

Credit crunch shakes Wall Street, intensifies the chance of recession

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At the center of a storm of historic events that shook America's financial foundations Monday is a widening credit crunch that's causing lending of virtually ; recession.

On an unprecedented day on Wall Street, major investment bank Lehman Brothers went bankrupt, Merrill Lynch went in a fire sale to Bank of America, and American International Group -- nearly collapsed.

Major stock markets are on pace for one of their worst years ever, although even the Dow Jones industrial average's 4.4 percent drop wasn't the panic se

How the worsening woes will trickle into the nation's economy is still unclear, but it's almost certain lenders will get even more conservative about making l allows houses to be sold, consumers to buy and businesses to expand. Lenders will say, "We would have made that condo loan but let's not do that now," consultant and economist. "Credit that was tight and had gotten tighter is going to be even tighter."

Late Monday, American International Group was still searching for a solution.

The Treasury Department and Federal Reserve rejected the insurer's request for an emergency loan and instead were pushing investment banks Goldma afloat while it tries to shed valuable assets to raise capital and remain solvent.

AIG's problems underscore why Wall Street is in a state of near panic. AIG isn't insolvent; it has already raised \$20 billion this year to shore up its balance

But its falling stock is forcing it to sell assets and to plead for investment from private equity companies. It needs to raise about \$40 billion in new capital, t more capital, rating agencies could downgrade it, requiring even more capital to stay afloat.

"It's a perverse situation," Bill Gross, considered the country's leading investor in bonds, said on CNBC.

If AIG fails, it poses unique problems for financial markets because not only is it a conventional insurance company, it's also a big player in a complex mar companies take out a form of market insurance against the risks of bond default. OPAQUE MARKET "The market is opaque, and it is opaque by design," firm Rosewood Trading in Glenview, Ill., noting that there's no exchange or clearinghouse for unwinding these swaps if a big player goes bust. "It's going to an information vacuum."

Wall Street has suffered this kind of financial turbulence only a few times before, most notably during the Depression.

Fed Chairman Ben Bernanke is one of the world's leading scholars on the Depression, and he's putting that knowledge to use as he tries to avoid a comp he broadened the collateral the Fed is willing to take as it makes emergency lending to investment and commercial banks to keep them solvent.

"There's nothing like this in the post-war period," said Lyle Gramley, a veteran markets watcher who was a Federal Reserve governor from 1980 to 1985. about that. But we could get into a recession that accumulates if things don't get better in financial markets. I think we have to worry a lot that this may be th significant recession."

Like Bear Stearns, which was sold to JP Morgan Chase in March, the 158-year-old Lehman Brothers was heavily weighed down by bad investments in m helped Lehman shop for partners but would not use taxpayers' money to bail out the investment bank, as it had with Bear Stearns.

"The situation in March and the situation and the facts around Bear Stearns were very, very different to the situation we are looking at here in September," news conference Monday afternoon.

Two Florida economists said the government's decision was good news, bad news. Bad news because it makes other lenders cautious about extending government to bail them out.

Good news because bailing out Lehman would have encouraged what economists call "moral hazard," which is the tendency of companies and individual the full consequences of a mistake, said University of Florida economist David Denslow.

COMPETING GOALS

Krishnan Dandapani, a finance professor at Florida International University, said the government is trying to balance two competing goals preserving conf perception that it will rescue every big financial services company that runs into trouble. Paulson on Monday was noncommittal about whether regulators w

When does the crisis end? Paulson said when housing's problems ended.

"Until we stem the housing correction, until the biggest part of that is behind us and we have more stability in housing prices, we're going to continue to ha

Miami Herald business writers Scott Andron and Ina Cordle contributed to this report.