ops expectations of government rescues, it loses the healthy fear of financial failure. This leads directly to excessive and reckless speculation—a condition known as moral hazard.

Historically, excessive greed, recklessness, and foolish speculation were punished by the market. Speculators lost their capital, their reputation, and their influence. (Back in the days when skyscrapers had windows that opened, some even lost their lives.) Their pools of cash migrated to people who handled risk in a more intelligent fashion. This is—or perhaps was—the great virtue of capitalism: money finding its way to where it is treated best. Capital gravitates to those who can balance risk and reward, who can obtain positive investment results without "blowing up." It's no coincidence that the largest venture capital firms, the biggest hedge funds, and the longest-lasting private trusts know how to manage risk. They preserve their capital. They have a healthy respect for losses, and strive to keep them manageable. They do not, as so many have done recently, put all their money on a single number, spin the roulette wheel, and hope for the best.

The present system has lost its autocorrecting mechanism. As economist Allan Meltzer noted, "Capitalism without failure is like religion without sin—it just doesn't work." While the profit motive is alive and well, with rewards potentially in the billions of dollars, for some, there is no corresponding and offsetting risk

Chapter 1

A Brief History of Bailouts Pre-1913

Au: title ok? period discussed ends much later than 1913

The national budget must be balanced. The public debt must be reduced; the arrogance of the authorities must be moderated and controlled. Payments to foreign governments must be reduced if the nation doesn't want to go bankrupt. People must again learn to work, instead of living on public assistance.

—Cicero, 55 BC

Image to come.

Figure 2-1 Federal Reserve Act of 1913 via Boston Federal Reserve

Is Boston Federal the source for this?

Chapter 4

Industrial-Era Bailouts (1971–1995)

When things are going well, the companies stress the idea of free enterprise, with no need for Government regulation. But when things aren't going well, they suddenly become a close partner with the government and want it to bail them out. All they have to do is threaten to collapse and the government pours in more money.

—A. Ernest Fitzgerald
Civilian cost analyst and
Management Systems Deputy
to the Air Force Assistant Secretary
for Financial Management

Chapter 6

The Irrational Exuberance Era 1996–1999

[The Fed chairman's job is] to take away the punch bowl just as the party gets going.

—William McChesney Martin, Jr.

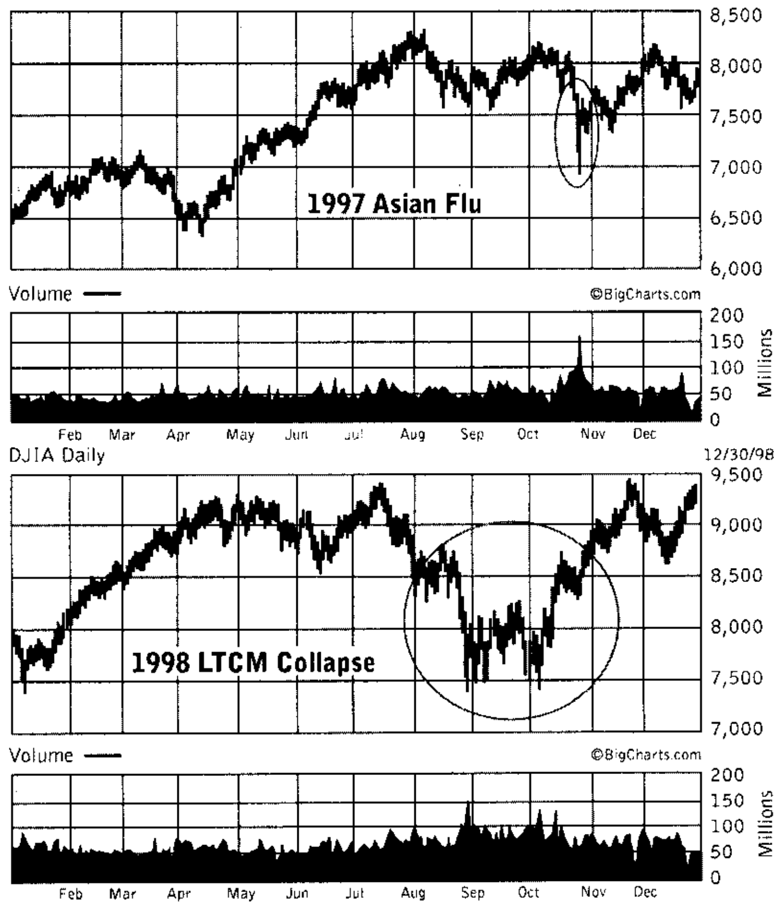

Figure 6-1 1997 Asian Flu, 1998 LTCM

Au: Supply in-text reference to Figure 6-1

Thus, Wall Street was exposed to many of the same risks throughout 1998. When Russia defaulted on its debt in August of that year, spreads on emerging market bonds not only didn't revert to "normal" levels, but continued to widen. The widening credit

them another 25. A scheduled Fed meeting on November 17 brought yet another quarter-point cut. In about seven weeks, "Easy Al" lopped off 75 basis points from the fed funds rate.

The statement after the November cut was unusually telling: "Although conditions in financial markets have settled down materially since mid-October, unusual strains remain."[6]

Thus, the Greenspan put was born.

About the same time Easy Al was cutting rates that September, William J. McDonough, the president of the New York Federal Reserve Bank, was having a little get-together one Tuesday evening at the Fed's fortresslike building on Maiden Lane. He called for a meeting of the *patresfamilias*—the heads of the 16 largest banks, along with the New York Stock Exchange chairman. The discussion was over what to do about the imminent collapse of Long-Term Capital Management.

Roger Lowenstein's narrative When Genius Failed is a fascinating read for anyone interested in the grisly details of LTCM. For our purposes, we need only note that

1. The Fed was cutting rates.
2. The Fed was using its authority and prestige to help work out the demise of a private partnership.

The central bankers jawboned the 14 largest banks—with the notable exception of future bailoutee Bear Stearns—into kicking in $3.65 billion to buy out the assets of LTCM. These included leveraged assets of over $100 billion and derivatives with a notional value of more than $1 trillion.

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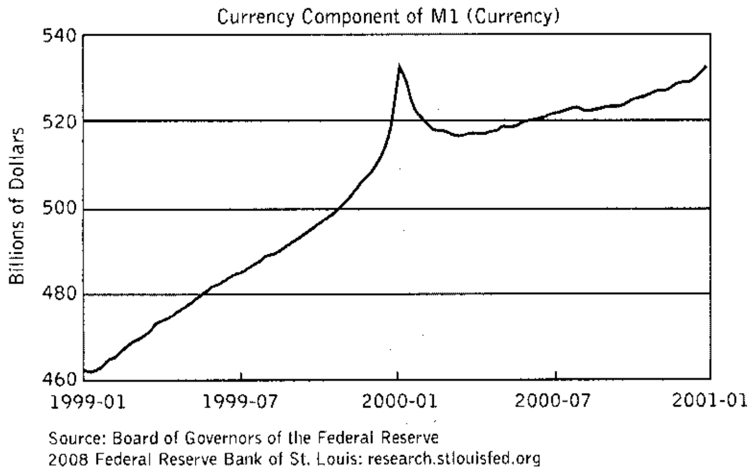

Figure 7-2 **Is U.S. currency still good at the end of the world? If it is, can anyone break a $20?**

2,600 to over 5,100. It was a 100 percent gain in only half a year. There simply was no precedent for anything like this in stock market history.

It was the perfect setup for the coming "blowoff top."

The final up-leg of a bull market often takes the form of a "blowoff top." This occurs when the merely absurd becomes the utterly ridiculous. Blowoff tops occur when stocks (or indexes) make all-time highs, sucking in the last of those spectators who had been sitting idly on the sidelines.

In 2007, for example, China's Shanghai Stock Exchange (SSE) index had a blowoff top, rocketing from 1,200 in 2006 to 6,400 by October of 2007. The Shanghai had gained an unsustainable 100 percent plus year-to-date. A year later, it was back at 1,800, a tumble of 71 percent.

Au: If numbers given are correct, this is more than 400%; should you say so explicitly?

In 2008, crude oil had a similar blowoff top. During the summer, crude peaked at over $147 per barrel. Before year's end, it had plummeted more than $100 a barrel, falling 69 percent to $46. Such is the nature of speculative tops.

Y2K came and went. The clocks rolled over on December 31, 1999, without incident.

Markets pulled in a bit in January, then made new highs. After some backing and filling, the Nasdaq resumed its record-breaking pace in February. Thus, 2000 looked to be yet another good year. From 3,600, the index gained another 35 percent over the next six weeks, breaking 5,100. But there were some residual effects of the Y2K bug that would soon be felt.

Corporate America had just completed a massive technology upgrade. It had essentially rebuilt its entire IT infrastructure over

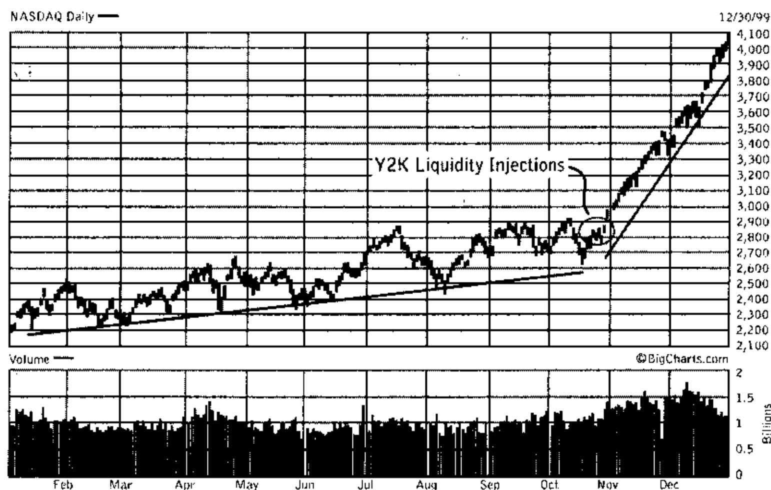

Figure 7-3 Nasdaq, 1999

AU: supply in-text reference for this figure

Table 7-1 2001 Rate Cuts

Date	Federal Funds Rate	
	Change	New Level/Range
2001		
December 11	−¼	1¾
November 6	−½	2
October 2	−½	2½
September 17	−½	3
August 21	−¼	3¾
June 27	−¼	3¾
May 15	−½	4
April 18	−½	4½
March 20	−½	5
January 31	−½	5½
January 3	−½	6

revisionism is factually incorrect. As the record plainly shows, the recession had begun one year after the market peaked, and half a year prior to the terrorist attacks.

On September 10, 2001, the Nasdaq was at 1,700. If you ever for a moment doubted that Greenspan had specifically targeted the stock market and not the economy, consider his actions after the 9/11 attack. That Tuesday saw the nation in shock. By design, the entire event played out live on television. That day, the Fed did . . . nothing. It released a two-sentence statement, saying: "The Federal Reserve System is open and operating. The discount window is available to meet liquidity needs."

Au: Is footnote needed here?

My firm was headquartered on the twenty-ninth floor of 2 World Trade Center (I was in the Long Island office that day),

Over the next few years, numerous events would test the bull market that began in 1982. After the recession of 1990–1991, the next major wobble would be the bankruptcy of Orange County, California, late in 1994. That story is the topic of yet another book (try *Big Bets Gone Bad* by Philippe Jorion), but for our purposes, we need only note that it caught the Fed's attention.

Two weeks later, Mexico devalued the peso.

The markets shook off the bad news. The Dow ended the year under 4,000, but it began rising shortly after the calendar flipped. By the middle of 2005, the blue chips were well over 4,500—more than a 13 percent gain in half a year. But concerns about Mexico's stability, as well as currency issues, began to catch up with the indexes. They began to stall in midsummer. (See Figure 5-2.)

On July 6, 1995, Federal Reserve Chairman Alan Greenspan reversed the string of seven rate increases of the past 12 months and cut the federal funds rate 25 basis points. The Fed would follow with another 25-basis-point rate cut in December and yet another in January of the following year.

The Fed justified the July and December rate cuts as a means to "decrease slightly the degree of pressure on bank reserve positions." The January 31, 1996, rate cut was put forth because "moderating economic expansion in recent months has reduced potential inflationary pressures going forward. With price and

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disappeared. It looked as if the crash was going to continue Tuesday, with the Dow off 6 percent in the morning.

It wasn't until Federal Reserve Bank of New York President Gerry Corrigan jawboned banks into restoring credit lines—and futures information between New York and Chicago was turned off—that the mother of all turnaround Tuesdays took place.

It is a classic example of the Fed's authority being used to avoid a full-blown liquidity crisis.

"This affirmation of the Fed's responsibilities to serve as lender of last resort was intended to reverse the crisis psychology and to guarantee the safety and soundness of the banking system," was how Robert T. Parry, president of the Federal Reserve Bank of San Francisco, described its actions at a University of California–Davis conference 10 years later. He affirmed what the Fed saw as its proper role.

Now, it's at precisely this point in our narrative that we must stop for a moment to point out something that you may not have taken the trouble to consider before. Precisely when did the Fed come to be in charge of *psychology*? The central bank was originally established to bring financial order to the early Wild West days of banking. Somehow, resolving fiat currency issues and supervising credit morphed into a far more subjective role. "Mission creep" is how Michael Panzner, author of the doomsday tome *Financial Armageddon*, describes it.

Au:
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We know what happened next: over the ensuing years, the role of the Fed "crept" significantly, from that of inflation fighter to market therapist, and ultimately to the guarantor of asset prices.

The 1987 crash laid bare many of the structural flaws of the market. During the highest-ever volume trading on Black Monday, the market's internal plumbing had failed. Orders were not executed for hours, quotes did not update, and specialists were overwhelmed at their posts. At brokerage firms, phones rang and rang unanswered.

The mechanical functioning of the NYSE was not the result of any intelligent design. The conventions for executing equity orders had evolved on an ad hoc basis. It took the stresses of the crash to reveal the market's warts.

But it is not the crash itself, but rather the response of various parts of the government, that is of particular interest to us.

Before the markets opened on Tuesday, October 20, the Fed issued the following statement: "The Federal Reserve System, consistent with its responsibilities as the nation's central bank, affirmed today its readiness to serve as a source of liquidity to support the financial and economic system."

Au: Source NOTE?

Note that the address is to the system, which was threatened by the large movement downward of asset prices. The central bank added substantially to reserves through open market operations. Over the next two weeks, the fed funds rate fell to 6.5 percent from 7.5 percent just prior to the crash.

But the Fed's pledge was not sufficient to halt the selloff. According to Tim Metz, author of *Black Monday*, there was a slight problem prior to the opening of the markets the next day: most of the NYSE floor specialists were technically insolvent. Not only had they absorbed enormous losses during the crash, but the various bank lines of credit that they used each day had

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