

## Paulson's plan was not a true solution to the crisis

By Martin Wolf

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Desperate times call for desperate measures. But remember, no less, that decisions taken in haste may shape the financial system for a generation. Speed is essential. But it is no less essential to get any new regime right.

No doubt, the crisis has long passed the stage when governments could leave the private sector to save itself, with just a little help from central banks. For the US, the rescue of **Bear Stearns** was the moment when that option evaporated. But the events of the past two and a half weeks – the rescues of **Fannie Mae** and **Freddie Mac**, the failure of **Lehman Brothers**, the sale of **Merrill Lynch**, the rescue of **AIG**, the flight to safety in the markets and the decisions by **Morgan Stanley** and **Goldman Sachs** to become regulated bank holding companies – have made a comprehensive solution inevitable.

The US public expects action. The question is whether it will get the right action. To answer it, we must agree on the challenge the US financial system faces and the criteria for judging how it should be met.

What then is the challenge? The answer given by Hank Paulson, the all-action US Treasury secretary, last Friday, in announcing his "troubled asset relief programme", is that "the underlying weakness in our financial system today is the illiquid mortgage assets that have lost value as the housing correction has proceeded. These illiquid assets are choking off the flow of credit that is so vitally important to our economy." The core challenge, then, is viewed as illiquidity, not insolvency. By creating a market for the toxic assets, Mr Paulson hopes to halt the spiral of falling prices and bankruptcies.

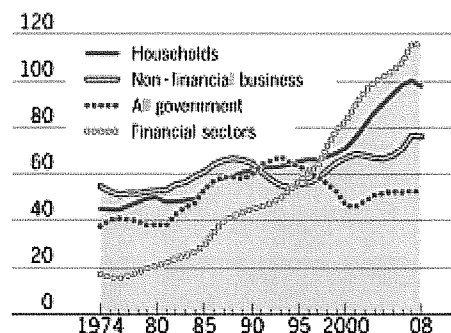
I suggest we should take a broader view of events. The aggregate stock of **US debt** rose from a mere 163 per cent of gross domestic product in 1980 to 346 per cent in 2007. Just two sectors of the economy were responsible for this massive rise in leverage: households, whose indebtedness jumped from 50 per cent of GDP in 1980 to 71 per cent in 2000 and 100 per cent in 2007; and the financial sector, whose indebtedness jumped from just 21 per cent of GDP in 1980 to 83 per cent in 2000 and 116 per cent in 2007 (see charts). The balance sheets of the financial sector exploded, as did the sector's notional profitability. But leverage, alas, works both ways.

Since US net international debt was 39 per cent of GDP at the end of 2007, virtually all of this debt is an asset of another domestic entity and would net out to zero. But when the gross debt stock is huge and economic conditions difficult, the chances that many entities are bankrupt is high. When people fear mass insolvency, lenders stop lending and the indebted stop spending. The result can

be the "debt deflation", described by the American economist, Irving Fisher, in 1933 and experienced by Japan in the 1990s.

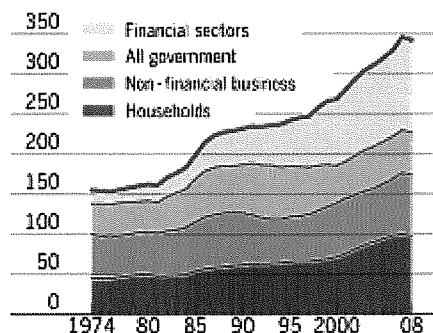
### Sectoral gross debt

% of GDP



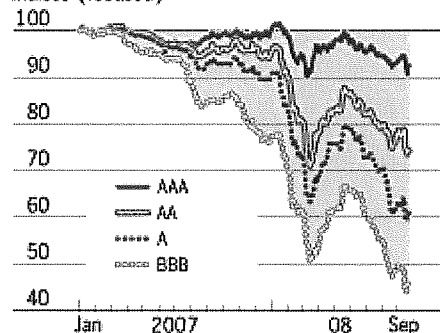
### Sectoral contribution to debt

% of GDP



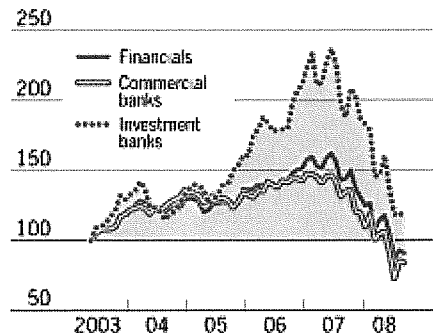
### Commercial mortgage backed securities

Indices (rebased)



### US financials

S&P500 Indices (rebased)



Sources: Federal Reserve; Thomson Datastream

Given the recent explosion in leverage, the challenge is unlikely to be one of mispricing of the toxic mortgage-backed securities alone. Many people and institutions made leveraged bets that have since gone sour. Their debt cannot be repaid. Creditors are responding accordingly.

Now turn to the criteria to be used in judging the intervention. First, it would deal with the systemic threat. Second, it would minimise damage to incentives. Third, it would come at minimum cost and risk to the taxpayer. Not least, it would be consistent with ideas of social justice.

The fundamental problem with the Paulson scheme, as proposed, is then that it is neither a necessary nor an efficient solution. It is not necessary, because the Federal Reserve is able to manage illiquidity through its lender-of-last resort operations. It is not efficient, because it can only deal with insolvency by buying bad assets at far above their true value, thereby guaranteeing big losses for taxpayers and providing an open-ended bail-out to the most irresponsible investors.

Furthermore, these assets are illiquid precisely because they are so hard to value. The government risks finding its coffers stuffed with huge amounts of overpriced junk even if it tries not to do so. Also objectionable, though more in design than in the fundamentals, were the unchecked powers for the Treasury. Such a fund should be operated professionally, under independent oversight. Finally, if the US government is to bail out incompetent investors it should surely also provide more help to the poor and often ill-informed borrowers.

Yet, above all, a scheme for dealing with the crisis must be able to remedy the looming decapitalisation of the financial system in as targeted a manner as possible. A fascinating debate on how to do this is under way in the **economists' forum** on FT.com. To the contributions, including Tuesday's Comment page **article** by Dominique Strauss-Kahn, managing director of the International Monetary Fund, I would add one by Luigi Zingales of Chicago University's graduate school of business.\*

The simplest way to recapitalise institutions is by forcing them to raise equity and halt dividends. If that did not work, there could be forced conversions of debt into equity. The attraction of debt-equity swaps is that they would create losses for creditors, which are essential for the long-run health of any financial system.

The advantage of these schemes is that they would require not a penny of public money. Their drawback is that they would be disruptive and highly unpopular: banking institutions would have to be valued, whereupon undercapitalised entities would have to adopt one of the ways to improve their capital positions.

If, as seems plausible, a scheme that imposes such pain on the financial sector would be rejected out of hand, the next best alternative would be injection of preference shares by the government into decapitalised institutions, on the lines proposed by Charles Calomiris of Columbia University. This would be a bail-out, but one that constrained the behaviour of beneficiaries, not least on payment of dividends. That would make it far better than dropping benefits on the unworthy, via mass purchases of overpriced toxic paper.

What then do I conclude? Yes, there may well be a place for intervention in the market for toxic securities. But this is a costly and ineffective way of meeting today's deepest challenge. What is needed, still more, is a clear and effective way of deleveraging and recapitalising the financial sector, ideally without using taxpayer funds. If such funds are to be used, they must also be injected in as carefully targeted and controlled a way as possible. Comprehensive action is essential, as Mr Paulson has decided. But let the US take the time to make that comprehensive action right.

\*Why Paulson is wrong, [www.chicagogsb.edu/igm](http://www.chicagogsb.edu/igm)

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