The Trillion Dollar Scandal

by Kenneth A. Kuhn
Oct. 26, 2008, revised April 4, 2009

The author is an electrical engineer and private investor with over twenty years experience managing a conservative portfolio of stocks and some bonds. His study of how money works began as a teenager when he had virtually none of it. He has been debt free for over fifteen years and believes everyone can become debt free if they will only try. He believes in free markets with proper regulation and enforcement and is an anti-socialist.

Introduction

The purpose of this article is to connect the dots that led to the sub-prime housing and Wall Street debacle that in the United States that began to be painfully noticed around 2006 and is continuing in 2008. Although a lot of creative and clever accounting will minimize the total official number, it is not inconceivable that the true cost will be many trillions of dollars. This article tells a long story of how the government began manipulating the housing market in the 1930s and has continued in a consistently wrong direction for over seventy years without a single instance of corrective action. The only right direction taken ended up being corrupted into a wrong direction. Such a record is not incompetence. It is a conspiracy.

I am mad as hell! I am a victim that has been lied to, misled, and cheated by a corrupt government and system. I do not believe in political correctness and I call things as I see them for it is my own money in the system. I am not swayed by various news stories. It is my own experience that counts. I see things as an individual who without any help bought and paid for a house the old fashioned way and who lives well within his means and manages his own <u>earned</u> money without debt and makes wise investments on Wall Street. I have very high expectations of those who are paid astronomical salaries to manage money. I am very disappointed in their pathetic results. If I have the competence to manage money then why don't they? My disgust and disappointment with our corrupt government is such that I am beginning to believe that <u>the only solution is to **forcefully** overthrow the politicians and the bureaucracies</u> and restore our original Constitution.

I do not have a smoking gun proof of what I am going to say but the circumstantial evidence is very compelling. I am an engineer and do not have time to do an in-depth investigation. My hope is that someone in that business will. I think the result will be a huge shock that would actually cause the temporary shutdown of the United States government as numerous senators, congress persons, and others in government would be going to jail as well as many thousands of people in various financial, real-estate, and other related businesses. The scandal is across both political parties with no saints anywhere. Do not interpret the many negative things that I will state about our government in this article to mean that I am against the Constitution. To the contrary, it is among the greatest works ever produced. I just wish our government operated by it.

The Trillion Dollar Scandal

It is disgusting that our government serves the special interests instead of the people. There was ample opportunity for this debacle to never happen but all parties failed in their duties. What is worse is that the same sleazebag politicians that got us into this mess will preside over the “changes” and reforms thus insuring that the debacle reoccurs. I think the proven old fashioned solution of tar and feathering with a free ride out of town on a rail is very appropriate for all the guilty.

In several places I pause to discuss several sidebar important economic details that relate to the debacle. Without understanding of economics the debacle is little more than a lot of odd facts that mean little to the average person. This article focuses on understanding the economics and what happened and how it happened rather than focusing on blame – although my position on who all to blame is clear.

You will observe that I place a number of words in quotation marks for the purpose of illustrating that a popular word or phrase is actually incorrect – typically the inverse. There are a number of parenthetical comments too. English writing frowns upon this practice but it is the best way I know of to illustrate how words can be deceptive and we have been greatly deceived. This article is about a message rather than structure.

The Short Story

The sub-prime housing crisis and the separate but related Wall Street debacle that became noticed around 2006 was no accident and was caused by collusion between some large established financial firms, the Federal Reserve, the Securities and Exchange Commission, the United States government – particularly HUD, both houses of Congress, and using Fannie Mae and Freddie Mac as puppets to implement the conspiracy. Numerous smaller entities such as realtors, banks, home appraisers, financial operators (Wall Street), and many others took advantage of the scandalous situation for personal profit and thus collectively though independently contributed to the total debacle.

This collusion has been ongoing for a very long time. The purpose of the collusion was to put as many Americans as deep in debt as possible for the purpose of making a lot of money via interest on that debt. This process has been growing ever since its beginnings in the 1930s but took on explosive growth starting in the late 1990s. The cover for the collusion was numerous government programs over the years to “help” Americans buy homes and other programs to “help” low-incomers obtain credit. These nice sounding intentions, like those of all government programs, duped the public into supporting them. It was the classic application of populist socialism to benefit the wealthy puppeteers who for a relatively small amount of money as puppet strings (for political campaigns and gratuities for rendered “services”) control our government. Our politicians are beholden to them, not the population.

The Trillion Dollar Scandal

Since this is a long article I will present the summary of how the dots connect here. These are the conclusions that one logically arrives at after studying the individual dots, how they lay, and then looking at the big picture.

- The subprime housing debacle began in the 1930s with the government subsidizing home mortgages thus driving up home prices and the amount of debt buyers would take on. Many subsequent acts expanded on this. The decoy was assistance for low incomers and many actually were helped – but a price would be paid later.

- In the 1970s the government began requiring that mortgages be made to high risk borrowers with the government assuming the risk. This expanded significantly in the 1990s. The real purpose was to force a large population to move into higher priced houses to escape undesirable neighbors and in local schools. There were many beneficiaries – realtors, banks, etc. as people took on higher debt.

- In the late 1990s the government eliminated certain regulations on Wall Street. This enabled a whole family of complex derivatives to be created and transacted without any oversight – in effect legalizing corruption. These derivatives were based on mortgage debt. The purpose was a set up to trap certain competing financial firms in a squeeze not unlike what was done over one hundred years ago by certain Wall Street barrons. It worked! Some competitors are now history.

- In the early 2000s the government ordered Fannie Mae and Freddie Mac to enable banks to make hundreds of billions of dollars of bad loans. The banks did and the absurdity was well documented in the news media. With government manipulation the price of housing shot up like a rocket but no matter how absurd the price a "cheap" loan was available also thanks to the government. The very successful purpose was to put as many people as deep into debt as possible for the enrichment of the high financial puppeteers that control the government.

- The collapse of the housing market caused the value of many financial instruments on Wall Street to collapse thus eliminating many competitors of the high financial puppeteers. I have to give them an A+ for clever.

- As of this writing the government has new unprecedented financial powers that it has already used in questionable activities such as forcing perfectly solvent financial institutions (Wells Fargo is an example) to create and sell stock to the government thus diluting existing shareholders. It is too early to comment.

- I do not know what is coming next but I suspect many bad things (exorbitant taxes, confiscation of private assets – like was done with gold in 1933, reduced freedoms, a new war to "stimulate" the economy are only some of the very real possibilities) that we will be stuck with for a long time. The government is totally corrupt and I believe the worse is yet to come.

Politics

Politicians, both Republicans and Democrats, are to blame for the debacle. Anyone that advocates blame for a particular party is very naïve. As usual, each side today is making use of selected facts to blame the other – the classic example of how incomplete truths add up to a lie. In each case the complete facts clearly show both parties working in concert. I do not advocate for either side and this article looks at the whole picture rather than populist fragments. Blaming a particular political party is making the assumption that there really are two separate parties. It is not certain that that is the case anymore. I will let the reader ponder that controversial topic. Our politicians serve the purpose of being the visible persons the sheeple (I make this Freudian slip throughout) love or hate in order to cloak the real actions of their hidden puppeteers.

It is popular to blame the current President Bush and his fellow Republicans for the mess as he is probably the most hated president in the history of the United States. If one believes all of the Internet "facts" about Bush then it seems that he caused the extinction of the dinosaurs, the sinking of the Titanic, and modern earthquakes and hurricanes among other evil things. The same Internet chatter also credits Bush with being extremely dumb and inept. The Bush haters somehow avoid explaining how a person deemed so inept could accomplish so much and pull off the mother of all scandals. I accept the theory that Bush is clueless for that is what makes for an excellent puppet.

Others blame the socialist programs instituted generally by Democrats over the years for causing the debacle (I contend that the socialist aspect of these programs was cover for wealth transfer towards the economic elite). While it is true that these programs were a significant part of the debacle, the Republicans for the most part either supported the programs or only made token opposition to provide the illusion of representing their constituents. The puppeteers got what they wanted. The sheeple were led to think they got what they wanted.

Arguing over politics is the perfect distraction for the real powers to remain in control. The problems will never be solved as long as the sheeple are arguing. The election of 2008 is approaching and the sheeple have a choice between two puppets. It is a certainty that a puppet will win and the same corrupt system will continue under the guise of "change."

I am from the government and I am here to help

Like all scandals involving collusion between government and private parties, positive sounding government acts are used as decoys. In this particular case the concept over the years was to make housing more affordable for first time buyers. That sounds nice enough. How could anyone be against that? The problem is that housing was made less affordable in the process and certain participants made a lot of money on inflated demand. By definition, a free market is one that is not manipulated. With the government as the prime manipulator for many years, the housing market has not been free.

As a brief aside, it is no secret that the cost of education and healthcare has risen dramatically in recent decades in response to government "attempts" to make it more affordable. To be fair, part of the increase in health care expense is the result of advances in science that has enabled treatment of many previously terminal situations. But, the government has imposed a situation on medical practice in the name of "helping" that makes it costly for the patient but very profitable for the suppliers. I will only briefly mention the educational system where government subsidized excess demand has significantly driven up the cost for those "fortunate" people who have to pay their own way. The proposed solution to both problems is more government involvement thus making the expenses higher. I mention these two examples because practically everyone has been a victim whether they understood that they were a victim or not. The scandal is not confined to housing but that is all I am going to focus on to keep this article short.

The Federal Reserve (a sidebar economic discussion)

The advertised theory for the **Federal Reserve Act of 1913** that created the Federal Reserve System was to manage the financial system so that major financial crises would never occur again. In reality by the ability to greatly expand the money supply it enabled rampant price inflation and simultaneous deflation of the value of the dollar. The Federal Reserve is an independent organization but is subject to certain congressional oversight. Purportedly, this makes for balance. It has been stated that the Federal Reserve is as much a part of the Federal government as Federal Express. The structure of the Federal Reserve is designed to give the illusion that it is part of the government – the name, the fact that the President appoints the chairman, etc. What is important for the discussion in this article is that the Federal Reserve manages (i.e. creates or destroys) the amount of money in existence thus influencing our economy. The Federal Reserve also has authority over all banks and can halt unsound banking practices – something it suspiciously failed to do in recent years.

The Federal Reserve (often referred to as the Fed) creates money primarily by the process of purchasing Treasury bonds thus injecting cash into the market. The money to pay for these is literally created out of thin air which leads to the term, printing money. The effect of the fractional reserve system in our banks is to multiply the amount of money that the Fed created. One interesting result is that the Fed holds a marketable asset (debt) that it paid nothing tangible for. They can later sell this asset for real money when it is necessary to destroy money (to correct for prior excess creation) in the economy. This process has been criticized by some and is the subject of debate because money is created as debt owed to the Fed and real money flows to the Fed when they sell the debt.

Another mechanism for creating or destroying money is via the Federal Funds Market where banks loan their excess reserves and these are then loaned to other banks that are short on reserve requirements. The federal funds target interest rate is set by the Federal

Open Market Committee meetings that often make the news. By various open market actions, the Fed attempts to drive the actual rate to the target. The Fed lowers the target interest rate to enable money creation by the banks and raises the target interest rate to stifle money creation.

The issue is not that money is created but how much should be created (see the Central Bank sidebar). If too little money is created then the money supply would run short and eventually there would not be money to pay salaries and the economy would seriously contract. The ensuing demand for money would drive up interest rates. If too much money is created then the money supply would expand too fast causing economic activity to accelerate. Interest rates are driven down as money is easy to obtain resulting in plentiful loans. This sounds great until you realize that acceleration in the economy is driving up price relative to value – i.e. inflation. Eventually, there will be an economic crash as the economy accelerates past what is possible to sustain.

The Federal Reserve Act of 1913 stated a number of specific purposes but allowed any amendments – an open ended clause that enables most any law to be quietly expanded in the future. The role of monetary policy has been relegated to the Federal Reserve. This is a huge amount of power and opens the door to monetary manipulation – not that I am accusing them of that but the power is there. Recent events suggest that the Fed has not acted in the best interests of the country.

About loans (a sidebar economic discussion)

Making a loan is a money creation event – however this created money has a finite life. The money that is loaned remains the property of the original investors although it is locked from circulation for the duration of the loan. Via a secondary market, rights to that money can be sold to others so that any particular investor is not stuck for a long time without access to his money. However, both the original money and the loaned money now exist at the instant of loan creation. The money in circulation does not change because the invested money is locked while the loaned money becomes circulated. The money to loan comes from long term investors and not from the money deposited by individuals into personal accounts. However, the money deposited can count towards the minimum reserve requirements.

In the case of a home, the loaned money will typically be paid back over a fifteen to thirty year period. Paying off a loan is a money destruction event. At the end of the loan the principal money is returned to the investors who also collected interest for use of their money over the loan period. Thus, there is balance in this process. The investors benefited from the time value of money. The person borrowing the money benefited from the translation of future cash into the present to enable a higher standard of living. The price paid for this benefit is interest. Nothing can be free. The payment of interest is necessary for this process to work. With no interest payments there will be no investors to put up money for loan. A loan free or debt free world would require someone to spend a large part of their life paying rent while trying to save the cash to purchase a house.

Life is too short for that and the interest paid is actually less than the sum of realistic rent that a person would pay over the same period. Thus, this type of loan (or debt) is very beneficial to all parties. The process breaks down if the loan is not paid back and all parties suffer. That is why it is important to structure the loans conservatively so that failures are minimal.

An interesting extension of the process just described can and does occur. All of the money loaned is paid to various suppliers and laborers associated with the construction of a house. It is likely that all parties do not need all of the money for present use. They may invest part of the money for loans in return for interest. Thus, more money is created. This process can repeat indefinitely until in theory the banking system (not necessarily a particular bank) has made loans totaling the original money invested divided by the required reserve ratio. In recent history the minimum reserve ratio is 0.1 so up to ten times the original money can be ultimately loaned in theory. In practice it turns out to be closer to six as not all of the money becomes investment for new loans. Although this multiplication effect seems dramatic it must be realized that this created money has only a finite life while the original money has a much longer life. It is important to understand that this created money does not have perpetual life and is ultimately destroyed as loans are repaid.

What has been described in the two previous paragraphs is the concept of fractional reserve banking in which money is created (actually borrowed from the future) apparently out of nothing. This concept is controversial among various economic types. The opponents of this money creation process typically discuss only the creation and do not mention the balancing money destruction process that occurs later to illustrate a run away system of ever increasing debt. Properly done, the debt gets retired over time and does not keep accumulating to infinity. To me the issue is not whether fractional reserve banking is wrong but how much leverage should be allowed. Leverage can magnify profits but it can also magnify losses. My personal feeling is that the 0.1 reserve ratio requirement is too low and creates leverage approaching dangerous levels (This is a good place to point out that the large investment banks that failed during 2008 had been exempted from minimum reserve requirements and operated with reserves in the 0.05 to 0.025 range). I would feel more comfortable with a value in the 0.15 to 0.2 range. The result would be fewer loans and higher interest rates on loans that were made. But, the system would be more stable and less vulnerable to bad times.

The Generic Purpose of a Central Bank (a sidebar economic discussion)

This discussion is more about theory than practice. The Federal Reserve is the central bank of the United States. A central bank in of itself is not a bad thing. There are good reasons for it to exist provided it operates ***for*** the country and not for the interests of debt mongers. One purpose of a central bank is to manage the money supply. Few people ever ponder how much money should exist but the answer to that is critical for the economy. The complete answer to this question is complicated and impossible to determine exactly as it is always changing. However, an adequate simple answer is that the money supply should be roughly equal to some portion of the net worth of the country plus new wealth that is created via daily employment and other wealth generating operations (such as pay for work done, farming, mining raw materials, processing materials, etc.) minus the wealth that is consumed (i.e. food eaten, items that have become trash, etc.). The central bank should monitor all of this and should create (or in unusual cases, destroy) money to maintain balance (this is known as elastic currency). This created (or destroyed) money is primarily an accounting entry as the amount of hard currency in circulation only needs to be a fraction of the total money supply. In theory, if such a balance were maintained then there would be no overall inflation or deflation. The value of the currency would be stable. That does not mean that prices would never change because new technology generally reduces manufacturing costs thus driving prices down and shifts in prosperity increases demand for other products thus driving prices up. Economics is not a study in statics but is always a study of the dynamics of money.

The key is not prices at any given time but value – price and value are two separate concepts that must not be confused. Money has been defined as the exchange of value. That statement is critical to the understanding of the financial problem. If money is created without being related to value (government stimulus checks for example or bailout money) then it is no different from counterfeit money which also devalues the currency. It is a major error to think that money should be backed by gold or some other commodity as it is impossible in modern times to obtain enough of any of those to be held in some vault. The value of a currency is derived from wealth creation in society as previously described. Money must be simultaneously created to maintain balance with the growing net wealth of a country.

As for gold, the truth is that the United States Government does not own any gold so a switch to a gold standard that some advocates swear by would render our currency worthless. The gold stored at Fort Knox (approximately 250 billion dollars in 2008 – if all of the original gold were still there the value would be approximately 750 billion dollars) is in lien by the Federal Reserve for payment of government debt. Although that is a lot of money it is only a drop in the bucket compared to the total amount of money that needs to exist for the United States economy to operate today.

I am not aware of any central bank anywhere in the world that is not guilty of creating too much money. It is tempting to create an excess of money as that stimulates the economy and increases the rate of growth but at the price of inflation and devaluation of the currency. Thus, the apparent growth that the population is eager to see is really phony. The ensuing inflation leads to popular annual pay increases which provide the false impression of becoming richer. Except for people who receive raises in excess of inflation the broad population is really becoming more and more behind all the while feeling better off. Few people in the population really understand economics and are easy victims of manipulative methods that rob the value of their money without their understanding that they have been robbed. In their ignorance they demand that their favorite politicians rob them more. Politicians are glad to comply. In recent years the Federal Reserve has targeted an annual inflation rate of roughly three percent as a maximum. The real target should be zero. Three percent inflation means that money loses half its value every twenty three years. With this rate the value of a dollar decreases by ninety five percent over a one hundred year period – i.e. a dollar would be worth only a nickel. Even though an inflation rate of three percent does not sound bad (the population has been conditioned – i.e. manipulated to accept it as good) it is a horrific thief of value. The average inflation rate over the 94 year period of the existence of the Federal Reserve from 1913 to 2007 was 3.32%. The average inflation rate over the 100 year period prior to the existence of the Federal Reserve from 1813 to 1913 was a remarkably low -0.0048% (http://www.measuringworth.com/ppowerus/). To be fair, there were a number of extenuating circumstances (technology was a big one) that resulted in an *increase* in the value of a dollar over that time period.

It does not take much to realize that a central bank has enormous power. A good question to ask is that should this power be in private hands as in the case of our Federal Reserve or in public hands if the Department of Treasury were in control per our Constitution. This is not a question about which is best but which is least bad. There is an old saying that power corrupts and absolute power corrupts absolutely. If people are involved where large amounts of money are concerned then corruption is inevitable. It is beyond the scope of this article to explore if there is any method by which the operations of a central bank under whichever authority can be performed without corruption. This is really a scary topic to ponder.

The concept of the Fed loosening or tightening credit in reaction to the economy is dangerous. These actions are always lagging and from control system analysis leads to business cycles and causes instability as we have seen over the years. Fed adjustments have been dramatic over the years and there have been dramatic cycles as a result. With the money supply at the right level the economy has a difficult time overheating or starving. Only small adjustments over a long time are needed if done properly. In short, manage money, not the economy. The Fed would be well advised to study control dynamics like I do and make only calculated moderate adjustments.

Housing – connecting the dots of the debacle over seventy years

A place to live or housing is very dear to people. Whether one rents or buys, a significant sum of money is paid over a life time for housing. In any arena where a lot of money is involved there will be clever thieves who figure out schemes to acquire some for themselves. It is much better to steal via legal methods backed by the government than to steal via violations of law. Smart thieves use the first method. Ordinary dumb thieves use the second. Thievery of any sort works great when the person being robbed is not aware of it. The ultimate in thievery is when the victim through ignorance (the result of crafty manipulation by a government that is "looking out for the people") supports the theft. Stealth thievery has been taking place for a long time and it led to the housing debacle.

The Trillion Dollar Scandal

The debacle is not a singular event but the culmination of many events over many years. With few exceptions any singular event is not a major factor. In the following I will discuss in chronological order certain legislation that is either related to or contributed to the crisis. I omit a number of lesser known related legislation in the interest of brevity. A number of these were amendments to what is discussed below and are briefly noted as they relate. These are the dots. Many of them taken in isolation do not seem bad but the collection lines up in a very bad direction. I encourage the reader to look these up and read the gory details – some of which may sound good in isolation and some parts may actually be good. It is the total package that counts. That is what got us where we are.

This is not one of the dots but is important to mention. The **Glass-Steagall Deposit Insurance Act of 1933** created the Federal Deposit Insurance Corporation (FDIC) that insures bank accounts up to a certain maximum. Banks pay into a fund that insures individual accounts from loss should the bank fail. This gives people confidence to deposit money in bank accounts and to not withdraw the funds in a panic during bad times thus providing bank stability. Once in a while congress actually comes up with excellent legislation. This is one of the best examples of that and has probably done more to prevent economic crises over the years than anything else.

The Federal Housing Administration (better known as FHA) was created by the **National Housing Act of 1934** for the purpose of lowering the risk to lending institutions for making home loans to persons who did not meet the more rigid standards of conventional loans. Very little down payment is required and income standards are relaxed for FHA loans. Thus, these are higher risk loans. An insurance fee was charged to the borrower and added to the loan payment. The fee was generally discontinued once the borrower's equity in the house passed approximately twenty percent. FHA became part of the Department of Housing and Urban Development in 1965. In of itself the original FHA is not a blame for the debacle although it was the beginning of concepts that would lead to the debacle. In the early years FHA loans did well because buyers were really intent on moving up the economic ladder and their intent reduced their theoretical risk – that intent is critical to the understanding, for later a lot of that intent degenerated into the entitlement concept. A lot of people benefited from it by being able to obtain loans that were otherwise difficult to impossible. For the most part these loans were paid back. FHA was a gamble that happened to pay off for the country. It is folly to think that one lucky outcome would be repeated for future gambles.

In 1938 the government created a quasi private corporation known as a government sponsored enterprise or GSE, the Federal National Mortgage Association better known as Fannie Mae (derived from **F**ed**E**r**A**l **N**at**I**o**N**al **M**ortg**A**g**E** with the 'IE' folded as shown in the smaller caps – I guess to make the name sound more cute). The mission was to make it easier for more Americans to buy homes by providing a secondary market for financial institutions to sell loans thus increasing liquidity. Money from those sales enabled more loans to be made. In theory, overall risk could be reduced by packaging loans from across the country. Lower risk makes it possible to loan more money thus enabling more people to borrow to buy a house. There is certainly nothing wrong with that. It sounds like a government that is really for the people. All government programs have nice sounding names and mission statements that for the most part cloak the real mission. Understand that I am not placing blame on this concept for if (oh what a big word, if) executed properly a program such as this can be good. The big mistake was that it was not separated from the government. Later, its operations would be dominated by politics rather than sound business practice. That dooms it to failure – which happened in 2008.

It is an economic law that an increase in demand leads to an increase in price. Thus, with programs to facilitate home mortgages, home prices began to rise. People who already owned homes were happy because their net worth (much of which was the value of their house) was rising – although one must be careful to separate inflation from value and never equate inflation with a value increase. People buying houses were happy because financing was now relatively easy to obtain. Financial institutions making loans were happy because they were making more money on interest. Realtors were happy because they were selling more homes and thus earning higher commissions. Stores owners were happy because homes need appliances, furniture, and other stuff. This goes on and on. Everybody is happy. Everybody is making money. Everybody is getting richer. Life is good. A critical result was that the price (notice I said price, not value) of a home grew faster than income thus making a home a good "investment" as it has been commonly advertised – or so it seemed. This made existing home owners even happier. First time buyers felt good about borrowing more and more money because they would recoup this and then some as the value (oops, I mean price) of their home grew. Years later they would sell their first homes for significantly more that they paid. This process of borrowing ever more money to pay ever high prices continued for decades. Initially, there were very few losers – just as in a Ponzi scheme. Everybody was winning except those who delayed buying a house. Thus began a multi decade run up in home prices that someday would have to end like all Ponzi schemes do.

There is a fatal flaw in the preceding utopia. If the price of housing is rising faster than income then at some point in time it will require extraordinary debt to buy a house. That extraordinary debt becomes extraordinary profit for the financial institutions as long as the buyer can pay it. However, because it is the price rather than the value of housing that is rising, the risk of making a loan also keeps increasing. Carried further, eventually the price of housing would become so high that no one could buy a house and the risk of making such a loan would become a certainty of loss. In a free market that could not happen for it takes demand to push prices up and without demand prices must fall to some stable point. However, with a government subsidized and manipulated market most anything is possible. It is the perfect example of the greater fool theory and what happens when there are no more greater fools. An economic disaster can (and did!) happen when the government manipulates the market upwards. It is the classic bubble that has happened over and over again throughout history and will happen again and again in the future. The last buyers and the last lenders are the ones wiped out by the ensuing crash to reality. However, because of the interdependency (and that is not necessarily bad) of everything in our economy the damage spreads to the rest of us.

I bought my house in 1986 and paid a premium for it – like many people. The tax assessed value of my house today in 2008 has increased by a factor 2.7 times what I paid for it while my salary has only increased by a factor of 1.9. Thus, my house is less affordable today than what it was when I bought it. Am I richer for this? – No. Does this help someone else who will someday buy my house? – No. Such an increase in price (rather than value) is not sustainable and eventually home prices have to collapse back to the value level.

In 1968, government converted part of Fannie Mae to a private corporation and created the Government National Mortgage Association better known as Ginnie Mae as a government owned business within the Department of Housing and Urban Development to provide the insurance that had been part of Fannie Mae. Ginnie Mae provides government insurance which guarantees payment of principal and interest on mortgage backed securities which are pools of home loans sold as bonds to investors. The concept of Ginnie Mae was to transfer risk from the private sector to the public sector – a potentially dangerous move. Again, the gamble paid off because aspiring Americans were proud to pay off their loans. But without the determination of home buyers to pay their mortgages the gamble turns into the certainty of loss as has happened.

The **Fair Housing Act of 1968** opened the door to sub-prime mortgages on a grand scale. Although various discrimination practices were wrong, this was the wrong "solution". In theory an institution could refuse a loan based purely on economic risk (i.e. no racial or other discrimination) but once accused of discrimination the institution was guilty with no hope of proving innocence – thus risky loans were imposed by the government. Not all of the risky loans ended up bad – not all gambles fail but that does not make gambling good. The end result was special consideration for the privileged groups identified in the act while non-privileged groups with the same credentials or lack thereof could safely be denied loans. That is not fair. The law perhaps could have worked had it required only risk factors to be considered and not effectively required the "numbers" to come out "right" – but then it would not have become a powerful financial enrichment tool by the puppeteers. To paraphrase a line from Clint Eastwood, "Rationale ain't got nothing to do with it."

The **Emergency Home Finance Act of 1970** created the Federal Home Loan Mortgage Corporation, another government sponsored enterprise (GSE) better known as Freddie Mac (a creative acronym in the style of Fannie Mae). Freddie Mac serves as competition to Fannie Mae. Like Fannie Mae, Freddie Mac buys mortgages on the secondary market and pools them in to mortgage backed securities that are insured by the government. This process makes more money available for loans via the same gamble of Fannie Mae. For many years this gamble worked. A working gamble should not be interpreted as low risk.

The **Community Reinvestment Act of 1977** (CRA) was passed to "encourage" financial institutions to make more loans available to low-incomers. The argument was that banks were making loans based on racial factors – and with carefully selected data this can always be shown to be the case. While I have no doubt that various individual banks did practice racial discrimination the real issue was financial risk – people of any race at the low end of the economic ladder have a high risk of being unable to repay the loan. If you use various numerical methods or proportions then it is easy to show discrimination when avoidance of risk may have been the dominate factor. There is a lot more depth needed on this and that may be the topic of a future article. In short, banks want to make money and turning qualified people of any group away is counter-intuitive as they will ultimately become good customers of a competitor. This law has been modified numerous times over the years. Beginning roughly in the 1990s this law in conjunction with the Fair Housing Act of 1968 effectively (though not officially) with puppet strings from ACORN forced lending institutions to make a certain amount of bad loans or face government sanctions. In of itself it this act was not the cause of the debacle but in conjunction with subsequent acts it became a principle driver. It should be pointed out (repeatedly) that the low incomers were not in of themselves the cause but used as pawns to accomplish the purpose of a grand theft by the puppeteers. Yes, some low incomers benefited from this and even paid their loans – but that is not the point. The cost on society for each beneficiary was astronomical. Later in this article I point out a vastly better system that actually did accomplish help and at a fraction of the cost. But the puppeteers made little if any money in the process. Thus, that concept had to be killed.

The **Financial Institutions, Reform, Recovery, and Enforcement Act of 1989** among other things brought Freddie Mac under the oversight of HUD. This move embedded politics into a business operation. With this concept there is no risk of failure – there is only the <u>certainty</u> of failure. An example is the **Federal Housing Enterprises Financial Safety and Soundness Act of 1992** which required Fannie Mae and Freddie Mac to devote a percentage of their lending to support affordable housing (a code phrase for loans to those who will never pay them back). In 1999, Freddie Mac announced that HUD would require it to devote half of its business to low and moderate income families (a.k.a. sub prime loans). This is so crazy that it is impossible to believe it to be an accident. Clearly, there was some ulterior motive driving this. People at that end of the economic scale should not be taking on loans of substantial size – it is a huge risk for them and whoever (the real taxpayers) is insuring the loan.

In 1998, the hedge fund named Long Term Capital Management failed by making numerous risky transactions that a flawed mathematics indicated to eliminate risk. The Federal Reserve made a huge mistake by arraigning for a private-sector rescue. This bailout taught the dangerous lesson that taking on huge risk was fine – if you win then great, if you lose then you get bailed out. This bailout probably led to other institutions taking on higher risk than they otherwise would – thus contributing to the debacle.

The **Financial Services Modernization Act of 1999** repealed part of the Glass-Steagall Act 1933 which had prohibited banks from offering investment, commercial banking, and insurance services. The large financial institutions had been seeking this legislation for a long time and large mergers could now take place but only if the financial holding institutions had a “satisfactory” history of making sufficient numbers of sub-prime loans. Enforcers of the Community Reinvestment Act (CRA) had absolute authority over this. The bill was introduced by Phil Graham and ultimately passed by an overwhelming majority (90 – 8 and 352 – 57) and signed by President Clinton. Because Phil Graham was a Republican the Democrats have been using selective facts to blame the

Republicans for the debacle. Likewise, using different selected facts the Republicans blame the Democrats for the debacle. Notice from the voting record that both are guilty. Clinton could have saved himself from any blame by vetoing the bill. His veto would have been easily overridden but then he would have been disassociated from it. It is debatable whether the merger of investment banking, commercial banking, and insurance services is good or bad. All are financial products but with widely different operations. Such diversity makes it difficult to see how a singular management of all could operate effectively. In theory, diversity reduces risk but unmanageable diversity can not be a good thing. The connection of this act to CRA was probably the biggest downfall. Making bad loans became a cost of doing business.

"In 2000, HUD told the GSEs to increase their commitment to lower-end loans over the next decade, by a sum of $500 billion to a total of $2.4 trillion." (source: http://www.fundinguniverse.com/company-histories/Freddie-Mac-Company-History.html) This quoted sentence is extremely scary. It shows a government intent on manipulating home prices upwards by creating excess demand. This shows that a bubble had been building for some time and was destined to get worse. As of 2000 the potential damage of this was limited because there were not yet mechanisms to rapidly run up the price of homes. That would come very soon after the terrorist attacks in 2001.

The **Commodities Futures Modernization Act of 2000** excluded certain commodities from oversight by the Commodity Futures Trading Commission. Thus, trading in interest rates, currency prices, and complex derivatives known as credit default swaps were unregulated. This incredibly absurd piece of legislation enabled the Wall Street debacle to grow with a high exponent as it in essence legalized corruption. Although the Republicans have been blamed for deregulating the financial industry thus causing the debacle, it must be noted that this act (which had support of both parties) was signed by President Clinton – again associating him with the debacle. I am not blaming Clinton as he just did the job he was supposed to do. A Republican president would have signed it too for the same reasons and would have received similar rewards afterwards.

The terrorist attacks in September, 2001, provided the government with a motive to turn the economic stimulus spigots wide open to thwart a supposed recession. Although I do not accept the 9/11 conspiracy theories I have to admit that that event was mighty convenient. Part of that stimulus may have been proper and good – I am not a fan of government stimulus – it is basically market manipulation which I am against. But the stimulus went too far and created a grand opportunity for a lot of money to be made in housing. One could argue that that was done out of incompetence and I will offer no counter argument. But my theory is that they were incompetent like a fox.

A big factor was that the Fed cut interbank interest rates to practically nothing. This made it possible for all (including the government, Federal, state, and local) to borrow (i.e. take on a lot of debt) large sums of money cheaply. Let me digress for a moment to discuss some victims of this debacle who are rarely mentioned in any discussion. I knew this as it was happening because I was one of the victims. The victims were anyone who had a lot of money earning interest. This would typically be retired people but could also be people like me who have significant cash savings. The victims were forced to accept below real market interest rates (approaching zero) for their money because the Federal Reserve was creating such a phenomenal amount of (fake) money that banks did not need deposits (real money). The money we did not receive in interest was used to finance an unsustainable major economic expansion. We were in essence forced to finance the debacle that we knew was absurd from the start.

The same thing is happening again with the trillion dollar bailout and we get to be victims again with interest rates again artificially heading towards zero. The proper thing to happen is for those of us who saved money to be able to loan it at premium interest rates to those who are desperate for it. But we have a corrupt system that caters to the wrong doers at the expense of the right doers. That is called fair and is a triumph of socialism. That scourge has got to be stamped out before it enslaves the entire population except for the slave masters in the supreme party.

Couple this with various government incentives to buy a house and the price of housing skyrocketed with artificial demand. Keep in mind that the stated purpose of these government incentives was to help first time buyers. The government "helped" them by making housing more expensive and then enabled (i.e. "helped") them to go much deeper into debt than otherwise possible or necessary. But no matter – interest rates were at all time lows – it does not matter how inflated the price of housing is – the loan is affordable – get yours while it lasts.

Simultaneously with this, Fannie and Freddie were on a mission to help first time home buyers (with puppet strings from the government) and the financial institutions were basically informed to just make loans and not worry about qualifications or details. Thus, began an era of the most absurd loan deals in the history of loans. The absurd loans were made and purchased by Fannie or Freddie and then resold to other players on Wall Street. The absurdity of these loans often made the news and other publications. These loans would never have been made years ago. The term, liar loan, was coined to describe the common phenomena of some one walking into a loan office and claiming to earn some high income and immediately qualifying to buy a house when it was obvious to all that the person was lying. It was a complete joke but a joke that is now very not funny. The loans would even have low risk ratings based on the lies. Everybody knew what was going on. But no matter. The result of all the loose money created by the Federal Reserve via the banks caused a staggering increase in the demand for housing followed by a staggering increase in price (not value). A $200,000 house could be bought for $250,000 and soon sold for $300,000 and the liar could gross a quick $50,000 only to do it again. The seller made money. The liar made money. The buyer got a cheap loan. The bank made money. Everybody was happy. What could possibly go wrong? This was a new prosperity that could go on forever! Bubbles do not pop anymore like they did in the past – right? The Federal Reserve had the authority but miserably failed to use it to regulate banks in order to prevent or stop the above from happening. That failure was a major contributor to the debacle. It is such an obvious failure that one cannot believe it was accidental.

The Trillion Dollar Scandal

The SEC granted an exemption to the **Net Capital Rule** in 2004 for very large institutions. This rule had served the very sane purpose of limiting risk by restricting the maximum debt to net capital ratio (leverage) to 12 to 1. Without this rule there was no limit and risk could grow exponentially. The "beneficiaries" of this rule were Bear Sterns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley. These institutions had been requesting this for a long time. They claimed that their business would be seriously hurt if they did not receive this. Afterwards, they promptly increased their leverage up to 40 to 1 – an extremely dangerous level. In my research I have found no conceivable benefit to doing such a stupid thing. Let history record that within four years after this was done that three of the above firms no longer exist – some "benefit" that turned out to be. The two surviving firms changed their charter to become part of the Federal Reserve System. Thus all five entities no longer exist in their original form. This seems strangely convenient – I smell a scheme. This rule change is related to the Wall Street debacle. This exemption was such an act of stupidity that one cannot believe it was accidental.

By 2005 home prices were shooting up like a rocket. In theory banks make loans based on value not price. Home appraisers are employed to provide an accurate assessment of home value prior to the loan. However, with the heated market and corrupt secondary market the name of the game was to make loans – as fast as possible. Honest appraisals were creating problems by holding up loans. Thus, there was incentive to inflate appraisals so that the loan process could go on unimpeded. I remember news stories about this but nothing was done. The government and regulators looked the other way. They have never explained why. Again, we have obvious problems that were strangely ignored – accidental? – I doubt it.

The loan process became totally absurd. Don't have money for a down payment or even the closing costs? No problem – just roll all the closing costs into the loan and borrow 105% plus of the premium price (not value) of the house. Don't have money to pay interest? No problem – just take a loan with a teaser interest rate for the first year and add the real interest to the principal. Then later when the price has gone up a lot the house can be sold for huge profit that will payoff all the costs and then some (until things change). Another option is to sign up for an adjustable rate mortgage – the rates are low and probably will go even lower but never go higher – why be stupid and sign up for a fixed rate? I could go on with more examples of absurd financing but the point should be very clear by now. There was a total breakdown of order and reason in the financial system. But this breakdown could not have occurred without help. A system of greater fools was needed. That brings me to the Wall Street debacle.

The Separate Wall Street debacle – more dots connected

All the while that the price of housing was soaring and loans were becoming more absurd another financial game was being played. Under the concept of portfolio theory it is normal for financial institutions to buy each other's loans for the purpose of risk reduction or more certainty of a needed cash flow. As interest rates rise and fall the value of various loans (assets in accounting lingo) fluctuates. Each institution has its own different needs for return on investment thus one institution may deem certain assets as less than desirable while another institution would be glad to acquire them if the price were right. Thus, the secondary market for loans exists. There is nothing inherently wrong with this. It is done all the time for similar reasons in every other type of market. In fact, this exchange is what makes a market.

The number of individual loans is huge and nobody really has the time to examine each for its proper value. The concept (again, nothing inherently wrong with it) of bundling a variety of loans into a single package that buyers could bid on was created. Various averages and other metrics would be available to potential buyers so each could value it according to their own requirements and bid accordingly. This works and makes the market more efficient for both sellers and buyers. Everyone is happy.

Suppose the seller lied about what was in the package in such a way that led buyers to bid higher prices than reality considering the actual risk. The buyers would soon discover the lie and either sue the seller or not do business with them anymore. Other buyers would scrutinize business as word spread. That is a self correcting feature of a free market that can keep things honest.

Now suppose the seller provided market accepted information that was actually bogus. The seller does not lie and is committing no wrong. The bogus information in this case would be higher than reality ratings of the loans by “independent” risk rating agencies that the buyer trusts. In this case the buyer will not find out until long after the purchase. The rating agencies use information from the sellers that is supposed to be true and might have been true at some point – although if you believe that you probably believe in the tooth fairy. The sellers had incentive to lie and to manipulate risk advisors to lie because that increases the price they can obtain for the loans in the secondary market. The old adage of buyer beware was abandoned.

The result was hundreds of billions of dollars of absurd loans that were packaged as “good” investments in the secondary market. Those institutions who bought these should have been very suspicious because it was common knowledge that many absurd loans were being made. But no matter. One could buy a package of such loans and sell it to a greater fool for profit. The greater fool could perform another repackaging and sell it to an even greater fool for profit. And so on and so on. Everybody is making money. Nobody should be asking any questions that might ruin the system.

These two debacles began to collide in roughly 2006 and the collision has intensified through 2008. How this will end is yet to be determined as of this writing.

The bubble detonates

In 2006 it was becoming very clear that a serious financial cancer was spreading fast. It began showing up as a crisis for homeowners who were faced with significant increases in monthly payments as interest rates reset upwards per the loan contract and temporary sweetheart deals expired. The new payments were beyond anything affordable and the only solution was to walk away from the loan. There were numerous news stories about people who "suddenly" found themselves in this situation. They knew it was coming. Didn't they read the loan contract? No, they were too stupid – blinded by their own greed. Near the end of 2006 a number of "experts" said that this would be only a small problem and that the worst was probably over. An editorial concerning that nonsense in either the Wall Street Journal or Barron's (I forget which) made the point that the crisis had only just begun and the worst was yet to come and its magnitude would be severe.

Sure enough – the first half of 2007 saw an increasing number of defaulting mortgages and collapsing financial institutions. Again there were statements by "experts" that the worst was over – not to worry. By August, 2007 the situation had reached crisis status and the Federal Reserve began rapidly dropping interest rates in an effort to prevent a total collapse of the economy. Let's see if I have this right – the problems caused by lowering the interbank interest rate too low can be solved by lowering the interbank interest rate too low. I concede that I do not have a PhD in economics from one of the well-known playboy schools in the northeast but that makes about as much sense as the fire department pumping gasoline on a fire. When this first began I told my colleagues that it was the wrong thing to do. I would have raised rates had it been up to me. The problem was an economy that had been hyper stimulated by low interest rates and needed the cold shower of proper (i.e. higher) interest rates. Yes, a number of institutions would fail as a result as they should – not that any big institutions failed in 2008 anyway! The problem was too loose credit – making credit easier can not solve the problem. Credit should never have been so easy in the first place.

A common theme often heard from the government during this was, "The government has got to do all it can to keep home prices up." Home prices (not value) were exorbitantly high – that was the problem. So I am to believe that the solution is to keep them high and higher – bogus – they need to radically drop. This is strong evidence of market manipulation on a grand scale. The problem of the manipulation is that our whole economy depends on home prices being exorbitantly high – that is a serious problem.

Next, it started showing up in the secondary markets where it was becoming increasingly difficult to find greater fools. By the fall of 2007 it had become painfully obvious that the secondary market for mortgage securities was collapsing as all the greater fools had been exhausted. Major financial firms were discovering that what they thought were billions of dollars of assets on the books were actually worthless and multibillion dollar write downs were being made on an almost daily basis. Still, a number of "experts" were insisting that the worst was over and recovery would be soon. But other people who really did know were predicting that there would be a number of major failures in coming months and that it was hard to say when we would reach bottom.

Then in February, 2008 the auction rate market for bonds and other financial products died and has remained dead to this day (Oct. 2008). This is a derivatives based market that depends on a balance between buyers and sellers. There were no buyers. Sellers were stuck. Some of the derivatives had some dire terms if the market did not work right. Indeed, the county government in the place where I live (Jefferson County, Alabama) had foolishly gambled heavily in the derivatives market and was now stuck with over three billion dollars of debt with a reset interest rate that was beyond anything possible to pay. Although the county was technically bankrupt in March of 2008 the stupid politicians spent tens of millions of dollars in delaying tactics and the issue is still not settled as of this writing. Except for a stupid bailout, the only option is bankruptcy.

As expected, a number of big financial players are no more. Numerous more banks are expected to fail within the next nine months. The credit debacle has been called the classic failure of a free market system. That is totally wrong and anyone who makes that statement is either naïve or manipulative. I have said it before and I will say it again – by definition, a free market is one that is not manipulated. The housing market has been manipulated by the government for a long time. The credit debacle is correctly labeled a failure caused by government manipulation. Free markets would never have made over a trillion dollars of absurd loans. It would have been their own money that was lost.

The Bailout

The concept of a bailout is to negate any lessons that might be learned from doing something wrong. Thus, bailouts always lead to bigger wrong doings. I can tell you with absolute certainty that there will be an even larger debacle in the future – regardless of whatever "changes" or "reforms" are passed now. In the closing days of September, 2008 a three-page legislation was presented to congress that would among other things grant unprecedented power to the secretary of Treasury to buy debt and equity. At hearings before the Senate and House the Fed chairman predicted dire consequences if the bill was not passed very soon. I thought this was very unusual. In the past the Fed had rightfully complained numerous times about excessive government spending/borrowing. Now the Fed chairman was making a case to loan $700,000,000,000 (the zeros are more impressive than the word, billion) to the government. On Monday, Sept. 29, the House rejected the bill and the stock market dropped. Presumably, they rejected the bill based on concern for their constituents. But that turned out to be phony. The problem was not that the bill was too expensive but that it was not expensive enough – so much for the wishes of the constituents. The Senate took up the bill and over the course of several hundred pages added somewhere between one and two hundred billion dollars for frivolous gratuities (a.k.a. pork – very fat) and passed the bill. On Friday, Oct. 3, the House (now with the gratuities added) quickly passed the more expensive version and Bush, puppet as he is, signed the **Emergency Economic Stabilization Act of 2008**. I thought it was interesting that after all the hype for quick passage so bad things would not happen that after the president signed it that he said not to expect much good to happen soon. The country is saved! The market proceeded to collapse even further. The bad things happened anyway. The following week the market experienced huge collapses – not just in the United States but around the world as credit markets froze. I was led to believe (not that I did) that passage of this bill would prevent this. The new act has an interesting name, **Troubled Assets Relief Program (TARP)**. I can not think of a better name for a cover-up. One comical letter writer in the Oct. 20, 2008 issue of Barron's hoped that that TARP does not become THONGS – Troubled Housing Ongoing Negotiated Government Support because THONGS have difficulty covering problem assets!

The bailout package was not needed. The Federal Reserve can create and pump as much money ($700 billion, a trillion, ten trillion, or whatever) as it wants into the banking system without congressional approval for they are independent of the government. They can even loan all the money the banks need at zero percent if necessary. The only purpose of the bailout was to be a rouse to grant the government more powers and to distribute a lot of pork. The public was duped – as usual.

A continuing theme still is, "The government has got to do all it can to keep home prices up." Every time I hear this moronic statement in the news I have the urge to do this country a favor and shoot the moron. The government who had created the grandest Ponzi scheme in history is now desperate to maintain it. It can not be done. It must collapse. And it is collapsing. The trouble is that none of this actually costs the government anything – they are only the beneficiaries. The cost is to the productive people of this country who have only a minority vote.

The whole theme of the upcoming presidential election is change. As in the past the sheeple have been primed to accept change as better. Change will happen. As always, the solutions will involve less freedom and more expenses for everyone. But no matter – change is better! Whichever puppet is elected, the government is going to dole out unprecedented tax cuts on top of free money for the middle class (now increasingly becoming a subsidized welfare class) and below and change the whole financial structure of things for the "good" of us all. The sheeple have been conditioned to think that their standard of living is defined by tax cuts, credits, and other dole. They are not capable of the thought process to connect increased expenses with this scheme and visualize the trap they are voluntarily walking into. The "evil" rich are going to pay for all of this as they have been paying for a long time but they have never become poorer as a result. And everyone will need the tax cuts and stimulus and dole to pay the increased prices for goods that will come. But no matter – the government is "helping" us – if not outright forcing us into economic slavery. The master plan keeps working and the stupid sheeple are in full support of the wolves.

The dots connected

The events described in the preceding paint a picture of a definite direction being taken over the course of many years. Many times it was clear that the direction was wrong but corrective action was never taken. Over the short term, that is plausible as political errors may take a while to show. Over the long term it becomes much less plausible to dismiss a unified direction as the "errors" are clearly visible. Although the evidence for what was done is compelling, it is the combination of the lack of evidence for corrective action that makes it impossible to believe that the debacle was an accident of a “free” market.

Go back to the Short Story section that begins on page 2 of this article to see the summary of how all the above dots connect. Technically, it belongs here but I decided to place it early in the article so that readers would know where I was going with this.

Who are the puppeteers?

By modern design it is very expensive to run for and hold political office. For the most part this keeps out the “undesirables” that might represent the interests of tax paying voters. Politicians must serve those who finance them and they do. Thus, the puppeteers are those who control the money and the puppets are those who do what is required to obtain this money. The population only gets to select the puppets, not the puppeteers. It is a big help for the puppeteers if the puppets are mostly chosen by non tax payers as has been the case for some time now. A truly intelligent puppet that tax payers might select may resist the pull of the strings. Thus, we have the modern corrupt political system.

A listing of all the puppeteers would be a massive document. Because of their very close connection to the debacle I must mention one group in particular known as ACORN that supposedly advocates for low income types. Instead, it capitalizes on the ignorance of its non tax paying constituency to build a power base for itself and its wealthy leaders. The control tool of choice has been massive subsidies (delivered by the government it manipulates) to discourage advancement and to construct a high wall of escape to the American middle class thus maintaining the base. This group has strong controls on a growing portion of government and the resulting actions led to some of the very absurd laws and policies described previously. The actions of ACORN bear high guilt for the debacle all while they blame Republicans and conservative Democrats not under their control. There is considerably more evil with this sleazy group than I have space here to write. I have made my basic point. I will let the reader do their own independent research and discover much more shocking information. I find it interesting that a portion of their web site is dedicated to defending numerous charges of vote fraud and other scandals against them. If what they do is so good then why do they need to be so defensive? Other agencies aren’t.

There can be no doubt that a number of high financial operators have considerable strength as puppeteers as also evidenced by a number of absurd laws and policies previously described. The many puppeteers work only for their interests and rarely work in any sort of concert – be thankful for that. The result is that we have a total corrupt mess for a government. In many ways it is a wonder that things are not worse than they are.

Public Housing (a sidebar discussion)

Because housing assistance from the government was the prime driver that got us into this mess, this story would not be complete without a brief discussion of public housing. This was (technically it actually still is but not in the form it should be) a mechanism in the distant past that actually did help low-incomers to buy a house without putting them in jeopardy of high debt or burdening society as a whole with high government debt. This involved social investment rather than socialism – there is a huge difference. I think very few if any of us wish for someone to have to live in the proverbial cardboard box. Prior to the disaster of the Great Society a program known as public housing had generally worked very well across the country. Public housing began with the **Housing Act of 1937** and grew rapidly over the subsequent decades. My father was a major player in that arena and I grew up very cognizant of what public housing was about. I remember the construction and touring the units.

The concept was simple and efficient. A major obstacle for striving lower income persons who hope to buy a house is rent – there is little if any money left to save for a down payment (in the pre-debacle days a significant down payment was expected). The concept was that the government would build a not for profit apartment system and charge a very low rent based on the renter's ability to pay. In extreme cases the rent was zero. There were also subsidies for some utilities. On the surface this sounds like socialism (which I am opposed to) but is the same concept practiced by virtually every successful family who provides a starting mechanism (i.e. limited short term subsidies) for their children entering adulthood to launch from. The young adults are expected to "take the ball and run with it." Public housing then is a method for society to provide a short term subsidy to an aspiring family who is expected to "take the ball and run with it" and also climb the ladder of success. My father dedicated his life to that concept.

The renter had to meet a number of strict qualifications to get into public housing as public housing was not meant to be a cheap permanent existence. Stable employment and quality of character were some of these qualifications. Persons could be kicked out for falling from these standards. The result was that quality low-income families could very affordably live in a safe and respectable area while saving to buy a house (compare this last sentence with how things are today). To be accepted into public housing was a matter of pride. It meant that the person or family was aspiring to move up in the world. In the early days the graduation rate (that is those persons who bought a home and thus moved out of public housing) was very high – I vaguely remember my father discussing numbers roughly in the 80% range for roughly any five-ish year period. In those days there were decent low-priced homes in decent neighborhoods that were affordable if one could make a down payment. Today with "help" from the government those homes either no longer exist or are now slums to avoid. Public housing enabled families to save for the down payment. This is the success of social investment over socialism.

In the early days there were many detractors of public housing and my father received a number of vile threats. There were those who did not want squalor cleaned up. But there was no denying the success. I remember rows of crammed together shacks with squalor conditions replaced with nice apartments that also provided ample grounds for children to safely play. My father said that it was critical for the population density not to be too great or there would be nothing but problems – as in the well known Chicago high-rise projects disaster. I once had a summer job cutting shrubs and doing other ground work around these apartment units and met many of the tenants and can tell you from personal experience that these people were as nice as anyone. That is no surprise – they met the standards required to live there.

After the Great Society, things changed for the worse. Sleazebag lawyers used the courts to rule that public housing should be open to all – no qualifications necessary. This led to public housing becoming the dumping ground for the dregs of society who were too worthless to ever have a place to live. Some of them had been in institutions but sleazebag lawyers used the courts to rule that dregs have rights (even special rights) and society (and public housing in particular) had to accept them. As these dregs moved in, quality families accelerated moving out to escape. They did not want their children exposed to such and thus became those who had to sacrifice so that dregs could have a nice place to live. I do not think the news media ever picked up on that. This enabled more dregs to move in. The process continued until public housing consisted mostly of society's undesirables. Some desirables were stuck living in public housing for they had no where else to go. By the 1980s my father lamented that the graduation rate was practically zero as temporary public housing for aspiring families had become permanent housing for society's dregs. I have encountered low income people today who could benefit from the public housing concept but they had too much pride and aspirations to even think of living in the hell-hold known as the projects. What had been a successful social investment was transformed into another failure of socialism. Thus, another "success" story of our courts! Viva sleazebag lawyers! Although I am no longer around public housing, I have heard some tidbits that there are isolated success stories today in scattered areas. Perhaps some needed reforms have since been made. I am sure more reforms are needed.

The short of this is that properly executed public housing like what used to exist is far less expensive and far more successful than the gross subsidies of manufactured debt in recent years for loans that perpetuate the debt trap.

Financial Reforms

The following are some of the financial reforms that are badly needed. The problem is beyond financial and major reforms in other arenas are necessary as well.

- Governments must not provide incentives for low-incomers to buy a house. This socialist concept only causes problems such as inflating the price of housing by manipulated demand which in turn drives unassisted people to move out of stable neighborhoods as lower class persons move in thus fueling price increases for more expensive homes and creating more debt for society to pay interest on. The government can not subsidize interest or principal payments nor assist in down payments. Such actions belong in the realm of private charity which is far more effective. Those charities must <u>not</u> be tax-exempt in order that they have the freedom to aid only those who are actually trying. Tax-exemption gives the government authority to meddle whether the entity is a church or whatever.

- All loans must be fixed rate, fixed payment, and fixed term, and contain simple and standard terms that can be understood by the majority of the population. Gimmicks such as buying a lower interest rate for a fee, and locking in an interest rate for fee must be outlawed. The interest rate must be the prevailing rate at the time of the loan. All loan fees must be paid up front and must not be rolled into the loan.

- Persons borrowing money must meet rigorous standards indicating that they can repay the loan.

- Persons borrowing money must have a hard stake in the success of the loan. This means that as a minimum, the down payment for a house must not be less than ten percent. Let me point out that the sub-prime debacle consisted primarily of loans for which there was little if any down payment. Although it is possible that it can happen, I have not heard of a single bad loan during the debacle period where a significant down payment (i.e. twenty percent or more) was made.

- Housing loans should be local. It is important for the financial institution to have a stake in the community that it makes loans to. This ties the success of the institution to the success of the community it serves and balances that with the success of the community tied to the institution. Thus, it is in the natural interest of the institution and the community to work as a team. Although very over simplified to stay within the practical limits of a movie, this concept was illustrated in the Christmas movie classic, *A Wonderful Life*.

- The buying and selling of mortgages must be better regulated so that the true risk is known to all parties.

- Abolish derivatives of soft commodities such as stocks, bonds, mortgages, etc. for this is just gambling. Markets should be about investing, not gambling. If you want to gamble then go to Las Vegas. Some would call these instrument hedges that can reduce risk. I can tell you as a seasoned investor that that is wrong – the correlation between the “different” risks is too high. Proper portfolio management (i.e. not buying too much risky entities) of long term investments reduces risk without the expense and additional risk of hedging. Some derivatives such as currency and hard commodities serve a valuable purpose and trading in those items is essential for stable markets.

The bottom line is that financial institutions must make money in order to exist. But making money must be accomplished via an exchange for value rather than cheating. Without regulation and enforcement, cheating is a certainty. Proper regulation and enforcement provides the critical public confidence necessary to make investments. We all suffer when investments are not made. We all benefit when they are.

Consequences of Reform

The tightening of loan standards and limiting the money available for loans will obviously lead to fewer loans. But the quality of those loans will be high. It does society no good to create a loan that is not going to be paid off. Without excess demand, upward pressure on the price of housing will fade and home prices will be relatively stable. For many people who already own homes that seems like a horror as their home will no longer be increasing in price (confusing price with value) that had been enabling them to enjoy an artificial wealth. For those seeking to buy a home that is great news as they no longer have to buy into a Ponzi scheme and home prices become affordable without government help – like they once were. Market stability benefits everyone. Fewer homes will be sold as many people decide that it makes little sense to move unless really necessary. Thus, neighborhoods will take on stability that they have not seen in many decades. In short, there would be a lot to get used to but those things existed back in what are fondly remembered as the good old days. There will not be as much money to be made in the financial world or in real-estate and fewer employees will be necessary. I can see no negative in that. Eliminating the many and unneeded financial products on Wall Street would mean the end of a lot of jobs. But those jobs accomplish nothing that is actually needed. In fact there are a lot of positives as former employees in those fields find productive employment that enhances rather than shuffles the wealth of the country.

Conclusion

Unfortunately, none of the reforms I outlined will be made. The only reforms that will be made involve continuing the problem with a new disguise and these will be supported by the American sheeple (oops, I keep making this Freudian slip – I meant people). Thus, the debacle will happen again, again, and again. We never learn from history. Government facilitated greed can only lead to disaster. This debacle is strongest example yet. The typical American is equally greedy as any Wall Street sleazebag (let me point out that there are high quality people on Wall Street who rarely ever make the news). Collectively, the greed of the population dwarfs that of Wall Street so blaming Wall Street greed exclusively for the debacle is very wrong. I am reminded of the One who said, “Let he who is without sin cast the first stone.” A serious problem with modern Democracy (a.k.a. socialism) is that the greedy elect those who will facilitate more greed. We are doomed.