BUSINESS

The Case for Derivatives

Economist Robert Shiller believes they could help solve the crisis.

Richard Drew / AP

Traders watch the inauguration from the New York Stock Exchange

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They've been dubbed financial weapons of mass destruction, attacked for causing the financial turmoil sweeping the nation and identified as the kryptonite that brought down the global economy. Derivatives have become the universal symbol of Wall Street greed, yet few Main Streeters really know what they are—namely, financial contracts between a buyer and a seller that derive value from an underlying asset, such as a mortgage or a stock. That hasn't stopped public opinion from turning forcefully against them. Most experts believe that Barack Obama needs to put an end to the financial alchemy that turned low-quality mortgages into trillions of dollars of high-priced derivatives. There seems to be near consensus that derivatives were a source of undue risk.

And then there's Robert Shiller. The Yale economist and financial soothsayer believes just the opposite is true. A champion of financial innovation and an expert in management of risk, Shiller contends that derivatives, far from being a problem, are actually the solution. We need more of them, not less, he says, and warns about the dangers of misguided regulation (though he agrees some regulation is vital). Shiller has an impressive track record of getting real-world things right. He published "Irrational Exuberance," which became a bestseller, just as the stock-market bubble burst in March 2000. He was eerily prescient in sounding the alarm about the housing bubble and the effects of its bursting on global financial markets.

Derivatives, Shiller says, are merely a risk-management tool the same way insurance is. "You pay a premium and if an event happens, you get a payment." That tool can be used well or, as happened recently, used badly. Shiller warns that banishing the tool gets us nowhere. Instead, he envisions a world where derivatives become as common as cash.

What separates Shiller from the majority of economists is his lack of faith in the "efficient-market hypothesis." That belief, which also guides the hand of most money managers, holds that the market will price assets according to their fundamental value and that those prices reflect all pertinent information. Shiller instead follows those, like John Kenneth Galbraith, who hold that market prices reflect "animal spirits" and popular passions, not perfect information. That is why bubbles form, and that, for Shiller, is why financial innovation, and not just government regulation, is imperative.

For all the trillions in derivative trading, there were very few traders. Almost all the subprime mortgages that were bundled and turned into derivatives were sold by a handful of Wall Street institutions, working with a small number of large institutional buyers, ranging from the Bank of China to HSBC to sovereign wealth funds. And as we now know, these derivatives were black boxes whose contents were known by neither the sellers nor the buyers. It was a huge but illiquid and opaque market.

Meanwhile, the system was built on the myriad decisions of individual homeowners and lenders around the world. None of them, however, could hedge their bets the way large institutions can. Those buying a condo in Miami or Marbella had to believe that the market was going up, and had no way to protect themselves if the market went down. When it did, millions were left with homes they could not sell, even for less than they paid.

Derivatives, according to Shiller, could be used by homeowners—and, by extension, lenders—to insure themselves against falling prices. Say you bought a house for $300,000, hoping its value would increase to $350,000. In Shiller's scenario, you would be able to go to your broker and buy a new type of financial instrument, perhaps a derivative that is inversely related to a regional home-price index. If the value of houses in your area declined, the financial instrument would increase in value, offsetting the loss. Lenders could do the same thing, which would help them hedge against foreclosures.

The idea is to make the housing market more liquid. In the United States alone, housing is (or was) a $20 trillion market, and there are few ways to unlock profit when the market falls. But for stocks, because of the use of derivatives and options, money can be made when markets fall, which significantly increases the potential number of buyers and sellers at any given point. And more buyers and sellers—according not just to Shiller but to most finance scholars and traders—means that markets stay liquid and functional even under pressure.

Shiller has been exploring ways to put this theory into practice for nearly 20 years. With business partners he created the Case-Shiller U.S. Home Price Index, a measure of the national housing market that can be traded on the Chicago Mercantile Exchange. But so far it has attracted mostly gamblers and speculators who want to take bets on whether average home prices are going to go up or down.

Some critics dismiss Shiller's basic premise that more derivatives would make the housing market more liquid and more stable. They point out that futures contracts haven't made equity markets or commodity markets immune from massive moves up and down, and may have made such moves steeper, sharper and more rapid. They add that that Shiller has never had to manage a portfolio or a trader's book, and that a ballooning world of home-based derivatives wouldn't lead to homeowners' insurance: it would lead to a new playground for speculators.

Given that these ideas are untested in the real world, it's impossible to know who's right. But Shiller's radical ideas have a parallel in the thinking of the influential Peruvian-born economist Hernando de Soto. De Soto's pathbreaking observation was that the Western world began to outstrip the rest of the world when its legal and banking systems allowed people to turn land into cash. The contemporary system of using property as collateral for loans is the result, and it has given the Western world a huge advantage. In essence, Shiller is laying the intellectual groundwork for the next financial revolution. We are now suffering through the first major crisis of the Information Age economy. Shiller's answers may be counterintuitive, but no more so than those of doctors and scientists who centuries ago recognized that the cure for infectious diseases was not flight or quarantine, but purposely infecting more people through vaccinations. "We've had a major glitch in derivatives and securitization," says Shiller. "The Titanic sank almost a century ago, but we didn't stop sailing across the Atlantic."

Of course, people did think twice about getting on a ship, at least for a while. But if we listen only to our fears, we lose the very dynamism that has propelled us this far. That is the nub of Shiller's call for more derivatives and more innovation. Every major crisis in capitalism is met by calls to return to an earlier, mythic time when life was more secure and things were better. Shiller's appeal is a tough sell at a time when derivatives have produced so much havoc. But he reminds us that the tools that got us here are not to blame; they can be used badly and they can be used well. And trying to stem the ineffable tide of human creativity is a fool's errand.