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Learning the Wrong Lessons From Multiple Financial Crises

By FLOYD NORRIS DEC. 11, 2014

"There are good crises and there are bad crises. Every crisis breaks a deadlock and sets events in motion. It is either a disaster or an opportunity. A bad crisis is one in which no one has the power to make good use of the opportunity and therefore it ends in disaster. A good crisis is one in which the power and the will to seize the opportunity are in being. Out of such a crisis come solutions."

— Walter Lippmann, March 7, 1933

The world has experienced one financial crisis after another over the last few decades — runaway inflation, the stock market crash of 1987, the East Asian crisis of the late 1990s, the popping of the dot-com bubble in the face of accounting scandals and, finally, the crisis that led to the Great Recession.

And yet, at least according to the stock market, these have been the golden years. Never have United States stock prices done so well during a 36-year period as they have since 1978.

That one fact is an indication that the world has, on balance, handled the crises well enough — or at least that investors now believe that to be true. This column, which will conclude next week as I end a 26-year career at The New York Times, is an attempt to evaluate those crises and how they were sometimes misunderstood in ways that came back to haunt the world years later. Inflation was the big crisis of the late 1970s, when I first began to write about markets and the economy. Its persistence discredited economists and governments. It drained faith in the American economy.

In 1979, Business Week published an article that was destined to become a classic example of how wrong journalists could be: "The Death of Equities," the cover proclaimed. "How inflation is destroying the stock market." Betting on continuing inflation, through gold and silver prices, became popular. Long-term bonds became known as "certificates of confiscation" because investors were sure to be losers. The upward march of oil prices was viewed as a sure thing.

Inflation was vanquished by Paul Volcker, who was appointed Federal Reserve chairman in 1979 and showed a single-minded determination to conquer it.

He did that largely by raising interest rates to levels that had previously been unthinkable. Not since the Civil War — when the country's very survival was in question — had the federal government paid as much as 10 percent to borrow money. Before Mr. Volcker was through, the government would pay more than 15 percent, and there would be back-to-back recessions in the early 1980s.

Mr. Volcker was not tremendously popular at the time — starting recessions is not a surefire strategy to improve poll ratings — but in the aftermath he deservedly became a legend.

The crisis was solved. The stock market took off in late 1982, and interest rates soon began to fall.

But like many solutions, the victory created other problems. It helped to destroy the savings and loan business, which was based on taking in short-term deposits and lending out the money for 30-year mortgages. The shadow banking system — largely exempt from normal banking regulation — filled the breach when interest rates rose above the levels that banks were allowed to pay.

More than 20 years later, the world would have good reason to regret that so much financial activity was no longer regulated. But at the time, what was clear was that the central bank had solved a problem that the politicians were said to have created. Around the world, there was a trend to independence for central bankers, whose brilliance was taken for granted. Mr. Volcker's aura carried over to his successor, Alan Greenspan, who in his first days in office was confronted with a crisis that shook the world's financial markets. The great 1980s bull market came to an abrupt end on Oct. 19, 1987 — known instantly as Black Monday — when the Dow Jones industrial average lost 22 percent of its value in one day. The immediate reaction was fear that the crash signaled a new recession, or worse.

Mr. Greenspan responded by opening the monetary spigots, assuring that battered brokerage firms would have access to cash. There was no recession, and by late 1989 stock prices returned to setting records.

The lessons learned from that crisis were generally the wrong ones, or at least they turned out to be counterproductive. The first was that prompt monetary easing would rescue any situation. The Fed had not done that immediately after the 1929 crash, and disaster ensued. But it had done so in 1987, and all turned out fine. The central bank had saved the day.

For many investors, the lesson learned was that rapid declines in stock prices created buying opportunities. Regulators and investors might have done better to ponder why the crash had happened at all.

There had been speculation driving share prices to perhaps unsustainable levels, but that speculation had not been nearly as widespread as in 1929.

What had become different was the markets themselves. A primary cause of the decline was the widespread popularity of "portfolio insurance," an idea developed largely by academics at the University of California. The idea was that a money manager need not trouble himself — in those days, there were few women managing large sums of money — with worries that the market was becoming overheated.

Instead, managers could simply use stock index futures to reduce a portfolio's exposure to the stock market. If stock prices began to decline, selling some futures would reduce the risk. If they fell further, all the managers had to do was sell more futures. In that way nearly all the profits from the bull market could be protected.

That strategy assumed that the stock index futures market would remain liquid — that someone else would buy the futures if panic struck. Instead, the futures exchange market makers who bought the first futures sold by the managers turned around and sold stocks to protect themselves. That drove prices down more and ignited more selling of futures. Everybody could not get out at the same time.

What might have been learned? That new regulatory mechanisms were needed. Markets were very different from even a few years earlier, involving products that were complicated and used primarily, if not exclusively, by large financial firms. Computers had become fast enough to automatically issue trade orders — and had done so by pushing out orders to sell stock index futures even when it should have been clear those orders were only making the crisis worse.

Had that been learned, some of the disasters of recent years might have been averted, including the 2010 "flash crash," in which badly programmed computers combined with badly designed markets to drive some high-quality stocks down to $1 a share.

But what was learned was that the Fed could, and would, rescue Wall Street if markets got out of hand, and that it could be relied upon to do so. Mr. Greenspan became an oracle, one who preached the wisdom of markets while standing ready to clean up any messes they made. That became known as the "Greenspan put:" You could make money when prices rose and avoid severe losses because he would step in if they fell.

It carried the seeds of its own demise, but that would not become clear until 2008.

Next week: Markets go from being worshiped to feared.