

## ECONOMIC NEWS UPDATE

Irwin Stelzer

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### **To Bail or not to Bail**

The life of a self-styled paragon is not an easy one. So Eliot Spitzer found when it was revealed that he not only prosecuted prostitution rings, but patronized them. And so David Rubinstein discovered when Carlyle Capital Corporation's (CCC) hedge fund collapsed. "I don't think one fund out of 60 will spoil a reputation built over twenty years," the co-founder of the wildly successful Carlyle Group told the press. Perhaps not, but it has dented it. The awe-inspiring smartest guys on Pennsylvania Avenue have been shown to be less than infallible.

And the toughest guys on Wall Street -- the cigar-chomping, go-it-alone bunch at Bear Stearns -- have been shown not to be so tough after all. They first needed a bail-out by the Fed and J.P. Morgan Chase to survive for a few days until J.P. Morgan took the firm over, ending its tenuous hold on its existence and independence. The Fed has taken Bears' liabilities onto its own balance sheet, and Morgan got what seems to be a bargain: it paid 1% of the

value of Bear Stearns just 17 days ago, and far less than the stricken firms' headquarters building is worth. Which is why Bear Stearns' shareholders are shopping for a better deal. Bear Stearns, it will be recalled, was the one firm that refused to cooperate in or contribute to the 1998 bail-out of Long Term Capital Management when the Fed pleaded for it to go along with other firms so as to avoid a systemic collapse. It had few friends upon whom it could call in its unsuccessful effort survive on its own.

The Bear Stearns deal was only one matter that kept Fed chairman Ben Bernanke from having a relaxed weekend of the sort that was his when he walked the quiet corridors of Princeton. He also arranged a new credit facility for troubled investment banks, and announced a cut in the short-term rates at which such institutions might borrow from the Fed.

The question now is whether the markets will see the takeover of Bear Stearns and the Fed's latest moves as a

sign that out-of-control events are no longer in the saddle, or a sign of panic by Bernanke. It would not be unreasonable to assume that the CCC and Bear Stearns problems were only the tip of the iceberg towards which the U.S. financial ship is headed, and that recent history suggests that even an energetic captain can't change the credit markets' course.

After all, Bernanke has been cutting short-term interest rates in attempt to ease the credit log-jam, to little effect. Longer-term rates remain stuck on high. So the Fed then made the banks an offer they will find it difficult to refuse. Come to us with your AAA-rated mortgages, Bernanke told strapped financial institutions, and we will give you in exchange \$200 billion of the risk-free Treasury securities that we hold on our own balance sheet. And for 28 days, rather than the few hours as is our usual custom. Still no peace in the canyons of Wall Street.

The Fed's swap offer is not quite the same thing as buying these mortgages from the banks, which would love to unload them permanently for cash. That would be a bail-out, something Treasury Secretary Hank Paulson is eager to avoid lest it create what economists call "moral hazard" -- encouraging a repeat of bad behavior by shielding the players from the consequences of that behavior. In the case of the banks, saving their shareholders from losses would encourage them to repeat their recent willingness to lend to people in no condition to repay.

The Fed's non-bail-out is aimed at driving up the price of mortgages, increasing their valuation on bank balance sheets. That, along with the good paper (risk-free Treasury notes),

would enable the banks to start lending again.

All of which puts me in mind of the Clintons, who in a desperate bid to salvage Hillary Clinton's campaign for the Democratic nomination decided to "throw the kitchen sink" at Barack Obama. Which they have done, but with only limited success as Obama remains on course to victory. Bernanke has now thrown the kitchen sink at the credit crunch. Optimists are hoping that credit markets will get a real kick-start when the Treasury notes are auctioned off on March 27. By that time, the Fed's weekend announcement of easier credit for investment banks will also have taken hold. Better still from the point of the banks, the Fed will probably also have cut short-term interest rates, a move that, regrettably, will add to the already-substantial inflationary pressures created by rising food and energy prices, and the falling dollar.

There are four problems with all of this. The first is that bad news will continue to overwhelm good. If another investment bank hits the rocks, or even if there are less devastating events such as the \$3 billion write-off recently announced by the masters of the financial universe at Goldman Sachs, fear will be the prevailing mood in the board rooms of America's banks.

Second, Bernanke is a tiny player in the mortgage market. The \$200 billion of mortgages he will be taking on are a barely noticeable in the \$11-trillion mortgage market. And even if he wants to convert the entire asset side of his balance sheet to mortgages, he only has another \$400 billion to play with.

Third, so long as house prices continue falling, the value of mortgages will continue falling. And we seem to have a long way to go before house

prices reach some bottom, excess inventories of unsold houses are absorbed, and the market turns up. You remember “up” -- the only direction in which house prices ever go!

Finally, the Fed might be fighting yesterday’s war, when the problem seemed to be a liquidity crisis. No one would lend to anyone else except at relatively high interest rates because of uncertainty as to the ability of the borrower to repay. The first round of Fed ammunition was fired from a blunderbuss, aimed at generally lowering interest rates to facilitate borrowing. No luck; long-term rates were immovable. The second round was fired from small arms weapons at the seize-up in credit markets, making some funds available to credit markets for very short periods on attractive terms. No luck, again. So now we have the heavy artillery: \$200 billion of high-quality assets to replace those of lesser quality, a bail-out of Bear Stearns, more credit for investment banks. We won’t know whether these shells have knocked down the barriers to lending for several weeks now.

Meanwhile, some nervous observers are saying that the enemy is no longer liquidity, but the threat of insolvency. It might just be that trading and lending in these paper assets has stopped because, gulp, the assets are worthless. We already have had billions in write-offs, and hundreds of billions more of such “marking to market” is in our futures. So steep will these write-downs be that the banks will find they are bust -- what they owe to depositors and creditors exceeds the value of their shriveled assets. Unless they can get more capital, they will have to shutter their tellers’ windows.

So far, sovereign wealth funds have put up that capital, but even they do not have deep enough pockets to shore up the entire US banking system. Others are not exactly eager to sign on for a trip on what might prove to be the financial equivalent of the Titanic’s first and last voyage. If things get really bad, the banks might conserve their existing capital by ending dividend payments, as Paulson is urging them to do. So far, they have ever so politely told him to fuggedaboutit, as we say in New York.

Faced with a systemic collapse of the banking system, the government can do one of two things. It can flood the economy with cash, driving up inflation and the nominal value of the assets underlying bank loans. Lenders would get repaid in depreciated dollars, a warning to them to keep their vaults locked next time someone wants to borrow the odd hundred million.

Or it can nationalize the debt. Taxpayers’ funds would be conscripted, and pumped into failing financial institutions to prevent their collapse. Sound like Northern Rock in Britain? Or what our government did when Continental Illinois bank hit the rocks in 1984? Or what former treasury secretary and Harvard president Larry Summers, now a hedge fund adviser, says the government should “at least be thinking about”? Or what 32 of 51 economists surveyed by the Wall Street Journal say is now somewhere between likely and certain?

If it looks like a bail-out, and sound like a bail-out, it is a bail-out. But “Capitalism without failure is like religion without sin. It doesn’t work,” warns Carnegie Mellon professor Allan Meltzer. Guarantee lenders against failure and they will again lend and lend and lend, diverting resources to ill-

conceived ventures, driving down productivity and living standards. Only if the shareholders are first wiped out, or if the taxpayers gain a real opportunity to profit in a recovery, can a government rescue package avoid becoming an invitation to a repeat disaster.

It is certainly true that we need failure to make capitalism work. But the cost should fall on those who made serious errors in pursuit of inordinate profits, not on innocent by-standers. It is the prospect of the infliction of pain on the innocent that makes it so difficult to balance the danger of moral hazard against the risk of a protracted downturn.

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