Nonfiction Book Proposal

Current Affairs and Economics

The New, New Deal: The Re-Industrialization of Post Depression America

by Eric Janszen

Proposal Contents

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I. Overview

> "The current crisis marks the end of an era of credit expansion based on the dollar as the international reserve currency. The periodic crises were part of a larger boom-bust process. The current crisis is the culmination of a super-boom that has lasted for more than 60 years. The danger is that the resulting political tensions, including U.S. protectionism, may disrupt the global economy and plunge the world into recession or worse." - *George Soros, Financial Times, Jan. 2008*

It is human nature to extrapolate the present into the future and we all tend to associate current events with similar periods in our own past experience. As the U.S. enters its first recession since 2001 the business press will continue to report it as a garden-variety business cycle recession as in the early 1990s. The expectation is that the recession will be short and shallow; while the housing industry which is leading the recession declines, other industries will rise to replace lost jobs and boost consumer spending, spurring employment and demand and ending the recession. The cycle, it is widely believed today, will be a so-called V-shaped economic event of decline and recovery.

In reality, the U.S. is entering a period of debt deflation that has profound implications for the structure of its economy. Much economic growth has been debt- rather than savings-financed since the birth of the FIRE Economy (Finance, Insurance, Real Estate) out of the recessions of the early 1980s. This has been even more the case since 2001 as debt stimulus added $1.8 million in new private and public sector debt for each new job created. As the debt deflation evolves, more than 30 years of debt excess will be unwound. The U.S. economy will experience a lengthy period of economic decline and stagnation, an L-shaped economic event, as it is weaned off debt-financed growth and restructured to grow based on savings and investment.

By the end of 2008 the seriousness of the recession and the debt deflation dynamic will be felt but misunderstood. Traditional methods of reflating the economy – currency depreciation, interest rate and

tax cuts, and fiscal stimulus – will have mysteriously failed to stimulate the economy while these policies continue to fuel inflation. By mid 2009 the new administration will be faced with unprecedented economic and political challenges calling for radical and unorthodox, yet practical, policy solutions.

Also in 2009, new books will take the place on bookstore shelves previously occupied by housing bubble books that explained how to get rich in real estate, which earlier had replaced technology bubble books explaining how to get rich in technology stocks. Like the ephemeral bubble of investing books that came before them, these next books will take either a bullish or bearish view of the future, comparing the 2009 economic crisis to either the early 1990s recession, and forecasting incipient recovery, or to the 1930s Great Depression and forecasting dire decline.

In truth the period will be more like the period of Japan's debt deflation and rolling recessions that began in 1990 and continue today, except with an inflationary versus deflationary bias, a hangover from decades of reckless foreign borrowing, lack of savings, and over-consumption. But the U.S. is not Japan; with the right set of policies the U.S. can restructure and recover, and *The New, New Deal* offers a viable model for economic recovery with or without government cooperation. *The New, New Deal* explains the nature of the current U.S. crisis, how it developed, where it's headed, what policy makers should do to head it off, and what readers can do.

The four key enablers of the political shift will be Economic Recession, Dollar Weakness and Inflation, Energy Insecurity, Peak Cheap Oil. To smooth the economic structural transition from a borrow-and-consume to produce-and-save economy, *The New, New Deal* proposes the development of major for-profit transportation, energy, and communications infrastructure (TECI) projects designed to spark employment and economic stimulus, reduce U.S. dependence on imported energy, reduce the energy intensity of the U.S. economy, and improve the efficiency of the economy for all growth industries for the 21st century.

The New, New Deal answers critical questions about our economy we all want answered. Why can't the U.S. have the best automobile industry in the world, producing the most advanced and efficient

next generation cars? Why can't the U.S. have the world's most modern energy infrastructure with the lowest carbon emissions? Why can't we travel by high-speed rail from New York to Florida? The impediments to progress are not technological but political, the result of the momentum of 30 years of flawed FIRE Economic policy.

The developing economic depression will kill the momentum of the FIRE Economy and open the door to a sane and sustainable economic future. What may appear at first to be an intractable crisis will instead be a once-in-a-generation opportunity to correct decades of bad economic policy. *The New, New Deal* shows the way, not with big government bureaucracy but by deploying America's unique capacity for innovation and its highly developed capital market institutions. At a time when most will see crisis, anger, and hopelessness, readers of *The New, New Deal* will already know the solution.

II. About the Author

The author has more than 20 years experience in the technology industry in software engineering, product marketing and sales management. As CEO of two venture-backed companies he raised $30 million in venture capital during the most difficult period for raising venture capital, from 2001 to 2004. Before that as managing director he ran Osborn Capital, LLC, a seed stage investment firm that made 20 investments and saw seven positive liquidity events, including two IPOs, two sales to Cisco, one sale to Microsoft, and one sale to Nortel. Based on research from the author's contrarian investment site iTulip.com, Osborn Capital sold its stock positions in the spring of 2000. After an analysis of the "reflation trade" they purchased gold at $270 a ounce in 2001, and the author contributed a chapter to the book *America's Bubble Economy: Profit When It Pops* (John Wiley & Sons, 2006), which was based on an article written for iTulip in August 2001 explaining that prescient investment decision at a time when gold was trading at 20 year lows and widely regarded as a "dead" investment.

The author founded iTulip.com in 1998. iTulip has been covered by The New York Times, CNBC, Reuters, Barron's, Business Week, USA Today, the BBC and the Washington Post. The site has received more than eight million visitors. In September 2007 the author was approached by Harper's to write an article to explain where the asset bubbles in technology and housing came from and their implications for the future of the U.S. economy. The result was the 5,000 word February 2008 cover article *The Next Bubble,* produced in a little over two months, as compared to six to eight normally devoted by Harper's for projects of similar length. Harper's has already asked the author to write another long article this year and has begun discussions about making him a regular columnist. The author's unique experience, abilities and perspective stem from his uncommon combination of a Bachelor of Science Degree in Resource Economics (from the University of Massachusetts, Amherst); more than 20 year of operating experience in the high technlogy industry; experience running a seed stage venture firm, two venture backed companies and an Internet-based publishing business; and writing for Bankrate, AlwaysOn and other publications for more than 10 years.

III. Comparable Titles

From a competitive standpoint, *The New, New Deal* can be thought of as a hybrid of books on several popular themes: globalization, global economic imbalances, America's foreign debt and fiscal deficit dependence, and the threat of a major U.S. and global economic crisis developing as the U.S. housing bubble continues to deflate and the credit crunch begins to feed into the developing recession. *The New, New Deal* ties these themes together in the context of an economic crisis that the author expects will bear down on the U.S. economy and drag the world economy into an economic and then a political crisis by the middle of 2009.

Some books in this general category focus on the rise of global trade and finance, others cover debt-financed asset bubbles in housing and other markets and forecast a dire macro-economic aftermath. *The New, New Deal* is the first book to tie these related trends together; it explains the seeds of a

developing global political-economic crisis, and demonstrates how the U.S. and the world can avoid undemocratic and anti-capitalist policy responses. The following books have touched on subjects *The New, New Deal* explores in detail:

- In his New York Times best seller *Three Billion New Capitalists* (Basic Books: 2005), Clyde Prestowitz discusses the economic decline of the U.S. characterized by massive trade and budget deficits, diminishing investments in engineering and science, deteriorating schools, a negative savings rate, a depreciating currency and a debt-dependent economy while competing nations, especially China and India, follow industrial policies aimed at producing trained workers who save and invest versus borrow and consume. Prestowitz expects an eventual crisis that he refers to as an "economic 9/11" after foreign creditors that have been financing the U.S.'s twin deficits withdraw their support. Unlike the author of *The New, New Deal*, however, Prestowitz does not tie the market dysfunctions that produced the technology stock market and housing bubbles to the coming crisis, nor cite the decline of the housing bubble as the trigger, nor does he have a prescription that allows the market institutions that created America's wealth to survive the eventual crisis.
- In his New York Times best seller *Globalization and Its Discontents* (W. W. Norton: 2003), Joseph Stiglitz offers a balanced critique of globalism. Stiglitz blames the "market fundamentalism" that endorses the view that a "free" market solves all problems flawlessly. As Stiglitz authoritatively indicates, one-size-fits-all economic policies can damage rather than help countries with unique financial, governmental and social institutions. He calls for public institutions to reform and become more transparent and responsive to their constituents. But he doesn't tie together the key trends of global economics and finance in a historical context, explain the implications of imbalances and dysfunction that developed over decades, nor lay a clear solution to the crisis that is now developing as a consequence of these imbalances.

The New, New Deal is the first book that shows readers how technology, capital markets, and the institutions of markets and government can be deployed to solve a crisis that currently threatens not only market institutions but, as in the 1930s, the democratic and capitalist traditions of the U.S.

IV. Marketing and Promotion

The focus of marketing activity will be PR to generate book reviews and interviews. The author will hire an agency to approach media targets as discussed below.

Blurbs

The author has direct relationships with a number of notables in the world of media and finance who are likely to blurb the book, including hedge fund managers (e.g., FutureSelect), managing directors of venture capital and private equity firms (e.g., Charles River Ventures, Trident Capital, TA, and Bain), investment banking (e.g., Lehman Bros. and Goldman Sachs); and Engineering and Business school leaders at Stanford, MIT, and Harvard.

Media Relations

In the wake of the Harper's article *The Next Bubble* the author has received interview requests and has been appearing live on CNBC and many other television stations in the U.S. and Canada, and on National Public Radio and other radio outlets across the U.S., Canada, and Germany. Interviews are ongoing with a live appearance on CNBC's *Closing Bell* show March 3, 2008 (see video clip and links to others at www.twliterary.com/itulip) and an interview the same day for Wired Magazine. The author expects an even stronger response to the issuance of a book that provides deeper coverage of the general topic of the Harper's article that generated so much media interest.

The Harper's article was picked up by more than 40 blogs, including the Wall Street Journal's "The Informed Reader," Hoover's "Business Insight Zone.," and Paul Farrell of Fox News. Each will be contacted and made aware of the book.

All of this interest was generated organically without any PR effort. In the case of *the New, New Deal* book, the author will hire a PR firm to actively go after major media and book review targets internationally. We will aim high with media targets that include *the New York Times* and the *Charlie Rose Show*.

Speaking Appearances

The author has more than ten years' experience as a public speaker presenting to large audiences at investor's and technology industry conferences around the world. Most recently he was hired as the keynote speaker at the Hard Assets Investor's Conference in Las Vegas in 2007 where he presented to an audience of more than 500. He is currently scheduled to appear on a panel with Henry Blodget at a wealth management services event being put on by Reuters in April, 2008. He has traveled extensively to Europe and Asia in his career in the high technology industry, has a current passport and is glad to tour and speak with interested audiences worldwide.

Serialization

In addition to additional articles, the author is in discussions with Harper's about potential serialization opportunity for *The New New Deal*. Other targets are Wired Magazine, which interviewed the author March, 2008.

V. Detailed Table of Contents

Section explains U.S. economic and military leadership, its sources and outcomes.

2.2 Heavy Industrialization

Section explains the role of industry and export in building the U.S. economy after WWII.

2.3 The Rise and Fall of the Yankee Dollar

Section explains how the U.S. dollar is both a function of and a determinant of U.S. global economic dominance.

2.4 De-Industrialization

Section explains the process of loss of industry to Asia and other competitors and the impact on the U.S. economy and currency.

2.5 Investment Banks as Penny Stocks

Section explains the devastating impact of deindustrialization on the U.S. financial services industry between the 1960s and 1980.

Chapter 3 – FIRE Economy

Chapter explains the rise of the Finance, Insurance, and Real Estate industry (FIRE Economy) and how it created a recovery for the post-industrial economy from 1980 to 2007 and set the U.S. up for a second crash and depression and the world for a second period of de-globalization.

3.1 Free-for-all Markets

Section explains the way the ideology of free markets was used as cover by both the Republican and Democratic parties to develop a U.S. economy based on FIRE via tax policy and other subsidies and protections.

3.2 Finance-Based Economy

Section explains the parts and function of the FIRE Economy.

3.3 Credit Bubble Version 2.0

Section explains how the second credit bubble in 100 years formed in the U.S. between 1995 and 2007.

3.4 Risk Pollution

Section explains how deregulation, financial engineering, and free market ideology coincided to mass-produce financial system risk and spread it worldwide.

3.5 Technology and Housing Bubbles

Section explains the development and decline of the 1990s and 2000s asset price inflations.

3.6 Beginning of the End

Section explains how the unwinding of the FIRE Economy started with the crash of the market for an obscure securitized debt instrument called a CDO (Collateralized Debt Obligation).

Chapter 4 – Debt Deflation and Recession

Chapter explains the process of debt deflation and recession that started in Q4 2007 and will continue for years.

4.1 Credit Contraction

Section explains the dynamics of credit contracts.

4.2 Recession and Depression

Section characterizes the rolling recessions that will plague the U.S. for the next five years or longer.

4.3 Wealth Impedance Mismatch

Section explains the differential impact of the recessions in the context of poor distribution of wealth that developed during the period of the FIRE Economy.

4.4 Nothing to fear but nothing itself

Section explains that war as a means for government and private industry to create employment is not an option in the nuclear age.

4.6 Crossroads: Boom or Doom?

Section explains the stark choices that confront global leaders, that strong leadership is needed to put long-term national interests before short-term political expediency.

Chapter 5 - The New, New Deal

Chapter shows how the New, New Deal is a viable option to ongoing recessions and de-globalization.

5.1 Limits of the old New Deal

Explains why the old New Deal did not work.

5.2 Economic Stimulus, Trade Balance, Energy Security, Energy Intensity

Explains the main drivers for a structural change to the U.S. economy to promote economic growth, maintain good trade relations, rebuild the value of the U.S. dollar, and decrease U.S. dependence on imported energy.

5.3 The Real New Economy

Explains the parts of and function of the Real New Economy

5.3 New America

Explains the new role of the U.S. economy in the world economy

5.4 The Growth Machine

Explains how the New Economy is sustainable and will continue past the completion of the Core Projects.

Abstract

By the middle of 2009, after almost a year and a half of denial, the world will begin to grapple with the most severe global economic crisis in more than 60 years. The credit crisis that started as a sub-prime mortgage crisis in June 2007, and which recently spread to the state and local government bond and

corporate markets, will spread to reach the markets for credit card, student loans, and other key sources consumer and business loans. A debt deflation will be in full swing. As businesses shed workers to conserve cash, unemployment will rise to more than 7% nationally in 2008; according to the Bureau of Labor Statistics, as of December 2007 unemployment is already at 6.1% in California, up from 4.4% December 2006.

Governments around the world will be too preoccupied with domestic economic and political problems to focus in international matters; unilateralist and populist decision-making will dominate national politics. Geopolitical and economic alliances going back to WWII will come under strain, and newer alliances of economic convenience such as between the U.S. and China will start to disintegrate as domestic economic turmoil, high unemployment, inflation, and political unrest cause national leaders to withdraw from international interests and focus on critical domestic concerns.

Once-benign trade conflicts will develop into open economic battles, especially between oil exporting nations who keep oil production constrained to maintain high prices while western oil consuming nations, most notably the U.S., struggle with the policy conundrum of high inflation, debt deflation, and economic stagnation.

The global financial system that is dependent on international central bank cooperation for liquidity to manage currency and credit risk and prevent cascading debt defaults will start to break down. The U.S. will continue to externalize its economic stress through dollar depreciation, and U.S. trade partners in turn will take action to protect themselves via currency controls and other non-market measures.

A U.S.-centric global monetary system created by the victorious powers after WWII will likely dissolve as nations fight global debt deflation with competitive currency depreciations. World leaders will face the stark choices of their grandparents' generation: one path leads to restructuring and a new era of sustainable, balanced global economic growth, while the other ushers in, for the second time in 100 years, a multi decade period of de-globalization, economic stagnation, and war. The new U.S. administration in

2009 will have a relatively brief period to pull together a modern form of the New Deal to get the U.S. on the first path before the second path develops as a natural consequence of political and economic forces already in motion.

The U.S. will begin to pay the price for decades of the FIRE Economy: reliance on sales of financial assets in exchange for goods to fund its merchandise trade and fiscal deficits. The dollar will continue to decline as the U.S. seeks to externalize its economic distress via dollar depreciation, creating ongoing domestic inflation and fueling inflation across the Middle East, Europe and Asia. By mid-2009 orthodox methods of economic reflation – tax cuts, rate cuts, deficit spending, and currency depreciation – will have been repeatedly deployed but the economy will continue to decline.

The U.S. needs a New Deal, but not in the 20th century form as in steel and heavy industry. It needs a modern New Deal that develops 21st century industries – biotechnology, nanotechnology, and energy technology – and does it in a way that leverages the U.S.'s unique financial markets and systems of business financing.

The solution is a program of large, capital intensive, for-profit, private-public transportation, energy, and communications infrastructure projects**.** These core projects will provide opportunities for feeder technology companies to compete to supply core project technologies. Private-Public Partnerships (P3) will provide the deep pockets and safety of government backing while the public charter enforces market discipline (e.g., no more Boston Big Dig fiascos).

This will effectively simulate the development that eventually occurs when debt deflation runs to its logical conclusion: the global economy shrinks, the clock turns backwards on globalization – free trade, democracy and capitalism diminish. A merger of government and private enterprise happens anyway but via the appropriation of private production by the government for military uses.

As the U.S. and the developed world enters its second major global debt deflation in a century, stark choices confront U.S. politician leaders: re-industrializing the U.S. economy or another period of

economic stagnation and geopolitical political conflict potentially leading to de-globalization, depression, and war.

The New, New Deal, unlike the old New Deal which focused on bridges and highways, will bring the U.S. into the strongest competitive position on earth with a focus on Alternative Energy and Communications Infrastructure (AECI). Rather than relying on direct government oversight and funded for project management and employment, AECI leverages the private sector and engages the uniquely American system of entrepreneurship, innovation, private funding, competition, and economic reward. Public-Private Partnerships (P3) will need to be founded to develop major energy and communications infrastructure projects. Around these mega-projects hundreds of independent start-ups will form and compete to meet critical technology needs, from nanotechnology paints that reduce heat absorption and decrease cooling needs to light emitting diode-based lighting that consumes $1/10^{th}$ the energy of incandescent lights and lasts for 1,000 years of continuous use.

The options are Boom or Bust. *The New, New Deal* offers a path of hope at a time of confusion.

VI. Sample Writing

See attached cover article from February 2008 Harper's Magazine.

FREDERICK KAUFMAN: THE WASTE ECONOMY

HARPER'S

HARPER'S FEBRUARY 2008

THE NEXT BUBBLE

Taking Stock of Our Irrational Exuberance

By Eric Janszen

STAYING AWAKE

Notes on the Alleged Decline of Reading

By Ursula K. Le Guin

WARS IN DISTANT LANDS

A story by Najem Wali

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THE NEXT BUBBLE

Taking stock of our irrational exuberance

By Eric Janszen

A financial bubble[1] is a market aberration manufactured by government, finance, and industry, a shared speculative hallucination and then a crash, followed by depression. Bubbles were once very rare—one every hundred years or so was enough to motivate politicians, bearing the post-bubble ire of their newly destitute citizenry, to enact legislation that would prevent subsequent occurrences. After the dust settled from the 1720 crash of the South Sea Bubble, for instance, British Parliament passed the Bubble Act to forbid "raising or pretending to raise a transferable stock." For a century this law did much to prevent the formation of new speculative swellings.

Nowadays we barely pause between such bouts of insanity. The dot-com crash of the early 2000s should have been followed by decades of soul-searching; instead, even before the old bubble had fully deflated, a new mania began to take hold on the foundation of our long-standing American faith that the wide expansion of home ownership can produce social harmony and national economic well-being. Spurred by the actions of the Federal Reserve, financed by exotic credit derivatives and debt securitiztion, an already massive real estate sales-and-marketing program expanded to include the desperate issuance of mortgages to the poor and feckless, compounding their troubles and ours.

That the Internet and housing hyperinflations transpired within a period of ten years, each creating trillions of dollars in fake wealth, is, I believe, only the beginning. There will and must be many more such booms, for without them the economy of the United States can no longer function. The bubble cycle has replaced the business cycle.

Such transformations do not take place overnight. After World War I, Wall Street wrote checks to finance new companies that were trying to turn wartime inventions, such as refrigeration and radio, into consumer products. The consumers of the rising middle class were ready to buy but lacked funds, so the banking system

[1] *I will use the familiar term "bubble" as a shorthand, but note that it confuses cause with effect. A better, if ungainly, descriptor would be "asset-price hyperinflation"—the huge spike in asset prices that results from a perverse self-reinforcing belief system, a fog that clouds the judgment of all but the most aware participants in the market. Asset hyperinflation starts at a certain stage of market development under just the right conditions. The bubble is the* result *of that financial madness, seen only when the fog rolls away.*

Eric Janszen is the founder and president of iTulip, Inc. He formerly served as managing director of the venture firm Osborn Capital, CEO of AutoCell, Inc. and Bluesocket, Inc., and entrepreneur-in-residence for Trident Capital.

Illustrations by Tim Bower

accommodated them with new forms of credit, notably the installment plan. Following a brief recession in 1921, federal policy accommodated progress by keeping interest rates below the rate of inflation. Pundits hailed a "new era" of prosperity until Black Tuesday, October 29, 1929.

The crash, the Great Depression, and World War II were a brutal education for government, academia, corporate America, Wall Street, and the press. For the next sixty years, that chastened generation managed to keep the fog of false hopes and bad credit at bay. Economist John Maynard Keynes emerged as the pied piper of a new school of economics that promised continuous economic growth without end. Keynes's doctrine: When a business cycle peaks and starts its downward slide, one must increase federal spending, cut

taxes, and lower short-term interest rates to increase the money supply and expand credit. The demand stimulated by deficit spending and cheap money will thereby prevent a recession. In 1932 this set of economic gambits was dubbed "reflation."

The first Keynesian reflation was botched. To be fair, it was perhaps impractical under the gold standard, for by the time the Federal Reserve made its attempt to ameliorate matters, debt was already out of control.[2] Banks failed, credit contracted, and GDP shrank. The economy was running in reverse and refused to respond to Keynesian inducements. In 1933, President Franklin D. Roosevelt called in gold and repriced it, hoping to test Keynes's theory that monetary inflation stimulates demand. The economy began to expand. But it was World War II that brought real recovery, as a highly effective, demand-generating, deficit-and-debt-financed public-works project for the United States. The war did what a flawed application of Keynes's theories could not.

A few weeks after D-Day, the allies met at the Mount Washington Hotel in Bretton Woods, New Hampshire, to determine the future of the international monetary system. It wasn't much of a negotiation. Western economies were in ruins, and the international monetary system had been in disarray since the start of the Great Depression. The United States, now the dominant economic and military power, successfully pushed to peg the currencies of member nations to the dollar and to make dollars redeemable in American gold.

Americans could now spend as wisely or foolishly as our government policy decreed and, regardless of the needs of other nations holding dollars as reserves, print as many dollars as desired. But by the second quarter of 1971, the U.S. balance of merchandise trade had run up a deficit of $3.8 billion (adjusted for inflation)—an admittedly tiny sum compared with the deficit of $204 billion in the second quarter of 2007, but until that time the United States had run only surpluses. Members of the Bretton Woods system, most famously French President General Charles de Gaulle, worried that the United States intended to repay the money borrowed to cover its trade gap with depreciated dollars. Opposed to the exercise of such "exorbitant privilege," de Gaulle demanded payment in gold. With the balance of payments so greatly out of balance, newly elected President Richard Nixon faced a run on the U.S. gold supply, and his solution was novel: unilaterally end the U.S. legal obligation to redeem dollars with gold; in other words, default.

More than a decade of economic and financial-market chaos followed, as the dollar remained the international currency but traded without an absolute measure of value. Inflation rose not just in the United States but around the world, grinding down the worth of many securities and brokerage firms. The Federal Reserve pushed interest rates into double digits, setting off two global recessions, and new international standards and methods for measuring inflation and floating exchange rates were established to replace the gold standard. After 1975, the United States would never again post an annual merchandise trade surplus. Such high-value, finished-

[2] *Historians argue whether the Federal Reserve and Congress did enough soon enough to slow the rate of debt liquidation at the time. Most agree that once the inflation rate turned negative, monetary stimulus via short-term interest-rate management was ineffective, since the Fed could not lower short-term rates below zero percent. The Bank of Japan found itself in a similar predicament sixty years later.*

goods-producing industries as steel and automobiles were no longer dominant. The new economy belonged to finance, insurance, and real estate—FIRE.

FIRE is a credit-financed, asset-price-inflation machine organized around one tenet: that the value of one's assets, which used to fluctuate in response to the business cycle and the financial markets, now goes in only one direction, up, with no more than occasional short-term reversals. With FIRE leading the way, the United States, free of the international gold standard's limitations, now had great flexibility to finance its deficits with its own currency. This was "exorbitant privilege" on steroids. Massive external debts built up as trade partners to the United States, especially the oil-producing nations and Japan, balanced their trade surpluses with the purchase of U.S. financial assets.[3] The process of financing our deficit with private and public foreign funds became self-reinforcing, for if any of the largest holders of our debt reduced their holdings, the trade value of the dollar would fall—and with that, the value of their remaining holdings would be decreased. Worse, if not enough U.S. financial assets were purchased, the United States would be less able to finance its imports. It's the old rule about bank debt, applied to international deficit finance: if you owe the banks $3 billion, the bank owns you. But if you owe the banks $10 trillion, you own the banks.

The FIRE sector's power grew unchecked as the old manufacturing economy declined. The root of the 1920s bubble, it was believed, had been the conflicts of interest among banks and securities firms, but in the 1990s, under the leadership of Alan Greenspan at the Federal Reserve, banking and securities markets were deregulated. In 1999, the Glass-Steagall Act of 1933, which regulated banks and markets, was repealed, while a servile federal interest-rate policy helped move things along. As FIRE rose in power, so did a new generation of politicians, bankers, economists, and journalists willing to invent creative justifications for the system, as well as for the projects—ranging from the housing bubble to the Iraq war—that it financed. The high-water mark of such truckling might be the publication of the CATO Institute report "America's Record Trade Deficit: A Symbol of Strength." Freedom had become slavery; persistent deficits had become economic power.

The bubble machine often starts with a new invention or discovery. The Mosaic graphical Web browser, released in 1993, began to transform the Internet into a set of linked pages. Suddenly websites were easy to create and even easier to consume. Industry lobbyists stepped in, pushing for deregulation and special tax incentives. By 1995, the Internet had been thrown open to the profiteers; four years later a sales-tax moratorium was issued, opening the floodgates for e-commerce. Such legislation does not *cause* a bubble, but no bubble has ever occurred in its absence.

I had a front-row seat to the Internet-stock mania of the late 1990s as managing director of Osborn Capital, a "seed stage" venture-capital firm founded by Jeffrey Osborn,[4] with positions on the boards of more than half a dozen technology companies. I observed otherwise rational men and women fall under the influence of a fast-flowing and, it was widely believed, risk-free flood of money. Logic and historical precedent were pushed aside. I remember a managing partner of one firm telling me with certainty that if the company in which we'd invested failed, at least it had "hard assets," meaning the notoriously depreciation-prone computer equipment the company had received in exchange for stock. A year after the bubble collapsed, of course, the market was flooded with such hard assets.

Deregulation had built the church, and seed money was needed to grow the flock. The mechanics of financing vary with each bubble, but what matters is that the system be able to support astronomical flows of funds and generate trillions of dollars' worth of new securities. For the Internet, the seed money came from venture capital. At first, Internet startups were merely one part of a spectrum of enterprise-software and other technology industries into which venture capitalists put their money. Then a few startups like Netscape went public, netting massive returns. Such liquidity events came faster and faster. A loop was formed: profits from IPO investments poured back into new venture funds, then into new startups, then back out again as IPOs, with the original investment multiplied many times over, then finally back into new venture-capital funds.

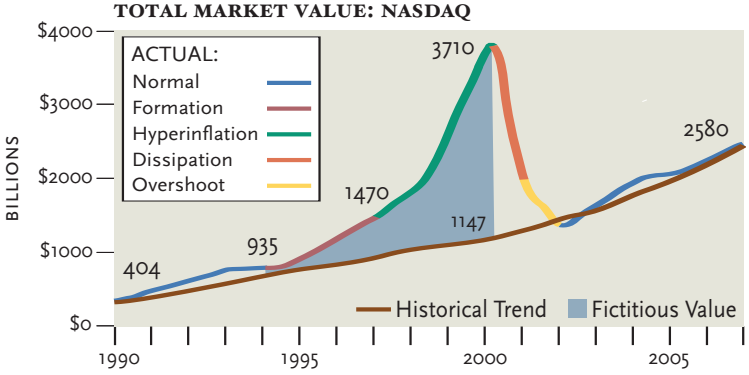
The media stood by cheering, carrying breathless profiles of wunderkinder in their early twenties who had just made their first hundred million dollars; business publications grew thick with advertisements. The media barely questioned the fine points of the new theology. Skeptics were occasionally interviewed by journalists, but in gen-

[3] The motivation was in part political: the Saudis, Japanese, and Taiwanese hold a great portion of U.S. debt; not coincidentally, these nations receive military protection from the United States.

[4] Venture-capital firms are defined by when, not where, they place their investments; a "seed stage" firm usually puts the first money into very young firms and takes an active role in that investment. Jeffrey Osborn was a senior executive at commercial Internet provider UUNet before and after the legislation passed. Prior to the legislation, bookings were less than $4 million a year; a few years later they were greater than $2 billion.

eral the public was exposed to constant reiterations of the one true faith. Government stood back—after all, there was little incentive for lawmakers to intervene. Members of Congress, who influence the agencies that oversee market-regulation functions, have never been unfriendly to windfall tax revenues, and the FIRE sector has very deep pockets. According to the donation-tracking website opensecrets.org, FIRE gave $146 million in political donations for the 2008 election cycle alone, and since 1990 more than $1.9 billion—nearly double what lawyers and lobbyists have donated, and more than triple the donations from organized labor.

TOTAL MARKET VALUE: NASDAQ



11% annual growth derived from pre-bubble valuation (peak occurred march 10, 2000, when the nasdaq traded as high as 5132.52 and closed the day at 5048.62)

Part of my job was to watch for the end-time, to maximize gains and guard the firm against sudden losses when the bubble finally popped. In March 2000, the signal arrived. One of our companies was investigating the timing of an IPO; the management team was hoping for April 2000. The representatives of one of the investment banks we talked to gave us a surprisingly specific recommendation that ran counter to advice offered by banks during the IPO-driven cycle of the preceding five years: they warned the company not to go public in April. We took the advice in the context of other indicators as a clear sign of a top, and over the next few months we liquidated stocks in public companies that we held as a result of earlier IPOs. Shortly thereafter, millions of investors with unrealized gains in mutual funds sold stock to raise enough cash to pay taxes on their capital gains. The mass selling set off a panic, and the bubble popped.

In a bubble, fictitious value[5] goes away when market participants lose faith in the religion—when their false beliefs are destroyed as quickly as they had been formed. Since the early 1980s, the free-market orthodoxy of the Chicago School has driven policy on the upward slope of an economic boom, but we're all Keynesians on the way down: rate cuts by the Federal Reserve, tax cuts by Congress, deficit spending, and dollar depreciation are deployed in heroic proportions.

The technology industry represents only a small fraction of the U.S. economy, but the effects of layoffs, cutbacks, and the collapsing stock market rippled through the economy and produced a brief national recession in the early part of 2001, despite a concerted effort by the Federal Reserve and Congress to avoid it. This left in its wake a crucial dilemma: how to counter the loss of that $7 trillion in fictitious value built up during the bubble.

The Internet boom had been a matter of abstract electrons and monetized eyeballs—castles in the sky translated into rising share prices. The new boom was in MacMansions on the ground—wood and nails, granite countertops. The price-inflation process was traditional as well: there was way too much mortgage money chasing not enough housing. At the bubble's peak, $12 trillion in fictitious value had been created, a sum greater even than the national debt.

We certainly should have known better. Historically, the price of American homes has risen at a rate similar to the annual rate of inflation. As the Yale economist Robert Shiller has pointed out, since 1890, discounting the housing boom after World War II, that rate has been about 3.3 percent. Why, then, did housing prices suddenly begin to hyperinflate? Changes in the reserve requirements of U.S. banks, and the creation in 1994 of special "sweep" accounts, which link commercial checking and investment accounts, allowed banks greater liquidity—which meant that they could offer more credit. This was the formative stage of the bubble. Then, from 2001 to 2002, in the wake of the dot-com crash, the Federal Reserve Funds Rate was reduced from 6 percent to 1.24 percent, leading to similar cuts in the London Interbank Offered Rate that banks use to set some adjustable-rate mortgage (ARM) rates. These drastically lowered ARM rates meant that in the United States the monthly cost of a mortgage on a $500,000 home fell to roughly the monthly cost of a mortgage on a $250,000 home purchased two years earlier. Demand skyrocketed, though home builders would need years to gear up their production.

With more credit available than there was housing stock, prices predictably, and rapidly, rose. All that was needed for hypergrowth was a supply of new capital. For the Internet boom this money

[5] Fictitious value *is the delta between historical-trend growth and growth brought on by asset hyperinflation. As an anonymous South Sea Bubble pamphleteer explained: "One added to one, by any rules of vulgar arithmetic, will never make three and a half; consequently, all the fictitious value must be a loss to some persons or other, first or last. The only way to prevent it to oneself must be to sell out betimes, and so let the Devil take the hindmost."*

had been provided by the IPO system and the venture capitalists; for the housing bubble, starting around 2003, it came from securitized debt.

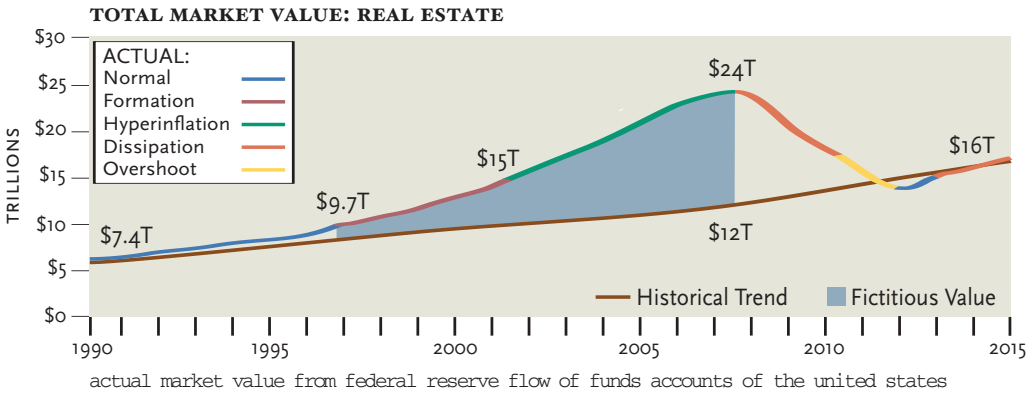
To "securitize" is to make a new security out of a pool of existing bonds, bringing together similar financial instruments, like loans or mortgages, in order to create something more predictable, less risk-laden, than the sum of its parts. Many such "pass-thru" securities, backed by mortgages, were set up to allow banks to serve almost purely as middlemen, so that if a few homeowners defaulted but the rest continued to pay, the bank that sold the security would itself suffer little—or at least far less than if it held the mortgages directly. In theory, risks that used to concentrate on a bank's balance sheet had been safely spread far and wide across the financial markets among well-financed and experienced institutional investors.[6]

The U.S. mortgage crisis has been labeled a "subprime mortgage crisis," but subprime mortgages were only a sideshow that appeared late, as the housing-bubble credit machine ran out of creditworthy borrowers. The main event was the hyperinflation of home prices. Risks are embedded in price and lurk as defaults. Even after the faith that supported a bubble recedes, false beliefs continue to obscure cause and effect as the crisis unfolds.

Consider the chemical industry of forty years ago, back when such pollutants as PCBs were dumped into the air and water with little or no regulation. For years, the mantra of the industry was "the solution to pollution is dilution." Mixing toxins with vast quantities of air and water was supposed to neutralize them. Many decades later, with our plagues of hermaphrodite frogs, poisoned ground water, and mysterious cancers, the mistake in that logic is plain. Modern bankers, however, have carried this mistake into the world of finance. As more and more loans with a high risk of default were made from the late 1990s to the summer of 2007, the shared level of credit risk increased throughout the global financial system.

Think of that enormous risk as ecomonic poison. In theory, those risk pollutants have been diluted in the oceanic vastness of the world's debt markets; thanks to the magic of securitization, they are made nontoxic and so pose no systemic risk. In reality, credit pollutants pose the same kind of threat to our economy as chemical toxins do to our environment. Like their chemical counterparts, they tend to concentrate in the weakest and most vulnerable parts of the financial system, and that's where the toxic effects show up first: the subprime mortgage market collapse is essentially the Love Canal of our ongoing risk-pollution disaster.

Read the front page of any business publication today and you can see the mess bubbling up. In the United States, Merrill Lynch took a $7.9 billion hit from its mortgage investments and experienced its first quarterly loss since 2001; Morgan Stanley, Bear Stearns, Citigroup, along with many other U.S. banks, have all suffered major losses. The Royal Bank of Scotland Group was forced to write down $3 billion on credit-related securities and leveraged loans, and Japan's Norinchukin Bank suffered $357 million in subprime-related losses in the six months prior to September 2007. Even more of this pollution will become manifest as home prices continue to fall.



The metaphor is not lost on those touched by debt pollution. In December 2007, Chip Mason of Legg Mason, one of the world's largest money managers, said that the U.S. treasury should put $20 billion into a "structured investment vehicles superfund" to boost investor confidence.

As more and more risk pollution rises to the surface, credit will continue to contract, and the

[6] *As happens with most bubbles, a perfectly good idea is taken to an extreme. In the case of the housing bubble, the new securitized debt product that drove the final stage—which has come to be known as the "subprime meltdown"—was the collateralized debt obligation (CDO). A CDO is a class of instrument called a credit derivative; specifically, a derivative of a pool of asset-backed securities. Parts of pools of asset-backed securities that were, for example, rated at a moderately high risk of default—junk grade, such as BBB—were modeled, packaged into CDOs, and rated at lower risk-investment grades, such as AAA. These were used to finance the more creative mortgages—stated-income or "liar loans"—which we now hear are not quite living up to the issuers' hopes.*

Historical trend from Robert J. Schiller, *Irrational Exuberance*

FIRE economy—which depends on the free flow of credit—will experience its first near-death experience since the sector rose to power in the early 1980s. Because all asset hyperinflations revert to the mean, we can expect housing prices to decline roughly 38 percent from their peak as they return to something closer to the historical rate of monetary inflation. If the rate of decline stabilizes at between 6 and 7 percent each year, the correction has about six years to go before things stabilize, leaving the FIRE economy in need of $12 trillion. Where will that money be found?

Bubbles are to the industries that host them what clear-cutting is to forest management. After several years of recession, the affected industry will eventually grow back, but slowly—the NASDAQ, for example, at 5,048 in March 2000, had recovered only half of its peak value going into 2007. When those trillions of dollars first die and go to money heaven, the whole economy grieves.

The housing bubble has left us in dire shape, worse than after the technology-stock bubble, when the Federal Reserve Funds Rate was 6 percent, the dollar was at a multi-decade peak, the federal government was running a surplus, and tax rates were relatively high, making reflation—interest-rate cuts, dollar depreciation, increased government spending, and tax cuts—relatively painless. Now the Funds Rate is only 4.5 percent, the dollar is at multi-decade lows, the federal budget is in deficit, and tax cuts are still in effect. The chronic trade deficit, the sudden depreciation of our currency, and the lack of foreign buyers willing to purchase its debt will require the United States government to print new money simply to fund its own operations and pay its 22 million employees.

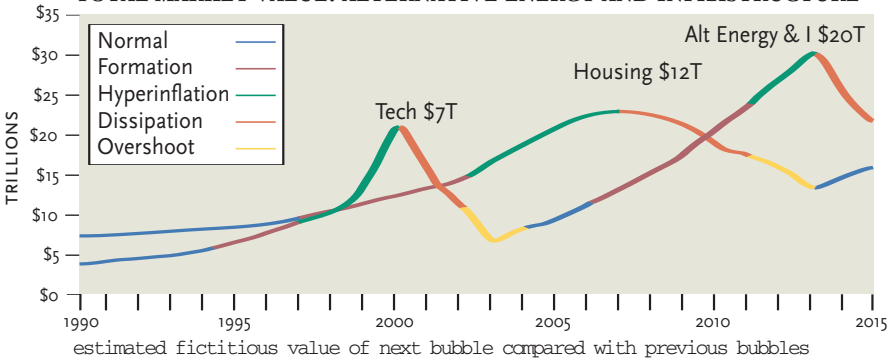
Our economy is in serious trouble. Both the production-consumption sector and the FIRE sector know that a debt-deflation Armageddon is nigh, and both are praying for a timely miracle, a new bubble to keep the economy from slipping into a depression.

We have learned that the industry in any given bubble must support hundreds or thousands of separate firms financed by not billions but trillions of dollars in new securities that Wall Street will create and sell. Like housing in the late 1990s, this sector of the economy must already be formed and growing even as the previous bubble deflates. For those investing in that sector, legislation guaranteeing favorable tax treatment, along with other protections and advantages for investors, should already be in place or under review. Finally, the industry must be popular, its name on the lips of government policymakers and journalists. It should be familiar to those who watch television news or read newspapers.

There are a number of plausible candidates for the next bubble, but only a few meet all the criteria. Health care must expand to meet the needs of the aging baby boomers, but there is as yet no enabling government legislation to make way for a health-care bubble; the same holds true of the pharmaceutical industry, which could hyperinflate only if the Food and Drug Administration was gutted of its power. A second technology boom—under the rubric "Web 2.0"—is based on improvements to existing technology rather than any new discovery. The capital-intensive biotechnology industry will not inflate, as it requires too much specialized intelligence.

There is one industry that fits the bill: *alternative energy*, the development of more energy-efficient products, along with viable alternatives to oil, including wind, solar, and geothermal power, along with the use of nuclear energy to produce sustainable oil substitutes, such as liquefied hydrogen from water. Indeed, the next bubble is already being branded. *Wired* magazine, returning to its roots in boosterism, put ethanol on the cover of its October 2007 issue, advising its readers to FORGET OIL; NBC had a "Green Week" in November 2007, with themed shows beating away at an ecological message and Al Gore making a guest appearance on the sitcom *30 Rock*. Improbably, Gore threatens to become the poster boy for the new new new economy: he has joined the legendary venture-capital firm Kleiner Perkins Caufield & Byers, which assisted at the births of Amazon.com and Google, to oversee the "climate change solutions group," thus providing a massive dose of Nobel Prize–winning credibility that will be most useful when its first alternative-energy investments are taken public before a credulous mob. Other ventures—Lazard Capital Markets, Generation Investment Management, Nth Power, EnerTech Capital, and Battery Ventures—are funding an array of startups working on improvements to solar cells, to biofuels production, to batteries, to "energy management" software, and so on.

TOTAL MARKET VALUE: ALTERNATIVE ENERGY AND INFRASTRUCTURE



estimated fictitious value of next bubble compared with previous bubbles

The candidates for the 2008 presidential election, notably Obama, Clinton, Romney, and McCain, now invoke "energy security" in their stump speeches and on their websites. Previously, "energy independence" was more common, and perhaps this change in terminology is a hint that a portion of the Homeland Security budget will be allocated for alternative energy, a potential boon for startups and for FIRE.

More valuable than campaign rhetoric, however, is legislation. The Energy Policy Act of 2005, a massive bill known to morning commuters for extending daylight savings time, contained provisions guaranteeing loans for alternative-energy businesses, including nuclear-power technology. The bill authorizes $200 million annually for clean-coal initiatives, repeals the current 160-acre cap on coal leases, offers subsidies for wind energy and other alternative-energy producers, and promises $50 million annually, over the life of the bill, for a biomass grant program.

Loan guarantees for "innovative technologies" such as advanced nuclear-reactor designs are also at hand; a kindler, gentler nuclear industry appears to be imminent. The Price-Anderson Nuclear Industries Indemnity Act has been extended through 2025; the secretary of energy was ordered to implement the 2001 nuclear power "roadmap," and $1.25 billion was set aside by the Department of Energy to develop a nuclear reactor that will generate both electricity and hydrogen. The future of transportation may be neither solar- nor ethanol-powered but instead rely on numerous small nuclear power plants generating electricity and, for local transportation, hydrogen. At the state and local levels, related bills have been passed or are under consideration.

Supporting this alternative-energy bubble will be a boom in infrastructure—transportation and communications systems, water, and power. In its 2005 report card, the American Society of Civil Engineers called for $1.6 trillion to be spent over five years to bring the United States back up to code, giving America a grade of "D." Decades of neglect have put us trillions of dollars away from an "A." After last August's bridge collapse in Minnesota, it took only a week for libertarian Robert Poole, director of transportation studies for the Reason Foundation, to renew the call for "highway public-private partnerships funded by tolls," and for Hillary Clinton to put forth a multibillion-dollar "Rebuild America" plan.

Of course, alternative energy and the improvement of our infrastructure are both necessary for our national well-being; and therein lies the danger: hyperinflations, in the long run, are always destructive. Since the 1970s, U.S. dependence on foreign energy supplies has become a major economic and security liability, and our superannuated roadways are the nation's circulatory system. Without the efficient transit of gasoline-powered trucks laden with goods across our highways there would be no Wal-Mart, no other big-box stores, no morning FedEx deliveries. Without "energy security" and repairs to our "crumbling infrastructure," our very competitiveness is at stake. Luckily, Al Gore will be making principled venture capital investments on our behalf.

The next bubble must be large enough to recover the losses from the housing bubble collapse. How bad will it be? Some rough calculations[7]: the gross market value of all enterprises needed to develop hydroelectric power, geothermal energy, nuclear energy, wind farms, solar power, and hydrogen-powered fuel-cell technology—and the infrastructure to support it—is somewhere between $2 trillion and $4 trillion; assuming the bubble can get started, the hyperinflated fictitious value could add another $12 trillion. In a hyperinflation, infrastructure upgrades will accelerate, with plenty of opportunity for big government contractors fleeing the declining market in Iraq. Thus, we can expect to see the creation of another $8 trillion in fictitious value, which gives us an estimate of $20 trillion in speculative wealth, money that inevitably will be employed to increase share prices rather than to deliver "energy security." When the bubble finally bursts, we will be left to mop up after yet another devastated industry. FIRE, meanwhile, will already be engineering its next opportunity. Given the current state of our economy, the only thing worse than a new bubble would be its absence. ■

[7] To create these valuations, I first examined the necessary market capitalization of existing companies; then, using the technology and housing bubbles as precedents, I estimated the number of companies needed to support the bubble. The model assumes the existence of nascent credit products that will eventually be deployed to fund the hyperinflation. While the range of error in this prediction is obviously huge, the antecedents—and more important, the necessity—for the bubble remain.