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Preface to the Second Edition

IT WAS with mixed feelings that I witnessed the end of the housing boom in the United States in 2006. I was sad, because the real estate downturn confirmed my prediction, made two years ago, that the global economy was on track for a major slump. Millions of pensioners and home buyers will lose billions of dollars. With cheap credit, those families had borrowed their way into the great American Dream. They were encouraged to assume that rising house prices would provide adequate collateral for their homes, furniture, car and vacations. Those dreams will now be crushed by the brutal mathematics of property speculation.

But I was also angry, because it could have been avoided. The financial 'products' that were used by the banks to raise further loans had locked families and pensioners into a trap. Rising interest rates caused sub-prime householders to default, which precipitated the fall in house prices. This, in turn, undermined the value of the collateralised products that banks traded among themselves. And that was why the credit chain snapped.

I had predicted this outcome. But when *Boom Bust* was published in 2005, economists told me that it was fanciful to believe that we would live through another depression. Central banks around the world, I was assured, had learnt the lessons of the 1930s.

So why was I standing in a queue with hundreds of depositors, many of them pensioners, at dawn on Monday, September 18, 2007, outside the locked doors of the Northern Rock? As Britain's fifth largest mortgage lender, this was supposed to be a secure home for their life's savings. But they wanted their money out – causing a run on the bank, a classic feature of the 1929 crash in America that led to the Great Depression.

I wanted to know why the savers did not accept the reassurances of the Bank of England, which offered bail-out money. They were not willing to take the word of the government that it would guarantee their deposits. This loss of trust was the most disturbing feature of the credit crisis. People voted with their feet to tell the politicians that their guarantees were not worth anything.

I should not have been surprised at this absence of trust. The depositors could not be expected to read the Northern Rock's balance sheet and work out whether it was solvent. After all, even the bankers of Wall Street and the City of London were caught unawares as credit began to dry up in August. When it came to the crunch, *the banks did not trust each other!* They were unwilling to lend money between themselves, so people's instincts – to reclaim their cash from Northern Rock – appeared to make sense. Their bank was the most exposed to the credit crunch in Britain.

There was a deep irony about the plight of Northern Rock. For me, it symbolised the cynicism of a financial sector that had grown fat on bonuses. Did that explain why they were not interested when I sounded the alarm bell? A senior executive from Northern Rock inadvertently revealed the attitude of the moneymen. It happened at a meeting in London. I was invited to brief a group of high-powered financiers. As we were departing, the man from Northern Rock said: 'At least we will still be here' – meaning, if there was a housing-led recession, his bank would survive the turmoil that I was forecasting.[1] Little did he know that Northern Rock would become the first big league victim in Britain. Four weeks after the credit crunch began in the US, Northern Rock was For Sale.[2]

Over four days, depositors removed an estimated £3bn from the bank's vaults. They panicked because they were not familiar with the fine detail of the crisis that originated with the multi-billion dollar payments for assets that were of dubious value. The bankers had invented a new game of Money Musical Chairs. Now the music had stopped. The problem was that many of the losers left standing could not be identified. Some of them held financial instruments that were worthless; but balance sheets did not reveal who held them.

One man who should have given sufficient warning to the banks was Alan Greenspan, when he was Chairman of the US Federal Reserve. He failed to do so, and after retiring in 2006 he invented a new school of thought that we will call *psychonomics*. House price bubbles, he claims in *The Age of Turbulence*, were rooted in the human psyche and people's euphoria-to-fear mood swings. This mystification of the science of economics enabled him to blame the credit crisis on 'human nature'. He also claims that no one could have forecasted the crisis. But a year before he retired, the first edition of *Boom Bust* warned (on page 181) of the exotic financial devices that were created in the speculative phase of the cycle, which concealed bad debts.

> The regulatory authorities lost track of this debt mountain, because it was quickly repackaged in new financial instruments and sold to institutions.

Mortgages were wrapped up in collateralised debt obligations (CDOs) and sold to others to 'spread the risk'. Reckless lenders mixed poor quality loans (to borrowers who purchased houses built on sand in Florida, for example) with secure mortgages on properties in high-value locations in New England. Then they off-loaded the packages and pocketed the proceeds. So the credit merry-go-round whirled on the back of house prices that were soaring towards what I called the 'Winners' Curse' phase of the business cycle (see page 89). I warned that, instead of 'a clean-out of the debt, the excesses ... were concealed in opaque accounting practices and laundered through the world's financial markets'.

No one, anywhere in the world, was immune. People who did not engage in real estate speculation on a socially significant scale, like Germans, were exposed to the virus that was incubated in the US money markets. Germany was infected because her banks invested in financial instruments that contained mortgaged properties from as far afield as San Diego in Southern California, where house prices rose by 22% in 2002 alone. The warning of the clear and present danger went out with the first edition of *Boom Bust*:

> The banks transferred the risks to others; and that, ultimately, meant it was carried by working people through a reduction in the quality of the investments held by their pension funds.

As home-owners defaulted, the implications of the bad debts dawned on the bankers. Stock markets panicked as investors tried to get their money back. Bill Gross, head of the world's largest bond fund (the California-based Pacific Investment Management Company), appealed to President George W. Bush to 'write some cheques' to 'prevent destructive housing deflation'. A 10% drop in house prices, he warned, would represent the sharpest drop in asset prices since the Great Depression of the 1930s. In some regional markets, the drop exceeded 10%.

For the UK, I predicted that house prices would achieve double-digit growth in 2007. I was correct (see Table 1 below). I also forecast that Britain's housing market would stall at its peak when the ratio of average house prices to average earnings hit 6.5 (see page 6, Table 1:1). That ratio was achieved in the summer of 2007.[3]

TABLE 1

House Price Increases at 2007[Q1] (%)

	1 year change	*2 year change*	*5 year change*
UK	13	30	90
Australia	9	13	54
Canada	10	24	36
USA	-1.3	18	36

Source: Halifax; Datastream.

The financial trauma of 2007 need not have happened, but that is not what Alan Greenspan wants to hear. He has a legacy to protect as 'the world's greatest central banker'. So referring to the cycles of boom/busts, he asserts: 'There's no way of altering the pattern'.[4] But thanks to the policy failures of people like Greenspan, patterns *will* now be altered. For in the upswing of the next business cycle, cash-flush, resource-rich nations will no longer be in awe of the acumen of Wall Street and the City of London. The consequences for geo-political power will be profound. Yesterday's underdogs – in China and India, in Russia and the Middle East – will watch in horror as millions of people in the Anglo-American countries lose their homes. This will be interpreted as the betrayal of the trust on which moneymen depend for their business. A weakened Western economy – the crises compounded by the failure of President Bush's foreign policies (notably, in the Near East) – will suffer the fragmentation of its financial centres in favour of Shanghai, Mumbai and Dubai. The degree to which the West will be able to recover to meet this challenge depends on the willingness of its leaders to adopt the counter-cyclical policy that I describe in Part IV.

London
November 2007

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1 Because the meeting was sponsored under Chatham House rule (everything said would remain confidential), I cannot disclose the identity of the host organisation, one of Britain's leading financial institutions.

2 Lloyds TSB was reported to have been invited by Northern Rock to launch a rescue takeover, which the Bank of England vetoed. John Waples and Grant Ringshaw, 'Northern Rock takeover blocked', *Sunday Times Business*, September 16, 2007.

3 The Halifax Rural Housing Review reported that the ratio hit 7.1 in the country-side and 6.2 in towns.

4 Edmund Conway, 'You cannot end cycles of boom and bust – it's human nature', *The Daily Telegraph*, September 17, 2007. This was an interview with Greenspan, to promote his memoirs.

Prologue

NASA is the US Government's space-probing agency. American taxpayers have funded its scientific research and manned missions with hundreds of billions of dollars. No expense is spared to gather the best brains to devise the most sensitive instruments to deepen our knowledge of the physics affecting Earth. And yet, NASA failed to alert us to an emerging danger, one that has the potential to destroy life itself. The hole in the ozone layer, an earth-scorching opening of the curtain that screens us from ultraviolet radiation, was not identified. It remained nature's secret until Joseph Farman and his colleagues of the British Antarctic Survey discovered it in 1985.

Why did NASA fail? Actually, it did not miss the changes. The agency's sophisticated equipment logged the data. 'Their instruments had recorded the losses [of ozone],' reported *Business Week* (July 22, 1991, p.10), 'but the computer interpreting the results had been programmed to ignore readings that deviated so far from normal.' Computers are as intelligent as the intelligence that is fed into them. The problem was with the way NASA applied its knowledge. The scientists chose to ignore as unimportant the numbers that were too far from what they regarded as the norm. Because the readings on the instruments were abnormal, they could be dismissed as aberration.

A similar problem arises with the way social scientists apply their knowledge of the working mechanisms of capitalism. The instruments employed by governments are far from perfect, but they *do* collate alarming evidence that should trigger the red warning lights. But like NASA, government goes into sleep mode when the statistics on inflation deviate from the expected norm (anywhere between 2% and 10%) to alarmingly high (20% increases in house prices) to shattering annual price rises of up to 60% in the land market. Conventional economic wisdom excludes the numbers that deviate too far from the officially sanctioned norm.

As a result, the 'hole' in the capitalist economy – the cyclical recessions that play havoc with the finances of households and the budgets of nations – remains a mystery. The problem is with the way that the data is interpreted. The representatives of the people fail to *comprehend* what we can see with our eyes. We walk all over the facts, but we cannot make sense of them. Despite the best brains at the disposal of governments, despite the vast amounts of money devoted to research in our universities, we continue to disregard the earth-bound realities.

In this study, I level the charge of negligence against Tony Blair's finance minister, Gordon Brown, and American central banker Alan Greenspan. But this study is not a party political attack. It diagnoses the problem with the philosophy at the heart of government economic policy. Aspects of that philosophy which ought to be challenged are silently accepted by all parties. Thus, while I partly characterise the problems in Britain and the USA in terms of the biographies of a few influential men, we have to remember that finance ministers and central bankers come and go; the booms and busts that destabilise our societies, however, are the product of some of the laws and institutions that underpin our communities.

My argument with the people in authority is that they ought to know better. Central bankers have a duty to speak plain English, to offer a comprehensive account of the financial workings of the economy so that we may take control of our destinies. But Greenspan turned his knack of disguising the meaning of his words into a joke. Irwin Stelzer, a close observer of the US economy, noted that Greenspan 'is famous for his ability to use language in such a way that it ceases to be a means of communication'.[1] As for politicians, they have a duty of leadership to the people who trusted them with their votes of confidence, so they ought to offer decisive plans for change rather than compromising for fear of losing votes. They would lose those votes only if they failed to explain the reasons why it is necessary to reform some of our key practices in the realms of public finance and property rights.

Self-censorship has damaged governance to the point where central bankers and finance ministers have imposed on us a crude tool of economic management – the rate of interest, the cost of borrowing money. Monetary policy – as it is currently administered – exacts a heavy price on people who work for their living. Economists call that price the 'sacrifice ratio' – the cumulative loss of output that results from action to reduce inflation.[2] They cannot agree on the scale of those losses. If the policy moderated the booms and busts, the price might be worth paying. It doesn't. Monetary policy is forced to carry too great a burden of responsibility for the excesses of those who can exploit the weaknesses in the structure of the capitalist economy. Monetary policy affords the appearance of action for the people in authority, but it cannot ultimately challenge the powerful forces that periodically cause economic activity to slump.

If there were no remedy to the cycles of booms and busts we might tolerate the charade. There is therapeutic value to be derived from engagement in acts of symbolic gestures. We may not actually be able to exclude the evil spirits from our communities, but the chants and rituals that warn them may make some people *feel* more secure. But I claim that a remedy for booms and busts does exist.

If I am correct, what are the implications? We would need to reinterpret the significance of the central bankers' conclaves. When they meet to judge whether to raise or lower the interest rate, they participate in a psychodrama that has more to do with appearances than with reality. Do we feel better for this ritual? When the bankers emerge to pronounce on how much we will have to pay to borrow money, the collateral consequences of their decisions are damaging for the enterprise economy. The negative impacts apply whether the interest rate is raised or lowered. Either way, a malfunctioning economy is further impaired, not stabilised, in a financial onslaught that transmits negative effects on the way people work, save and invest.

In the course of my interrogation of the evidence, I challenge Gordon Brown with the accusation that his analysis is fatally flawed. He appeals to 200 years of history to endorse his management of the UK economy – a claim promoted by Tony Blair's government in the general election of 2005. I draw on 400 years of evidence to demonstrate that the decisions he took when coming to power in 1997 would make little difference to boom-bust cycles.

Everyone needs shelter. And yet, for three centuries, working people have found it difficult to provide decent homes for themselves. Either we have to blame nature as being niggardly (in which case, nature is curiously selective in the way it bestows its favours), or the foundations of our laws and institutions are seriously defective. I refute the claim that we can hold nature responsible. The Industrial Revolution provided us with the compressed power to deliver all the material goods that we could possibly want. And yet, many people are denied the dwellings they need at prices they can afford. From the agricultural 18th century through the heyday of industrialism in the 19th and 20th centuries to the so-called 'New Economy' of the 21st century, the same pattern may be traced: the same social processes that deprive people of that most basic of needs, the shelter that is supposed to be the family nest.

I take as representative of the conventional views the words and deeds of the Governor of the Bank of England and the Chairman of the US Federal Reserve. They believe that the rate of interest can be manipulated to iron out the business cycle. I will explain why this is based on a fundamentally deficient understanding of the internal mechanisms of the market economy. *As it is at present structured, capitalism is congenitally incapable of balanced growth.* Manipulation of interest rates will not alter that fact; on the contrary, it exacerbates the turbulence in the markets that are supposed to order people's labour and their savings.

If I am correct, if my explanation provides a robust account of the causes of booms and busts, the implications are profound. It becomes possible for people to plan with greater confidence, to time the purchase of their homes and the amount they must save to meet the needs of their children and their retirement years.

If I am correct, the onus is placed on people to take control of their fate. The booms and busts over three centuries have slipped through the sophisticated financial and organisational defences invented by the most ingenious of entrepreneurs, they have overwhelmed the most powerful of governments and defeated the collaborative efforts of people working in partnership through organisations such as trade unions and co-operative societies. But these failures arose because people were not equipped with the knowledge that would enable them to trace so many of their problems to the root cause. That knowledge is now at their disposal.

If I am correct, the time has come to declare a democratic war on taxation. The public's finances have been transformed into a divisive tool in what are supposed to be democracies of the people. I shall explain why the home-owner, in particular, bears a heavy responsibility. For many reasons, the people who hold the title deeds to their properties ought to take the initiative and lead a campaign of reform to change the way we pay for the services that we share.

Now, armed with the insights that I offer, it is no longer possible to resign ourselves to the inevitability of feverish booms and ruinous busts. We must cease to demonise the hate-figures of history, notably the landlords. Socialists continue to fight the wars of obsolete doctrines. The *New Statesman*, for examples, the voice of the British Left, in a cover story (September 20, 2004), shrieked: 'Hands off our land! How millions are deprived of a home by a few aristocrats'. While we continue to wage ideological war on the enemies of yesterday, millions of people will continue to suffer exclusion from their birthrights and labour rights. Political philosophy needs to move on to the realities of today, because *we the people* have become part of the problem. We cannot honestly continue to blame others for the repeated breakdowns in the economy.

We, the property-owning people, have the democratic power to insist on changes to those laws and institutions that conspire to defeat the legitimate aspirations of all of us. But the temptations to remain silent are great. Homeowners, in particular, have been enriched beyond their wildest dreams by the injustices that are built into the principles of governance. The increase in the equity in their homes, however, has its dark side: the escalation of debt that hangs around the necks of millions of people. As we see from the table below, the debt burden in Britain accelerated during the housing boom at the beginning of the century. Professor Peter Ambrose estimates that housing debt between 1980 and 2004 ought to have increased to about £155bn, allowing for inflation and the increase in home ownership.[3] In fact, debt rose to more than £800bn (2004). For those cashing in their equity, the housing market looks like a sure-fire bet. For those who need homes, the housing market means a lifetime of bondage.

TABLE 1

UK Housing Debt & GDP: £bn

	1980	1985	1990	1995	2000	2002
Housing debt outstanding	53	127	295	390	536	671
Gross Domestic Product	231	355	557	719	950	1037
Debt as % of GDP	23	36	53	54	56	65

Source: Steve Wilcox, *UK Housing Review 2003/2004*, Coventry: Chartered Institute of Housing, 2003, Table 45, p.131.

This pathological state of affairs cannot be blamed on the psychological failings of individuals. Economic instability is primarily due to tax-and-tenure laws that institutionalise booms and busts, for which governments are responsible. Two examples from the run-up to the Depression of 2010 illustrate the failure of politics.

- **In the USA**, investors uncovered an old tax law that enabled them to buy commercial property without paying capital gains tax. Speculators created Tenants in Common Associations and rushed into 'the fastest-growing property ownership strategy since the Oklahoma land rushes of the 1890s'.[4]
- **In the UK**, Gordon Brown opened a yawning gap in the tax laws to foster speculation in property from April 2006. Under his new pension rules, investors could channel pension funds into real

estate and reduce their tax liabilities – their money matched by donations from the public purse.[5]

In both cases, the privileged treatment of real estate (i) pushes prices above realistic levels, and (ii) transfers tax revenue paid by low-income wage-earners to high-income owners of land. Thus, fiscal policy – working through the land market – redistributes income from the poor to the rich; fostering windfall gains for a minority and a lifetime's indebtedness for the poor.

In the course of my investigation into the pathological conditions that foster this indebtedness, I shall accuse some of our policy-makers and social scientists of failing in their duties as stewards of the nation's interests. They presume to organise people's lives by manipulating the cost of borrowing money, but their decisions are ultimately grounded in wilful ignorance. The Bank of England's Monetary Policy Committee (MPC) is a case in point. In 2004, it raised interest rates without a full understanding of the impact on the housing market. Its economists did not know what the consequences would be on people's consumption decisions or the direction in which house prices would move. It was no comfort to be told by Mervyn King, the Governor of the Bank of England:

> I do not know where house prices are going – but I also know that no-one else does either.[6]

People who are handsomely paid to know the answers may be ignorant, but the reader of this book will now gain a deeper understanding of the vital trends without having to rely on the experts. And that is how it should be, for the ultimate responsibility for our common wealth, our personal prosperity and the welfare of our communities resides in the hearts and minds of each and every one of us.

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