PLUNDER AND BLUNDER

THE RISE AND FALL OF THE BUBBLE ECONOMY

DEAN BAKER

FOREWORD BY THOMAS FRANK

An Excerpt From

Plunder and Blunder: The Rise and Fall of The Bubble Economy

by Dean Baker
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Foreword

The economic history of the last decade is the history of asset bubbles. The pattern repeats itself again and again: the same industries, the same millennial rhetoric, the same crooked insider behavior, sometimes even the same individual players. Each time we convince ourselves that this is it, that tech stocks are going to make us all millionaires, that real estate never goes down but only goes up, and up, and up.

So the bubbles expand and burst, leaving trillions of dollars of destruction in their wake, and yet we refuse to recognize the essential similarity between the first one and the second one and, surely, the third one, which will no doubt take us all in a few years down the road.

Dean Baker's contribution is to point out not only the essential similarity between the dot-com bubble and the real-estate bubble, but also to historicize the phenomenon. For forty years after the end of World War II, asset bubbles were insignificant, while blue-collar workers participated in the country's prosperity alongside shareholders. Boom and bust were leveled out by a variety of regulatory devices.

With the atavistic economic policies of the Reagan, Clinton, and Bush years, however, the old ways have returned. Money flows irresistibly to the top, and along the way oversight is muted or compromised in some manner, professional ethics cease to restrain, conflicts of interest run rampant, and government becomes the property of those who can afford it. The accountants don't detect Enron's massive debts, and the bond ratings agencies miss the dangers of subprime mortgages. Firms backing the dot-coms press dot-com stock on their clients, even as the home appraisers work in confederation with the real-estate industry. The SEC simply misses the whole thing, while the chieftains of the Federal Reserve pooh-pooh the idea of an overheated real-estate market.

Accountability is as passé as independent-minded corporate boards. And not just in matters of executive compensation. Idiocy prevails from top to bottom. Managers book bogus profits to pad their own paychecks and eventually drive their companies into bankruptcy. Workers are laid off by the thousands; the managers who never saw disaster coming retreat to their castles with $100 million packages. Meanwhile, in the larger culture, we take stock-picking (and political) advice from the authors of *Dow 36,000*; we take real-estate advice from the author of a book called *Why the Real Estate Boom Will Not Bust*. Our most esteemed professional economists get it wrong again and again, and yet their day of reckoning never seems to come. The culture has been gamed as thoroughly as the financial system.

Dean Baker is one of those who got it right, and in this book he tells us exactly what we must do to stop the cycle from repeating itself yet again. Deflating bubbles must become one of the chief economic priorities of our regulatory system, and that system itself must be rebuilt, essentially, from the bottom up.

This time, let's listen to the man.

Thomas Frank

Introduction

For the second time this decade, the economy is sinking into a recession due to the collapse of a financial bubble. The housing collapse is likely to produce a recession that's far deeper and longer than the 2001 downturn caused by the stock-market crash. Because many more families own homes than have large stock portfolios, the collapse of the housing bubble is likely to affect the economic security of many more Americans. In short, this is a huge deal.

Good policy can ease the economic pain of the crash, but the tragic part of this story is how preventable it was. As was the case with the stock bubble, any competent expert should have recognized—and warned against—the housing bubble.

This is especially true for experts in policy positions, such as Federal Reserve Board Chairman Alan Greenspan and top officials in the Bush administration. Nothing they were doing between 2002 and 2006 was more important than reining in the housing bubble. Instead, they cheered it on, celebrating the growth in housing wealth and homeownership.

The failure was not just in government. Top executives in the **financial sector*** fueled the housing bubble in ways that probably would have landed less prominent citizens in jail. These executives pocketed vast sums of money while pushing their companies toward or into bankruptcy. While millions of families face the loss of their homes, and tens of millions have seen their life's savings evaporate with the plunge in home prices, most of the financiers responsible for this disaster remain fabulously rich.

The failure was also in the economics profession. With extremely few exceptions, economists ignored the growth of an $8 trillion housing bubble—an average of $110,000 for every homeowner in the country. For the most part, economists who focused on the housing market denied that any bubble existed. Their colleagues were more concerned with other problems: for example, the possibility that we might have to raise Social Security taxes in 40 years. (Never mind the fact that we did so in every decade between the 1950s and the 1990s.)

*The first instance of economic terms whose definitions can be found in the glossary are shown in a **bold typeface.**

A lack of attention to the housing bubble didn't stop top economists from praising the leading policymakers. In 2005, when the housing bubble was inflating rapidly, central bankers paid tribute to Alan Greenspan at their annual meeting in Jackson Hole, Wyoming. One paper discussed the proposition that Greenspan was the greatest central banker of all time.

One other group—the media—figures prominently in this story. Key news outlets presented the bubble promoters as experts on the economy. Even the most extreme bubble celebrants could count on a respectful hearing in these circles. James Glassman, coauthor of *Dow 36,000*: *The New Strategy for Profiting from the Coming Rise in the Stock Market,* was a regular columnist for the *Washington Post,* as well as a guest on the *NewsHour with Jim Lehrer,* in the months just before the stock market's 2000 crash. David Lereah, chief economist of the National Association of Realtors and the author of *Why the Real Estate Boom Will Not Bust and How You Can Profit from It*, was the most widely cited housing expert in major media outlets during the peak years of the housing bubble. Careful readers of the most respected newspapers and viewers of the top-rated news shows saw little information suggesting that stock prices in the late 1990s were seriously overvalued, or that real estate prices in this decade could fall sharply.

In short, the story of these financial bubbles is a tale of major institutional failures. The top corporate actors enriched themselves even as they drove their companies toward bankruptcy. The Federal Reserve Board and other regulatory institutions largely sat on the sidelines. Economists and the media promoted these bubbles, or at least ignored the danger of them popping.

This book is an effort to understand how these bubbles developed and how future financial disasters can be prevented. It is not an exercise in 20/20 hindsight. As I will show, it was possible to recognize these bubbles in time to avert them. A few of us did warn Americans about the likelihood of the problems we're facing now. We didn't have the same megaphone as a Federal Reserve Board chairman, a Treasury secretary, or even a *Washington Post* columnist, so these warnings had relatively little impact. But it would be wrong to conclude, as many would have us believe now, that it was beyond our ability to predict or avert these market meltdowns.

Beneath all the surface complexity of our current mess lies a basic story—not only of institutional failure, but also of energetic self-deception. Grasping that story is the first step toward preventing the next economic calamity.

CHAPTER 1

How We Got Here

There's nothing natural or inevitable about financial bubbles. They aren't like hurricanes or earthquakes. In fact, the stock- and housing-market bubbles of the last decade are largely the culmination of very human policy choices that began in the early 1980s.

For most of the three decades before that, the U.S. economy was strong and on solid ground. Between 1947 and 1973, the economy grew steadily, productivity increased rapidly, and the unemployment rate was low. Moreover, the benefits of that economic growth were shared widely. The real income of the typical family, for example, rose at a 2.8 percent annual rate during this time.[1] Given this record, most Americans believed that their children would have better opportunities than they did.

There were other signs of growing affluence. The share of families that owned homes rose from 55 percent in 1950 to over 64 percent in 1973. (Since then, the homeownership rate has only inched up modestly.) Cars became standard household items even for people with relatively modest incomes. At the beginning of the period, just over half of all families owned a car. By 1973, more than 83 percent of families did.[2]

Rapid **productivity growth** was the key to this broad prosperity. To appreciate the magnitude of this growth, consider the following: if we maintained the same rate of productivity growth the United States experienced in the early postwar era, we would be able to take an additional 24 weeks of vacation each year, or reduce our average workweek to 21 hours, and still have the same income in 2030 as we do today.

The postwar period had its social problems, so we shouldn't idealize it. In much of the country, racial segregation was entrenched in law until the mid-1960s and in social reality long after that. African Americans, Latinos, and other minority groups faced overt discrimination in employment, education, and housing. Discrimination based on gender and sexual orientation was standard practice, though the movements challenging such discrimination gained enormous strength through the 1960s and 1970s.

Despite these social problems, it was possible to say that things were getting better, at least economically. Broad prosperity worked for America. In addition to helping more families, it produced a kind of virtuous circle. Productivity gains were passed on to workers in the form of wage growth. Higher wages led to more consumption, which encouraged companies to invest in new plants and equipment. That investment increased productivity, which provided the basis for further wage growth. In this way, growth fed upon itself.

The stock market rose during this postwar period, but it never drove the economy. In the aftermath of the Great Depression, when Americans were more ambivalent about stock ownership, the percentage of Americans with stock portfolios grew gradually, as did public and private sector pension funds. By the end of the 1970s, these funds owned 18.5 percent of the stock market.[3] But the vast majority of Americans still had no other direct stake in the stock market. Their savings were mostly held in traditional pension plans or in old-fashioned savings accounts.

This was also a period of expanding home construction. An average of 1.56 million units were added to the housing stock each year between 1959 and 1973. Increases in home values in many parts of the country exceeded the overall rate of inflation, but many cities (including Detroit, Cleveland, and St. Louis) lost jobs and population, and house prices decreased there. On balance, inflation-adjusted house prices for the country as a whole actually fell by 12 percent between 1953 and 1973.[4] The country had solid growth and prosperity by any measure, but that growth wasn't driven by runaway real estate values.

The economy in those decades differed from the economy today in other important ways. At that time, the U.S. economy was far more insulated from international competition. Imports on average ranged from 4.2 percent of **gross domestic product (GDP)** in the 1950s to 7.6 percent in 1970. Much of that increase was due to the rise in oil prices. By 2007, the import share of GDP exceeded 17 percent.

In the early post–World War II period, the U.S. financial sector played a comparatively small role in the economy. This sector accounted for less than 6 percent of corporate profits in the late 1940s and averaged less than 10 percent in the 1960s. In its peak year in 2004, however, the financial sector accounted for more than 30 percent of corporate profits (see figure 1.1).

Part of the extraordinary growth in the financial sector was due to a simple rearrangement of tasks. Financial activities formerly carried out by the nonfinancial sector were contracted out to separate firms in the financial sector. For example, many small stores used to extend credit to their customers and send them monthly bills. Credit cards like MasterCard and Visa largely displaced this sort of store-based credit in the 1970s and 1980s, shifting profits from retail stores to companies in the

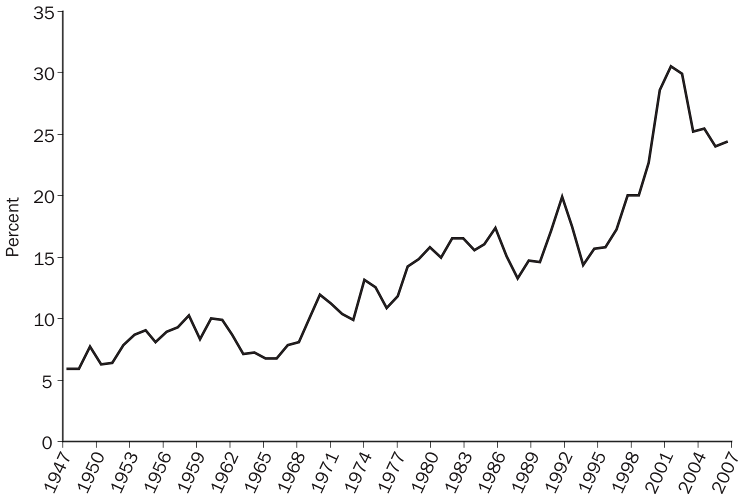

FIGURE 1.1 Financial Sector Share of Domestic Corporate Profits

Source: Bureau of Economic Analysis, National Income and Product Accounts.

financial sector. Similarly, it became more common for nonfinancial businesses to outsource accounting and various types of money management activities. This trend increased the size of the financial sector relative to the nonfinancial sector.

But the financial sector didn't grow only for these reasons. With the increase of computer power, the expansion of deregulation, and the internationalization of financial markets, the financial sector developed a qualitatively different character and became a major economic force in its own right.

Cheap computing power allowed for the proliferation of complex financial instruments that were previously impractical. For example, new forms of information technology made it easier to create **options** on a wide range of **commodities** and financial products, including stocks, treasury bonds, and currencies. These options, in turn, could provide a relatively low-cost form of insurance to companies and investors. For example, an investor who wanted to protect herself from the possibility that her shares of General Electric stock would fall in price could buy an option that gave her the right to sell her stock at a specific price. If the price of General Electric stock plummeted, the investor could take advantage of the option and protect herself against most of the loss. Of course, she would lose the cost of the option if the share price didn't fall, but insurance isn't free.

Such options provided a mechanism for placing highly **leveraged** bets, in which even small investors could rack up large gains or losses. As **derivative markets** expanded in the 1980s and 1990s, it became standard practice for companies to use these instruments to insure themselves against a wide range of possible risks, such as rises in commodity prices, fluctuations in currency values or interest rates, and defaults by borrowers. Speculators also used these instruments to make bets with large potential payoffs and risks. The most successful of these speculators accumulated vast fortunes on these highly leveraged bets.

Especially after the election of Ronald Reagan in 1980, many business interests and policymakers pushed successfully for the deregulation of financial and other markets. Many of the rules governing financial markets had been put in place after the financial abuses of the 1920s, which led up to the Great Depression. Deregulation or weakened enforcement meant that the old lines between commercial banks, investment banks, and insurance companies were blurred or disappeared altogether. Deregulation proponents argued that outmoded regulations put an unnecessary drag on financial markets, but in some cases, the deregulation efforts were even more costly. The deregulation of savings and loan institutions in the 1980s led to the failure of over 2,400 U.S. thrift institutions and cost about $560 billion, most of which was ultimately paid for by U.S. taxpayers. The bailout also contributed to the large federal budget deficits of the early 1990s.

Despite these high-profile debacles, the deregulatory zeal remained undiminished. The enforcement of clear boundaries between financial sectors weakened during this time, and the Glass-Steagall Act, which mandated separation between investment banks and commercial banks, was finally repealed in 1999. This allowed financial giants to operate in new markets and grow even larger.

The internationalization of financial markets also meant that vast pools of investment capital were made available to a new kind of financial operator. Previously, small and midsize firms might be taken over by outside investors, but these new sources of capital made it possible for relatively small groups of investors to take over even the largest firms. Takeover artists like Carl Icahn and T. Boone Pickens managed to buy up companies almost entirely with borrowed money. In these **leveraged buyouts (LBOs)**, the new management tried to cuts costs or sell off assets quickly to reduce its debt. Often the cost-cutting involved big layoffs, substantial pay cuts for remaining workers, and confrontations with labor unions. Frank Lorenzo, who specialized in airline takeovers, frequently sought such confrontations and replaced striking union workers with nonunion employees.

Several of the largest U.S. corporations were taken over through LBOs in the 1980s. If an LBO worked, the takeover artist took the company public again and sold shares for a large gain. If it didn't work, the company often went bankrupt, as was the case with several airlines taken over by Lorenzo.

With the advent of such takeovers, corporations changed the way they did business. Because they were vulnerable to takeovers any time their stock price dipped, corporate managers became far more concerned about daily share prices. Also, companies had to emulate the practices of the LBOs. A company that showed low profitability might trim its workforce for fear that it would be bought up by outside investors, who would then take this step themselves.

TRICKLE-UP ECONOMICS

After 1973, the U.S. economy began to change in other important ways. First, the extraordinary productivity growth of the postwar era came to an end. Economists are still debating the reasons for this productivity slowdown that began in 1973 and continued into the 1980s. One important factor was a huge increase in oil prices. Another likely factor was increased competition from Europe and Japan, whose economies had by then fully recovered from the destruction of World War II.

Whatever the causes, the slowdown in productivity growth meant that wage growth also stagnated. The typical family still saw rising income during this period, but much of that increase was the result of women entering the labor force in large numbers. The proliferation of two-paycheck families both masked and responded to that period's sluggish productivity and wage growth.

Something else changed in the U.S. economy after 1980. In the 1970s, the benefits of productivity growth, though small, were still shared more or less evenly. In the 1980s, productivity growth remained weak, but the benefits of that growth began to go almost exclusively to those at the top of the income ladder.

This upward redistribution of income was largely the result of conscious policy changes. One such change was the Reagan administration's campaign to weaken unions. That campaign had several different facets. First, the administration appointed people to the National Labor Relations Board (NLRB) who were markedly more pro-management than appointees of previous presidents of either party.[5] The Reagan administration also reduced funding to the NLRB, so that it developed a large backlog of cases. This meant that workers who filed complaints might wait years for their cases to be heard.

In 1981, Reagan also took the extraordinary step of firing striking air traffic controllers and replacing them with their military counterparts. He had the legal authority to take this action, because strikes by federal workers are illegal. But previous strikes by public sector employees hadn't led to mass firings. Soon, other major employers took the step of firing striking workers, and many other employers used this threat to end or head off strikes. As a result, unions lost much of their bargaining power.

Reagan also blocked increases in the minimum wage during his presidency. As a result, the real value of the minimum wage was eroded each year by inflation. In real terms, the minimum wage was 26 percent lower when Reagan left office in 1989 than when he took office in 1981.

Another Reagan policy indirectly undermined the living standards of middle-class workers. The large federal budget deficits of the Reagan years, coupled with the high interest rate policy pursued by the Federal Reserve Board, caused the dollar to rise in value against the currencies of our major trading partners. The higher dollar made imports from these countries relatively cheap for American consumers, but it also made it harder for American firms to sell their products abroad. This in turn led to the loss of many high-wage jobs in manufacturing, especially in the automobile and steel sectors.

Trade agreements signed in the 1990s also contributed to the upward redistribution of income. NAFTA (North American Free Trade Agreement) and other pacts were explicitly designed to put U.S. manufacturing workers in direct competition with low-paid workers in the developing world. In effect, NAFTA helped transfer U.S. manufacturing capacity to Mexico. Again, this was a conscious policy decision. Imagine what would have happened if, in the name of free trade, a deal was struck to put our most highly educated professionals—doctors, lawyers, and dentists, for example—in direct competition with their much lower-paid counterparts in the developing world. That would put downward pressure on their earnings, just as current trade deals put downward pressure on the earnings of blue-collar American workers.

Immigration policy has also been structured and enforced in a way that widens income gaps. Specifically, the lax enforcement of immigration laws amounts to an implicit policy of allowing undocumented immigrants to work in low-paying jobs. By increasing the supply of low-wage labor, this policy drives down wages for native-born workers who might otherwise hold these jobs. Again, less-educated American workers have faced competition in the labor market, even though the most highly educated workers have been largely protected.

Taken together, these policy changes hurt average American workers. Between 1980 and 1995, their real wages declined 0.9 percent. For workers lower down the income ladder, the situation was even worse. Workers at the 30th percentile of the wage distribution saw their wages decline by 2.7 percent after adjusting for inflation. Workers at the 10th percentile had a 7.5 percent decline in real wages over this period.

Other Americans profited handsomely during this time. Some of the big winners were professionals, CEOs, and Wall Street fund managers. The pay of CEOs went from 24 times the pay of a typical worker in 1965 to 300 times the pay of a typical worker in 2000.[6] This change was due to the breakdown in the **corporate governance structures** that had previously kept CEO pay in check. The top executives of major corporations were answerable to boards of directors, whom they often appointed. Corporate boards and compensation committees dished out sweetheart contracts to their allies, even when the performance of many of these executives should have earned them a pink slip. Wall Street fund managers did even better than CEOs, with the most highly paid among them earning hundreds of millions of dollar in good years. But even in the bad years, many fund managers made out fine.

The upward redistribution of income after 1980 meant that the economy couldn't sustain the same virtuous circle that characterized the postwar period. Wages weren't rising consistently, so workers couldn't buy more with their income. Even with more two-paycheck households, many families saved less and borrowed more to support their standard of living. The increased globalization of the economy, especially in the manufacturing sector, meant a weaker connection between increases in domestic demand and increases in investment in new U.S. plants and equipment. American firms could meet increases in demand with production from abroad, and many did. In short, policy changes during this period helped break the virtuous circle of rising productivity, wages, consumption, and investment.

More and more, the U.S. economy depended on something far less virtuous than productivity gains and broad prosperity. In pursuit of short-term growth, key institutions relied on risky bets and unsustainable policies. In short, we got hooked on bubbles.