Creative Destruction:

Coming to Grips with the Panic of ’08

By

David Hurst

Sir Isaac Newton knew a thing or two about up and down, but not even he could understand the gyrations of stock markets. “I can calculate the motion of heavenly bodies, but not the madness of people,” remarked the famous English physicist, after he reportedly lost twenty thousand pounds (over $5 million in present day value) in the collapse of the South Sea Bubble in 1720. His puzzlement must be shared by many contemporary experts, especially the “rocket scientists” who developed the arcane financial instruments and valuation techniques that have contributed so heavily to the collapse of Wall Street in 2008. Indeed, one of the more complex such instruments, Credit Default Swaps, have been described as the “dark matter of the financial universe.”

After the March meltdown of Bear Stearns, one of America’s most admired companies, the markets seemed to stabilize for a bit and the scientists might have retained their equanimity. But then, after 158 years of successful operation, Lehman Brothers evaporated over a weekend and that icon of American business, Merrill Lynch, a.k.a. the thundering herd, nearly went off the precipice, disappearing instead into the arms of the Bank of America. AIG, the world’s largest insurance company, needed an $85 Billion bailout. Staunch Republicans have supported government intervention to which they were unalterably opposed and markets around the world have swooned. While stunned economists and mathematicians wrangle about what went wrong, perhaps it would be helpful to reframe our understanding of what is happening. In addition to science, it’s useful to use some history; it also helps to enhance economics with some ecology.

History

While many talk of a global recession, some are even using the “D” word as they recall events from 1929. Historians have suggested, however, that analogies to 1929 are misguided and that the current financial turmoil is more similar to that of the Bankers' Panic of 1907. In that year the stock market fell nearly 50% as the economy went into recession and there were numerous runs on banks and trust companies. By strange coincidence, that crisis had also begun in March of that year, with the collapse of Union Pacific stock, which was widely used as collateral for raising finance. The stock market survived that, more or less, but it was done in by the collapse of The Knickerbocker Trust, the third largest in America, in October 1907. It turned out that the trust had been funding speculation in the copper market, which had slumped a few months earlier. A fierce contraction in liquidity followed, with depositors trying to withdraw their holdings from banks across the country. The United States did not have a central bank at that time, so there was no lender of the last resort to throw out a lifeline. The economy was saved by the efforts of J.P. Morgan and his banking associates, who acted together as a financial backstop. Charles Barney, the President of Knickerbocker, shot himself on November 14, 1907. However the trust company opened again after a few weeks of closure and paid out all its depositors plus interest. The panic was over.

References to economic crises in history remind us that, although they are infrequent, financial panics are by no means rare. Professor Charles Kindleberger in his classic, *Manias, Panics, and Crises,* has identified nearly forty of them since the beginning of the 17^{th} Century i.e. about one every ten years, although eighteen of them were in the 19^{th} Century. So we have been here before. What makes the Panic of 2008 so frightening is its global scope and the suddenness with which it came upon us, contrary to all expert opinion. Former Chairman of the Federal Reserve, Alan Greenspan observed in 2005 that "increasingly complex financial instruments have contributed to the development of a far more flexible, efficient, and hence resilient financial system than the one that existed just a quarter-century ago." These remarks now seem destined to go down with economist Irving Fisher's observation on the eve of the market crash of 1929 that "Stock prices have reached what looks like a permanently high plateau." Famous last words indeed.

Ecologics

None of the dynamics of the Panic of ’08 are surprising to anyone who looks at the world through an ecological rather than an economic lens. For this is the way nature works. Long slow processes of growth are followed by swift bouts of destruction that prepare the environment for renewal. Take a lodge-pole pine forest for example, like those that flourish in the Rockies. Lodge-pole pines are self-pruners. As they grow, they drop their lower branches on the ground, building up highly flammable debris. After forty years or so they get attacked by bugs like the mountain pine beetle and the weaker trees die, creating standing firewood. When lightning then strikes, fires devour the dead trees and tinder-dry underbrush in brief but violent infernos. Efforts to put them out are in vain – the best that fire-fighters can do is to try to control the boundaries and hope for assistance from nature in the form of rain. In the aftermath of fire, however, the scorched ground is ready for renewal. The fire removes the large trees that had hogged resources and prevented any variety from growing in their shade. It recycles their resources, supplying nutrients in their ashes that can nourish small scale organisms. The fallen trees supply innumerable refuges for armies of insects to assist with the recycling. The lodge-pole pines themselves have special heat-resistant cones that burst only when the temperature rises above 140º F and release their seeds into the warm ash. Within a year the ecology is bursting with renewal, as the weeds and seedlings and migrant animals and birds, the entrepreneurs of the natural world, flourish in the open patches.

Such natural systems work well, provided they are left alone. But we know that human intervention often makes the cycles more violent. Until recently forest managers made forest fires much more destructive by mistakenly suppressing natural fire in national parks like Yellowstone. The strategy works for a while, often confirming the wisdom of the strategists. But after a while so much fuel builds up that nothing can stop it from burning. Indeed, the effective exploitation of nature to make it more “efficient” mandates that we turn systems with variety into mono-cultures. The forests that supply the paper on which we blow our noses and clean our counters are such mono-cultures: all the trees are evenly spaced and are of the same age and same type. Without variety or fire-breaks, they are vulnerable to being wiped out by sudden catastrophes, ranging from wind and fire to disease and insect attack. The pan-caking floors of the Twin Towers after the attacks of 9/11 and the toxic NINA (no income, no assets) mortgages have this dynamic in common. Once one went, they all went. In crises economists call the process “financial contagion”. From an ecological perspective Alan Greenspan was quite wrong. Resilience does not follow from efficiency: it requires variety, which is the opposite of efficiency. And the restoration of resilience to a complex system often demands destruction first.

After the Panic of 1907 the Federal Reserve System was formed to act as lender of last resort. I am glad we have them this time around, as they try to avoid the mistakes they made in 1929. More generally, meaningful social, political and institutional change happens only in the aftermath of crisis. To a considerable and unacknowledged extent society and its component organizations advance strategically by accident, economically by windfall and politically by disaster. Armies are reformed only after defeats. Safety regulations are usually introduced after accidents. Certainly a comprehensive overhaul of the financial system is needed to ensure that the unregulated growth of mono-cultures is checked and monitored. We will have to avoid, however, the excesses of regulatory zeal such as the Sarbanes-Oxley legislation, enacted in the aftermath of the Enron collapse. In his prescient book, *A Demon of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation*, investment expert Richard Bookstaber describes how, at times like these, markets can suddenly change their character. They flip from a well-understood game like probability-based roulette to a high-stakes one like psychology-based poker, offering huge rewards for those brave enough to seize the opportunities and disaster for others. He suggests that, among other things, we need to reduce the complexity of financial instruments, even if this means slowing down the rate of financial innovation. If the risks of complex derivatives are not understood, he argues, their risk cannot be mitigated.

Socially and intellectually these are humbling times, when many who thought they understood the system have found that they did not. The world’s politicians have not been helpful. President George W. Bush, to quote *The New York Times*, “had nothing to offer but fear itself." Apart from dealing with the economy to restore confidence, our leaders need to get back to our ideas about values and community: the soil in which economies are nurtured. In our proclamation of the triumphs of markets we have forgotten their origins in and continued dependence upon human relationships and mutual trust. Trust, like the lubricant in an engine, is noticed only when it is gone and the motor has seized. Many of us live such fragmented lives and some say our values of hard work, thrift and support for each other have been eroded by decades of easy money, consumerism and a cult of selfish individualism. Changing that will not be easy. Rulers throughout the ages have known that nothing is more destructive of social order than a fall in the standard of living from a higher level, real or imagined, to a lower one. It will help immensely if we know that everyone is in it together and that the pain is being shared. Disasters, whether physical of financial, often have the effect of bringing the human community back together again in a common fate and a shared survival.

In the meantime it couldn't hurt to pray for rain.

David Hurst is the author of *Crisis & Renewal: Meeting the Challenge of Organizational Change* (Harvard Business School Press, 1995/2002). He is a speaker, consultant and writer on management. He is a also Contributing Editor to *Strategy+Business* and his writing has appeared in the *Harvard Business Review*, *The Financial Times* and other leading business publications.