



Red Queen, Failure to Launch or Numbers in Hiding

The peculiar lack of specificity in the Treasury's Financial Stability Plan revealed yesterday in the Treasury's statement and the testimony of the Secretary of the Treasury to the Senate Banking Committee has produced a set of interlocking puzzles to be solved by serious observers of American political economy. Did the new Administration miscalculate the market's likely reaction to the vagueness and lack of specificity of the plan? Perhaps it did not care, but that would seem strange as we point out later in the note. More fundamentally, the lack of specific detail suggests that we ask about the actual issue agenda regarding a financial stability plan as seen by this Administration? What does the Administration know? What does it wish to tell the public? What does it want? What does it fear? Each of these questions must be answered to decipher the issue agenda possessed by the leadership of this Administration. Until that issue agenda is revealed, it is almost impossible to decipher the current strategy being deployed by this Administration to confront the financial crisis.

What does the Administration know? Geithner was Secretary Paulsen's trusted aid-de-camp as President of the NY Fed. He has been involved in the TARP since its inception. Apparently, new Administration wished to separate itself from deliberating with the staff of the previous Administration, yet Geithner, above all, must know the details of the program's intent and evolution. He is sure to know why Paulsen pulled back suddenly and unexpectedly from buying toxic assets and shifted to capital infusions into weakened banks a shock that led the market to its November lows. He must have a strong suspicion or perhaps the real reason why Paulsen stopped halfway and never asked for the second tranche of the Bazooka? Could it be that true amount required to take away any doubt over the stability of publicly owned banks was far, far greater than the 700 billion dollars first voted on by the last Congress? Could it be that the real amount runs to multiples of the then yet to be spent \$350 billion? Does it possibly stretch to three or four trillion dollars an amount that would shock the public and send the Treasury market into orbit? Suppose the Bush Administration realized that to do the entire job it would have taken such a large bailout? Having lost the election, Paulsen was in no position to try to put together a plan that would take care of that amount of toxic waste? Maybe the reason that the current plan has been delayed so long is that even now, there is no obvious way to "hide" such an amount from the public? Having vilified bank executives over bonus compensation, having made them the villains of the financial dilemma the country now faces, and solemnly swearing that "nationalization" is not their preferred option, no real justification has been presented to the public about the true magnitude of the likely expenditure or how such a request would have impacted the much desired stimulus plan? Instead, there is the ambiguous total of \$500 Billion to a \$Trillion plus an as yet unspecified public-private partnership that is functionally designed to be the "Bad Bank" with private "bail in?" There is more here than meets the eye.

What does the Administration really want? There are many curious aspects of the Treasury's new Financial Stability Plan that remain unanswered at this point of which the very size of the asset pool suspected to be causing trouble for banks is foremost. This plan scarcely deals with the obvious question of the basis for asset valuation. Should these assets be marked to market and Treasury acquisition forced upon the banks on that basis? Unless nationalization is deemed a realistic strategy, why would the Banks sell at "market?" If they had been willing to do that, it is unlikely that Paulsen would have dropped the program in the first place. The new plan hardly touches on the proper accounting that should be used to value these assets. Instead, whatever now passes for the "Bad Bank" is now thrown into an unspecified public-private structure that focuses on private "bail in" but no specifics of asset valuation. There is the implied promise of Fed financing for assets purchased in this private-public partnership structure, but no specifics. This suggests various inducements to be offered for "bail in" and raises the question of 'crony capitalism' in the extreme. Clearly, being able to borrow from the Fed at attractive rates with some guarantees on the maximum level of loss (which is a variation on the 'ring fence' for toxic assets) suggests that "access" to the Fed's balance sheet will



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be critical. Who gets that access and with what guarantees? To read the Geithner statement and the ensuing testimony, the public is treated to pledges of solemnity and promises of experimentation with a willingness to admit mistakes. Rules versus Authority *déjà vu*, from an Administration that has pledged transparency and accountability? We have been here many times before. Don't we know where this road leads?

What does the Administration Fear? The worst position for this Treasury is to be caught up in a well defined effort to rid the banks of their currently bad assets that weigh down potential new lending and then find out several months or years down road that even more "bad" assets are weighing down bank balance sheets. That's the Japan syndrome and we know where it led: **The Lost Decade**. An unwillingness to tackle the problem totally and frontally can only lead to a debilitated financial sector. Zombie banks with zombie clients. Too big to be recognized and too embarrassing to bury, except under a highly non-transparent set of guarantees with an unspoken valuation metric offered on a less than totally transparent basis to "private buyers." We saw that in Japan with the private buyouts of the Long Term Credit Bank and it's "put" back to the Japanese Government on assets whose value had sharply deteriorated from the initial takeover by Shinsei Bank. It was not a pleasant ode in Japanese politics. It could easily happen here. It arises precisely because the metrics of the bailout are never tightly defined, made open to the public and public adequately briefed.

All of the foregoing unanswered questions coming from after a three month period of study by much ballyhooed expert advice suggests two possible, but equally unpleasant interpretations: (1) this administration cannot make up its collective policy mind about what to do or (2) the problem is much larger than the administration wishes to admit and it must seek to bury that magnitude under a myriad of different programs hoping one will work. A more sinister interpretation is that Administration policy officials believe that the stimulus plan will drive up GDP and lessen the magnitude of the impending defaults, thereby reducing the scope of the bail out magnitude. That is a plausible but untidy inference. It is reminiscent of the frustrated policy hopes in Japan. In Japan, the bailout bill never got smaller---it rose incessantly. The fallacy was the hope that Japan could grow out of the size of the bailout. Reality was just the opposite. Because the credit infarct was not quickly resolved, the economy was constrained in its growth patterns. Is it necessary to follow that faulty path again? It will be unless the truth wins out, the magnitude of the problem is clearly revealed and the solution is sized to the problem revealed.

It is one thing to tell the voters that the stimulus plan will produce three or four million jobs (both numbers are now in the public domain). But even the most hearty advocates of the stimulus plan recognize that will be a multi-year process at best. If the *raison d'être* for being non-specific as to the magnitude of the problem to be solved and the specific methods to be deployed to solve it is a hope to reduce the scope of the needed bailout, then we are consigning our financial system to a lengthy period of financial water boarding.

It may help this Administration to put the bankers in the docket in front of a hostile Congress. It may give the public scapegoats for rising unemployment, but this is not a problem of \$40 Billion in executive bonus compensation. Would that the problem were this small? In truth, it is likely that we have the wrong number of zeroes to contend with and that "financial zombism" is the danger the economy faces.

Will the real bank bailout plan please stand up?