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TOO CLEVER BY HALF?

by James Surowiecki

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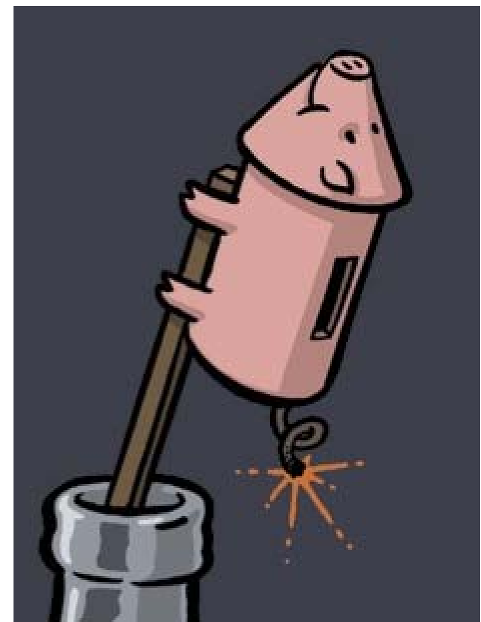

Innovate or die. The phrase, popularized in Silicon Valley in the nineteen-nineties, has since become a mantra throughout the business world, and nowhere has it been more popular than on Wall Street, which in recent years has churned out a seemingly endless stream of new ways to manage capital and slice and dice risk. But, while Silicon Valley's innovations have brought enormous benefits to society, the value of Wall Street's innovations seems a lot less clear. (The former Fed chair Paul Volcker has said, for instance, that the last valuable new product in banking was the A.T.M.) The Valley gave us the microprocessor, Google, and the iPod. The Street gave us the C.D.O., the A.B.S., and the C.D.S.—not to mention the kind of computerized trading that enabled last week's stock-market nosedive. Not surprisingly, then, the whole notion of "financial innovation" is being looked at with a gimlet eye, and Congress is now considering various ways to rein in the banking industry's excesses. Given the tumult of the past few years, the barter system is starting to look good.

Not all of Wall Street's concoctions have been pointless or destructive, of course. Take junk bonds, whose use Michael Milken pioneered in the nineteen-eighties. They got a bad name when Milken went to prison for securities

fraud. But his insight that high-yield bonds could be a good investment—that, historically, the rewards outweighed the risks—allowed new companies, including eventual giants like Turner Broadcasting and M.C.I., as well as countless smaller businesses, to raise billions in capital that previously would have been out of their reach. Today, almost two hundred billion dollars' worth of junk bonds is sold every year; they're an integral part of the way Wall Street does what it's supposed to do: channel money from investors to productive enterprises.

There are plenty of comparable examples, as Robert Litan, a scholar at the Brookings Institution, showed in a recent essay. Currency and interest-rate swaps, for instance, allow global corporations to focus on their businesses without having to worry about wild swings in currency values. Index funds have given individual investors a low-cost way of putting their money to work. Venture capital provides startups with access to tens of billions of dollars every year. Raghuram Rajan, a former chief economist at the I.M.F. and a finance professor at the University of Chicago, says, "There's a lot of stuff that does a lot of good that we take for granted, because it's just become part of our everyday financial lives."

Unfortunately, the benefits of good financial innovations have, of late, been swamped by the costs of the ones that went bad. Things like "structured investment vehicles," for instance, were designed to evade regulations and make bank balance sheets look safer than they were. Subprime loans, which offered lower-income Americans a rare chance to accumulate wealth, ended up inflating the housing bubble and leaving these same people with debts they couldn't pay. Credit-default swaps, which are a useful way for investors to protect themselves against unavoidable risks, became a way for institutions like A.I.G. to make easy money in the short term while piling up billions of dollars in potential obligations that taxpayers ended up paying for. And securitization—the packaging of many loans into a single complex financial product—led investors to neglect the quality of the actual loans that were being made.

"No more 'Hardball'—I'll talk!"

Some of these ideas, as it happens, were reasonable ones, within limits. But limits aren't something that Wall Street knows much about: in recent years, it has shown an uncanny knack for taking reasonable ideas to unreasonable extremes. The economists Nicola Gennaioli, Andrei Shleifer, and Robert Vishny argue in a recent paper that financial innovation often leads to financial instability: investors get interested in a new product that seems to offer high returns, and, precisely because it's new, underestimate the chance that this product will eventually blow up. They pour more and more money into the market, until things start to go wrong, at which point they panic en masse. The complex financial engineering that went into creating products like C.D.O.s exacerbated the problem by making the risks of those investments opaque. If investors had known the risks they were taking in the pursuit of greater returns, they would have been more prepared for failure—and would presumably have put less money into the housing market. Instead, they thought that financial wizardry had engineered all the danger out of the system. As Rajan argued in a prescient 2005 paper, financial development, which was supposed to make the system safer, could in fact make it riskier. The fundamental problem with innovation was that it made investors and executives forget the need to think for themselves.

The cost of all these mad-scientist endeavors can be measured in the trillions of dollars that vaporized when the housing bubble burst. But another cost has been the damage done to the whole notion of financial innovation. "The real question is how do we keep the good parts of innovation without being stuck with the bad," Rajan says. But even a potentially useful idea like the creation of a carbon-permit market to fight global warming is already being dismissed as Wall Street's "next big scam." And while the Yale economist Robert Shiller has long advocated using markets to help individuals protect themselves against things like declining house prices or future unemployment, the chances of that happening now seem smaller than ever. Someday, perhaps, we'll be in the mood to experiment again. But that will happen only when Wall Street remembers that the phrase is "Innovate or die," not "Innovate *and* die." ♦

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