

# The Theory and Practice of Bailouts

Desmond Lachman

American Enterprise Institute

Oct 8, 2008

# Bailing Out on the Run

- Crisis was not anticipated and policy is being made in a reactive manner.
- Major inconsistencies have emerged in policy approach
- Basic approach has been to deal with liquidity rather than solvency problems.
- Bailout policy is not being formulated as part of an overall strategy to promote economic recovery.

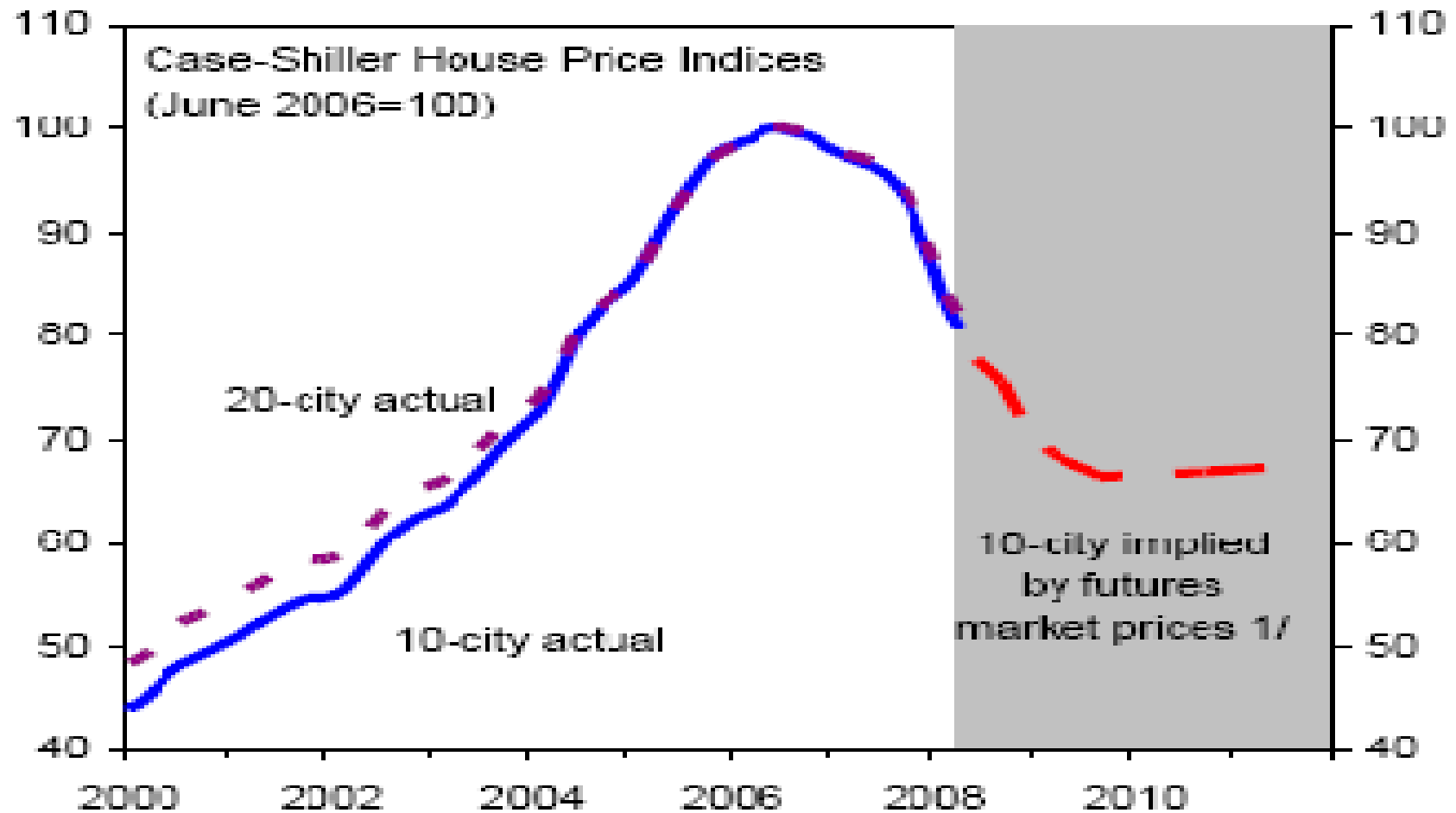
# Framing a Strategy

- Make the correct diagnosis on the U.S. economy's woes.
- Recognize that a bailout of the banks is only part of the solution.
- Recognize that we are dealing with solvency rather than liquidity issues.
- Design a bank bailout plan that addressed the underlying cause of de-leverage.

# Anatomy of the Present Crisis

- U.S. asset prices have fallen by around 20 percent over the past year
- Banks are engaged in a vicious de-leveraging process
- The large shadow banking sector is frozen
- Falling asset prices and tightening credits will lead to a deep and prolonged crisis.
- An adverse feedback loop is developing

## House Prices



Sources: Haver Analytics; Bloomberg, L.P.; and Fund staff calculations.

1/ Illiquidity in market may lend a downward bias to prices implied by futures contracts.

# Change in U.S. Housing Prices, Stocks, and Bonds

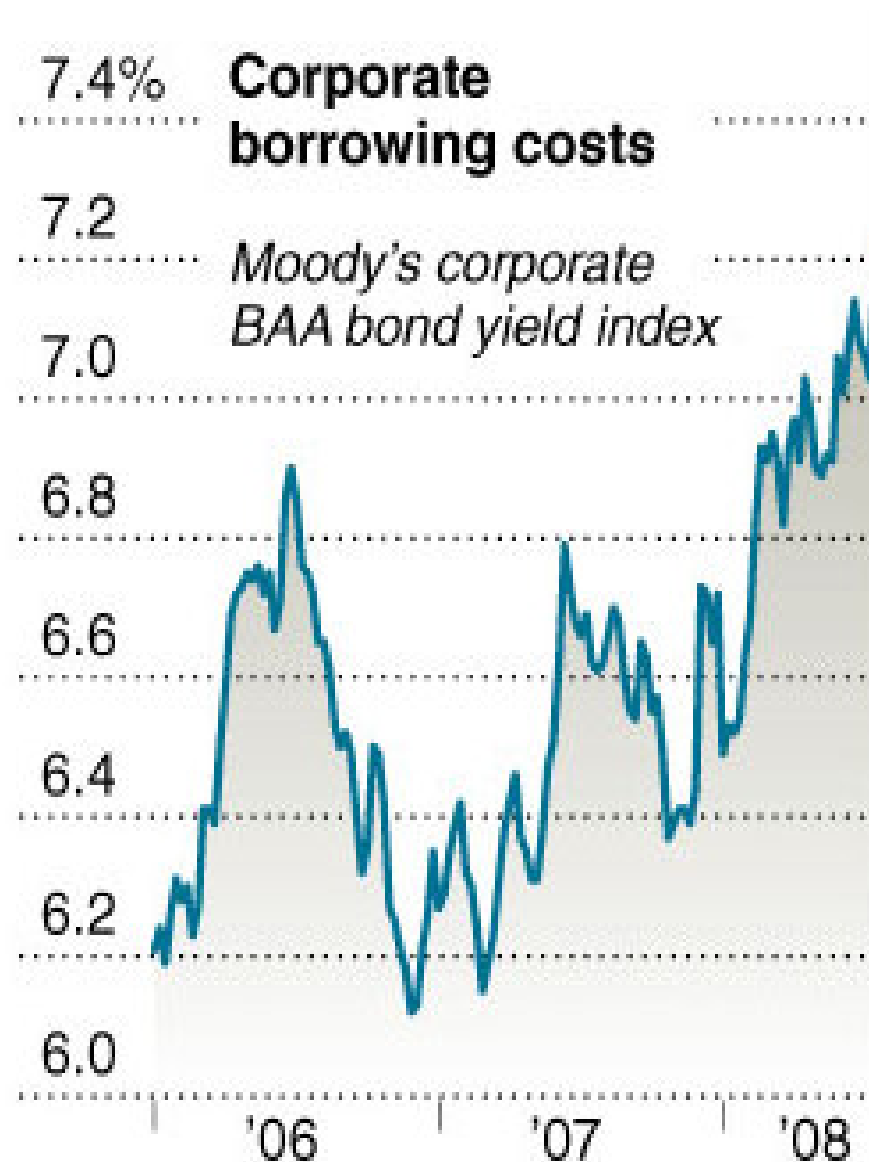


Source: PIMCO

.TEDSP:INI

## U.S. Ted Spread 2007-2008





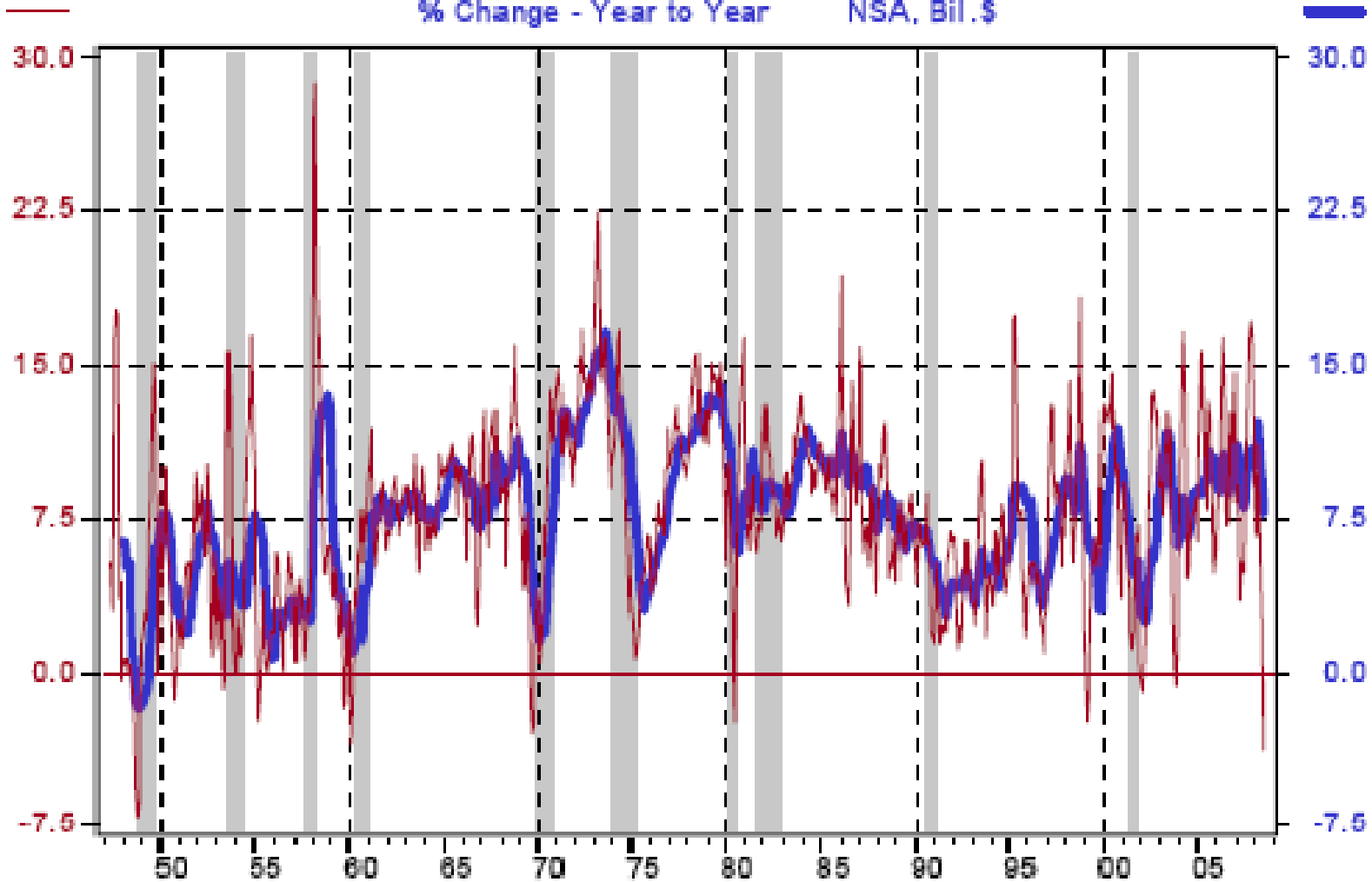
Sources: Federal Reserve Board, via Haver Analytics; Bloomberg

### Bank Credit: All Commercial Banks

3-month %Change-ann SA, Bil.\$

### Bank Credit: All Commercial Banks

% Change - Year to Year NSA, Bil.\$



Source: Federal Reserve Board /Haver Analytics

# A Bail Out is Only Part of the Solution

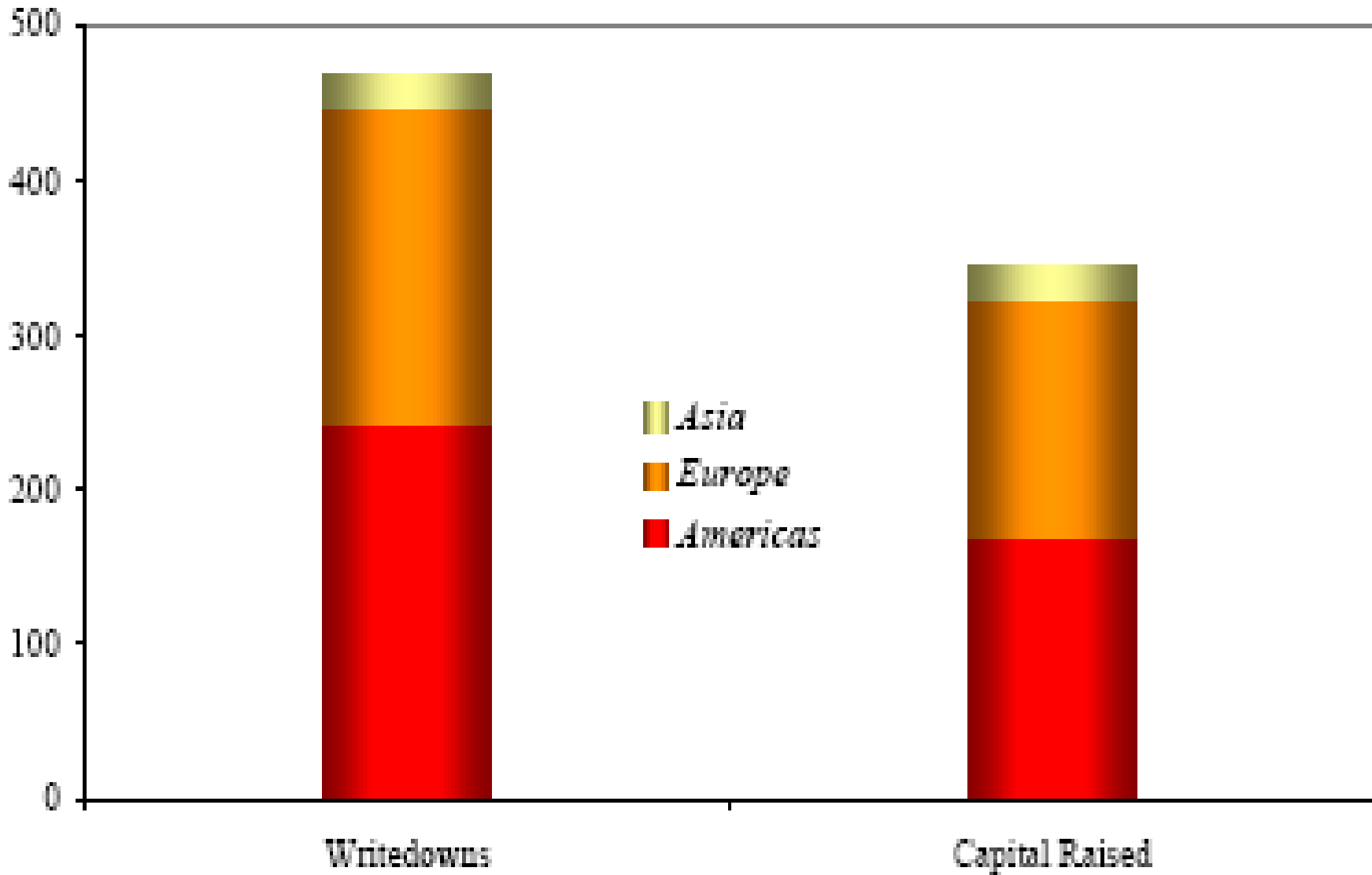
- Stabilize the housing market by addressing the foreclosure issue
- Articulate a policy for addressing the banks' capital problem
- Introduce a second fiscal stimulus package that is more focused on infrastructure spending
- Maintain an accommodative monetary policy stance

# Paulson's Plan Will Not Work

- The crucial problem with the banks is a capital shortage that forces them to de-leverage
- Banks probably need to reduce balance sheets by US \$ 2,000 billion
- All banks cannot de-leverage at the same time
- Paulson's Plan is not targeted and allows banks to only de-leverage by US \$ 700 billion

# Bank Write-downs and Capital Raised

*(in billions of U.S. dollars)*

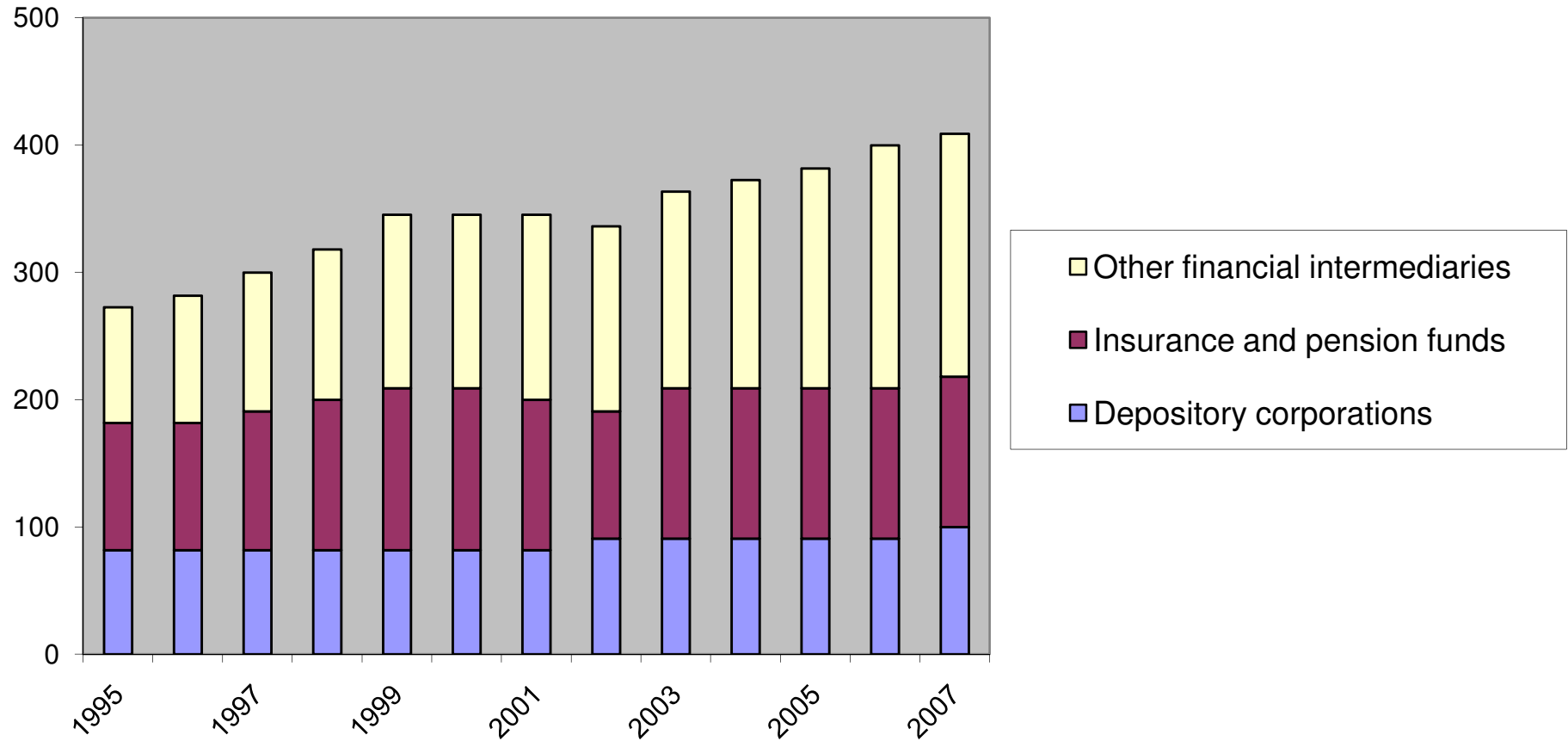


# Financial Problems Extend Beyond Money Center Banks

- Non-Banks have become more important than the banks in financial intermediation
- The highly leveraged hedge funds have sustained large losses and substantial redemptions
- The \$62 trillion unregulated credit derivatives market is a ticking time bomb
- Many regional banks exposed to the housing market will fail

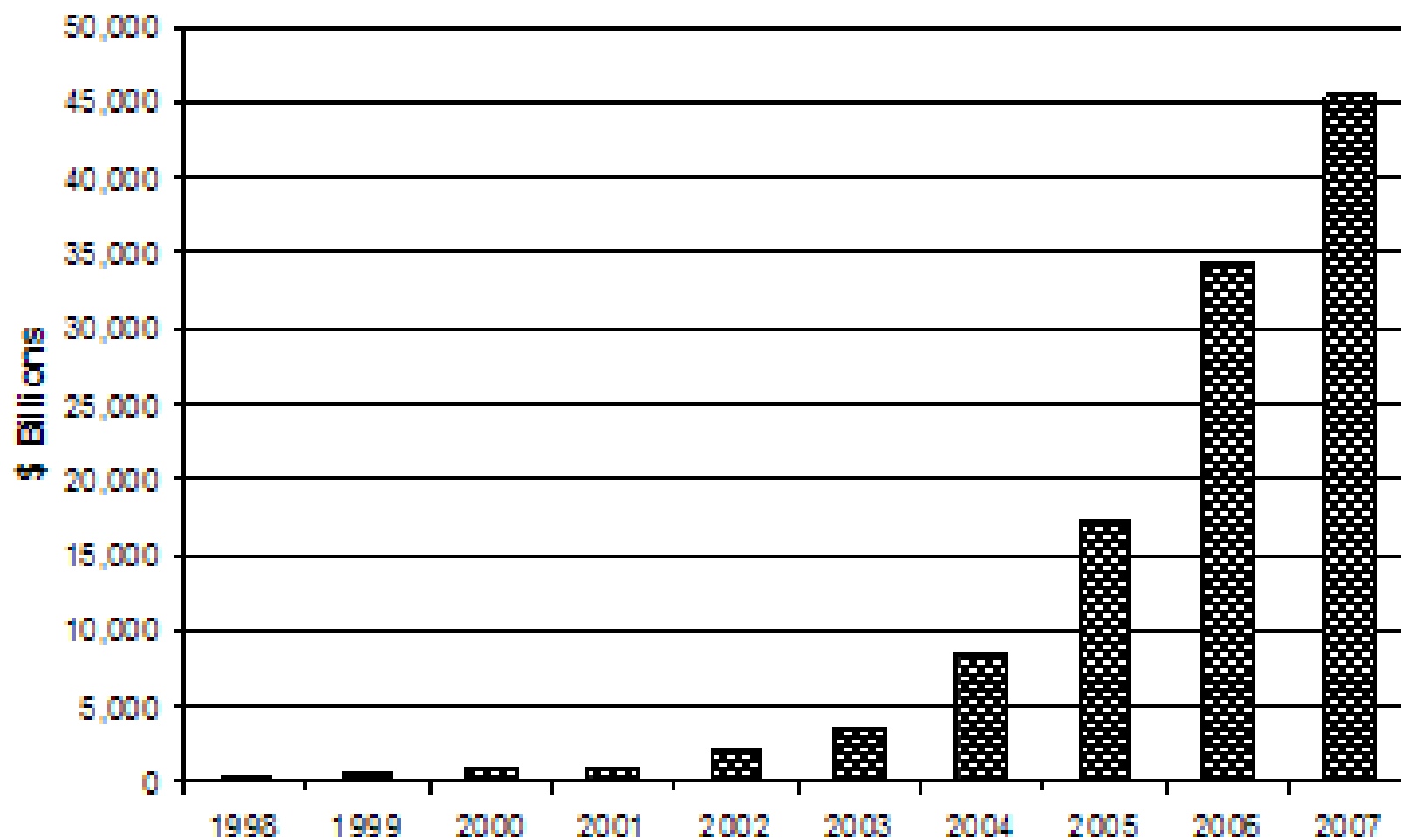
# Assets of Financial Sector in the United States

ratio to nominal GDP, %



SOURCE: FRB, "Flow of Funds Account of the United States"

## Notional Amount of Outstanding Credit Derivatives



*Source: BBA ISDA*