

## Nationalisation without prices: a recipe for disaster

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*By Ricardo J Caballero*

In all likelihood, political constraints severely limited the ambition and effectiveness of the US financial stability package. Economists need to unite behind relaxing these constraints. Talking lightly about nationalisation, as is increasingly taking place, does exactly the opposite.

There are two types of arguments for nationalisation. One argument is a gut reaction that enough-is-enough and we must stop transferring resources to Wall Street's "crooks and oligarchs." This reaction only adds fuel to the fire and exacerbates self-destructive mob-mentality behaviour.

We need to stop this. The second argument is more reasoned and wonders whether it is not too late for any other solution. At current prices banks are either insolvent or will soon be, hence the only option is a time-out in which the government takes control of some of these banks, at least temporarily.

While I sympathize with this second view on the underlying premise that policy has been behind the curve and the call for a time-out, I disagree with its policy conclusion. This view takes for granted that nationalisation would buy us the time-out. I think this will do just the opposite.

The risk is enormous that it may trigger fears, uncertainties, and indirect effects that would make the aftermath of the Lehman episode seem like the "good old times."

There are at least two reasons why nationalisation is likely to backfire: First, there are no (sensible) prices for the key assets in the balance sheets of financial institutions. Uncertainty and fear have ravaged all types of explicit and implicit financial insurance markets, destroying any sensible metric for the fundamental valuation of almost every risky asset. But without these prices, any decision of who is insolvent and needs to be nationalised is arbitrary.

Wherever the line is drawn, the fear of nationalisation will swallow the next financial institution, and then the next one, and so on. Of course, there is no problem of fear, uncertainty and contagion if the US government takes over all banks, and insurance companies, and pension funds... and foreign governments do the same with their banks, and insurance companies, and so on. But this is lunacy at best, and it is why the existing evidence of nationalisations in small economies is irrelevant for the case at hand.

The second reason, which we should have learned from the Lehman event and the near collapse of money markets that ensued, is that the interlinkages of the modern financial systems are too complex to risk major dilution of any stakeholder in this jittery environment. We do not know the systemic impact of such an action. This complexity interacts with uncertainty aversion, and could trigger massive flight-to-quality episodes.

But if nationalisation is not an option, how do we get the time-out? My preferred (part of the) solution is to provide universal insurance for the assets that are currently clogging the balance sheets of banks and other financial institutions.

For now, this insurance should be provided at pre-crisis prices for the corresponding asset class (or one notch below). This arrangement should be coupled with tight monitoring of the insured institutions and with retroactive punishments a few years down the road to those institutions (and their management) whose assets underperform relative to their asset class. This retroactive punishment is needed to limit adverse selection problems, where banks insure their worst assets without declaring them as such.

Another important aspect of this insurance arrangement is that it effectively removes from these institutions much of the burden of holding aggregate risk in a volatile environment. While some of these financial institutions played an important role in causing the crisis, a significant share of the losses of the surviving financial institutions stem from poor policy responses, which have exacerbated the systemic problem.

There is no reason to concentrate the cost of the policy mistakes on these institutions. Once this risk is removed from their balance sheet, the short-run need for recapitalization which is behind the nationalisation push is eliminated, and we can wait until normality returns for financial institutions to rebuild their capital if the need is still present.

There are related proposals which I also like, such as injecting capital now and determining the price of it in the future, again once normality returns. A problem of this initiative is that it seems to leave the aggregate risk in the balance sheets of financial institutions.

US Treasury Secretary Tim Geithner's proposal has elements of both approaches, and it is probably as much as he could get in a heavily-politicised environment. Coupled with the bad bank arrangement and guarantees for private asset buyers, it resembles the insurance solution described above.

This mechanism appears more complex to jump start than the insurance one as it depends on more private sector decisions, and it transfers much of the upside to private capital rather than to the financial institutions that have been hurt the most by the systemic crisis. It is also worrisome that this strategy will require further capital injections in the short-run, which given the political environment may not allow the Treasury to honour its commitment to not nationalise the supported institutions. If this concern can be put to rest, the principles behind the Financial Stability Plan point in the right direction.

Of course time-outs are not very useful unless we work at restoring the pieces that are needed to return to normality and to restart the key securitisation markets. Supporting distressed homeowners and mortgages is an important step, both in alleviating households' debt and in boosting the value and liquidity of the assets clogging the balance sheets of financial institutions.

The recent announcements are short on details, and perhaps revealed that the Treasury's economic team overestimated people's ability to distill the good news in an abstract message of principles when in panic mode.

But there is good news in them, as they reflect a deeper understanding of the fundamental uncertainty problem than commentators and politicians possess. It is time for us to stop proposing ideas that only add fuel to the fire, and focus instead on facilitating the difficult task which lies ahead.

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February 17, 2009 3:59pm in Credit squeeze, Fiscal policy, Nationalisation | Comment