Quashing the Financial Firestorm

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Now that the House has voted down the bailout bill, where do we go next? John McCain advises that we begin calling it a rescue plan instead of a bailout. Perhaps that will help, but more is needed than a PR campaign to make the plan economically sensible and politically sellable.

I signed the now famous economists' petition opposing Paulson's initial plan, but I don't oppose dramatic action, I just want it thought through. After all, I can think of one thing worse in a crisis of confidence than failing to act immediately: spending $700 billion without solving the problem.

One thing to realize is that the solution, if we find one at all, may come in pieces, and may come in iterative legislation. Much like fighting a wild fire, I'd begin with a strategy of containment, then try to eliminate or limit the problem.

A new Great Depression is too much to risk. Therefore, I am with Paulson as far as this: We should hold our nose and do something, and something big. First things first: Fully insure all bank deposits and guarantee continuous access to funds. This will secure the payment system. That done, I would create administrative processes to write down mortgages, and spend some of the $700 billion in direct efforts to prevent foreclosures. As to the direct bank rescue, spend some on limited auction-based asset purchases sufficient to achieve price revelation and dedicate perhaps half the money to injecting needed capital to banks through stock purchases.

A FIREBREAK AROUND THE PAYMENT SYSTEM

Ask a firefighter how to fight a wild fire and he will tell you not to start at the flames; instead, begin by building a wide fire break miles from the fire, a line beyond which the fire cannot and must not go.

With this in mind, let me say: The banking system, which includes our payment system, must not fail. The problem with financial panic is that if there is going to be a panic, then there is every rational reason to panic and run to the bank. The first to the bank get their

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money and the rest get bubkis. One may say that the only thing we have to fear is fear itself, but that fear is no trifle.

The solution to bank runs is simple and has been known for 75 years: Deposit insurance. Ben Bernanke knows from his research on the great depression that we cannot allow runs on banks. To eliminate runs, we need unlimited deposit insurance and we need a credible assurance that all good checks drawn on accounts will clear without delay even if a bank fails. The Fed and FDIC can guarantee this with Congressional approval if necessary. Part of this promise is unlimited insurance. The other part is a promise of continuous access to funds.

For 30 years, the FDIC has offered $100,000 of deposit insurance. This is not enough. Unless something is done soon, and if the situation deteriorates, then every retiree and every CFO and Treasurer will become trigger happy and withdraw any funds, and in particular any amounts over $100,000, from a bank on the sketchiest of rumors. Chaos could result as such withdrawals would lead to one failure after another. Without full and comprehensive deposit insurance such panic would be fully warranted. This insurance must be explicitly backed by the full faith and credit of the government, not just by the FDIC.

Doubt we could have devastating bank runs? Doubters must explain why people who could get 3% interest at their bank instead bought 90 day Treasuries yesterday yielding 0.14% or yielding 0.03% on Wednesday September 20, 2008. I know folks with a million or two of cash that they need to run a business or to retire who are very nervous. How many are there? I don't know. Today, there are enough to make Treasuries yield next to nothing. Tomorrow, there could be more unless something is done.

It is not enough just to offer insurance. The government and the media must make clear to everyone that they will gain no advantage from moving funds. Funds will not be tied up. The fed will clear checks from failed institutions. Currently even depositors under the $100,000 limit withdrew money from Washington Mutual, for example, presumably out of fear that their funds would be tied up in a collapse. So people and firms must have continuous access to their funds and they must believe that they will have continuous access.

Why limit insurance even at the expanded $250,000 limit that Obama, McCain and Bush all support? That is better than $100,000, but if there are significant funds over $250,000 then that limit isn't enough and if there aren't, then offering unlimited insurance may be unnecessary but is not particularly problematic. In any event, any fixed limit will eventually become obsolete, and the impetus to change it seems to require a crisis which crisis will be in part created by the mere existence of a limit.

Deposit insurance is not a giveaway. The government charges now, and can raise, premiums to correspond with the new higher coverage.

This firebreak should be installed now. Afterward, we can breathe a little easier and consider the Treasury's massive asset purchase plan together with alternatives or supplements to address the fire as it now stands.

DEDICATE SOME OF THE MONEY TO HOUSING

Splitting the rescue fund makes sense. This is for both political and economic reasons. Politically, if more people get something, more will support the legislation. Economically, it makes sense to hedge our bets on the remedy when, to be honest, no one

fully understands the malady and can predict its response to medicine.

Much of the problem—all of it if you believe what you read—originates with mortgage defaults. These defaults result from the combination of mortgages resetting at higher interest rates, homeowners being stretched thin to begin with, and housing prices falling. Direct palliatives for this problem seem warranted; on this, I commend Joseph Stiglitz's and Edward Leamer's *Economists' Voice* pieces.

Foreclosures are extremely costly. A significant problem of mortgage securitization is to increase the complexity and costs of renegotiating mortgages instead of foreclosing. Two possibilities emerge. One is to give administrative authority to rewrite mortgages in a way that makes them affordable, as Joseph Stiglitz and others propose. Another is to subsidize mortgagees in some way.

One of the most attractive subsidies is Martin Feldstein's idea to allow homeowners whose mortgages exceed their home value to refinance some of their loan on the cheap from the government in exchange for making at least the government's second mortgage full recourse. The hope would be to help them stay in their homes, not only for the immediate benefits, but also to prevent a continued flood of foreclosures which could drive down property values further and lead to more foreclosures.

TOXIC ASSET PURCHASE

Paulson has proposed that the government spend up to $700 billion buying toxic assets. This is worrisome for at least two reasons. First is that the Treasury pays too much and runs out of money before it solves the problem. Second is that it pays too little and doesn't improve bank balance sheets enough to increase credit.

At least two stories emanate from the Fed and the Treasury. One is that they will pay fair market value, so no one will be subsidized. The other is that these assets have depressed values today, and so more can be paid without any real subsidy.

The stories sound contradictory; however, people have argued to me that they can be squared in a funny way if the rescue plan creates enough new demand for toxic securities to raise their market prices. Such a price increase is quite likely. Hence, in the rescue, the government may pay more for the assets than today's price and yet no more than tomorrow's price. According to this argument, asset holders are helped because of the price rise even though the government buys securities at market prices.

My wife says that this argument sounds like a snake eating its tail. I agree. Putting on my legal hat for a moment, two analogies leap to mind. Socony and other oil companies argued long ago (in the Great Depression as a matter of fact) that their conspiracy to raise prices didn't raise prices anticompetitively because all the gas they bought up off of the market, they bought at the going market price: The Supreme Court didn't bite. Even more analogous: If the government wants to take a piece of property, the constitution requires fair compensation. This fair compensation does not mean that the government must pay the market price realized given its demand. That would not solve the holdout problem that eminent domain is intended to cure. The fair market price is the price that would prevail absent the government's demand. Applied to the current situation, this would mean that fair market value must be determined without consideration for the added value the rescue would bring.

This price difference could be large. Keep in mind that these assets are illiquid. Illiquidity means that there is no ready market, and if there is a market for a small amount of trade in a given security, dumping all that security would drive the price down a lot. That is one big reason that firms continue holding large quantities of these assets even though the holdings limit their ability to attract equity or credit.

If the market demand curve for toxic assets is steep, then if the Treasury buys up 90% of a security, it will pay a big premium. Buying less limits the premium but also leaves the assets in the market.

All this said, there is something to be said for the asset purchase idea. Even if they don't get all the toxic assets off of the banks' books, auctions for the assets could lead to prices being made explicit or price revelation.

PRICE REVELATION

One virtue of asset purchases emphasized by Lawrence Ausubel and Peter Cramton is the possibility that the auctions used to buy the assets could create price revelation. The assets are hard to value for many reasons, not the least is that the past is not a good guide to future mortgage defaults.

So, if you imagine that many players each have some information about the value of the assets, an auction such as those the Treasury is considering could aggregate that information revealing, ideally, the best possible current estimate of their value.

If you think that the uncertainty that has frozen credit markets, interbank lending, and made it tough for banks to raise equity is comprised of three parts—uncertainty about the value of the toxic assets today, uncertainty about how that value will change with time, and uncertainty about the exact exposure of each institution (increased given the complex of counterparty obligations), a Treasury sponsored auction could eliminate at least the first uncertainty even with the Treasury buying only a small amount of each security.

I would limit the asset purchases to the goals of creating price revelation and purchasing assets with a reservation price close to pre-rescue levels.

INJECTING CAPITAL DIRECTLY BY BUYING STOCK

Many have proposed that the government should get stock or options (see e.g., Lucian Bebchuk's *Economists' Voice* piece or Edmund Phelps in the *Wall Street Journal*). Some propose this as a kicker to the purchase of toxic assets; others think the stock purchase should be separate.

The advantage of buying stock is that it transparently injects needed capital that could free up credit markets. Stock is liquid and its price easy to determine as markets already exist. At first, this would appear to lessen the danger of overpaying.

One should not be too sanguine, however. For one thing, the total market capitalization of the traded financial sector had fallen to a little over $2.5 trillion by mid September. Hence if we were to add $700 billion of demand for new equity issues, one could easily imagine the price of equity rising significantly. The other issue is adverse selection. If sales are voluntary, only the worst will be sold as my colleague George Akerlof explained long ago.

Still, one advantage to injecting money through stock purchases is that the stock purchases can be targeted separately from the mortgage backed security purchases. For this reason, and because it is a transparent way to improve balance sheets (unlike overpaying for assets), I would put half of the rescue plan money here.

EXPEDITED CORPORATE BANKRUPTCY

Luigi Zingales proposed in the *Economists' Voice* that a sort of expedited bankruptcy be imposed on troubled firms, forcing debtholders to take stock and either wiping out stockholders or diluting them. Many of my colleagues likewise wonder why most talk is of punishing equity holders and less of punishing debtholders.

This solution is appealing in that it creates good incentives in the future for both equity holders and debt holders to monitor managerial risk taking because they do not expect a government bailout.

One significant problem though is that if it is rumored that a given firm will end up in Zingales' bankruptcy court, its debt holders will call their debt to avoid the "haircut." There is a debt run equivalent to a bank run. Note that in this way the Zingales recommendation is opposite to my recommendation of deposit insurance which guarantees payment to depositors, a form of debtholder.

I think the debt-run problem is a serious one. Therefore, while expedited corporate bankruptcy seems attractive, my take is that haircuts can unfortunately only be practically given to equity holders or long term debt holders whose investments are stuck so that they cannot really flee but not to revolving creditors or others who can pull credit or otherwise call it.

INVOLUNTARY VS. VOLUNTARY REMEDIES

Finally, I want to raise one last issue. So far all the remedies the Administration proposes are voluntary. Conventional wisdom has it that involuntary remedies are politically impossible. Maybe so, but I don't think it says much for our politics if a $700 billion dollar bailout, I mean, rescue plan, is being demanded and those directly being rescued will be able to dictate their terms and willingness to go along.

If the crisis worsens anyway, then I think we may have to give the Treasury or the Fed more authority or license to force involuntary transactions.

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