We are running out of time and there is no end in sight unless massive political capital is put at risk now. We have a superb team of economists and technicians, but their voices all seem to have been lost. I recall Larry Summers rightly claiming that if markets over-react, the government has to over-react even more. Secretary Geithner, even in his much criticized first announcement, sounded to me like a man of principles, the right principles: We must stabilize the financial system, regardless of cost, was the message delivered with clenched teeth. However, Geithner’s and Summer’s actions do not match their own strong rhetoric. It is not that they don’t draw lines in the sand when faced with political pressures, but rather, they seem to be spending much of their energy tackling political hurdles rather than facing head-on the financial crisis.

We are dealing with a massive problem of uncertainty and fear. There are, for sure, important real problems to solve, especially in our main financial institutions, but these are problems that are hard enough to solve in normal circumstances, and they are insurmountable unless panic is put to rest. No matter how many inefficient contortions, liquidations, and conversions individual financial institutions may do, until the problem of systemic panic is resolved, it is only a matter of time until the next crisis blows up in our faces. Those that think that solving the problems of one bank, by nationalizing it or otherwise, will restore confidence, fall into an extreme fallacy of composition: What may be the right solution for an isolated case, is not, or may even backfire, for a systemic problem.

Last week, we all saw the importance of confidence in an environment gripped by fear. As chairman Bernanke testified in front of the Senate Banking Committee, markets began to rise. It was not only his clear message and sense of competence, but it was also the change in tone of the whole debate — somehow political posturing vanished as the Q&A progressed, and the exchange became responsible and focused.

But the mood changed with the conversion-deal Citi was, directly or indirectly, forced into. The key word is “deal.” Our government seems to be so terrified of a political backlash from being perceived as favoring banks over taxpayers (as if that indeed was an available tradeoff!), that it is approaching financial policy with a “deal” mentality rather with a systemic and medium-run perspective. “Are we getting a good deal for the taxpayer in this particular transaction?” is not the right question to ask. Instead, the right question is “What is the best solution that will enable us to recover as soon as possible?” Trillions of dollars of wealth and income are being sacrificed for political appearance sake.

Let me contrast this Citi deal and the financial panic it triggered with an alternative I proposed last week in a Washington Post article (and in a longer version in Roubini’s RGEMonitor and in Baldwin’s VOXEU). There I argued that an effective mechanism to stop the current downward spiral in equity markets would be that the government guarantees a minimum price in some of these shares a few years from now. The mechanism works by what economists call backward-induction: If we know that the price will be at least
something in the future, and there is an upside potential as well, then the price must be even higher today. Since last week I have worked out with Pablo Kurlat, an MIT Ph.D. student, a little model that yields some interesting numbers. This is no place for details, but it suffices to say that one of the conclusions that came out of it is that the government offered a minimum future share price guarantee to new equity holders of $2.7, it would have boosted share prices today to $6.8 and allow Citi to attract all the private capital that it may need for an extreme scenario.

It gets more interesting than this however. Because investors are so scared, the government can make a good business by selling insurance. Suppose that instead of the $2.7 guarantee, the government decides to offer a super-guarantee on the new equity of $5.8 per share. This guarantee would immediately boost the share prices to $8.4 (even of the old shares, which are not directly guaranteed) and allow the bank not only to raise enough private capital to fight a potential liquidity shock, but also to repay $17b of the government's preferred shares. This policy has an expected net gain for the government of $3.8b and a much lower risk exposure than direct equity holding. Of course these are very rough estimates, but their qualitative features are robust. Essentially, through the insurance mechanism the government transforms heavily discounted equity into a treasury bond plus a call option on the upside of the bank. By doing so it makes it possible for banks to raise capital through equity issuance at reasonable prices, and to repay the Treasury for its insurance provision service.

More important than this specific proposal, the key message I hope to convey is that squeezing current stakeholders for political appearance is short-sighted and self-defeating. Conversely, doing exactly the opposite is probably the only hope we have for a (mostly) private sector solution to the problem, and hence for a real and permanent solution.

At this stage of the crisis, bad news spread quickly across the financial network. Recall that Citi’s share prices crashed by 40% after last week’s conversion, but the demise didn’t stop at Citi, as Bank of America’s shares fell by more than 20%, Wells Fargo by 16%, and so on. It is imperative that we reverse this contagion mechanism. For example, it is not too farfetched to think that had the equity insurance policy been adopted for Citi instead of the conversion plan, the price of the other financials also would have risen sharply—after understanding that the government is truly committed to supporting wealth enhancing private solutions; then the rest of the market would have risen, thus triggering a good feedback mechanism. Policy needs to focus on mechanisms that have the potential to spread good news throughout the system.

Taxpayers do not live on the moon and hence are exposed to the costs of financial catastrophes as well. Throughout the world governments are hoping that small repairs (relative to the magnitude of the crisis) will suffice, and interactions are becoming more virulent by the day. It is time to put a stop to this madness and to match the strong rhetoric with equally strong ammunition, which will require using political capital in the short run. There is no place to hide. However, the return from reversing the downward spiral will be enormous. This is the North to keep in mind.