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Six Errors on the Path to the Financial Crisis

By ALAN S. BLINDER

WHAT'S a nice economy like ours doing in a place like this? As the country descends into what is likely to be its worst postwar recession, Americans are distressed, bewildered and asking serious questions: Didn't we learn how to avoid such catastrophes decades ago? Has American-style capitalism failed us so badly that it needs a radical overhaul?

The answers, I believe, are yes and no. Our capitalist system did not condemn us to this fate. Instead, it was largely a series of avoidable — yes, avoidable — human errors. Recognizing and understanding these errors will help us fix the system so that it doesn't malfunction so badly again. And we can do so without ending capitalism as we know it.

My list of errors has six whoppers, in chronologically order. I omit mistakes that became clear only in hindsight, limiting myself to those where prominent voices advocated a different course at the time. Had these six choices been different, I believe the inevitable bursting of the housing bubble would have caused far less harm.

WILD DERIVATIVES: In 1998, when Brooksley E. Born, then chairwoman of the Commodity Futures Trading Commission, sought to extend its regulatory reach into the derivatives world, top officials of the Treasury Department, the Federal Reserve and the Securities and Exchange Commission squelched the idea. While her specific plan may not have been ideal, does anyone doubt that the financial turmoil would have been less severe if derivatives trading had acquired a zookeeper a decade ago?

SKY-HIGH LEVERAGE: The second error came in 2004, when the S.E.C. let securities firms raise their leverage sharply. Before then, leverage of 12 to 1 was typical; afterward, it shot up to more like 33 to 1. What were the S.E.C. and the heads of the firms thinking? Remember, under 33-to-1 leverage, a mere 3 percent decline in asset values wipes out a company. Had leverage stayed at 12 to 1, these firms wouldn't have grown as big or been as fragile.

A SUBPRIME SURGE: The next error came in stages, from 2004 to 2007, as subprime lending grew from a small corner of the mortgage market into a large, dangerous one. Lending standards fell disgracefully, and dubious transactions became common.

Why wasn't this insanity stopped? There are two answers, and each holds a lesson. One is that bank regulators were asleep at the switch. Entranced by laissez faire-y tales, they ignored warnings from those like Edward M. Gramlich, then a Fed governor, who saw the problem brewing years before the fall.

The other answer is that many of the worst subprime mortgages originated outside the banking system, beyond the reach of any federal regulator. That regulatory hole needs to be plugged.

FIDDLING ON FORECLOSURES: The government's continuing failure to do anything large and serious to limit foreclosures is tragic. The broad contours of the foreclosure tsunami were clear more than a year ago — and people like Representative Barney Frank, Democrat of Massachusetts, and Sheila C. Bair, chairwoman of the Federal Deposit Insurance Corporation, were sounding alarms.

Yet the Treasury and Congress fiddled while homes burned. Why? Free-market ideology, denial and an unwillingness to commit taxpayer funds all played roles. Sadly, the problem should now be much smaller than it is.

LETTING LEHMAN GO: The next whopper came in September, when Lehman Brothers, unlike Bear Stearns before it, was allowed to fail. Perhaps it was a case of misjudgment by officials who deemed Lehman neither too big nor too entangled — with other financial institutions — to fail. Or perhaps they wanted to make an offering to the moral-hazard gods. Regardless, everything fell apart after Lehman.

People in the market often say they can make money under any set of rules, as long as they know what they are. Coming just six months after Bear's rescue, the Lehman decision tossed the presumed rule book out the window. If Bear was too big to fail, how could Lehman, at twice its size, not be? If Bear was too entangled to fail, why was Lehman not?

After Lehman went over the cliff, no financial institution seemed safe. So lending froze, and the economy sank like a stone. It was a colossal error, and many people said so at the time.

TARP'S DETOUR: The final major error is mismanagement of the Troubled Asset Relief Program, the $700 billion bailout fund. As I wrote here last month, decisions of Henry M. Paulson Jr., the former Treasury secretary, about using the TARP's first $350 billion were an inconsistent mess. Instead of pursuing the TARP's intended purposes, he used most of the funds to inject capital into banks — which he did poorly.

To illustrate what might have been, consider Fed programs to buy commercial paper and mortgage-backed securities. These facilities do roughly what TARP was supposed to do: buy troubled assets. And they have breathed some life into those moribund markets. The lesson for the new Treasury secretary is clear: use TARP money to buy troubled assets and to mitigate foreclosures.

Six fateful decisions — all made the wrong way. Imagine what the world would be like now if the housing bubble burst but those six things were different: if derivatives were traded on organized exchanges, if leverage were far lower, if subprime lending were smaller and done responsibly, if strong actions to limit foreclosures were taken right away, if Lehman were not allowed to fail, and if the TARP funds were used as directed.

All of this was possible. And if history had gone that way, I believe that the financial world and the economy would look far less grim than they do today.

For this litany of errors, many people in authority owe millions of Americans an apology. Richard A. Clarke, former national security adviser, set a good example when he told the commission investigating the 9/11 attacks that he wanted victims' families "to know why we failed and what I think we need to do to ensure that nothing like that ever happens again." I'm waiting for similar words from our financial leaders, both public and private.

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