We Aren't Done Yet: Comments on the Financial Crises and Bailout

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It doesn't take a genius to figure out that our financial system is in a mess, and that something needs to be done. As I write, the House of Representatives has just rejected HR 3997 which modified Treasury Secretary Paulson's bailout proposal of September 20, 2008. It appears that adding 100-odd pages was not sufficient to make the plan popular.

Paulson and Wall Street have urged quick passage to restore confidence. But will it do so, if some future modification survives Congressional scrutiny? One problem is that there is a widespread view, at least partially correct, that Wall Street is trying to put over another confidence trick on the American people, and if it fails to resotre our financial system to health—and there is more than a reasonable chance that it will not succeed—that failure will further erode confidence both in Wall Street and in the Fed and Treasury's ability to deal with the problems. If it does work, it will most likely be because Paulson and his crew have managed to pull a confidence trick on the American taxpayer.

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The Bailout Proposal's Flaws

There are three critical flaws in the proposal. The first is that it relies—once again—on trickle down economics: somehow, throwing enough money at Wall Street will trickle down to the benefit of Main Street, helping ordinary workers and homeowners. (The irony is that Wall Street was itself destroyed in an act of *trickle up economics*—in its rush to make sure that the money it had discovered at the bottom of the pyramid was moved to the top.) Trickle down economics almost never works, and it is no more likely to work at this time than at any other. Even if it "works," it's neither the most efficient nor the fairest way of addressing the problem.

The second is that it sees the fundamental problem as a crisis of confidence. That no doubt is *part* of the problem; but the failure of confidence is because the financial markets made some very bad loans. That's not just a matter of imagination or perception. It's reality. There was a housing bubble, which supercharged our economy, and that has now burst. Best estimates are that house prices have a ways to fall before they are back to normal. We *might* be able to stop overshooting; but that is perhaps the best we can hope for. And if prices do continue to fall, there will be more foreclosures. The bad loans have created a hole in banks' balance sheets. That has to be repaired. If the government pays fair value for these assets, it will do nothing to repair that hole.

The third is that real contractionary dynamics are already in play, and this proposal does nothing about that. Even if the proposal were implemented quickly, there would be some credit contraction. But beyond that, states and localities are hurting, and are cutting back expenditures. Household balance sheets are weaker, and we can expect consumers to contract expenditure—or at least not expand it at a pace to sustain growth. The U.S. economy has been sustained by a consumption boom fueled by excessive borrowing, and that will be curtailed. But an economic slowdown will exacerbate all our financial problems. The President has made it clear that he will veto any effective stimulus bill, including an extension of unemployment benefits.

SCANDINAVIA AND BUFFETT POINT TO A SIMPLER WAY

What should have been done is simple. The hole in the balance sheet of financial institutions should be filled in a transparent way. The Scandinavian countries showed the way, almost two decades ago. Warren Buffett showed another way, in providing equity to Goldman Sachs. By issuing preferred shares with warrants (options), one reduces the public's downside risk, and insures that they participate in some of the up-side potential. This approach is not only proven, it provides both the incentives and wherewithal to resume lending. It also avoids the hopeless task of trying to value millions of complex mortgages and even more complex products in which they are embedded, and it deals with the "lemons" problem—the government getting stuck with the worst or most overpriced assets. Finally, it can be done far more quickly.

If the Administration refuses to go along with this more sensible way, at least the government should demand both preferred shares and warrants from any bank from whom it buys these toxic mortgages, to provide some downside protection, and some upside participation. It would mean that if we overprice the assets, at least we will share with the banks' shareholders the windfall gains.

ADDRESSING FORECLOSURES

Large amounts of foreclosures may accelerate the downturn, and may result in overshooting, and so it is important to address the foreclosure problem. Let's be clear about one thing: the Administration's view that the $700 billion bail-out will ensure that the mortgages the market views as bad aren't really so bad is a fantasy. The fact is that loans were made on the basis of inflated prices, and real estate prices are falling. No amount of talking up the market is going to change that. But direct aid to homeowners can make a difference.

That is why it is also absolutely essential that we deal directly with the foreclosure problem. The Paulson plan is like providing massive blood transfusions to an ailing patient while vast internal hemorrhaging is occurring. Unless we deal with the underlying source of the problem, the bleeding of our financial system will continue. There are three things we could do easily and quickly, and for a fraction of the price of the Wall Street bail-out. First, we can make housing more affordable for poor and middle income Americans, by converting our mortgage deduction into a cashable tax credit. The government pays in effect 50% of mortgage interest and real estate taxes for upper income Americans, yet for poor Americans it does nothing. This reform is, in any case, long overdue. Secondly, we need bankruptcy reform allowing for homeowners to write down the value of their homes and stay in their houses, in addition to the help that the current legislation proposes. Thirdly, government could assume part of the mortgage, taking advantage of the lower interest rate at which it has access to funds and its greater ability to demand repayment. In return for the lower interest rate—which would make housing more affordable—it could demand from the homeowner the conversion of the loan into a recourse loan (reducing the likelihood of default), and from the original holders of the mortgage, a write down of the value of the mortgage to say 90% of the current market price.

ALCHEMY AND ASYMMETRIC INFORMATION

The Paulson approach solves one problem. Our financial institutions have all these toxic products—which they created—and, as no one trusts anyone about their value, no one is willing to lend to anyone else. The Paulson approach solves this by passing the risk to us, the taxpayer—and for no return.

Paulson's approach is another example of the kinds of shell games that got us into the mess in the first place. The investment banks and credit rating agencies believed in financial alchemy, the notion that by slicing and dicing securities, you could create significant value—in a world in which financial markets already supposedly worked fairly well. Now we are told that by unslicing and undicing, pulling these assets out of the financial system and turning them over to the government, you can again create real value. We may do that for the banks—but mainly by overpaying for the assets.

The proposal shows little evidence of having learned the lessons of information asymmetry which played such a large role in getting us into this mess. The banks will pass on their lousiest mortgages. Paulson may assure us: we will hire the best and brightest of Wall Street to make sure that this doesn't happen. (Wall Street firms are already licking their lips at the prospect of a new source of revenues: fees from the U.S. Treasury.) But even Wall Street's best and brightest don't exactly have a credible record in asset valuation; if they had done better, we wouldn't be where we are. This also assumes that they are really working for the American people, not their long term employers in financial markets. Even if they do use some fancy mathematical model to value different mortgages, those in Wall Street have long made money by gaming against these models. We will then wind up not with the *absolutely* lousiest mortgages, but with those which Treasury's models most underpriced risk.

Lawrence Ausubel and Peter Cramton have emphasized in *The Economists' Voice* that we can lose less with well designed auctions. True. We should divide the auctions into *more* homogenous products. But the fact of the matter is that each mortgage differs in location, borrower, terms, etc. Within any class, large information asymmetries persist, and we, the taxpayer, will almost surely wind up with the lousiest mortgages within the category. We then have the further problem of figuring out how much money to spend on each category. Unless the banks are willing to pay a high premium for liquidity, we the taxpayer are likely to lose. And if we don't lose, balance sheets won't be repaired, and lending will almost surely contract.

OVERSIGHT

One of the other problems with the Paulson proposal—the lack of oversight, judicial review, and accountability—has been partially dealt with in the Congressional revisions. But even then there is a real problem. After the Administration demonstrated repeatedly a lack of grasp of the magnitude of the problem, after veering recklessly from one course to another, from one non-transparent bail-out on one set of terms to another non-transparent bail-out with another set of terms, it now is asking of America, "Trust us." An Administration whose economic misjudgments contributed greatly to the current debacle is asking us now to have confidence that it will make the right judgments going forward. But even as the Administration makes such a request, through its veto threats against an effective stimulus package and its other actions, it is giving us every reason *not* to trust it. The very design of the Paulson proposal, with the government taking over literally millions of separate assets, requires assuming that it will be done in a way that is fair to the American taxpayer. Congress may insist that the taxpayer get *some* equity share in the firms being bailed out. Will the Treasury be as tough with the banks as it was with AIG? Or will it go soft with its friends? We don't know, but I would be willing to take a bet.

SUMMING UP

In the end, there is a high likelihood that the American taxpayer will be left on the hook. Think of what a couple trillion dollars might buy. The president vetoed a bill to provide health insurance to poor children—costing a few billion a year—saying that we *could not afford it*. Without needed medical care, some of these children may be scarred for life, and others not live to adulthood.

In environmental economics, there is a basic principle, called the polluter pays principle. It is a matter of both equity and efficiency. Wall Street has polluted our economy with toxic mortgages. It should now pay for the cleanup. How can Paulson oppose such a proposal? After all, he is promising us that it won't cost us anything, because he will make sure that they pay fair market value, which we will recover. If he's right, then no tax will need to be imposed. Any opposition is a sure sign that he thinks that there is a reasonable chance that we will be stuck with a bill and that he doesn't want his friends on Wall Street to have to pay it.

In short, my judgment is that this bail-out won't do the trick. To be sure, some Wall Street firms will benefit, but the huge increase in the national deficit and the perception that even $700 billion is not enough to rescue the American economy will erode confidence and contribute to our economic weakness.

It may, in the end, make sense to go ahead nonetheless—knowing that this is only a short term fix. Getting things right—including a new regulatory system to reduce the likelihood that it will happen again—is one of the many tasks to be left to the new Administration.

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REFERENCES AND FURTHER READING

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