CHAPTER 1

WHY A DEPRESSION IS INEVITABLE

America is sinking into its Second Great Depression of modern times. The place is every home, business, and community. The time is now.

America's Second Great Depression is not a typical twentieth-century recession that happens to hit a bit harder or linger somewhat longer. Nor is it merely a fictional scenario conjured up by gloomy economists with a murky crystal ball.

America's Second Great Depression is the inevitable consequence of a great housing bust, a massive mortgage meltdown, and the biggest debt crisis in history.

Already, it has brought the largest financial failures and the greatest wealth destruction any citizen under 90 has ever experienced.

Already, it challenges the most brilliant minds in Washington, defies the deepest pockets on Wall Street, and threatens to rip through our lives with the force of a hurricane. And yet, among all those making the decisions that could forever change our future, no one has personal experience with a similar episode.

I don't either. I was born in 1946, just as we were leaving the final vestiges of America's First Great Depression behind. I've studied that historic period with books, charts, and numbers, but that's not the same thing. I've lived in Brazil and Japan during tough times, but that, too, was different.

What truly brings me close to a visceral understanding of this crisis is the half-century I shared with my father, J. Irving Weiss, one of the few economists who not only advised investors during the First Great Depression, but actually predicted it.

Dad was so proud of that unusual feat that he began telling me stories about it when I was five years old. Vicariously, I lived through the Roaring Twenties, the Crash of '29, the massive bank failures of the 1930s, and the many years of human suffering that ensued. Through Dad's teachings, I felt as though I were there with him when investors lost fortunes, when we hit rock bottom in 1933, when we eventually recovered, and when brand new fortunes were made. Dad was not only a loving father, but also my mentor, partner, and best friend.

I wish he could be here today to write to you directly and help you get through these tough times personally. But as soon as I was old enough, I helped him write his investment books; and in 1971, soon after I founded my own investment research company, he helped me write mine. Although he's gone, I can feel his vibrant energy and calming spirit beside me; and in almost every chapter of this book, I will let him speak to you posthumously.

Think of this book as coauthored by the two of us. He will tell you about his experiences and analysis during America's First Great Depression; I will tell you what it means for America's Second Great Depression—*and what you can do about it.* A lot has changed since then. What hasn't changed is my family's passionate desire to help you through it.

Dad first went to Wall Street in 1924 to learn everything he could about money. Five years later, when the great crash struck, he did not own any stocks. His parents were recent immigrants from eastern Europe with barely enough to keep food on the table. He had to save everything he earned, bring it home, and give it to his mother. He knew how real estate had collapsed in Florida, and he saw how America's farms were in disarray. He didn't want to gamble his hard-earned savings on another bubble.

After the crash, the stock market rallied for almost six months, and nearly everyone on Wall Street thought the crisis was over. But Dad persuaded his clients and friends to sell everything, get the heck out of the market, and pile up as much cash as they could. He was so convinced the market would fall again that he even borrowed $500 from his mother to sell short–to profit handsomely from the market's decline.

Sure enough, the Crash of '29 was just the opening act of the greatest market decline in modern history. From its peak, the Dow Jones Industrials Average fell 89 percent. Compared to the Dow's peak in 2007, that would be tantamount to a plunge of more than 12,600 points–to a low of approximately 1,500. Dad explains it this way:

> In the 1930s, at each step down the slippery slope of the market's decline, Washington would periodically announce some new initiative to turn things around. President Hoover would give a new pep talk promising "prosperity around the corner." And often, the Dow staged dramatic rallies–up 30 percent on the first round, 48 percent on the second, 23 percent on the third, and more. Each time, I sought to use the rallies as selling opportunities. I persuaded more of my clients to get rid of their stocks and pile up cash. I even told them to take their money out of shaky banks.
>
> On the surface, it might have appeared that just sitting out the crisis got you nowhere. Actually, though, it was a great strategy for building wealth. Prices were falling–on homes, on automobiles, on almost everything. So the more prices fell, the more your money was worth. Just by saving money, stashing the cash, keeping your job, and going about your daily life, you were building wealth. You didn't have to know about investing. All you needed to figure out was how to protect yourself from the bad times. Then, when we hit rock bottom–that was the time to start buying real estate, stocks, or bonds.
>
> You could also profit immensely from the decline itself, with short selling. That's how my friend Bernard Baruch built a great fortune, and how I did, too. But even if you never sold one share of stock short, just sitting out the crash and building cash opened up great wealth-building opportunities as we approached the end of the decline.
>
> That end came with two events: the inauguration of our new president, Franklin D. Roosevelt, and the national banking holiday he declared on his third day in office. But after three years of panics and crashes, most people greeted those events with dread. They thought it would be the beginning of another, even

> steeper slide. Some people even said it was the final chapter of capitalism itself. As it turned out, that was precisely the right time to pick up some of the greatest bargains of the century and make a lot of money.

Helping people make money was Dad's profession, but his passion in life went far beyond money; he was a man of deep empathy and feeling for his fellow man. When others suffered, he suffered alongside them. He gave them jobs, bought them meals, and offered an abundance of free advice.

Most of all, he did not want to see America go through another depression ever again. His vision for accomplishing that goal, however, was different from that of most economists in the post-Depression era. Their strategy was to yank the economy out of nearly every slump and slumber, forever seeking to keep the economy growing, always bailing out major institutions that failed. His philosophy was *moderation* in both directions. "The only way to avoid the pain of a great bust," he wrote, "is to refrain from the excesses of a great boom."

Now, in the twenty-first century, it's clear that you will face similar dangers and have similar opportunities.

Despite any differences between then and now, all depressions have some key elements in common: They are far deeper and longer lasting than recessions—a severe contraction in the economy over multiple years, creating massive unemployment, and delivering devastating financial losses to the majority of the population.

How long could this depression last? How much further can home prices fall? How far down will the stock market go? Will it be as bad as the 1930s?

At this juncture, you can count on your fingers the number of serious analysts who believe that's even a remote possibility. And yet, stranger things have already happened, including the largest bank and insurance company collapses of all time. Before he passed away, Dad wrote:

> Some people of my generation have fond memories of the family togetherness and shared sacrifices of the Great Depression, and I do, too. But I also cannot forget the numbers I studied or the suffering they implied. In just three short years between the

> peak of the stock market boom in 1929 and the bottom in 1932, it felt like the entire world was falling apart. The financial bubble burst. Big companies failed. America lost 13 million jobs. Unemployment surged to 25 percent. American industry cut its production nearly in half. Home construction plunged by more than four-fifths. Deflation—falling prices—drove the value of almost every asset into the gutter. Over 5,000 banks failed and ultimately disappeared.
>
> Most Americans—especially the youngsters who manage billions of dollars on Wall Street—have no concept of the power and speed of a great stock market crash. They've never lived through one. So it's hard for them to visualize it. In 1929, people were jumping out of windows, and once-wealthy people were selling apples on street corners. The shock waves reached into almost every office and every home in the country and in the world. Next time, especially if Washington tries too hard to stop the crisis, it could ultimately be just as bad, or even worse.

I agree. Yes, the government is acting more aggressively this time to prevent the worst-case scenario, but is that good or bad? Yes, we have a more modern market system, but we also have new, unprecedented risks and weaknesses that were small or nonexistent in the 1930s.

Unprecedented Risks and Weaknesses

If you're still skeptical about the imminence of a twenty-first century depression, you don't have to believe the former chairman of the Federal Reserve when he says we're already experiencing the worst financial crisis in 100 years. Nor must you heed the secretary of the Treasury when he literally drops to his knees begging for more billions to save us from a financial meltdown. All you have to do is get up from your chair, open the door, and take a walk outside.

Nearly everything you see and hear will clue you in to the true plight of our time—1 out of 10 households delinquent or foreclosed on their mortgage, 4 out of 10 upside down on their home equity, 8 out of 10 fearful of the future, and rightfully so.

Or just turn on the news. You see America's largest companies–Merrill Lynch, General Motors, AIG, Fannie Mae, Citigroup–bankrupt, bailed out, or bought out. You see bursting bubbles in housing, commercial real estate, stock markets, and commodities. You see economic booms busting in the Americas, Europe, and Asia.

Even economies thought to be immune, like China or Australia, are crumbling. Even investments said to be safe, like corporate bonds, municipal bonds, and large government-sponsored companies, have sunk.

Our leaders themselves have sounded the alarm. Unless they can act swiftly, they say, the world as we know it today will fall apart. Thus, to avert what they fear could be the ultimate disaster, the governments of the richest countries have embarked on the most expensive financial rescue operations of all time. In less than a year, the U.S. government alone has spent, lent, committed, or guaranteed over $8 trillion, *sixteen* times its biggest-ever federal deficit. European governments have jumped in with several trillion more; China, over $600 billion.

They've bailed out bankrupt banks, broken brokerage firms, insolvent insurers, ailing auto manufacturers and any company they deem "essential" to the economy.

They're pumping resources into mortgage markets, consumer credit markets, and even stock markets. They're prodding lenders to lend, consumers to consume, and investors to invest. They're doing everything in their power to prevent America's Second Great Depression. But will they succeed in this endeavor? Here's Dad's answer to a similar question I asked him before he passed away:

> In the 1930s, I was tracking the facts and the numbers as they were being released–to figure out what might happen next. I was an analyst, and that was my job. So I remember them well.
>
> Years later, economists like Milton Friedman and my young friend Alan Greenspan looked back at those days to decipher what went wrong. They concluded that it was mostly the government's fault, especially the Federal Reserve's. They developed the theory that the next time we're on the brink of a depression, the government can nip it in the bud simply by acting sooner and more aggressively.

> Bah! Those guys weren't there back then. When I first went to Wall Street, Friedman was in junior high and Greenspan was in diapers.
>
> I saw exactly what the Fed was doing in the 1930s: They did everything in their power to try to stop the panic. They coddled the banks. They pumped in billions of dollars. But it was no use. They eventually figured out they were just throwing good money after bad.
>
> You didn't have to be an economist to understand what the real problem was. It was sinking public confidence, and money didn't buy confidence. To restore confidence would take more than just money. It would also take time.
>
> The true roots of the 1930s bust were in the 1920s boom, the Roaring Twenties. That's when the Fed gave cheap money to the banks like there was no tomorrow. That's why the banks loaned the money to the brokers, the brokers loaned it to speculators, and the speculation created the stock market bubble. That was the real cause of the crash and the depression! Not the government's "inaction" in the 1930s!
>
> By 1929, our economy was a house of cards. It didn't matter which cards the government propped up or which ones we let fall. We obviously couldn't save them all. So no matter what we did, it was going to come down anyway. The longer we denied that reality and tried to fight it, the worse it was for everyone. The sooner we accepted it, the sooner we could get started on a real recovery.

Today, however, it seems the governments of the world have yet to learn this lesson. They're still trying to bail out nearly every major institution and market on the planet. Again, the big question: Will they succeed?

The quick answer is: yes, for a while, perhaps. They can kick the can down the road. They can buy time and postpone the day of reckoning. They can stimulate stock market rallies and even flurries of economic recovery. But that's not the same as assuming responsibility for our future. It doesn't resolve the next crisis and the one after that. It does little for you and me, and even less for our children or theirs.

The longer term answer is: *no, they will fail.*

My *Safe Money Report* coeditor, Mike Larson, and I documented the reasons in a white paper we submitted to the U.S. Congress on September 25, 2008: *The government bailouts are too little, too late to end the debt crisis; too much, too soon for those who will have to foot the bill.*

Indeed, even as the government sweeps piles of bad debts under the carpet, mountains of *new* debts go bad–another flood of mortgages that can't be paid, a new raft of credit cards falling behind, a new line-up of big companies on the verge of bankruptcy.

Even as the government commits new billions to be spent on financial rescues, *trillions* in wealth are wiped out in falling real estate, stocks, bonds, and commodities.

Even as the government promises prosperity around the corner, we see more home prices falling, more factories closing, more jobs lost.

The primary reason is simple and quite obvious: *Our society is addicted to debt.* As long as government can keep the credit flowing–and as long as borrowers can get their regular debt fix–everyone continues to spend to their heart's content. But as soon as the credit stops flowing or, worse, as soon as it's cut off cold turkey, spending vanishes, the American economy suffers withdrawal pains, and the financial markets go into convulsions.

To better understand why and how, consider the sequence of events . . .

Failed Attempts to End the Debt Crisis

We saw the first telltale warning of America's Second Great Depression when a credit crunch hit in full force in August 2007. Banks all over the world announced multibillion losses in subprime (high-risk) mortgages. Investors recoiled in horror. And it looked like the world's financial markets were about to collapse.

They didn't–because the U.S. Federal Reserve and European central banks intervened. The authorities injected unprecedented amounts of cash into the world's largest banks. The credit crunch subsided, and everyone breathed a great sigh of relief. But it was a pyrrhic victory, because in early 2008, the crunch struck anew, this time in a more virulent and violent form, this time impacting a much wider range of players.

The nation's largest mortgage insurers, responsible for protecting lenders and investors from mortgage defaults on millions of homes, were ravaged by losses. Municipal governments and public hospitals were slammed by the failure of nearly 1,000 auctions for their bonds, causing their borrowing costs to triple and quadruple. Low-rated corporate bonds were being abandoned by investors, their prices plunging to the lowest levels in history. Hedge funds got slammed, with one fund, CSO Partners, losing so much money and suffering such a massive run on its assets that its manager, Citigroup, was forced to shut it down. And above all, major financial firms, at the epicenter of the crisis, were being hit with losses that would soon exceed $500 billion.

The big question was no longer "Which big Wall Street firm will post the worst losses?" It was "Which big firm will be the first to go bankrupt?" The answer: Bear Stearns, one of the largest investment banks in the world.

Again, the folks at the Fed intervened. Not only did they finance a giant buyout for Bear Stearns, but, for the first time in history, they also decided to lend hundreds of billions to any *other* major Wall Street firm that needed the money. Again, the crisis subsided temporarily. Again, Wall Street cheered, and the authorities won their battle.

But the war continued. Despite all the Fed's special lending operations, another Wall Street firm—almost three times *larger* than Bear Stearns—was going down. Its name: Lehman Brothers.

Over a single weekend in mid-September 2008, the Fed chairman, the Treasury secretary, and other high officials huddled at the New York Fed's offices in downtown Manhattan. They seriously considered bailing out Lehman, but they ran into two serious hurdles: First, Lehman's assets were too sick—so diseased, in fact, even the federal government didn't want to touch them with a 10-foot pole. Nor were there any private buyers remotely interested in a shotgun marriage. Second, there was a new sentiment in America that was previously unheard of. A small, but vocal, minority was getting sick and tired of bailouts. "Let them fail," they said. "Teach those bastards a lesson!" was the new rallying cry.

For the Fed chairman and Treasury secretary, it was the long-dreaded day of reckoning. It was the fateful moment in history that demanded a life-or-death decision regarding one of the biggest

How to Reduce Debts in Bad Times

In a depression, families overloaded with debts face the worst of all worlds: they miss out on major opportunities, get trapped making payments that are more onerous than expected, confront increasingly aggressive collection agencies and must abide by harsher bankruptcy laws. Therefore, if there ever were a time to get rid of debt, *this is it*. Amber Dakar, Weiss Research's personal finance specialist, explains how:

Step 1. Declare your own personal war on debt. If debt has the potential to disrupt your life and cause your family serious grief, we assure you it is *not* your friend. Focus all your energy on killing it.

Step 2. Attack the plastic first. Collect all credit cards in the entire household, including your own, your spouse's, and those of anyone else you're responsible for. Then grab a pair of scissors and cut them up.

Step 3. Attack your credit card statements next. Gather all your recent statements and find the annual percentage rate (APR). At the top of each statement, write down the APR in large numbers. Then, sort the statements with the highest APR at the top, the lowest at the bottom.

Step 4. Add up your minimum monthly payments. Credit card companies *deliberately* require very small minimum payments. Their agenda is to let you pile up as much debt as possible so they can earn as much interest as possible. How long would it take to pay off a credit card with minimum monthly payments alone? If you owe $2,000 with 17 percent interest, it could take you 24 years. And on some credit cards, the compound interest you're paying could be over 35 percent! Do your best to *pay them all off*, even if that means borrowing from friends and relatives. If that's not possible, at least pay off the ones with the highest APR.

Step 5. Shun all new credit cards. Once you've kicked the credit card habit, don't go back. If you need the convenience of a card, get a *debit* card instead. But ask your bank to give you a *true, pure debit card*–not one that comes with a built-in credit card feature. If new, unsolicited credit cards show up in your mailbox, trash them immediately.

Step 6. Start paying down any other personal loans you may have. If you've been able to get along with, say, $600 less per month in spending money until now, and if your circumstances don't change, you should be able to stick with it. Use it to pay down any other personal loans you may have.

Step 7. Pay down your mortgage. This is especially important if you're locked into a high rate or have an adjustable-rate mortgage (ARM). But in a depression, you must assume that even a lower, fixed-rate mortgage could become a bigger burden. The reason: A depression usually comes with deflation, which means almost everything–including wages–goes down. Unfortunately, one of the few things that does *not* go down is fixed debt payments, and these can strangle borrowers no matter how favorable the loan may have seemed originally. Your goal should be to send the mortgage company a larger monthly check than required. Then, that extra amount should be automatically deducted from your principal. If your regular payment is, say, $2,400, send them $3,100. You'll be surprised how much more quickly your mortgage will be paid off.

Step 8. Build up your cash savings! If you're afraid of losing your job, postpone paying down your fixed-rate mortgages until you have enough cash to cover six months of expenses. Plus, be sure to follow the steps detailed below.

How to Protect Your Job in Bad Times

In a depression, job cuts can affect almost *everyone*–regardless of profession, job status, income level, gender, or ethnic origin. In other words, we're all in this together.

(*Continued*)

Ultimately, layoffs could be across the board–financial, manufacturing, services, even states and municipalities. However, for the most part, you can rely more on jobs with the federal government; with companies that provide debt recovery and bankruptcy services; and with industries that sell or service basic necessities, such as those related to health care and food. To help protect your current job, consider these steps:

Step 1. Check the financial prospects of your company. If its shares are listed on a stock exchange, you can get a general idea simply by looking at how the stock has performed compared to the S&P 500 Index. If your company is not listed on an exchange, inquire about its revenues and profits for the last few quarters. If your employer says it is confidential, you should be able to acquire a report from Dun & Bradstreet (www.dnb.com).

Step 2. If your company's prospects are positive, devote more effort to Strategy A below. If they are negative, devote more effort to Strategy B.

Step 3. In a depression, pursue both of the following strategies:

Strategy A. Do your utmost to make yourself a valuable employee. Seek company-sponsored opportunities for learning new job skills. And even if none are available, allocate at least an hour per day of your spare time to learn skills of value to the firm. With the Internet, you'd be amazed at how much you can learn for free or at a very low cost. And if you do not have access to the Internet from home, free access is available at most public libraries. The librarian should be able to give you some excellent tips on the latest, best sites.

Strategy B. Stay continually on top of the job market. Visit job web sites to take advantage of a wealth of free information on the most marketable job skills, tips on how to get a job, and updates on what's going on in various industries. Also use these sites to keep your resume posted on the Web as much as possible.

Step 4. Learn more about other income opportunities, such as a home business. It can take time to find the right situation, and many "surefire" business schemes can waste your time or, worse, lead you to losses you cannot afford. So start researching soon. Even if your company is currently doing well, that could change as the depression deepens. For more information on some of the most reliable options, visit www.moneyandmarkets.com/homebusiness.

Step 5. Rather than just buying into someone else's prepackaged opportunity, the single best approach to starting a home business is to leverage any unique skills you may already have. In most cases, though, what could make or break your business will be how you *market* your skills. To learn how to market yourself most effectively in a depression, visit www.moneyandmarkets.com/skills.

financial institutions in the world–bigger than General Motors, Ford, and Chrysler put together. Should they save it? Or should they let it fail? Their decision: to do something they had never done before. *They let Lehman fail.*

"Here's what you're going to do" was the basic message from the federal authorities to Lehman's highest officials. "Tomorrow morning, you're going to take a trip downtown to the U.S. Bankruptcy Court at One Bowling Green. You're going to file for Chapter 11. Then you're going to fire your staff. And before the end of the day, you're going to pack up your own boxes and clear out."

In both the Bear Stearns and Lehman failures, America's largest banking conglomerate, JPMorgan Chase, promptly appeared on the scene and swooped up the outstanding trades of the two companies, with the Fed acting as a backstop. In both failures, the authorities played a role. But Lehman's demise was unique because it was thrown into bankruptcy.

It was the financial earthquake that changed the world.

Until that day, nearly everyone assumed that giant firms like Lehman were "too big to fail," that the government would always step in to save them. That myth was shattered on the late summer weekend when the U.S. government decided to abandon its long tradition of largesse and let Lehman go under.

All over the world, bank lending froze. Borrowing costs went through the roof. Global stock markets collapsed. Corporate bonds tanked. The entire global banking system seemed like it was coming unglued.

"I guess we goofed!" were, in essence, the words of admission heard at the Fed and Treasury. "Now, instead of just a bailout for Lehman, what we're really going to need is the Mother of All Bailouts–for the entire financial system." The U.S. government promptly complied, delivering precisely what they asked for–a $700-billion Troubled Asset Relief Program (TARP), rushed through Congress and signed into law by the president in record time.

In addition, the U.S. government has loaned, invested, or committed $200 billion to nationalize the world's two largest mortgage companies, Fannie Mae and Freddie Mac; over $42 billion for the Big Three auto manufacturers; $29 billion for Bear Stearns, $150 billion for AIG, and $350 billion for Citigroup; $300 billion for the Federal Housing Administration Rescue Bill to refinance bad mortgages; $87 billion to pay back JPMorgan Chase for bad Lehman Brothers trades; $200 billion in loans to banks under the Federal Reserve's Term Auction Facility (TAF); $50 billion to support short-term corporate IOUs held by money market mutual funds; $500 billion to rescue various credit markets; $620 billion for industrial nations, including the Bank of Canada, Bank of England, Bank of Japan, National Bank of Denmark, European Central Bank, Bank of Norway, Reserve Bank of Australia, Bank of Sweden, and Swiss National Bank; $120 billion in aid for emerging markets, including the central banks of Brazil, Mexico, South Korea, and Singapore; trillions to guarantee the Federal Deposit Insurance Corporation's (FDIC's) new, expanded bank deposit insurance coverage from $100,000 to $250,000; plus trillions more for other sweeping guarantees.

Grand total: Over $8 trillion and counting.

Washington said it was all for a good cause–to save the world from depression.

But it was obviously reaching levels that were beyond belief, and it *still* had serious obstacles to success.

Obstacle 1: Too Much Debt

First and foremost, America's debt burden was far too big. By midyear 2008, there were $52 trillion in interest-bearing debts in the United States, including mortgage loans, credit cards, corporate debt, municipal debt, and federal debt; the federal government needed another $60 trillion for Social Security, Medicare, and other commitments kicking in at a quickening pace; and U.S. commercial banks held another $182 trillion in side bets called "derivatives." Grand total: $294 trillion in the United States alone.

The numbers are not directly comparable, but just to give you a sense of the magnitude of the problem, that's 420 times more money than the hotly debated $700 billion bailout package signed so hurriedly into law by President Bush in late 2008 (Figure 1.1).

Still, most people believe that if only Washington can avoid the mistakes it made in the 1930s . . . if only Washington can preemptively nip this crisis in the bud . . . if only Washington can be our lender and spender of last resort . . . a second Great Depression will never come to pass.

What they did not see is the fact that the debt buildup in the United States was far greater than it was on the eve of 1930s depression. Indeed, Claus Vogt, coeditor of the German edition of our *Safe Money Report,* shows how, prior to the 1930s, the total debt in the United States represented no more than 170 percent of our economy. By 2008, it was close to 350 percent of our economy (Figure 1.2).

Moreover, Mr. Vogt reminds us that this does not even include the high-stakes, gambling arena of big side bets called derivatives. Those kinds of bets barely existed in the 1930s. By contrast, in the 2000s, they were a major factor behind large bank and insurance company losses and failures.

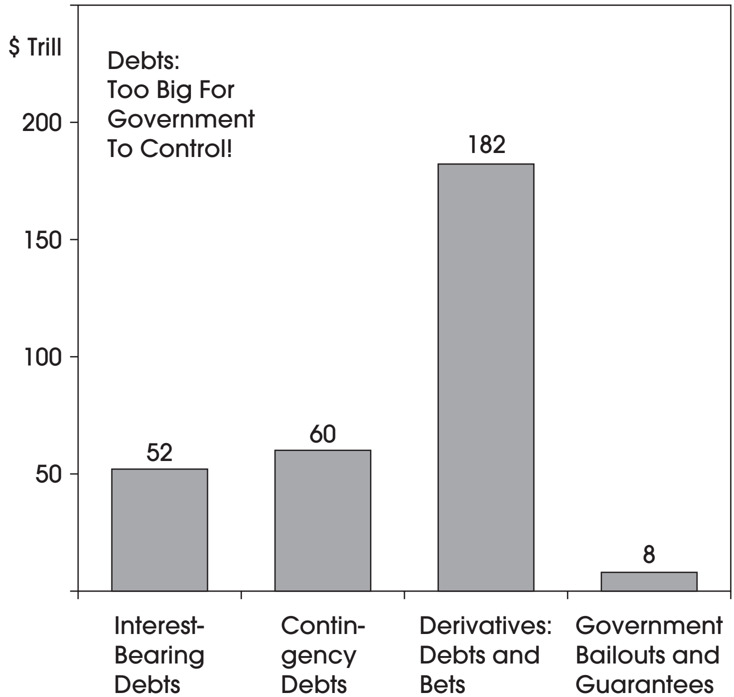

Figure 1.1 Even the Largest Rescue Pales in Comparison to the Buildup of Debts and Bets

A major challenge to the U.S. government in dealing with the debt crisis is the sheer volume of debts outstanding. At midyear 2008, in addition to $52 trillion in interest-bearing debts reflected in Figure 1.2, the government had an estimated $60 trillion in contingent debts for obligations such as Social Security, Medicare, and veterans' benefits; and U.S. banks were committed to $182 trillion in bets called derivatives. Even the most ambitious of government bailout efforts would be small by comparison.

Data Source: Federal Reserve, Government Accountability Office (GAO), and U.S. Comptroller of the Currency (OCC).

If, along with their big debts, Americans at least had plenty of cash, it would not have been such a problem. But, alas, nothing could have been further from the truth. Americans saved less than ever before in history and less than their counterparts in almost every other industrial country on Earth. Often, in recent years, average Americans saved zero or even less than zero, dipping into their nest egg to spend even more.

Much of Corporate America was also running cashless, keeping minimum cash or equivalent on hand and leveraging maximum

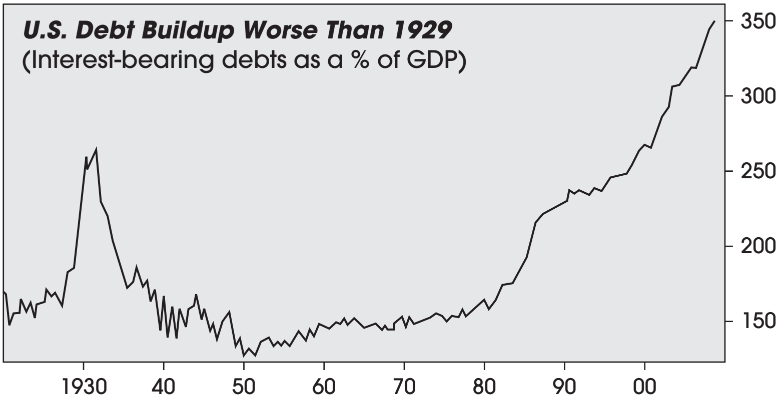

Figure 1.2 U.S. Debt Buildup Worse than 1929

In 1929, the total build-up of interest-bearing debt in the United States represented no more than 170 percent of Gross National Product (GNP). Then, in the early 1930s, as the economy contracted, although new debts were not added in significant amounts, the existing debts became far more burdensome in relation to the shrinking economy, exceeding 260 percent of GNP. This continuing burden prolonged the Great Depression; and a meaningful recovery could not begin until a substantial portion of the debts were liquidated through bankruptcies, write-downs, and repayment. In the modern era, U.S. debts have greatly exceeded the peak levels of the 1929–32 period, reaching 350 percent of Gross Domestic Product (GDP). Moreover, these do not include other forms of debts depicted in Figure 1.1. Data: Federal Reserve.

amounts of debt. A while back, Dad and I studied a sample of 10 of America's largest corporations: AT&T, Anaconda, DuPont, General Electric, General Motors, Goodyear Tire, International Harvester, Sears Roebuck, U.S. Steel, and Westinghouse Electric. We found that, between 1910 and 1950, even in the giddiest of times, they almost invariably had plenty of cash; for every dollar of bills and debts coming due within a year, they kept at least 70 cents on hand. But in the modern era, that approach fell by the wayside: they let their cash and equivalent drop to as little as 10 cents on the dollar.

So if you've been wondering why so many big companies have gone bankrupt so quickly, now you know one of the key reasons: They ran out of cash to pay debts coming due.

No cash in the kitty? Big debts? How could they be so reckless? And how could they have kept that going for so many years without ever paying the piper?

Actually, they thought they were pretty clever, and their most clever invention of all was, in effect, their own no-limit commercial "credit card." Any time a big company ran a bit low on funds, it could use this supercard and grab nearly all the quick cash it needed. Its name: commercial paper–short-term IOUs that companies printed up and sold to investors.

As it turned out, commercial paper didn't just act as a *temporary* stop-gap for cashless corporations. It became a permanent fixture for almost all major companies whether they needed the cash or not, and they tapped it continually for a half century! It allowed them to operate year after year, decade after decade, with minimal cash and maximum debt–all until that one fatal day in September 2008, when Lehman Brothers went bankrupt and the commercial paper market froze up. Banks, money market funds and other investors refused to buy most commercial paper. For all practical purposes, the market died.

The government jumped in immediately to revive it by making all kinds of guarantees, and it did make some headway. But that didn't change the fact that most of Corporate America was drowning in short-term debt. Nor did it change the reality on the ground that American consumers were in the same predicament, with no life vest of cash and some of the most burdensome debts of all time.

Obstacle 2: Nobody Wants to Pick Up the Tab

The second big obstacle the government faced was raising the money for all its bailouts. Apparently, in the rush to spend, lend or guarantee trillions of dollars, no one in the government bothered to seriously consider the simple question, "Who's going to pick up the tab? Where are we going to get all that money?"

With the economy already weak, it certainly wasn't going to come through higher taxes. And with unemployment and welfare expenses surging, cutting the budget wasn't going to yield very much either. The government had only one choice: to borrow the money.

More big debts!

Sure enough, in November 2008, the U.S. Treasury department announced that it would have to borrow $550 billion in the fourth quarter, *more* than the total budget deficit for the entire year. At the same time, Goldman Sachs estimated that the upcoming borrowing needs of the U.S. Treasury would be a shocking $2 trillion–to pay for the bailouts, to finance the existing deficit, and to refund debts coming due. That was about *four* times the size of the entire yearly deficit. And it meant that, to raise the money, the government would shove aside consumers, businesses, and other borrowers; hog most of the available credit for itself; and then, adding insult to injury, bid up interest rates for everyone.

Some people hoped the government's resources, by some feat of magic, might be unlimited. But the reality is that there is no free lunch; someone has to raise the money and pick up the tab. And as soon as the bills come due, the consequences could strike swiftly—in the form of steeper mortgage rates, higher consumer loan rates, or worse, virtually no credit at all.

Obstacle 3: Sinking Confidence

The third obstacle the government ran into was even more daunting. Like in the 1930s, money alone, no matter how lavishly dished out, could not restore public *confidence.* While the government bought some reprieve for large banks, it could do little to help thousands of smaller banks. While it could help some percentage of consumers some of the time, it could not help the majority most of the time. Consumer confidence plunged to the lowest level in recorded history. Consumer spending collapsed. And Corporate America responded with huge cutbacks. This story Dad told me about 1930 shows some interesting similarities:

> After the crash, President Hoover was worried about the sinking U.S. economy. So he called the leaders of major U.S. corporations down to Washington—auto executives from Detroit, steel executives from Pittsburgh, banking executives from New York. He said, in effect:
>
> "Gentlemen, when you go back home to your factories and your offices, here's what I want you to do. I want you to keep all your workers. Don't lay anyone off! I want you to keep your factories going. Don't shut any down! I want you to invest more, spend more, even borrow more if you have to. Just don't do any cutting. It's for a good cause—so we can keep this economy going."
>
> That may have sounded like a good idea at first. But then the executives went back to their factories and offices and said to their associates: "If the president himself had to call us down

> to Washington to lecture us on how to run our business, then the economy must be in even worse shape than we thought it was."
>
> They promptly proceeded to do precisely the opposite of what Hoover had asked: They laid off workers by the thousands. They shut down factories. They slashed spending to the bone. They cut back.

Now, history is repeating itself, albeit on a much grander scale with a more ambitious government. As before, each new government bailout is initially greeted with some enthusiasm. But as the crowd of wannabe bailout candidates swells, and as people recognize the inability of authorities to satisfy them all, confidence sinks even further.

Washington tries to encourage consumers and businesses to borrow more, spend more, and save less, but they do precisely the opposite.

Washington prods bankers to dish out more credit, but the Fed's own surveys show that banks all over the country do precisely the opposite, sharply tightening their lending standards.

Government officials give frequent pep talks to inspire investors to take the risk of investing more, but most investors would rather slash their risk—or their wrists.

In each case, folks realize that it was too much borrowing, too much spending, and too much risk-taking that got them into so much trouble in the first place. So they just do what comes naturally: They cut back.

The Biggest Obstacle of All: The Vicious Cycle of Debt and Deflation

Debt alone is usually tolerable. People can pile up debts year after year, and as long as borrowers have the income—or as long as they can borrow from Peter to pay Paul—they continue making their payments. Life goes on.

Deflation—falling prices and income—is also not all bad. It makes homes more affordable, college education more achievable, a tank of gas easier to fill.

It's when the debts and deflation come *together* that the wheels are set into motion down the path to depression. That's what happened in the 1930s, and that's what's beginning to happen this time as well.

In the housing market, Americans abandon their homes or are forced into foreclosure. The foreclosures precipitate distress selling. The distress selling causes price declines. And as homeowners discover they owe more on their homes than they're worth, the price declines prompt more people to abandon their homes or let them slide into foreclosure.

On Wall Street, a similar cycle emerges: Big companies and banks run out of capital, cannot pay their debts, and go bankrupt. The bankruptcies—and the fear of more to come—drive investors to sell their shares, forcing stock prices lower. With lower stock prices, corporations and banks cannot raise capital, and more go bankrupt.

Consumers, small and medium-sized businesses, city and state governments, hospitals and schools, even entire countries are caught up in a similar downward spiral: slashing their spending, laying off workers, dumping assets, losing revenues, and then slashing their spending still more.

These vicious cycles naturally gain momentum. Once set into motion, it is extremely difficult—if not impossible—for any government to stop them. Once the speculative bubbles burst, all the king's men cannot put them back together again.

This is especially true for the first bubble to pop on the eve of America's Second Great Depression—real estate, the subject of the next chapter.