

Low-Tech Archive of The Baseline Scenario for September 2008

Known problems:

- Block quotes are not indented, so they don't look like quotations.
- Some media may not appear properly.

[The Paulson Bailout and Governance](#)

Watch Your Wallet

Ordinarily, you would not hand \$100 to your broker to invest on your behalf without some idea of how he or she would invest your money. You would be even less likely to hand over your cash to someone planning to invest it in illiquid assets with no established market prices. However, the original version of the government bailout plan, released on Thursday last week, handed \$700 billion of taxpayer money to Treasury to invest in mortgage-backed securities at any price it saw fit.

Our [Washington Post](#) op-ed article discusses this governance question and floats a few possible solutions that could align incentives properly and promote transparency. At the same time, opposition from both sides of the aisle on Capitol Hill has greatly increased the chances that some form of improved governance will be included in the final plan. In following the ongoing debate, however, it will be important to make sure that there are adequate mechanisms for setting prices objectively and transparently, or else the opportunity for abuse will remain.

Written by James Kwak [Edit](#)

September 23, 2008 at 7:57 pm

Posted in [Op-ed](#)

Tagged with [Global Crisis](#), [governance](#)

[It's All About the Price](#)

The debate on what the Treasury should or will pay for mortgage-backed securities has moved fast in the last week. Last week, Mr Paulson said it would be “market prices.” On Tuesday, Mr Bernanke said it would be “close to mark-to-model prices,” which you can presume would be

above, and perhaps substantially above market prices. Since then, Mr Bernanke seemed to back track from that statement, towards some version of market prices.

But what are market prices or any other prices in this situation? You need to answer this question to know whether the Treasury is intending to overpay — or whether, after the fact, you can figure out if they did in some meaningful sense overpay.

We attempted to sort this out in [The Price of Salvation](#) on the Financial Times website (Economist Forum). It's hard to say if any of this is getting through, but we are a little bit encouraged by the reaction.

Written by Simon Johnson [Edit](#)

September 24, 2008 at 8:46 pm

Posted in [Op-ed](#)

Tagged with [Global Crisis](#), [pricing](#)

[There Is No Alternative. Really?](#)

This morning (September 25, 10am) I was on the [Diane Rehm show, on WAMU](#). The guest host, Frank Sesno, did a great job of moving the conversation from today's White House Summit on the bailout plan to the likely impact on the global economy, with relevant stops along the way. We spent a great deal of time on alternatives.

It turns out, of course, that there are alternatives to the current bailout plan — even if you agree that there is a serious problem and we need to move fast. In fact, perhaps the one thing all three guests could agree on is the availability of workable alternatives.

I was really struck by Ken Rogoff's points about the need to take over and close down many banks. I think he puts more weight on that part of any sensible approach than I do at present, but I'm definitely taking his points on board.

The more I talk with people, the more I hear agreement that we really need to address the problems of homeowners who are having trouble with their mortgages. It's actual and expected defaults that got us into this mess, and attacking that issue directly is the best way to make sure we really get out.

Think of it like this. The Treasury wants to use its balance sheet (i.e., it's ability to borrow at low interest rates) to help the banking system get back on its feet. If a substantial amount of taxpayer money is on the table, which it apparently is, let's talk more about how to use the Treasury balance sheet to help homeowners get back on their feet.

Written by Simon Johnson [Edit](#)

September 25, 2008 at 9:04 pm

Posted in [Interviews](#)

Tagged with [alternative strategies](#), [Global Crisis](#)

[The Feldstein Proposal](#)

There's a resurgence of interest in the proposal originally made by Marty Feldstein. The link to his recent Financial Times [piece is here](#). He wants the Treasury to borrow and on-lend to homeowners, in a way that would improve their cash flow and make it easier for them to avoid defaulting on mortgages. Of course, anyone who participates would reduce their mortgage (a claim on their house) but create a debt to the government (to be collected, if necessary, by the IRS.)

I must say that I find this broadly appealing, in the moment we now find ourselves. I know it doesn't address mortgages already in default, and there are many questions about how it could be implemented. And I agree that Congress, at this juncture, would need a lot of convincing.

Still, it's one way to use the Treasury balance sheet to directly reduce likely mortgage defaults. And, if it's part of a comprehensive approach (including recapitalizing banks), I think this general approach could make sense.

I hope others will post reactions, or links to any variants with plausible details.

Written by Simon Johnson [Edit](#)

September 26, 2008 at 12:41 pm

Posted in [External perspectives](#)

Tagged with [Alternatives](#), [mortgages](#)

Bailout Plan - The House Republican Alternative

And Now, Behind Door #2 ...

Whatever the motivations of the [House Republican plan](#) - as distinct from the plan agreed upon by the Republican President, Republican Treasury Secretary, Republican Fed Chairman, Senate Republican leadership, and Democratic leadership of both houses - it is still a plan, and as such merits consideration. The “Common Sense Plan to Have Wall Street Fund the Recovery, Not Taxpayers” has two main elements: first, a Treasury Department insurance program for mortgage-backed securities that will be entirely financed by premiums collected from the holders of those securities, not taxpayers; and a combination of tax breaks and deregulation intended to attract private capital to the banking sector.

The insurance proposal amounts to more of the wishful thinking that has allowed the financial crisis to last as long as it has. Such a proposal would only work if the fundamental problem were an inability to distribute risk, and if there were no available insurance mechanisms. But the fundamental problem is not that banks can't distribute the risk of deteriorating assets, but that they are holding assets that are already not worth very much, and therefore the insurance premiums for those securities would be prohibitive. (Instead of paying by writing down the assets, they would have to pay insurance premiums.) And there are insurance mechanisms already (remember credit-default swaps?), but that insurance is too expensive to buy. The only way a Treasury insurance program could change things is by offering insurance at artificially low premiums, which is just another way of handing taxpayer money to banks - with no recompense to shareholders.

The proposal to attract private capital to the industry is too little, too late. Washington Mutual, for example, was unable to find a buyer until the government used a forced bankruptcy to wipe out \$28 billion of its debt; no one is lining up to offer capital to Wachovia. It is hard to see how offering tax breaks to banks (which is yet another way of handing taxpayer money to banks) will encourage new capital investment, at least as long as their mortgage-related assets remain under a cloud of uncertainty.

Given that few people want to lend to or invest in banks these days, it's hard to see how a solution is possible without taxpayer money. The important thing is to make sure that the taxpayers get something in exchange for their money.

Update: [Politico](#) has a survey of economists' reactions to the House Republican plan. The short version: economists were concerned by the original Paulson plan, but baffled by the House Republican plan.

Written by James Kwak [Edit](#)

September 26, 2008 at 5:49 pm

Posted in [Commentary](#)

Tagged with [insurance](#)

[The Death of Washington Mutual](#)

Poor Washington Mutual ... on any other day, its government-brokered takeover by JPMorgan Chase would have been the lead story, as opposed to Henry Paulson begging Nancy Pelosi on bended knee to save his bailout plan. At first glance, the purchase raises a glimmer of hope: is it really as simple as having the healthy banks buy up the unhealthy banks? But there is still a clear loser here, besides WaMu's shareholders, who must have seen this coming: anyone holding non-secured debt is [not covered](#) by the transaction, since that liability remains with the WaMu holding company and was not transferred to JPMorgan along with the assets and the banking operations. According to [Bloomberg](#), WaMu had \$28.4 billion in outstanding bonds, which have just gone up (mostly) in smoke, triggering an unknown volume of credit-default swaps. (Remember AIG? Those are now the taxpayers' credit-default swaps).

The transaction raises another worrying issue. Before yesterday, Washington Mutual had taken \$19 billion in losses on mortgage loans. In the acquisition, JPMorgan acquired \$176 billion in mortgage-related assets and immediately wrote them down by \$31 billion, or 18%. This seems to be more evidence that some banks have these assets on their books at inflated prices, which is the problem that everyone is working so hard to solve.

Written by James Kwak [Edit](#)

September 26, 2008 at 9:56 pm

Posted in [Commentary](#)

[Plan A, Plan B](#)

We've been getting quite a few questions about our views on the big picture. Let me try to set this out clearly, in terms of where we are (September 27, 2008, early Saturday morning) and where we are heading.

Let's call the \$700bn package currently under discussion Plan A. Despite the roadblock thrown up by the House Republicans, we think some form of this plan will pass Congress soon, and so it should. The situation in the financial system is serious and inaction would be a recipe for disaster, especially now that the government has created the expectation of action. We are also of the view that the package could have been better designed (e.g., we emphasized governance and transparency in the articles posted here). And we are encouraged that its design has improved this week, at least in the draft agreement of Thursday afternoon.

Plan A is obviously not comprehensive, and again we've covered the two main missing issues (a direct approach to defaulting mortgages and deficient bank capital) here and in various other on-the-record remarks. (We'll post more of these to help complete the picture regarding our views.)

If Plan A comes out of Congress in reasonable shape, as seems likely, we will support it. We need it to work. But we also need to start discussing what would have to be done if Plan A does not work, or if the cracks now visible in the global financial system continue to widen.

Yes, we need a Plan B. Even if the odds of success for Plan A are high (ask us again on Monday about that), it makes sense to plan for contingencies. And we really don't want to repeat the experience of this week, in which the initial proposal is weak and has to catch up with economic and political realities in a hurry.

And it strikes us that the discussion on Plan B needs to be public, in places like this. This does not undermine Plan A, in our view, because Plan B will not be so difficult. It will not be business (lobbies) as usual, but it will be doable. Our submission, longer than 2 1/2 pages, will be up here by 9am Monday, Washington time, at the latest.

Written by Simon Johnson [Edit](#)

September 27, 2008 at 6:45 am

Posted in [Commentary](#)

Tagged with [Alternatives](#)

[Henry's Ark](#)

In case you missed it, Simon (my co-author) was interviewed by Scott Simon this morning on [Weekend Edition](#). One point he made, that I don't believe has gotten a lot of attention in general, was about the global implications of the bailout plan. One way of putting this is that the plan creates a "Noah's Ark" for financial institutions to escape the storm, but the next question is who will get a ticket onto the ark. The original legislative proposal would only have authorized Treasury to buy assets from "any financial institution having its headquarters in the United States." While there was talk over last weekend about possibly including foreign banks, or their subsidiaries in the U.S., that was not mentioned in Thursday's bullet-point agreement between the Executive Department and Congress (the one that was blocked by the House Republican caucus). Indeed, it seems hard to believe that Congress or the American public would be able to stomach a bailout of foreign banks. But if the reason to save financial institutions is the risk of cascading disruption to their counterparties - and that was the reason cited for both Bear Stearns and AIG - we have to be aware of the risk presented by global banks such as UBS that would have similar counterparty effects. While I'm not suggesting that the U.S. bail out every major non-U.S. bank, someone may have to, and right now there is a distinct lack of a coordinated global response.

Update: 9:20pm, Saturday, September 27th, the Financial Times on-line edition is reporting that Bradford and Bingley, a UK mortgage lender, will be nationalized tomorrow. Sounds like Gordon's Ark just got a bit bigger.

Written by James Kwak [Edit](#)

September 27, 2008 at 11:30 am

Posted in [Interviews](#)

Tagged with [Global Crisis](#), [international](#)

Who Will Be the Blackwater of the Bailout?

Where there are \$700 billion of funds to manage, there will be fund managers. And whether because of the ideological (small-government) preferences of the administration, or because mortgage-backed securities really are hard to analyze and value, or because of the speed required, it is highly likely that those fund managers will be working as contractors, not as employees of the Treasury Department.

Simon and I wrote our first [op-ed](#) last week on the challenges of aligning fund managers' incentives with those of investors (in this case, taxpayers), but with all of the events of the last week this topic has not received a lot of attention. Christopher Dodd did add language addressing

the problem of conflicts of interest, but it's not clear how conflicts will be avoided in practice. Fortunately, Philip Mattera at [Dirt Diggers Digest](#) has been focused on just this issue for the past week. His prediction? The big winner could be the bond specialists at Pimco - who boast a special advisor named Alan Greenspan.

Written by James Kwak [Edit](#)

September 28, 2008 at 2:41 pm

Posted in [External perspectives](#)

Tagged with [governance](#)

[The Paulson Bailout Plan, Version 4.0](#)

There was the initial, 3-page proposal; the 6-page version of last Sunday; the grand compromise of Thursday, which lasted only a few hours; and now, as of this morning, a tentative agreement on a proposal that should be brought to a vote tomorrow. House Speaker Pelosi's office issued a summary entitled "[Reinvest, Reimburse, Reform: Improving the Financial Rescue Legislation](#)," which reads more like a set of talking points than a legislative proposal. But some of the major differences from the original proposal that have been reported on include:

1. Division of the \$700 billion into effectively two tranches, with Congressional review of the second
2. Warrants on stock in firms participating in the bailout
3. Tax provisions intended to limit compensation for senior executives of participating firms
4. The ability for Treasury to use its power as the owner of mortgages and mortgage-backed securities to modify those mortgages on behalf of homeowners
5. An unspecified commitment that, if the taxpayers lose money on the deal, the losses will be made up from the financial services industry
6. Strengthened oversight, including an Inspector General, transparency of financial transactions, and some form of judicial review
7. An option for Treasury to offer mortgage insurance to financial institutions

#5 and #7 seem to be the main provisions added since Thursday.

It goes without saying that it is the details that matter. At a high level, the current proposal improves over the original in two main areas: oversight (#6), which was absent in the original, and taxpayer protection (#2 and #5), which was brushed off with the optimistic assumption that the government would buy assets at their long-term fair market value (whatever that is). #3 and #7 are sideshows; #1 probably is as well, although there is a small risk that this will reinforce the sentiment that the bailout is not big and decisive enough.

But that still leaves two huge open issues. First, as Simon and I discussed in an [op-ed](#) on Wednesday, there is the issue of the price: too low and no bank will want to sell; too high and the taxpayers will not get the warrants they deserve. Second, although the proposal will exhort Treasury to modify mortgages, it's not clear how, or whether Treasury has to do anything at all. We'll see what the final legislation looks like, but this could be a grand gesture intended for the electorate. If so, even after the current crisis of confidence is averted, the problem of repairing the direct damage of mortgage delinquencies and foreclosures will remain.

So, our provisional grades (pending the full bill):

- Restoring confidence in financial sector: B
- Recapitalizing financial sector: C
- Addressing underlying mortgage problems: D
- Preserving value for taxpayers: too vague to tell

Written by James Kwak [Edit](#)

September 28, 2008 at 5:19 pm

Posted in [Commentary](#)

Tagged with [bailout](#)

[The Baseline Scenario, First Edition \(Our Plan\)](#)

This first edition of our Baseline Scenario ([online](#); [pdf](#)) makes three main points. First, we are facing a serious crisis of confidence in much of the world's financial system. Second, the Paulson Plan may well bring this crisis under control, at least for a while. But, even so, we

should plan ahead for measures to deal directly with the deeper underlying problems of bank capital and restructuring mortgages. Third, if as we expect, further serious measures are needed (particularly bank recapitalization and dealing with the underlying mortgage problems), these are entirely feasible and well within the resources available to the US government. Governments in Western Europe and some other countries also need to act, and they also have more than sufficient resources at their disposal; however, we remain worried that some of these governments do not yet understand the gravity of the situation.

Update: to be clear, our plan for pulling the global financial system out of its nose dive is at the end of the document; feel free to skip straight to that and then work your way backwards to see our reasoning.

Update: the next edition will appear by 9am Monday morning, October 6.

Written by Simon Johnson [Edit](#)

September 29, 2008 at 9:15 am

Posted in [Baseline](#)

Tagged with [Global Crisis](#)

[The Paulson Bailout Bill and the Need for Leadership](#)

In case it wasn't clear from earlier posts, our position on today's bailout bill can be summarized as follows: the bailout is neither a complete nor a perfect solution, but it is better than the original proposal of ten days ago, and it is a valuable first step toward restoring confidence in the markets. This morning when the Dow fell 200 points shortly after opening, there were news stories speculating that the markets were not happy with the bailout plan; well, we saw this afternoon what the markets really thought about the bailout.

So if the professional investors who manage most of our money wanted the bailout, what happened? The free-market libertarians were opposed to the bill on supposedly fundamental grounds, but they were not enough to vote it down. The bill failed because enough representatives did not want to go home to their reelection campaigns having voted for a widely unpopular bailout bill. And why is it unpopular? Because no one took the time to educate the public on what the crisis means, how the bailout would operate, what the potential costs of inaction would be, what is happening to the money, and so on. These are complicated issues, but in the absence of explanation the public (based on the "man on the street" interviews" I heard on the radio today) focused on a few simplistic ideas: that this is a bailout for rich Wall Street

bankers; that the \$700 billion (at least) is a complete loss for the taxpayer; that the current administration cannot be trusted; and so on.

Perhaps there was not time in the last ten days for this type of education. But this only points out the importance of planning ahead. By repeating that the economy was “fundamentally sound” until suddenly discovering that it wasn’t, Bush, Paulson, and Bernanke lost the opportunity to prepare the ground for major government intervention in the economy. This bill will almost certainly be renegotiated and brought to another vote. But the underlying lesson is that intervention on the scale we are talking about requires political legitimacy, and that legitimacy requires the willingness to explain to the public just what is going on and why it matters to them.

Written by James Kwak [Edit](#)

September 29, 2008 at 5:11 pm

Posted in [Commentary](#)

Tagged with [bailout](#)

[Do We Need to Move the Baseline Already?](#)

I thought it might be an eventful day when the news broke that a major bank (Wachovia) was being taken over (by Citi) while I was in the midst of posting our Baseline Scenario. But I took it in stride, feeling confident that this was consistent with what we thought, broadly, was going to happen – remember that the point of the Baseline Scenario is to make clear, to you and to ourselves, the logic that lies behind what we think will unfold.

In fact, the details of the Citi-Wachovia deal looked to be very much in line with our expectations (and, yes, we have a list of banks that we expect to run into trouble, but we’re not posting it here.)

The Baseline Scenario can also handle the Paulson Plan struggling in Congress, in two senses. First, if it doesn’t pass, there are other measures that the Fed and Treasury can take to shore up markets in the short term. None of these are attractive for the long haul, but we really need to get through November 4, so a new team can get in place (I know they don’t take office until January, and you can’t have more than one President, but there are workarounds.)

Second, even if it does pass, we’re quite skeptical that the Paulson Plan will fix the deeper underlying issues (see the long memo that is the First Edition of our Baseline Scenario). So

you've got to get cracking in any case on discussing, educating, and negotiating around a potential Plan B.

Also, market volatility and downward pressure on equity prices are very much in our Baseline. The dollar, you will have noted, held up rather well today. Where else are you going to put your money, particularly when there may be further nasty surprises lurking somewhere in the European banking system?

Still, I would mark the day overall as slightly below expectations. I think it was the general tone and sense that order was lacking (and that expected votes in the House did not materialize). Also, I wonder what will happen tomorrow, which is not a working day for Congress while the markets will be open.

Days until the election: 35

Written by Simon Johnson [Edit](#)

September 29, 2008 at 10:13 pm

Posted in [Baseline](#)

[Do We Need to Move the Baseline Already?](#)

[Credit and Equity at the O.K. Corral](#)

A long time ago in a place far, far away (i.e., February), Greg Ip had a nice piece in the Wall Street Journal entitled, "[Stocks are from Venus, Credit is from Mars](#)," with his point being that stock prices painted a considerably more optimistic picture than did conditions in the credit market. The same point holds today, despite the large fall in stock prices Monday and the significant decline over Monday-Tuesday combined.

In fact, I feel the situation is considerably more ominous given that today, Tuesday, there was a large rebound in stock prices in the US at the same time that pressures in the credit market appeared to worsen. As I wrote in [Inside Risks](#), way back when the world economy looked much more stable (i.e., March), the credit default swap (CDS) spreads of banks and the like have been the most consistent indicator of pressure and contagion within the financial sector around the world; see that article for examples.

It's not so much that equity and credit are from different planets, as that would just make for a presumably difficult relationship. It's that equity and credit are having regular showdowns,

expressing fundamentally different views: the business model vs. the access to financing under stress. And in pretty much all the cases that I have followed closely, it's credit that wins this confrontation, in part because if credit market sentiment turns negative, your access to funding dries up, you become more vulnerable to stress, the cost of funds goes up, and the viability of the underlying business model crumbles.

The CDS spreads of key large banks and some other financial intermediaries (no names please) widened today, in a familiar pattern. Within a set of institutions with a similar profile, there is usually one firm with a CDS spread that implies they are out of business. This lasts longer than you might think. Then they are out of business. And then, of course, it starts all over with the financial institution perceived to be the next weakest in that set.

The series of self-fulfilling runs appears unlikely to be broken by today's equity rally. The credit default swap market raises many concerns about its size and nature, of course, but as an indicator of what is to come, it has worked well over the past year. And this indicator, at the end of US trading on Tuesday, was flashing red.

Days until the election: 34

Written by Simon Johnson [Edit](#)

September 30, 2008 at 9:13 pm

Posted in [Commentary](#)