THE ECONOMICS OF THE GEITHNER PLANS

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Background

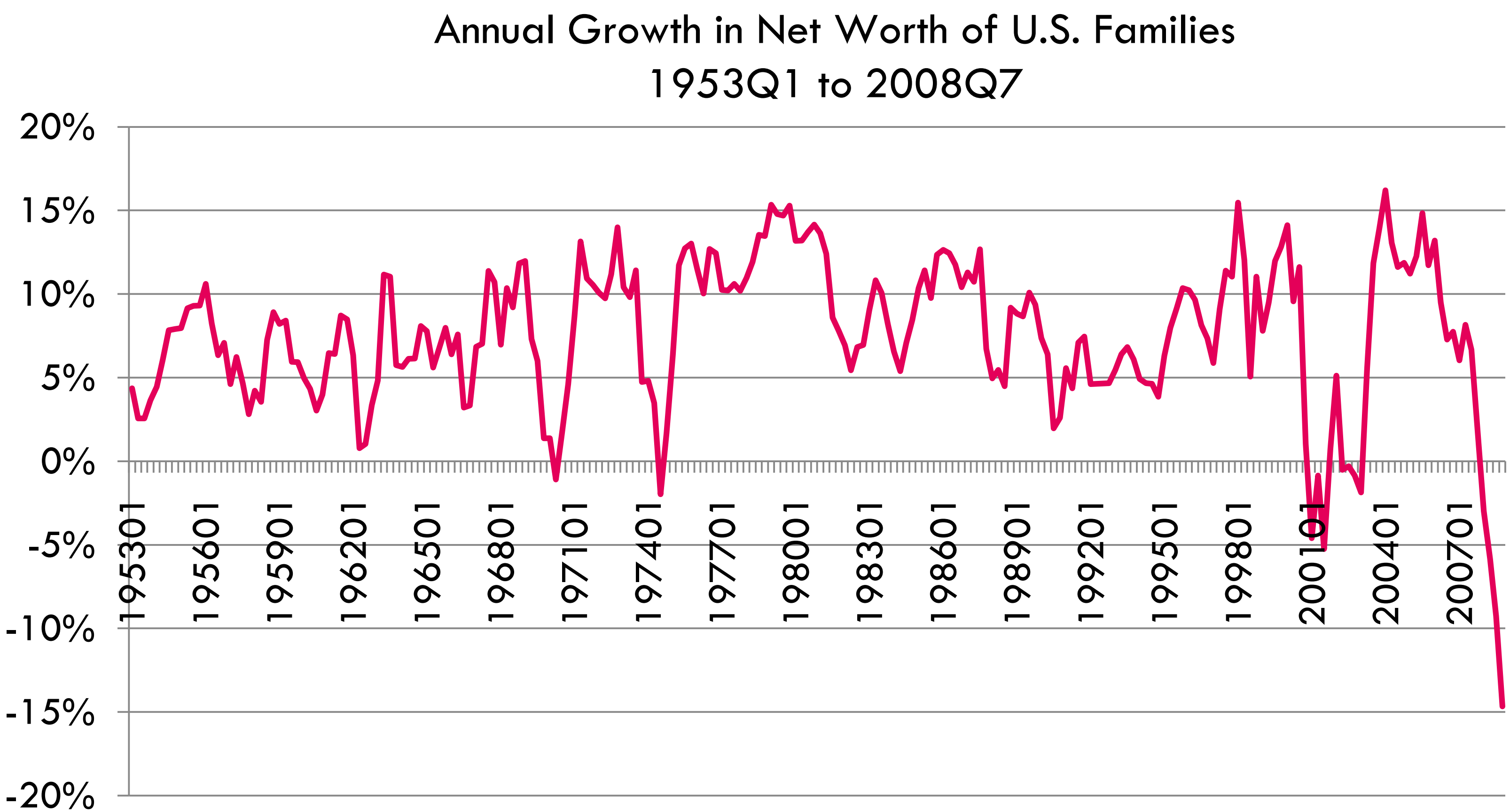
- Collapsing bubbles make us less trustworthy
  - Why? Net worth falls
  - Net Worth = Assets – Liabilities

Assets: What you own (stocks, bonds, homes)

Liabilities: What you owe (loans, mortgages)

- With high net worth, everyone wants to lend to you
  - Liquidity: There when you don't need it.

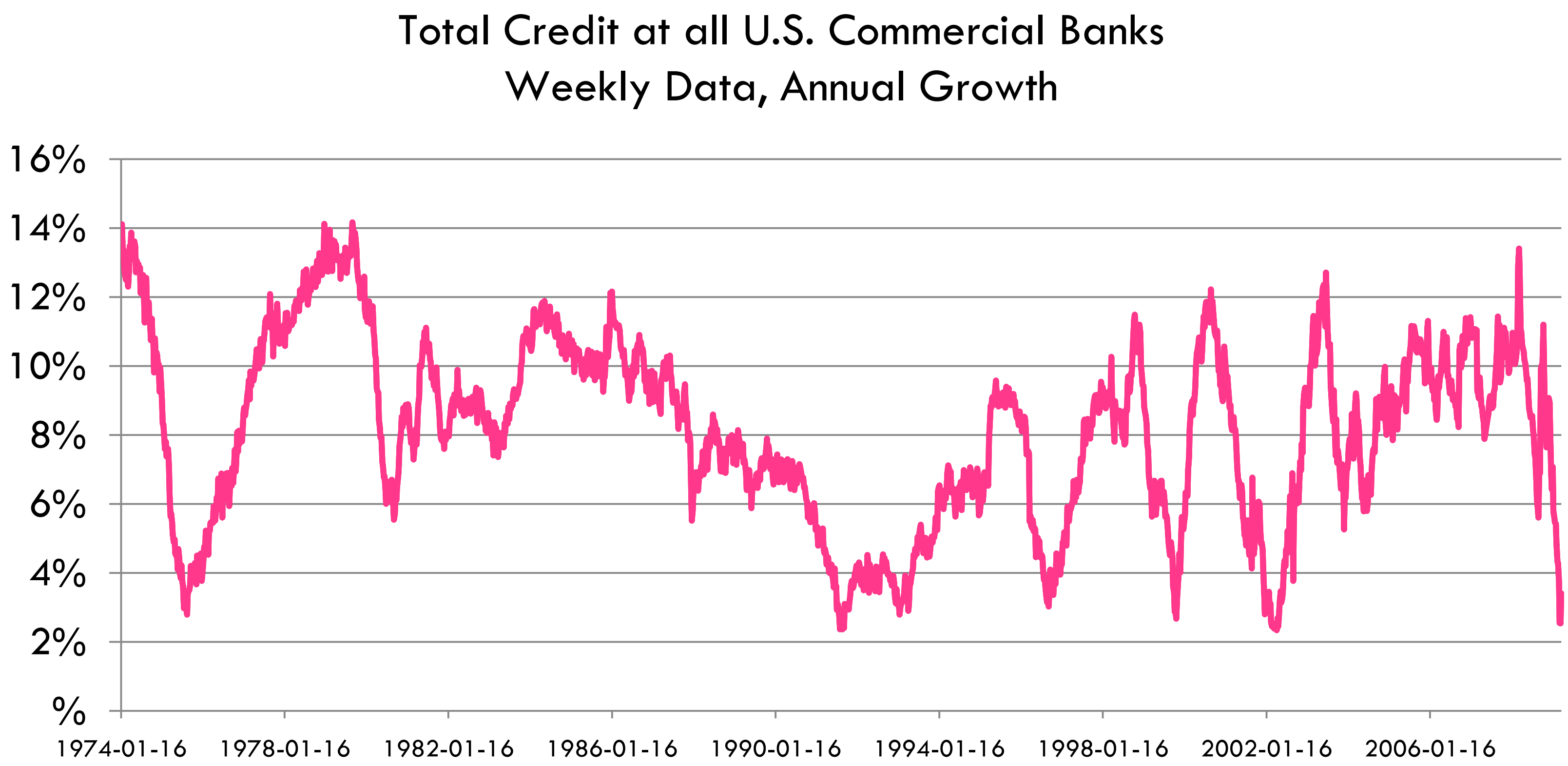
Less net worth→Less trust→Less credit



(See why banks are reluctant to lend and refi?)

Source: Federal Reserve flow of funds accounts

Yet banks are still lending (a little) more—for now



Source: St. Louis Fed

Fixing the Financial System: Secretary Geithner's twin plans

- Plan 1: Overpay for assets
  - Toxic/Legacy assets, Securitized student/consumer/auto loans
  - Popular, if you're getting bought out: Good TV coverage
  - Will this redistribution yield big positive spillovers?

- Plan 2: Create a new regulatory structure
  - Give FDIC/Fed/Treasury power to impose "speed bankruptcy"
  - Give FDIC/Fed/Treasury power to guarantee private-sector debts on short notice
  - Give FDIC and Treasury power to lend aggressively to weak firms
  - Will this power be used judiciously (Art. III) or politically (I and II)?

Plan 1: Overpay for risky assets

- BIG Caveat: “Overpay” means “pay more than the private sector will pay right now”
  - If private sector is too pessimistic>>Taxpayers benefit
  - If private sector is correctly pessimistic>>Funds lose $

Doing Plan 1, Part 1: PPIP

From a proponent, Brad DeLong:

Clinton Treasury DAS, Berkeley professor, student of Larry Summers, blogger of some fame: delong.typepad.com

Q: What is the Geithner Plan?

A: The Geithner Plan is a trillion-dollar operation by which the U.S. acts as the world's largest hedge fund investor….

Q: Where does the trillion dollars come from?

A: $150 billion comes from TARP (equity)

$820 billion from the FDIC (debt)

$30 billion from the hedge fund and pension fund managers who…run the program.

How PPIP could work (version 1 of 2)

1. Market is now irrationally pessimistic about value of mortgage-backed securities
2. Highly-leveraged PPIP pays about the right price
    1. Perhaps because PPIP leverage just balances out market irrationality?
3. Banks sell toxic/legacy MBS, bank net worth rises
4. Healthy banks make healthy loans, get healthy levels of depositors and bond investors, things get better
5. Someday, market wises up, wants to pay lots for toxic MBS
6. Taxpayers profit

How PPIP could work (version 2 of 2)

1. Market is now ***correctly*** pessimistic about value of mortgage-backed securities
2. Highly-leveraged PPIP overpays for MBS
    1. Because private-sector investors don't worry about the downside: It's (almost) a call option.
3. Banks sell toxic/legacy MBS, bank net worth rises
4. Healthy banks make healthy loans, get healthy levels of depositors and bond investors, things get better
5. Because of better economy, toxic/legacy MBS ***become*** a better investment
6. Taxpayers profit

What v.1 and v.2 have in common

- The government holds $1 trillion of risky assets for years and years, so private banks don't have to.
- Private sector banks can focus on:
  - Searching for new customers
  - Checking credit worthiness of "normal" business opportunities
  - Building good relations with borrowers and lenders
- Treasury's implicit advice:

  Banks should "stick to their knitting." *(based on Bernanke's research)*

What *else* they have in common

- 97% "non-recourse" federal funding for investors

  Heads I win 50¢, tails I lose 3¢

  - Prediction: Private investors will flip the coin a lot of times.
  - They could overpay a *lot*--killing taxpayer upside.

*But: Could be worth it for taxpayers as **citizens**, not **investors***

-Higher GDP

-Lower unemployment and welfare payments.

Current Administration TARP assumption: We lose 1/3 in long run.

-Would you take that deal?

What about the other FSP lending program?

- The reverse of PPIP:

  Buy the safest consumer, student, and auto loans

- Possible reasons:
  1. "Jump Start" securitization again (a weak metaphor)
  2. Prevent private sector from holding these ultra-safe assets to nudge other investors to take "normal" levels of risk
- Funding: 1 Treasury dollar = 9 Federal Reserve dollars
  - Hard for Fed to unwind when economy picks up?

Plan 2: Regulatory Reform

- Goal: Create an FDIC for non-bank banks.

  Example: WaMu went from troubled to safe in 24 hours
  - Big WaMu losers: Bondholders
    - Shareholders already lost their shirts
    - FDIC didn't spent a dime

- Q: Why no 24-hour turnaround for AIG? Or Lehman?

  A: FDIC "speed bankruptcy" exists for banks, but not them.
  - Judicial bankruptcy: Supposedly slow
    - But Lehman sold in days
  - Derivatives contracts a huge legal problem in bankruptcy (Zingales)
    - But despite doomsayers, Lehman didn't set off swap crisis
    - Big spike in risk/Plummet in markets:
      - Day of Paulson testimony (9/23), not day of Lehman failure (John Taylor, *Getting Off Track*)

Corporate finance in 1 lesson

Recall: Net worth = Assets – Liabilities = Own - Owe

If net worth >> 0, you're popular

Bankrupt = Net worth < 0

Two ways out of bankruptcy:

1. Government provides assets (TARP), gets flexible shares.
2. Government declares some (bond) liabilities null and void: Usually converts them to flexible common shares (the normal thing). ***A consolation prize with upside.***

Analogy: Your weak bank converts your deposits into bank shares.

Citi: Most likely to speed-bankrupted?

Epilogue: Even if we fix the banks…