The Financial Crisis: Bad and Getting Worse, but Put Away that D-word

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It began as the "subprime crisis" in 2007, and then mushroomed into a full-blown global recession in 2008. And still, despite mammoth government intervention, the bad news keeps getting worse. Are we now teetering on a precipice, ready to plunge into another Great Depression? Can the latest proposals pull the economy out of its nosedive?

There is plenty to worry about. But while many experts say this crisis is the worst since the Depression, that does not mean it will be as bad.

Unemployment and other economic gauges will continue to worsen, but unless governments make a major misstep, like igniting a worldwide trade war, economies should stabilize and recover on a "very flat path" that could take several years, says Wharton finance professor Marshall E. Blume.

Japan went through a similar bank crisis in the 1990s without tumbling into a full-blown depression, adds Wharton finance professor Jeremy J. Siegel. "Given that we're reacting faster than Japan, I think you can make a good inference that [a depression is] not going to happen here," he says.

Many estimates call for gross domestic product in the U.S. to shrink by 2.6% in the first quarter of 2009, Siegel notes. That's bad, but small compared to the 27% decline from 1929 through 1933. A depression is generally defined as a drop of 10% or more.

Still, there is more bad news than good, and the depth of the problem can be measured by the lack of consensus on what to do about it. Consider this gloomy observation in a January 20 *Wall Street Journal* story about the British government's abrupt decision to pump billions more into what the writer called the country's "flagging" financial-rescue plan: "Governments on both sides of the Atlantic are struggling to keep up with the deepening economic crisis -- and may be running out of ammunition to battle it."

In the U.S., banks continue to withhold loans despite huge infusions of government cash, and Goldman Sachs estimates that financial institutions will lose $2 trillion on loans, with only half of that realized to date. Banks are even starting to call in loans to borrowers, such as home builders, who have made all their debt payments on time. Troubles are now expanding to commercial real estate firms. The numbers of layoffs, bankruptcies and foreclosures are growing. Household names, such as Circuit City electronics stores, are closing their doors, and problems have worsened at Citigroup and Bank of America despite government help.

There is little consensus on how to remedy the problem. Indeed, the U.S. government is again considering buying up toxic assets held by financial firms, a plan adopted last fall and then immediately scrapped in favor of direct cash infusions to banks.

The tale of woe and confusion is much the same around the world. The economic slowdown is so steep as to cause oil prices to drop to around $40 a barrel, from more than $140 last summer. Trade is so sluggish that shipping rates have plunged to astonishing lows. The European Commission warned on January 20 that the 27 nations of the European Union are likely to experience a "deep and protracted recession."

At the request of then President-elect Barack Obama, the Senate on January 15 voted to release the second half of the $700 billion Troubled Asset Relief Program. (No action by the House is required.) Comments from Obama administration officials suggest much of this $350 billion may be used to buy "bad assets" held by financial institutions. Those include mortgage-backed securities and other holdings that have plunged in value and become all but untradeable. Getting these assets off the financial

institutions' books was at the heart of the TARP program when it was proposed in September by Treasury Secretary Henry Paulson and Federal Reserve chairman Ben Bernanke.

Paulson and Bernanke say that removing the toxic assets would remove uncertainty about the banks' health, and encourage the banks to resume lending, seen as the key to turning the financial crisis around. But after Congress approved TARP, Paulson instead pumped the money directly into troubled banks, taking some preferred shares and warrants in exchange, arguing the banks needed quicker help because they had turned out to be in worse shape than previously thought. But the banks remain reluctant to lend, and it is not clear the first half of the TARP fund was the good investment Paulson said it was. The Congressional Budget Office estimated in a January 16 report that taxpayers would lose $64 billion of the first $247 billion in TARP spending.

Whether the government should now revive the asset-purchase plan is subject to debate.

Wharton finance professor Richard Marston thinks the direct infusions will restore banks' lending ability faster than asset purchases would, but the government should in return demand a bigger ownership stake than it has. "The Treasury should find a way to inject capital where the taxpayer ends up with large stakes in the banks -- even if they are not formally nationalized. The bank shares are going to soar with recovery, and someone is going to make a fortune." That should be taxpayers if they take on the cost and risk of propping up the banks, Marston argues.

According to Blume, there is so much uncertainty that it is impossible to know which bank-rescue approach is best. Cash infusions can help very quickly, while the asset purchases take longer. But if direct infusions mean toxic assets are left on the banks' books, doubts about the banks' long-term health will remain. Other institutions would then be reluctant to do business with them, and investors would refuse to provide private capital, which ultimately is key to the banks' return to health.

Building a 'Bad Bank'

Also under discussion in Washington is the creation of a "bad bank" to buy the toxic assets. This government-run bank, partly owned by the banks that sell it the assets, would hold those assets, sell them or bundle them into securities for sale to investors. A big question: What should the bad bank pay for those assets if there are no recent sales to show what they are worth? FDIC chairman Sheila C. Bair has said the assets could be purchased at "fair value," which is a price the banks set themselves.

"The idea of setting up a 'bad bank' in which to transfer bad debt may be a good idea," Marston says. But he finds the price dilemma troubling, since paying fair value could cause the government to pay more than it will eventually recover by reselling the assets. "Do we pay market prices for the debt, in which case it does not help the banks? Do we pay above-market prices" and take shares of the banks in exchange?

Under yet another approach, modeled on that used for Citigroup and Bank of America, the government would provide taxpayer-backed insurance against losses in toxic assets that stay on banks' books. But that, too, could leave the public shouldering the banks' losses. Wharton finance professor Franklin Allen argues that the best approach would be "temporary nationalization" of those banks that get public help. That would allow the government to install its own managers, clearing out executives who have presided over so much trouble.

Controlling TARP

"This injection of capital without any [government] control is just not working," says Allen, noting that the banks had not resumed lending after the first TARP infusion. "This [second $350 billion in] TARP money is not going to be used well, and it's going to end up in a black hole. What keeps happening is they give money and then the banks keep coming back for more."

Siegel, too, feels that TARP support should have more strings attached, such as a requirement that banks not call in loans to borrowers who are solvent, creditworthy and up to date on their payments. "I'm not optimistic about this [second half of the] TARP money. Clearly, the first half didn't seem to help."

Obama administration officials also have said they want to use part of the new round of TARP funding --

perhaps as much as $100 billion -- to help homeowners avoid foreclosures. Advocates say this is only fair, since huge sums have gone to rescue corporations, and many argue that stemming foreclosures will help stop the freefall in home prices which has been a major cause of the banks' losses. Hence, attacking the foreclosure problem could lead to more lending by banks, giving the economy the fuel it needs to start growing again.

There are various ways to use government money to put a dent in foreclosures, from providing direct assistance to homeowners to insuring lenders against further losses if they modify loan terms. It is not yet clear what approach the Obama administration favors.

Nor is it a given that reducing the number of foreclosures will have much effect. Allen believes the economic problems are now so widespread that shoring up the housing sector would not help turn things around the way its advocates hope, so that public spending on foreclosures might be wasted. "I think the crisis has moved on from real estate," he says.

Allen and Siegel note that some banks already have expanded programs to renegotiate loan terms to help borrowers stay in their homes. Accepting reduced payments can be less costly for the lenders than foreclosure, especially if there are no buyers for foreclosed properties. J.P. Morgan, for example, recently announced a vastly expanded plan to modify loans on its books as well as those among more than $1 trillion in loans sold to investors.

Too Many Homes

"I think [foreclosures are] a very important problem, but I think it's being worked out by the private sector," Siegel says. The root problem, according to Siegel: There are too many homes and too many were bought at inflated prices. "The price of homes has to fall. There's no way to stop that from happening."

Blume, too, doubts the government can effectively stop the wave of foreclosures. With the economy worsening and unemployment rising, fewer and fewer people can afford the homes they have, and many potential buyers lured by bargain prices can't find banks to give them mortgages. "I have not yet seen a plan to help reduce foreclosures that gets to ... the problem ... that people bought houses they could not afford. If you reduce the interest rate a little bit, they still can't afford them."

He concludes that there may be no alternative but to let the housing market adjust on its own. "Ultimately, all these houses will be off the market," Blume says. "Somebody will buy them and then the market will stabilize."

But there's no telling, he adds, how long that will take, or how far home prices will have to fall.