WORLD TRENDS

Specter of a Crisis Looms Over Cradle of Innovation

By BRAD STONE
and CLAIRE CAIN MILLER

SAN FRANCISCO — Since the credit crisis began gripping the financial world, Silicon Valley has watched from the sidelines, secure in the faith that it was insulated from the coming storm.

That faith is now being seriously undermined. High-tech entrepreneurs, investors and executives now believe the question is when, not if, the financial chaos will hurt America's cradle of innovation.

From San Francisco to San Jose, the effects are already palpable. During the week of September 28, Apple lost 16.3 percent of its value as investors reasonably concluded that consumers would shun expensive gadgets over the holidays in favor of lower-ticket items — or paying down their credit cards. Shares in Yahoo and eBay are at their lowest levels in years.

Other ominous signs abound. Semiconductor makers, many of which finance their capital-intensive operations with debt, have been hit hard.

According to a quarterly survey by Mark V. Cannice, director of the University of San Francisco Entrepreneurship Program, the confidence of venture capitalists has plummeted to the lowest level since the survey began in 2004. "Everyone is worried about their budgets and everyone is worried about the economy," said Jayant Kadambi, founder of Yume, a three-year-old online video advertising firm. "These are the conversations we have these days."

The main drivers of Silicon Valley's growth are start-up companies and the venture capitalists who back them. Many say that these engines of innovation are still moving along. Nevertheless, a pall of anxiety seems to be spreading.

"Funding will tighten up. We are certainly going to see some ripple effects," said Ron Conway, a prominent venture capitalist who has invested in hundreds of Web start-ups over the last decade.

Start-ups that have less than six months of cash in the bank "better reduce costs," Mr. Conway said. "I will certainly be advising my companies to do that."

Silicon Valley has recited several calming mantras to itself during the prolonged economic turbulence. People are spending more and more time on the Internet — and advertising will inevitably follow. Blue-chip tech firms like Google, eBay and Cisco have balance sheets loaded with cash, not debt.

Yet nonstop economic gloom in other parts of the economy seems to have shaken the faith of even the most sublimely confident. Discussions of the economic crisis dominate conversations in the Valley. Technology blogs offer prescriptions for riding out the crisis and intense debates over what percentage of start-ups are destined to fail.

In the hardest-hit sectors of the overall economy, companies appear to be cutting their Internet spending. General Motors said in September that it was cutting its digital ad spending, after saying earlier this year that it would dedicate $1.5 billion, half its annual budget, to online advertising.

Many Valley start-ups have still been reporting successful fund-raising. But an increasing number of those that have raised money say they feel as if they slipped through a rapidly closing door. In early September, Skydeck, a 10-employee start-up that allows people to use the Web to organize their mobile phone calls and text messages, raised $3 million in venture capital. The very next weekend, the government took over Fannie Mae and Freddie Mac, and Lehman Brothers filed for bankruptcy protection.

"When I woke up on Monday morning I was pretty happy to have our fund-raising behind us," said Jason Devitt, the company's founder. "This week, I received a slew of e-mail congratulating us on raising money in this economy. Clearly there's a real awareness of the impact."

Jonathan Abrams, who founded the social networking pioneer Friendster, now runs a party-planning start-up called Socializr. Mr. Abrams is unimpressed with the Valley's readiness in general, saying numerous uninspired, copycat entrepreneurs are obsessed with the internal gossip and minutiae of the industry.

"It seems to me like the industry is still in denial," he said.

Ashlee Vance contributed reporting.

PETER DASILVA FOR THE NEW YORK TIMES

Jason Devitt, a start-up founder, says that fund-raising has become more difficult in Silicon Valley.

CARL T. GOSSETT/THE NEW YORK TIMES

Party's Over: Wall Street Lights Dim

By TIM ARANGO and JULIE CRESWELL

As the proprietor of Harry's Cafe, a landmark saloon in Manhattan's financial district, Harry Poulakakos, 70, has seen his share of ups and downs on Wall Street. During the 1987 stock market crash, Harry's filled up at 4 p.m. and stayed open all night. But the upheaval he's witnessing now is, he said, the worst in decades.

"I hope this is going to be over," he said. "If Wall Street is not active, nothing is active." Mr. Poulakakos isn't planning to disappear. But the cultural tableau and the social swirl that once surrounded Harry's are certainly fading.

"It's the beginning of the end of the era of infatuation with the free market," said Steve Fraser, a historian and author of "Wall Street: America's Dream Palace." "It's the end of the era where Wall Street carries high degrees of power and prestige. And it's the end of the era of conspicuous displays of wealth. We are entering a new chapter in our history."

To be sure, living large and flaunting it are unlikely to exit the American stage, infused as they are in the country's spirit. But historians, economists and pundits are busily debating the ways in which Wall Street's demise will filter into the popular culture.

It's an era that traces its roots back more than two decades, when suspendered titans first became fodder for books and movies. It's an era when eager young traders wearing khakis and toting laptops became dot-com millionaires overnight. And it is an era that roared into hyperdrive during the credit boom of the last decade, when business-school graduates and mathematicians raked in millions by trading and betting on ever more exotic securities.

Over all, the past quarter-century has redefined the notion of wealth. In 1982, the first year of the Forbes 400 list, it took about $159 million in today's dollars to make the list; this year, the minimum price of entry was $1.3 billion.

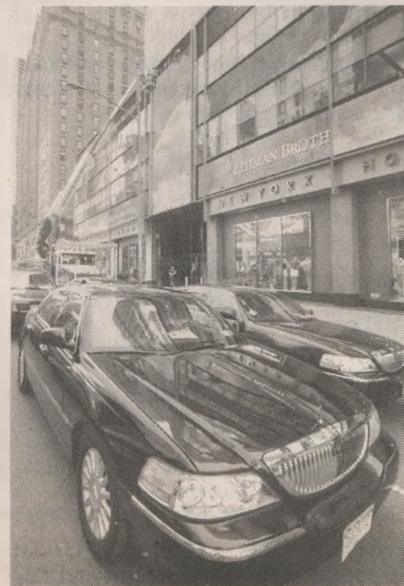
"The money was big in the '80s, compared to the '50s, '60s and '70s. Now it's stunning," said Oliver Stone, who directed the 1987 film "Wall Street" and is the son of a stockbroker. "I thought the '80s would have been an end to a cycle. I thought there would be a bust. But that's not what happened."

Now, with jobs, fortunes and investment banks lost, a cultural linchpin seems to be slipping away.

"This feels very similar, historically, to 1929 and the emotions that filled the air in the months and years that followed the crash," Mr. Fraser said. "There is a sense of extraordinary shock and astonishment, which is followed by a sense of rage, outrage and anger directed at the centers of finance."

In response, some will inevitably downsize.

"The yacht is probably the first thing to go," said Jonathan Beckett, in a telephone interview from Monte Carlo as he attended the annual Monaco Yacht Show last month. Mr. Beckett, the chief executive of Burgess, a yacht broker, said that for the past eight years there have been few sellers in the market.



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Above, a jubilant New York Stock Exchange on New Year's Eve, 1971. Left, limousines lined up at the Lehman Brothers headquarters in Manhattan, pre-bankruptcy.

Ostentatious homes are also up for sale. While brokers say they have yet to see an avalanche of high-end sales, they do say that upheaval is present in the minds of buyers.

In all likelihood, the real estate market could be frozen for the next 6 to 18 months or so as buyers and sellers struggle to reach agreement on prices, said Barbara Corcoran, who has spent years selling high-end luxury properties to New York's elite.

"The buyers have jumped to the sidelines and the sellers refuse to budge on their prices, completely in a state of disbelief that anything has changed," she said.

Even if the current crisis leads to a prolonged slowdown, people may still flock to finance jobs. But they may have to recalibrate their expectations.

"There's no question that people on Wall Street are going to make less money," said Jonathan A. Knee, a Columbia Business School professor and author of "The Accidental Investment Banker."

Like any cultural force concerned about its legacy, the financial world has a custodian of its past. On Wall Street, it can be found at the Museum of American Financial History, just a block from the New York Stock Exchange.

Located in a grand space once occupied by the Bank of New York, it features a long timeline charting major market events. The last event it notes is the popping of the dot-com bubble earlier this decade.

Robert E. Wright, a financial historian at New York University who is a curator of the museum, said that there were still many unknowns about how recent events would be recalled.

"If the economic system shuts down and we go in for a deep recession, it probably is the end of an era," he said.

The museum has already started collecting mementos from the current crisis to post on its wall.

MONEY & BUSINESS

Lesson From a Credit Crisis: When Trust Vanishes, Be Worried

DAVID LEONHARDT

ESSAY

In 1929, Meyer Mishkin owned a shop in New York that sold silk shirts to workingmen. When the stock market crashed that October, he turned to his son, then a student at City College, and offered a version of this sentiment: It serves those rich scoundrels right.

A year later, as Wall Street's problems were starting to affect the broader economy, Mr. Mishkin's store went out of business. He no longer had enough customers. His son had to go to work to support the family, and Mr. Mishkin never held a steady job again.

Frederic Mishkin — Meyer's grandson and, until he stepped down in August, an ally of Ben Bernanke's on the Federal Reserve Board — told me this story the other day, and its moral is obvious enough. Many people in Washington fear that the country is starting to spiral into a terrible downturn. And to their horror, they see the public, and many members of Congress, turning into modern-day Meyer Mishkins, more interested in punishing Wall Street than saving the economy.

All of which may be true. But there is good reason for the public's skepticism. The experts and policy makers have failed to tell a compelling story about why they're so afraid.

It's not enough to say that markets could freeze up, loans could become impossible to get and the economy could slide into its worst downturn since the Great Depression. For now, the crisis has had little effect on most Americans, beyond their retirement account statements. So the specter of a depression can sound alarmist.

Mr. Bernanke and his fellow worriers need to use their power as public officials to teach a little lesson on the economics of a credit crisis.

Almost no economist thinks that even a terrible downturn would look like the Depression. The government has already responded more aggressively than it did in Herbert Hoover's day. On October 3, Congress gave final approval to a $700 billion bailout for the financial system and central banks in the United States, England and Europe coordinated a cut in rates on Wednesday in an effort to stanch the financial crisis. So a Depression-like contraction — a 30 percent drop in economic activity — is highly unlikely.

But the Depression is still relevant, because the basic mechanics of how the economy might fall into a severe recession look quite similar to those that caused the Depression. In both cases, a credit crisis is at the center of the story.

At the start of the 1930s, despite everything that had happened on Wall Street, the American economy had not yet collapsed. Consumer spending and business investment were down, but not horribly so. In late 1930, however, a rolling series of bank panics began. Investments made by the banks were going bad — or, in some cases, were rumored to be going bad — and nervous customers besieged bank branches to demand their money back. Hundreds of banks eventually closed.

Once a bank in a given town shut its doors, all the knowledge accumulated by the bank officers there effectively disappeared. Other banks weren't nearly as willing to lend money to local businesses and residents because the loan officers at those banks didn't know which borrowers were less reliable than they looked. Credit dried up.

"If a guy has a good investment opportunity and he can't get the funding, he won't do it," said Mr. Mishkin, who's now an economics professor at Columbia University in New York. "And that's when the economy collapses."

As a young academic economist in the 1980s, Mr. Bernanke largely developed the theory that the loan officers' lost knowledge was a crucial cause of the Depression. He referred to this lost knowledge as "informational capital." It means that trust vanished from the banking sector.

The same thing is happening now. Financial markets are global, so the problem isn't that the failure of any single bank locks individuals or businesses out of the credit markets. Instead, the nasty surprises of the last 13 months — the sort of turmoil that once would have been unthinkable — have caused a breakdown in informational capital.

The current fears can certainly seem irrational. Most households and businesses are still in fine shape, after all. So why aren't some banks stepping into the void and taking advantage of the newly high interest rates to earn some profit?

There are two chief reasons. One is fairly basic: bankers are nervous that borrowers who look solid today may not turn out to be so solid.

The second reason is a bit more complex. Banks own a lot of long-term assets (like mortgages) and hold a lot of short-term debt (which is cheaper than long-term debt). To pay off this debt, they need to take out short-term loans.

In the current environment, bankers are nervous that other banks might shut them out, out of fear, and stop extending that short-term credit. This, essentially, brought about the collapse of Wachovia and Glitnir Bank in Iceland. To avoid their fate, other banks are hoarding capital, instead of making seemingly profitable loans. And when capital is hoarded, further bank failures become all the more likely.

The crucial point is that a modern economy can't function when people can't easily get credit. It takes a while for this to become obvious, since most companies and households don't take out big new loans every day. But it will eventually become obvious, and painfully so.

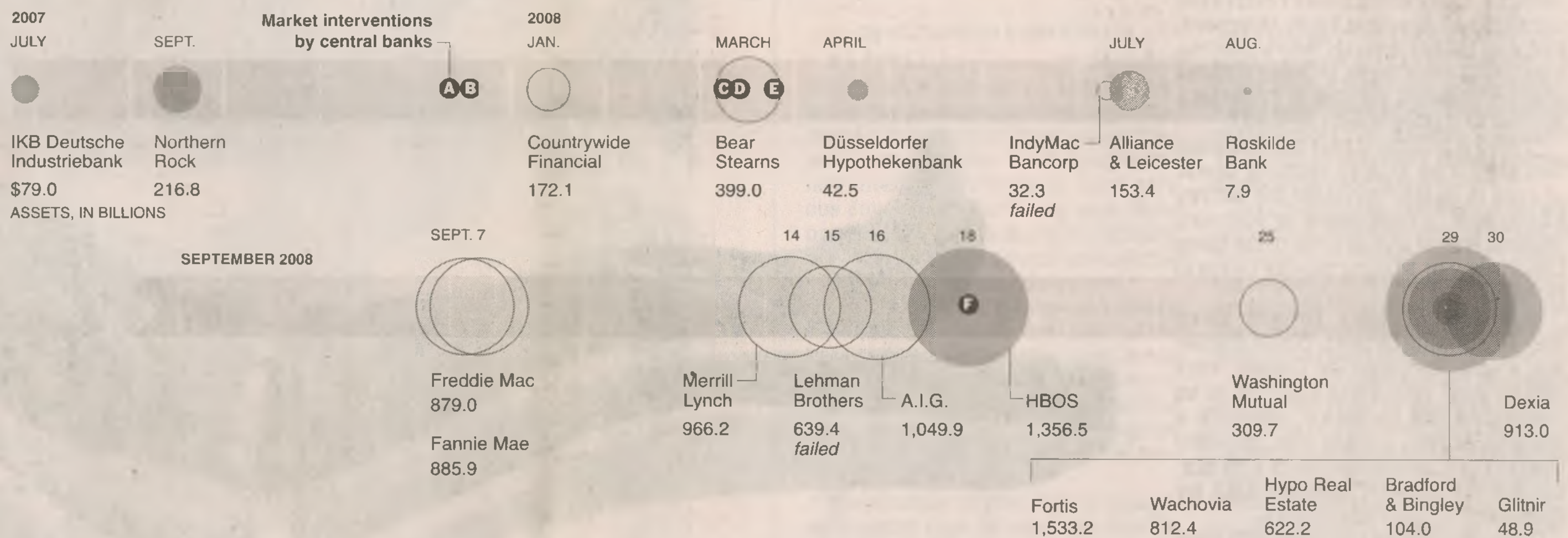
In the end, this really isn't about Wall Street. It's about reducing the risk that something really bad happens. Unfortunately, there is no way to accomplish that without also extending a helping hand to Wall Street. That is where our credit markets are, and we need them to start working again.

"We are facing a major national crisis," as Meyer Mishkin's grandson says. "To do nothing right now is to do what was done during the Great Depression."

Casualties of the Financial Meltdown

A timeline of bailouts, buyouts and takeovers of financial services companies in the U.S. ◯ and Europe ● since the subprime mortgage crisis began.

Figures are assets as last reported and do not include the value of securities that some companies, notably Fannie Mae and Freddie Mac, guaranteed.



Market interventions by the Federal Reserve or the European central banks

Ⓐ **DECEMBER 12** Central banks of the United States, the European Union, Canada and Switzerland announce a plan to provide at least $90 billion in short-term financing to banks.

Ⓑ **DECEMBER 18** The European Central Bank injects $500 billion into the financial system. The Bank of England auctions off $20 billion in three-month loans.

Ⓒ **MARCH 7** The Federal Reserve offers up to $200 billion in 28-day loans to banks and big financial institutions.

Ⓓ **MARCH 11** The Federal Reserve offers investment banks up to $200 billion in Treasury securities in exchange for mortgage-backed securities.

Ⓔ **MARCH 21** The European Central Bank offers up to $24 billion in loans to help banks shore up balance sheets. The Bank of England offers up to $10 billion in loans.

Ⓕ **SEPTEMBER 18** The Federal Reserve, the European Central Bank, the Bank of England, the Bank of Japan and the central banks in Switzerland and Canada make $180 billion available in currency swaps.

Source: Bloomberg

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