

It's 1929, Not 1985

By John Tuccillo, PhD

I've been trying to decide whether the current financial meltdown is like 1929, when numerous banks failed and the rest were reluctant to lend, leading to a sharp and prolonged economic slowdown, or like 1985 when a subclass of institutions, savings and loans, failed because of reckless (and in many cases criminal) behavior. The difference between the two will determine the proper policy path. On balance, I think this is 1929.

The big issue we have to address right now is the impact of tightening credit on the economy as a whole. I think that really is the big threat. There is a significant capital crisis in the financial sector. Bad loans and assets have forced companies to write down their capital. As they write down their capital, they don't have the capacity to expand their provision of funds to support economic growth. And that will affect the real economy and spreads the financial crisis to the entire economy. In that sense, this is like 1929.

But the immediate causes were the misunderstanding of risk by consumers and the misportraying of risk on the part of securities issuers. Consumers thought the housing boom would continue indefinitely, so they failed to integrate the possibility of price declines into their calculations. Creators of exotic securities misled their buyers into thinking that these were less risky than they actually were. In that sense, the crisis (although large) is limited in scope, as it was in 1985.

The question is how do you solve this? If you think it's 1929, you look to infuse capital into financial institutions so that they can resume their lending activities. Warren Buffett looks at it this way and so invested \$5 billion into Goldman Sachs. The FDIC looks at it this way and so arranged for the purchase of Washington Mutual Savings Bank. What they have done is say, 'Let's take an ailing institution and hook it up with an institution that has a strong capital base.' In Warren Buffet's case, 'Let's increase the capital base. Let's invest directly in the financial institutions. And then let the market sort out all the problems.'

Now that's not going to help people who have foreclosed properties or are in danger of having foreclosed properties. But by the same token, it is going to keep the financial system sound and functioning. This will isolate the financial crisis from affecting the greater economy. People who have suffered the foreclosure of their houses are in trouble and we might want to think about some way to help them. But we don't want to generate an economic downturn that will hurt everybody else.

Treasury Secretary Paulson's plan treats the current situation like the savings and loan crisis. In that case, what we need to do is have the government step in as an intermediary and buy bad assets at face value and sell them off at market value. In other words, say, 'Look, we're not going to absorb the whole hit, we're going to absorb

the difference between face value and market value. And I know there are people out there who will buy these things at market value, betting that they will come back to market and they will make a lot of money, just like people did during the savings and loan crisis. Granted, the proposal is still vague. The details aren't spelled out and there's a lot of discretion for the Secretary. But essentially, the lines of that proposal are very close to the solution we used in the savings and loan crisis.

The Democrats in Congress are introducing another aspect into this by saying, 'We have to do something for the consumers who are losing their houses.' They want the government to go through and selectively buy loans that have gone bad so that people can retain their houses. That is a complicated solution because it puts the government in the business of actually being a bank, as opposed to investing in a bank.

The bottom line here is that we have mechanisms that will allow banks to recapitalize without costing the tax payers any money. The FDIC is a marvelous vehicle for matching up institutions that are strapped with those who still have capital. With a stronger banking system, the market can then sort out what to do with the bad assets.

As far as consumers and businesses are concerned, there are sources of credit out there, but they require a search. Small community banks, the independent banks that are left, are well capitalized, and are not terribly hit by the foreclosure problem. They are going to be good sources of credit. Unfortunately, there are not enough of them, and they are not big enough in volume to keep this whole engine going. You really do need the big boys to weigh in.