The Obama rescue

Saving the banks

This week marked a huge wasted opportunity in the economic crisis.

There was a chance that this week would mark a turning-point in an ever-deepening global slump, as Barack Obama produced the two main parts of his rescue plan. The first, and most argued-over, was a big fiscal boost. After a lot of bickering in Congress a final compromise stimulus bill, worth $789 billion, seemed to have been agreed on February 11th; it should be only days away from becoming law. The second, and more important, part of the rescue was team Obama's scheme for fixing the financial mess, laid out in a speech on February 10th by Tim Geithner, the treasury secretary.

Illustration by KAL

America cannot rescue the world economy alone. But this double offensive by its biggest economy could potentially have broken the spiral of uncertainty and gloom that is gripping investors, producers and consumers across the globe.

Alas, that opportunity was squandered. Mr Obama ceded control of the stimulus to the fractious congressional Democrats, allowing a plan that should have had broad support from both parties to become a divisive partisan battle. More serious still was Mr Geithner's financial-rescue blueprint which, though touted as a bold departure from the incrementalism and uncertainty that had plagued the Bush administration's Wall Street fixes, in fact looked depressingly like his predecessors' efforts: timid, incomplete and short on detail. Despite talk of trillion-dollar sums, stockmarkets tumbled. Far from boosting confidence, Mr Obama seems at sea.

Toxic tantrums, contingent chaos

The fiscal stimulus plan has some obvious flaws. Too much of the boost to demand is backloaded to 2010 and beyond. The compromise bill is larded with spending determined more by Democrat lawmakers' pet projects than by the efficiency with which the economy will be boosted. And it contains "Buy American" clauses that, even in their watered-down version, send the wrong signal to trading partners.

For all those shortcomings, the stimulus plan gets one big thing right. Given the pace at which demand is slumping, a big, and sustained, fiscal boost is vital for America's economy. This package, albeit imperfectly, administers it.

That makes the inadequacy of the financial rescue all the more regrettable. Fiscal stimulus, indispensable as it is, cannot create a lasting economic recovery in a country with a broken financial system. The lesson of big banking busts, such as Japan's in the 1990s, is that debt-

laden balance-sheets must be restructured and troubled banks fixed before real recoveries can take off. History also suggests that countries which address their banking crises quickly and creatively (as Sweden did in the early 1990s) do better than those that dither. This is expensive and painful, but cautious, penny-pinching governments end up paying more than those that tread boldly.

By any recent historical standards America's banking bust is big (see article). The scale of troubled loans and the estimates of likely losses—which are now routinely put at over $2 trillion—suggest many of the country's biggest banks may be insolvent. Their balance-sheets are clogged by hundreds of billions of dollars of "toxic" assets—the illiquid, complex and hard-to-price detritus of the mortgage bust, as well as growing numbers of non-housing loans that are souring thanks to the failing economy. Worse, banks' balance-sheets are only one component of the credit bust. Most of the tightness of credit is owing to the collapse of "securitisation", the packaging and selling of bundles of debts from credit cards to mortgages.

Fixing this mess will require guts, imagination and a lot of taxpayers' money. Mr Geithner claims he knows this. "We believe that the policy response has to be comprehensive and forceful," he declared in his speech, adding that "there is more risk and greater cost in gradualism than aggressive action."

But his deeds did not live up to his words. His to-do list was dispiritingly inadequate on some of the thorniest problems, such as nationalising insolvent banks, dealing with toxic assets and failing mortgages. Mr Geithner promised to "stress-test" the big banks to see if they were adequately capitalised and offer "contingent" capital if they were not. But he offered few details about the terms of public-cash infusions or whether they would, eventually, imply government control. His plan for a "public-private investment fund" to buy toxic assets was vague and its logic—that a nudge from government, in the form of cheap financing, would enliven a moribund market—was heroic. Banks' balance-sheets are clogged with toxic junk precisely because they are unwilling to sell the stuff at prices hedge funds and other private investors are willing to pay. Vagueness, in turn, led to incoherence. How can you stress-test banks if you do not know how their troubled assets will be dealt with and at what price? Amid these shortcomings were some good ideas, such as a fivefold expansion of a $200 billion fledgling Fed facility to boost securitisation. But for nervous investors and worried politicians, desperate for details and prices, the "plan" was a grave disappointment.

A great failure of nerve

How serious is this setback? One interpretation is that Mr Obama's crew mismanaged expectations—that they promised a plan and came up with a concept. If so, that is a big mistake. Managing expectations is part of building confidence and when so much about these rescues is superhumanly complex, it is unforgivable to bungle the easy bit.

More worrying still is the chance that Mr Geithner's vagueness comes from doubt about what to do, a reluctance to take tough decisions, and a timidity about asking Congress for enough cash. That is an alarming prospect. "Banksters" may be loathed everywhere (see article), but more money will surely be needed to clean up America's banks and administer the financial fix the economy needs. That, as this newspaper has argued before, means both some form of "bad bank" for toxic loans (with temporary nationalisation part of that cleansing process, if necessary) and guarantees to cover catastrophic losses in the "good" banks that remain. Mr Obama's team must recognise this or they, like their predecessors, will come to be seen as part of the problem, not the solution.

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