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HOW TO DEAL WITH THE US FINANCIAL CRISIS

AT NO COST TO THE TAXPAYER

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Some 80 years after the Great Depression the stream of analysis of causes and of actual or hypothetical alternative policies continues. The analysis of the present crisis, particularly the question of how to deal with it, are still in a very early stage. The most recent contributions are largely reactions to the 700 billion dollar bailout of the financial sector proposed by treasury secretary Paulson and after some modifications passed into law. While a scholarly article is not going to impact the current crisis management in the US or elsewhere, hopefully it can contribute to understanding and to better decisions in the future.

I discuss briefly the crisis itself and then give some criteria that should be used in evaluating any policy proposed to deal with it. This is followed by a critical discussion of some of the policy measures that have been suggested. Finally, I give a list of proposals, that I believe best satisfy the stated criteria. In contrast to almost all of the proposals that have been made, mine involve no bailout of the financial sector with public funds.

The Subprime Mortgage Crisis

The immediate mechanisms leading to the crisis are fairly clear and agreed upon. Moreover, this understanding has been available for some time. I quote from a column of Paul Krugman titled *Mystery of the mortgage mess* and dated November 17, 2007:

There's a very good *Economic Letter* from the Dallas Fed about the housing crisis, which explains a lot about how the mess happened. In short: lenders began making lots of dubious loans in large part because they were able to slice and dice the loans and sell them off to investors who didn't know what they were buying. My only fault with the letter is that it doesn't emphasize the extent to which borrowers were also suckered in.

Even earlier, on July 2, 2007 Krugman had written:

What do you get when you cross a Mafia don with a bond salesman? A dealer in collateralized debt obligations (C.D.O.'s) - someone who makes you an offer you don't understand.

Seriously, it's starting to look as if C.D.O.'s were to this decade's housing bubble what Enron-style accounting was to the stock bubble of the 1990s. Both made investors think they were getting a much better deal than they really were. And the new scandal raises two obvious questions: Why were the bond-rating agencies taken in (again), and where were the regulators?

Few would quarrel with this analysis today. The only element missing then and to some extent missing still is knowledge the magnitude of C.D.O.'s that were issued and of the amounts held by individual financial institutions. The crisis has been out in the open and its nature pretty well understood for some time. It is surprising that the discussion of how to deal with it has begun so late and is still far from a consensus on what needs to be done.

Criteria for Judging Proposed Measures

Very generally the criteria for any kind of government action are the same: achieving a maximum of efficiency and fairness. Efficiency in this case means restoring the financial system to normal functioning and doing so at minimum cost. Fairness means distributing the costs and benefits of the action among the various groups involved in a manner that is felt to be fair by a majority of the population. Fairness in relation to the current crisis requires a consideration of the treatment of the following groups: The top managements of financial institutions, particularly of those firms that have become or are close to becoming dysfunctional; the ordinary employees of these firms; their stockholders; the general

population; tax payers; last but not least, the borrowers under subprime mortgages, many of whom are in financial difficulty, or even facing foreclosure.

For many types of government actions, particularly in the economic sphere, a necessary condition for the achievement efficiency and fairness is that the action must be in accordance with clearly stated and explicit rules that can be communicated to the general public and can gain public support. In the absence of such rules, the bureaucracies charged with carrying out a policy tend to operate badly. This is particularly true in the present crisis. Given the mighty lobby of the financial industry, procedures that are not transparent are likely to favour them at the expense of the public. Even in the unlikely case that such procedures would be completely fair, the public would still suspect that undue advantages were gained by those present at the negotiating tables. Explicit and binding rules also have the advantage that they can be implemented more rapidly than procedures that may involve protracted negotiations and bargaining, also an important consideration in the present crisis.

Proposed Solutions: Paulsen and Beyond

The initial Paulson bailout proposal qualifies as a textbook example of how not to do it. It is totally unfair in that it involves a vast transfer from those already damaged by the crisis, the tax payers, to those who caused it and reaped substantial gains while the going was good, the executives and shareholders of the financial industry. Moreover, at least in the initial version, there was no compensation going in the opposite direction. Also, the proposed transfers are to be made at the sole discretion of the Secretary and are thus totally lacking in transparency. Finally, there is nothing in the proposal designed to make the financial industry act more responsibly in the future. On the contrary, the giant bailout increases moral hazard and encourages equally irresponsible future behaviour.

Modifications of the proposal following its initial justified rejection by the House of Representatives involved mainly cosmetic changes plus some unrelated goodies to make the package more acceptable. Thus, congressional oversight, in the absence of clear criteria, does not produce transparency. A modification to the original Paulson proposal that has been suggested and appears to have been adopted in the latest modification is that taxpayers should get some equity in return. This is eminently fair, but raises further problems.

The lack of transparency in pricing the distressed assets that the treasury wishes to buy could plausibly be dealt with by holding auctions. Ausubel and Cramton (2008) have suggested that the treasury hold reverse auctions for this purpose. According to Bajaj (2008), the same idea has also been advanced by the Treasury and it is found in the revised versions of the Paulson plan. The pricing of distressed CDO's is however very difficult under any mechanism. Bajaj discusses this in general terms and Stiglitz (2008a) specifically in relation to the auction proposal:

The administration attempts to assure us that they will protect the American people by insisting on buying the mortgages at the lowest price at auction. Evidently, Paulson didn't learn the lessons of the information asymmetry that played such a large role in getting us into this mess. The banks will pass on their lousiest mortgages. Paulson may try to assure us that we will hire the best and brightest of J Wall Street to make sure that this doesn't happen. (Wall Street firms are already licking their lips at the prospect of a new source of revenues: fees from the US Treasury.) But even Wall Street's best and brightest do not exactly have a credible record in asset valuation; if they had done better, we wouldn't be where we are. And that assumes that they are really working for the American people, not their long-term employers in financial markets. Even if they do use some fancy mathematical model to value different mortgages, those in Wall Street have long made money by gaming against these models. We will then wind up not with the absolutely lousiest mortgages, but with those in which Treasury's models most underpriced risk. Either way, we the taxpayers lose, and Wall Street gains.

Based on the articles of Bajaj and Stiglitz, it seems clear that while auctions may be better than pure discretion, they are not a good solution.

An entirely different approach is taken by Leamer (2008). He takes the central element in the crisis to be the decline in housing prices and he proposes to address the problem directly:

One honest way to transfer the losses directly to the taxpayers would have the Treasury buy homes directly at inflated prices and rent them to deserving Americans. Though the Treasury Plan involves buying mortgage backed securities at inflated prices, keep in mind that foreclosures will then turn the homes over to Uncle Sam. For \$700 billion, the Treasury could purchase 2.3 million homes at an average “affordable” share based on their household income, and the government’s subsidy would be spread over the duration of the mortgage, rather than being an immediate payout of three quarters of a trillion dollars to financial institutions.

While I have complete sympathy with the idea of directly helping home owners rather than financial institutions, I disagree with both Leamer’s premise and his conclusion. Leamer attributes the mortgage defaults to falling housing prices. The reality is not only that there is mutual causation between these variables, but that in addition there are distinct causes operating on each. The principal causes of the rise in mortgage defaults are: **a.** The poor creditworthiness of recipients of subprime mortgages. **b.** The general rise in interest rates, leading to increases in interest on variable interest mortgages. Falling housing prices play a role in that families about to default find it more difficult to sell the house and move to a cheaper one. This is hardly the major cause and fixing it would not remove the other two. Leamer’s proposed solution would turn the government into a gigantic real estate agent dealing with millions of homes all over the United States. Each home is different in quality and location. That is why real estate agent are usually small or medium sized local operations; the government is ill suited to this task. In addition, Leamer’s proposal requires a new welfare bureaucracy to determine the needs and paying abilities of families. There must be a better way!

A simpler and in my view better way to help home owners is the voucher plan advocated by Barton (2008) and similarly by Stiglitz (2008b). However, Dix (2008) points to a moral hazard problem created by the voucher proposal. What I don’t like about these proposals is that it is still the taxpayer who foots the bill to compensate the financial industry for the losses that they would (and should) otherwise incur.

The analysis that I like best is that of Edlin (2008) because: **a.** He proposes a comprehensive approach incorporating several distinct elements. **b.** He distinguishes between ‘fire fighting’ the current crisis and longer term reforms. **c.** He advocates what I agree is the most important immediately required measure: full insurance for *all* deposits.

Edlin’s other proposals may be described as ‘bailout light’: buy some toxic assets; inject some equity into the financial sector. I think that this is better than the plan that has just been adopted, but I am against *any* bailout.

Saving the Financial Sector at No Cost to the Taxpayer

a. As the first prong of my plan I shamelessly adopt Edlin’s proposal for insurance of all deposits and assurance of payments. I have nothing to add to his analysis, however I want to point in this connection to the article by (my former teacher) Telser (2007) who wrote:

LESSONS FROM BERNANKE

Ben Bernanke provided a better explanation of the Great Depression back in 1983 in a seminal article in the *American Economic Review*: widespread bank failures were the critical factor behind the Great Depression. Markets cannot function without acceptable means of payments. Bank failures caused people to lose confidence in the safety of their deposits. More than 17 percent of all National Banks never re-opened their doors after the end of the Bank Holiday declared by President Roosevelt in March 1933. The real job of the Fed was one it failed to do: to maintain the solvency of banks. The Great Depression was the result.

I don’t know if Bernanke was instrumental in raising the limit on insured deposits from 100 thousand to 250 thousand dollars. This may not be enough; all deposits should be insured!

On the evening of the day that I wrote the above, the German government announced that it was guaranteeing all accounts. The Irish government insured all accounts a few days ago, resulting in massive capital flows from British to Irish banks. This shows that an action that is desirable taken by itself may not be desirable when taken unilaterally in an interdependent system. The Greek government has also insured all accounts.

b. Transparency has been the buzzword in international discussions of the financial crisis. At the G8 conference at Heiligendamm in June 2007, the German delegation strongly pushed for greater transparency in international finance, but was blocked by the Americans and the British. Now the subject is at the top of the international agenda. This is all to the good, but to ameliorate the present crisis I propose *instant transparency*. All financial institutions should be required to reveal the face value of their holdings of CDO's *within ten days*. This would immediately remove the biggest source of uncertainty in the financial system.

c. The simplest, fastest, most cost effective and fairest way to help subprime borrowers and to restore value to subprime mortgages and derived CDO's is to pass a law that would reduce the payments due under these mortgages by some fixed proportion. A reduction in the range of 20-40 percent should be enough to very largely eliminate defaults. The flow of payments under these mortgages would resume with the result that the derived securities would again become as marketable as any other assets. The reduction in their value should be in about the same proportion as the reduction in interest payments. The loss relative to the initial face value would be borne by the financial industry, which is as it should be! Fairness requires the reduction to be retroactive. Since the law would apply only to existing mortgages, no moral hazard is created.

d. Several of the authors cited advocate an injection of funds into the financial sector in return for equity. The proposals have however remained vague. How much is to be injected into a given institution? How is the corresponding equity share to be determined? What role is to be assigned to the funds thus obtained? I make instead a proposal that is completely clear and definite in all of these respects.

My starting point is the article by Telser (2008). He shows that as a consequence of deregulation the ratio of reserves kept by banks against their deposits has effectively declined to zero. I propose that this deregulation should be reversed and that bank should be required to maintain a traditional reserve ratio of say five percent. The government should offer to give them the required funds against equity. The equity shares should be valued at market prices.

e. The above measures would improve the condition of the financial sector and substantially reduce, but not eliminate, the risk of bankruptcy. I don't see bankruptcy as the huge problem that it is generally made out to be. Bankruptcy by itself does not in any way reduce the human and physical resources present in a firm. After reorganization and the installation of a new management, these resources may be more productive than before. Bankruptcy in fact plays a similar role in a market economy as physical death does in biology; there the purpose is to assure the health and survival of the species, here of the market economy.

This proposal is in the spirit of Beim (2008) who wrote:

A central feature of good bailouts is that the shareholders of insolvent banks are wiped out and their senior management is dismissed. Why? Because these are the people who created the problem, they must be seen to pay a high price. Remember that most banks are conservative, well-run and solvent; only a minority got over-extended.

Conclusion

I reviewed and criticized various proposals to deal with the 'firestorm' of the current financial crisis and advanced several proposals of my own. Equally important is the question of how to construct a new financial architecture that is less prone to such conflagrations. How well that question is answered and the answer translated into actual policy will significantly impact the evolution of the new century. Stay tuned.

Update

Events are unfolding with great rapidity. The Paulson plan that was center stage when I began to write this note is dead. Beginning with Germany, various countries have initiated large programs in support of the financial sector. These, as well as the revised US program have

largely espoused at least in principle the idea expressed in my heading that the programs should at least in principle and in the long run involve no costs to the taxpayers.

One aspect of the German experience is relevant in relation to my proposals. To the surprise and disappointment of the German government, none of the private sector German banks have thus far applied for any part of the aid package. The apparent reason is that no bank wants to bear the onus of being the first to apply for aid. It would have been better to force them to act by mandating a certain level of reserves, as I proposed.

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