

Justification for a Rescue Plan

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What I would like to do is spend a little time talking about why the specific bailout was needed and give some completely random guesses as to whether it will work. The first thing to realize is that the U.S. Federal Reserve Bank has been fighting a liquidity problem in the financial sector for the better part of a year. In the last month some very disturbing things have been going on at the Federal Reserve. In particular, when the Federal Reserve wants to inject liquidity into the banking system they buy up treasury bills. In exchange the Fed essentially prints electronic currency that is handed over to banks and financial institutions. They also simply take Treasury Bills as collateral on short terms loans.

In the last month, the Federal Reserve has been accepting mortgage back securities as collateral on loans. So effectively what's been happening over the last month is that the Federal Reserve by itself has been buying out these financial institutions by taking potentially mortgage backed securities as collateral on their loans. If that process had continued in the long run it would have amounted to massive printing of electronic currency. The numbers we are talking about here are on the order of about 10 billion dollars a day in loans that were being injected into the system in exchange for potentially worthless assets. If money is viewed as a commodity like oil we can see what the impact of this continued creation would be. Money becomes more abundant and for a given demand level its value must decline. What does it mean for the value of money to decline? It means that the same grocery basket of goods will cost more. Prices of goods and services will rise creating inflation.

In addition, the Federal Reserve released 630 billion dollars in currency swaps. What this basically means is that they trade currencies with banks in Europe and Asia in an effort to get people to start lending in dollars. Again the goal was to increase liquidity in the U.S. banking sector (see the paper by Abbott and Foster in this series for more detail). The problem is this: You can lead a bank to liquidity but you can't make them lend. So the fundamental problem is no matter how much cash you have sitting on a bank's balance sheet creditors have got to have some confidence that borrowers will actually pay back loans.

Much angst has been expressed in public discourse concerning the wisdom of the recent Congressional rescue plan. Well meaning and educated people can and do disagree on the wisdom of these actions and their potential to prevent economic catastrophe. In the following paragraphs arguments are made that support the actions being taken by Congress, the Federal Reserve, and the Treasury Department.

It is first important to explain the intent of the \$700 billion rescue package. The plan is for the Treasury Department to purchase toxic assets from banks to improve the health and transparency of their balance sheets. This should free up lending between banks and increase liquidity thus avoiding a credit crisis. The first argument in favor of a rescue plan is that the Federal Reserve was going to do it anyway; and if the Federal Reserve was left to do it on its own the consequences would likely have been very severe inflation.

The second question is whether the rescue plan is likely to be successful. The answer comes down to the confidence issue and whether we are facing a kind of bank run. The metric to watch is not so much U.S.

investors and what they do, but rather the behavior of international investors. For a very long time now, banks in Asia in particular have been lending an incredible amount of money to the U.S. economy as a whole. Consequently, the U.S. accrues a current account balance of \$700-\$800 billion a year meaning that every year the U.S. economy must absorb \$700-\$800 billion in new capital flows from abroad. It is fair to ask whether or not this process is sustainable. Such borrowing can continue indefinitely so long as the creditors are content to lend at prevailing interest rates. Consider the return to a Japanese bank of lending money to the US Treasury. Those treasury notes are currently offering a dollar return of less than one percent per year. But the Japanese bank cares about their return in yen. If they believe that the value of the dollar is going to drop by 5 percent or 10 percent, then those treasury bills will generate a substantial negative return and the Japanese bank will not buy.

There was a meeting a few weeks ago between the heads of the banks of Korea, Japan and China to talk about an orderly withdraw from their U.S. investments. That is to say they all hold a lot of dollar valued assets. If they think the dollar is going to fall it makes sense to sell before it falls. But there is a problem in that the first to liquidate their position retains much of the value of their assets but the second and third see a substantial reduction in the value of those assets because the dollar will start to decline. This is the same kind of logic that creates bank runs. So the major lenders coming from Asia are starting to talk about how they can rebalance their portfolios. The only saving grace in this, from the U.S. perspective, is that the situation in Europe appears to be bad and getting worse. In fact, the dollar has risen substantially against the Euro in early October. Europe has some similar problems as the U.S. Even though they don't have domestic exotic mortgage derivatives they do have investment linked to such derivatives primarily in the U.S. market. However, their biggest problem is that their banks tend to be much larger than U.S. banks and so the ability of their government to rescue them is much more suspect. European politicians have announced plans to purchase bank assets in a plan not unlike that of the U.S. rescue plan.

The question for the coming months is whether Asian lenders would rather pull their money out of Euros or dollars and which one happens more quickly. On the whole, the U.S. has a 50-60 year track record of credibility that should tide it through this. If this were happening in a country like Argentina, they would be in deep trouble already. The solid history of the U.S. has bought it breathing room to implement the rescue plan.