INTRODUCTION BY NOURIEL ROUBINI

INFLATED

HOW MONEY AND DEBT BUILT THE AMERICAN DREAM

R. CHRISTOPHER WHALEN

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For Pamela

Voici mon secret. Il est très simple: on ne voit bien qu'avec le cœur. L'essentiel est invisible pour les yeux.

—Antoine de Saint Exupéry, *Le Petite Prince* (1943)

I do not think it is an exaggeration to say that it is wholly impossible for a central bank subject to political control, or even exposed to serious political pressure, to regulate the quantity of money in a way conducive to a smoothly functioning market order. A good money, like good law, must operate without regard to the effect that decisions of the issuer will have on known groups or individuals. A benevolent dictator might conceivably disregard these effects; no democratic government dependent on a number of special interests can possibly do so.

—F. A. Hayek
Denationalization of Money,
Institute of Economic Affairs (1978)

Preface

What is the American dream? The historian and Pulitzer Prize winning author of *The Epic of America*, James Truslow Adams, is recognized as the first American to define the concept:

> The American Dream is "that dream of a land in which life should be better and richer and fuller for everyone, with opportunity for each according to ability or achievement. It is a difficult dream for the European upper classes to interpret adequately, and too many of us ourselves have grown weary and mistrustful of it. It is not a dream of motor cars and high wages merely, but a dream of social order in which each man and each woman shall be able to attain to the fullest stature of which they are innately capable, and be recognized by others for what they are, regardless of the fortuitous circumstances of birth or position."[1]

Adams's observation was as much a reflection on the nation's past as it was asking about its future. Adams published his book, *Epic of America*, in 1931 during the Great Depression. His world view was more egalitarian and libertarian than the corporate perspective, which today governs much of American life. Adams expressed hope for a world that was not merely defined by commercial standards but comprised of a society where individuals were free to pursue their own definitions of liberty and success.

In the twentieth century, the concept of the American dream can be said to trace its roots back to the promise of "life, liberty and the pursuit of happiness," the most famous line in the Declaration of Independence. Simply stated, when the immigrants who built the United States came to this country, they expected to be able to achieve a level of personal freedom and material security that was substantially better than that which was available in other nations of the world. Today's Americans as well as the thousands of immigrants who come to the United States each year still have that same promise in mind.

Americans as a whole view themselves as reasonably prudent and sober people when it comes to matters of money, though the choices we make at the ballot box seem to be at odds with that self image. As a nation we seem to feel entitled to a national agenda and standard of living that is beyond our current income, a tendency that goes back to the earliest days of the United States. This book examines this apparent conflict by reviewing our nation's past from a political and financial perspective, with an emphasis on the portions of the narrative prior to the decade of boom and bust.

Events such as the Gold Rush of the 1840s, the Civil War, the creation of the Federal Reserve System, and the two World Wars, are examined in the context of the changing definition of the aspirations of a nation. Whether taming the frontier in the 1800s, fighting poverty in the 1930s or bailing out private banks and corporations in the twenty-first century, successive American governments turned debt and inflation into virtues in order to make ends meet, a choice not unlike that made by leaders in many other nations of the world. But Americans have taken the tendency to borrow from the future to an extreme and in the process made it a core ethic of our society. In pursuing the American dream today without limitation, we have made our tomorrows less certain.

The rejection of any practical limits on expenditure is a view particularly encouraged by the generations of Americans that have come since WWII and the subsequent half century of Cold War. By virtue of the sacrifices of the past, Americans believe that we are somehow exempted from the laws of gravity as regards finance and economics. We speak of our "special" role in the global economy even as we repeat the mistakes of Great Britain, Rome, and other ancient civilizations whose financial systems have come and gone. The same popular delusions about inflation and debt that have affected societies in the past are also present in America today.

By highlighting the work of some of the great economists, historians, and researchers of the past two centuries, I've attempted to tell the unique American story of money and debt from a layman's perspective. And by describing the use of the printing press and credit as enduring features of the American dream, the story of a nation that is just two centuries old, I hope to illuminate these issues and thereby encourage a broader national discussion about the future of America's political economy and our place in the world.

Acknowledgments

This book is the synthesis of several decades of conversations and research on the topic of politics and finance. The dialogue began with my parents, Richard and Joan Whalen, who taught my brother Michael, sister Laura, and I to think and write independently. I especially want to thank my father and fellow writer Richard J. Whalen for his suggestions regarding this book and about life over the past half century.

There have been many other teachers and editors who have taught me to write and to think about the political economy. Karl Pflock and Terry Hauser at *Legislative Digest*, a publication of the Republican Conference Committee of the U.S. House of Representatives, introduced me to the world of political journalism and the *Chicago Manual of Style*. Congressman Jack Kemp, who chaired the committee in those days, will always symbolize the optimism and the hope for a brighter future, which are the American dream.

Great journalists and editors such as Robert Bleiberg, Tom Donlan, and my other friends at *Barron's* taught me how to write editorials. James Lucier, Sr. at *Insight on the News* likewise made me a better writer through vigorous editing. My political mentor John Carbaugh was one of the most effective Washington political operatives of his generation and supported some of the research reflected in this book. Robert Novak called John Carbaugh his best source ever. He was my good friend.

Martin Mayer, Alex Pollock, Alan Meltzer, Bill Greider, Anna Schwartz, Bill Janeway, Paul Volcker, Ed Kane, George Kaufman, Murray Rothbard, Robert Higgs, F.A. Hayek, Roger Kubarych, and Nouriel Roubini are a few of my personal influences when it comes to matters of economics and money. Some of these people I've known for decades, others more recently or through their writings, but all have shaped my understanding of money and debt.

Former colleagues from the Federal Reserve System and Treasury have contributed greatly to my understanding of the nuances of finance and economics, including Walker Todd, Richard Alford, Terry Checki, Roger Kubarych, Joseph Mason, Bill Arzt, Brian Roseboro, Jim Martin, Gerry O'Driscoll, Alan Boyce, Greg Zerzan, Chris Laursen, Thomas Day, and Robert Eisenbeis, as well as other current and former employees of the Fed and Treasury I cannot mention by name—what we refer to as the *Herbert Gold Society*.

Over the past decade, the comments from the readers and interview subjects of *The Institutional Risk Analyst*, have also influenced my thinking on money and finance. Collaborating with my friend and business partner Dennis Santiago has informed my view of the workings of the global financial system and also on the limitations of analysis.

Many colleagues on and off Wall Street have tried to teach me the business of finance with varying degrees of success. Alan Schwartz, Gerry Stanewick, John Crudele, David Setchim, Joe Calvo, David Weild, Joan McCullough, John Liscio, Charlie Biderman, Mark Pittman, and Bill King have been just some of my friends and colleagues over the years when it comes to understanding the markets.

Some of my fellow travellers who work in and around the money markets and share their views, perspectives, and insights include James Lucier, Jr., Henry Smyth, Lenny Glynn, Josh Rosner, Robert Arvanitis, John Crudele, Chuck Gabriel, David Reilly, Marshall Auerbach, Richard Leite, Jay Cook, Frank Leitner, Joseph Engelhard, Sylvain Raines, Scott Frew, Ann Rutledge, Dawn Kopecki, Matthieu Royer, Susan Webber, and Barry Ritholtz. There are many more and I thank them all.

My friend David Kotok and all of our colleagues who attend the annual fishing trips to Leen's Lodge in Grand Lake Stream, Maine, deserve thanks for the discussions we have shared over the years. David bears chief responsibility for spurring me to take on this project and for the introduction to the good people at John Wiley & Sons. Special thanks to Laura Walsh, Stacey Fischkelta, and their colleagues at John Wiley & Sons for making this project a reality.

I owe a special debt of gratitude to Jack Tatom, Martha McCormick, and their colleagues at the Networks Financial Institute of Indiana State University. Jack's interest in my work and sponsorship of research and published papers in many of the areas that are covered by this book made this project possible. I have included some of the material from previously published papers with the permission of Networks Financial Institute.

Special thanks also to Nouriel Roubini for taking the time in mid-August to write the Introduction for this book. I look forward to working with Nouriel on other projects we have in process over the months and years ahead.

My longtime friend and Washington consultant Robert Feinberg reviewed early versions of this book and provided comments. Our discussions over the years about the nature of power in Washington and its evolution are reflected in this book. He has been proactively proofreading and commenting on my work for more than a decade, a true sign of friendship.

Ad majorem Dei gloriam

Introduction

Chris Whalen is one of the leading independent analysts of the U.S. banking and financial system. In a world where too many sell-side analysts of the financial sector are not truly independent, Chris represents a fearless beam of enlightened and independent light who avoids the usual self-serving spin that is presented in so much Wall Street research. In this book he also emerges as a leading historian of the U.S. financial system and of the complex nexus between banking/finance, politics, and fiscal policy. This tour de force of the financial history of the United States is also a political history and sovereign fiscal history of the United States.

Whether you agree or not with Chris' views on the state of U.S. banks, which reforms of the system of financial regulation and supervision are appropriate, the risks that large monetized fiscal deficit imply in terms of future inflation, and risks of a crash of the U.S. dollar, he is always thought provoking, a master of details of financial history and presenting lateral and contrarian thinking that challenges the conventional wisdom. You may believe—as I do—that the greatest short-term risk facing the United States is deflation, as a slack in goods and labor markets implies seriously strong deflationary forces. But Chris correctly points out that large and monetized fiscal deficits eventually may cause, in the medium term, a rise in expected and actual inflation as they did after the Civil War and World War II. Indeed, the temptation to use a moderate and unexpected inflation tax to wipe out the real value of public debt and avoid the debt deflation of the private sector is powerful, and history may repeat itself—even if the short-term maturity of U.S. liabilities, the risk of a crash of the U.S. dollar and associated runaway rising inflation, and the related risk that the United States' foreign creditors may pull the plug on the financing of the U.S. deficit may constrain these inflationary biases.

Similarly, Chris stresses the role of poor fiscal and monetary policies and botched regulatory policies in triggering recent and not so recent financial crises. But financial crises existed well before there was a central bank causing moral hazard distortions through its lender of last resort role, before misguided regulation and supervision of banks, and well before there was a significant role of federal fiscal policy in the United States. Indeed, my recent book, *Crisis Economics: A Crash Course in the Future of Finance* (The Penguin Press HC, 2010) shows that financial crises and economic crises driven by irrational exuberance of the financial system and the private sector—unrelated to public policies—existed for centuries before fiscal deviant sovereign and central banks distorted private-sector incentives.

Markets do fail, and they do fail regularly in irrationally exuberant market economies; that is the source of the role of central banks and governments in preventing self-fulfilling and destructive bank runs and collapses of economic activity via Keynesian fiscal stimulus in response to collapse in private demand. The fact that these monetary policies and fiscal policies may eventually become misguided—creating moral hazard and creating large fiscal deficits and debt—does not deny the fact that private market failures—independent of misguided policies—triggered asset and credit bubbles that triggered a public rescue response. Market solutions to market failures don't work because in periods of panic and irrational depression markets fail given collective action problems in private sector decisions. Still, there is a long-standing debate about whether bubbles and the ensuing crises are due to poor government policies (the traditional conservative and Austrian view) or due to market failure requiring policy reaction (the liberal and Keynesian view). Chris takes the Austrian view but the Great Depression experience shows that too much Schumpeterian "creative destruction" leads to uncreative destructive depression. On the other hand, the Japanese experience of the 1990s also suggests that keeping alive zombie banks and companies can lead to persistent near depression.

The most fascinating parts of this great book are about the historical similarities in U.S. financial history:

- Cycles of asset and credit booms and bubbles followed by crashes and busts;
- The fiscal recklessness of U.S. states that leads to state and local government defaults;
- The temptation to socialize those state and local government losses, as well as the losses of the private sector (households and banks) via federal government bailouts;
- The recurrent history of high inflation as the solution to high public deficit and debt problems and private debt problems both after wars (Civil War, World War I, Vietnam War, and possibly now following budget-busting wars in Iraq and Afghanistan) and in the aftermath of asset and credit bubbles gone bust;
- The historical resistance of U.S. state, local, and federal governments to raise enough taxes to finance an increasing public demand for public services and entitlements that cause these large fiscal deficits, and the schizophrenia of an American public that hates high taxes but also wants public and social services—the trouble being that you cannot have at the same time public spending like in the social welfare states of Europe and low tax rates as under Reagan—at least the Europeans are willing to bear high taxes for the public services that they demand instead of living in the delusional bubble that both the government and the household sectors can live beyond their means, piling on more private and public debt.

The recurrence of financial crises—especially in the last 30 years (three big bubbles gone painfully bust since the 1980s) after a long 50-year period of relative financial calm following the reforms of the Great Depression—leads to the question of why these crises keep occurring in spite of attempts—after each crisis—to better regulate and supervise the financial system. Here I would like to develop a point that is only half fleshed out in Chris's analysis of U.S. households and governments living beyond their means and piling public debt on top of private debts; it is the role of rising income and wealth inequality in these financial crises.

Indeed, in the last 30 years there has been a large increase in income and wealth inequality in advanced economies. This rise is due to many factors: winner-take-all effects of an information society; trade integration of China, India, and other emerging markets in the global economy; knowledge and skill-biased technological innovation; rise in finance and increased rent-seeking and oligopoly in financial markets.

This increase in inequality led to a "keeping up with the Joneses effect": households in the United States and Europe could not maintain their living standards and spending and lifestyle goals as wages and labor incomes rose less than productivity, with the share of income going to capital and to the wealthy rising.

This rising inequality is the root cause of the American household tendency to spend beyond its means that Chris correctly bemoans in this book. Indeed, this inequality led to alternative policy responses in the Anglo-Saxon countries versus the social welfare countries of continental Europe. In the former group (United States, United Kingdom, Ireland, Spain, Iceland, Australia, and New Zealand) the response was one of democratization of credit that allowed households to borrow and spend beyond their means: the boom in mortgage and consumer credit (credit cards, auto loans, student loans, payday loans, subprime loans, and so on) led to a massive increase in private household debts that found it matching in the rising leverage of the financial sector (banks and shadow banks). This financial system leverage was abetted by reckless financial deregulation—repeal of Glass Steagall, non-regulation of derivatives, explosion of toxic financial innovation, rise of a subprime financial system, explosion of the shadow banking system. Since households, and the country, were spending more than their incomes, all of these Anglo-Saxon countries run large current account deficits financed by over-saving countries (China and emerging markets, as well as Germany and Japan). The explosion of private debt and foreign debt eventually became unsustainable, and led to the financial crisis of 2007 to 2009.

In continental Europe, the response was more that of a social welfare state: the governments spent more than their revenues and increased budget deficits and public debts to provide households with semi-free public services—education, health care, social pensions, extended unemployment benefits, and other massive transfer payments—as the slow-growing incomes did not allow private spending to grow quickly enough. This increased public debt was absorbed by households that maintained positive savings rates as the government was spending (dis-saving) massively, as well as by banks and other financial institutions. So the financial system piled on public sector assets (government debt) rather than claims on the private sector (as in the Anglo-Saxon countries).

In one set of countries you had an initial rise in private debts and leverage, while in the other group a rise in public debt and leverage. However, when private liabilities became unsustainable in the Anglo-Saxon countries—leading to an economic and financial crisis—you eventually had a massive re-leveraging of the public sector for three reasons: automatic stabilizers, counter-cyclical Keynesian fiscal stimulus to prevent the Great Recession from turning into another Great Depression, and socialization of the private losses. This third factor put many of the debts of the private sector (especially banks and financial systems, but also households and non-financial corporations) on the balance sheet of governments, as the fiscal costs of bailing out the financial system became very high. At the end of this cycle, the Anglo-Saxon countries ended up with large budget deficits and stocks of public debt as the democratization of credit and massive releveraging of the private sector (households and banks) became unsustainable.

Now we have problems of combinations of large stocks of private debts and public debts in most advanced economies: household debts, bank and financial system debts, government debts, and foreign debts. That is why crises will continue and we will have an era of economic and financial instability: households will default when their debts are unsustainable; governments will default when their debts are unsustainable; and banks and shadow banks will be insolvent because they are full of bad assets, including claims on the private sector in Anglo-Saxon economies and claims on the public sector in the social welfare state economies.

Thus, the problems of Greece and the Eurozone are only the tip of an iceberg of large private and public debts and leverage in most advanced economies. This implies a new normal of—at best—slow growth in advanced economies for the next few years as households, financial systems, and governments need to deleverage by spending less, saving more, and reducing their debts. At worst, if these deficit and debt problems are allowed to fester, we will get households defaulting en masse, governments going bankrupt, banks and financial institutions going bankrupt as their public and private assets go sour, and countries going bankrupt with more economic and financial instability. So the coming financial instability and economic crises, with the twin risks of deflation followed by inflation will be driven not only by the unwillingness to rein in—via proper regulation and supervision—a financial system run amok. They will also be driven by the deeper economic and social forces that have led to income and wealth inequality and a massive rise in private and public debts given the stresses of rising inequality and globalization of trade and finance.

So we can unfortunately say goodbye to the Great Moderation and hello to the era of financial instability/crises and economic insecurity. Chris provides us with a fascinating and deep financial history and road map of how we have gone through repeated cycles of great moderations followed by asset and credit bubbles leading to financial crises driven by excessive debt and leverage in the private sector (households, banks, corporate firms) leading to excessive public sector debt accumulation—via socialization of private losses—that leads to twin risks of outright default (usually by U.S. states) or use of the inflation tax through monetization of fiscal deficits (at the federal level).

The philosopher Santayana once said: "Those who cannot learn from history are doomed to repeat it." This deep study of U.S. financial history may help policy makers to avoid repeating the mistakes of the past; even if—in thoughtful Marxist spirit—one could argue that powerful economic, financial, and, thus, political forces drive these repeated cycles of boom and bust that study of history alone cannot prevent.

—Nouriel Roubini

Nouriel Roubini is professor of economics at the Stern School of Business at New York University and chairman of Roubini Global Economics (www.roubini.com).

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