FINANCIAL MELTDOWN 2008
A Working Paper

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September 2008 brought to a head a financial crisis in the United States which quickly locked up financial markets and by shutting down vital sources of credit threatened to spread to product and resource markets and in turn to the entire global economy. Many commentators considered it the worst crisis since the Great Depression.

The meltdown was a long time in the making, having originated with defaults in sub-prime, adjustable-rate mortgages and spreading to giant investment banks in the United States and financial institutions elsewhere which had purchased huge bundles of mortgage-back securities on the promise of a return on their investment which would boost their bottom line. The crisis was further exacerbated by the development of credit default swaps that were intended to provide investors with insurance for any losses from borrowers unable to meet their obligations.

Federal government intervention came swiftly though clumsily as it searched for the right remedies. It settled on bailing out financial institutions thought to be too big to fail. A vocal minority urged the government to let the markets deal with the problem by eliminating failed institutions. Their pleas were swept aside.

In this paper we address the financial meltdown of 2008 in terms of eight questions. What went wrong? Who's responsible? What caused the meltdown? Are the assets toxic or the management? Why are banks still failing? How did AIG get tangled up in this mess? Are the economic fundamentals strong? How to deal with the public debt?

This is by no means the final word on the meltdown. Even so, it should help us understand better how it happened and how best to deal with it when it happens again. And it will happen again.

WHAT WENT WRONG?

What went wrong with U.S. financial markets and the real economy? A simple enough question, with a simple answer – gross human failure. Although specific examples of human failure abound, the reasons for that failure aren't so simple to track down. It's best to begin with the basics.

All economies are systems designed by and set in motion by human beings acting alone as individuals or together as either private groups or public agencies. To refer to the U.S. economy as a market system means that decision-making is vested primarily in individuals and to a lesser extent in private groups such as professional and trade associations and labor unions, and public agencies.

The market system functions well when economic agents act knowledgeably, rationally, fairly, and with restraint especially as regards self-interest. Share prices on stock exchanges move up and down depending largely on the underlying fundamentals of the public corporations whose shares are being traded.

***Greed* takes over when that restraint on self-interest is cast aside leading in the extreme to what the chairman of the Federal Reserve in 1996 called "irrational exuberance" -- a type of market failure in the sense that the underlying fundamentals of the corporations whose shares are being traded indicate that those shares are grossly over-valued. However, the opportunity to buy shares and cash in on the gains that derive from rising share prices**

which seem to continue indefinitely attract additional investors who drive prices even higher.

***Fear* takes over when shareholders begin to realize that the shares they hold in fact are over-valued and they must sell quickly before the price falls precipitously and wipes out their gains. This too is a type of market failure in the sense that panic selling drives share prices well below the prices that the underlying fundamentals otherwise would support.**

Financial markets dysfunction whenever human behavior is driven mainly by fear and greed, traits that are deeply embedded in human nature. Fear follows greed, which has morphed into irrational exuberance but is not a proper corrective for that greed anymore than another round of drinks cures a hangover. Personal restraint on self-interest is the proper corrective. In the past we called that corrective moderation. Libertarians including many mainstream economists today argue otherwise: "let the market sort through the problem by shaking out the losers whose own bad judgment got them into trouble in the first place." Their remedy can be characterized as a form of social Darwinism: the weak die, the strong survive.

While attractive to many, that solution presents one major problem. Those who behave responsibly may be taken down with those who acted irresponsibly, as with homeowners whose property has slipped in value because their neighbors got mortgages they could not afford, eventually defaulted and were pushed into foreclosure. Limits have to be imposed on stock traders because experience has shown that left unchecked greed and fear can trigger not just a financial market meltdown but also a collapse of the entire economy. Reasonable limits, for example on naked short selling and buying on margin (borrowing from a broker to buy stock), are necessary to assure orderly trading activity and in the worst case scenario to ward off a bloodbath like the Great Depression of the 1930s.

Individuals, private groups, and public agencies impose those limits. Individual investors are routinely instructed to exercise due diligence – carefully examining the details of an investment opportunity – before instructing their broker to invest their funds. Sadly, many did not and bought securities about which they knew little or nothing at all.

Private groups such as publicly traded corporations are required to have their books examined by independent auditors to assure their shareholders and the public that their performance is accurately reported. The same requirement applies to publicly traded financial institutions including notably investment banks and commercial banks. Here too there was a failure to exercise due diligence and assets were carried on their books, which initially were over-valued thereby inflating the institution's net worth. When it became clear that those assets were not producing the expected revenue stream, they had to be sharply lowered in value thereby reducing the institution's net worth, cash flow, and profitability. Inevitably the price of their shares tumbled, and for a small number of troubled commercial banks triggered a silent run – withdrawal of their deposits by electronic transfer -- forcing them to close or to be bought out.

In their eagerness to promote wider home ownership, Congress through its oversight committees failed to rein in the risky practices at Fannie Mae and Freddie Mac that purchased sub-prime adjustable rate mortgages on which borrowers simply could not make their monthly payments when interest rates and interest charges were ratcheted upward.

Some commentators assert that the current financial market crisis originates from too little regulation. Others hold exactly the opposite view. Strictly speaking, both are wrong. The central problem is that there has been widespread failure to *enforce* the limits already in place, limits on individuals, private groups, and public agencies.

One of the most important lessons of the current financial crisis is that regulation alone is not sufficient to control irrational exuberance or panic selling any more than a football rule against roughing the passer assures that quarterbacks will not be injured. What are necessary are strict enforcement and certain penalties for breaking the rule, breaching the limit, especially when it involves private groups or public agencies.

Nevertheless, just as quarterbacks are injured even with strict enforcement, so too financial markets sometimes will dysfunction even under a strict enforcement regime. Because human beings including those who practice moderation in their everyday affairs make mistakes and do no know and fully understand how markets change with new financial products and new global connections, enforcement can limit the damage but cannot prevent every serious dysfunction.[1]

Economic history teaches us that the one thing the market system cannot do is assure the financial security of everyone.

WHO'S RESPONSIBLE?

Who's responsible for the current financial crisis? The simple answer: Main Street, Wall Street, Capitol Hill.

***Main Street.* For signing mortgages without sufficient financial resources to meet the obligations inherent in those mortgages -- to make monthly payments as set forth in the terms of those mortgage documents.**

For writing mortgages without evaluating the applicant's financial resources, without requiring the usual 20 percent down payment, because the institutions writing those mortgages eliminated their risk by selling them to other financial institutions.

For bundling those mortgages and selling them to other financial institutions with an appetite for the high return promised but a blind eye for due diligence.

Who benefited? Low-income families, loan originators, building contractors, realtors, title companies, appliance, hardware, lawn and garden, furniture, and carpet stores, insurance and telecommunications companies, commercial banks … the entire local economy.

***Wall Street.* For selling insurance to the financial institutions holding those bundles of securitized assets in order to cover any defaults in the underlying mortgages.**

For embracing the accounting practice of "mark to market" which requires financial institutions to re-value their assets according to their current market value, even as the

[1] **See Kane [p. 1] in which he describes the current financial crisis as "a scandal of the highest order."**

market for those assets deteriorates precipitously, rather than valuing them according to the discounted value of the future cash flows of those assets.

For paying generous bonuses to Wall Street regulars on the basis of the short-term performance of their working units thereby reinforcing an incentive to boost performance by buying and selling risky financial instruments.

Who benefited? Investment banks, hedge funds, companies selling credit default insurance, directors of aggressive financial institutions, anyone especially senior managers of financial institutions whose compensation depends largely on year-end bonuses, sellers of luxury goods, expensive housing and furnishings, exotic leisure activities.

Capitol Hill. **For encouraging Fannie Mae and Freddie Mac to buy, hold, and re-sell sub-prime mortgages as a way of extending home ownership to families at the margin of the mortgage market who were drawn in by assurances that their homes would increase in value over time.**

For allowing Fannie Mae and Freddie Mac to lobby members of Congress, contribute to their re-election war chests, offer assurance that all was well, and thereby turn aside any further efforts to examine their practices more carefully and exercise their oversight role more diligently.

Who benefited? Fannie and Freddie shareholders and lobbyists, Congressional Republicans and Democrats.

This enormous financial house of cards began tumbling down when sub-prime mortgage holders on Main Street could not continue to make their monthly payments as their mortgages rates were adjusted upward and at the same time some were losing their jobs.

WHAT CAUSED THE MELTDOWN?

Defaults, foreclosures, surplus housing stock, decline in the demand for new housing and the construction jobs tied to that housing, loss of business for building suppliers, realtors, title search, mortgage, and property insurers. Decline in property values for those who own their homes free of any mortgage and those who continue to pay their mortgages on time. Loss of tax revenues to local, state, and federal governments.

Financial institutions use mark-to-market rules to write down the value of the mortgage-backed securities they hold on their balance sheets, and sustain operating losses because the anticipated flow of income from those toxic assets has not materialized. The market capitalization of those institutions begins to fall as traders sell shares in those institutions, and buy and drive up the prices of more attractive holdings such as gold, or oil, or government securities.

Given the extent to which these mortgage-backed securities are held by financial institutions large and small, banks are reluctant to lend money to other banks even as the Federal Reserve drops the rate of interest (the federal funds rate) one bank can charge for inter-bank borrowings. To get the cash they need to continue operating on a daily basis and serve their customer base, banks turn to the Federal Reserve to borrow money through the discount window. Private loans including loans to Main Street businesses made under the

condition that they are payable on demand are called in by banks which are short of cash on hand. As banks with large holdings of toxic, mark-to-market mortgage-backed securities are forced to report their financial losses to the public, some of their depositors become restless and decide to withdraw funds from their accounts. Banks with insufficient cash on hand to cover those withdrawals are forced to close their doors in many cases permanently.

The problem is that there is no ready market for the toxic mortgage-backed securities, which originated on Main Street, and therefore no way to trade them for cash on Wall Street. With the rescue plan recommended last fall by Treasury Secretary Paulson and modified by Congress, the federal government intended to purchase those securities from Wall Street by selling additional Treasury bonds in order to raise the cash necessary for the deal. When it became clear that this rescue plan wouldn't work because the banks and the Treasury Department could not agree on a price for those toxic assets, the plan morphed into direct cash infusions into the banking system.

The crisis is linear, systemic, with a downside feedback loop to match the earlier upside loop that fueled the bubble. The crisis is so massive that many experts think that only the federal government has access to the financial resources necessary to deal with it. Their mantra is "too big to fail." Others object to this view arguing that massive government intervention leads inevitably to government control of the banking system and through it the real economy. They insist that the best remedy, harsh though it may be and even when it hurts those who conducted their financial affairs responsibly, is to let failing institutions fail and rebuild the system on the foundations of the surviving institutions.

ARE THE ASSETS TOXIC OR THE MANAGEMENT?

As we have just indicated, months after the financial crisis came to a head last fall and the federal government intervened to rescue the banking system, banks still were loaded down with and frozen by toxic assets. Bankers are reluctant to confess that they even hold such assets for fear it would frighten the public and correspondent banks. The government is afraid of paying too much for those assets and saddling the taxpayer with more debt or paying too little and further draining the net worth of the troubled banks. In other words, what's the right price for toxic assets in a market where buyers and sellers are holding back and therefore the exchange process has broken down and banks are trapped by their own toxic assets?

Let us assume, for the moment, that the government buys those assets at a price that is acceptable to taxpayers and bank stockholders. Does that solve our problems with the banking/financial sector?

Sadly, it does not. Those assets were purchased by senior executives who were eager to pad bank revenues with the enhanced earnings to be gotten from holding those assets but who did not investigate the quality of those assets carefully enough and seriously underestimated the risk involved. They did not know what they were buying and failed tragically to exercise due diligence and practice the required moderation.

Does capping the annual compensation of senior executives at $500,000 as a condition for getting monies from the Treasury solve the problem? *Yes*, if the salary ceiling shames them into changing their ways. *No*, if it leaves in place precisely the management, which got us

into this problem, and the directors who failed to protect the interests of the stockholders. To illustrate, if senior executives had rejected those assets when they were offered and directors had insisted on following that course of action, mortgages would not have been made available to persons/families who could not afford to make their monthly payments, housing prices would not have been inflated, the defaults which followed would not have taken place, the housing bubble would not have developed, and the credit freeze would not have happened because banks would have continued to trust one another knowing that due diligence and moderation protected them against collapse. The current crisis was set in motion by human beings and will take humans to put the proper remedies in place.

We need to transform the senior management and directors, either by replacing them outright or changing the way they operate. If we decide to replace the senior management and directors, will we be able to find trustworthy and competent replacements to assume the management and direction of those problem-banking institutions? Would those replacements not be drawn from the very same institutional culture, which boosted performance, by reckless decision-making rewarded and reinforced by huge bonuses? What would keep the expelled senior executives from simply finding work at other banks?

If these people indeed cannot be replaced, how do we change the institutional culture so that sound judgment and steadfastness are restored and recklessness and greed are driven out? This is the age-old question, which has puzzled humankind since the ancient Greek philosophers. At this very moment, we face a terribly troubling dilemma: leave the senior management and directors in place and risk a repeat performance or replace them and risk poor performance.

There are two factors working in our favor: fear and role modeling. Some senior executives and their junior-level colleagues can be frightened into changing their behavior by severely punishing the ones who have most egregiously violated the public trust. Today that would be the men who have amassed enormous wealth through ponzi schemes. They must be publicly disgraced, stripped of their holdings to the full extent possible so that their victims can recoup their investments to the full extent possible. And they should be prosecuted with no plea-bargaining and no "country-club" imprisonment. Upon release they should be banned for life from owning, working in, or serving as a director of a financial institution. Likewise for those elected officials sitting on Congressional oversight committees and public regulators who have either pushed the financial institutions under their supervision into risky behavior or turned a blind eye to clear abuses.

Other bank executives can change their behavior by the role-modeling of superiors and mentors who are recruited from the pool of retired military officers whose lives have been shaped and formed by the six articles of the military code of conduct and by duty, honor, and country. Other high-level replacements can be drawn from the senior management of regional banks and local banks who have steered their institutions away from the false promises offered by bundles of high-risk assets.

Reforming and reconstructing our banking institutions in a one-time effort which assures that the current crisis will not happen again is doomed to failure. Recall a similar mess in the 1980s with U.S. savings and loans, which in a reckless pursuit of higher returns from risky investments collapsed under the weight of bad loans. It follows that reform efforts must be ongoing in order to change a dangerous and ultimately dysfunctional institutional

culture. To extend Thomas Jefferson well-known admonition, "eternal vigilance is the price of freedom, fairness, and security in financial affairs."

Finally, there is nothing fundamentally wrong with being paid handsomely for work done well and nothing intrinsically right about imposing a ceiling on the compensation of senior executives. The financial gains from work done well are the stuff which makes possible sharing and caring for others. There are more than one million public charities and private foundations in the United States which in the end not only rely on contributions from persons who have earned their financial rewards but also provide opportunities for their donors to transform financial gain into human virtue. And virtue, to the ancient Greeks, is the secret of the good life. The Treasury may find a way to remove toxic assets from bank balance sheets but unless virtue somehow is infused into the system there is no way to get rid of a toxic culture poisoning the ranks of senior bank executives.

WHY ARE BANKS STILL FAILING?

Last September a fire broke out in the U.S. banking system which overnight threatened to engulf not only the entire U.S. system but also banking systems elsewhere linked in a network of agreements, transactions, and mutual dependencies. An alarm was sounded and fire department personnel and equipment arrived on the scene but learned quickly they were not prepared for the kinds of combustible materials (derivatives) fueling the fire.

Containment was their immediate objective. A massive response was launched focused on combustibles (TARP first tranch with backup from FDIC) but nothing worked and the fire continued to rage out of control. Next they sprayed enormous volumes of water over the entire structure (TARP second tranch with FDIC backup) hoping that effort would suppress the flames, which by then were igniting fear and anxiety around the globe. It didn't help that last January the senior firefighting team (Treasury) was being replaced while the fire had not yet been contained. Further heightening fear and anxiety were arsonists who enjoyed playing with fire (ponzi schemes) to enrich themselves at the expense of their investors.

Containment was achieved but the still smoldering combustible materials stubbornly resisted efforts to snuff them out forcing fire crews to remain on the scene months after the initial breakout. Managers of other structures in the system not immediately threatened by the fire was persuaded to let firefighters spray water on their structures on the premise that a little water (TARP Capital Purchase Program) would encourage them to step up their efforts to get credit flowing again.

Efforts to deal with the smoldering combustibles by hauling them away failed because no one could figure out how much to pay the haulers for removal services. Another suggestion was made to haul out of the damaged structures any and all materials of value yet untouched by the flames and to let those structures and combustible materials burn themselves out. That suggestion, however, has gotten no traction. Most recently, the damaged structures, which hold those combustibles, are being forced by the legal system to retrieve them, clean them up, and make them viable (mortgage cram-down) even at the risk that they may become combustible again.

Fire inspectors report that the blaze which since January 2008 has consumed 51 banks started in the sub-flooring long before it broke out in September [FDIC 2009a, pp. 1-2]. In

spite of warnings from the fire prevention bureau, negligence on the part of senior managers eager to pocket the fees for holding the combustible materials and by building code enforcers willing to turn a blind eye to that negligence made it easy to accept and store those materials. Ignition came suddenly and unexpectedly from large numbers of cash-strapped homeowners defaulting on their mortgages.

A few powerful persons advocate repairing the broken financial system by nationalizing the banks, putting them under direct government control. But that's like asking firefighters to remain at the site, demolish the structures, and build others in their place. Opponents object to this remedy arguing that when the fire is out, firefighters should withdraw and leave the rebuilding to competent and trustworthy financial specialists who know best how to rebuild the system. However, the few who would nationalize the system are supported by the many who are persuaded that government knows best. Today there are 305 banks on the FDIC list of "problem banks," up from 252 at the end of 2008 [FDIC 2009b, p. 1] and the issue of bank ownership and control remains unresolved.

Just as the fire prevention bureau attempts to educate the public about hazards such as overloaded electrical circuits, blocked exits, and natural gas leaks, the general public needs to be better informed about the risks involved in financial ventures especially as new financial instruments such as credit default swaps are developed. The problem is that the U.S. financial system continues to operate with a fire prevention bureau that functions on just one broken principle – *let the buyer beware*.

Negligence in storing combustible materials and in building code enforcement, not to mention arson, is a felony punishable by imprisonment. Those who were negligent, whether they are bank executives, regulators, or members of Congress on financial oversight committees, should go to jail. Removing the perpetrators is necessary in order to *reduce* the risk of a similar financial collapse in the future. Even so, there is no way to assure that a fire will not break out again even if the entire system were nationalized because the smartest and best-intentioned human beings can and do lapse into ignorance and negligence and are too easily enticed to reach for a deal that is too good to be true.

HOW DID AIG GET TANGLED UP IN THIS MESS?

The insurance giant American Insurance Group got tangled up in the financial market meltdown through its financial products division which developed and sold credit default swaps to insure buyers that whenever they suffer a loss due to default on the assets they hold AIG would cover their losses. The premise on the part of AIG is the usual insurance premise: the funds taken in by selling insurance protection will be more than sufficient to cover the claims made for losses suffered. In other words, AIG makes a profit as long as normal conditions prevail in financial markets.

Banks purchased this insurance to protect themselves against defaults on their holdings of mortgage-backed securities and other assets. Municipalities purchased credit default swaps to insure that they would be able to pay their bondholders in the event of a fiscal crisis brought on by an economic downturn. When AIG's operating premise collapsed, it was not able to pay in full the amount owed to its insurers holding toxic assets. The huge government bailout of AIG which amounted to $170 billion [LaCapra, p. 1] allowed AIG to make good on those claims and protect its customers from collapse.

Ironically AIG actually saw its own collapse on the horizon. In its Form 10-K filed with the Securities and Exchange Commission in February 2008 the company stated that its "procedures may not be fully effective in mitigating risk exposure in all market conditions, some of which change rapidly and severely."

The public outrage over bonuses paid to AIG employees reflects at the gut level some basic ideas of justice governing exchanges between buyer and seller, worker and employer, and others in a market system. Simply put, justice demands that both parties to any exchange are to trade things of equal value and impose equal burdens on one another. This principle applies in all exchanges whether sealed by a written contract or not.

Parents teach this principle to a child who takes a piece of candy off the store shelf by insisting that the shopkeeper must be paid or the candy returned. It is violated by price gouging and shoplifting in the marketplace and embezzling and pilfering in the workplace. Nevertheless the fact that these practices and others are condemned as illegal confirms the principle and teaches the importance of compliance. *Let the buyer beware* is no substitute for this commonsense principle.

In the marketplace, justice demands in most cases at the point of sale when the seller transfers the item to buyer that the buyer is obligated to make payment in full. Commonly this transaction involves no written contract. Even so, the demands of justice apply. If the item is defective, the buyer usually can expect to return it to the merchant for a refund or for exchange with an equivalent item. If the buyer pays with a worthless check, the seller has legal options to recover the full amount owed. The rule is that a defect in the exchange voids the contract. The contract *per se* is not sacrosanct.

One major exception to the strict application of this principle involves the sale of a big-ticket item such as an automobile or house where the buyer cannot make payment in full at the point of sale, borrows the money, and repays the lender over time. Those payments in the future include interest to cover the lender's risk that the borrower may default and the risk that inflation may erode the value of the money when it is repaid.

In the workplace, the employer is obliged to pay the worker promptly for the work performed. If the employer fails to make payment as agreed, the worker can sue the employer for unpaid wages. If the worker fails to perform as agreed, the employer can adjust the wage downward or fire the worker. Virtually every employment contract, whether written or strictly verbal, calls for performance evaluation as a way of affirming that both parties are being faithful to the terms of the contract. Common sense alone tells us that there must be a tight linkage between performance and pay, that there must be some equivalence between the work done and the wages paid.

This is the nub of the problem, at least the public perception of the problem, regarding Wall Street bonuses in which AIG was contractually obligated to pay $165 million to certain employees in the financial products division. Is there an equivalence between the work done and the compensation paid these employees? Judging by AIG's collapse as a viable company, there clearly were *serious mistakes in risk management* made by senior AIG executives, notably with credit default swaps, which required AIG to make payments to their clients who purchased this product to insure themselves against the risk of defaulting on their obligations to their debt holders.

One public commentator trying to dismiss the AIG bonus issue described it as a "pimple" on the face of an enormous bailout package and urged President Obama to apply himself to more important matters. This argument misses the point. The AIG bonus controversy is not about the money so much as it is about the underlying principle which demands equivalence in exchange.

This principle is critical to a properly functioning market economy. Without it all manner of abuses including the ones previously mentioned are tolerated and become commonplace. This in turn weakens compliance with the other principles of justice regarding the relationships between a superior and his/her subordinates and between a member and the group to which that person belongs, leading to other abuses such as discrimination, bribery, insider trading, and insurance fraud, and shaking the foundations of a market economy. Subsequently it came to light that one prominent U.S. senator lied about his role in changing the language of the stimulus package which allowed AIG to pay retention bonuses.

The Wall Street bonus system needs overhauling because what happened at AIG is not an isolated incident. It is commonplace to pay bonuses even when there is no evidence that the compensation paid to an employee matches that person's own performance or the performance creates any lasting value for the company. The bonus is paid to keep them from leaving and that's why it's called a retention bonus. In strict ethical terms, it really is extortion in which corporate managers, employees, and directors in effect form a conspiracy to fleece the stockholders because they are being paid twice, the first time for work done poorly, the second time for cleaning up their own mess. In the case of AIG they are fleecing the U.S. taxpayers who hold about 80 percent of the shares of the company.

Even though these contracts strictly speaking conform to the letter of the law, in ethical terms a contract arranged through a conspiracy is not valid and we should not hesitate to set it aside. A contract must be grounded on firm ethical principles if it is to be sustained. Otherwise, the contract and the law by implication endorse abuse in economic affairs.

The bonuses paid under the terms of those contracts are much more than a pimple on the face. They are a malignant tumor.

ARE THE ECONOMIC FUNDAMENTALS STRONG?

The U.S. economy is like an aging, overweight left tackle on the offensive line. Big but not strong. Not willing to watch what he eats and drinks and maintain a vigorous off-season training regimen. No longer quick enough to protect his right-handed quarterback from a younger, trimmer, stronger defensive end attacking from the blind side. Reluctant to retire and give up his hefty salary and the hope of winning a Super Bowl ring.

The economy is a human system and as with any system built and operated by humans such as the judicial system, the military system, the educational system, it depends critically on the underlying culture – the totality of ideas, beliefs, convictions, ideals, values, principles shared by a people and expressed through their language, customs, music, art, religion, rituals, practices, mannerisms. Standing and singing the national anthem before a sporting event is deeply embedded in the American culture. So too are gifting the bride and groom at their wedding reception, attending worship service on the Sabbath, allowing an adversary to speak without interruption, enjoying turkey dinner with the family on

Thanksgiving, paying one's respects to the family of the deceased. The fundamentals of the U.S. economy are not strong because they have been undermined by a culture that increasingly is coarse and corrosive.

The culture shapes and forms everyone raised and conditioned within its reach and in turn is re-shaped and re-formed by each new generation. Human beings as economic agents in effect carry that culture with them like a purse or wallet into the marketplace and the workplace. Notice, in this regard, the historical importance to the U.S. economy of getting to work on time, recognizing the customer as always right, treating superiors, subordinates, and peers with respect, demanding no more than what is owed and giving more than what is required, sealing an agreement with a handshake, delivering in full according to the terms of the agreement, putting in extra time and effort when the company faces a deadline or crisis.

Consider, however, the following ways in which the American culture and the economy have changed and in our opinion have become coarsened and corroded.

► Luck not hard work is the key to success. A sign over every casino reads "abandon hard work all ye who enter, you're going to get rich today with the roll of the dice, the turn of a card."

► At the university, athletics competes with learning for resources. If fundamental values are expressed in financial terms, what does it say about U.S. universities that nearly all of the football coaches of the top teams are millionaires?

► Whatever is legal is ethical. If there is no law that prohibits an action or practice, not to worry, just do it.

► No pay is okay. If you *want* something like designer clothes or jewelry, you can have it even if you can't afford it. If you *need* something like housing or emergency room care, you have a right to it even if you are unable to pay for it. Millions of Americans file for bankruptcy every year because they are overwhelmed by credit card debt and other bills they cannot pay. Others pay a premium for their purchases to cover debts that have been dismissed through bankruptcy.

► Death is the answer. When nothing else is effective in resolving a problem, death is the answer. Shooting sprees in the workplace, in the classroom. Growing acceptance of the idea that there is a life which is not worth living, of physician-assisted suicide, of mercy killing, murder-suicide and, with a shrug of the shoulder, gangbanging.

► Public officeholders are a privileged class. Power, influence, and money drive decision-making in public affairs where all three are worshipped. The results are incumbents holding on for decades with little or no concern for the public good.

► Scapegoat your problems to someone else. If you're a Democrat, the Republicans did it. If you're a Republican, the Democrats did it. If you're a reformer, insiders did it. If you're a worker, the boss did it. If you're a boss, the union did it. If you're a teacher, parents did it. If you're a preacher, the devil did it. If you're ultra-conservative, fluoridation did it. If you're far-left liberal, Wall Street did it.

► "Gotcha" is all that matters. Attack, intimidate, misrepresent, ridicule, demean, smear, and lie are becoming the dominant language of our public discourse.

► There's a drug for any ailment. Wet or dry, injected or ingested, legal or illegal, there's a drug available to address any human problem. And to make access easier, there's a government program to either provide or pay for many of those drugs.

To connect our comments on culture to the performance of the economy, visualize the economy as a twin-engine aircraft, which flies higher, faster, with a heavy payload when both engines operate at maximum efficiency. One of those engines represents the energizing force of competition, the other the driving force of cooperation. The plane's control surfaces such as its flaps and rudder allow the pilot to handle the aircraft in flight. In this analogy those surfaces stand for the limits imposed on the economy by public agencies such as the Federal Reserve, SEC, OSHA, which help assure the safe functioning of the system. The pilot represents business leaders notably entrepreneurs who decide where the economy is headed and which route to take to its final destination.

The engines operate on a fuel supply, which represents the credit available through the financial sector. At this very moment, the huge financial crisis still threatens the entire economy in just the same manner as contaminated fuel threatens an aircraft in flight. The immediate problem for the crew is how to siphon off the contaminated fuel while the aircraft remains in flight and replace it with clean fuel. The fuel became contaminated by human failure in the refining, transportation, storage, or handling of the fuel as it was being pumped into the aircraft's fuel tanks.

Similarly, today's financial crisis is directly attributable to human failure in mortgage origination, securitization, trading, and asset valuation, brought on ultimately by a new cultural environment that has tossed aside the tried and true practices of the past. Those toxic mortgage-back securities slowly are being removed from the financial system by the de-leveraging process. In the end a public agency or private party will acquire them, hold them, hope to re-sell them later when normal, stable conditions return to financial markets, or will simply write them off. The contaminated fuel, in other words, must be reformulated to make it usable again or dumped.

For years and on many occasions, John Paul II warned the west of its downward spiral into a culture of death and despair, to which we add crippling dependency. We are seeing the consequences of that descent in current economic affairs. All is not lost, however, if only we would accept his admonition and embrace once again a culture of life, hope, and personal responsibility. It can be done, but it won't be easy.

HOW TO DEAL WITH THE PUBLIC DEBT?

Financial news commentators tell us more than we really want to know about our deeply troubled economy. A banking system on life support requiring billions of dollars of taxpayer monies simply to survive. Stock, bond, and commodity exchanges which in the twinkling of an eye wipe out a baby boomer's retirement nest egg. A federal government piling deficit spending on more deficit spending assuring that our grandchildren will be saddled with huge interest payments for years to come. A health-care system which every day produces new miracles of human survival and recovery all the while laboring under a reimbursement system that threatens its very foundations. An economy which produces

more than $14 trillion in goods and services every year and yet Americans are afraid that the system will fold like a house of cards. A culture in which state governments justify the lottery and casino gambling on grounds that the public revenues are needed to support education.

The public debt of the United States on January 1, 2008 was 9.2 trillion; today it stands at 11.4 trillion [Treasury Direct 2009a, pp. 1, 9]. Since the end of World War II, that debt has increased every year except 1946-47, 1947-48, 1950-51, 1955-56, and 1956-57 [Treasury Direct 2009b, p. 1; Treasury Direct 2009c, pp. 1-2; Treasury Direct 2009d, pp. 1-2]. Since then we've had more than 50 consecutive years of deficit spending. Consumer debt today totals $2.6 trillion [Federal Reserve, p. 1]. Since every taxpayer is also a consumer, the total debt load is $14 trillion. What can we label this mountain of debt other than a serious addiction to debt?

I propose the following 12-step recovery program to address our addiction problem. In the following, economic recovery is defined as a monthly unemployment rate of 4.9 percent for the United States -- the jobless rate in January 2008 when the downward slide in jobs began.

1. **Suspend all new government mandates, such as tougher automobile emission standards, until the U.S. economy and the auto industry have recovered.**

2. **Approve no new refundable tax credits -- a welfare check in disguise -- until the monies in the stimulus package are fully expended. .**

3. **Turn off the flow of funds from the stimulus package when the economy has recovered.**

4. **Allocate bank bailout money only to those banks on the FDIC list of "problem institutions." Require banks which have taken TARP monies but are not on that list to return those funds immediately.**

5. **Initiate a binding national referendum on the debt ceiling every presidential election year. The ceiling presently is set by Congress and raised whenever it engages in deficit spending.**

6. **Lay out a schedule to pay down the public debt with a one percent tax on all credit card transactions imposed at the point of sale and collected from credit care companies. This action will have the intended secondary effect of getting credit cardholders to think again before running up their personal debt.**

7. **Require a two-term president to balance budget deficits with budget surpluses over his/her eight years in office, thereby adding nothing more to the public debt. In this matter Congress may not drag its feet.**

8. **Reject any federal or state legislative initiative to make filing bankruptcy easier.**

9. **Put all new highway construction on hold until every bridge in the United States is safe to use.**

10. Approve no new welfare programs for persons/families above 200 percent of poverty.

11. Suspend all new public expenditures on stadia and arenas and all current subsidies for professional sports teams until economic recovery has been achieved.

12. Prosecute members of Congress for the mistakes and failures of the public agencies for which they have direct oversight responsibility.

When it works, a 12-step program does not get rid of the addiction, it separates the user from the addictive drug. Further, it does not assure that the addict will never again succumb to his/her addiction. Nor does it assure that our children and grandchildren will not become addicted. But it's a start. Even Federal Reserve chairman Ben Bernanke [p. 3] agrees that it's time to start.

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