The Wayback Machine - https://web.archive.org/web/20090322075805/http://blogs.ft.com:80/economistsforum/2009/03/constructive-solutions-to-the-financial-crisis/

FINANCIAL TIMES All times are London time

ft.com/economistsforum

Constructive solutions to the financial crisis

March 16, 2009 5:50pm by FT

By Ricardo J. Caballero

Suppose it was possible to rewind the clock to the first time we had a strong urge to rewrite economic history. A favourite stopping date would be the days before the Lehman-AIG debacle last year. Until then, we were dealing with localised inefficiencies and predatory behaviour among the main financial institutions. There was plenty to fix but it seemed manageable, mostly a matter of accelerating the medicine and aggressively dealing with problems on a case-by-case basis.

All of this changed for the worse after the Lehman-AIG event. The problem ceased to be firm-and market-localised, and turned into a severe systemic panic attack. This change in the nature of the problem has strong policy implications, since it requires a systemic, not a case-by-case, remedy. Of course the systemic problem first appears in relatively weaker institutions, but one should not confuse causes and consequences. Surely some financial institutions will appear insolvent in the strict accounting sense; this is what mark-to-market accounting will do to almost any leveraged institution in the midst of a severe systemic crisis.

However, simply destroying the intangible capital of a financial institution, or forcing a significant dilution of a stakeholder as a means of dealing with a systemic symptom of fear, is a highly inefficient and counterproductive policy response. It is the economic equivalent of putting out a fire with gasoline.

Fortunately, both the US Treasury and the Federal Reserve have the right diagnosis. They understand that the need is to restore *systemic* confidence with a limited amount of financial and political capital. They are on the right track, although not at the speed we all feel is required.

To remedy the latter, we should help, rather than obstruct them. We all have our favourite plans, but at this point we are of little help to anyone when we keep changing the entire policy paradigm. We should take what we know of their current plan as given, and restrict our recommendations to operate within their framework. This is important not only to accelerate the process, but also to eliminate the enormous policy uncertainty that is destroying the stock market, private wealth, and balance sheets.

In this spirit, I would propose that any new recommendation should satisfy three constraints:

- *Only good (policy) news is allowed.* Any amendment to their plan must do more, not less, for the financial institutions and their stakeholders. This principle should be advertised broadly right away
- *It must have a reasonable cost.* The amendment cannot be significantly more expensive for the US government than the current plan, and
- *It must be wealth enhancing.* It cannot go against, and it hopefully should reinforce, the fiscal stimulus package.

The following plan satisfies these constraints:

- *Raising private capital.* Announce today that banks in need of more capital if aggregate conditions worsen (the stress test), will be given an option between the previously announced programme and one in which new private capital raised receives a government guarantee for a price five years from now set at the February 2009 price used for the preferred shares. Alternatively, the government may invest in common shares but give the right to new investors to repurchase the government shares within five years at that price plus an interest rate charge. This guarantee holds regardless of whether the financial institution survives the crisis. Any difference between the expected costs of these two options is paid as a premium by shareholders (and possibly debt-holders).
- *Insuring aggregate risk.* The return on hard to value assets, whether they remain on the books of the financial institutions or are sold into the PPIF (public-private investment fund), should be guaranteed by the government at the insurance prices prevailing before the Lehman-AIG crisis. These assets can be subject to a "representations and warranties" clause where the financial

institution pays a penalty if the performance of its insured assets is worse than the average of the corresponding category, five years hence.

The first item is clearly a positive development for shareholders since it adds an option which has no additional value over the current programme if the financial institution's post-crisis future is poor, but is very valuable otherwise.

Interestingly, whenever the option has value, it also helps the government since now the private sector injects the capital in exchange for a guarantee that is not likely to be executed in such a scenario. Moreover, by bringing some sense of a floor, this policy also would trigger a stock market boom and hence reinforce the aggregate demand effects of the fiscal package. The second item has similar virtues, and it deals directly with one of the key adverse selection problems complicating asset valuations at this time (that banks will sell and insure their worst assets).

Will these policies be enough? Surely not, but if we are all rowing the same boat in the same direction, and keep a cool head, we will get out of this mess sooner rather than later.

Ricardo J. Caballero is head of the department of economics at Massachusetts Institute of Technology

March 16, 2009 5:50pm in Banks, Crisis, Federal Reserve | Comment

Help • About us • Sitemap • Advertise with the FT • Terms & Conditions • Privacy Policy • Copyright

© THE FINANCIAL TIMES LTD 2009 FT and 'Financial Times' are trademarks of The Financial Times Ltd.