

The Bailout Bust

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Anyone who exudes confidence that the federal government's bailout of the financial sector will work is either smoking something, blowing smoke, or both.

When Secretary of the Treasury Henry Paulsen and Federal Reserve Chairman Ben Bernanke first proposed the \$700-billion bailout, I grudgingly set aside my free-market proclivities, held my nose, and leaned in favor of the bailout. Having not thought very much about the likely politics of a bailout policy track or how a bailout might work at the time, I also set aside my worries that a bailout would compound the “moral hazard” problem in debt decision (which amounts to the distinct possibility that the bailout will encourage more bad financial decisions, including errant risk-taking, in the future).

Now, we have the political record of how the bailout was driven through Congress, recklessly, through buyoffs of members. The bailout proposal quickly became a political Christmas tree, covered with bailout ornaments – tax cuts and a variety bailouts for other past bad credit decisions (for example, \$25 billion for bad car loans) – all designed to achieve the requisite number of votes. The bailout bill as passed must now exceed \$1 trillion, and no one should be surprised if the total bailouts for all sectors will eventually exceed \$2 trillion, or even \$3 trillion as bailout ornaments continue to be hung.

California and Massachusetts have already appealed for their own bailouts from the federal governments, with other states preparing their requests. “Conservative” Republican presidential candidate John McCain has begun the political press for the bailout of homeowners facing foreclosure, which, according to McCain, could cost at least \$300 billion. Even if McCain loses the election (which he more likely will because of his bailout proposal), someone else will surely pick up the mantle to save homeowners, regardless of whether they irresponsibly bought more house than they could afford or played in the housing bubble casino.

There now appears to be truly no natural or political limit to the expansion of the “bailout bubble.” Certainly, other sectors of the economy can make the case that their bad financial decisions have been no worse, and no less deserving of political attention, than those of the financial sector. Other nonfinancial sectors of the economy with “toxic assets” on their books can now claim that they will face the added financial distress that the financial sector's bailout will cause as more of the country's financial and real resources are diverted to propping up the wayward financial sector.

I understand the urgency in the case for the original bailout proposal: There was a threat of the economy being throttled because of growing fears of “panic thinking” taking hold with a possible run on banks and money market funds. Now, however, we have to worry that bailout mania will set in with every interest group bellying up the government trough in Washington with cups in hand. Surely, at some point the “solution” can become a bigger mess than the

original problem. And at this writing, I've lost almost all hope that the prospective drain on the economy from the burgeoning bailout monster in our midst will be held in check.

The fact of the matter is that the bailout "solution" has been greatly oversold with all the talk of dire consequences if the government doesn't open a main fiscal pipeline gushing into Wall Street with branches to the country's Main Streets. The fact of the matter is that the proponents of the bailout really can't be confident that the bailout will work as advertised, or even that the bailout will not make the country's economic problems worse, which no one has even hinted at. How can that be? Consider several missed points in the bailout debate.

First, the hundreds of billions of bailout dollars that will be used to buy the "toxic" mortgage-backed securities that banks now hold (because of poor management decisions in the past, made with political encouragement from several congresses and administrations) will not emerge from some magic lantern in Washington. The bailout billions will be borrowed, adding to the federal deficit and the national debt. The billions will flow into the banks and add to the banks' financial wherewithal to make loans. However, those billions will come from government bond buyers, which means that the bailout billions will soak up credit that would otherwise be available in the financial sector. There *might* be a net positive effect on the financial sector and the broader economy, but no one really knows how big that net effect may be. And the net effect could be very small -- if not nonexistent (banks could buy the bonds, trading their "toxic assets" for government-grade securities, if the government doesn't mar its credit worthiness in the process). If bailouts are extended broadly to non-financial sectors and all homeowners, the net benefits for the financial sector could be negative because the financial sector would have to shoulder its share of the burden that will come with helping the nonfinancial sectors and homeowners. All depends on how large the bailout monster in our midst becomes, and our democratic shackles do not, at this writing, appear very strong.

Second, all the talk about the dire need for a bailout for the financial sector that has been portrayed as teetering on the brink of collapse could have encouraged the very panic thinking that is at the foundation of the current financial crisis, elevating the need for the bailout (and, ironically, elevating the total cost of the bailout). For all we know, the world's stock markets could have been crashing recently partly because of all the dire bailout talk, with the passage of the bailout bill actually increasing the number of investors who have gone into full panic (sell) mode.

Third, when many investors on Wall Street and ordinary people on Main Street come to their senses and reflect for a moment about the consequences of adding an additional one, two or even three trillion dollars to the national debt, they might see in that debt the (unmentioned) strong likelihood of a long-term increase in their taxes and decrease in their favored government programs (education, roads, welfare checks – take your pick). Moreover, the moral hazards the country will face in the future because of the current bailout are real and nontrivial, and those future problems can be captured in people's current expectations about the future health of the country, thus undercutting the country's economic vitality today, and worsening today's financial mess.

Be assured that the bailout (or a sequence of bailouts going into the distant future) will not be the proverbial "free lunch" as suggested by bailout advocates. And this future burden can throttle current economic incentives and, thus, the economic recovery in the short term.

I understand that bailout proponents have advocated the bailout on the grounds that the government can buy up banks' "toxic assets" at depressed prices (because of panic thinking) and sell them later for a handsome profit (up to \$2.3 trillion, according to one report) when market stability has returned. But don't bank on the profit. The Congress and the administration (no matter who wins the election in November) will not likely forego the chance to dissipate any emerging profit in ways that will often be foolish and detrimental to the economy. If the potential profit was as clear as the bailout advocates suggest, you can bet I would have no reservation in supporting the bailout, but the touted profit is immersed in rhetorical fog, a sense of urgency that can easily be overblown.

There is also the concern that banks will not sell their assets for anything close to fire-sale prices, because they would then have to mark their other assets to market, giving rise to book losses – and a reduction in the banks' credit ratings, which can further undermine their position in financial markets. But then, one of the reasons the country's credit markets may have choked up is that banks are now holding off on the sale of their assets in anticipation of getting better deals later this year from the Treasury, which now has very deep pockets and not a whole lot of incentive to weigh taxpayer interests on par with the interests of Wall Street bankers who, through the bailouts, will be in a better position to lobby Congress and the administration for favorable prices for what could be worthless assets. And don't be surprised if banks' "toxic assets" that the government buys are the most toxic of the toxic assets, which adds to the dubiousness of claims that the banks' "toxic assets" represent highly profitable investments that the likes of Warren Buffet and the sheiks of Abu Dhabi have overlooked.

Oh, and then there is the issue of falling housing prices that, by all accounts, during the housing boom got way out line with people's ability to pay because of "bubble thinking." Bailout advocates have argued that the bailouts are necessary to stop the fall in the prices of houses, if not boost their prices, in order to stop the freefall in foreclosures and the market value of mortgage-backed securities, which supposedly can avert bank failures. But then, how can housing prices get back to reasonable levels without falling? Any proposal to prop-up out-of-line housing prices is likely to be nothing more than a proposal to postpone economic problems, and very likely, to make them worse, especially since such a public policy course will encourage people and banks to make bad pricing and credit decisions for decades to come.

Advocates also lament the "frozen" credit markets. But tighter credit simply means that lenders have increased their credit standards and the interest they charge, which can be seen as prudent adjustments when credit standards, according even to bailout proponents, have been way too lenient and a source of the current financial crisis. Nevertheless, bailout advocates seem convinced that the solution to the financial crisis is to prevent financial institutions from serving the credit unworthy (mainly Americans concentrated within low-income groups).

I know, much of what I have written has an element of ivory-tower theorizing, maybe bordering on speculation. But is that not also true for the thinking behind the advocacy of the bailout, which to date has been unchecked? Frankly, I hope my pessimism turns out to be as unwarranted as the confidence that bailout advocates now exude for the policy course the country has taken.