

# WHY THE FRENCH ARE TO BLAME FOR AMERICA'S BANKING CRISIS

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**The sorry mess in our economy began when a New York banker sailed on his yacht off St. Thomas and read a biography of the French Sun King Louis XIV.**



Après moi, le déluge!



**So charmed was the banker by the French king's life style -- his resplendent attire, his chateaux, his stable of horses, his coterie of mistresses, his fine wines and his general philosophy of life – that the banker decided to live like Louis XIV as well and to apply Louis XIV's *avant garde* philosophy of life to modern banking – starting with the bank's hitherto boring mortgage department.**

## OLD FASHIONED, 20<sup>TH</sup> CENTURY MORTGAGE

Thank you for the mortgage loan. We promise to pay it back, with interest over 20 years, with equal monthly payments.

Gratefully,

*John and Jane Doe*  
*Trustworthy Borrowers*

# THE BANKER'S LOUIS XIV™ BUSINESS-MODEL

I don't think I can afford this mortgage!

Don't worry about it. Who gives a s - dang, I mean. Après nous le déluge!



# LOUIS XIV™ 21<sup>ST</sup> CENTURY MORTGAGE

Thanks for the dough. But if you nitwits think we'll ever pay you back, we have news for you:

FUGEDDABOUTIT !

Mazel tov !

*John and Jane Doe  
Subprime Borrowers*

**Upon being advised by legal counsel that the *nouveaux* Louis XIV™ mortgages were, indeed, duly signed by the borrowers, the banker deemed these mortgage good.**

**In modern banking, this kind of fact-finding process is called “due diligence.”**

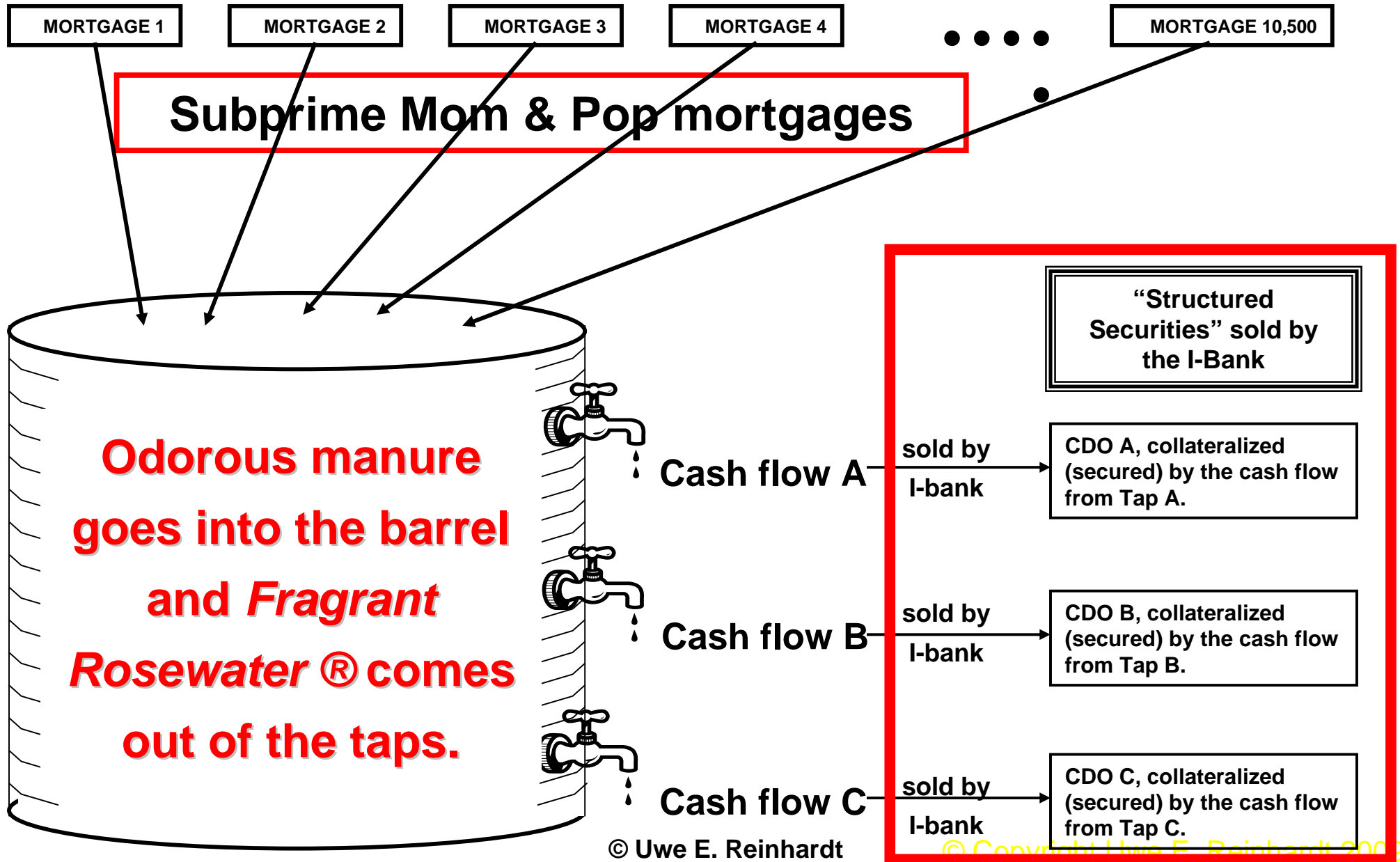
**Soon the banker not only made mortgage loans himself, but also bought thousands of similar mortgage loans from other, smaller, local Mom & Pop banks near and far.**

**The expected cash flows from these *nouveau* mortgages, whatever they might turn out to be, were then pooled in a big vat with faucets at its side, like the one depicted on the next slide.**

**The big bank then issued and sold to others so-called “Collateralized Debt Obligations” (CDOs) giving their owners fractional rights to stick a tin cup once a month under the faucets of the big vat.**

**As we shall see, this transformation of cash flows can be likened to the process of morphing manure into fragrant rose water.**

# MORPHING MANURE INTO ROSEWATER

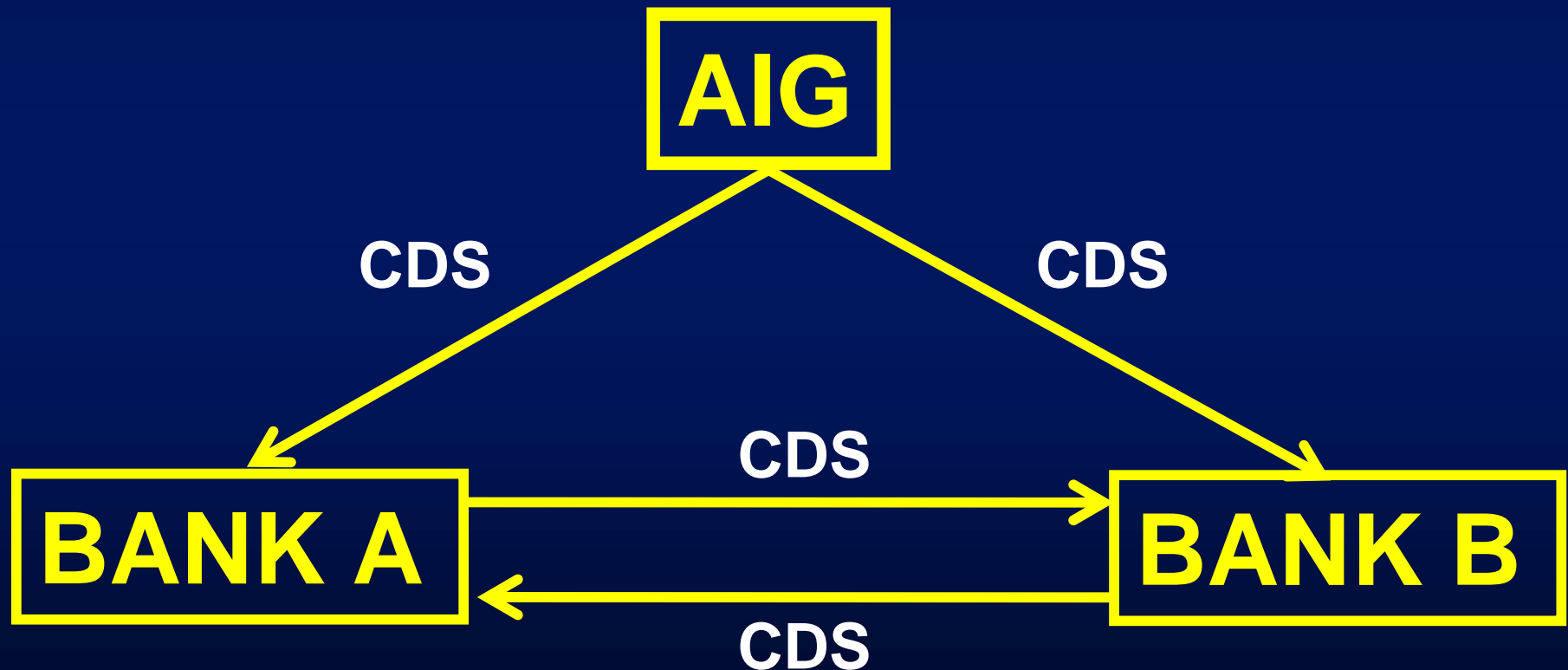


**To make sure these CDOs would always smell like fragrant rosewater, people who bought them insured their full value by buying insurance on them via mysteriously sounding contracts called “Credit Default Swaps” (CDS).**

**The giant insurance company AIG believed that selling such insurance contracts was like selling life insurance to immortals.**

**Therefore AIG insured some \$450 billion of CDOs and other bonds with CDSs, assuming there would be few if any claims on that insurance.**

**Soon, not only AIG sold insurance on the rosewater, but every bank sold every other bank such insurance, i.e., *Credit Default Swaps (CDS)***



**Shown AIG's insurance policies (CDSs) on the rosewater (the CDOs issued by the banks) , America's great perfume sniffers – *Moody's, Standard & Poor, and Fitch* – certified the rosewater AAA, meaning that the rosewater (the CDOs) would never ever lose its fragrance.**

**With that AAA rating, American bankers peddled these CDOs all over the world and invested in them as well, mainly with money borrowed from others.**

**Billions upon billions of these bank borrowings took the form of extremely short-term, overnight loans from other banks or lenders with temporary surplus funds.**

# TYPICAL BANK'S BALANCE SHEET, 2007



**Contributed by  
the owners.**

The typical bank  
borrowed  
between \$30  
and \$40 for  
every \$1 of  
owner's equity  
to buy assets,  
including  
mucho  
Rosewater.

**Because all of the CDOs manufactured by the banks were fully insured by the CDSs sold by AIG or by the banks to one another, and because therefore the perfume sniffers Moody's, Standard and Poor and Fitch, rated these bonds AAA, all of the bankers collectively believed that they had made the risk inherent in the dodgy (no-payback) Louis XIV™ subprime Mom & Pop mortgages evaporate into thin air.**

**And believing to have performed this *8<sup>th</sup> Wonder of the World*, the bankers modestly paid themselves \$50 million a year and more, full well knowing they deserved more.**

## II. THE PERILS OF EXCESSIVE DUE DILIGENCE



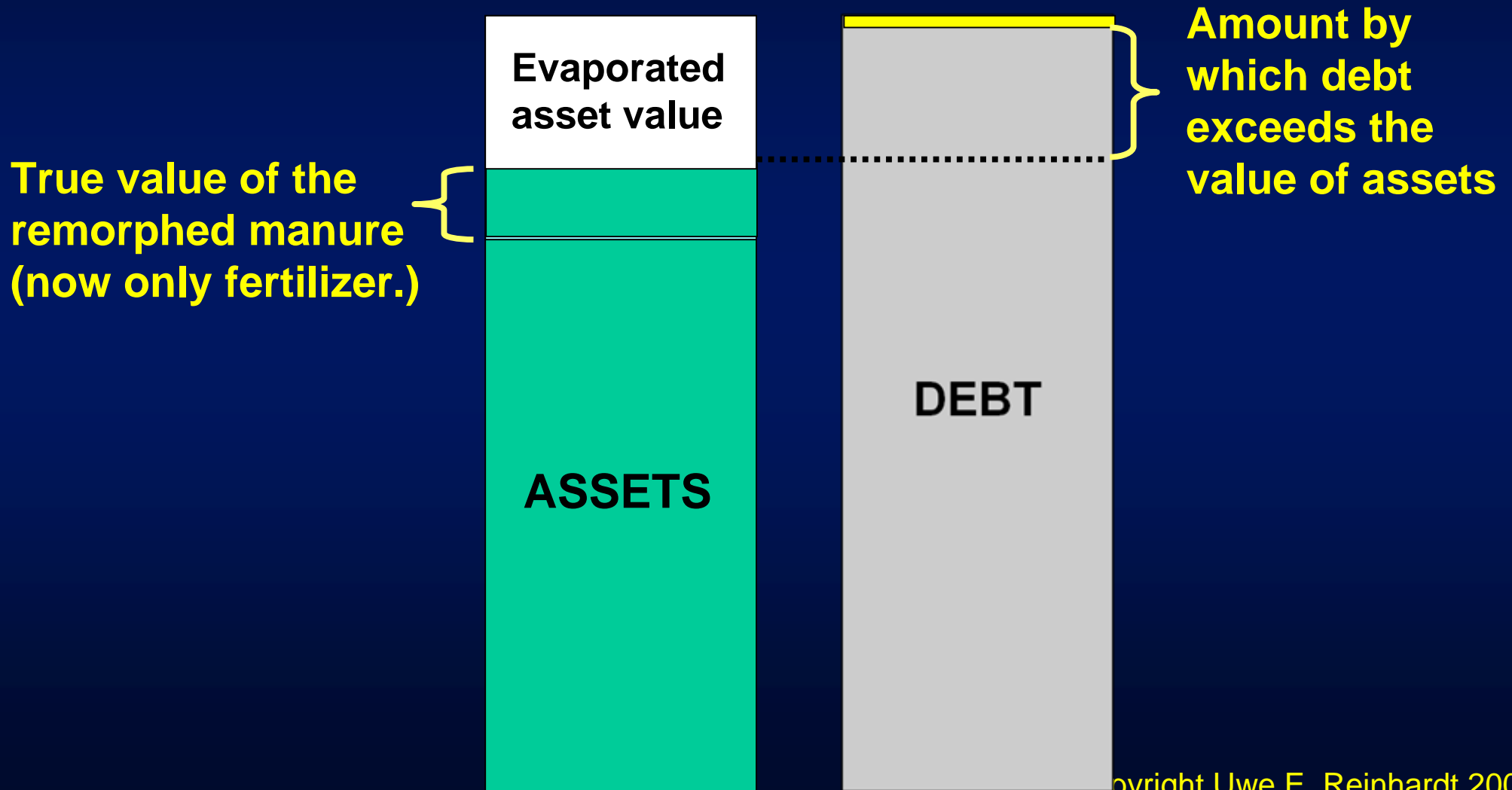
**Alas, an old fashioned analyst working for a bond fund decided to inspect some of the real estate backing up the Collateralized Debt Obligations (CDOs) issued by the big banks and to inquire whether the original borrowers on the *nouveau* Mom & Pop mortgages could actually make their mortgage payments on time.**

**Sadly, this *excessive* due diligence - snooping, really -- ultimately brought down the glorious American banking sector and with it the rest of the world.**



**Waterfront property backing up Big Bank CDO**

It began to dawn even on the sophisticated big NY banks that the CDOs on their balance sheets might not be worth what they paid for it and would have to be “marked down to market.”



**And thus Wall Street – where  $2 + 2$  can remain 5 for entire decades – became reacquainted with the standard arithmetic they once learned in elementary school and, possibly, even in business school.**

**In terms of our earlier metaphor, the molecular structure of the rosewater the banks had manufactured and had put on their own balance sheet had morphed back into the molecular structure of manure, polluting the banks' balance sheets with an awful stench.**

## II. THE GOVERNMENT TO THE RESCUE



**With their balance sheets polluted, and under the time-honored mantra of American rugged individualism**

**WHEN THE GOING GETS TOUGH,  
THE TOUGH RUN TO THE GOVERNMENT**

**AIG and America's rugged bankers swiftly jetted down to Washington, where they got a sympathetic ear from their blood-brother, Secretary of the Treasury Hank Paulson, and from his sidekick, utterly shell-shocked Federal Reserve Chairman Ben Bernanke.**

**“Our balance sheet stinketh to heaven,” lamented AIG and the bankers, who seemed as surprised by the stench of their assets as they were distraught. “Pray, brothers Hank and Ben, take this stinky mess off our balance sheet and sell it to the taxpayer. Tell them it’s good for the country.”**

**And an oh so compassionate *Paulson-Bernanke Duo* promptly obliged, selling the stinky mess to Congress and the taxpayer as potentially valuable “fertilizer” to make the economy grow again.”**

**“But were not the CDOs backed up by the dodgy Mom & Pop mortgages insured by the credit default swaps?” you might query. “So what was the problem here?”**

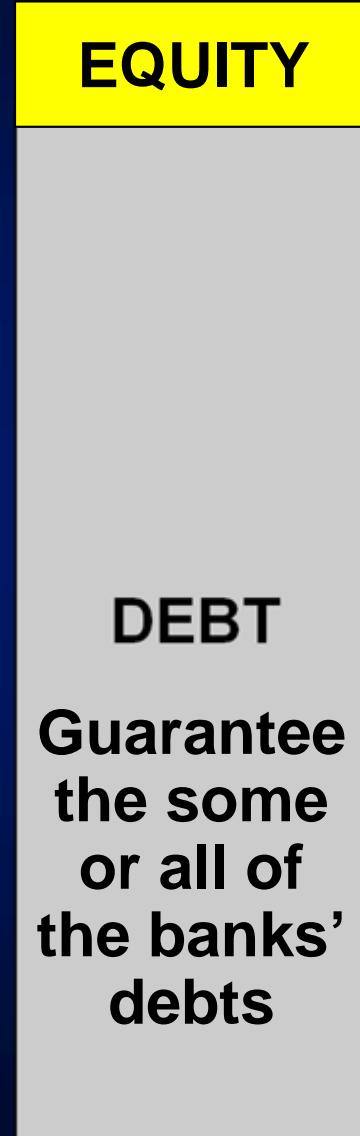
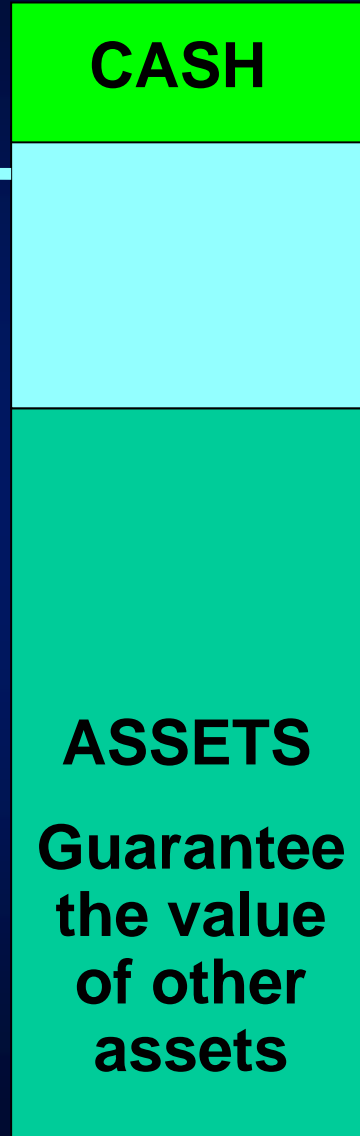
**It turns out that AIG and other sellers of such bond insurance, believing it was like selling life insurance to immortals, had never set aside the cash reserves to back up the insurance they had issued for the CDOs.**

**No one in government had ever worried about this lack of reserves, because to do so would have meant interfering with the free market, which is always bad.**

# THE ALL-AMERICAN BANK BAILOUT OPERATION™

Dump stinky assets on taxpayer

Get solid cash or Treasury Bonds



2. Inject more cash in return for non-voting "preferred" stock.



The Hank & Ben Duo

**And brother Ben Bernanke now kneels daily before the bankers, fervently praying**

**Please, please, dear bankers, please make loans to Main Street now!**



**But the banks wrote a thank you note to their brother Hank Paulson and his sidekick Ben Bernanke, and worded it thus:**

Thanks heaps for your help, guys. But if you nitwits think we'll now make loans to Main Street,

**FUGEDDABOUTIT !**

**Mazel tov !**

*America's Proud Bankers*

**Best in the world!**

**And somewhere in a far away cave sits Osama bin Laden, gloating over the economic damage that a bunch of infidel American bankers have done to their own country.**



**It appears that, by and large, the Obama Administration has continued the general approach of the previous Administration.**

**The sincerely held objective, now as then, does appear to be to help revive the flow of credit and thus economic activity where it has ceased or is diminished.**

**But the new administration hobbles itself with the self-imposed constraints that (a) the creditors of the banks' be kept whole and (b) as much as is possible of the wealth of the banks' shareholders be protected from loss – a strange form of genuflection before Wall Street.**

### **III. BETTER APPROACHES**

**A better idea would have been to subject banks in trouble to a prepackaged bankruptcy that would have let the banks' shareholders eat the banks' losses and would have converted the holders of the banks' subordinate debt into shareholders so as to restore the bank's balance sheet to health.**

**This idea has been proposed by Prof. Luigi Zingales of the University of Chicago.**

**An alternative idea would be simply to nationalize failing banks, and idea that has quite a few supporters outside the Administration.**

**Finally, several experts have proposed to use taxpayers' funds only to create new banks whose debt would be guaranteed by government and that would make loans to business on Main Street, because that would be the new banks' mandate.**

**The old zombie banks could then be left to languish on their own – either to recover or to wither away.**

# IV. AND WHERE WERE THE ECONOMISTS?

**Private markets in  
deep do-do?  
Ayn Rand never  
mentioned it in  
*ATLAS SHRUGGED***



**Sadly, with a few and notable exceptions (Princeton's Paul Krugman being one) the economics profession -- from Federal Reserve Chairmen Greenspan and Bernanke on down -- was blindsided by its credo (next slide) and slept right into the middle of this brewing storm, firmly believing that what did happen in practice could not possibly happen in theory.**

**ECONOMIST'S CREDO:**

**Est, ergo optimum est – dummodo  
ni gubernatio civitatis implicatur\***

**\* *It exists, therefore it must be  
optimal – unless government  
is involved.***



I swear on Adam Smith's Wealth of Nations that I shall always believe in and propagate everywhere the **Efficient Market Hypothesis**



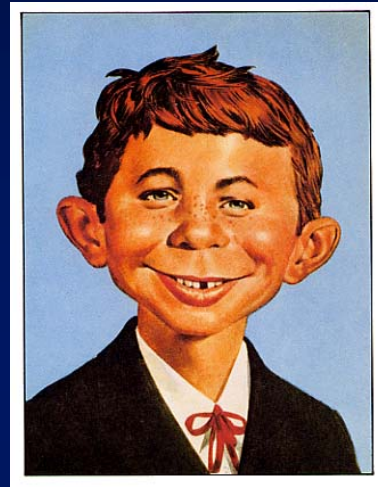
**Having just recently awoken to the perilous state of the economy that, in theory, should not have obtained, it is small wonder that the still groggy economics profession now cannot even agree what should be done to lead the nation out of the current economic crisis.**

**So, as far as the profession is concerned, you're on your own, folks.**

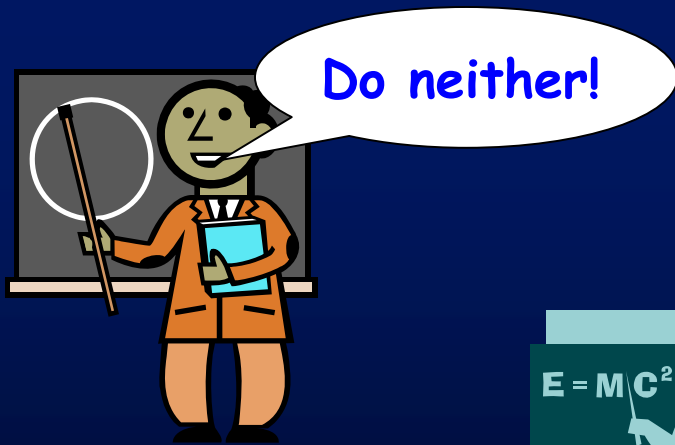
# ECONOMIC POLICY ADVISORS AT WORK



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U. S. Voter



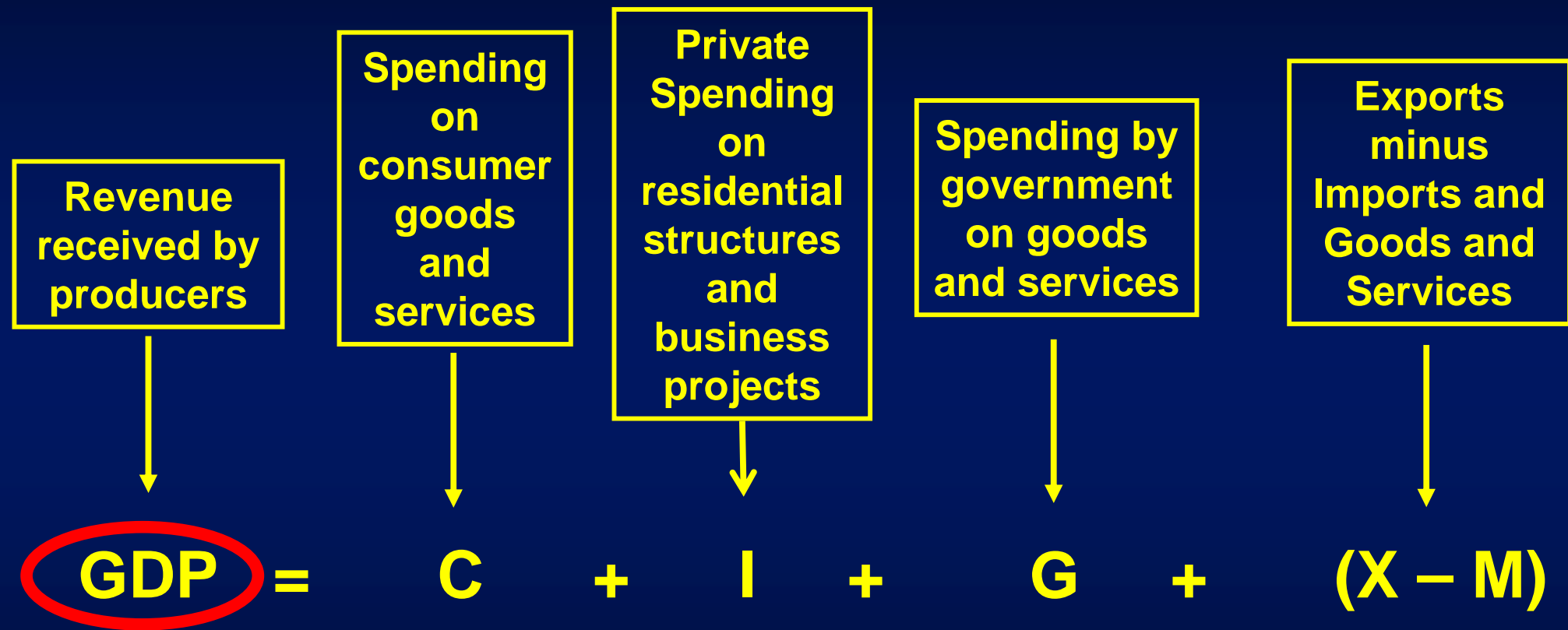
# V. THE LATE LORD KEYNES TO THE RESCUE



**Anyone who ever had taken ECONOMCS 101 will fondly remember the fundamental equation defining the nation's GROSS DOMESTIC PRODUCT (GDP).**

**It is reproduced on the next slide.**

# The Demand-Side of the Economy



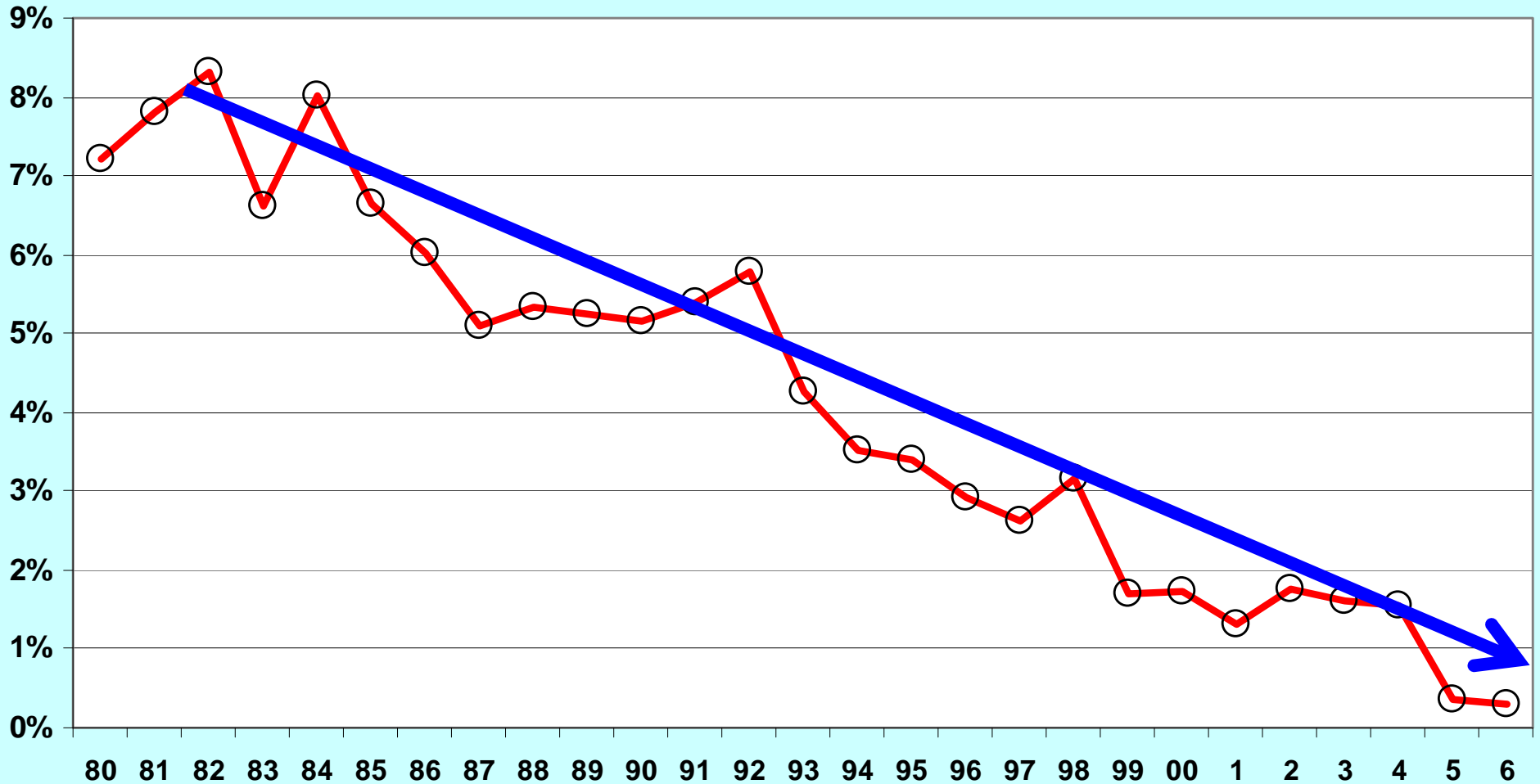
**G = gov't spending on operations + gov't spending on investment**

**As is well known by now, all types of private spending in this equation (C, I and X) have been declining sharply.**



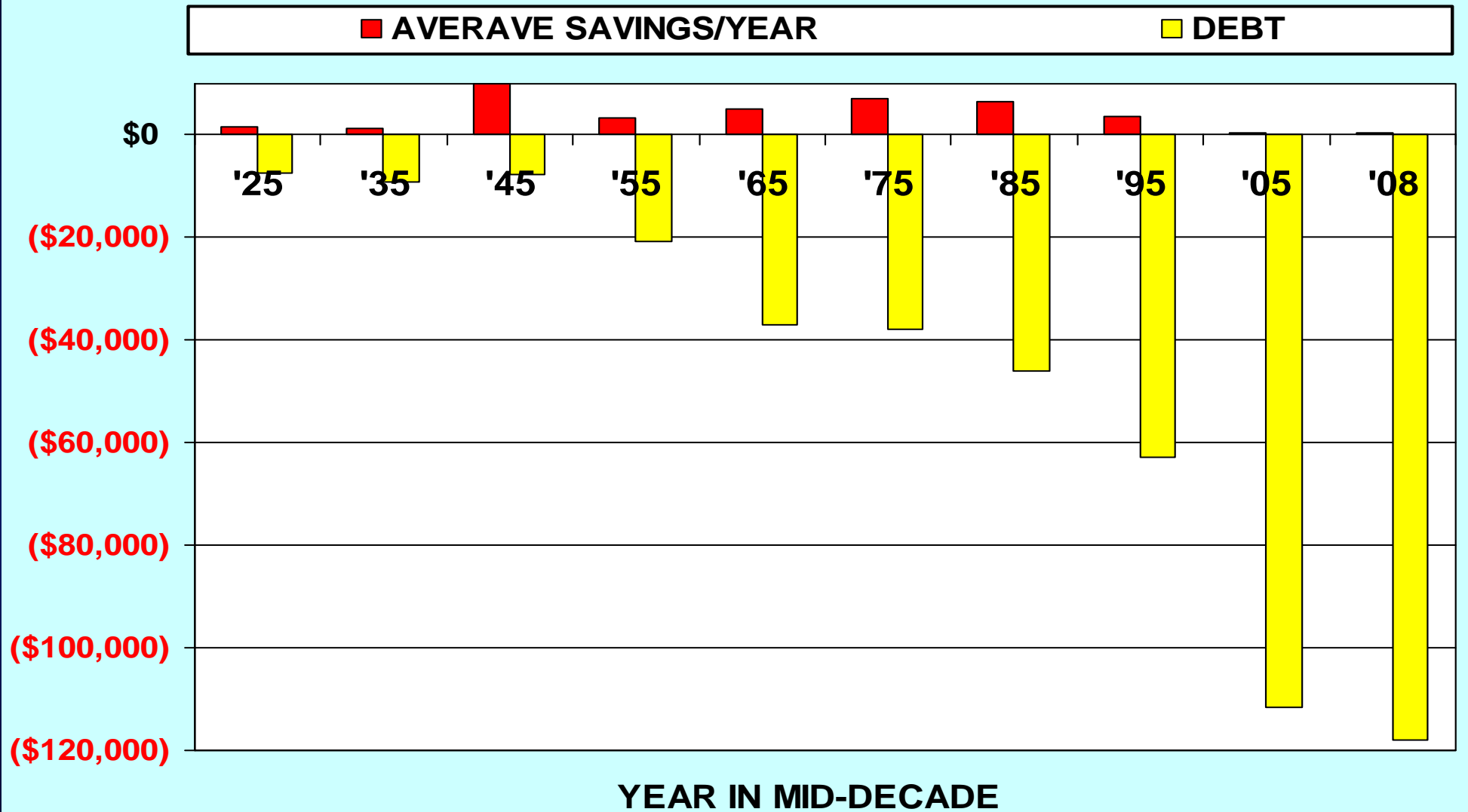
**Spending by consumers, in particular, has declined sharply, because American households are deeply indebted and have maxed out on credit.**

## PRIVATE PERSONAL (HOUSEHOLD) SAVINGS AS A PERCENTAGE OF GDP, NET OF DEPRECIATION ALLOWANCE



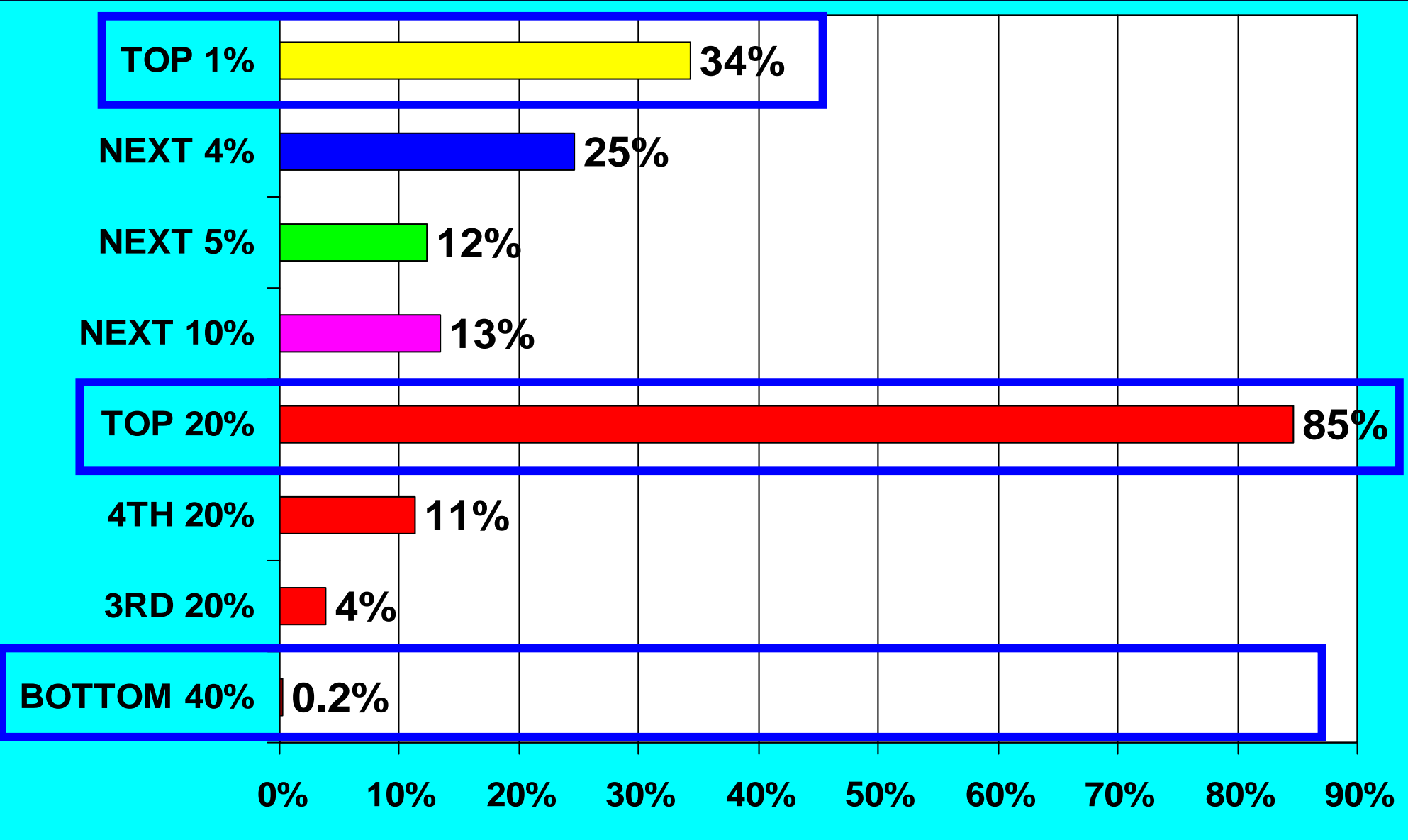
**SOURCE: Economic Report of the President 2008, Table B-1 AND B-32.**

# AVERAGE SAVINGS PER YEAR PER HOUSEHOLD AND AVERAGE DEBT PER HOUSEHOLD



SOURCE: The New York Times, <http://www.nytimes.com/interactive/2008/07/20/business/20debt-trap.html>

# FRACTION OF TOTAL WEALTH (NET WORTH) HELD BY INCOME GROUP



SOURCE: Edward N. Wolff, Recent Trends in Household Wealth and Income (May 2007)

FEBRUARY 26, 2009

# Economy in Worst Fall Since '82

*Output Sank 6.2% Last Quarter; Plunging Trade, Investment Signal Trouble Ahead*

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By CONOR DOUGHERTY and KELLY EVANS

The U.S. economy deteriorated far more than previously thought in the fourth quarter, according to new revisions of government data, casting fresh doubt about the chances of a recovery this year.

With falloffs in consumer spending and exports, gross domestic product declined at a 6.2% annual rate in the fourth quarter of 2008, according to a Commerce Department report Friday. The agency's first estimate for GDP, reported in January, was for a 3.8% decline.

# Pulling Back | Key segments of the economy in the fourth quarter

Share of fourth-quarter 2008 GDP

Personal consumption expenditures

70.9%

Investment in equipment and software

8.4%

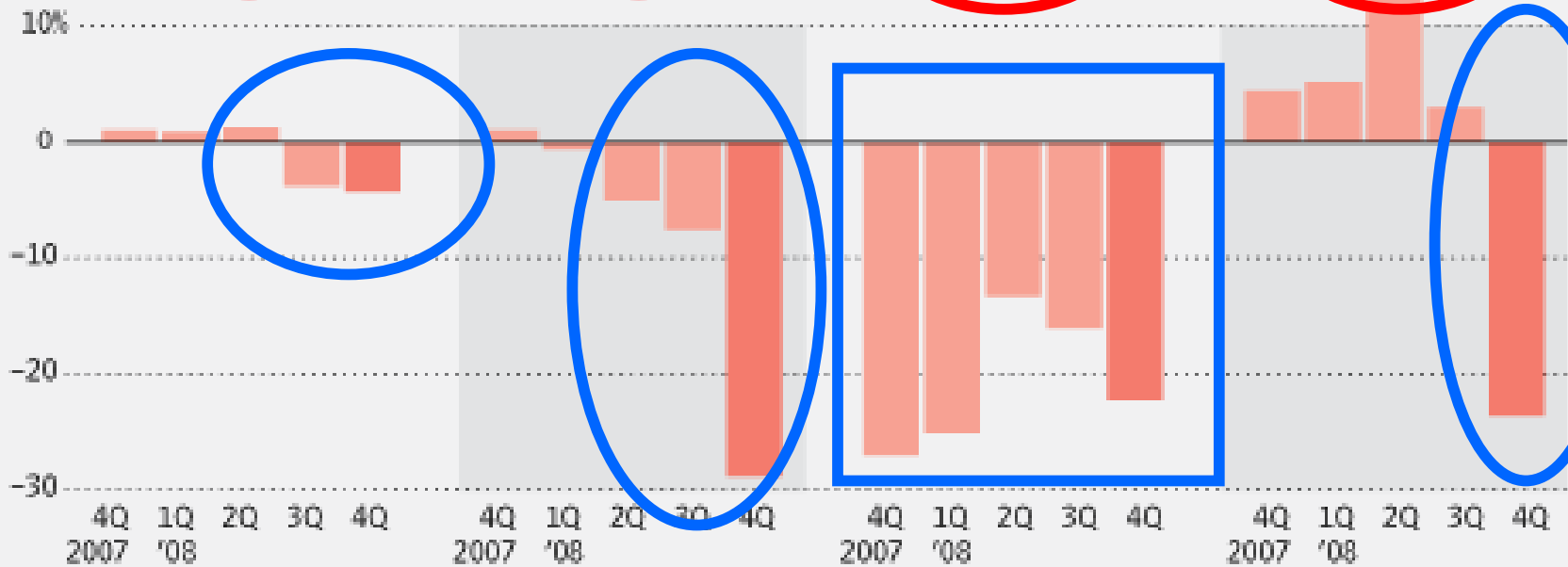
Residential fixed investment\*

2.9%

Exports

12.6%

Quarterly percentage change since the start of the recession



\*Housing-sector activity

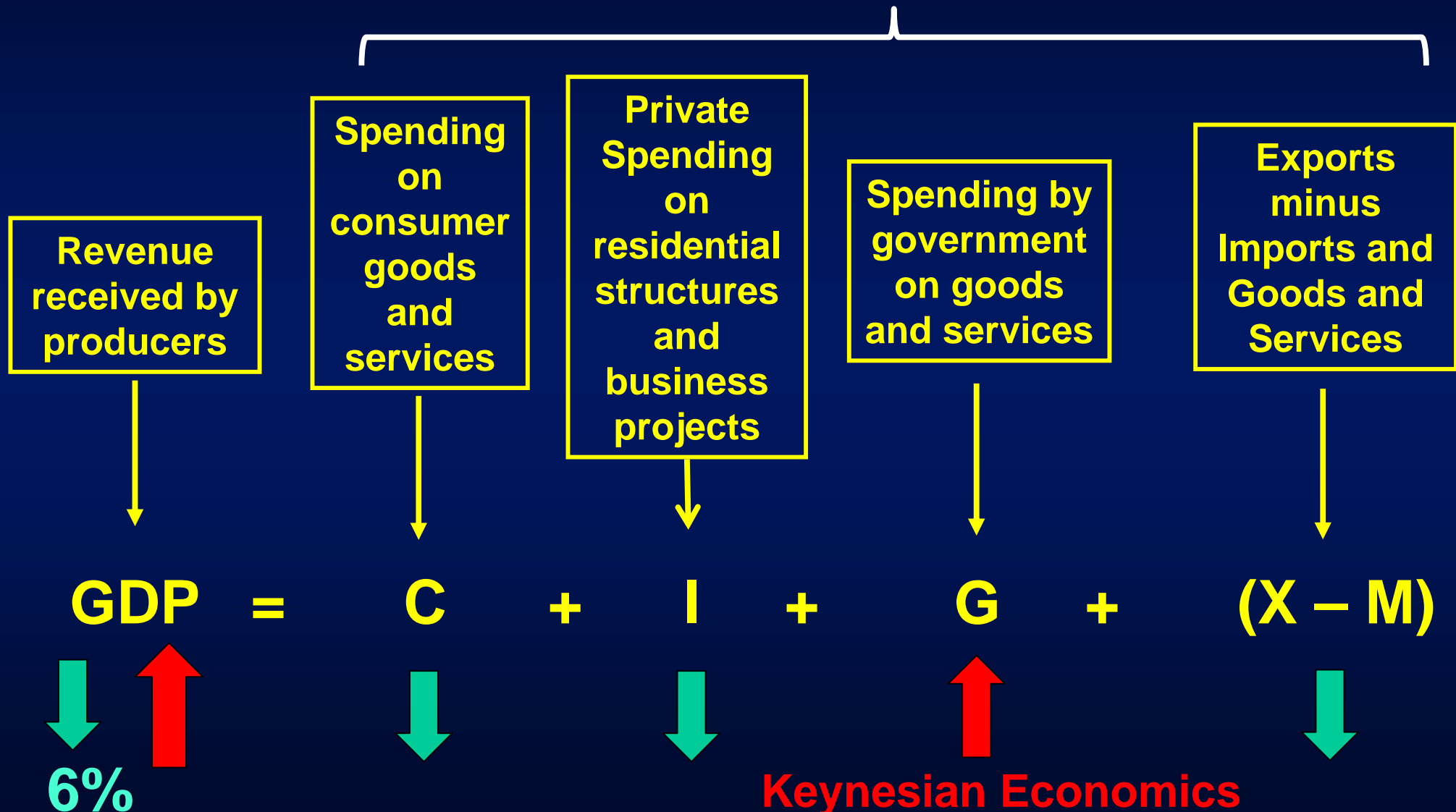
Source: Commerce Department

**An idea credited to the late British economist John Maynard Keynes is that in times when private consumption (C) and investment spending (I) and exports (X) are down, government can try to maintain GDP and employment at previous levels by compensatory increases in government spending on goods and services – i.e., by raising G in the equation.**

**This is what is meant by Keynesian demand-side stimulus policy.**

# A BASIC EQUATION FROM ECON 101

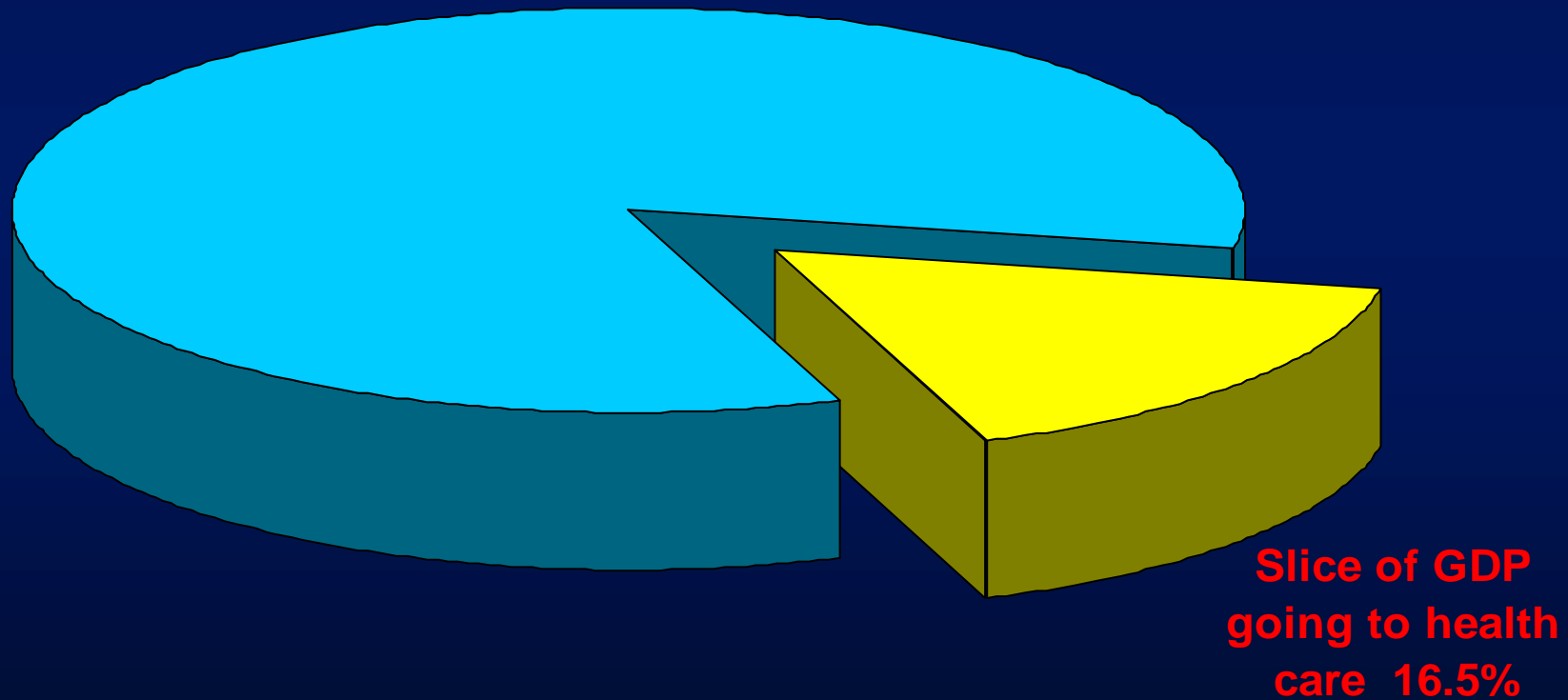
## The Demand-Side of the Economy



# V. HEALTH CARE TO THE RESCUE

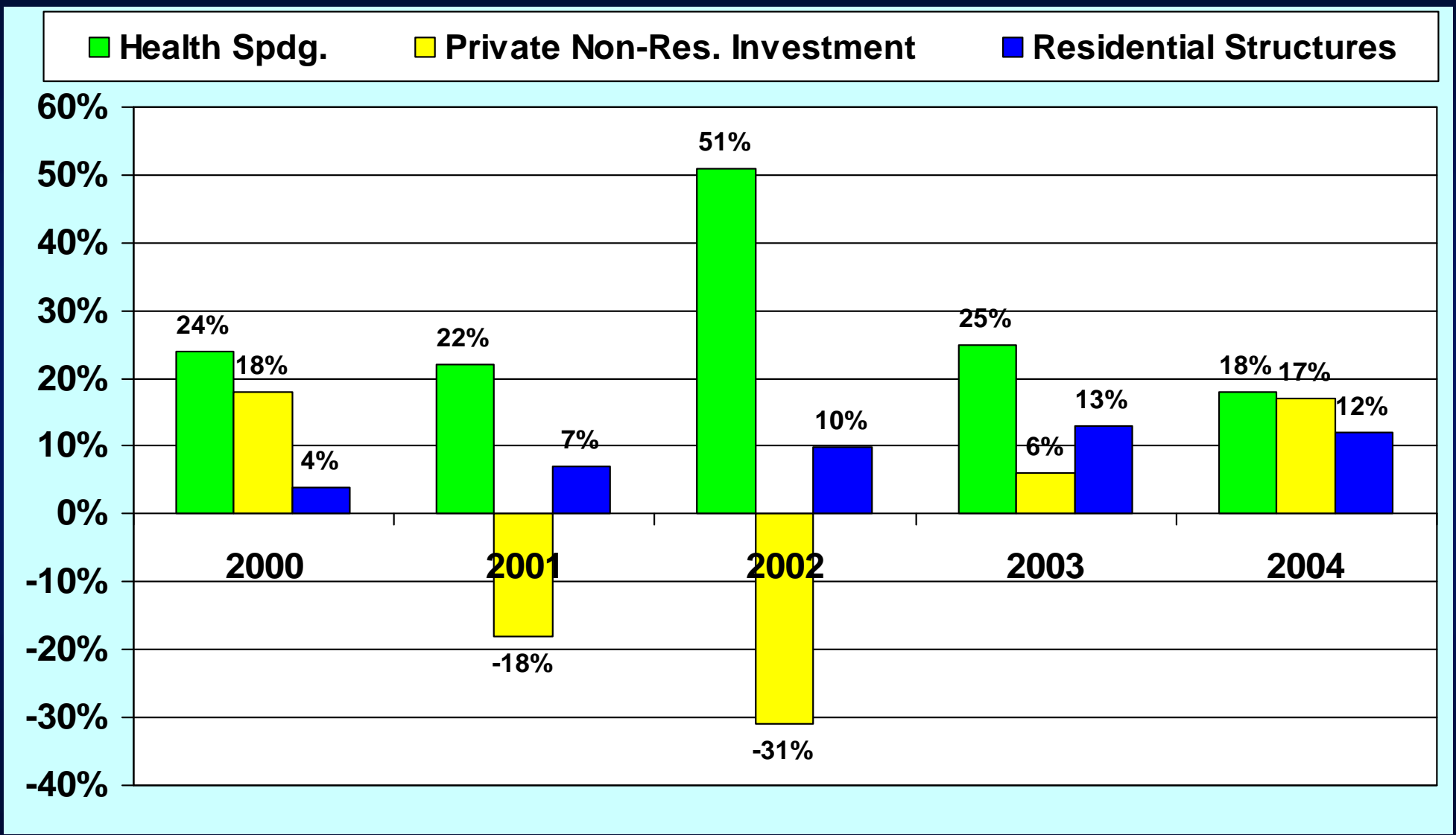


**Health care is part of the GDP and should be part of any stimulus package that increases G, government spending.**



**Health-care spending was THE economic locomotive that pulled the American economy along in the 1999-2004 recession.**

# FRACTIONS OF GROWTH FROM PRIOR YEAR IN U.S. GDP THAT IS ACCOUNTED FOR BY GROWTH IN U.S. HEALTH SPENDING AND PRIVATE INVESTMENT, 2000-2004



SOURCE: President's Economic Report 2006 and *Health Affairs*, Jan/Feb 2006.

The McGraw-Hill Companies

# BusinessWeek

SEPTEMBER 2, 2007

www.businessweek.com

## What's Really Propping Up the Economy



Health care  
has added  
1.7 million  
jobs since  
2001. The  
rest of the  
private  
sector?  
None.

BY MICHAEL  
MANDEL  
(P. 54)

**Therefore, judiciously targeted government spending on health care (for the uninsured, for health information technology and for cost-effectiveness research) could be a powerful part of any economic stimulus package in 2009-2012.**

## VI. A FINAL THOUGHT

**"I sincerely believe... that banking establishments are more dangerous than standing armies ...".**

*Thomas Jefferson to John Taylor, 1816. ME 15:23*

**END OF STORY**