How to Save the World

Business World

By Holman W. Jenkins Jr.

Thank you, John Meriwether.

All the Saints in Heaven are looking down, wondering whether the rescue of Long-Term Capital Management will be an inducement to sin. But in a world without moral hazard, the outcome would have been just right.

The assets passed smoothly into the hands of creditors. There was no forced liquidation roiling the markets. There was no Japanese-style looking the other way. The pain was doled out rather than delayed, and new owners were installed with the incentive to do the right thing.

We hope no secret deals are in place to make fools out of us for saying this. Mr. Meriwether and his 15 partners have supposedly seen their ownership of the firm whittled down by 90%. Some partners are said to have borrowed to finance their stakes and now face personal bankruptcy. Our condolences to them and their heirs, but this is a good thing.

As for the fund's outside investors, a group which seems to have included not just the odd plutocrat but also the governments of China and possibly Singapore and Taiwan, these folks haven't been the beneficiaries of spontaneous deposit insurance. By one estimate, the average $10 million investor has been reduced to $400,000.

But most of the $80 billion at stake was borrowed from banks and brokerage houses. Now these same banks and brokerages are in charge of LTCM. By all that is holy, we hope they move with dispatch to liquidate their loans regardless of the cost to Mr. Meriwether and his clients. This is just the kind of bailout the world needs more of.

Not that there isn't moral hazard galore in this episode. Only in a world soaking in moral hazard would anybody have lent him so much money in the first place. Only in a world where money is a plaything would he have taken a huge stake in Russian bonds—and would his lenders have stood around with their thumbs in their suspenders while he did so. But all believed that Russia would be bailed out.

And where did Mr. Meriwether get the idea that government bonds are without credit risk if not from the IMF? His most massive bets turned on the assumption of converging interest rates between the securities of different nations. Then Russia defaulted and everybody raced for the safety of Uncle Sam's IOUs, dropping those of other countries like so many second-hand syringes.

As with most hedge funds, LTCM set a steep minimum for new investors, $10 million, and its partners helped themselves to 25% of any profits they managed to generate. Even this makes us suspicious.

Had we all been brought up in a world where money is a terrible responsibility, and where investment returns of 40% are considered unseemly if not sinful, would anybody with $10 million to spare have given it to some math professors to invest according to an incomprehensible strategy? Would hedge funds even exist without a fatty dollop of moral hazard somewhere at the end of the great protein chain of lending?

Would plutocrats send their money flying around the world in search of faddish opportunity and outsized profits? Would so many little investors have tramped in their wake and tossed their own nickels and dimes into the pot in Asia and Russia? How does it occur to people to invest in these places except by the example of their presumed betters?

The ways in which our financial system has been conditioned by moral hazard, or the belief that government will step in if the bankruptcy is big enough, run even deeper.

If LTCM had folded, various lenders would have had to write off $10 billion or so. This might have been survivable, but one of the brighter accounting solutions after the thrift debacle was to make banks carry their securities at current prices (much like the brokerage industry's margin requirements), even if they have no intention of selling. Thus the banks that refloated Mr. Meriwether to the tune of $3.5 billion were acting out of naked fear that a distress liquidation of his portfolio would push theirs over the red line too.

John Meriwether

Somehow it all worked out this time, but the rules put a premium on panic in volatile times. Orange County could have saved itself $2 billion by riding out the bond market a few years ago instead of dumping at a loss. But there will be no needless wastage in this case, because lenders are being made to take responsibility for their lending.

Like we say, bring us more such bailouts. Around the globe we see Mr. Meriwether writ smaller and larger, and nobody like the New York Fed making the banks act nobly or the miscreants fess up. The planet is not in a financial crisis but a political crisis, one revolving around how losses will be recognized and who among the mighty will become the fallen.

In hopeless Japan, everyone who owns property or shares has become part of the protected class. The banks have spent eight years refusing to liquidate their mistakes to save these markets from cratering further. Until they do, the overhang prohibits what animal spirits still exist in the economy from taking up the wreckage and making it profitable again.

Indonesia is painfully assembling a mega-liquidation agency for the country's deadbeat assets but expect a war over stripping the Suharto cronies of their possessions. In Malaysia, the prime minister did not jail his understudy and finance minister so he could impose exchange controls. He imposed exchange controls so he could jail his finance minister, who was pressing for the bankruptcy of crony companies.

Achingly, a few small sins are being owned up to, but more is needed. GE, United Technologies and Merrill Lynch have fished among the Asian casualties and are turning some into modern businesses. And Ford dropped out of the bidding for South Korea's bankrupt Kia Motors only because the government assumed the company's debts and refuses to take a reasonable haircut.

In Britain, the courts have frozen Russian bank accounts at the behest of Lehman Brothers, and certain foreign creditors have seized shares of the energy conglomerate Yukos as collateral. Whether these rights will amount to anything in the hands of Western investors should be closely watched. The quickest way to resurrect Russian finances would be to hand the energy assets over to Western oil firms. But instead the IMF and the Primakov government are playing a game of chicken over whether Russian borrowers will resume payments or the banks will go suck an egg.

Given all this, we can imagine a useful afterlife for Mr. Meriwether. When Wall Street is done with him, the IMF could send this star penitent out to preach to the Asians and others about how confession and bankruptcy are good for the soul.