher on time in December 2008. It’s been said a book is done when the manuscript is torn from its writer’s hands, and Aaron made sure that when that date came, what was being torn was something readable.

Much of this book involves dollar amounts, dates, data, and numbers. Staying on top of that would not have been possible without a crack research team, and I was fortunate to have worked with three of the best: Eugene Ashton-Gonzalez and William J. Miller were terrific, and my research intern, Ariel Katz, deserves special praise for her insights. She graduates from business school in May 2010, and some lucky company should snag her right away. Special thanks also go to Marion Maneker, for his gentle shoves in the right direction and his insights into the world of publishing.

Jeanne Glasser at McGraw-Hill was uniquely patient in dealing with writing a book about live events as they happened. When that publisher took issue with my criticisms of Standard & Poor’s (a division of McGraw-Hill), Jeanne fought hard for the book. That the book in your hands ended up at John Wiley & Sons—and Jeanne at FT Press and Wharton School Publishing—tells you something about character. And I would be remiss if I did not add that Lloyd Jassin, my literary agent, went above and beyond the call of duty throughout. As you might imagine, this was not the typical book deal.

Speaking of which: I am thrilled to be published by Wiley. The people there were especially excited about this project. It was a pleasure working with Kevin Commins and Meg Freeborn and the rest of the Wiley crew.

Perhaps this is an acknowledgment first, but I have to give a shout out to Google Docs—the collaborative editing process would have been a bear without it. We had so many different versions of each chapter floating around before we

started using it. G-Docs made staying on top of the latest changes and edits a breeze. Chalk one up for cloud computing.

On a personal note, my wife showed infinite patience during this lost year of writing *Bailout Nation*. If it wasn't for her, this book would never have been finished. (*Go for a walk! You're babbling again! Stop procrastinating! And for goodness' sake, will you take a shower already!*)

I must also express my gratitude to my partners at FusionIQ, Kevin Lane and Mike Conte, who gracefully allowed me to take many days off to finish this beast and to close the door to my office to bang out a few more pages during the workweek.

Many additional authors colored my worldview, and much of what you read is due to the prior work of Roger Lowenstein, Richard Bookstaber, Tom Metz, Paul Desmond, Stephan Mihm, Satyajit Das, Robert J. Shiller, Robert F. Bruner and Sean D. Carr, Reginald Stuart, and Ed Gramlich. Their writings influenced what you now hold in your hands, and if it's any good, it's because I stole only from the very best.

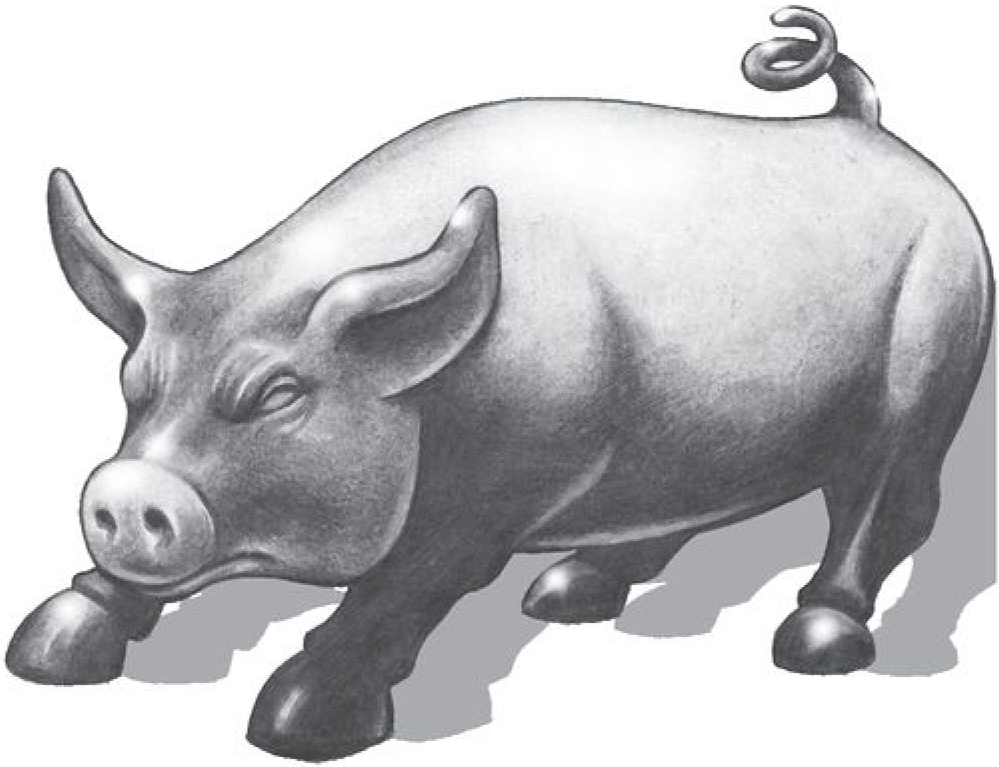
# Introduction

## Bailout Nation

*Owe the bank $100, that's your problem. Owe the bank $100 million, that's the bank's problem.*

*—J. P. Getty*

**W**e like to think of the United States as a rugged country of determined, self-reliant individuals. The iconic image is the American cowboy. You can picture him on a cattle drive, watching warily over his herd. All he needed to get by were his wits, his horse—and his trusty Winchester.



This idealized vision of America is fading fast, rendered moot by present-day cattle rustlers. The new gauchos ride not on the range, but on the financial vistas. Instead of herding cattle, they rope derivatives, wrangle financial instruments, and round up paper wealth. The differences between the modern-day cowboy/bankers and the ranch hands of the old West are many, not the least of which is monetary—today's banker/rustler makes a whole lot more money than the frontiersmen did in the past.

But there is another crucial difference between the two—the "individualist" part. The newfangled herdsman may look rugged, but he sure as hell ain't independent. The modern cowpoke has become way too reliant on a different sort of cavalry: Uncle Sam—and all the taxpayers that support him.

How did we go from being a nation that revered the idea of the self-reliant broncobuster into something else entirely?

What turned us into a nanny state for well-paid bankers?

How did the good ole U.S. of A. turn into a Bailout Nation? That is what this book is about.

It's easy to understand why *bailout* is such a dirty word in the American financial vernacular. There are many reasons, but I want to focus on the three biggest ones.

First, there is something inherently unjust about some people getting a free ride when everyone else has to pay his or her own way. We Americans are always willing to lend a hand to someone down on their luck, but that is not what the current crop of bailouts is about. This is the government financially rescuing people despite—or perhaps because of—their own enormous recklessness and incompetence.

This inequity is especially galling to those of us who work in the financial markets. Wall Street has long been a brutal meritocracy. Success is based on skills and smarts and the relentless ability to identify opportunity while simultaneously managing risk. All of the people I know who work on the Street—whether in stocks, bonds, options, or commodities—have a strong sense of fair play. "Eat what you kill" is the classic Wall Street attitude toward risk and reward, profit and loss.

There are, however, those market players who fail to live or die by their own swords—but then expect to be rescued by others from their own folly. They embody a fair-weather belief in the free market system, somehow thinking it applies only during the good times. This is a high form of moral cowardice, and it is rightly despised by those who play fairly and by the rules.

Since the turn of the twenty-first century, well-connected, moneyed interests have managed to keep all of their profits and bonuses during good times, but have somehow thrown off their risk and the results of their own bad decision making onto the public taxpayers. "Privatized gains and socialized losses" is hardly what capitalism is supposed to be.

Second, the process of how some groups get rescued by the government, while others are left to flounder, is in and of itself suspect. The cliché that "no one should see how laws or sausages get made" is especially true when it comes to bailouts. The political mechanisms—and the dollar amounts involved—are especially egregious. Why? In all modern cases, they are done quickly, on an emergency footing. There is often little or no debate. Transparency has been nonexistent. Many observers not only object philosophically to the concept of bailouts, but are particularly offended by the ham-fisted way they are foisted upon the public. Nearly everything has been done on an ad hoc basis, with little thought and less planning. Who has time for strategy or long-term thinking when we have trillions of dollars to spend?

Third, and finally, there are the costs. If we have learned anything about bailouts over the past hundred years, it is that each rescue attempt is more costly than the one that preceded it. This is usually true in terms of the immediate expenditure, but even more so in terms of the long-term damage done to the financial system. As of February 2009, the costs have raced past $14 trillion. That is an unprecedented sum of money, greater than any other single government expenditure in the nation's history (see Table I.1).

**Table I.1** Cheaper to Clean Up After?

SOURCE: Data courtesy of Bianco Research

| Big Budget Expenditure | Cost | Inflation Adjusted Cost |
|---|---|---|
| Marshall Plan | $12.7 billion | $115.3 billion |
| Louisiana Purchase | $15 million | $217 billion |
| Race to the Moon | $36.4 billion | $237 billion |
| S&L Crisis | $153 billion | $256 billion |
| Korean War | $54 billion | $454 billion |
| The New Deal | $32 billion (est.) | $500 billion (est.) |
| Gulf War II/Invasion of Iraq | $551 billion | $597 billion |
| Vietnam War | $111 billion | $698 billion |
| NASA | $416.7 billion | $851.2 billion |
| **Total** | | **$3.92 trillion** |

Beyond the actual out-of-pocket expenses lies the dangerous hazard of corporate bailouts. The government's largesse encourages greater and greater reckless speculation. The ordinary liability and risk that is supposed to go with investing and business ventures seem to have disappeared. A grotesque distortion of normal capitalist incentives is formed. When a sector of the economy expects to be rescued by the government, it loses the healthy fear of financial failure. This leads directly to excessive speculation and reckless behavior—a condition known as moral hazard.

■ ■ ■

**H**istorically, excessive greed, recklessness, and foolish speculation were punished by the market. Speculators lost their capital, their reputation, and their influence. (Back in the day when skyscrapers had windows that opened, some even lost their lives.) Their pools of cash migrated to people who handled risk in a more intelligent fashion. This is—or perhaps was—the great virtue of capitalism: Money finds its way to where it is treated best. Capital gravitates to those who can balance risk and reward, and who can obtain positive investment results, without blowing up. It's no coincidence that the largest venture capital firms, the biggest hedge funds, and the longest-lasting private trusts know how to manage risk. They preserve their capital. They have a healthy respect for losses, and strive to keep them manageable. They do not, as so many have done recently, put all their money on a single number, spin the roulette wheel, and hope for the best.

The present system has lost its auto-correcting mechanism. As economist Allan Meltzer noted, “Capitalism without failure is like religion without sin—it just doesn’t work.” While the profit motive is alive and well, with rewards potentially in the billions of dollars for some, there is no corresponding and offsetting risk of enormous loss. Any system that allows profits to be kept by a select few but expects the loss to be borne by the public is neither capitalism nor socialism: It is the worst of both worlds.

Government intervention thwarts this migration of capital. Instead of the relentless efficiency of the marketplace—I call it the back of Adam Smith’s invisible hand—we have instead politically expedient shortcuts that bypass this process. In the end, this results in a misallocation of capital, and an embracing of risk and short-term motives that leads to utter recklessness. Hence, the mortgage broker who fudges the loan application, the bank that looks the other way to process it, and the fund manager that ultimately buys this crappy paper are all focused not on sustainable, long-term returns, but on the quick buck. As we will see, the implications for the broader economy have been dire.

■ ■ ■

**T**he modern era of finance is now defined by the bailout. *Systemic risk* has become the buzzword du jour. History teaches us that these bouts of intervention to save the system occur far more regularly than an honest definition of that phrase would require. Indeed, systemic risk has become the rallying cry of those who patrol the corridors of Washington, D.C., hats in hand, looking for a handout. As we too often learn after the fact, what is described as systemic risk is more often than not an issue of political connections and politics. Perhaps a more accurate phrase is *economic expediency*.

The past generation has seen increasing dependence on government intervention into the affairs of finance. Industrial companies, banks, markets, and now financial firms have all become less independent and more reliant upon Uncle Sam. This is no longer a question of philosophical purity, but rather a regular occurrence of politically connected corporations—and their well-greased politicians—throwing off the responsibility for their failures onto the public. Any sort of guiding philosophy or ideology regarding free markets, competition, success, and failure seems to have simply faded away as inconvenient. No worries, the taxpayer will cover it.

Some people—most notably current Federal Reserve chairman Ben Bernanke and former chairman Alan Greenspan—seem to feel that it is the responsibility of governmental entities such as the Federal Reserve or Congress to intervene only when the entire system is at risk. The events since August 2007 have made it clear that this is a terribly expensive approach. Perhaps what the government should be doing is acting to prevent systemic risk before it threatens to destabilize the world's economy, rather than merely cleaning up and bailing out afterward. An ounce of regulatory prevention may save trillions in cleanup cures.

The United States finds itself in the midst of an unprecedented cleanup of toxic financial waste. As of this writing, the response to the credit crunch, housing collapse, and recession by various and sundry government agencies had rung up over $14 trillion in taxpayer liabilities, including bailouts for Fannie Mae and Freddie Mac, General Motors and Chrysler (twice, and soon to be three times), American International Group (AIG) (four times), Bank of America (three times), and Citigroup (three times). It has forced capital injections into other major banks, and government-engineered mergers involving once-vaunted firms Bear Stearns, Goldman Sachs, Morgan Stanley, Merrill Lynch, and Washington Mutual (see Table I.1). It has led to the Federal Deposit Insurance Corporation (FDIC) receivership, nationalization and sale of Washington Mutual (now in the hands of JPMorgan Chase), and Wachovia, flipped over the course of a weekend to Wells Fargo.

Yes, that's $14 trillion (plus)—about equal to the gross domestic product (GDP) of the United States in 2007. And as 2008 came to a close, even more industries caught the scent of easy money: Automakers, home builders, insurers, and even state and local governments were clamoring for a piece of the bailout pie.

The implications of this are significant. The current bout of bailouts—the banks and brokers, airlines and automakers, lenders and borrowers in the housing industry—will have significant, long-lasting repercussions.

So far, they have turned the United States into a Bailout Nation.

And that's just the beginning.

# Part I

## A BRIEF HISTORY OF BAILOUTS

*Source*: By permission of John Sherffius and Creators Syndicate, Inc.

# Chapter 1

## A Brief History of Bailouts

*"The ultimate result of shielding men from the effects of folly is to fill the world with fools."*

*—Herbert Spencer, English philosopher*

**A**merica's relationship with bailouts has been a complex and nuanced affair. It has evolved gradually, morphing through var ious phases over time. The United States has had several distinct bailout eras, and each has seen an incremental shift in the attitudes toward government rescues. Philosophically, the country has moved from finding the mere idea of a government intervention to any corporation abhorrent, to begrudgingly accepting interventions as a rare but necessary evil. Since the late 1990s, bailouts have been embraced around the world as a near-normal responsibility of government to save the financial markets from themselves. Most recently, a backlash has been building against bailouts as a reward for dumb and irresponsible behavior.

Let us consider an earlier period in U.S. history—the nineteenth century to the pre-Great Depression era. The popular attitude toward both governments and corporations was very different at that time from today. Government was much smaller, and was not seen as a lender of last resort to either banks or industry. A general suspicion of corporate entities was commonplace among the populace, and there was a near-adversarial relationship between the government and the larger corporate interests.

The federal government's involvement in companies in the nineteenth century was more as an incubator than a rescuer. There wasn't much in the way of venture capital funding then, and a few start-ups sought and received modest amounts of government assistance. Railroad and telegraph firms were given easements and rights of passage, facilitating the government's desire for expansion into the West. Later on, telephone companies also enjoyed government largesse. Eminent domain was used to purchase properties for the benefit of companies as varied as mining, cattle ranches, railroads, and telegraph firms. In each of these early examples, the government's cash outlays were quite modest, and often facilitated a broad public good.

Rather than betting on any single company, the government found it to be in its own interest to jump-start a sector and then allow a brutal Darwinian competition to take place. Ultimately, that left standing only a few survivors as the rest of the industry fell by the wayside. Automobiles, computers, electronics—history is replete with examples of the U.S. government staying out of the way of a competitively developing industry. The government left these companies to follow their own natural life cycle via the mechanics of the free market. In *Pop! Why Bubbles Are Great for the Economy*, Dan Gross details the thousands of railroads, telegraph companies, automakers, and Internet companies that boomed and then eventually went bust.[1] In most industries, this process leaves behind a valuable infrastructure for subsequent companies to build upon. This was Joseph Schumpeter's "creative destruction" at work.

The groundwork for modern bailouts was laid in the early twentieth century, when in 1913, the Federal Reserve

System was created. As we will see in a later chapter, this had major implications a century later. As originally envisioned, it was imbued with only modest monetary and fiscal powers. Eventually, these powers were expanded dramatically.

The next phase took place in the 1930s and 1940s, between the Great Depression and World War II. The widespread economic turmoil and political discontent forced the government to engage in a series of economic stimuli designed to generate jobs, income, and economic activity. While some political historians have described this as a bailout, it was not directed toward any specific corporation or economic sector. The public works programs of the Depression era were designed to impact the entire economy, stimulate growth, and reduce the 25 percent unemployment rate.

The latter years of this second era preceded World War II. The U.S. steel industry had previously enjoyed a booming decade in the 1920s, but had collapsed during the economic crisis. The United States, anticipating the possibility of its entry into World War II, recognized the importance of a viable industrial manufacturing sector. Without a healthy steel industry, the country would've been hamstrung in its attempts to build ships, tanks, planes, and other tools of warfare. The munitions industry also received much of Uncle Sam's largesse, as did the metals companies and the rubber industry. Indeed, the ramp-up to World War II saw an enormous amount of government assistance to companies that were war-related.

Were these truly bailouts? It's hard to call any nation's national defense buildup in wartime a true bailout.

After World War II, the United States entered a long period of economic expansion. The building of suburbia, the automobile industry's enormous growth, the expansion of