The Committee to Destroy the World

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

Michael E. Lewitt

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For Marcie, Alessia, Alexander, and Preston

And in memory of Laurence G. Lewitt, 1930–2015

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

—Adam Smith

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

—Charles Kindleberger

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ACKNOWLEDGMENTS

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

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

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

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

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

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

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

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

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I also had the privilege to study with the equivalent of the 1927 Yankees in literary studies as a graduate student at Yale University in the early 1980s: Harold Bloom, Paul de Man, Geoffrey Hartman, Thomas

Greene, J. Hillis Miller, Peter Brooks, Frederic Jameson, R.W. B. Lewis and Peter Gay. Jacques Derrida and Umberto Eco would stop by to lecture and meet with us from time-to-time as well. I sometimes pinch myself to remember how lucky I was to interact with these great minds.

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

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

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

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

CONTENTS

Acknowledgments		xi
Introduction	**The Committee to Destroy the World**	**1**
Chapter 1	**The 2008 Crisis—Tragedy or Farce?**	**57**
Chapter 2	**The Death of Capital**	**93**
Chapter 3	**Capital Ideas**	**109**
Chapter 4	**Empty Promises**	**145**
Chapter 5	**Financialization**	**163**
Chapter 6	**From Innovators to Undertakers**	**181**
Chapter 7	**Welcome to Jurassic Park**	**225**
Chapter 8	**The Road to Hell**	**259**
Chapter 9	**Finance after Armageddon**	**277**
Chapter 10	**Unfinished Business**	**317**
Chapter 11	**How to Save Yourself**	**339**

Conclusion "This Is Later" **359**
Notes 367
Bibliography and Other Sources 397
About the Author 405
Index 407

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INTRODUCTION

The Committee to Destroy the World

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

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

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

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

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

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

According to the McKinsey Global Institute, China's total debt increased from $7 trillion in 2007 to $28 trillion by mid-2014.[1] To place these figures in context, household debt in the United States increased by $7 trillion in the period leading up to the financial crisis in 2008.

And America's federal deficit increased by roughly $7.5 trillion between January 2009 and mid-2015.[2] So China, an economy only 50 to 60 percent as large as the United States, saw its debt increase by three times as much as America's household debt grew during the housing bubble or, alternatively, three times as much as America's federal deficit grew during the first six-and-a-half years of Barack Obama's presidency (a period that included four consecutive years of $1 trillion deficits). Moreover, much of China's debt was directed into wasteful and unproductive real estate and commodity investments that will never produce a reasonable return or generate enough income to service or repay the capital that funded them. So much for China's "economic miracle."

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

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

By mid-2015, serious cracks began to appear in global markets. Greece defaulted and had to be bailed out again by the European Union while solidifying its status as a failed state and global security threat as an entry point for refugees from a shattered Middle East. Emerging

markets were melting down with particular weakness in Brazil and Russia. China's stock market was crashing and the country shocked global markets by beginning a concerted effort to devalue the yuan. Puerto Rico declared itself insolvent (something anyone with a functioning cerebellum already knew was the case). Leveraged oil and gas companies in the U.S. were filing for bankruptcy left and right. And then the U.S. stock market, which had struggled to rise all year, suffered sharp losses and extreme volatility in August and September, shaking the confidence of investors. The post-crisis debt party had run long past midnight—and nothing good ever happens after midnight.

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

A Regulatory Theocracy

The 2008 financial crisis and, before that, the 9-11 attacks drastically reshaped the world. Each of these seminal tragedies unleashed massive policy responses that radically altered American life for the worse. As a result of the 9-11 attacks, the United States invaded Iraq and Afghanistan and launched anti-terror operations in Pakistan, Yemen, and Somalia; passed the Patriot Act that expanded surveillance of its citizens; and established a massive new bureaucracy in the Department of Homeland Security to protect the nation. As a result of the expansion of the radical Islamic terrorism around the globe that triggered the 9-11 attacks, Americans can no longer travel freely or feel secure in public places due

to the growing threat of random violence. American police forces are militarized and the freedoms enjoyed by our parents and grandparents are limited by our own fears and our government's failure to effectively fight our enemies at home and abroad.

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

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

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

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

In the aftermath of the financial crisis, Congress passed The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Naturally, this bill turned into a regulatory and lobbying orgy that ended up sapping liquidity and vitality from the financial system while leaving derivatives inadequately regulated and the individuals who committed crimes that contributed to the financial crisis unpunished. Dodd-Frank was 14,000 pages in length and included 398 rule-making requirements, rendering it almost impossible to administer by the SEC and other

agencies charged with administering it. Like the badly flawed Affordable Care Act, which House Majority Leader Nancy Pelosi famously (and disgracefully) said had to be passed into law in order for the members of Congress to know what it actually said, Dodd-Frank was another piece of absurdly complex legislation that was voted on by people who didn't read it or understand its contents or its unintended consequences.

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

Legislators and regulators failed to recognize that inflexibly bolstering bank capital would severely reduce market liquidity, yet that is precisely what occurred. By 2014, liquidity in fixed income markets had dried up as banks restructured their businesses to meet the demands of the new law. Corporate bond inventories held by dealers dropped by 70 percent while Treasury market liquidity evaporated. This happened as debt markets increased dramatically in size; by 2015, the U.S. corporate debt market had doubled in size to $4.5 trillion since before the crisis, yet it had become much more difficult to trade bonds than a decade earlier. The evaporation of market liquidity will inevitably make the next crisis more severe than the last.

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

The expansion of the regulatory state is appalling in breadth. Over the last decade, 768,920 pages of federal regulations have been added to

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