

Paul Krugman

Financial policy despair

Over the weekend newspapers reported leaked details about the Obama administration's bank rescue plan, which is to be officially released this week.

If the reports are correct, Tim Geithner, the Treasury secretary, has persuaded President Obama to recycle Bush administration policy — specifically, the “cash for trash” plan proposed, then abandoned, six months ago by then-Treasury Secretary Henry Paulson.

This is more than disappointing. In fact, it fills me with a sense of despair.

After all, we've just been through the firestorm over the A.I.G. bonuses, during which administration officials claimed that they knew nothing, couldn't do anything, and anyway it was someone else's fault.

Meanwhile, the administration has failed to quell the public's doubts about what banks are doing with taxpayer money.

And now Mr. Obama has apparently settled on a financial plan that, in essence, assumes that banks are fundamentally sound and that bankers know what they're doing.

It's as if the president were determined to confirm the growing perception that he and his economic team are out of touch, that their economic vision is clouded by excessively close ties to Wall Street. And by the time Mr. Obama realizes that he needs to change course, his political capital may be gone.

Let's talk for a moment about the economics of the situation.

Right now, our economy is being dragged down by our dysfunctional financial system, which has been crippled by huge losses on mortgage-backed securities and other assets.

As economic historians can tell you, this is an old

story, not that different from dozens of similar crises over the centuries. And there's a time-honored procedure for dealing with the aftermath of widespread financial failure. It goes like this: The government secures confidence in the system by guaranteeing many (though not necessarily all) bank debts. At the same time, it takes temporary control of truly insolvent banks, in order to clean up their books.

That's what Sweden did in the early 1990's. It's also what we Americans did after the savings and loan debacle of the Reagan years. And there's no reason we can't do the same thing now.

But the Obama administration, like the Bush administration, apparently wants an easier way out. The common element to the Paulson and Geithner plans is the insistence that the bad assets on banks' books are really worth much, much more than anyone is currently willing to pay for them. In fact, their true value is so high that if they were properly priced, banks wouldn't be in trouble.

And so the plan is to use taxpayer funds to drive the prices of bad assets up to “fair” levels. Mr. Paulson proposed having the government buy the assets directly. Mr. Geithner instead proposes a complicated scheme in which the government lends money to private investors, who then use the money to buy the stuff. The idea, says Mr. Obama's top economic adviser, is to use “the expertise of the market” to set the value of toxic assets.

But the Geithner scheme would offer a one-way bet: If asset values go up, the investors profit, but if they go down, the investors can walk away from their

debt. So this isn't really about letting markets work. It's just an indirect, disguised way to subsidize purchases of bad assets.

The likely cost to taxpayers aside, there's something strange going on here. By my count, this is the third time Obama administration officials have floated a scheme that is essentially a rehash of the Paulson plan, each time adding a new set of bells and whistles and claiming that they're doing something completely different. This is starting to look obsessive.

But the real problem with this plan is that it won't work. Yes, troubled assets may be somewhat undervalued. But the fact is that financial executives literally bet their banks on the belief that there was no housing bubble, and the related belief that unprecedented levels of household debt were no problem.

They lost that bet. And no amount of financial hocus-pocus

— for that is what the Geithner plan amounts to — will change that fact.

You might say, why not try the plan and see what happens? One answer is that time is wasting: Every month that we fail to come to grips with the economic crisis another 600,000 jobs are lost.

Even more important, however, is the way Mr. Obama is squandering his credibility. If this plan fails — as it almost surely will — it's unlikely that he'll be able to persuade Congress to come up with more funds to do what he should have done in the first place.

All is not lost: The public wants Mr. Obama to succeed, which means that he can still rescue his bank rescue plan. But time is running out.

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