Federal Reserve Bank *of* Atlanta

MACROBLOG

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Time out

I am often amazed by the ability of folks to speak with absolute certainty on subjects that are defined by absolute uncertainty. Here is what we know, as of the moment on Tuesday afternoon when I am writing this, about U.S. Treasury Secretary Paulson's proposal to obtain authority to purchase troubled assets: A request has been made for Congress to authorize up to $700 billion (with automatic adjustments to the national debt ceiling) for the purpose of purchasing distressed assets from US financial institutions. Here's what we don't know: Almost every other relevant detail.

Though a possible version of a possible House bill has been drafted, the final details remain a conjecture. Even more uncertain is the ultimate impact once the program is implemented. I think Tom Maguire nails it:

> Suppose Merrill Lynch (to pick a name at random) has marked its sludge down to 50 percent of face value. Let's further suppose that with perfect foresight investors could see that this is the "right" price in the sense that over the life of the assets Merrill will receive that amount in present value, risk adjusted terms.
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> Does this mean that Merrill's financial statements are reliable and lenders will lend to them? Not in the current environment . . .
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> Lacking perfect foresight, investors have no idea whether 50 cents on the dollar is fair but even if they suspected it was they also have an excellent idea that lightning could strike and Merrill could go bust tomorrow, which means they won't lend to Merrill today. Or, if the idea of a lightning strike seems too abstract, investors might believe that, although 50 cents is the mean expected value of the assets in question there is a high enough probability that they will ultimately be worth 25 cents that a loan to Merrill is too risky.
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> However, if Merrill sells those assets at 50 cents, they have not received a subsidy but they have removed a major source of volatility from their financial statement - there is no possibility that Merrill will later mark those assets down to 25 cents because they have been sold. Of course, they will never mark them to 75 and book a profit, but lenders were hardly worried about that . . . So why doesn't Merrill and everyone else sell their troubled assets and move on? Well, sell them to whom? Merrill did sell some of this stuff but the collectively the financial firms simply have too much to move. Hence, there is a role for the government as a patient, well-capitalized investor of last resort—it is *possible* that the government can break even or make money on these assets if the purchase price is fair. Obviously, it is also possible that the government will get stuffed with the worst of the worst at inflated prices, or that the government will consider it its patriotic duty to pay inflated prices in order to quietly re-capitalize some of these firms. But this bail-out can be effective without assuming that to be the case.

In other words, the devil may be in the details, but might be a good idea to see some of those details before judging the final product.

The second line of discussion that I think deserves a time-out is the pronouncements of all sorts regarding the ultimate cost of the plan to U.S. taxpayers. Many others have focused on the analogy to the Resolution Trust Corporation — or lack thereof — but let's revisit the facts one more time. This is from a 2000 analysis by FDIC economists Timothy Curry and Lynn Shibut:

> In response to the deepening [savings and loan] crisis, Congress enacted FIRREA on August 9, 1989, beginning the taxpayers' involvement in the resolution of the problem… FIRREA also created the RTC to resolve virtually all troubled thrifts placed into conservatorships or receiverships between January 1, 1989, and August 8, 1992. Because of the continuing thrift crisis, however, the RTC's authorization to take over insolvent institutions was twice extended, the second time to June 30, 1995 . . .
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> FIRREA provided the RTC with $50 billion to resolve failed institutions… Because the $50 billion in initial funding was insufficient to deal with the scope of the problem, Congress enacted subsequent legislation three times, raising total authorized RTC funding for losses to $105 billion between 1989 and 1995.
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> Before, during, and even after the RTC's lifetime, estimates of the costs of the crisis created widespread confusion. Federal agencies, politicians, thrift industry experts, and others put forth myriad estimates on what was called the size of the problem. These forecasts often diverged widely and changed frequently in response to surging industry losses . . . Reflecting the increased number of failures and costs per failure, the official Treasury and RTC projections of the cost of the RTC resolutions rose from $50 billion in August 1989 to a range of $100 billion to $160 billion at the height of the crisis peak in June 1991, a range two to three times as high as the original $50 billion.
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> As of December 31, 1999, the RTC losses for resolving the 747 failed thrifts taken over between January 1, 1989, and June 30, 1995, amounted to an estimated $82.7 billion, of which the public sector accounted for $75.6 billion…

You can either be concerned by the fact that the RTC workout cost more than originally projected, or take comfort in the fact that the costs did not even approach the worst-case scenarios. It is certainly true that in any case taxpayers are being asked, via their duly elective representatives, to take on large risks. But, as Secretary Paulson and Chairman Bernanke emphasized today, risk is not avoided by doing nothing.

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