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Introduction: Everything Old Is New Again

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Introduction: Everything Old Is New Again

Abstract
[Excerpt] In the 1920s, Americans, both borrowers and lenders, discovered new ways to finance consumer credit, and, of course, it was only the beginning. Debt was everywhere, and its ubiquity was made possible by changes in finance, manufacturing, and law that had occurred after the First World War. High interest on consumer loans had long been illegal in the U.S., but around World War I, progressive reformers, seeking to drive out loan sharks, pushed states across the country to raise the legal interest rate. Now able to lend money legally, at rates which could be profitable, new consumer finance industries sprung up overnight. The legal changes coincided with a new generation of cars and electrical appliances that were both expensive and mass produced. The installment credit allowed manufacturers to sell these new wonders at a volume, and consumers could afford them because of the easy monthly payments. What ultimately made all this lending possible was that lenders could now, for the first time, resell their debt.

Keywords
debt, credit, finance, loans, borrowers, lenders, consumers, mortgage

Disciplines
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Comments

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Introduction: Everything Old Is New Again

"Dick" and "Jane" Smith met shortly after they had both moved to the city, coming upon each other in the park on a sunny Sunday afternoon. Romantic sparks flew, declarations of love were exchanged, rings and vows followed—and then they began their search for a home of their own where they would start their new life together.

Dick hadn't gone to college, but he had recently found work in a new industry that was sweeping the country. The company's IPO a few years back had been one of the most successful in history and he was going to help manufacture the killer product that, as one of his executives had said in his firm's annual report, had "given us all something worth working for." Dick and Jane, like the rest of the country, were caught up in the heady optimism of what newspaper pundits said was a New Era.

Flush with love and short on cash, the Smiths went their local bank to find out if they could get a mortgage. The home that they wanted was expensive, like all houses these days, but the Smiths knew that houses were a good investment. Prices had gone through the roof in the past few years and real estate was always a sure thing. "You can't make more land!" Jane remembered her father always saying.

At the bank, the Smiths met with a well dressed mortgage officer. Looking over the application, the mortgage officer asked them far fewer questions than they had expected: how long had he had his job, how long had they lived at their address, how much did he make? After a few calculations, the mortgage officer somberly informed Dick and Jane that an "amortized" mortgage—one in which they repaid against both interest and principal every month—would not get them the house they wanted. Dick's income was just not enough to cover it.

But the Smiths didn't have to worry. The bank offered another, better option that most smart people were using these days: an interest only "balloon" mortgage. With a balloon mortgage, Dick and Jane could buy the house immediately, sleeping soundly with the knowledge that their household income had nowhere to go but up, right alongside real estate values. And, when the time for bigger payments finally came

a few years down the road, they could simply refinance with a new loan that was just as affordable as the first. Why pay off the house when they would probably just sell it in a few years, anyhow?

In fact they would have to refinance since the loan was only for four years, but that wouldn't be a problem at all. The mortgage officer explained, in confident tones, that refinancing would never be a problem again because banks had started issuing bonds to finance customers' mortgages. Investors were always looking for a good deal, and real estate was a sure thing.

Four years! Dick would almost certainly move up in his burgeoning high tech industry in that time. Jane already envisioned a bigger space, the envy of her sisters. The couple looked at each other knowingly, trusting in the guidance of the mortgage officer, and signed the papers that he offered to them. Dick and Jane thought they couldn't go wrong. They were in the middle of one of the greatest housing booms in American history, with home values seeming to double every time they turned around. Developers couldn't buy houses fast enough. Smart buyers would act fast, they thought, before home prices rose even more. There was no risk, only reward.

Dick and Jane moved into their house, and Dick went to work. But within the year, orders began to slow down. He didn't lose his job, but his overtime got cut. Then it hit. The big stock market crash didn't hit him, but it spilled over. Everywhere confidence in the economy slid. The newspaper stopped using "New Era" except in derision. And then, just as he began to look to refinance his house, everything fell apart.

House values began to plummet, balloon mortgages became impossible to refinance, foreclosures in their neighborhood were, seemingly overnight, more common than rare. Like the stock speculators who borrowed on the margin, millions of Americans just like Dick and Jane were living on the margin of their household incomes so that they could "own" their homes. All too late, Dick and Jane realized that they were speculating just like those hucksters on the Street.

Dick walked into the S&L only to find that the mortgage officer had been sacked. His replacement, considerably less friendly than his predecessor, told him in no uncertain terms that he had to come up with the principal or he would be foreclosed on.

Dick sputtered. He had done what the man in the suit had told him. How had this happened? Before turning his back and returning to his work, the new guy at the bank told Dick that investors no longer wanted to buy real estate bonds. The well was dry. Without mortgage funds to lend, the bank had to collect.

When the bank repossessed their dream house, Dick and Jane didn't have even the most basic of personal luxuries—no iPod, no netbook, not even a hand me down BlackBerry. Desperate as they were, they literally couldn't even give these things up in one last fruitless effort to save their home. After all, none of these things would be invented until the next century.

It was 1932.

Dick had gotten his manufacturing job at General Motors in Flint only a few years earlier. Like Jane, Dick was part of a broad population shift from the country to the city in the early part of the century that tipped the census, for the first time, in favor of urban America. Moving to the city, Dick and Jane did what so many of their generation did, they borrowed.

As investors fled the mortgage markets, the U.S. housing industry fell apart—not initially from unemployment, but from a credit crisis. By 1933, the national foreclosure rate had reached 1,000 homes a day. After four years of withdrawals that withered even the sturdiest of mortgage funds, in 1933 the U.S. housing industry was effectively dead, having contracted to just 1/10 what it had been only a few years before. A third of all American families who qualified for "relief" at the height of the Great Depression landed there by losing a construction job. Dick didn't work in construction, but his business, building automobiles, was hit just as hard.

The 1920s were not only similar to today in terms of young love and mortgage debt, but for all forms of debt. In fact, it was the very spread of automobile debt that gave Dick his job in the first place. Automobile finance emerged after World War I as one of the hottest industries, spreading its methods in just a few years to nearly all other household durables. Vacuum cleaners, washing machines, and oil burners could all be had on the installment plan. The American savings rate dropped precipitously and nearly all of it went into installment credit.

Then, as now, critics of debt predicted economic catastrophe and railed against moral decline. The young couple's choices were expressed most damningly by one of America's great industrialists, the chief competitor of Dick's employer GM, a man who by his popularization of the automobile had perhaps done more than any other single person to put us in debt—Henry Ford. While Ford may have pushed cars, he never pushed debt. Ford so loathed the sapping of freedom that debt represented for him that for most of the 1920s he refused to sell his cars on financing plans, and in the process nearly bankrupted Ford Motor Company. His hostility to finance, coupling an anti Semitic hostility to Jewish bankers and a mechanic's hostility to anyone who didn't make anything, hobbled the company. That Dick could get a job at General Motors, which believed in debt wholeheartedly, is largely a testament to Ford's hostility to consumer credit.

In the 1920s, Americans, both borrowers and lenders, discovered new ways to finance consumer credit, and, of course, it was only the beginning. Debt was everywhere, and its ubiquity was made possible by changes in finance, manufacturing, and law that had occurred after the First World War. High interest on consumer loans had long been illegal in the U.S., but around World War I, progressive reformers, seeking to drive out loan sharks, pushed states across the country to raise the legal interest rate. Now able to lend money legally, at rates which could be profitable, new consumer finance industries sprung up overnight. The legal changes coincided with a new generation of cars and electrical appliances that were both expensive and mass produced. The installment credit allowed manufacturers to sell these new wonders at a volume, and consumers could afford them because of the easy monthly payments. What ultimately made all this lending possible was that lenders could now, for the first time, resell their debt.

Networks of finance stood behind each consumer purchase. When Dick bought his first car, the dealer had him sign some papers. Dick agreed to pay for the car over 24 months and to pay some additional fees, but that was it. Dick never knew where the money came from, and if he wondered at all he probably thought it came from the dealer. But the dealer took that agreement and sold it, the next day, to the General

Motors Acceptance Corporation (GMAC). The dealer didn't have the capital to finance all his customers, but GMAC did. GMAC could issue bonds in the market or use its own profits to finance its dealers. As networks developed for all forms of debt—mortgages, cars, charge—consumers found that credit became cheaper and easier to use. Retailers and financiers used credit to drive their sales and their profits. Some networks emerged from the private sector, like car financing, while others emerged from the federal government, like mortgages. Wherever they came from, the new networks of debt made possible this consumer utopia. But when those networks failed, as with the resale of mortgage bonds during the Great Depression, credit could just as quickly turn dystopian.

This picture could have hung in any small late nineteenth century shop—maybe a grocer, maybe a hardware store—anybody that didn't want to give more credit to his customers. While cash loans were illegal, credit in the nineteenth century was retail credit—but its logic was nearly the mirror image of today. While today credit lending is profitable, in the nineteenth century it was anything but. The well fed, prosperous guy only sells for cash while the emaciated, nervous guy with the mice sells on credit.

The picture's message was clear: we don't want to lend. Yet its logic of lending, like ours today, is grounded in a very particular set of historical circumstances. Borrowing is more than numbers, it is a set of relationships between people and institutions. More than any graph, this picture, if we can understand it, clarifies the differences between then and now—and how debt has changed.

Shopping every few days for food—generally the largest portion of an 1890 budget—customers could quickly build up a tab. On payday, wives were supposed to stop by and settle the bill. Yet many did not. Grocers charged higher prices for credit purchases, but there was no interest—interest would have violated the usury laws. So if someone paid every week or didn't pay for months, it was the same price—and the same profit or lack thereof. Shopkeepers could quickly lose money on credit sales because the money that they lent was their own.

Customer credit came out of the grocer's own pocket. As you can see in the picture, the credit lender's vault is empty while his basket is filled with IOUs. Americans

didn't have credit cards. No bank would lend the skinny guy money to finance his customers. No third party would buy the debt and try to collect what was owed. Loans were not commodities bought and sold as they are today. In our economy, financiers figure out ways to get us to borrow and then resell that debt to investors. Debt is produced like any other commodity—shoes, steel, computers—for the market. Buyers of our debt—whether mortgages, credit cards, or car loans—evaluate it like any other investment weighing the return against the risk. And today's debt is easy to resell. Then, consumer debt was business error. That is to say, bankers and entrepreneurs didn't think debt was a good investment. It was not a good use of their scarce, constrained capital. Consumer debt was a way to lose money. If we can understand how this grocer turned into our retail life today, we can understand how small loans became big business. We can understand how creditors became fat.

Who would invest in this debt? The history of how corner grocers, and all the other retailers, began to resell their debt is a complex one spanning the century, from the first automobiles to our present financial crisis. While borrowing might be as ancient as currency itself, markets for consumer debt are as modern as a bobbed haircut. In the 1920s, a few different changes in business and law collided to move personal debt from the margin of capitalism to its center, taking a position alongside commercial and national debt. Usury laws had limited interest rates for centuries, but progressive reformers, seeking to provide a profitable alternative to the loan shark, pushed for higher rates. As states raised usury limits and institutions began to buy personal debt from retailers, debt escaped the personal and became a commodity to be bought and sold. Once debt could be sold, it could be invested in. Debt became a place for investors to put money, connecting it with the most basic operations of capitalism.

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