"Finance: Before the Next Meltdown"

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If innovation must be good, then financial innovation should be good, too. If finance is the lifeblood of our economy, then figuring out new ways to pump blood through the economy should foster investment, entrepreneurialism, and progress. Right? This, in any case, has been the mantra throughout three decades of deregulation and expansion of the financial sector.

And yet today, financial innovation stands accused of being complicit in the financial crisis that has created the first global recession in decades. The very innovations that were celebrated by former Federal Reserve Chairman Alan Greenspan—negative-amortization mortgages, collateralized debt obligations (CDOs) and synthetic CDOs, and credit default swaps, among countless others—either amplified or caused the crisis, depending on your viewpoint. The journalist Michael Lewis recently argued that the credit default swaps sold by A.I.G. brought down the entire global financial system—and found that the A.I.G. traders he talked to completely agreed.

Recent financial innovation is not without its defenders, of course. As current Fed Chairman Ben Bernanke said in a speech in May:

We should also always keep in view the enormous economic benefits that flow from a healthy and innovative financial sector. The increasing sophistication and depth of financial markets promote economic growth by allocating capital where it can be most productive. And the dispersion of risk more broadly across the financial system has, thus far, increased the resilience of the system and the economy to shocks.

Intellectual conservatives and bankers have mounted an even more fervent defense of financial innovation. Niall Ferguson has claimed, "We need to remember that much financial innovation over the past 30 years was economically beneficial, and not just to the fat cats of Wall Street." Bernanke and Ferguson are being too generous. For the past 30 years, financial innovation has increased costs and risks for both individual consumers and the global economy. To take the most obvious example, consumers bought houses they could not otherwise have bought using new mortgages they had no hope of repaying, creating a housing bubble, while new derivatives helped hide the risk of those mortgages, creating a securities bubble. The collapse of those bubbles has shaken the world for the last year. Today's challenge is to rethink financial innovation and learn how to separate the good from the bad.

Financial innovation is different from what we traditionally think of as innovation, which, in recent years, has occurred most visibly in the field of information technology. Certainly, the financial services industry has taken advantage of technological innovation; you can now access your financial statements and pay your bills online, for example. However, these innovations do not affect the core function of the financial sector, which is financial intermediation—moving money from one place where it is not needed to another place where it is worth more.

The classic example of financial intermediation is the community savings bank. Ordinary people put their excess cash into savings accounts; the bank accumulates that money by paying interest and loans it out at a slightly higher rate as mortgages or commercial loans. Savers earn interest, households can buy homes without having to save for decades, and entrepreneurs can start or expand businesses.

The main purpose of financial innovation is to make financial intermediation happen where it would not have happened before. And that is what we have gotten over the last 30 years. As Ferguson said, “New vehicles like hedge funds gave investors like pension funds and endowments vastly more to choose from than the time-honored choice among cash, bonds, and stocks. Likewise, innovations like securitization lowered borrowing costs for most consumers.” But financial innovation is good only if it enables an economically productive use of money that would not otherwise occur. If a family is willing to pay $300,000 for a new house that costs $250,000 to build (including land), and they could pay off a loan comfortably over 30 years, then that is an economically productive use of money that would not occur if mortgages did not exist. But the mortgage does not make the world better in and of itself; that depends on someone else having found a useful way to employ money.

In addition, financial innovation can go too far much more easily than innovation in other sectors. Financial intermediation creates value by making credit more available to people who can use it effectively. But it is possible for the economy to be in a state where people have too much access to credit. With the benefit of hindsight, it is easy to see how the U.S. housing sector passed this point earlier this decade. With negative-amortization mortgages (where the monthly payment was less than the interest, causing the principal to go up) and stated-income loans (where the loan originator did not verify the borrower’s income), virtually anyone could buy a new house, leading developers to build tens of thousands of houses that are now rotting empty, their current value far less than their cost of construction. In short, excess financial intermediation, the result of hyperactive financial innovation, destroys value by causing people to make investments with negative returns. Put another way, we cannot say that innovation is necessarily good simply because there is a market for it. The fact that there was a market for new houses does not change the fact that building those houses was a spectacularly destructive waste of money. Therefore, when it comes to financial innovation, we must distinguish beneficial financial intermediation from excessive, destructive financial intermediation.