Rescuing monolines is not a long-term solution

By William Gross

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W hat is good for Ambac, the bond insurer, is good for the country. Well, per- haps in the short run if it prevents a run on the shadow banking system - our over-leveraged system of financial conduits that have provided the spending power to keep the US economy going in recent years. But not in the long run.

The Ambac business model is as faulty now as was chairman Charles Wilson's forecast for General Motors more than a half century ago. Wilson's response to a US Senate inquiry in 1955 implied that GM's near monopolistic control was beneficial to the country. It was, until the domestic motor industry fell asleep at the wheel of innovation and became more concerned with placating its labour unions with

outsized pay packages and long-term pension and healthcare benefits. Creative destruction and the incessant march of globalisation changed a GM chairman's smile to a frown, and the US economy turned from industrialisation to financialisation in order to stay at the top of the global pecking order.

Those who put their faith in the ability of a finance-based economy to remain healthy are being similarly challenged today. A critic can find numerous examples of incredible, bubble-popping asset structures - from subprime mortgages to structured investment vehicles to collateralised debt obligations squared - that are threatening to reverse the expansion of the shadow banks and break our finance-based economy's back. The most recent one, however, centres around the monoline insurers with Ambac as the most important link in the chain that presumably cannot be allowed to break.

Monoline insurers are so named because they originally covered just one line of business - municipal bonds. Today, however, because they do not insure lives, or automobiles or medical expenses, the name has stuck despite their additional reach into insuring financial assets of all varieties. In a real sense, the monolines have taken on their shoulders a supersized portion of the guaranteed solvency of modern asset structures. In combination with overly generous triple-A ratings on not only these assets but the monoline companies themselves, they have fostered a bubble of immeasurable but clearly significant proportions.

That the monolines could shoulder this modern-day burden like a classical Greek Atlas was dubious from the start. How could Ambac, through the magic of its triple-A rating, with equity capital of less than $5bn (£2.5bn), insure the debt of the state of California, the world's sixth-largest economy? How could an investor in California's municipal bonds be comforted by a company that during a potential liquidity crisis might find the capital markets closed to it, versus the nation's largest state with its obvious ongoing taxing authority? Apply the same logic to the gargantuan size of the asset-backed market it has insured in recent years - subprimes and CDOs in the trillions of dollars - and you must come to the same logical conclusion: this is absurd. It is as if Barney Fife, television's Sheriff of Mayberry in *The Andy Griffith Show* , promised to bring law and order to the entire country.

As long as the illusion lasted, however, it is clear that monoline guarantees fostered an expansion of our modern shadow banking system and therefore an extension of US and even global economic prosperity. Because US consumers were able to borrow at "guaranteed" triple-A rates with an additional servicing/underwriting spread, their spending power was artificially elevated. In order to maintain those levels and avoid a nasty recession, authorities through both official and backdoor channels now endorse a rescue effort. What is good for Ambac, they reason, is good for the country - and by extension the world.

As stock markets rise on optimistic workout developments, it is clear that it is - in the short run. But like General Motors a half century back, the sense of stability imparted to an oligopolistic industry with visible flaws is not likely to last, nor may the hope for a return to economic growth of recent years. The modern US financed-based economy has a striking resemblance to Barney Fife, guaranteeing global prosperity without the productive industrial-based firepower to back it up. Neither ultra-low interest rates or tax rebates, nor investor-led and authority-based monoline bailouts are likely to change that significantly during the next few years.

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