Nationalise the Banks

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> The U.S. banking system is close to being insolvent, and unless we want to become like Japan in the 1990s -- or the United States in the 1930s -- the only way to save it is to nationalize it.
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> As free-market economists teaching at a business school in the heart of the world's financial capital, we feel downright blasphemous proposing an all-out government takeover of the banking system. But the U.S. financial system has reached such a dangerous tipping point that little choice remains. And while Treasury Secretary Timothy Geithner's recent plan to save it has many of the right elements, it's basically too late.

The subprime mortgage mess alone does not force our hand; the $1.2 trillion it involves is just the beginning of the problem. Another $7 trillion -- including commercial real estate loans, consumer credit-card debt and high-yield bonds and leveraged loans -- is at risk of losing much of its value. Then there are trillions more in high-grade corporate bonds and loans and jumbo prime mortgages, whose worth will also drop precipitously as the recession deepens and more firms and households default on their loans and mortgages.

Last year we predicted that losses by U.S. financial institutions would hit $1 trillion and possibly go as high as $2 trillion. We were accused of exaggerating. But since then, write-downs by U.S. banks have passed the $1 trillion mark, and now institutions such as the International Monetary Fund and Goldman Sachs predict losses of more than $2 trillion.

But if you think that $2 trillion is high, consider our latest estimates at the financial Web site RGE Monitor: They suggest that total losses on loans made by U.S. banks and the fall in the market value of the assets they are holding will reach about $3.6 trillion. The U.S. banking sector is exposed to half that figure, or $1.8 trillion. Even with the original federal bailout funds from last fall, the capital backing the banks' assets was only $1.4 trillion, leaving the U.S. banking system about $400 billion in the hole.

Two important parts of Geithner's plan are "stress testing" banks by poring over their books to separate viable institutions from bankrupt ones and establishing an investment fund with private and public money to purchase bad assets. These are necessary steps toward a healthy financial sector.

But unfortunately, the plan won't solve our financial woes, because it assumes that the system is solvent. If implemented fairly for current taxpayers (i.e., no more freebies in the form of underpriced equity, preferred shares, loan guarantees or insurance on assets), it will just confirm how bad things really are.

Nationalization is the only option that would permit us to solve the problem of toxic assets in an orderly fashion and finally allow lending to resume. Of course, the economy would still stink, but the death spiral we are in would end.

Nationalization -- call it "receivership" if that sounds more palatable -- won't be easy, but here is a set of principles for the government to go by:

First -- and this is by far the toughest step -- determine which banks are insolvent. Geithner's stress test would be helpful here. The government should start with the big banks that have outside debt, and it should determine which are solvent and which aren't in one fell swoop, to avoid panic. Otherwise, bringing down one big bank will start an immediate run on the equity and long-term debt of the others. It will be a rough ride, but the regulators must stay strong.

Second, immediately nationalize insolvent institutions. The equity holders will be wiped out, and long-term debt holders will have claims only after the depositors and other short-term creditors are paid off.

Third, once an institution is taken over, separate its assets into good ones and bad ones. The bad assets would be valued at current (albeit depressed) values. Again, as in Geithner's plan, private capital could purchase a fraction of those bad assets. As for the good assets, they would go private again, either through an IPO or a sale to a strategic buyer.

The proceeds from both these bad and good assets would first go to depositors and then to debt-holders, with some possible sharing with the government to cover administrative costs. If the depositors are paid off in full, then the government actually breaks even.

Fourth, merge all the remaining bad assets into one enterprise. The assets could be held to maturity or eventually sold off with the gains and risks accruing to the taxpayers.

The eventual outcome would be a healthy financial system with many new banks capitalized by good assets. Insolvent, too-big-to-fail banks would be broken up into smaller pieces less likely to threaten the whole financial system. Regulatory reforms would also be instituted to reduce the chances of costly future crises.

Nationalizing banks is not without precedent. In 1992, the Swedish government took over its insolvent banks, cleaned them up and reprivatized them. Obviously, the Swedish system was much smaller than the U.S. system. Moreover, some of the current U.S. financial institutions are significantly larger and more complex, making analysis difficult. And today's global capital markets make gaming the system easier than in 1992. But we believe that, if applied correctly, the Swedish solution will work here.

Sweden's restructuring agency was not an out-of-control bureaucracy; it delegated all the details of the cleanup to private bankers and managers hired by the government. The process was remarkably smooth.

Basically, we're all Swedes now. We have used all our bullets, and the boogeyman is still coming. Let's pull out the bazooka and be done with it.

http://www.washingtonpost.com/wp-dyn/content/article/2009/02/12/AR2009021201602.html

Cleaves Alternative News. http://cleaves.lingama.net/news/story-1443.html