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Sceptical US politicians slow to buy Paulson's $700bn bailout plan

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By Alan Ahearn

WANTED: A rescue plan for the crumbling US financial system that won't cost the taxpayer dearly. The problem is that such a plan probably doesn't exist. The credit crisis is now so deep that enormous amounts of public money will almost certainly be needed to stave off a financial meltdown.

US Treasury Secretary Hank Paulson thinks he has a solution. His proposal has support from Federal Reserve Chairman Ben Bernanke, who has warned that any delay in implementing the plan could be disastrous.

But there is significant opposition to the bailout package from members of Congress and among economic commentators. So for the time being the Paulson plan is stalled in Congress and the global financial system remains extremely vulnerable.

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There can be no mistaking the urgency of the situation. Major financial institutions have been falling like dominoes over the past 10 days as short-term funding has evaporated. The mess in which US banks now find themselves is unprecedented. Oddly, several US senators on Tuesday suggested that Congress should wait until after the elections in November before passing the bailout legislation. What they don't seem to realise is that by then there might not be much of a US financial system left to bail out.

Congress

With negotiations between Congress and the Bush administration over details of the rescue package continuing, it could be next week at the earliest before a final deal is done. But even that may be too late, given the extraordinary pace of deterioration in financial conditions recently.

There is much to like about the Paulson plan -- and some things not to like. Under the proposal, the government would spend up to $700bn (€478bn) to buy so-called "toxic assets" such as mortgage-related securities from financial institutions.

By removing the toxic assets from banks' balance sheets, Mr Paulson hopes to restore confidence in the system. At the moment, banks are reluctant to lend to other banks largely because of worries about their counter-parties' exposure to the subprime mortgage market.

If that exposure is shifted to the government, banks may begin to trust each other again.

The plan has some of the features of strategies that have been used successfully in previous banking crises whereby state-owned asset management companies were created to buy and handle bad assets.

Enough

One question is whether $700bn will be enough. The answer is almost certainly no. The US government has already forked out about $300bn to bail out Fannie Mae and Freddie Mac, Bear Stearns and the insurance company AIG. Add to this figure the cost of the Paulson package and it would bring the total fiscal cost of resolving the crisis to $1trn, an amount equivalent to 7pc of US GDP. That would be a bargain.

In a study of the fiscal costs of banking crises, Trinity College economist Patrick Honohan has shown that governments typically spend nearly 13pc of GDP to clean up their financial systems.

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Another question is what price the government should pay the banks for the toxic assets? Buying the assets at inflated prices would amount to a backdoor recapitalisation of the banks, with the government getting nothing in return. Mr Paulson proposes that the government pay "fair market prices" for the securities. But putting a fair market value on these assets will be extremely difficult.

Importantly, a fair market price is not the same as the price that these illiquid securities could fetch in the market today.Mr Paulson argues that the market for these securities has failed and they can only currently be sold for fire-sale prices. He has a point.

The fundamental value of many of these assets may well be considerably higher. The treasury secretary wants the US government to pay this fundamental price.

When the financial crisis has been fixed, Mr Paulson hopes to sell the securities back into the market at a price close to what the government paid, thereby minimising losses to the taxpayer. Sounds like wishful thinking.

This raises the question of how the government can determine the fundamental value of dud mortgage paper. Ben Bernanke's suggestion is to use reverse auctions. In an ordinary auction, the seller puts an item up for sale and many buyers make bids.

In a reverse auction, the role of the buyer and seller are reversed. Banks wanting to unload toxic assets will submit quotes containing the prices at which they are willing to sell. The government will then buy securities from the banks who bid the lowest price.

Though Mr Paulson's plan will prevent fire sales, banks will still be selling assets at well below cost price. That means huge losses for the banks. The elephant in the room is whether banks have enough capital to absorb these losses. They probably do not. The fact that many financial institutions would go bust if they sold even at fundamental prices underlines the main weakness in the bailout plan: It is silent on how banks will raise new capital to plug the hole.

Foreign investors might inject new funds. Already, sovereign wealth funds from the Middle East and Asia have bought stakes in troubled US financial institutions. This week brought news that Mitsubishi UFJ Financial Group, Japan's largest bank, will buy 20pc of Morgan Stanley. The irony is that for more than a decade US government officials and bankers have been bashing Japanese officials about the poor state of Japan's banking system.

Of course, Treasury Secretary Paulson, who for seven years was head of investment bank Goldman Sachs, and others in the Bush administration may not be too keen to see large chunks of venerable Wall Street firms sold to foreigners.

This week's announcement that Goldman Sachs will receive a $5bn capital infusion from US billionaire Warren Buffett was no doubt warmly welcomed in Washington DC.

The other major weakness of Paulson's proposal is that the taxpayer is being asked to take enormous risks for what looks like little return.

Congress won't buy this. The final plan will likely involve the government getting equity stakes in financial institutions in return for toxic assets. A partial nationalisation of the US financial system is on the cards. Desperate times, desperate measures.

Alan Ahearne lectures in economics at NUI Galway and is a research fellow at **Bruegel**, the Brussels-based think tank. He is a former senior economist at the Federal Reserve in Washington DC.