Why Paulson is (maybe) right - Charles Wyplosz

The world's bankers created a reckless mix of lending and securitisation that exploded in their faces last year; they've stonewalled since. It would be criminal to bail them out, but spilling blood for its own sake is foolish. Here one of the world's leading macroeconomists explains how the 'Paulson Package', history's largest bet, might work and might not cost taxpayers too much. It's too early to know which label to apply: "bailout" or "shrewd cleansing operation".

First of all, let me state clearly my position. Banks have made huge mistakes.

Even though many serious economists (the likes of Robert Shiller and Nouriel Roubini) had warned for years – not months – that the credit boom and the housing price bubble would end up in tears, bankers superbly closed their ears and soldiered on, driven by greed and short-term analyses. When the mix of reckless lending and securitisation exploded in their faces, more than one year ago, they stonewalled and drove the economy down in the hope of being bailed out. It would be criminal to bail them out. It would guarantee even worse crises in the future. Conclusion, there must be blood.

This being said, spilling blood for the sake of it is a bit silly. Banks are not oil companies. When an oil company goes bust, by definition, it is because its liabilities exceed its assets. After bankruptcy, its assets remain as valuable as before. Oil is safely tucked away under ground, refineries and gas stations stay put above ground.

A bank goes bust when its assets have collapsed. Bankruptcy means that its liabilities collapse too and these are assets of other banks and of millions of hapless citizens. This is why contagion and bank runs occur more frequently than oil runs. Sure, with patience, both assets and liabilities can regain value, but in the meantime the financial system is impaired and the resulting credit crunch provokes an economic crisis that spares no one. This is why large, systemic financial institutions cannot be summarily dispatched to receivership. Avoiding a credit crunch ought to be every one's priority.

Bleeding the culprits cannot be done with a truncheon, it requires a surgical intervention.

Secretary Paulson has obviously been testing many scalpels:

- He half bailed out Bears Stearns.
- As he butchered Lehman Brothers, he so frightened Merrill Lynch that this last problem was not solved at taxpayer's cost.
- On the next day, though, the Fed and many other central banks were lending huge amounts of money – presumably to Lehman's creditors

and to horrified financial institutions that realised that bailouts are not part of the plan anymore.

- The following day, he effectively nationalised AIG. This is not a bailout. AIG shares have been so diluted that shareholders lost most of their money. The Treasury will keep this too-big-to-fail company functioning but over time it will dispose of its assets. For all practical purposes the old AIG is gone.
- Then, on the final day of the creation of the new financial order, Paulson did a mega-AIG – he offered to buy all the toxic assets that financial institutions will care to sell.

The details of the plan are not known yet, so it is too early to determine whether it is a bailout or more blood. All will depend on two things. The price at which the assets will be acquired by the yet unnamed RTC, and the price at which the RTC will dispose of these assets.

Indications are that these assets will be bought at auctions. These will have to be reverse auctions, probably of the Dutch variety. If the sellers are confident in their financial health, or just smart enough to collectively bluff Paulson, the price will be close to the purchase price and it will be a bailout. If the sellers are scared and unable to organise themselves, the price will be a deep discount. Willem Buiter argues that the auctions are likely to force the sellers to reveal their true reservation price and I tend to agree.

Let us assume that, indeed, the toxic assets will be acquired at a deep discount. What happens next?

- First, the selling financial institutions will have to acknowledge their losses, a step that they did their utmost to resist for more than a year. They argued all along that there was no market for these assets – indeed they refused to sell them – so no price to mark them and therefore no objective way of entering the losses in their books. The auctions will provide a market price, at long last. Whether they sell or not, being forced to mark their assets to market, all financial institutions will have no choice but to formally acknowledge their losses. Either they recapitalise quickly, which dilute existing shares, or they will file for bankruptcy, which is even worse for the shareholders.

That does not look like a bailout, but it still could be one. Before we reach any conclusion, we must consider the second stage of the story.

- Second, the RTC will hold a huge portfolio of toxic assets, but it will be in no rush to sell them.

Like the previous RTC, thanks to taxpayers' money, it can take years to do so. If the toxic assets gain some value, the RTC and the taxpayers will make a profit and the financial institutions that sold them will definitely not have been bailed out. We will be able to call the operation a bailout only if toxic-asset prices go on falling, since it will then be established that the financial institutions managed to sell these assets above market price and at taxpayer's expense.

It is therefore much too early to call the operation a bailout or a shrewd cleansing operation. Judgment will have to wait until the yet-to-be-created RTC is folded, several years from now. Meanwhile, for the first time since mid-2007, we can foresee the beginning of the end of the crisis since the financial institutions will have either to promptly recapitalise or fold. This, in my view, justifies Paulson's bet, probably history's biggest ever.