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Policy Note

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TIME TO BAIL OUT: ALTERNATIVES TO THE BUSH-PAULSON PLAN

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It's official—the Maestro (former Federal Reserve Board Chairman Alan Greenspan) has spoken: the wizards of Wall Street messed up. Big-time. After a career that spanned a half century, during which he had continuously claimed, "We don't need regulation," Greenspan admitted before the House of Representatives that he was "in a state of disbelief" since the ongoing financial turmoil has shown that private market regulation and counterparty monitoring didn't work[1] (Greenspan 2008). Nay, market self-discipline failed catastrophically. While serving as Fed chairman, he had advocated unsupervised securitization, subprime lending, option ARMs, credit-default swaps, and all manner of financial alchemy in the belief that markets "work" to reduce and spread risk, and to allocate it to those best able to assess and bear it. Free of nasty government intervention, markets would stabilize. His successor, Ben Bernanke, drank at least some of that Kool-Aid, opining that the era of the Great Moderation had arrived, guided by the gentle hand of the benevolent Fed.[2] So long as the Fed kept inflation expectations in check through well-telegraphed interest rate fine-tuning, all would be hunky-dory. As Greenspan now admits, he could never have imagined the outcome: a financial and economic crisis of biblical proportions.

Here's the problem. Market forces are not stabilizing. Left to their own devices, Wall Street wizards gleefully ran right off the cliff, and took the rest of us with them for good measure. The natural instability of market processes was recognized long ago by John Maynard Keynes, and convincingly updated by our late colleague Hyman P. Minsky throughout *his* career. Indeed, the current crisis has been called a "Minsky moment"—and Minsky deserves credit, as the crisis has

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been a long time coming, and the fallout will affect us for years (Wray 2008a, 2008b; Kregel 2008). It is more fitting to call it the "Minsky half century," for Minsky's theory explained the transformation of the economy over the whole postwar period from robust to fragile, and warned that increasingly severe financial crises would result. To wit, in the past three decades we have experienced the savings-and-loan crisis, the leveraged buyout–junk bond fiasco, three stock market crashes (1987, 2000, 2008), the Long-Term Capital Management failure, today's global financial crisis that began with America's subprime mortgages, and the commodities market crash that is unfolding. Minsky pointed his finger at managed money—huge pools of pension funds, hedge funds, sovereign wealth funds, university endowments, money market funds—that are outside traditional banking and therefore largely underregulated and undersupervised. With a large appetite for risk, managed money sought high returns promised by Wall Street's financial engineers, who innovated highly complex instruments that few people understood. That actually made them more desirable because their values would be anything Wall Street wanted them to be. High prices could be assigned to toxic waste (that is, literally, the technical term used by insiders and regulators to describe the new financial instruments) and large fees booked. Because the rewards were stupendous, the financial engineers did not mind that their job tenure was expected to be measured in months. They would collect eight-figure bonuses and jump ship when the whole Ponzi pyramid scheme suffered the inevitable collapse. Only the free-market true believers, like former Fed Chairman Greenspan, are surprised by the outcome. Everyone else saw it coming.[3]

But a funny thing happened on the way to Armageddon. Wall Street's movers and shakers bailed while the bailing was good, but they moved on to Washington just in time for the chickens to come home to roost. Their (Bush) administration has had to deal with the crisis—a task for which it has been ill prepared. Wall Street *creates* crises, but it is "Clueless in Seattle" when it comes to bailing them out. Hence, we've had more Paulson Plans than Heinz has pickles—as Minsky might have put it—with one after another resoundingly rejected by markets, Congress, and the public. After presenting Congress with a three-page ultimatum to authorize him to spend $700 billion with impunity, Treasury Secretary Henry M. Paulson was forced to return with hat in hand for a good thrashing and an 800-odd-page law to constrain him. While he still wanted to spend most of the money buying toxic waste, markets rejected even that plan on the recognition that the volume of bad assets on the books of financial institutions is in the trillions of dollars. They preferred the strategy adopted abroad: inject capital. Paulson caved in, but he added an American twist: Treasury would become an owner in exchange for a capital injection but would not exercise any ownership rights, such as replacing the management that created the mess. We wouldn't want the visible hand of government to interfere with precious market forces, after all.[4]

Perhaps more importantly, Secretary Paulson has recently confirmed the worst fears of conspiracy theorists: the bailout would be used as an opportunity to consolidate control over the nation's financial system in the hands of a few large (Wall Street) banks.[5] His team will use the bailout funds to subsidize purchases of troubled banks by "healthy" banks. What are the odds that the list of the names of healthy banks might include a Goldman Sachs, or a Morgan (or two)? Crises inevitably lead to some consolidation, so the rescue package will be used to help the process along. Incredibly, Wall Street banks can pick the takeover targets by downgrading the outlook of the financial institutions they would like to own (raising the price of credit-default swap "insurance" and lowering stock values), triggering Treasury, FDIC, and Fed intervention to subsidize the merger. Markets do work in mysterious ways. Who needs socialism?

Alternatives to the Bush-Paulson Plan

Policymakers and commentators have tended to confuse liquidity and solvency issues, and similarly, lending with spending. As the crisis unfolded, many financial institutions were hit with liquidity problems: they could not cover required payments or withdrawals because they could not obtain "cash." For the most part, this resulted because they could not borrow, either from the Fed or from financial markets. The Fed initially limited its lending to only those institutions for which it was directly responsible, and only lent against qualifying assets. Institutions needing funds but unable to meet the Fed's requirements could not borrow in the market because potential lenders feared they could be caught short of "cash" themselves, or that the borrowers would not be able to repay the loans in a timely manner. Thus, Bear Stearns fell quickly for liquidity reasons; after its demise, the Fed expanded its lending to types of institutions formerly excluded—an action that might have prevented the fire sale of Bear if the Fed had acted only a few hours earlier. More recently, the Fed expanded the range of assets it accepts as collateral, and

even decided to buy commercial paper. In addition, FDIC insurance was extended to cover deposits up to $250,000, and guarantees were extended to previously uninsured deposits at money market funds (to avoid a run after the Reserve Fund "broke the buck"). All of this helps to reduce liquidity pressures because the government guarantees reduce the incentive for depositors to demand cash—thereby lessening financial institutions' need for cash. While it took far too long for the Fed (and the FDIC) to recognize the proper policy response to a liquidity crisis, we have finally come close to a resolution.

To complete this "lender-of-last-resort" intervention, the Fed should remove all collateral requirements. A crisis is not the right time to try to teach financial institutions about the wisdom of holding "secondary reserves" of safe assets eligible for discounting. Since regulators and supervisors sat by idly while financial institutions accumulated tons of toxic waste on their balance sheets, they were implicitly (and in Greenspan's case, explicitly) approving these purchases as acceptable assets. To quell the run to liquidity, the Fed must now lend without limit no matter what assets reside in bank portfolios. The Fed has moved to pay interest on reserves—which will allow it to hit its overnight interest rate target with much greater precision—another good decision as it lets banks earn interest on the reserves they must hold for protection against withdrawals. It needs to go a step further: it should provide loans farther out the maturity structure at targeted rates. For example, it should offer one-month, two-month, and three-month lending at interest rates it chooses. This will allow the Fed to stabilize interest rates of longer maturity, while providing loan terms to suit the borrower's needs. Finally, the FDIC should eliminate any caps on its insurance to include all demand and time deposits in member institutions. This would protect the larger deposits held by business to cover payrolls and other expenses. The idea that depositor surveillance helps to discipline bank lending has been exposed as pure folly. Even the wealthiest and most sophisticated depositors never voiced concern that their financial institutions were taking excessive risk. In truth, depositors cannot legally obtain the information they would need to determine what risks the institutions were exposed to—even if they were capable of understanding the data and models used—because borrower confidentiality is protected. What really matters is regulation and oversight by the supervisory agencies. Once institutions are allowed to buy some asset class, the Fed must be willing to lend against it, and the Treasury is on the hook to protect the depositors.

We now turn to the more vexing issue: insolvency. This is one of Donald Rumsfeld's "unknown unknowns," although it is probable that many and perhaps most financial institutions are insolvent today—with a black hole of negative net worth that would swallow Paulson's entire $700 billion in one gulp. For this reason, markets immediately rejected the plan to buy bad assets: it is far too small to make a dent, so banks will be left with plenty of capital-draining toxic waste. Indeed, if the U.S. Treasury pays anything near to "true" value for the bad assets, banks are actually worse off. Those left holding them will need to recognize the losses and announce to the world that they are insolvent, along with all those that do sell assets to the Treasury at equity-destroying prices. On the other hand, if the Treasury pays prices high enough so that banks don't have to recognize large losses, the $700 billion (now much less because $250 billion of that is being diverted to capital injections) will buy only a tiny fraction of the "troubled" assets. This would work only if we let financial institutions pretend that the Treasury's overpayment represents market value. But we could accomplish this result with no purchases at all: Treasury can just declare that all assets are good and business can go on as usual.

That is not a half-bad idea. Unlike a liquidity problem, insolvency problems do not have to be resolved in haste. Indeed, there are very good reasons to postpone action. First, the Paulson team will be gone soon, with matters left to President-elect Obama's new administration. Second, as mentioned above, the planned use of bailout funds for industry consolidation is troubling. Perhaps the next administration would not look so favorably on that; and it is possible—one can at least have the audacity of hope—that the next Treasury team will not be so heavily drawn from one particular Wall Street bank. To keep the banks open, there are any number of accounting sleights of hand that can be used. For example: let them value assets at the original price paid; let them write "net worth certificates" to count as capital (essentially lending capital to themselves); let them temporarily lower capital requirements; or, simply ignore the problem and hope it will go away. Surprisingly, that can work—we did it in the early 1990s, when all large banks were plausibly said to be insolvent. As the economy recovers, some assets will recover values and banks will buy new, good assets and thereby earn their way back to solvency. As Jessie Jones, who headed the Reconstruction Finance Corporation's (RFC) successful attempt to rescue the financial system during the Great Depression, said: "Things nearly always get better if you give them time. That is particularly true with

collateral and properties and people" (Jones 1951, p. vi; see also, Wray 1994).

This doesn't always work, however. We left insolvent thrifts open in the mid-1980s and they managed to transform a pretty big problem into a monumental crisis that required a major bailout. Here is the reason: we let them pursue business as usual even though many of these were run by crooks engaged in control fraud (Black 2005). We left the crooks in charge, and they grew their frauds as fast as they could (in his previous incarnation as a character witness, Greenspan certified that high-flying thrifts run by crooks like Charles Keating were providing the model of good behavior to be emulated by all thrifts) (Wray 1994). Jones, on the other hand, replaced the management of all the banks the RFC took over with—get this—honest and prudent managers. This is something the current plan refuses to consider—even though the government purchases ownership shares, it would exercise no control over the financial institutions it owns. If we are going to leave insolvent institutions open, it is critically important to replace or at least control management. Business as usual would be a disaster. The safest course of action is to limit growth, as growth is the lifeblood that makes control fraud profitable.

We should follow the Jessie Jones example and place financial institutions into three categories: healthy, troubled, and doomed.[6] If there are any healthy banks, they will need only supervision. Troubled banks should be placed in a form of conservatorship, closely managed and constrained—essentially held in abeyance to see if their assets recover. Doomed banks need to be "resolved"; that is, liquidated. Rather than adopting the Treasury's consolidation plan, it is probably better to sell the assets, pay off the depositors, and let the owners and holders of subordinated debt lose. There will be repercussions from that, but they can be dealt with. For example, equity holders include pension funds, which are already suffering huge losses. There is little doubt that the Pension Benefit Guaranty Corporation (PBGC) is going to be severely tested and may well become insolvent. And paying off the depositors is going to bankrupt the FDIC, too. Hence, we are going to need yet another bailout, of the PBGC and FDIC. Uncle Sam will need to keep the checkbook handy.

Part of the justification for all of the bailout plans is the argument that we need to open the flow of credit, on the view that there is a huge unmet demand for loans by credit-rationed, but safe, borrowers. Relieving banks of some of their bad assets, or injecting some equity into them, is supposed to increase their willingness to lend. That seems highly unlikely. There is now no doubt that we are moving into a deep recession—not a good time to lend even if we didn't have the mother of all financial crises. After a dozen years of virtually unrelenting deficit spending by the private sector, our households and firms are already too heavily indebted. They should not, and probably do not want to, borrow more. Government should not rely on, much less encourage, more borrowing by the private sector to pull us out of this recession. Resolving the liquidity crisis (mission almost accomplished) plus an imposed purgatory to prevent financial institutions from growing too fast by making unsound loans is the best strategy. The Fed has already done what it can to increase liquidity of commercial paper (an important source of short term borrowing for firms and others). Keeping small-to-medium-size banks open is the best way to ensure access to credit once the economy recovers. Anecdotal evidence demonstrates the wisdom of favoring "local community banks because those are the bankers who understand their markets, and know the businesses in their market. . . . Big banks don't have a personal relationship with their small business customers" (Nocera 2008). This is yet another reason to reject the Treasury's plan to promote consolidation. Wall Street banks do not serve small, local businesses. If policy strives to protect the supply of credit to small firms, it needs to preserve local banks. Perhaps it is time to reject "too big to fail" doctrine in favor of "too big to save," while saving the small banks.

Economic recovery is essential, but should not be sought at the expense of burying households under another mountain of debt. More jobs and rising incomes is the ticket for policy formation by the new administration.

So far, the rescue plan has offered very little for homeowners saddled with mortgage debt they cannot afford. Financial institutions have been asked to voluntarily renegotiate mortgages, but that hasn't worked for a variety of reasons. Many banks holding mortgages don't want to recognize losses, particularly if there is a possibility that the Treasury will use bailout money to buy the bad assets. Since most mortgages were sliced and diced, to be used as collateral against very complicated securities, renegotiating terms is extremely difficult. Government has to take a more active role. Presidential candidate John McCain proposed that the government provide low fixed-rate mortgages at the current value of the homes, while paying off existing mortgages. This means the Treasury would take the full loss between the original mortgage amount and the value of the

new mortgage, while the financial institutions would get off scot-free. Any such plan also faces a difficult selection process, since it must determine exactly who deserves mortgage relief. A better alternative is to offer a 5 percent, 30-year mortgage provided directly by Fannie Mae or Freddie Mac to all comers. The new mortgages would be made for 90 percent of the current appraised value, with homeowners providing a down payment of 10 percent. Many home purchasers over the past five years were duped by shady mortgage brokers into assuming subprime and other mortgages they could not afford; whatever down payment they made originally is now lost because their mortgages are underwater (greater than the current value of the house). The federal government should provide grants to them equal to their original down payment plus any fees they have paid. They can use these grants for new down payments; or they can "take the money and run." Some analysts, including Dean Baker, have proposed "rent-to-own" schemes, whereby homeowners can remain in their homes by paying fair market rent, with an option to buy later. FDIC chief Sheila C. Bair has said that the goal should be to reduce home payments to no more than one-third of household income. That sets a reasonable standard for identifying those needing help: if current mortgage payments exceed one-third of income, the family would be eligible for the new Fannie- and Freddie-supplied loans.

Through such programs, we can keep most people in their homes if they want to remain there. When all is said and done, there is going to be a cost of "bailing out" homeowners because the original mortgages are greater than the new mortgages to be made. This cost should be shared by the Treasury and institutions holding the mortgages (mostly, the mortgages are the collateral behind securities). Carrots and sticks can induce the institutions to take these deals—even 80 cents on the dollar is a lot better than foreclosure. This will be a complex procedure that will take many months to resolve. Meantime, a moratorium on foreclosures is necessary. In any case, putting $700 billion into keeping Americans in their homes will do a lot more good than handing $700 billion to the financial geniuses that created the mess. Mortgage relief and restoring economic and social stability to neighborhoods will bring about recovery faster than Paulson's plan to try to push credit on a string.

This brings us to the issue of affordability: can government afford to "bail out" Wall Street, "bail out" homeowners, and provide fiscal stimulus? Over the past year, the Fed has lent hundreds of billions of dollars (some estimate that the Fed is on the hook for $1.4 trillion) to U.S. banks and other institutions as well as to Euroland central banks; it has also guaranteed assets in private bank takeovers. Treasury has extended guarantees to the government-sponsored enterprises and to deposits of up to $250,000. Paulson proposes to inject $250 billion into bank equity and to use much of the remainder of the $700 billion "bailout" to buy bad assets. Congress is considering another fiscal stimulus. And there is a well-recognized need to directly help homeowners. The total of all of this is surely in the trillions of dollars.[7]

Will this bankrupt Uncle Sam? First, it is necessary to clearly separate lending from spending. Most of these funds represent loans that will be mostly repaid. Even Treasury purchases of bad assets are not really spending—it represents substitution on bank balance sheets of good assets (Treasury debt) for bad assets; the Treasury issues a liability to obtain assets of questionable but nonzero worth. And when the Treasury buys equity in financial institutions, it shares in the profits (or losses) until such time that the institution finally fails (wiping out the Treasury's shares) or recovers (perhaps returning the Treasury's investment with capital gains). The cost of these operations will not be known for a long time, but it will not come close to the total $700 billion.

By the same token, these operations do very little to directly increase aggregate demand; thus, by themselves they will not help to bring us out of the deepening recession (although they might prevent the recession from morphing into a depression). Only a fiscal stimulus (tax cuts or spending increases) and direct homeowner relief will do much to stimulate demand. To be clear, the main responsibility for economic recovery is and must be in the hands of the Treasury. The Fed is able to deal with the liquidity crisis, but it can't put more income into the hands of consumers. And since interest rates are already very low, there isn't much the Fed can do directly to lower borrowing costs. This reality has finally begun to seep into the consciousness of beltway insiders. We had been assured for years that fiscal policy is unneeded and even impotent, while monetary policy is powerful. It is now apparent that pundits had it exactly wrong: it has always been about fiscal policy, while the Fed's machinations were just a diversion.

We are still left with the question, Can the Treasury afford it? Quite simply, the answer is yes—and it is a bargain if one considers the cost of not doing it. In a sovereign nation, the spending of the national government is not constrained by its balance sheets. Instead, spending is, and should be, constrained by political considerations as well as real economic constraints:

are there resources available to be mobilized? It is obvious that there exist unused resources today, as unemployment rises and factories are idled due to lack of demand. Markets are also voting with their dollars for *more* Treasury debt—it is about the only thing that global investors want to buy right now. Again, it is obvious that if the Treasury offers more dollars and more dollar-denominated debt, they will be welcomed. Any constraints now facing the Treasury are political. Of course, recognizing this does not mean that the Treasury should spend without restraint—whatever rescue plan is adopted should be well planned and well targeted, and of the appropriate size.

Many proposals have been suggested, including "lowering the price of consuming" by suspending sales taxes, with the federal government covering the state and local government revenue losses (Rosenwald 2008). We favor a temporary suspension of the collection of payroll taxes, with the Treasury directly making all Social Security payments at least until the economy recovers. This will put more income into the hands of households while lowering the employment costs for firms, fueling spending and employment. The United States faces a huge public infrastructure deficit of $1.6 trillion—best represented by collapsing levies and bridges—that can be rectified through federal government grants to support local spending on needed projects (Rohatyn and Rudman 2008). Whatever package of policies is adopted, we will know when the Treasury has spent enough because the economy will start growing again toward full employment, and financial markets will recover. It is impossible to say in advance whether that will take $700 billion or $2 trillion; but in any case, it is affordable. Once the expansion gets under way, tax revenue will begin to rise and government can cut back on its own spending growth, automatically reducing the budget deficit. The point is that setting arbitrary budget constraints is neither necessary nor desired—especially in the worst financial and economic crisis since the Great Depression.

So, that is the good news. As we hope we have made clear, the nation can afford it. Likewise, Greenspan ended his testimony on an upbeat note: "This crisis will pass, and America will re-emerge with a far sounder financial system." There's that audacity of hope, but from a rather unlikely source. The sounder financial system likely to emerge will be more closely regulated, smaller and simpler, less leveraged, and based on sound underwriting. A healthy dose of fear will have returned to markets to counterbalance the natural greed of markets. Finally, we will have a bigger role for fiscal policy, as we will have finally banished to the dustbin the unwarranted hope that some maestro in control of an inflation-fighting Fed is all that is required.

Notes

1. Greenspan (2008) testified that the crisis "has turned out to be much broader than anything I could have imagined. . . . [T]hose of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief."
2. Bernanke argued that, in large part due to competent central bank policy, the economy had become much more stable (Wray 2008a). The reference to Kool-Aid comes from Warren Buffet: "It's sort of a little poetic justice, in that the people that brewed this toxic Kool-Aid found themselves drinking a lot of it in the end" (quoted in Dabrowski 2008).
3. Internal messages leave no doubt: they knew they were dealing in trash and openly admitted that they hoped they would be long gone before the piper had to be paid. Instant messages between two Standard & Poor's officials called a deal "ridiculous," said that the assessment models used did not even "capture half the risk," and bragged, "We rate every deal. It could be structured by cows, and we would rate it" (U.S. Congress 2008).
4. William Greider (2008) calls it "Goldman Sachs socialism." See also, Creswell and White 2008.
5. Matt Landler (2008) reports, "In a step that could accelerate a shakeout of the nation's banks, the Treasury Department hopes to spur a new round of mergers by steering some of the money in its $250 billion rescue package to banks that are willing to buy weaker rivals. . . . Two senior officials said the selection criteria would include banks that need more capital to finance acquisitions." An anonymous official said, "One purpose of this plan is to drive consolidation."
6. The Treasury is currently applying some such procedure when it decides to inject equity. However, the agency insists that its criteria must be kept secret, on the implausible argument that if a bank is turned down on criteria known to the market, then there will be a run out of that bank. It is hard to see why markets would be less likely to run when the Treasury rejects a bank's application for a capital injection on the basis of unknown criteria.
7. "Trillions" may sound like a lot. To put this in perspective, the RFC injected $50 billion to rescue the banks in the

1930s (it recovered its spending in subsequent years and actually made a small profit on the resolution). If we were to adjust that figure by inflation of the CPI, that would be equal to $800 billion today. If we further adjust the figure to take account of GDP growth (our economy is much bigger today, so the problem is bigger in absolute value terms), that figure rises to $12 trillion!

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