The Financial Crisis

How It Happened, and Why It Is Still Happening

by William J. Quirk

"Stock-jobbers will become the praetorian guard of the government, at once its tool and its tyrant, bribed by its largesses and overawing it by clamours and combinations," wrote James Madison in 1791. He and Thomas Jefferson both knew that Alexander Hamilton's debt and financing policies would ultimately undermine the victory for democracy won in the American Revolution. And they were right: 75 percent of the American people opposed the recent bailout of the U.S. financial sector, yet that did nothing to stop Washington from committing eight trillion taxpayer dollars to finance purchases, loans, and guarantees, of which the people's elected representatives in Congress have approved only $700 billion. The Federal Reserve simply said it had the authority to issue the other $7.3 trillion and could make a plausible technical argument to back up its claim. No matter: Since Congress is not in control of the bailout, it lacks democratic legitimacy. "We can't keep doing this," Fed Chairman Ben Bernanke said to Treasury Secretary Henry Paulson in mid-September. "Both because we at the Fed don't have the necessary resources and for reasons of democratic legitimacy, it's important that Congress come in and take control of the situation." But given the public's opposition, Congress was not willing to take control, and Paulson and Bernanke went ahead on their own. They effectively nationalized the U.S. financial system. As socialism took hold of the country, Congress watched from the sidelines.

If government action is not based on law, it is just the exercise of raw power. The Federal Reserve's authority to "rescue" Bear Stearns was questioned by its former chairman, Paul Volcker. Later, after the Fed refused to "rescue" Lehman Brothers, Dean Baker of the Center for Economic and Policy Research said, "They've been doing things of dubious legal authority all year. Who would have sued them?"

An arrogant lack of respect for the law precipitated the financial crisis. In the early days of the crisis, the *New York Times* reported that it was impossible to tell even "who owes what to whom." That is an accurate description of the world created by the exotic new instruments known as "derivatives"—Collateralized Debt Obligations (CDOs) and Credit Default Swaps (CDSs). Larry Summers is head of President Obama's White House National Economic Council. In July 1998, as deputy treasury secretary, he explained to Congress that the derivative market "in just a few short years" had become "highly lucrative" and a "magnet for derivative business from around the world." The market, Summers continued, is developed "on the basis of complex and fragile legal and legislative understandings." It was true, he added, that "questions have been raised as to whether the derivatives market could exacerbate a large, sudden market decline." Summers didn't think so, noting that the derivatives supported "higher investment and growth in living standards in the United States and around the world." Moreover, there was no reason for concern, since

> the parties to these kinds of contract are largely sophisticated financial institutions that would appear to be eminently capable of protecting themselves from fraud and counterparty insolvencies and most of which are already subject to basic safety and soundness regulation under existing banking and securities laws.

Summers explained that the market was based on an "implicit consensus that the OTC derivatives market should be allowed to grow and evolve without deciding" the legal issues—*i.e.*, whether derivatives violated laws prohibiting gambling and trading in unregistered securities, not to mention doing so outside the regulated options exchange. "At the heart of that consensus has been a recognition that 'swap' transactions should not be regulated . . . whether or not a plausible legal argument could be made" that the contracts are "illegal and unenforceable." The $90-trillion derivatives market, according to Summers, was based not on law, but on "understandings" and an "implied consensus." Summers never explained how the exotic devices would be of any help to the real economy or why the market needed secrecy to operate.

It is now crystal clear that our elected and appointed officials did not understand what derivatives were or the damage they had done. Two months into the crisis, Treasury Secretary Henry Paulson, formerly CEO of Goldman-Sachs, announced that the original remedy he had sold to Congress—buying up the rotten assets—was be-

---

William J. Quirk is the author, most recently, of Courts & Congress: America's Unwritten Constitution.

ing abandoned, and the treasury would now inject capital directly into the banks. In late November, the treasury came up with a plan to rescue Citigroup. Congress called it a bait-and-switch—which it was—but the real problem is that you can't fashion a remedy if you're not able or willing to say what the problem is. The public knew that it did not understand—the sums were unimaginable, the vocabulary exotic, and even the purpose of the game obscure. There are two crises: One is the "troubled asset" crisis, caused by subprime mortgages. That problem is finite and should be fairly easy to solve: Either let the losses fall where they may or guarantee the bad mortgages. But amazingly, the total losses from the crisis far exceed the bad mortgages, which brings us to the second crisis—the derivative crisis where "sophisticated" parties bet on anything. Would a bond or loan default? Would a company fail? Loaning money to gamblers is never a good idea, and in this case, the lenders were major U.S. banks, which are now bankrupt.

Total U.S. debt, as a percentage of Gross Domestic Product (GDP), nearly doubled between 1980 and 2007. Financial-sector debt, however, rocketed from 21 percent of GDP in 1980 to 83 percent in 2000, then on up to 116 percent in 2007. A large part of the financial-sector debt was in the form of securities backed by mortgages and other debt—a practice begun in the 1980's to evade the capital requirements imposed by law. "Securitization" also created instruments that few could understand. Indeed, the rights and liabilities of the parties to such arrangements are so unclear that, when Bank of America recently promised to reduce 400,000 of its mortgages to prevent foreclosures, it was sued in a class action by an investor in the mortgage securities who pointed out that the mortgages were no longer owned by Bank of America, but by a trust that had bought them in the process of securitization.

Capital requirements are a basic safeguard that limits the loans a bank can make to some multiple of its reserved capital. "Securitization" evades the requirement, turning the bank into a loan originator. The problem is that the originator has a limited interest in the creditworthiness of the borrower, since it is passing the loan along to the buyer of the security. That caused a lot of trouble.

The technical definition of a "derivative" is something that derives its value from something else. A stock or bond is a thing itself, whereas an option to buy a stock at a date and price in the future is a derivative. The *Wall Street Journal* reports that a whopping $72 billion in Credit Default Swaps "had been bet on Lehman's success or failure." This was nothing but high-stakes gambling on the part of our major investment banks. Two months into the crisis, all of them were gone. (Goldman-Sachs and Morgan Stanley had turned themselves into commercial banks so they could borrow from the Fed.)

It is not wise to invest in anything you don't understand, and very few understood these exotic instruments. Derivatives are designed to allow betting on any outcome while avoiding state gambling laws, on the one hand, and insurance laws (which require regulation and reserves), on the other. The effort to disguise what CDSs and CDOs really are has complicated matters. Insurance is illegal wagering in this country unless one has an "insurable interest." Thus, you can buy fire insurance on your house. Similarly, if you own a mortgage-backed security, you might want to insure against the risk of default. The buyer in some Credit Default Swaps owned the underlying security. In most, though, he did not: He was simply betting the security would default. Most CDSs, therefore, violated state antigaming laws. In both swaps and options, a small down payment brings a big exposure to movements in the capital markets. Financial markets became casinos. Gamers could bet on anything—whether interest rates were going up or down; whether a security would pay off; whether Bear Stearns or Lehman would fail. That last wager was particularly interesting because the bettor could influence the outcome by short selling or denying credit to Bear Stearns or Lehman. He could try to fix the race.

There is no doubt that the Wall Street speculators, and their legal advisors, with their derivatives—and with the complicity of government regulators, particularly the Federal Reserve and the SEC—have brought the house down. "Right now, the U.S. economy is contracting very rapidly. We are looking at a period of global slowdown," said John Thain, chairman of Merrill Lynch, on November 11, 2008. "This is not like 1987 or 1998 or 2001; the contraction going on is bigger than that. We will in fact look back to the 1929 period to see the kind of slowdown we are seeing now." By late November, $8.3 trillion of stock-market wealth had been erased. Worldwide, $23 trillion, or 38 percent of the wealth of all the world's companies, was gone. Consumer spending had slammed to a halt. Sales of new vehicles dropped 32 percent in the third quarter of 2008. The Big Three carmakers announced they would soon be bankrupt. Over just three days in late November, Citigroup lost 75 percent of its market value. Economists predicted a savings rate of three percent, which means that consumer spending will drop by one percent next year, the greatest drop since 1942. In 1942, the country was at war, and there was nothing to buy. The stock market fell 46 percent from its all-time high from October 2007 to October 2008, according to the Standard & Poor's 500 Index. Harvard Law Prof. Elizabeth Warren, head of a congressional oversight panel set up in the $700-billion bailout bill, announced on December 1 that she could discern no "coherent plan" for the bailout.

Secretary Paulson wrote in the *New York Times* on November 18 that he's "always said the decline in the housing market is at the root of the economic downturn and our financial market stress." But since when does a downturn in one sector of the economy bring down the house? What was different about this burst bubble? In *The Great Crash, 1929*, John Kenneth Galbraith wrote that "The singular feature of the Great Crash of 1929 was that the worst continued to worsen." In 2008, the complex interlocking derivatives kept unraveling as the worst continued to worsen. Wall Street, in Michael Lewis's phrase, "had created a Doomsday machine."

Before the crisis hit, Citigroup had become the leading issuer and holder of Collateralized Debt Obligations—securities that bundled mortgages and other debt (including credit-card receivables) into packages for resale to investor-gamblers. In 2007, Citigroup was the number-one issuer of CDOs—$49.2 billion out of a total issuance of $442.3 billion. Citi also held large quantities of them for its own account. John C. Dugan, head of the Office of the Comptroller of the Currency, notes that "what most differentiates the companies sustaining the biggest losses from the rest was their willingness to hold exceptionally large positions [in CDOs] on their balance sheets which, in turn, led to exceptionally large losses." Bankruptcy may be the only way to keep Citigroup in American hands—it is so desperate for cash that it is likely to sell a controlling interest for a song to any Saudi prince who happens to be in the neighborhood. In November 2006, Citigroup promised to pay the New York Mets $20 million per year for the next 20 years for the naming rights to the Mets' new ballpark—CitiField. Maybe the Mets will let Citi out of the contract. (Who wants to be associated with a busted bank?)

The bailout was said to be necessary to stabilize the U.S. financial system after its worst crash since the 1930's. We were on the edge of a cliff. If the federal government did not rescue it, the system would collapse. There would be no credit available for ordinary business purposes; people could not buy cars, and grass would grow in the streets. On Thursday, September 18, Paulson and Bernanke met with congressional leaders to present the bailout bill. At that meeting, Bernanke stated, "If we don't do this, we may not have an economy on Monday." The public's disdain for the bailout was understandable, since Washington never explained exactly where the losses would fall if we did nothing—and who would benefit if we did something. That would have meant confessing that there had been a lot of gambling going on, and the leadership thought it best that the winners be paid in full. The public would have been outraged.

In a stunning surprise, the House of Representatives rejected the bailout on Monday, September 29, by a vote of 228-205. The press heaped abuse on the House majority. The *New York Times*' David Brooks called the House vote "the revolt of the nihilists." The House had "exacerbated the global psychological freefall." Now, he concluded, "we have a crisis of political authority on top of the crisis of financial authority." A few days later the Bush administration added $150 billion of pure pork to get the bailout passed.

What if the White House had seriously encouraged all parties to the Credit Default Swaps to settle their contracts peaceably without taking undue advantage of other parties? And if that didn't work, what if they had forced creditors—including CDS counterparties—to accept a restructuring plan with some debt forgiveness and possibly a conversion of debt to equity? Derivative contracts, at the Lehman bankruptcy, were settled without much problem.

The whiff of democracy, however, discouraged Chairman Bernanke and Secretary Paulson from seeking any more "democratic legitimacy." The bailout leaders decided they would not go back to Congress. President Bush, while talking incessantly of free enterprise—and with Congress too smart to share the blame—nationalized the country's financial system. Sen. Jim Bunning (R-KY) told Chairman Bernanke that when he picked up his newspaper, "I thought I woke up in France." But no: "It turned out it was socialism here in the United States of America."

In July 2008, Merrill Lynch sold $31 billion in mortgage-backed securities for 22 cents on the dollar. Where did the taxpayers' dollars go? Our government, in some cases, won't tell us. The Federal Reserve and the Treasury Department refuse to identify the recipients of two trillion dollars in emergency loans. Bloomberg News made a FOIA request, which the Fed and Treasury denied; Bloomberg sued on November 7.

In one case we do know where the dollars went. AIG had effectively written insurance (CDSs) without reserves. The *Wall Street Journal* reports that AIG "was almost entirely a seller of CDSs." By selling credit protection on mortgage-backed securities, AIG was making "a big bet on housing." If AIG could not meet its obligations, why was that a public problem? "Meanwhile," the *Journal* sarcastically reports, "the search continues for the major counterparty that would have been destroyed by AIG's collapse." The public money—$170 billion—financed lavish parties, collateral on AIG's CDS commitments, and, best of all, a lawsuit against the IRS for $320 million to get back taxes the IRS was claiming AIG owed for "disallowance of foreign tax credits associated with cross-border financing transactions."

The crisis was caused by the failure to understand the potential for destruction in the growth and development of derivatives. Usually the bettor was only after a small margin—like playing the favorite in the sixth race to show. But to win anything substantial with such a bet, the gambler has to bet an awful lot, which could be lost. But if investment bankers wanted to bet on whether interest rates would go up, or whether Lehman or mortgage-backed securities would fail, so what? The problem is that the banks were willing to finance the gambling with vast loans.

Derivatives brought down Barings Bank in 1995 and Long-Term Capital Management (LTCM) in 1998. Barings Bank had helped President Jefferson finance the Louisiana Purchase in 1802. Its 1995 collapse was caused by one Singapore trader doubling down on consistently losing currency bets. Did the board of the Barings Bank know what a "derivative" was or that their agent was gambling the bank's existence? Of course not.

Long-Term Capital Management, a hedge fund led by Nobel Prize winners and other very bright people, was formed in 1994. They were so smart they did not believe

John Maynard Keynes when he said, "The market can stay irrational longer than you can stay solvent." That was a mistake. At its peak, LTCM had $100 million in assets and faced $1 trillion of exposure because of derivative contracts. In 1998, Russia defaulted on her bonds, and LTCM was bust. The Federal Reserve orchestrated a complicated rescue involving 14 banks. Chairman Greenspan later explained that the Fed's intervention was itself a gamble since such a move might encourage future risk taking by investors: "To be sure, some moral hazard, however slight, may have been created by the Federal Reserve involvement," but the negatives were outweighed by the risk of "serious distortions to market prices had Long-Term been pushed suddenly into bankruptcy."

In 1999, there was somewhere between $65 trillion and $90 trillion in derivatives outstanding. The comptroller of the currency reported that, at the end of the third quarter of 2004, U.S. banks held $84 trillion of outstanding derivatives. On February 16, 2005, the *Financial Times* reported that the largest five "U.S. banks hold 95 percent of the total stock of derivatives." What in the world were they doing with those derivatives?

By July 8, 2008, Fannie Mae and Freddie Mac, two so-called government-sponsored entities, were holding about five trillion dollars' worth of subprime mortgages. They had issued $5.2 trillion of debt for which—it was said—the government had an "implied" obligation. Treasury Secretary Paulson, on September 7, announced that Freddie and Fannie were now a "conservatorship" of the government, which, in one fell swoop, added five trillion dollars to the national debt. Earlier efforts—some by Sen. John McCain—to bring the agencies under control had been defeated by their two main congressional allies, Sen. Chris Dodd (D-CT) and Rep. Barney Frank (D-MA). Both of these men became powerful players in designing the cure for the problem they had created.

In his congressional testimony in October, former Chairman Greenspan admitted, "Free markets did break down. And I think that, as I said, shocked me. I still do not fully understand why it happened. And obviously to the extent that I figure out where it happened and why, it will change my views." President Bush's initial explanations of what had happened sounded wooden—as if he were a hostage reading a text prepared by his captors. But by November 13, he was more confident: "The crisis was not a failure of the free market system and the answer is not to reinvent the system." What, then, had caused it? He must have thought the problem was too much regulation: "We must recognize that government intervention is not a cure-all. History has shown that the greater threat to economic prosperity is not too little government involvement in the market, but too much." But if too much government intervention was the problem, then the solution should be less of it, not more. The solution, if the President is right, is to let the losses fall where they will.

On October 1, Barack Obama told the Senate that "now is not the time to argue about how the fire got started . . . now is the time for us to come together and put out that fire." But if you don't know what kind of fire it is, how will you know how to put it out? Despite your good intentions, you may wind up fanning the flames. A solution has to be based on a correct diagnosis of the problem. If the problem, for example, was too much easy money, a solution based on more easy money is not plausible. The Bush administration's eight trillion dollars and President Obama's stimulus plan are both based on the same theory—or hope—that more easy money will restore confidence and make prices rise.

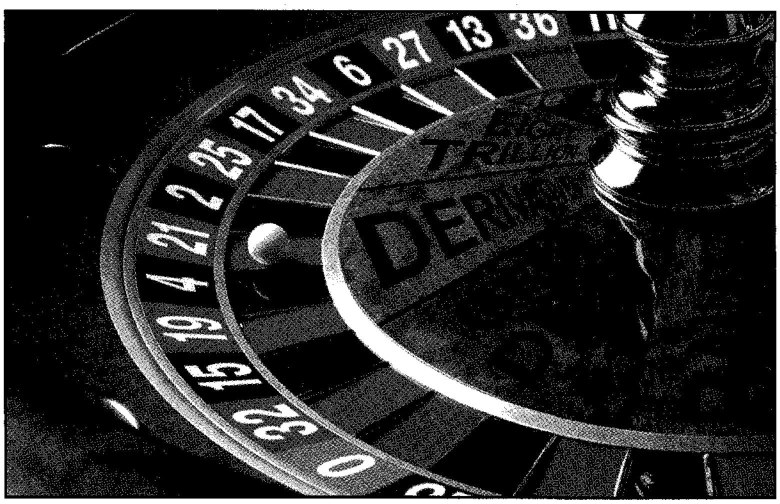
Former Chairman Greenspan was not questioned on the development of derivatives and their potential for destruction because neither Congress nor the people in general understood their complexity and interlocking relationships. In 1932, the banks ruined millions of families and businesses when "runs on the bank" destroyed perfectly healthy institutions. The requirement of deposit insurance of $10,000 per account solved that problem, so runs did not again threaten the economy. The insurance protected against a liquidity crisis but not, of course, against insolvency caused by derivatives and bizarre loans. In the 1930's it took eight years and our productive industry in World War II to replace the wealth destroyed by the bank failures.

The Glass-Steagall Act, passed in 1933, was based on the idea that greed was too strong to be regulated. But it could be isolated—sealed off from the banking system. Banking had a public purpose—it was essential to the working of a capitalist system. Glass-Steagall said deposit-taking banks had to stay out of any other business—essentially functioning as utilities. The Glass-Steagall barriers worked. As long as they lasted, the country had no serious commercial bank failures.

Between 1929 and 1932, 4,015 banks had failed. The depositors lost their money, and the Great Depression deepened. Commercial banks, such as Chase National Bank, had created entities known as investment affiliates to sell foreign bonds and other worthless securities to the public. The investment affiliates paid fabulous salaries. Charlie Mitchell of National City Bank, who earned $100,000 from his own bank, was paid $3,000,000 by its investment affiliate. The affiliates, explained Sen. Carter Glass (D-VA), "were the most unscrupulous contributors, next to the debauch of the New York Stock Exchange; to the financial catastrophe which visited this country and was mainly responsible for the depression under which we have been suffering since." Senator Glass proposed a bill that would prohibit "the use of Federal Reserve banking facilities for stock gambling purposes." True, many people called it "stock investment," but Senator Glass disagreed. "It is nothing in the world but pure gambling just as much as that at Monte Carlo."

On May 20, 1933, Rep. Henry Steagall (D-AL) introduced the House version of the legislation, noting "it is useless to censure or to attempt to trace the blame. It is enough to know that neither our financial nor our official leadership furnished the discernment and courage to avert theses unhappy developments":

> But we seemed to forget the lessons of experience. We departed from sound bank principles. Our great banking system was diverted from its original purposes into investment activities and its services devoted to speculation and international high finance. Our financial leaders went on a spree. They cranked up our great financial machine, charged it with high-powered gas, and soared away toward the heavens forgetting that there would ever be need for a place to land or that a wreck awaited them . . . Values were lifted to fictitious levels.


Melanie Anderson

Not only had leaders in the banking industry been "forgetful and neglectful of their responsibilities," but "they have forgotten their own best interests." Representative Koppleman supported the bill, saying "the unholy alliance between the brokerage office and the banks must be broken." The chief reason for the lack of confidence in the bankers, he continued, was the feeling that the bankers had "personal financial gain at heart." Instead of working for their depositors' interests, "they were silently working for their own interests. No amount of exhortation will restore confidence in the American banking system." Legal barriers were necessary.

Rep. Hamilton Fish (R-NY) noted that "There was nothing new about this depression as far as the principle involved."

> It was exactly the same as any other: There was an enormous inflation brought about because of the mass overproduction of stocks, bonds, and other securities largely emanating from these affiliates. The overproduction of securities meant a mass overproduction of commodities, real estate, and everything else.

The Glass-Steagall Act mandated a new structure separating investment banks from commercial banks, thereby securing depositors' savings against the risk of being used for speculation. However, since the government was subsidizing the banking business with deposit insurance, it imposed regulations to make failures unlikely. Bank lending was basically limited to safe commercial loans. Bankers were not supposed to be clever. In 1974, Henry Harfield, of the New York law firm of Shearman and Sterling, counsel to the First National City Bank, told a meeting of young lawyers, "Just remember this: if bankers were as smart as you are, you would starve to death." Investment banks, on the other hand, were strictly on their own—they were free to be as smart as they could be, to speculate as they wished and make or lose money as they wished. But taxpayers did not expect to share the profits and, of course, did not dream they would share the losses. Commercial banks took in deposits and were compensated in the form of interest and, to a lesser extent, origination and other fees. Investment banks, on the other hand, did not have vast capital; they provided advisory and knowledge-based services, and their compensation was contingent upon results.

Between 1995 and 2000, the great investment banks all changed from partnerships to corporations. The former partners, now corporate officers, could still take off most of the profits by way of compensation "packages," but now the risk of loss was on the stockholders. This change made the crisis possible. The insiders managed to separate the profits—which they largely retained—from the losses, which now would fall elsewhere. It was similar to "securitization," where the insiders took the lucrative origination fees and sold the debt as a security—with the risk falling on a distant investor.

Glass-Steagall, of course, was an American law governing banks doing business here. It did not cover hedge funds, which are a worldwide, post-1987 phenomenon. It did not cover European, Asian, Middle Eastern, Australian, and Canadian banks and financial institutions unless they wanted to do business here. All of them were vital contributors to the crash.

In 1999, President Bill Clinton signed the "Financial Services Modernization Act of 1999"—the repeal of Glass-Steagall. In Congress, the effort was bipartisan—it passed the Senate 90-8. Sen. Byron Dorgan (D-ND), although he knew the bill would pass, spoke against it:

> For those who have a vision of re-landscaping the financial system in this country with different parts operating with each other in different ways and saying that represents modernization, then I am just hopelessly old fashioned, and there is probably nothing that can be said or done that will march me towards the future. . . .
>
> Does anybody here think this makes any sense, that we have banks involved in derivatives, trading on their own proprietary accounts? Does anybody think it makes any sense to have hedge funds out there with trillions of dollars of derivatives, losing billions of dollars and then being bailed out by a

Federal Reserve-led bailout because their failure would be so catastrophic to the rest of the market that we cannot allow them to fail?

The bill, Senator Dorgan continued, had been heavily lobbied ($300 million was mentioned):

> I, obviously, am in a minority here. We have people who dressed in their best suits and they just think this is the greatest piece of legislation that has ever been given to Congress. We have choruses of folks standing outside this Chamber who spent their lifetimes working to get this done, to say: Would you just forget all that nonsense back in the 1930s about bank failures and Glass-Steagall and the requirement to separate risk from banking enterprises; just forget all that. Time has moved on. Let's understand that. Change with the times.

Dorgan had no doubt that, before too long, the chickens would come home to roost:

> I will bet one day somebody is going to look back at this and they are going to say: How on Earth could we have thought it made sense to allow the banking industry to concentrate, through merger and acquisition, to become bigger and bigger and bigger; far more firms in the category of too big to fail? How did we think that was going to help this country? Then to decide we shall fuse it with inherently risky enterprises, how did we think that was going to avoid the lessons of the past?

Republicans wanted to repeal Glass-Steagall because they thought it was hindering economic growth by limiting freedom and competition. Sen. Phil Gramm (R-TX), chairman of the Senate Banking Committee, praised the bill at its signing:

> In the 1930s, at the trough of the Depression, when Glass-Steagall became law, it was believed that government was the answer. It was believed that stability and growth came from government overriding the functioning of free markets. We are here today to repeal Glass-Steagall because we have learned that government is not the answer. We have learned that freedom and competition are the answers. We have learned that we promote economic growth and we promote stability by having competition and freedom.

The moment, said President Clinton, was "truly historic":

> So what you see here, I think, is the most important recent example of our efforts here in Washington to maximize the possibilities of the new information-age global economy, while preserving our responsibilities to protect ordinary citizens . . .
>
> It is true that the Glass-Steagall law is no longer appropriate for the economy in which we live. It worked pretty well for the industrial economy, which was highly localized, much more centralized, and much more nationalized than the one in which we operate today. But the world is very different.

Democrats and Republicans were in a self-congratulatory mood. President Clinton hailed them:

> So I think you should all be exceedingly proud of yourselves, including being proud of your differences and how you tried to reconcile them. Over the past 7 years, we've tried to modernize the economy, and today what we're doing is modernizing the financial services industry, tearing down these antiquated walls, and granting banks significant new authority.

In order to kill Glass-Steagall, Democrats enlisted the banks to perform social functions that, in normal societies, are performed by government rather than private parties. The banks would only get their new powers if they agreed to meet the "credit needs . . . of low and moderate income communities." And the Republicans signed on. So, in addition to massive deregulation, private banks were strong-armed into becoming welfare agencies, laying the groundwork for the subprime mortgage spree.

Before the repeal of Glass-Steagall, large capital's disrespect for the law was astonishing. In 1998, Citigroup merged with Travelers Insurance in bold defiance of Glass-Steagall. Yet the Federal Reserve approved the merger. In so doing, the Fed bizarrely declared that the new entity would have to divest the illegal businesses if the law was not changed within five years. Ordinary crooks, if caught, have to go to jail and don't get the option to try to get the law changed. Within one year, Glass-Steagall was repealed, Larry Summers had become treasury secretary, and his predecessor, Robert Rubin, had joined Citigroup. The illegal company became legal. In late November 2008, Citigroup became the largest victim of its victory. Rubin had received $115 million in compensation, but the bank was bust. Citigroup had raised $75 billion from sovereign-wealth funds and the U.S. government to cover its losses, but it needed between $50 and $100 billion to cover further losses over the next 18 months. The bank failed because it did exactly what Glass-Steagall would have prevented: It traded for its own account as if it were an investment-banking partnership.

"I made a mistake," said former Fed Chairman Alan Greenspan on October 23, "in presuming that the self-interest of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and the equity in the firms." As long as we have had capitalism, we've had bubbles: the South Seas Bubble, the Tulip Mania, the 1929 stock market, the dot-com bubble of 2000, and so on. Clearly, self-interest is not a safeguard.

Could state criminal laws against gambling have broken up the derivatives game? Without doubt, the "synthetic" Credit Default Swaps (in which the buyer did not own the underlying security) were pure gambling and violated state antigaming laws. Wasn't the $90—trillion derivatives market illegal? It was, until the waning hours of the Clinton administration, with a lame duck President and a lame duck Congress and a moral atmosphere conducive to a Marc Rich pardon. The quiet bill was called "The Commodity Futures Modernization Act of 2000." One hundred pages in length, it was introduced in both houses on December 14 and passed, without debate, the next day. The President's Working Group on Financial Markets, led by Summers and Greenspan, wrote Congress that it "strongly supports" the bill, which would maintain the U.S. "competitive position in the over-the-counter derivative markets by providing legal certainty and promoting innovation, transparency and efficiency in our financial markets." Section 17 of their 11th-hour bill states that "This Act shall supersede and preempt the application of any State or local law that prohibits or regulates gaming or the operation of bucket shops." The legalizing language was folded into a spending bill, so no member had to be on record as voting for it.

When the Founding Fathers talked about the consent of the governed, that's not what they had in mind. This dark-of-the-night law immunized derivatives from any reporting, regulation, or legal limits. Consequently, derivatives continued as a bilateral, unregulated market, which is why it happened that, when the trouble hit, no one knew who owed what to whom. On June 30, 2008, there were $684 trillion of derivatives outstanding.

Jefferson and Madison, unfortunately, were right: Hamilton's debt and financial policies have undermined the democratic victory of the American people. Hamilton's descendants created a financial system so complex that it could not be managed. It was so highly leveraged that it was prone to crisis at any time. The bailout hit one speedbump in Congress, then plowed ahead, operating outside the law and without, in Chairman Bernanke's phrase, any "democratic legitimacy." Will President Obama bring the bailout under democratic control? His team of economic advisors makes that unlikely. It is counterintuitive to think that those responsible for the train wreck can put it back on track. Larry Summers, with his "understandings" and "implied consensus," has obvious contempt for the consent of the governed. Aren't there any bright people in the country who haven't worked for Goldman-Sachs or the Treasury Department in the Bush-Clinton-Bush administrations?

The globalization chickens are roosting. Manufacturing has gone to China. Agriculture, to South America. The back office, to India. That leaves us with "management and financing," and Washington has made a royal mess of that. <C>

by Taki Theodoracopulos

To Spurn a Stranger Cur

By the time you read this it might be very old news, and if it is, treat it as a background briefing. But if the son-ofabitch I'm writing about is still out on bail and moving his ill-gotten assets around Israel and the environs, pay attention. What you read can one day save your savings.

It was last summer when a friend of mine of very long standing asked me to come on board his boat for a business meeting. "What are you doing for a regular income?" he asked. "I might have something very interesting for you. There is no risk involved." March 31, 2008, was the date I had exited from Fix Asset Management, the fund of funds I had invested in since the spring of 1990 and in which I had enjoyed 20 percent yearly compounded returns until the you-know-what hit the fan in October 2007. Fix Asset Management was the brainchild of my childhood friend Karolos Fix, a German-Greek whose ancestors had come to Greece from Bavaria with the first Greek king, Prince Otto of Bavaria, back in 1837 (as had some of mine). Fix had started his fund during the 1980's and had really hit his stride by the time I joined in.

But back to my "friend" on his yacht. He seemed awfully eager to make me rich. But being the fool that I am, I never suspected a thing. "The name is Madoff," said the yachtsman, "and he's more than a genius, he's a miracle worker. The trouble is his fund is closed, but you can have some of my action. There are no fees involved. It will cost you nothing except for your original investment, say ten million or more. I will allocate you some of my holdings."

I was dumbfounded. I thanked my friend and told him I was ready to invest immediately. But then I started thinking about "owing" him. I am getting on in years and don't care to owe anyone anything. He was obviously going out of his way to help me. That's when the princess came in, my wife, or better yet the mother of my children, as I like to refer to her. Alexandra had never warmed to my friend and told me she'd rather I didn't accept his generous offer. "There's something wrong when someone offers something for nothing," she said. A wise woman, as it turned out.

Four months later the megacrook Bernard Madoff was exposed, and you know the rest. Three very old and good friends, including Karolos Fix, whose fund I had exited only a short time before, had gone down for the count. Fix had lost 400 million greenbacks and counting. Now I ask you: Was my friend trying to unload worthless shares before exposure, or was he trying to do me a favor out of the kindness of his heart? The reason I have not revealed his name is because there are still doubts in my mind. Alexandra thinks he knew. I am not so sure. The reason I believe I'm right is because he, too, has been caught in the Jewish tsunami, as some Wall Street WASPs are calling it. In an ironic twist, I was informed by my Swiss banker that I owned Madoff shares, purchased by the bank after I had told them the megacrook was a genius and a miracle worker. Serves me right.

What I find outrageous is that the swindler was given bail by federal judge Gabriel Gorenstein, even though he failed to meet the requirements of his bond, and as of this writing is skulking around New York in his ankle bracelet, most likely moving assets to offshore funds. The other thing I find very strange is that Madoff had been investigated back in 1999 and repeatedly brought to the attention of SEC staff, without any action ever taken. That a Madoff family member was married to an SEC official, I am convinced, had something to do with the SEC's paralysis. Madoff is one of those ghastly human beings who maniacally pushed for more cash until the end. A week before his scam was discovered he was asking his pals to invest.

And another thing. The newspapers and media have been reporting from day one about all the Jewish charities that have been wiped out. In other words, Christians who lost don't matter. I almost feel like repeating Shylock's speech in *The Merchant of Venice*, updating it to 2008. Here's what I think happened. Madoff used his Jewish connections to raise funds, and when questions were asked, high-ranking respected Jewish leaders protected him. He was, after all, a big donor to Jewish charities. Indeed, he was using Jewish charities to attract Jewish investors. This does not take a genius to figure out. The Christians were the real schmucks. They are the ones who invested like gangbusters and have lost billions. Which leads me to ask: What the hell is going on here? A billionaire of the Jewish faith like Carl Shapiro drops $145 million, and his loss is called a catastrophe to Jewish charities. A goy like Walter Noel drops $7.5 billion, or my friend Karolos Fix loses $400 million, and they're called careless fools. European banks, ditto. Perhaps the game is rigged. Jews are the victims, *punto basta*, as they say in the land of pasta.

I have seen my yachtsman friend since, and we commiserated. He lost much, much more than I did. Here's chastened, bullet-dodging Taki's first rule: Never but never believe a sure thing, especially when the word *genius* is banded about. Especially when you're invited to leave your yacht for someone else's.