

within any kind of realm of reason that would see us losing \$1 in any of those transactions."⁸ When it came to his own money, that, indeed, was the case: His compensation totaled \$280 million over eight years and earned him a million a month for six months as a "consultant," after he was forced to retire in April 2008.

To add insult to injury, in March 2009, AIG, which by then was eighty percent owned by the government, used taxpayer money to pay out \$165 million in bonuses. Many of the bonuses went to those in the division that cooked up the disastrous derivative insurance that drove the company and the economy into the ground. Edward Liddy, AIG's chief executive, then came up with one of the lamest excuses since "the dog ate my homework." He wrote to treasury secretary Tim Geithner, "We cannot attract and retain the best and the brightest talent to lead and staff the A.I.G. businesses—which are now being operated principally on behalf of American taxpayers—if employees believe their compensation is subject to continued and arbitrary adjustment by the U.S. Treasury."⁹

Frank Partnoy, like virtually every financial writer, deploys a gambling metaphor to explain how the few major derivative dealers could bring down the house. He writes, "Imagine a poker game where everyone is borrowing from everyone else. Now supposing the biggest loser goes bust after losing a big bet with someone not at the poker table. Suddenly, all of the poker players at the table are insolvent."¹⁰

But let's take that metaphor a step further. Imagine that each insolvent player is now unable to pay his debts to players at other poker tables. Those other poker tables would go bust as well, and so on, right through the casino. Or, in reality, right through the entire credit system.

Enter the famous "credit freeze" of 2008. What exactly is that? In chapter 2 we used the analogy that the banking system in general provides the oxygen for the real economy. Like the air we breathe, money flows in myriad directions at the same time.

Companies use short-term loans on a daily basis to cover expenses like payroll. They need longer-term loans to invest in their plants, equipment, and research and development. Mortgages, car loans, student loans, credit cards, all need bank funds to circulate. Even the Wisconsin school districts borrow short-term money each year to smooth out their income flows as they wait for local tax revenues and state funds to arrive.

But this circulation depends on basic bank-to-bank loans. Smaller banks in the hinterland lend their surplus deposits to big banks in the financial capitals who in turn lend the money to large employers back in the hinterland. Large banks lend back and forth among each other for countless purposes. If they stop, all manner of lending grinds to a halt. And grind to a halt it did, once those derivatives went bust.

Think about it from the point of view of one of the nine surviving large national banks. You've got billions of dollars' worth of CDO assets that have plummeted in value. You are afraid to sell them because then you'd have to book the enormous losses and you might be declared insolvent. So you hold onto them and pray they come up in value. You also have billions upon billions of dollars' worth of swaps that might soon come due if other banks and companies fail. In fact you have bets in all directions—you're giving out insurance and buying insurance. Because of the crash in your toxic assets, you might have to write them down, so now your capital base is declining. You need more capital. You're also worried about having enough cash around to meet any unexpected obligations from the swaps. And to top it all off, you know for dead certain that every other financial institution is in a similar fix. Even if you thought you could profit by making loans to other banks you hold back because you don't know how bad off they really are since their toxic assets are hidden in special-purpose vehicles.

Given these conditions, are you going to lend away your precious money? No way. You'll sit tight, thank you very much.

And that's exactly what banks did (and are still doing as of this writing). They don't trust anyone and for good reason: They know they are loaded with toxic waste and they know everyone else is as well. If they lend, they might not get paid back.

It's taken massive federal guarantees to start unfreezing some of these markets. So far, all the government has managed to do is turn some of the ice to slush. We're still a long way from freely circulating financial air.

With inadequate financial air, it's just a matter of time before the "real" economy asphyxiates. No car loans mean very few car sales. No mortgage money means sharp declines in home sales and prices. Workers get laid off. Consumers stop spending. And the economy spirals downward.

Ben Bernanke, the self-proclaimed Great Depression "buff," did not take these events lightly. In a flash, his academic research no longer was academic. He knew full well what could happen if the financial system froze up and lending ceased. It happened in the 1930s, and now it was happening again.

Bernanke attacked the crisis the way his research suggested it should be attacked. Recall that he subscribed to Milton Friedman's view of what caused the Great Depression. He thought economic research had proven that speculative booms did not have to lead to disaster, even when they burst. While the 1929 stock market crash certainly caused a major disruption in the financial system, it did not have to lead inevitably to the Great Depression. Instead, Bernanke believed that the Federal Reserve had failed to provide enough liquidity to keep the economy going. It failed to bail out enough banks and inject enough money into the banking system to break the freeze. And the Fed of the 1930s had stayed glued to the gold standard, which actually reduced the amount of money circulating around the globe. In Bernanke's view, economists had

conclusively demonstrated that countries that had avoided such tight-money policies during the 1930s had ducked the worst of the Depression.

So as the financial crisis deepened, Bernanke knew just what to do. He lowered the Fed interest rates to just about zero. And he sounded the alarm. He knew that if the financial atmosphere stayed depleted for any length of time, the economy would slide into recession, or worse. It had to. There just would not be enough credit available for business as usual. More and more businesses would fail. And since so many institutions were linked together by swaps, the failure could spread rapidly around the globe. Bad news.

Bernanke also avoided the worst of free-market ideology. He, treasury secretary Henry Paulson, and other top Bush administration officials could not look the other way and pretend that the financial free markets would resurrect themselves. That would guarantee the next Great Depression. Government had to intervene and intervene directly.

Bernanke soon realized that the intervention would have to be massive. First the Fed helped to merge Bear Stearns into JPMorgan and to guarantee about \$25 billion in toxic waste stuck on their books. Then they took over Fannie and Freddie, and guaranteed more than \$200 billion in junk securities held by the two. They let Lehman Brothers fold. But they had to loan over \$100 billion to AIG, which held nearly a half trillion dollars in credit default swaps. They helped to merge away Merrill Lynch and Washington Mutual—companies that had been badly burned at the CDO casino. Next they asked for \$700 billion from Congress, ostensibly to clean the banks' books by buying up as much financial toxic waste as possible.

When all of that didn't work fast enough, Bernanke basically proposed nationalizing the nine major banks (without calling it that), as Sweden had done in a previous crisis and England was doing in this one. He and Paulson chose a very mild form of