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America's bail-out plan

The doctors' bill

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The chairman of the Federal Reserve and the treasury secretary give Congress a gloomy prognosis for the economy, and propose a drastic remedy

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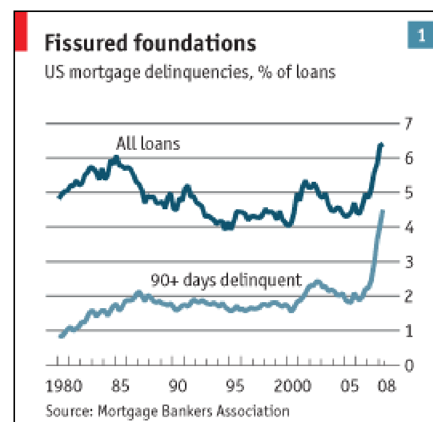
AMERICAN congressmen are used to hyperbole, but they were left speechless by the dire scenario Ben Bernanke, the chairman of the Federal Reserve, painted for them on the night of September 18th. He "told us that our American economy's arteries, our financial system, is clogged, and if we don't act, the patient will surely suffer a heart attack, maybe next week, maybe in six months, but it will happen," according to Charles Schumer, a Democratic senator from New York. Mr Schumer's interpretation: failure to act would cause "a depression".

Mr Bernanke and Hank Paulson, the treasury secretary, had met congressional leaders to argue that ad hoc responses to the continuing financial crisis like that week's bail-out of American International Group (AIG), a huge insurer, were no longer sufficient. By the weekend Mr Paulson had asked for authority to own up to $700 billion in mortgage-related assets. By the time *The Economist* went to press, Congress and Mr Paulson appeared to have agreed on the broad outlines of what is being called the Troubled Asset Relief Programme, or TARP.

However, passage was not assured as rank-and-file congressmen, in particular Republicans, balked. Uncertainty over the outcome rattled credit markets: three-month interbank rates jumped and Treasury yields fell on September 24th. In a prime-time address that evening to rally support, George Bush warned of bank failures, plummeting house values and millions of lost jobs if Congress did not act.

Both the crisis and the authorities' response have been called the most sweeping since the Depression. Yet the differences from that era are more notable than the similarities to it. From the stockmarket crash of 1929 to the federally declared bank holiday that marked its bottom, three and a half years elapsed, and unemployment reached 25%. This crisis has been under way for a little over a year and unemployment is just over 6%, lower even than in the wake of the last, mild recession. More than 4% of mortgages are now seriously delinquent (see chart 1), but the figure topped 40% in 1934.



The scale of the American authorities' response reflects both the violence with which this crisis has spread, and the determination of the American authorities, most importantly Mr Bernanke, to learn from the mistakes that made the Depression so deep and long.

In responding with such speed and vigour, they run several risks. One is that they overdo it, paying far too much for assets, sending the deficit into the stratosphere and triggering a run on the dollar. The risk of underdoing it may be even greater. Politicians, determined not to be seen as doing favours for Wall Street, might blunt the programme's effect in the name of protecting the taxpayer. Then there's the logistical nightmare of fixing a market whose very complexity is central to the crisis.

Experience, at home and abroad, is a poor guide. In past episodes authorities have typically not committed public money to their financial systems until bank failures and insolvency have become widespread. The first wave of savings-and-loan failures came in the early 1980s; the Resolution Trust Corporation was not created to dispose of their assets until 1989. Japan's banks began to fail in 1991, but a mechanism for taking over large, insolvent banks was not set up until 1998. Mr Paulson and Mr Bernanke are attempting to prevent the crisis from reaching that stage. "The firms we're dealing with now are not necessarily failing, but they are contracting, they are deleveraging," Mr Bernanke told Congress. They are unable to raise capital and are refusing to lend, and that, he said, is squeezing the economy.

One risk with such a pre-emptive bail-out is that to congressmen the benefits are hypothetical whereas the fiscal and political costs, five weeks before an election, are all too real. In polls voters waver between opposition and support depending on how the question is asked.

In spite of these risks, the odds seem to be in favour of both political passage and success. America has owned up to its mistakes with exceptional speed, and pulled out the stops to correct them.

After the crisis first broke in August last year, the Fed pursued a two-pronged strategy. The first element was to lower interest rates to cushion the economy. The second was to use its balance sheet to help commercial and investment banks finance their holdings of hard-to-value securities and avoid fire-sales of assets. Behind this approach lay the belief that the economy and the financial system were basically solid. Yes, too many houses had been built and prices were too high, but a return to more normal levels would be manageable if stretched over a few years. And banks in aggregate had entered the crisis in good shape, with much more capital this June than in 1990. The Fed saw their problem essentially as illiquidity, not insolvency. The Bush administration broadly shared this diagnosis—and an aversion to using public money to help overextended borrowers.

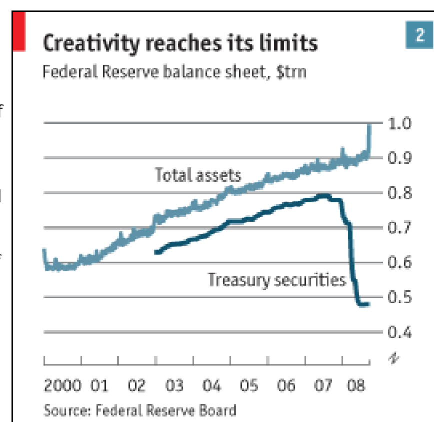
The intensification of the crisis came not from the banks but the "shadow banking system": the finance companies, investment banks, off-balance-sheet vehicles, government-sponsored enterprises and hedge funds that fuelled the credit boom, aided by less regulation and more leverage than commercial banks. As home prices fell and loan losses mounted, more of the shadow system became insolvent.

Insolvency cannot be cured with more loans, no matter how easy the terms. It requires more capital, which in deep crises only the government can provide. Mr Bernanke's groundbreaking paper on the Depression, published in 1983, noted that recovery began in 1933 with large infusions of federal cash into institutions, through the Reconstruction Finance Corporation, and households, through the Home Owners' Loan Corporation. They were, he wrote, "the only major New Deal programme which successfully promoted economic recovery."

A month ago Mr Bernanke and his closest aides began to think something similar might now be needed. The Fed and the Treasury had already drawn up contingency plans, thinking it would be months before a need arose. Then the financial hurricane blew up over the weekend of September 13th and 14th. That is when Mr Paulson, Mr Bernanke and Tim Geithner, president of the Federal Reserve Bank of New York, decided not to commit any public money to a bail-out of Lehman Brothers. They reasoned, wrongly, that the financial system was adequately prepared. The company's failure, coupled with the near-bankruptcy of AIG, threw the safety of all financial institutions into doubt, causing their stocks to plunge and borrowing costs to soar.

Several money-market funds that held Lehman debt reported negative returns, sparking a flight of cash to the safety of Treasury bills that briefly pushed their yields close to zero. On September 18th companies could no longer issue commercial paper. Banks, anticipating huge demands from companies seeking funds, began hoarding cash, sending the federal funds rate as high as 6%. That week, no investment-grade bonds were issued, for the first time (holidays aside) since 1981.

Conceivably, the Fed could have contained the damage by supplying lots of cash. But that would have meant ever greater and more creative use of its balance sheet. By September 17th it had grown to $1 trillion, up by 10% in a fortnight, with most of it tied up in loans to banks, investment banks, foreign central banks, AIG and Bear Stearns (see chart 2). It was becoming the lender of first resort, not last.



Such steps were also courting political risk. After the rescue of AIG, Nancy Pelosi, speaker of the House of Representatives, demanded, "Why does one person have the right to grant $85 billion in a bail-out [to AIG] without the scrutiny and transparency the American people deserve?" Mr Bernanke later acknowledged that the Fed wanted to get out of crisis management, for which it lacked authority and broad support. "We prefer to get back to monetary policy, which is our function, our key mission," he told Congress this week.

The Fed chairman told Mr Paulson on September 17th that the time had come to call for a big injection of public money. By the next day Mr Paulson was in agreement and the two men, after getting Mr Bush's approval, approached Capitol Hill.

Mr Paulson's first proposal left Democrats cold: it would give the Treasury virtually unchecked authority for two years to spend up to $700 billion on mortgage assets or anything else necessary to stabilise the system. It looked like a power-grab. Democrats countered with several conditions: troubled mortgages would be modified where possible to keep homeowners in their homes; an oversight board would watch over the programme; taxpayers would share any gains for participating companies via shares or warrants; and executives' compensation would be capped. By September 24th, Mr Paulson seemed to be bending to all these conditions. For its part, the finance industry is ready to yield to all of these conditions in order to get something done. "It was a gargantuan abyss that we faced last week," says Steve Bartlett, chairman of the Financial Services Roundtable, which represents about 100 big financial firms.

Assuming it comes into existence, there are still numerous risks surrounding the TARP. The first is that it does too much. At $700 billion, the amount allocated to it easily exceeds the Federal Deposit Insurance Corporation's (FDIC) estimate of roughly $500 billion of residential mortgages seriously delinquent in June, out of a total of $10.6 trillion, though that figure will rise. The Treasury has sought broad authority to buy not just mortgage securities but anything related to them, such as credit derivatives, and if necessary equity in companies weakened by their bad loans.

The arithmetic of crisis

When the loans to AIG and Bear Stearns assets are added in, the gross public backing so far approaches 6% of GDP, well above the 3.7% of the savings-and-loan bail-out in the late 1980s and early 1990s (see chart 3). That would still be much less than the average cost of resolving banking crises around the world in the past three decades, which a study by Luc Laeven and Fabian Valencia, of the IMF, puts at 16%. One reason why bail-outs, especially in emerging markets, have been so costly is inadequate safeguards against abuse, says Gerard Caprio, an economist at Williams College. "There was a lot of outright looting going on."

The price of safety 3

Cost of bail-outs

Country	Start of crisis	Gross fiscal cost, % of GDP
United States	1988	3.7
Finland	1991	12.8
Sweden	1991	3.6
Mexico	1994	19.3
Japan	1997	24.0
South Korea	1997	31.2
United States	2007	5.8*

*Includes $700bn to the Troubled Asset Relief Programme, $85bn to AIG, $29bn to Bear Stearns. Excludes capital investment in GSEs

Source: IMF, Luc Laeven and Fabian Valencia

The Congressional Budget Office had pegged next year's federal budget deficit at more than $400 billion, or 3% of GDP. Private estimates top $600 billion. Tack on $700 billion and various other crisis-related outlays and the total could reach 10% of GDP, notes JPMorgan Chase, a level last seen in the second world war. On September 22nd the euro made its largest-ever advance against the dollar on worries that America might one day inflate its way out of those debts. Such fears are compounded by the expansion of the Fed's balance sheet. Some even think that the burden of repairing a broken financial system could place the dollar's status as the world's leading reserve currency in jeopardy.

The consequences will probably not be so far-reaching. The true cost to taxpayers is unlikely to be anywhere near $700 billion, because many of the acquired mortgages will be repaid. The expansion of the Fed's balance sheet reflects a fear-induced demand for cash, which drove the federal funds rate above the 2% target.

It is more likely that the programme will not go far enough. Conscious of the public's deep antipathy to anything that smacks of favours for Wall Street, politicians from both parties have insisted that the protection of the taxpayer be paramount. Yet the point of bail-outs is to socialise losses that are clogging the financial system. If taxpayers are completely insulated from losses, the bail-out will probably be ineffective. "The ultimate taxpayer protection will be the market stability provided," Mr Paulson argues.

This is especially critical in deciding how the government will set the price for the assets it purchases. An impaired mortgage security might yield 65 cents on the dollar if held to maturity. But because the market is so illiquid and suspicion about mortgage values so high, it might fetch just 35 cents in the market today. Recapitalising banks would mean paying as close to 65 cents as possible. Those that valued them at less on their books could mark them up, boosting their capital. On the other hand, minimising taxpayer losses would dictate that the government seek to pay only 35 cents. But this would provide little benefit to the selling banks, and those that carried them at higher values on their books could see their capital further impaired.

To some, that would be fine. "If they choose to fail rather than sell their debt at its real market value and record the loss on the books, they should be free to take that option," said Michael Enzi, a Republican senator from Wyoming. The failure of smaller regional banks may be tolerable. The FDIC offers a proven system for coping with failed entities (although it too may need a loan from the taxpayer) and other banks are keen to snap up their deposits. But the final result of big-bank failures would be a deeper crisis and a bigger cost in lost economic output.

Similarly, requiring participating banks to give the government warrants or cap their executives' salaries might make them less willing to take part. Veterans of the emerging-markets crises of the 1990s say their effectiveness would have been crippled had their ability instantly to deploy cash as they saw fit been compromised. "There is far more risk that the authorities will have too little flexibility…than there is risk that they will have too much authority," says Lawrence Summers, a former treasury secretary.

A more serious criticism is that buying assets is an inefficient way to recapitalise the banking system. Better, many argue, to inject cash directly into weakened banks. A dollar of new equity could support $10 in assets, reducing the pressure to deleverage. Moreover, since the price of banks' shares are less arbitrary and more homogeneous than those of illiquid mortgage securities, the process would be far more transparent, says Doug Elmendorf of the Brookings Institution. But banks might not volunteer to sell equity to the government before they reach death's door; and the prospect of share dilution could discourage private investors. In any event, the Treasury plan could be flexible enough to permit such capital injections.

But will it work?

There have been several false dawns since the crisis began in August of last year. This could be another. The TARP may address the root cause, namely house prices and mortgage defaults, but the crisis has long since mutated. "The same underlying phenomenon that we saw in housing we're seeing in auto loans, in credit-card loans and student loans," says Eric Mindich, head of Eton Park Capital Management, a hedge fund. The crisis could claim another institution before the TARP's effect is felt.

Reuters

Time to mend the market

The TARP could conceivably slow the resolution of the crisis by stopping property prices and home ownership falling to sustainable levels. Some homeowners who are up-to-date with payments but whose home is worth less than their mortgage may stop paying, betting the federal government will be a more forgiving creditor. The Treasury is considering using the TARP to write down mortgages to levels that squeezed homeowners can afford. But in the meantime, buyers might be reluctant to step in while a big inventory of government-owned property hangs over the market. That's one reason Japan's many efforts to bail out its banks failed to revitalise its economy: the institutions that took over the loans were hesitant to dispose of them for fear of pushing insolvent borrowers into bankruptcy, says Takeo Hoshi of the University of California at San Diego.

All the same, the TARP is likely to mark a turning-point. "It promises to break the vicious circle of deleveraging in the mortgage market," predicts Jan Hatzius, an economist at Goldman Sachs. This does not mean the economy will soon rebound, but it does suggest the worst scenarios will be averted. If the TARP helps banks and investors establish reliable prices for mortgage securities, it could restart lending and help bring the housing crisis to an end.

This will not come without a price. The unprecedented intrusion of the federal government into the capital markets seems certain to be accompanied by a heavier regulatory hand, something on which both Barack Obama and John McCain now agree.

Even without new rules, more of the system will be regulated because so much of it has been absorbed by banks, which are closely overseen. Sheila Bair, chairman of the FDIC, thinks this is a good thing. Banks were relative pillars of stability because of their insured deposits and the regulation that accompanied it. Although some banks have failed, she notes that other banks, not taxpayers, will pay the clean-up costs. Now that institutions like money-market funds are caught by the federal safety net even though that was never intended, they can expect to pay for it.

Yet predictions of a sea change towards more invasive government are premature. The Depression witnessed a pervasive expansion of the federal government into numerous walks of life, from trucking and railways to farming, out of a broadly shared belief that capitalism had failed utterly. If Mr Paulson and Mr Bernanke have prevented a Depression-like collapse in economic output with their actions these past two weeks, then they may also have prevented a Depression-like backlash against the free market.

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