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HOW MUSICAL LOANS ENDED ON A SOUR NOTE, AND HOW WE ARE LEARNING TO PUT THE NEEDLE BACK ON TRACK

"We have nothing to fear but fear itself." Franklin Roosevelt made that statement famous. It is a powerful phrase because it is succinct and because it captures the power of free flowing anxiety, a force that is insidious and relentless in its destructive effect. Whether you agree with his political philosophy or not, one would say that Roosevelt was an effective politician who knew the power of language and words. He understood that fear was powerful because it could not be quantified or limited, or contained mathematically.

Fear is powerful because we cannot put time limits on it, and we cannot confine it to certain subjects. Fear can immobilize those who were imprisoned by it. Roosevelt knew that fear can become most virulent and self-destructive when there is no plan of action, no agreement on how to tackle a stagnant or contracting economy, and no clarity about which actions to take to reinvigorate the economy.

The answer to fear is a plan of attack based on consistency and clarity. While it is easy to criticize both Democratic and Republican leaders for missteps which they have taken to get the economy going again, it is also important to remember that the intangible we call the economy is a complex organism with millions of parts and an often unpredictable chemistry. In any case, our leaders have made some promising decisions to fix what is wrong, decisions, which I shall analyze in this letter later on.

In the meantime, it may be instructive to review the forces that led to the recession that started in 2007 to see what the probable path of recovery is, and how, as we take steps to reform our institutions and to encourage private capital to take risks again, fear will succumb to action and a plan of attack.

Almost every boom witnesses increases in debt, low interest rates, and the use of esoteric financial instruments whose risk is thought to be understood at the time they are created or engineered, but whose real dangerous and risky substance are only apparent after these instruments have done their damage. Only after the dust has settled and the aftermath of excessive expansion is obvious do we often realize that we had misunderstood and mispriced certain financial instruments. The last boom, which began in 2001 and ended in 2007 , saw unprecedented increases in consumer debt, and the heavy use of mortgage backed securities, with many mortgages bundled together and packaged and with guarantees of payment of interest and principal by Freddie Mac or Fannie Mae.

Low interest rates encouraged aggressive lending and reckless borrowing, developments which quickly led to mountains of debt.

Banks relaxed lending standards in the last bull cycle so that the definition of creditworthy became hazy. Standards were so loose that bankers often did not verify income nor liabilities as they rushed to approve loans on million dollar houses to young borrowers who had barely graduated from college and were just beginning to enter the workforce.

Credit was cheap, it was easy to get, and the temptation to use it became hard to resist.

Many, seduced by an apparently inexpensive avenue to a lavish lifestyle, embraced a life of fantasy, perhaps irresponsibility. Who was to blame? Was it the borrowers, who exaggerated their incomes, and minimized their expenses, or was it the bankers who teased the borrowers with rates that started low, but jumped astronomically after a few years?

Sometimes it seemed as if the country was attending one big party, with the price of admission (low interest rates) encouraged by the Federal Reserve. It appeared that the party would never end, and that the music would never stop.
Borrowers and bankers were soon consumed by an orgy of debt creation as prudence and parsimony succumbed to overconsumption and mindless self-destructive risk.

The best party was in real estate where banks strove to outcompete each other with attractive offers to the would be homeowner. The most seductive merchandise was the adjustable rate mortgage which was designed to seduce the borrower with an artificially low rate , a rate that the bankers publicly and privately called a teaser. At the signing of the mortgage, the rate was low, but the buyer understood that it could be set higher a few years later, after banker and borrower signed off on the loan, and at a rate often multiples of the original rate, so that a naïve homebuyer would start at a thousand dollars a month and five years later would be faced with a three thousand dollar a month commitment.

The fact that the rate could jump significantly but the excitement of buying a new house with more space was a temptation too great to resist and the opportunity to enjoy some conspicuous consumption was a pleasure too powerful to forego.

Indeed, the borrowers found that bankers were quite adept at the teasing game. I have long known how skillful bankers are with teasing, and t hat is why I have never allowed bankers to tease me, even though I encourage other people to do so. People tell me that they like to tease me. I do not mind being teased. But I never let bankers tease me. It is too expensive.

The culture of over consumption or conspicuous consumption led people to buy over sized homes and to purchase suits and dresses that they never wore. These dresses and suits often found a permanent place in the closet, with their price tags still on.

Conspicuous consumption was not new. Nor was the concept of the leisure class. Thorstein Veblen understood both concepts well, as he demonstrated in The Theory of the Leisure Class, published in 1889.

> Veblen wanted economists to grasp the effects of social and cultural change on economic changes. In The Theory of the Leisure Class, which is probably his best-known work, because of its satiric look at American society, the instincts of emulation and predation play a major role. People, rich and poor alike, attempt to impress others and seek to gain advantage through what Veblen coined 'conspicuous consumption' and the ability to engage in 'conspicuous leisure.' In this work Veblen argued that consumption is used as a way to gain and signal status. Through 'conspicuous consumption' often came 'conspicuous waste', which Veblen detested. Much of modern advertising is built upon Veblen's notion of consumption. (*Wikipedia 2009)*

Often the homebuyer would not consider seriously the odds of tripling his monthly salary in three years, a tripling necessary to meet the mortgage when the monthly payment was adjusted. Eager homebuyers did not put up much resistance to the sophisticated teasing that the banks offered, as adjusted rates appeared to be so far into the future as to be nothing but fantasy. Furthermore, many

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