Panic: The Story of Modern Financial Insanity

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I.

Bad times can clarify things. Take today's economic crisis. So far, it's put millions of people into unemployment lines, forced almost as many out of their homes, and, before all is said and done, might leave several destabilised nations in its wake. But it's also underscored a truth that was widely unacknowledged beforehand: for at least the past two decades, the centre of global power has resided not in Washington or with any government, but in the corporate boardrooms of Wall Street (as well as its hip, slick cousin, Silicon Valley). The truly momentous decisions, with immediate consequences affecting countless people, have largely been made in the private sector. Government, meanwhile, has endured as mostly a passerby, occasionally a first responder.

Panic: The Story of Modern Financial Insanity tells this tale by clipping together financial news accounts from four recent moments of peril – the crash of the late eighties, the Asian/Russian crisis of the late nineties, the Internet bubble's deflation a few years after, and the ravaged landscape we find ourselves in today. The book is edited by Michael Lewis, the popular financier-turned-writer, who dashes in and out to provide interstitial commentaries on each successive crisis (while also including some of his own articles in the collection). But this isn't merely a scrapbook of horrors; Lewis uses the articles he selects to advance a specific argument. These crises, it turns out, have followed a predictable pattern. First comes the Shiny New Thing. This Shiny New Thing is said to permanently change the rules; henceforth, history will be split in two – when we were aware of the Thing, and when we were not. This is followed by a rush to profit, which occurs without anyone bothering to check under the hood, let alone recognise inherent flaws. Eventually, everything collapses, and 'How could we have been so foolish?' becomes an international rallying cry.

Often, though, the 'we' is altered, and the question is turned to: how could they have been so foolish? The 'they,' of course, depends on who you are. There are the masses, the ignorant hordes that storm the financial beaches at the mere whiff of buried treasure. Then there are the financier-alchemists, who really do believe that they have invented a way of turning water into money. And then there are the experts, the economists, who pontificate and propagate conceptual financial models while setting aside the less easily quantifiable question of human emotion.

Our current troubles are owed, certainly somewhat, to the handiwork of such experts. Although Enron collapsed seven years ago, it seems reasonably clear that the Enron model has survived since, in which the ostensibly smartest guys in the room conspire to create profit schemes so complicated no one else can unravel them and figure out that, contrary to rumour, they are worth practically nothing. Some of the financial tools now bedevilling the market are so complicated, so intent on their own obscurity that even titans of the financial world weren't aware of them. Something called a 'liquidity put,' for instance, helped bring Citigroup to its knees. But Bob Rubin, the boss of Citigroup and the legendary former Treasury Secretary, 'had never heard of liquidity puts' (p. 343). And it's understandable why: a liquidity put was an option that 'allowed buyers of complex and presumably safe mortgage securities to hand them back to Citigroup at par if they became hard to finance' (p. 343). Anyone with a modicum of common sense would oppose such a thing.

But liquidity puts, not to mention Collateralised Debt Obligations (CDOs) and 'kilos' – don't ask – are merely the contemporary inheritors of a long tradition of complex financial tools gone awry. The crash of the 1980s was in part owed to the popularity of the Black-Scholes pricing option. Formulated by two economists, one of whom later won a Nobel Prize; Black-Scholes is basically a form of portfolio insurance. 'The model is based on the assumption that a trader can suck all the risk out of the market by taking short a position and increasing that position as the market falls, thus protecting against losses, no matter how steep' (p. 4). What Black-Scholes doesn't account for is the way in which emotion can intrude upon sterile theory. In a panic, no one is looking to buy, and short-selling becomes impossible.

Those most attuned to the winds of emotion, and thus most prone to irrational decision-making, are those who know the least: the small to mid-sized investors outside of the Wall Street/Silicon Valley world. In each boom, they, the people went in blindly – without anyone telling them to slow down – and quickly got in too deep, in financial shenanigans they didn't understand. In our ongoing tragedy, there are people like Joe Carey, a small real estate agent from Ohio, who, in 2002, moved to Florida and bet everything on a series of housing deals. By late 2007, after a few years of wild profits, the housing market was so bad that he had to close up shop altogether. In the mid-nineties, as the Asian economy was in rapid ascent, a Thai citizen, Sirivat Voravetvuthikun 'borrowed $8 million … to build two condominium towers outside Bangkok, but he went broke and started a small business selling sandwiches on the streets' (p. 149). These regular investors seemed to have imbibed the optimism of one LA screenwriter and part time investor, who told *Time Magazine* right before the 1980s crash that, 'It's so simple, it's insane. If you do this carefully, it's like picking money off trees' (p. 17).

But nothing is ever that easy; money does *not* grow on trees. Such spoonfuls of conventional wisdom would have benefited not just our screenwriter friend, but also the financiers who fall into fevers of irrational exuberance in every bull market. A Lewis piece written for *The New York Times Magazine* during the Internet-fuelled boom of the nineties is downright hilarious in retrospect. 'New New Money' showcases the efforts of Jim Clark, a famous Internet entrepreneur overflowing with hubris, to start up a company called Healtheon. Although it was bleeding cash and its business plan seemed to depend more on PR than anything else, Wall Street took Healtheon very seriously. Healtheon's mission: 'to slide in and eliminate $250 billion in waste [in the health care industry] without causing the people who made their living wastefully to raise hell, and it would do this by forming partnerships with the stronger companies (p. 180).' The intention, in other words: take a few PR gurus and a negative balance sheet, and conquer the notoriously dysfunctional American health care system. Healtheon has since mutated into WebMD, an adequate supplier of online medical advice. But it's no world-beater.

II.

It may impolite to say it, but it must be said: what all these people have in common is the vast gulf that separates them from reality. The best-trained economists, the most enthusiastic entrepreneurs, and the wizards of Wall Street have all, at various times over the last twenty years, been revealed as tragic know-nothings. Sometimes, it is comforting to laugh at the way in which their arrogance masked their ignorance. James Cayne, the CEO who rode Bear Sterns into the ground, is shown five days before the collapse of Bear's hedge funds, 'chatting with visitors over lunch … less interested in discussing the markets then in talking about a breakfast-cereal allergy and his stash of unlabeled Cuban cigars' (p. 337). After his company was set aflame by the imploding market, he kept his regular appointments at the golf course, as if nothing had happened.

But their ignorance is also tragic. While James Cayne is fortunate enough to find refuge on a golf course, many small- and mid-sized investors have no such luxury. Nor, for that matter, do those who never even considered themselves investors, but are caught in the maelstrom of global economics nonetheless, and who are now out of a job or worse. Unpredictability is the mother's milk of capitalism. But inexplicability is something else. When markets become inexplicable – that is, beyond the reach of even financial executives and esteemed economists – there is a grave danger to both the market and the democratic society that exists in tandem with it.

This holds true especially today, when the power of the market seems to trump government. Recall Bill Clinton's furious questioning of top aides in 1993: 'You mean to tell me that the success of my program and my re-election hinges on the Federal Reserve and a bunch of fucking bond traders?' [1] Well, yes, it did. Already, financial commentators, most notably Martin Wolf in *The Financial Times*, are warning that Obama's Administration is on the rocks due to the gyrations of the market. [2]

Political science 101 says that a democratic society depends on the consent of the governed, and the existence of clearly demarcated lines of accountability between citizens and their government. But if the most influential actor is not the government, but the private sector, what then? It seems to me that, at the very least, the private sector's behaviour must meet a threshold of accessibility and accountability. Judging by the contents of Panic, as well as the tumult of the past eighteen months, the private sector has clearly failed to meet that threshold. What's occurring now is, in a sense, a problem of delayed understanding: before the recession, too few people understood what was going on in major financial institutions.

The only man in *Panic* who intuited our current crisis before it happened is the one who profited off of it the most. The story of John Paulson, who turned a fortune of about $100 million into several billions by 'shorting' – betting against – the housing market at precisely the right time, seems distressingly emblematic of pre-crash America. 'Where is the bubble we can short?' he asked the employees at his investment firm (p. 361). Surely he was not alone in forecasting around 2005 that the bubble would burst. And no one ought to begrudge a Wall Street man his profit; after all, making money is why Wall Street exists. But where was the government's John Paulson? In each crisis profiled in *Panic*, government regulation and oversight function like an absentee parent – vaguely desired, but not really missed until after disaster has already struck.

It's time to reverse the order of things. Government must assert itself, as it has not done for decades. Equally comforting and distressing about Panic is the way it makes the current crisis seem all too familiar. To some extent, we've been here before. Even the protestations that we've never been here before – yes, we've been there, too. If the Herculean efforts now underway to reverse the economic collapse succeed, let's be sure that this is the last time we go through a downturn marked by such uncertainty, defined less by what we know about it than what we don't.

Easier said than done, of course. Moreover, it's a task made doubly hard by acknowledging what we must avoid: the temptation to head back into the mountains, throw away our computers, and abandon everything about the global economy. As liberals, we must not shirk modernity. You simply can't walk back technology. The advancements made in computer science over the past few decades, from the creation and promulgation of the PC to the inescapability of the Internet, are here to stay. These are the tools that gave us the global economy, and they will not evaporate. And they've done a great deal of good. But the global economy must now be matched by a global regulatory regime that prizes accessibility and accountability.

These twin principles of democracy, in other words, must become the twin principles of global regulation. Such a regime, however, must not merely content itself to restrain markets in the name of accessibility and accountability – although there will be times when restraint is clearly in order. What it also must do is promote investor education, and make the financial world explicable. Restoring trust in the market will not be easy, but for the sake of our commitment to democracy, it is essential. One hedge fund trader whose firm has stayed successful even in this down market recently explained their secret to me: 'We only invest in products we can understand.' Let us hope that such a sentiment becomes the guiding light of the next economy.

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References

Harris, John (2005) *The Survivor*, New York: Random House.

Wolf, Martin (2009) 'Why Obama's New Tarp Will Fail to Rescue the Banks.' *The Financial Times*, February 10.

Notes

[1] See Harris 2005, p. 5.

[2] See Wolf 2008.