Wall Street's Death

Suicide? Murder? Accidental death? Or a case of organ failure?

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You don't have to break a sweat to be a finance skeptic these days. So let's remind ourselves how compelling the logic seemed of the financial innovation that led us to our current predicament not too long ago.

Who wouldn't want credit markets to serve the cause of home ownership? So we start by introducing some real competition into the mortgage lending business. We allow non-banks to make home loans and let them offer creative, more-affordable mortgages to prospective homeowners not well-served by conventional lenders.

Then we enable these loans to be pooled and packaged into securities that can be sold to investors, reducing risk in the process. We divvy up the stream of payments on these home loans further into tranches of varying risk, compensating holders of the riskier kind with higher interest rates. We then call on credit rating agencies to certify that the less risky of these mortgage-backed securities are safe enough for pension funds and insurance companies to invest in. In case anyone is still nervous, we create derivatives that allow investors to purchase insurance against default by issuers of those securities.

If you wanted to showcase the benefits of financial innovation, you could not have come up with better arrangements. Thanks to them, millions of poorer and hitherto excluded families became homeowners, investors

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made high returns, and financial intermediaries pocketed the fees and commissions. It might have worked like a dream—and until about a year and a half ago, many financiers, economists, and policymakers thought that it did.

Then it all came crashing down. The crisis that engulfed financial markets in recent months has buried Wall Street and humbled the United States. The near $1 trillion bailout of troubled financial institutions that the U.S. Treasury has had to mount makes emerging-market meltdowns—such as Mexico's "peso" crisis in 1994 or the Asian financial crisis of 1997–98—look like footnotes by comparison.

But where did it all go wrong? If our remedies do not target the true underlying sources of the crisis, our newfound regulatory zeal might end up killing useful sorts of financial innovation, along with the toxic kind.

The trouble is that there is no shortage of suspects. Was the problem unscrupulous mortgage lenders who devised credit terms—such as "teaser" interest rates and prepayment penalties—that led unsuspecting borrowers into a debt trap? Perhaps, but these strategies would not have made sense for lenders unless they believed that house prices would continue to rise.

So maybe the culprit is the housing bubble that developed in the late 1990s, and the reluctance of Alan Greenspan's Federal Reserve to deflate it. Even so, the explosion in the quantity of collateralized debt obligations and similar securities went far beyond what was needed to sustain mortgage lending. That was also true of credit default swaps, which became an instrument of speculation instead of insurance and reached an astounding $62 trillion in volume.

So the crisis might not have reached the scale that it did without financial institutions of all types leveraging themselves to the hilt in pursuit of higher returns. But what, then, were the credit rating agencies doing? Had they done their job properly and issued timely warnings about the risks, these markets would not have sucked in nearly as many investors as they eventually did. Isn't this the crux of the matter?

Or perhaps the true culprits lie halfway around the world. High-saving Asian households and dollar-hoarding foreign central banks produced a global savings "glut," which pushed real interest rates into negative territory, in turn stoking the U.S. housing bubble while sending financiers on ever-riskier ventures with borrowed money. Macroeconomic policymakers could have gotten their act together and acted in time to unwind those large and unsustainable current-account imbalances. Then there would not have been so much liquidity sloshing around waiting for an accident to happen.

But perhaps what really got us into the mess is that the U.S. Treasury played its hand poorly as the crisis unfolded. As bad as things were, what caused credit markets to seize up was Treasury Secretary Henry Paulson's refusal to bail out Lehman Brothers. Immediately after that decision, short-term funding for even the best-capitalized firms virtually collapsed and the entire financial system simply became dysfunctional.

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In view of what was about to happen, it might have been better for Paulson to hold his nose and do with Lehman what he had already done with Bear Stearns and would have had to do in a few days with AIG: save them with taxpayer money. Wall Street might have survived, and U.S. taxpayers might have been spared even larger bills.

Perhaps it is futile to look for the single cause without which the financial system would not have blown up in our faces. A comforting thought—if you still want to believe in financial sanity—is that this was a case of a "perfect storm," a rare failure that required a large number of stars to be in alignment simultaneously.

So what will the post-mortem on Wall Street show? That it was a case of suicide? Murder? Accidental death? Or was it a rare instance of generalized organ failure? We will likely never know. The regulations and precautions that lawmakers will enact to prevent its recurrence will therefore necessarily remain blunt and of uncertain effectiveness.

That is why you can be sure that we will have another major financial crisis sometime in the future, once this one has disappeared into the recesses of our memory. You can bet your life savings on it. In fact, you probably will. ◆