Introduction

In the late summer of 2008, as Lehman Brothers teetered at the edge, a bell tolled for Wall Street. The elite of American bankers were enlisted to try to save Lehman, but they were fighting for something larger than a venerable, 158-year-old institution. Steven Black, the veteran JPMorgan executive, had an impulse to start saving the daily newspapers, figuring that historic events were afoot. On Sunday, September 14, as the hours ticked away, Lehman’s employees gathered at the firm, unwilling to say goodbye and fearful of what lay in wait. With bankruptcy a fait accompli, they slunk off to bars for a final toast, as people once did in advance of a great and terrible battle. One ventured that “the forces of evil” were about to be loosed on American society. Lehman’s failure was the largest in American history and yet another financial firm, the insurer American International Group, was but hours away from an even bigger collapse. Fannie Mae and Freddie Mac, the two bulwarks of the mortgage industry, had just been seized by the federal government. Dozens of banks big and small were bordering on insolvency. And the epidemic of institutional failures did not begin to describe the crisis’s true depth. The market system itself had come undone. Banks couldn’t borrow; investors wouldn’t lend; companies could not refinance. Millions of Americans were threatened with losing their homes. The economy, when it fully caught Wall Street’s chill, would retrench as it had not done since the Great Depression. Millions lost their jobs and the stock market crashed (its worst fall since the 1930s). Home foreclosures broke every record; two of America’s three automobile manufacturers filed for bankruptcy, and banks themselves failed by the score. Confidence in America’s market system, thought to have attained the pinnacle of laissez-faire perfection, was shattered.

The crisis prompted government interventions that only recently would have been considered unthinkable. Less than a generation after the fall of the Berlin Wall, when prevailing orthodoxy held that the free market could govern itself, and when financial regulation seemed destined for near irrelevancy, the United States was compelled to socialize lending and mortgage risk, and even the ownership of banks, on a scale that would have made Lenin smile. The massive fiscal remedies evidenced both the failure of an ideology and the eclipse of Wall Street’s golden age. For years, American financiers had gaudily assumed more power, more faith in their ability to calculate—and inoculate themselves against—risk.

As a consequence of this faith, banks and investors had plied the
average American with mortgage debt on such speculative and unthinking terms that not just America’s economy but the world’s economy ultimately capsized. The risk grew from early in the decade, when little-known lenders such as Angelo Mozilo began to make waves writing subprime mortgages. Before long, Mozilo was to proclaim that even Americans who could not put money down should be “lent” the money for a home, and not long after that, Mozilo made it happen: homes for free.

But in truth, the era began well before Mozilo and his ilk. Its seeds took root in the aftermath of the 1970s, when banking and markets were liberalized. Prior to then, finance was a static business that played merely a supporting role in the U.S. economy. America was an industrial state. Politicians, union leaders, and engineers were America’s stars; investment bankers were gray and dull.

In the postindustrial era, what we may call the Age of Markets, diplomats no longer adjusted currency values; Wall Street traders did. Just so, global capital markets allocated credit, and hordes of profitminded, if short-term-focused, investors decided which corporations would be bought and sold.

Finance became a growth industry, fixated on new and complex securities. Wall Street developed a heretofore unimagined prowess for securitizing assets: student loans, consumer debts, and, above all, mortgages. Prosperity in this era was less evenly spread. Smokestack workers fell behind in the global competition, but financiers who mastered the intricacies of Wall Street soared on wings of gold. Finance now was anything but dull; markets were dynamic and ever changing. Average Americans clamored to keep pace; increasingly they resorted to borrowing. By happy accident, Wall Street had opened the spigot of credit. People discovered an unsuspected source of liquidity—the ability to borrow on their homes. With global investors financing mortgages, ordinary families were suddenly awash in debt. The habit of saving, forged in the tentative prosperity that followed the war, gave way to rampant consumerism. By the late 2000s the typical American household had become a net borrower, fueled by credit from less developed countries such as China—a curious inversion of the conventional rules.

Paradoxically, the more license that was given to markets, the more that Wall Street called on bureaucrats for help. Market busts became a familiar feature of the age. Notwithstanding, it was the doctrine of the experts—on Wall Street and in Washington—that modern finance was a nearly pitch-perfect instrument. A preference for market solutions morphed into something close to blind faith in them. By the
mid-2000s, when the spirit of the age attained its fullest, the very fact that markets had financed the leverage of banks, as well as the mortgages of individuals, was taken as proof that nothing could be wrong with that leverage, or nothing that government could or should try to restrict. Financiers had discovered the key to limiting risk, and central bankers, adherents to the cult of the market, had mastered the mysterious art of heading off depressions and even the normal ups and downs of the economic cycle. Or so it was believed.

Then, Lehman’s collapse opened a trapdoor on Wall Street from which poured forth all the hidden demons and excesses, intellectual and otherwise, that had been accumulating during the boom. The Street suffered the most calamitous week in its history, including a money market fund closure, a panic by hedge funds, and runs against the investment firms that still were standing. Thereafter, the Street and then the U.S. economy were stunned by near-continuous panics and failures, including runs on commercial banks, a freezing of credit, the leveling of the American workplace in the recession, and the sickening drop in the stock market.

The first instinct was to blame Lehman (or the regulators who had failed to save it) for triggering the crisis. As the recession deepened, the thesis that one firm had caused the panic seemed increasingly tenuous. The trouble was not that so much followed Lehman, but that so much had preceded it. For more than a year, the excesses of the market age had been slowly deflating, in particular the bubble in home loans. Leverage had moved into reverse, and the process of deleveraging set off a fatal chain reaction.

By the time Lehman filed for bankruptcy, the U.S. housing market, the singular driver of the U.S. economy, had collapsed. Indeed, by then the slump was old news. Home prices had been falling for nine consecutive quarters, and the rate of mortgage delinquencies over the preceding three years had trebled. In August, the month before Lehman failed, 303,000 homes were foreclosed on (up from 75,000 three years before).

The especial crisis in subprime mortgages had been percolating for eighteen months, and the leading purveyors of these mortgages, having started to tumble early in 2007, were all, by the following September, either defunct, acquired, or on the critical list. Also, the subprime crisis had fully bled into Wall Street. Literally hundreds of billions of dollars of mortgages had been carved into exotic secondary securities, which had been stored on the books of the leading Wall Street banks, not to mention in investment portfolios around the globe. By September 2008, these securities had collapsed in value—and with them, the banks’
equity and stock prices. Goldman Sachs, one of the least-affected banks, had lost a third of its market value; Morgan Stanley had been cut in half. And the Wall Street crisis had bled into Main Street. When Lehman toppled, total employment had already fallen by more than a million jobs. Steel, aluminum, and autos were all contracting. The National Bureau of Economic Research would conclude that the recession began in December 2007—nine months ahead of the fateful days of September.

On the evidence, Lehman was more nearly the climax, or one of a series of climaxes, in a long and painful cataclysm. By the time it failed, the critical moment was long past. Banks had suffered horrendous losses that drained them of their capital, and as the country was to discover, capitalism without capital is like a furnace without fuel. Promptly, the economy went cold. The recession mushroomed into the most devastating in postwar times. The modern financial system, in which markets rather than political authorities self-regulated risk-taking, for the first time truly failed. This was the result of a dark and powerful storm front that had long been gathering at Wall Street’s shores. By the end of summer 2008, neither Wall Street nor the wider world could escape the imminent blow. To seek the sources of the crash, and even the causes, we must go back much further.

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