US Financial System Bailout: Reverse Socialism

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It has been an historic week with the news coming fast, furious and certainly profound. I will spare you the recap of the blow-by-blow carnage and focus rather on the mooted policy response to what has been a series of events that has probably changed the landscape of American finance forever. The proposed US Treasury Bailout Plan that Secretary Paulson is urging Congress to hastily approve raises as many questions as it answers.

Let us first focus on the questions relating to the US Treasury proposal itself.

Is $700,000,000,000 enough? Certainly the use of these monies will create a short-term pop as hitherto shunned securities will receive a "bid." However, whether this amount is enough will be affected by a number of current uncertainties that will impact the ultimate magnitude of the dead weight loss of the impaired securities. Current estimates vary from Secretary Paulson's view that predicts taxpayers will make money to others that believe ultimate losses will be counted in the hundreds of billions or even a trillion and more.

Recent events have revealed that the methodology of Wall Street's financial models used for valuing securitized assets is entirely broken. Furthermore, the Rating Agencies' credibility on assigning ratings that assess ultimate payouts for mortgage-backed and asset-backed securities is also bankrupt. Hence, in contrast to the potentially generous mark-to-model valuations that banks are currently using, it is anyone's guess as to what the value of level-three assets sitting on bank balance sheets are worth.

In contrast to the inherently unknown intrinsic value of these securities and the putative value currently assigned by the beleaguered investment and commercial banks, what is the price that the proposed RTC will actually pay for these securities? In many ways, this is likely to become a political decision.

The Treasury Secretary's Proposal states that "In exercising the authorities granted in this Act, the Secretary shall take into consideration means for (1) providing stability or preventing disruption to the financial markets or banking system; and (2) protecting the taxpayer." This is the crux of the distribution of the ultimate costs to bailing out the dead weight losses created by the bad loans and housing price deflation which is plaguing the United States. If the price paid by the RTC is above intrinsic value, then the taxpayer ends up with a losing proposition as they subsidize former banking largesse. If the price paid is below intrinsic value, then the taxpayer at least has a chance, perhaps even then slim, to invest in a profitable trade. In this latter case, however, the banks will be left with a huge gaping re-capitalization requirement. Please remind me, with whom will they finance this?

Even if the RTC wanted to pinpoint which of these two parties would be the winner and loser, the uncertainty over the intrinsic valuation makes this calculus virtually insoluble.

Then there is the issue on how far and wide to cast the bailout net. Does it extend only to US banks or is the program open to foreign banks holding eligible securities? There is currently a palpable tension between US and foreign-owned financial institutions. Foreign institutions sitting on huge apparent losses on what they thought were AAA (and other rated) securities, are reeling from the blow to the asset quality of their balance sheets. As global liquidity shrinks and risk aversion mounts, the infighting intensifies. Already, the FSA has demanded that Lehman repatriate the cash balances recently transferred to New York from their company's UK subsidiary, as this

would materially improve the ultimate financial settlement to UK investors exposed to Lehman (UK) counter-party risk. Then there is the issue of resolving unsettled trades in international bourses that remain outstanding due to the Lehman insolvency. Given the lack of clarity regarding these trades, a party's ability to trade are, in effect, frozen since the composition of their book is unknown even to them and their exchange. Undoubtedly, there will be many such stories playing out over the next several months and perhaps years as the carnage is sorted.

A third related issue is how exactly will the $700 billion bailout price tag be funded. Presumably, attempts will be made to fund it responsibly, which means a combination of debt issuance and increased US taxation. There have been vague rumblings of foreign government contributions but this source remains extremely uncertain. According to the US Treasury text, they also propose raising the Statutory Limit on the Public Debt to $11,315,000,000,000. This approaches 87% of Gross Domestic Product of the United States, not including off balance sheet and contingent liabilities. Who will buy this new debt issuance: cash-strapped Americans and American investors or foreign investors? If there is any inability or push-back in the willingness of investors to absorb this new debt issuance, we can expect a steepening of the US Treasury yield curve, renewed weakness in the US dollar and perhaps even the unthinkable, a down-grade of the US sovereign credit rating from AAA, ironically by the agencies that disingenuously rated some of the toxic mortgage-backed paper AAA.

An initial litmus test will be whether the US Treasury proposal, once finalized by the US Congress and signed into law by the President, will be accepted by the financial markets as a real solution. This will be measured, *inter alia*, by the TED spread (the difference between LIBOR and US Treasury Bill rates) returning to normal. After all, the spike in this spread was driven by fears of inter-bank counter-party risk, motivated in turn by concerns over asset quality issues and the opacity of bank balance sheets. This normalization, indeed, is one of the two objectives of the US Treasury initiative.

Recall that it took approximately 7 years and numerous proposals before the US Treasury-sponsored Brady Plan finally resolved the LDC syndicated loan defaults of the early 1980s and ultimately restored the US Money Center banks to solvency. Hence, there are several remaining issues to contemplate prior to judging whether or not Treasury Secretary Paulson's Proposal will live in fame or infamy.

How quickly will partisan politics in Washington DC allow this Proposal to be finalized? Politics in Washington have not been this polarized for many decades. The democrats are still smarting over the blow they received by supporting the unpopular republican Iraq war initiative. Whilst they would like to make political hay over this (republican made) financial crisis, they also need to avoid being seen as the obstacle to a solution. Hence, the Proposal most likely will be quickly (by legislative standards) finalized and signed into law. Let us hope that this Proposal, unlike those in the 1980s, gets it right the first time and normalizes capital markets and the banking system on the first attempt.

Whether this bailout plan comes together quickly or not, it in many ways already comes too late. The real economic sector in the United States has already been thrown into recession by the financial sector convulsions. Even with a coherent and quickly trotted out financial bailout, the US economy will suffer a recession. The severity could potentially be mitigated by a timely, insightful Plan, however the magnitude of the dead weight losses resulting from years of excessive reliance upon debt creation, loan pushing, borrowers' fraud, rating agency and regulatory incompetence, and mis-guided monetary policy under Chairman Greenspan suggest that the length and depth of the incipient recession will be long and deep. Despite a hopefully coherent bailout package, we are likely to witness a long economic recession, suggesting that bank balance sheets will additionally suffer from a further deterioration in credit quality: auto loans, C&I loans, credit card debt and other investments, apart from mortgages. So we can anticipate the recovery of bank profitability, re-capitalization and normalization of credit growth to be an extended process.

This missive would not be complete without a brief comment on the implications from this profound policy initiative for the country that, since WWI, has been the leading light of laissez-faire capitalism. The scope and magnitude of State intervention in the private sector that this initiative represents to stabilize the financial sector is nothing short of mind-boggling. As a trained social observer holding a Ph.D. in economics and having studied both the theories of vibrant laissez-faire capitalism of democratic countries and the inefficient policies of the planned economies in socialist counties, I struggle to categorize the implications for the paradigm shift that the proposed policy response to these challenging times catapult us into. On one hand, Secretary Paulson's aggressive State interventionism into the private sector is little different from the numerous examples in history of the nationalization of the banking sector with all the implications of moral hazard and inefficiencies this spawns. Yet there is a further absurd, bizarre twist. In many of these past instances, the mantra associated with the initiative was to take from the rich and subsidize the poor. In this current case, the US Treasury policy is effectively bailing out the rich, corrupt and incompetent on Wall Street and funding it by taxing current and future generations of the lesser-heeled, middle class on Main Street and further reducing American real incomes across the board with incipient inflation.

These wounds will be assuaged only if we demand that all banks that decide to participate in the RTC bailout refund all paid bonuses over the past seven years received by all bank officers from the CEO on down. Otherwise, this is has the makings of a Weimar Republic redux and an erosion of the Social Contract.

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