

# The Committee to Destroy the World



**INSIDE THE PLOT**

**TO UNLEASH A**

**SUPER CRASH**

**ON THE**

**GLOBAL ECONOMY**

Michael E. Lewitt

**WILEY**

# **THE COMMITTEE TO DESTROY THE WORLD**

**INSIDE THE PLOT TO UNLEASH A  
SUPER CRASH ON THE GLOBAL  
ECONOMY**

**MICHAEL LEWITT**

**WILEY**

Cover image: Burning Globe © Yasuhide Fumoto/Getty Images, Inc.; Blue Globe © Yuji Sakai/Getty Images, Inc.; Torn Blank White Paper © kyoshino/Getty Images, Inc.

Cover design: Paul McCarthy

Copyright © 2016 by Michael Lewitt. All rights reserved.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

The first edition was published by Wiley in 2010.

Published simultaneously in Canada.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 646-8600, or on the Web at [www.copyright.com](http://www.copyright.com). Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at [www.wiley.com/go/permissions](http://www.wiley.com/go/permissions).

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993 or fax (317) 572-4002.

Wiley publishes in a variety of print and electronic formats and by print-on-demand. Some material included with standard print versions of this book may not be included in e-books or in print-on-demand. If this book refers to media such as a CD or DVD that is not included in the version you purchased, you may download this material at <http://booksupport.wiley.com>. For more information about Wiley products, visit [www.wiley.com](http://www.wiley.com).

***Library of Congress Cataloging-in-Publication Data:***

ISBN 978-1-119-18354-9 (Hardcover)

ISBN 978-1-119-18369-3 (ePDF)

ISBN 978-1-119-18370-9 (ePub)

*For Marcie, Alessia, Alexander, and Preston  
And in memory of Laurence G. Lewitt, 1930-2015*

This disposition to admire, and almost to worship, the rich and the powerful, and to despise, or, at least, to neglect, persons of poor and mean condition, though necessary both to establish and to maintain the distinction of ranks and the order of society, is, at the same time, the great and most universal cause of the corruption of our moral sentiments.

—Adam Smith

For historians each event is unique. Economics, however, maintains that forces in society and nature behave in repetitive ways. History is particular; economics is general.

—Charles Kindleberger

# CONTENTS

[Acknowledgments](#)

[Introduction The Committee to Destroy the World](#)

[A Regulatory Theocracy](#)

[A Crisis Wasted](#)

[The Death of Fiscal Policy](#)

[Monetary Policy Follies](#)

[Out-of-Control Global Debt](#)

[Untamed Derivatives](#)

[Market Corruption](#)

[The Geopolitics of Appeasement](#)

[We Are On an Unsustainable Economic Path](#)

[America Must Make a Choice](#)

[A Few Words about This Book](#)

[Notes](#)

[Chapter 1 The 2008 Crisis— Tragedy or Farce?](#)

[The Death of Capital](#)

[Seeds of Instability](#)

[A Word on Speculation](#)

[Financialization](#)

[The Corruption of Moral Sentiments](#)

[Low Rates and Lax Rules](#)

[The Global Liquidity Bubble](#)

[A Crisis of Confidence](#)

[Why Finance Matters](#)

[Global Threats Require Systemic Stability](#)

## Notes

### Chapter 2 The Death of Capital

The Four Essential Characteristics of Capital

How Capital Dies

The Failure of Risk Management

## Notes

### Chapter 3 Capital Ideas

Adam Smith and the Tyranny of Crowds

Karl Marx and the Origins of Opacity

John Maynard Keynes

Hyman Minsky

Lessons on Capital from the Masters

## Notes

### Chapter 4 Empty Promises

Promises Aren't What They Used to Be

The Digitalization of Promises

Collateralized Mortgage Obligations

HSBC Drinks the Mortgage Kool-Aid

A Fetish Is Not a Promise

## Notes

### Chapter 5 Financialization

Money Begetting Money

Power Begetting Power

Theories of Financialization

The Monetization of Values

## Notes

### Chapter 6 From Innovators to Undertakers

The History of Private Equity Funds

[From Boom to Bust](#)

[Private Equity Fees: The New Agency Problem](#)

[The Myth of Private Equity Returns](#)

[Men Behaving Badly](#)

[Private Equity and Cheap Debt: Birds of a Feather Flop Together](#)

[Private Equity Goes Public: A Study in the Oxymoronic](#)

[Taxing Labor as Capital](#)

[Calling Dr. Kevorkian?](#)

[Private Equity: The Damage Done](#)

[Reform of Private Equity Firms](#)

[Notes](#)

[Chapter 7 Welcome to Jurassic Park](#)

[Isla Nublar](#)

[The New DNA of Finance](#)

[Warning Signs](#)

[Dinosaurs Turn on Their Makers](#)

[Bear Stearns: First Casualty](#)

[American International Group \(AIG\)— Second Casualty](#)

[The Bond Insurers—Third Casualty](#)

[Taming the Beasts \(Regulating Credit Derivatives\)](#)

[Notes](#)

[Chapter 8 The Road to Hell](#)

[Satan in the Garden](#)

[Reverse Black Swans](#)

[Birth of the Prudent Man](#)

[The Fallacy of Diversification](#)

[Notes](#)

[Chapter 9 Finance after Armageddon](#)

[Obama Goes to Wall Street](#)

[Principles of Reform](#)

[Impose a Tax on Speculation](#)

[End Balkanized Regulation](#)

[Too Big to Fail](#)

[Improving Capital Adequacy](#)

[Reforming Monetary Policy](#)

[Enhancing Systemic Transparency](#)

[Notes](#)

[Chapter 10 Unfinished Business](#)

[Monetary Policy](#)

[Fiscal Policy and the Federal Deficit](#)

[Tax Reform](#)

[Domestic Policy](#)

[Notes](#)

[Chapter 11 How to Save Yourself](#)

[Gold](#)

[Absolute Return Strategies](#)

[Equities](#)

[Income-Generating Securities](#)

[Conclusion](#)

[Notes](#)

[Conclusion: "This Is Later"](#)

[Notes](#)

[Bibliography and Other Sources](#)

[About the Author](#)

[Index](#)

[EULA](#)

## List of Tables

[Introduction](#)

[Table 1.1](#)

[Table I.2](#)

[Table I.3](#)

[Table I.4](#)

[Chapter 1](#)

[Table 1.1](#)

[Table 1.2](#)

## List of Illustrations

[Introduction](#)

[Figure I.1 Apocalypse Then](#)

[Figure I.2 The Committee to Destroy the World](#)

[Figure I.3 Rise in Inflation as Measured by the Government](#)

[Figure I.4 Debt Has Grown Much Faster Than the Economy in the U.S. Economy](#)

[Figure I.5 Global Debt Has Increased by \\$57 Trillion since 2007, Outpacing World GDP Growth](#)

[Figure I.6 The “JV” Team](#)

[Figure I.7 China’s New Silk Road](#)

[Chapter 1](#)

**Figure 1.1** United States Total Debt as Percent of GDP

Chapter 2

**Figure 2.1** Capital RIP September 2008

Chapter 4

**Figure 4.1** Increasing Complexity of Securitized Credit Model

**Figure 4.2** Basic CMO Structure

**Figure 4.3** Summary of Federal Home Loan Mortgage Corporation—Multiclass Mortgage Participation Certificates

**Figure 4.4** Degrees of Separation

Chapter 5

**Figure 5.1** Rising Post-World War II Dominance of Finance Industry and Decline of Manufacturing, 1971-2008

**Figure 5.2** Consumption as a Growing Percentage of U.S. GDP, 1971-2008

Chapter 6

**Figure 6.1** Institutional Leveraged Loan Market Size

**Figure 6.2** Historical Growth of the CLO Market

**Figure 6.3** KKR & Co. (KKR) Stock Prices, December 31, 2007, through December 31, 2015

**Figure 6.4** KKR Financial Holdings, LLC (KFN) Stock Prices, December 31, 2007, through April 30, 2014

**Figure 6.5** Fortress Investment Group LLC (FIG) Stock Prices, December 31, 2007, through December 31, 2015

**Figure 6.6** The Blackstone Group L.P. (BX) Stock Prices, December 31, 2007, through December 31, 2015

**Figure 6.7** Apollo Global Management LLC (APO) Stock Prices, March 29, 2011, through December 31, 2015

**Chapter 7**

**Figure 7.1** Bear Stearns' Death by CDS

**Chapter 9**

**Figure 9.1** Growth of SIVs' Total Assets

**Chapter 10**

**Figure 10.1** Federal Budget Deficits (\$ in billions)

# ACKNOWLEDGMENTS

As someone who has spent the last 25 years in the world of credit, I am unduly aware of the importance of acknowledging the debts we owe to other people. Despite the arguments found in the following pages, not all debts are onerous. In particular, the debts we owe other people are gifts, and it is my privilege to be able to acknowledge them publicly.

Many people like to say that life is short, but that is not true. Life is long. It is long in possibilities, long in the people we affect, and long in what lives on after we are gone. Life is also long in the people who affect us. This is my opportunity to thank the people who have enriched my life in ways that I am pleased to acknowledge here.

First and foremost, I want to thank my family. My wife Marcie is an unending source of strength and wisdom and love without whom my life would be unthinkable. I am blessed with a true life partner in every sense of the world, a wonderful friend and a wise and beautiful woman who has helped me accomplish much more than I could have on my own; I owe her everything. My children Alessia, Alexander, and Preston are the greatest gifts in our lives and have grown into warm, caring, and accomplished young adults largely due to the remarkable guidance of my wife. I could not be prouder of each of them.

My parents, Laurence and Roberta Lewitt, gave me the gifts of education, self-respect, and respect for others. They helped make me who I am and I love them very much. My father passed away shortly before publication of this book after a long and active life. He taught me to speak out and I hope that this book and the rest of my work lives up to his

example. My brother David is a gifted musician and teacher who makes me proud every day.

My in-laws Lester and Peggy Engel welcomed me into their family 30 years ago and made me feel like one of their own from the first day I met them. Peggy passed away shortly before my father and she lives on in her three wonderful children and nine grandchildren. My brother-in-law Dr. Marc Engel and my sister-in-law Lesli Sugerman have always made me feel like we grew up in the same house.

When I started writing *The Credit Strategist* in January 2001, I had no idea whether anybody would be interested in what I had to say. Since then, the publication has taken on a life of its own. It has also introduced me to people around the country from all walks of life who have broadened my understanding of the world. I owe a great debt to my readers to whom I am enormously appreciative.

One of the greatest things to have come out of *The Credit Strategist* is the community of brilliant people to whom it has introduced me and who continue to educate me about the markets on a daily basis while in many cases also becoming friends. It is my great pleasure to thank them here: Peter Boockvar, Paul Brodsky, Gil Caffray, Albert Edwards, Marc Faber, Martin Fridson, Joshua Friedlander, Dennis Gartman, James Grant, Dan Greenhaus, Fred Hickey, Lacy Hunt and Van Hoisington, Ed Hyman and his team at Evercore/ISI, Doug Kass, Bill King, Andrew Laphorne, Richard Lehmann, John Mauldin, Rafael and David Mayer, James F. Meisner, Russell Napier, Raoul Pal, Lee Partridge, Pedro J. Ramirez, David Rosenberg, Edward Scott, Kirby Shanks, Michael Shaoul, David Stockman, David Rucker, Cole Walton, Peter Warburton, Kate Welling, Christopher Whalen, Grant Williams, Christopher Wood, and Mark Yusko. Needless to say, I alone am responsible for the contents of the book.

I also continue to benefit from the enduring friendship, wisdom, and support of two of the wisest and most accomplished investors of our generation, Leon Cooperman and Steven Einhorn.

I am grateful for the support and friendship of my colleagues at The Third Friday Total Return Fund, L.P. – Michael Shatsky, Steven Artzi, Daniel Goldberg, as well as Perry Lerner, Chris Calise, Mitch Ackles, and Daniel Strachman.

My friends and colleagues Philippe Blumenthal and Greger Hamilton have helped me learn about the world outside the United States and are a constant source of wisdom and support.

I am very fortunate to enjoy the personal friendship of Dr. Paul Belsky, Gerald Brodsky, Fred and Sara Chikovsky, Mark Dern, Thomas Donatelli, Michael Felsher, Warren Greenspoon, Richard Hehman, Michael Kirsh, Donald Kittredge, Thomas Loucas, Jedd and Anna Novatt, Eric Oberg, Michael O'Rourke, Jeffrey Queen, Thomas Romero, Keith Rosenbloom, Dr. Amer Rustom, Azzam ("Skip") Rustom, Jeffrey Schreiber, Randall Shaw, Dennis J. Stanek, Jr., Charles Swanson, John Schiller, Laurence Silverman, Laura Stein, Burt Sugarman and Mary Hart, William Vanech, William Villafranco, Greg Walker, and Barry Wish. I am sure I left some people out inadvertently—please forgive me.

Chris Andersen and Frederick McCarthy have been great friends and mentors to me for many years since I met them at Drexel Burnham in the late 1980s.

My friends at Money Map Press and *Sure Money* have been wonderful supporters of my work. Mike Ward is the greatest editor in the business. Valerie Dowdle is the force behind *Sure Money* and was invaluable in bringing this

book to press. Elizabeth Latanishen is a constant source of energy and ideas at Sure Money. Greg Madison helps make sure that my weekly market reports get out on time and make sense. If all of Baltimore were run by Mike and his team, the city's problems would be solved.

My teachers have been among my most important lifelong influences. Arnold Weinstein, Edna and Richard Salomon Distinguished Professor of Comparative Literature at Brown University, has been a lifelong friend and intellectual and moral influence along with his incredible wife Ann. Mark Taylor, Chairman of the Religious Studies Department at Columbia University, has taught me Hegel, Kierkegaard, and a thousand other things and is a wonderful friend.

I also had the privilege to study with the equivalent of the 1927 Yankees in literary studies as a graduate student at Yale University in the early 1980s: Harold Bloom, Paul de Man, Geoffrey Hartman, Thomas Greene, J. Hillis Miller, Peter Brooks, Frederic Jameson, R.W. B. Lewis and Peter Gay. Jacques Derrida and Umberto Eco would stop by to lecture and meet with us from time-to-time as well. I sometimes pinch myself to remember how lucky I was to interact with these great minds.

And while I haven't seen them since leaving Vanderbilt Hall, my first-year teachers at New York University School of Law had a much greater influence on me than I realized at the time: John Sexton (civil procedure), who went on to become the dean of the law school and later president of the university; the late Daniel Collins (contracts); Sylvia Law (torts); James Jacobs (criminal law); and Lawrence Sager, now Dean of the University of Texas Law School (constitutional law). Former Dean of the law school Ricky Revesz brought me back to NYU after many years and for that I am very grateful as well.

Going further back, Professor John Halperin first inspired me to want to read and write when I met him at Camp Lenox, and my high school teachers at Paul D. Schreiber High School in Port Washington, New York, William Mock and Blaine Bocarde, taught me how to read and write.

Last but certainly not least, 25 years ago I had the good fortune to work at Drexel Burnham Lambert, Inc. for a brief period of time. That experience was a crash course in finance followed by a second crash course in human nature and markets when my two-man firm was chosen to manage the Drexel Burnham Employee Partnerships in the 1990s. My childhood friend Jonathan Sokoloff, who has brilliantly guided the pre-eminent private equity firm Leonard Green & Partners for many years, generously helped bring me to Drexel and while I have thanked him privately many times I am pleased to do so publicly here.

I am also grateful to have had the privilege to work with Michael Milken, Lowell Milken, Richard Sandler, and Peter Ackerman managing the Drexel Burnham Employee Partnerships and on other projects. I am confident that history will show not only that Michael, Lowell, and Drexel Burnham were ill-treated by the U.S. government, but that Drexel democratized capital in ways that will be felt for generations. Michael changed the world and paid a huge price for doing so, but like many artists and revolutionaries was not sufficiently appreciated while he was accomplishing his greatest feats. History will be kinder to him than his contemporaries.

# INTRODUCTION

## The Committee to Destroy the World

In a theater, it happened that a fire started offstage. The clown came out to tell the audience. They thought it was a joke and applauded. He told them again, and they became still more hilarious. This is the way, I suppose, that the world will be destroyed – amid the universal hilarity of wits and wags who think it is all a joke.

—Soren Kierkegaard

The 2008 financial crisis didn't materialize out of thin air—and neither will the next one. The worst financial crisis since the Great Depression was caused by policy errors that encouraged economic actors to borrow too much and spend or invest the money unproductively—and the next one will follow the same script. Surveying the debris of their work after the crisis, politicians, central bankers and regulators swore they would never allow such a crisis to happen again. Predictably, their promises were broken virtually the moment they were uttered.

By the time the first edition of this book was published in early 2010 under the title *The Death of Capital*, financial markets had stabilized but economies were still struggling to recover. Almost six years later, they are still struggling—except the world is much more leveraged, the geopolitical landscape is much more fractured, American politics are more divided, and policymakers have run out of answers.

Post-crisis economic reforms followed two paths: heavy regulation and activist monetary policy. Both of them missed the mark because neither addressed the rising tide of debt that is steadily suffocating the global economy. In fact, all of the responses to the financial crisis involved the creation of more debt. On the surface, it appeared that conditions were improving but under the surface the imbalances that caused the crisis were intensifying.

The post-crisis recovery was based on a mirage: an epic accumulation of debt created by central banks lowering interest rates to zero and engaging in trillions of dollars of quantitative easing. In their wisdom, policymakers decided to solve a debt crisis by creating more debt out of thin air, guaranteeing an even more severe crisis in the future. And it wasn't just the United States that saw its debt grow significantly. Debt also increased in Europe and Japan after the crisis. But in China, the country most responsible for driving the post-crisis global recovery, it exploded beyond reason. China's growth was built on the biggest debt bubble in history.

China's debt explosion was either ignored or cheered on by the financial press and Wall Street. These observers adopted the unfounded belief that China was exempt from normal economic forces. Some of us dissented from this view and warned that China's debt-fueled growth was unsustainable, but our voices were drowned out by the bubbled masses. But when China's economy began to slow sharply in 2014, it became apparent that China was playing a role in the post-crisis global economy analogous to that played by the U.S. housing market before the crisis. In the mid-2000s, the U.S. housing market created huge amounts of debt that not only inflated housing prices at home but ended up inflating asset prices around the world. In a similar fashion, China's so-called "economic miracle" inflated the prices of commodities, real estate, and other financial assets around the world. In 2007, the world experienced a debt crisis that originated in the U.S. housing industry and radiated out into the global economy. In 2016, the world faces a debt crisis that originated in China and commodities and is spreading out into the global economy. The common ingredient is excess global liquidity created by central banks.

According to the McKinsey Global Institute, China's total debt increased from \$7 trillion in 2007 to \$28 trillion by mid-2014.<sup>1</sup> To place these figures in context, household debt in the United States increased by \$7 trillion in the period leading up to the financial crisis in 2008. And America's federal deficit increased by roughly \$7.5 trillion between January 2009 and mid-2015.<sup>2</sup>

So China, an economy only 50 to 60 percent as large as the United States, saw its debt increase by three times as much as America's household debt grew during the housing bubble or, alternatively, three times as much as America's federal deficit grew during the first six-and-a-half years of Barack Obama's presidency (a period that included four consecutive years of \$1 trillion deficits). Moreover, much of China's debt was directed into wasteful and unproductive real estate and commodity investments that will never produce a reasonable return or generate enough income to service or repay the capital that funded them. So much for China's "economic miracle."

In a globalized world, the effects of China's epic debt explosion were not confined to that country's borders; China's unconstrained borrowing created unsustainable demand for commodities and massive overproduction in mining, mineral, chemical, and related industries throughout the world. It left in its wake massive overcapacity in commodity-related industries across the globe. Once this debt-fueled expansion began to run out of gas in mid-2014, China's growth began crumbling, commodity prices began collapsing, credit markets began collapsing, and global growth began slowing from already depressed post-crisis levels.

Then central banks did what central banks do—they compounded their earlier policy errors by repeating their old ones. They doubled down on the failed policies they were employing to stimulate economic growth in an over-indebted post-crisis world. On October 31, 2014, Bank of Japan Governor Haruhiko Kuroda announced unprecedented new stimulus measures in another desperate attempt to break Japan's decades-long economic spiral. In January 2015, European Central Bank (ECB) President Mario Draghi followed suit with Europe's first-ever quantitative easing initiative. Only Janet Yellen's Federal Reserve was moving in the opposite direction by ending its own quantitative easing program, but this was primarily through sins of omission that strengthened the dollar and exerted additional downward pressure on commodity prices, U.S. corporate profits, and the global economy.

By mid-2015, serious cracks began to appear in global markets. Greece defaulted and had to be bailed out again by the European Union while solidifying its status as a failed state and global security threat as an entry point for refugees from a shattered Middle East. Emerging markets were melting down with particular weakness in Brazil and Russia. China's stock market was crashing and the country shocked global markets by beginning a concerted effort to devalue the yuan. Puerto Rico declared itself insolvent (something anyone with a functioning cerebellum already knew was the case). Leveraged oil and gas companies in the U.S. were filing for bankruptcy left and right. And then the U.S. stock market, which had struggled to rise all year, suffered sharp losses and extreme volatility in August and September, shaking the confidence of investors. The post-crisis debt party had run long past midnight—and nothing good ever happens after midnight.

With interest rates around the world stuck at zero, there was little prospect that the \$200 trillion of debt suffocating the global economy could ever be repaid by conventional means. The world is incapable of generating enough income to pay the interest and principal on that much debt. Instead, it was obvious that this debt could only be repaid through a combination of currency debasement, inflation, and defaults. Stated plainly, this means that the value of fiat money is going to be obliterated. Of course, politicians, central bankers, and policymakers have been destroying the value of money for years. But now they are going to have to accelerate their efforts. Out-of-control debt is metastasizing, crippling global growth and sucking the lifeblood out of the global economy. Central bankers badly miscalculated when they decided to try to solve a debt crisis by printing trillions of dollars of additional debt.

## **A Regulatory Theocracy**

The 2008 financial crisis and, before that, the 9-11 attacks drastically reshaped the world. Each of these seminal tragedies unleashed massive policy responses that radically altered American life for the worse. As a result of the 9-11 attacks, the

United States invaded Iraq and Afghanistan and launched anti-terror operations in Pakistan, Yemen, and Somalia; passed the Patriot Act that expanded surveillance of its citizens; and established a massive new bureaucracy in the Department of Homeland Security to protect the nation. As a result of the expansion of the radical Islamic terrorism around the globe that triggered the 9-11 attacks, Americans can no longer travel freely or feel secure in public places due to the growing threat of random violence. American police forces are militarized and the freedoms enjoyed by our parents and grandparents are limited by our own fears and our government's failure to effectively fight our enemies at home and abroad.

Financial regulation was supposed to improve after the financial crisis, but instead it deteriorated into an orgy of mindless rulemaking. In a perverse interpretation of his campaign promise of "Hope and Change," Barack Obama left post-crisis financial regulation in the hands of the same cast of inept economic policymakers that led America into crisis in the first place.

He named Lawrence Summers as his chief economic adviser, a man whose inflated opinion of himself dwarfs his meager accomplishments such as rejecting CFTC Chair Brooksley Born's pleas to regulate derivatives in the late 1990s despite himself knowing virtually nothing about derivatives. He named Timothy Geithner, who ran the Federal Reserve Bank of New York before the crisis while Wall Street leveraged itself into insolvency right under his nose, as his Treasury Secretary.

And, in perhaps his most disappointing move, the president brought in Mary Schapiro, an undistinguished career regulator who had mastered the art of failing upward, to run the already ineffective Securities and Exchange Commission (SEC). Among Ms. Schapiro's notable failures was allowing Bernard Madoff to run the largest Ponzi scheme in history right under her nose as she served as a senior regulator and ultimately the Chair and CEO of the National Association of Securities Dealers in the mid-to-late 1990s, the height of Mr. Madoff's fraud.

Rather than new blood and new thinking, Mr. Obama relied on the same people responsible for the policy errors that contributed to the crisis to fix those errors. Those who had warned of the problems before they happened were nowhere to be found.

In the aftermath of the financial crisis, Congress passed The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Naturally, this bill turned into a regulatory and lobbying orgy that ended up sapping liquidity and vitality from the financial system while leaving derivatives inadequately regulated and the individuals who committed crimes that contributed to the financial crisis unpunished. Dodd-Frank was 14,000 pages in length and included 398 rule-making requirements, rendering it almost impossible to administer by the SEC and other agencies charged with administering it. Like the badly flawed Affordable Care Act, which House Majority Leader Nancy Pelosi famously (and disgracefully) said had to be passed into law in order for the members of Congress to know what it actually said, Dodd-Frank was another piece of absurdly complex legislation that was voted on by people who didn't read it or understand its contents or its unintended consequences.

The gargantuan Dodd-Frank bill was the government's main regulatory response to the financial crisis. The law required banks to reduce leverage and risk-taking activities using taxpayer money (reforms that I proposed in the first edition of this book). While some of these goals were accomplished, the forms in which they were implemented rendered the financial system less liquid, more rigid, and more susceptible to another financial crisis.

Legislators and regulators failed to recognize that inflexibly bolstering bank capital would severely reduce market liquidity, yet that is precisely what occurred. By 2014, liquidity in fixed income markets had dried up as banks restructured their businesses to meet the demands of the new law. Corporate bond inventories held by dealers dropped by 70 percent while Treasury market liquidity evaporated. This happened as debt markets increased dramatically in size; by 2015, the U.S.

corporate debt market had doubled in size to \$4.5 trillion since before the crisis, yet it had become much more difficult to trade bonds than a decade earlier. The evaporation of market liquidity will inevitably make the next crisis more severe than the last.

The government's role in the economy and its intrusions into the daily lives of its citizens are immeasurably greater today than on September 10, 2001. The costs in terms of lost privacy and freedom are incalculable. We live in a world run by regulators who are operating in the dark while exercising increasingly untrammelled power. We are lorded over by a growing regulatory state to whom courts—particularly the Roberts Supreme Court—have granted enormous and undue deference. The Tyranny of the Alphabet—the FBI, IRS, SEC, FINRA, NLRB, EPA, OSHA—governs our lives. The rise of the regulatory state coupled with the epic increase in debt are smothering the economic vitality of the United States and dooming this country and the rest of the world to generations of sluggish growth.

The expansion of the regulatory state is appalling in breadth. Over the last decade, 768,920 pages of federal regulations have been added to the *Federal Register*, an average of almost 77,000 pages a year.<sup>3</sup> A nearly incomprehensible 36,877 new regulations were added during that period.<sup>4</sup> It is a miracle that the American economy can function at all under the weight of all of these rules, many of which can give rise to substantial criminal and civil penalties in the hands of overzealous and corrupt prosecutors (of which there are no shortage).

We have come a long way from February 1999 when *Time Magazine* celebrated “The Committee to Save the World”—Alan Greenspan, Robert Rubin, and Lawrence Summers (see [Figure 1.1](#)). *Time*'s misguided anointment of these three men coincided with the birth of the European Union, which enslaved vast swathes of southern Europe in an economic straitjacket. Shortly before the three men were celebrated by *Time*, they had successfully thwarted efforts by U.S. Commodity Futures Trading Commission chair Brooksley Born to regulate over-the-counter derivatives, a decision that contributed less than a decade later to the worst economic crisis since the Great

Depression. As we came to learn, with men like these in charge of saving the world, the world was going to find itself in deep trouble.



**Figure I.1** Apocalypse Then

SOURCE: *Time*, February 1999.

A decade later, Mr. Greenspan admitted to Congress that his basic assumptions about economics and human behavior were wrong. Mr. Rubin was trying to justify his \$100 million sinecure at Citigroup, Inc. while refusing to acknowledge any responsibility for the actions of his underlings that pushed that bank into insolvency and a federal bailout on his watch. And Mr. Summers kept failing upward, retaining his sneer of intellectual superiority while consistently demonstrating why academic economists like him are the last ones anyone should ask for economic policy advice.

Unfortunately, economic governance would get much worse and “The Committee to Save the World” was succeeded by “The Committee to Destroy the World” (see [Figure I.2](#)) after the 2008

financial crisis (although the mainstream press never identified them as such, leaving that to me in *The Credit Strategist*<sup>5</sup>). In 2015, the troika leading the world's largest central banks was still pursuing crisis-era policies long after the crisis had passed. By that time, new strains were appearing in the global economy due to the failure of fiscal policymakers to adopt meaningful pro-growth policies and the perpetuation of crisis-era monetary policies long past their sell-by date.



**Figure I.2** The Committee to Destroy the World

SOURCE: Haruhiko Kuroda photo by Michael Wuertenberg, [https://commons.wikimedia.org/wiki/File:Accelerating\\_Infrastructure\\_Development\\_Haruhiko\\_Kuroda\\_\(8410957075\).jpg#filelinks](https://commons.wikimedia.org/wiki/File:Accelerating_Infrastructure_Development_Haruhiko_Kuroda_(8410957075).jpg#filelinks); Mario Draghi photo by Remy Steinegger, [https://commons.wikimedia.org/wiki/File:Mario\\_Draghi\\_World\\_Economic\\_Forum\\_2013.jpg](https://commons.wikimedia.org/wiki/File:Mario_Draghi_World_Economic_Forum_2013.jpg); Janet Yellen photo by Day Donaldson, <https://www.flickr.com/photos/thespeakernews/16165619661>.

Governed by intellectual fallacies and cowed by markets, The Committee to Destroy the World adopted policies that were guaranteed to lead the world straight into the jaws of another financial crisis. Global interest rates were kept at, near, or below zero for years while central banks purchased trillions of dollars/yen/euros of government bonds based on the delusion that these policies would stimulate economic growth. Naturally, they did precisely the opposite.

Einstein supposedly said that the working definition of insanity is repeating the same mistake and expecting a different result. That remark should be applied to the working definition of stupidity and central bankers. By 2014 (if not earlier), there was abundant and irrefutable evidence that quantitative easing was failing to stimulate growth in the United States. In fact, it was sapping economic vitality and market liquidity and contributing to the most disappointing economic recovery in memory. In the 2011–2014 period, GDP growth in the United States averaged a measly 2.0 percent according to the Bureau of Economic Statistics. And during Barack Obama’s presidency, the high point for annual GDP growth was a tepid 2.5 percent in 2010.

Nonetheless, faced with mounting evidence that their policies were not working, central bankers, demonstrating that there is a difference between being educated and being smart, refused to change course; instead, they persisted with their failed policies. Their subsequent expectations for economic growth never came close to materializing. [Table I.1](#) shows the “central tendency” projections of GDP growth by Federal Reserve governors and bank presidents compared to actual GDP in the 2011–2015 period.

**[Table I.1](#)** “Central Tendency” Projections of GDP Growth Compared to Actual GDP in the 2011–2015 Period

<b>Year</b>	<b>Fed Projections</b>	<b>Actual</b>
2011	3.0–3.6%	1.60%
2012	2.5–2.9	2.2
2013	2.3–3.0	1.5
2014	2.8–3.2	2.4
2015	2.6–3.0	1.5 (first half)

SOURCE: Federal Reserve Board.

Looking at this record, one could reasonably conclude that it would be more useful to ask a group of English professors to forecast the economy.<sup>6</sup> In the wake of their failures, the Fed left behind a grossly over-leveraged economy whose fragility was

disguised by artificially inflated stock prices, artificially low interest rates, and artificially suppressed volatility. You have to hand it to Ben Bernanke and his progeny—they couldn't have designed a more disastrous set of policies had they consulted Dr. Victor Frankenstein.<sup>7</sup>

Things didn't have to be this way. A sounder and more creative intellectual approach and bolder political initiatives would have produced far better results. But there are no Paul Volckers running central banks today and no Winston Churchills leading the world. Mr. Volcker was willing to battle inflation while being demonized in the press and Churchill fought the Nazis from an underground London bunker while being bombed by the Luftwaffe every night.

Today, we are left in the hands of people like Janet Yellen and Barack Obama. Mrs. Yellen was terrified to raise interest rates by a mere 25 basis points for years for fear of upsetting markets while Mr. Obama, who tellingly removed Churchill's bust from the Oval Office, loaded the American economy with job-killing regulations and multi-trillion dollar entitlements while appeasing tyrants, betraying our allies, and apologizing for American power and principles. They say that societies get the leaders they deserve. I say we deserve better.

## **A Crisis Wasted**

Shortly after President Obama took office in 2009, I received a telephone call from one of the Obama administration's top economic advisers. I was asked whether I was willing to speak to the small group advising the president how to regulate derivatives after the financial crisis. The individual who called me said he was uncertain whether he could get me a hearing but felt it was important for them to hear my views (which were published, among other places, in the first edition of this book) since the president and Lawrence Summers, the president's top economic adviser, believed it would be appropriate to leave regulation of derivatives in the hands of regulators. My view, which the caller had shared with the group, was that regulators

do not understand derivatives and are not qualified to regulate them. After some back and forth, I was not invited to share my views with the group; there was little appetite to hear them, and derivatives regulation was left in the hands of people who do not understand them.

On the first page of his magnum opus, *Stabilizing an Unstable Economy*, the great economist Hyman Minsky wrote: “Economic theory is the product of creative imagination; its concepts and constructs are the result of human thought.”<sup>8</sup> There is nothing foreordained about economics; it is merely a series of intellectual constructs about how the world works. It is a soft science. Accordingly, its forecasts are more often wrong than right. As a human intellectual construct, it is subject to the deficiencies of human thought—in the shorthand of the markets, greed and fear. These flaws lead economists to make less than optimal policy choices, and that is nowhere more apparent than in the responses to the 2008 financial crisis.

After the crisis, the government consistently sought advice, not from those who correctly predicted the housing bubble and resulting market collapse, but instead from those economists and strategists who missed the obvious warning signs and those investors who lost enormous sums of money. If your fund was down 80 percent, you were at the top of the list of the people the government called for advice. Of course, many of these people purchased their seats at the table with large campaign contributions; that is what happens in a system of crony capitalism. Nonetheless, it was a shame that we were calling on the same individuals who led us to the brink disaster to lead us out of it. We can see the results of that approach six years later: an over-leveraged and over-regulated financial system that is failing to fuel sufficient economic growth to pay our current and future obligations.

In the midst of the crisis, presidential aide Rahm Emanuel (who was not the individual who called me) famously said that it would be a shame to let a crisis go to waste. But that is exactly what happened. Despite heroic efforts to prevent a complete collapse of the financial system after the failure of Lehman

Brothers and the near demise of insurance giant AIG, policymakers failed to address many of the underlying regulatory, fiscal, and monetary policy failures that led to the financial crisis while also creating new ones.

That is not to say that they did nothing: they took some important steps to reform the U.S. banking system and make it better capitalized. But they failed to address the two biggest elephants in the room: (1) the incessant growth of debt in the U.S. and around the world; and (2) the \$650 trillion derivatives infrastructure that hangs over the entire edifice of global finance like a dark cloud waiting to burst. Excess debt and all that comes with it pose the greatest risk to global financial stability since the Great Depression and absolutely nothing has been done to tame this beast.

## **The Death of Fiscal Policy**

Mr. Obama inherited an extremely difficult situation upon taking office, but he made it worse through a series of deliberate policy choices that further weakened the American economy. His proclivity for government rather than market solutions imposed enormous regulatory burdens on the economy that impeded private sector growth while loading the government with trillions of dollars of future obligations that it can't afford to pay.

The first large piece of economic legislation that Mr. Obama promoted was the \$800 billion American Recovery and Reinvestment Act. The president touted this so-called stimulus bill as a massive boost for the American economy when it was passed by a Democrat-controlled Congress in February 2009, but it proved to be a bust. Very little of the money was spent to increase the productive capacity of the American economy as proven by the economy's sub-par growth in the years that followed. We may not have been building bridges to nowhere like Japan and China, but we weren't building bridges to the future either.<sup>9</sup>

Then Mr. Obama decided to impose a new multi-trillion-dollar entitlement on one-sixth of a struggling American economy—The