## The Problem with Speculative Debt

So how did we get into this mess?

Historians refer to the economic downturns of the 19th Century as financial panics, as in the Financial Panic of 1819. They use that term because it succinctly captures how these downturns always start. But before you can have a financial panic, you first need a financial boom. And for that, you need leverage.

Leverage is the financial term for investing borrowed money. Imagine that people start to buy and sell my columns, and suppose the price of a column begins to rise by 20% each year. Figuring to make some easy money, you pull $1000 out of savings and buy 10 columns. A year later, you sell them for $1200 – a $200 profit.

Now look at what happens with a little leverage. Again you buy 10 columns for $1000, but this time you take them down to the bank, and put them down as collateral on a $900 loan. With the loan you buy 9 more columns, again using these to take out still another loan. Continue the process until you've borrowed $9000, and bought $10,000 worth of columns. Then wait 1 year, sell them for $12,000, pay off the $9000 loan plus maybe $1000 in interest – and voila, you have a $1000 profit.

Leverage allowed you to increase your profit five fold. It's the basic principle behind almost all get rich quick schemes, and during a boom, at least for a while, it works. In fact, it works better and better. Because when your buddies find out how you made all that dough, and they start investing in my columns, the price increase will accelerate to 40% a year. Now your leveraged $1000 gets you a $3000 annual profit. Which stokes the fire even more.

Until someone actually reads one of the columns, and realizes they're not worth the price they're selling for. (I heard that, Hayford!) Suddenly the price rise halts, and all those speculators realize they're paying interest on all the money they borrowed to buy these things.

So, as they try to sell their holdings, the price begins to fall, and pretty soon the columns are worth less that the loans they were pledged as collateral for. Your buddies all go bankrupt, the banks are forced to repossess nearly worthless newsprint, they have trouble paying off on their own loans, and the whole financial house of cards collapses.

The stories of Bear Stearns, Lehman Bros. and the like were a bit more complicated, but they all boil down to making speculative investments with mostly borrowed money. It was a great ride until the rollercoaster stopped. And now we're stuck picking up the pieces.

Can we prevent it from happening again? Yes, through regulation. For the most part, the banks that you and I deal with, the M&Is and Choice Banks and the like, were unaffected by this mess. But that's because they have reserve requirements, and other regulations imposed by the Fed and the FDIC, that limit how leveraged they can get. Back in the 1900s, small banks would fail right and left during financial panics. Since the regulations of the Roosevelt Administration, that mostly doesn't happen any more.

Over the next year or so, you'll hear about proposals to rein in our financial sector, by rewriting our entire financial regulatory structure. Not all regulation is good, but this type of regulation is severely needed. We just can't afford to let all those Wall Street Wizards gamble with borrowed money any more.