Help the System Unwind Its Toxic Assets But Develop the Exit Strategy

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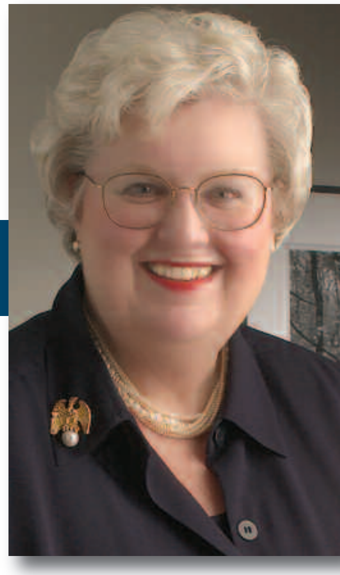

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The new Secretary of the Treasury will be facing perhaps the worst financial crisis since the Great Depression. The current financial team (Treasury, Fed, FDIC, FHFA and SEC) have been busy addressing the unfolding crisis with a series of innovative initiatives that largely are designed to try to contain the crisis first on Wall Street and now more generally to the banking and finance system. The hope is to keep the banking system solvent so that there can be a continuation of financial services to the real economy. Without access to credit, investors and businesses are likely to pull back –that is, from spending, investing and creating jobs. This is the so-called "gridlock," which can start the proverbial "downward spiral" of the real economy.

Our experience with financial crises indicates that if the financial intermediaries are no longer functioning and providing credit, or worse, sliding into bankruptcy, the damage to the entire economy will be greater. It is well worth our effort and resources to focus on recapitalizing the financial sector first, so that it does not have to be rebuilt before shoring up the rest of the economy. Rebuilding the banking system would certainly prolong the pain. But even if these early, first-stage recapitalization efforts bear fruit, there will still be many longer term problems for the new Secretary of the Treasury and financial team to address. The current team has made a good start and gotten legislation passed with funding ($700 b) to repair the longer term economic problems. That process is now only beginning. I agree with the recent decision to focus on financial intermediary recapitalization and not assume responsibility for various toxic assets. I also hope that the TARP resources are not used to bail out specific industries, but rather leave that to the politicians or the private sector to sort out.

What does need to be done? What went wrong? There are plenty to blame—the mortgage brokers, securitization gone wrong, credit rating agencies, bad credit and risk management decisions by some financial institutions and the GSEs and inadequate regulation and supervision. Not everything is broken and I hope the new team will take the time to examine what worked and what did not work before we rush to judgment and action. Merging federal agencies or passing new laws or regulations too quickly may have unintended consequences or even make things worse. Unless the enabling legislation of agencies scheduled to be merged is reviewed and modified, the resulting merger will likely fail, causing market participant confusion and even more gridlock. When addressing regulatory changes, I hope we can focus not on just more or less regulation, but instead trying to get the right regulation in place.

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Constructive discussion is starting to surface about various agency combinations and permutations where like functions are grouped together. Whatever happens, hopefully some of the regulatory "holes" can be plugged.

As the financial crisis gets debated in the coming months, the focus should move from the subprime mortgage market, which was really the fuse igniting the huge deleveraging and re-pricing of risk throughout the financial system. As the subprime mortgage problem began to play out, financial institutions started re-examining their on-and-off-balance-sheet portfolios in light of a changed world – one subject to energy vulnerability, bad mortgage sales practices, new risk instruments and systems not fully understood such as derivatives and hedging strategies, increased worldwide liquidity and an uncertain inflation outlook. Rising worldwide demand has put pressure on commodity prices, now being fed through as final price inflation. But as demand slows, the inflation risk may abate and if the economy continues to worsen, may turn to deflation risk. The asset revaluation process is underway, but far from over.

Before the housing bubble burst, we seemed to think that the Fed and other counter-cyclical federal policies could control and smooth out business cycles. After all we came through the bursting of the tech bubble with only a mild recession and the financial system felt few effects of the burst bubble. Moreover, we survived Long Term Capital, Y2K, 9-11, and corporate scandals without too much economic damage. This all contributed to a sense of lower, and thus undervalued, risk. The write-down of assets, and this wealth, will continue until the markets clear.

The new Treasury Secretary and financial team will have a large role to try to jumpstart the economy, clean up the supervision and regulation gaps, encourage improved transparency and clearance systems and figure out what to do with the GSEs. But these actions alone will not grow the economy. At some point, government will have to get out of the way and it is not too soon to be thinking about exit strategy. It is only when individuals and businesses see stability return to housing prices, the stock market, and other commodity and asset markets that they will return to spend, invest and thereby start job creation. If the banking system is recapitalized, there may even be the proper incentives for the banks themselves to unwind their toxic assets, eventually returning the focus to stability, safety and soundness.

I hope the new financial team will recognize not only the power of government, but also its limitations. Market participants need time to unwind their leverage, heal and regain the confidence to rebuild. If the rules keep changing everyday and the regulatory environment looks like it is in chaos, investors and consumers will stay on the sidelines. The transition to a new financial team provides the opportunity to reassess and regroup. I wish them the very best.