

TEATRO SERIES - Risk and The Future of the Global Economy

The 3rd annual speakers series, held at Teatro Restaurant, Calgary Alberta, explores the key issues facing the economy.

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It Ain't Over Yet

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The following is an edited transcript of Joe Nocera speech at Teatro Restaurant. Mr. Nocera is senior business writer for the New York Times and best-selling author.

I believe in informality, and I believe in Q and A. I don't really believe in long-winded speeches. So I think it would be a lot more fun if I just make a few opening remarks about financial reform, the Fed, economic collapse, Fannie and Freddie, that kind of stuff and then we can have a nice, back and forth discussion afterwards.

Looking back to last fall, there's an awful lot to cover: the taking over of Fannie and Freddie and then the following week allowing Lehman Brothers to fail and then the next day reading that Merrill Lynch had been taken over by the Bank of America, not to mention the government putting up 85 billion dollars to save AIG.

How has all of that turned out, Mr. Lewis?

You know, there was a six-month window, a six-month timeline, during which we should have prepared. And if you're going to fault our government and our financial system, then this is where they were at their worst. Apparently, there was a belief, a feeling, an assertion that Bear Stearns was a one-off. There was a lack of foresight. Those who should have understood didn't really understand that we were about to hit an awfully hard wall, and that the subprime crisis was about to

reach a crescendo.

When that happened, when we got to the events of early September, 2008, the government -- Secretary Paulson -- decided that they had no choice but to take over Fannie and Freddie, which they did. I don't know if you are aware of it, but there were actually some hedge funds people who wanted to sue the government under the takings clause of the Constitution, claiming that the takeover of Fannie and Freddie was illegal and that they should get their money back. That didn't go very far.

The weekend after Fannie and Freddie was the famous, or rather the infamous, Lehman Brothers weekend. They didn't even know AIG was two days away. It wasn't until sometime that weekend when somebody popped their head up and figured it out. You have to remember, they were in the New York Fed, and you had Jamie Dimon and Ken Lewis and John Thain -- it was sort of like the heads of the families, as they used to say in the Mafia. And they were sitting around a room trying to figure out what to do and Paulson was saying to them, "I want you guys to save Lehman Brothers, I can't do it. They're calling me Mr. Bailout and I can't be called Mr. Bailout anymore. You need to find a private market solution."

Their response to that was that if they saved Lehman Brothers, who would be next? Would it be me? Would it be you? Would it be Goldman? Would it be Morgan Stanley? And so Merrill Lynch, realizing that they would be next if Lehman were saved, turns to Bank of America and says, "Why are you talking to Lehman? Talk to us!"

So Lehman went bust. Because the government was not going to put up any money to save it and because everybody else was so concerned about themselves that there was no way they were going to put up any money to save it. So Lehman went bust. Bank of America

bought Merrill Lynch and two days later there was the case of AIG. Now AIG turned out to be a vastly, vastly more serious situation than Lehman Brothers.

Why? Because -- and I'm still sort of shocked by this -- because most of Europe's banks were being propped up, or they were avoiding their capital requirements by using AIG's credit default swaps. So for all the talk about Goldman Sachs, and how supposedly that was why Paulson saved AIG, the real reason he saved AIG was because every central banker in Europe was calling him up and saying, "If you don't save AIG, all of our banks are kaput."

I've written a bunch of columns over the past year that just sort of casually describe Lehman Brothers as the great mistake or the great disaster of the last year. I've been making what you might call the conventional case that Lehman Brothers should have been saved, that the rationale that the government gave after the fact doesn't really hold up. And it doesn't. The rationale is that we didn't have the regulatory authority to save Lehman Brothers so we had no choice but to let it go bust. But the truth of the matter is, if they'd wanted to find the regulatory authority they would have found it.

That is what I have been arguing. But I have come to a different place in my thinking about this. I've come to a place where I've wound up thinking that if you had to have one bank fail -- which perhaps we did -- I'm sure glad it was Lehman Brothers. Because the disaster, as bad as it was, would have been so much worse had it been Merrill Lynch, had it been AIG, had it been Morgan Stanley, had it been Goldman Sachs. These are much bigger companies and they're much more intertwined in the financial system. However much damage Lehman Brothers did to the system, it wound up actually being limited and it also wound up having, in a weird way, the effect of forcing the

government to save everybody else.

I've talked to people in Treasury and they've said, "If we had saved Lehman Brothers there is no way we would have saved AIG, no way, we just wouldn't have done it." We had run out of people. We had run out of buyers. There was nobody left. And if AIG had gone under, the disaster would have been much, much larger.

I will say, I've spent many years in Canada in the summertime -- in the Laurentians -- and I have to say that your banks have performed admirably, wonderfully. It's nice to live in a country as risk averse as Canada during times like these.

And let me say one other thing before I throw it open to questions, because I think it's a point that we'll get to, anyway. It is definitely worth talking about.

People want to know whether this will happen again. The answer is yes, of course it will. It's not even a question. Disasters like the one we've just had are not really about derivatives. They're not really about subprime mortgages. Those are just the vehicles through which financial insanity plays itself out. What these disasters are actually about is psychology.

James Grant, who is the great, bearish Wall Street analyst, told me, early in the crisis, that the way to think about a financial crisis is that it's about sex, not science.

Here's what he meant by that: when somebody makes a scientific discovery, it becomes part of science, upon which other things are built. Nobody forgets it, either. It becomes part of what we think of as science. When it comes to sex or relationships, nobody knows anything. You don't build on the past. You've got to learn it yourself. You make the mistakes. You screw up. Finance is the same way.

My grandparents lived through the Depression. As a result of that searing experience, they were deeply risk averse. Their whole lives. They had a hard time taking out a loan to buy a refrigerator. They understood the downside of debt. Two generations later, we have no memory of the Depression. All we know is what we heard from our grandparents. So when we think of debt we think of something that helped us in our lives. Debt was something that made life easier and was a function of allowing us to do things that we might not have otherwise been able to do. And the whole downside of debt we just forgot about – or never really learned from experience.

So it is inevitable that as people forget about the downside of risk, the downside of debt, the problems that come from taking too much risk, that they do take too much risk and they make mistakes, and you wind up with a case of national, or in this case, international insanity. And when I think about this crisis, I think it is no different than Dutch tulips in the 1700s. Derivatives and Dutch tulips are a little different, but the effect is exactly the same. Think about the South Sea bubble. Do you know what the South Sea bubble was? It was a company agreeing to take on England's debt, the government's debt, in return for a trade monopoly. That actually doesn't sound that different from what just happened. There was the Panic of 1907 and the Crash of 1929 and there was September, 2008.

So will we have another act of insanity? Absolutely, we will. But it will be after all of us are dead so you don't have to worry about it. But it will happen.