

The Bailout: Several Points of Financial Common Sense

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In response to the panic created by the recent financial crisis, on October 3rd, Congress approved the Emergency Economic Stabilization Act of 2008, which is also referred to as the Bailout program. While this program is an important step in the right direction, it has a number of flaws that must be corrected or it will eventually have important repercussions for financial institutions, businesses, and investors.

The current crisis started with the downturn in the real estate markets and the surge in energy and other commodity prices in 2006 which had tipped the U.S. economy towards a recession. As a consequence, financial markets began to show signs of stress during the summer of 2007. The severe decline in real estate values exposed a critical lack of judgment by those investment banks which created investment securities designed by computer model computations rather than based on realistic expectations regarding the value of the underlying assets.

While well-intentioned, the recently enacted Bailout program was a knee-jerk reaction to an unfolding crisis. As experience has demonstrated, the design of the program has left a number of issues unresolved.

1. Markets need to be calmed so that the Bailout program has some time to have a noticeable impact. We need a strong voice that will reassure investors, the government, and media: “Be calm; we will get through this”. What’s the surprise? Free markets experience economic cycles and are subject to human greed and incompetence. Our economy has weathered other serious problems caused by financial institutions since the Great Depression, including the Less-Developed-Countries debt crisis in 1982 and the Savings & Loan crisis in the early 1990s. Because of the global reach of the current crisis, the U.S. is calling on the co-operation of the other major economies of the world to implement a solution. What is important to remember is that our financial system operating under free market conditions has contributed to the health and strength of our economy over the years.
2. Some of the recent actions by the government have been somewhat alarmist, possibly contributing to the panic. Economic policymakers threatened Congress that if they did not approve the Bailout legislation, the markets would collapse. Putting a price tag of \$700 billion on the Bailout was not a good idea. First, no one can claim to know the final amount, and in reaching that figure the designers of the program were in effect making gross assumptions based on insufficient information. And second, investors are likely to respond: If the government says it will cost \$700 billion, then it will very likely be much more than that amount, therefore let us wait for the other shoe to drop. A more sensible approach would have been to ask for an initial amount and then return to Congress for additional funds to support specific short-term measures.
3. Much of the discussion concerning the financial markets has referred to financial institutions as banks, and in the process scared people into thinking that their deposits at commercial banks were

in jeopardy. However, there are two very distinct types of financial institutions, commercial banks and investment banks, and it is the largest investment banks which have been the cause of much of the current turmoil. Commercial banks and investment banks operate under two very distinct regulatory cultures. Commercial banking regulators such as the FDIC, OCC, and state banking regulators focus their attention on the safety and soundness of a bank by examining all areas of their operations. Banks and regulators are thus well-equipped with the tools to manage the current problems we are encountering.

4. Under the current Bailout program, no real costs will be imposed on the investment banks which caused the problems. A handful of the largest financial institutions control a major share of the financial system. And yes, this small clique of investment and commercial banks does have sufficient resources to eventually cover the cost of the bailout. When the housing market and the economy recover, these financial institutions will begin to make substantial profits and they are not now required to pay for the mess they created. Taxpayers are expected to pay the bill.
5. As specified in the program, the government will be purchasing from these few dominant financial institutions their securities and loans. In many cases these troubled assets are really liquidity-impaired only because markets have ceased to trade them and not due to a problem with their fundamental value. The government intends to purchase these troubled-assets at a price that the Treasury deems reasonable but which may not adequately reflect their true value. A technique that has been used successfully in countries that went through similar crises is for the government to buy the financial institutions' troubled assets with the condition that these banks buy back the improved assets in the future.
6. There is still a need for targeted regulatory relief in the Bailout package. One measure could include the designation of a new category on the balance sheets of investment banks as well as commercial banks. Liquidity-impaired assets could be exempted from mark-to-market accounting rules, and be reported at their book value. This type of temporary regulatory relief should eliminate a major portion of current market volatility.
7. Despite the expectation that the Bailout program will unclog the credit pipeline, the small group of huge banks that will receive cash from the government will probably not lend much of the cash they get for their troubled assets. Because we are in a recession, these financial institutions are likely to invest the cash in relatively risk-free U.S. government securities.
8. Recent plans for the government to become a shareholder in some of the large troubled financial institutions are worrisome. This amounts to nationalization of an important part of the banking industry. It would also represent a subsidy to existing shareholders, who are the ones who should come up with additional capital, and if necessary, to borrow those funds from the government and then repay those loans with the appreciation in the value of their shares. The government could also offer this financing arrangement to other potential investors. Government ownership of shares in the financial institutions will have the undesirable consequence of further politicizing the credit decision-making process. For example, borrowers from the huge banks where the government has acquired an equity stake may get more favorable terms than those borrowers from banks which continued to operate profitably as a result of their prudent lending standards.

9. Recently the Fed gave indications that it plans to lend directly to corporations since financial institutions are not lending to them. This would be a very risky move, since the Fed is a Central Bank, not a commercial bank. The Fed's massive injection of liquidity into the system has resulted in a de-facto change in its objectives from that of the Central Bank to that of a financial rescue bank, thus compromising its role as monetary authority.
10. An equally important priority now that the U.S. is in a full-fledged recession is for the government to apply one of its principal policy tools, that of fiscal policy, to help reduce the length and depth of the downturn. Monetary policy may have already used up its effectiveness in stimulating the economy. A focused program of fiscal stimulus such as investment in much-needed infrastructure can have a very positive multiplier effect on employment and help promote a recovery.

Based on the initial response to the Bailout package, both the design and the implementation of the program can be improved. Hopefully the lessons learned from previous crises can help to correct some of the design problems associated with the Bailout program through a reform of the 2008 Economic Emergency Act that will result in a sustainable solution. Congress is also planning an overhaul of the financial industry legislation in the next legislative session. Will a new financial system law favor the huge financial intermediaries that caused this mess and impose an even greater regulatory burden on the small community and mid-sized regional banks which have been busy minding the store and have not even asked the government for a bailout?

Each of the recommendations above has been proven successful in other times and places. Please call me at (305) 858 – 2825 if you would like to discuss any of these issues in more depth.

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