The Geithner-Summers-Bernanke Plan to Prop Up Asset Prices Has Failed

By Global Research
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> Paul Krugman wrote a couple of weeks ago:
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> Top officials in the Obama administration and at the Federal Reserve have convinced themselves that troubled assets, often referred to these days as "toxic waste," are really worth much more than anyone is actually willing to pay for them — and that if these assets were properly priced, all our troubles would go away.
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> Thus, in a recent interview Tim Geithner, the Treasury secretary, tried to make a distinction between the "basic inherent economic value" of troubled assets and the "artificially depressed value" that those assets command right now. In recent transactions, even AAA-rated mortgage-backed securities have sold for less than 40 cents on the dollar, but Mr. Geithner seems to think they're worth much, much more.
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> And the government's job, he declared, is to "provide the financing to help get those markets working," pushing the price of toxic waste up to where it ought to be.
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> What's more, officials seem to believe that getting toxic waste properly priced would cure the ills of all our major financial institutions….
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> The truth is that the Bernanke-Geithner plan — the plan the administration keeps floating, in slightly different versions — isn't going to fly ….

Today, Edward Harrison's must-read post explains why the Geithner-Summers-Bernanke plan to prop up asset prices cannot succeed (if you don't read the whole post, at least read the following excerpts):

> The U.S. government's efforts point in four directions:
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> 1. Increase asset prices. If the assets on the balance sheets of banks are falling, then why not buy them at higher prices and stop the bloodletting? This is the purpose of the TALF, Obama's mortgage relief program and the original purpose of the TARP.
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> 2. Increase asset prices. If assets on the balance sheet are falling, why not eliminate the accounting rules that are making them fall? Get rid of marking-to-market. This is the purpose of the newly prosed FASB accounting rule change.

3. Increase asset prices. If asset prices on the balance sheet are falling, why not reduce interest rates so that the debt payments which are crushing debtors ability to finance those assets are reduced? This is why short-term interest rates are near zero.

4. Increase asset prices. If asset prices on the balance sheet are falling, why not create Public-Private partnerships to buy up those assets at prices which reflect their longer-term value? This is what Geithner's Capital Assistance Program is designed to do.

So I lied, there is only one direction the government is headed: increase asset prices (or, at least keep them from falling). Read White House Economic Advisor Larry Summers' recent prepared remarks to see what I mean. (Summers on How to Deal With a 'Rarer Kind of Recession' – WSJ) ….

These plans are not going to work
As aggressive as this campaign by the U.S. government is, it will have limited effectiveness because the extent of the writedowns of assets already on the books is going to be too massive. …

The U.S. banking system is effectively insolvent
So, it should be pretty clear that we have some serious losses still left to work through in the financial sector. I reckon the U.S. banking system is effectively insolvent. This is what Nouriel Roubini means when he says there will be $3.6 trillion in writedowns before this is all over. This means that banks do not have adequate capital to absorb the likely losses facing them later this year.

To date we have addressed this problem by throwing more money at it — bailing out the banks and attempting to prevent asset prices from falling. I predict this solution will lead to another panic if continued indefinitely. (Remember, between now and the summer or fall, the unemployment rate could reach 9-10%, while home prices would still be falling and default rates rising.) American citizens would realize the system is insolvent and would cease to trust that a reasonable solution was in the offing.

Confidence in America's banking system is already lacking, especially in the large banks and large regional banks. This confidence can only be restored if banks are adequately capitalized now and in the future. Were we to suffer another round of major writedowns and capital injections into major institutions, I expect all confidence would be lost and bank runs would begin in earnest. This must be avoided at all costs.

Given the lack of capital the banking system now has and the likely level of writedowns, many institutions are fundamentally insolvent. They must, therefore, be liquidated or nationalized BEFORE confidence in the system is lost and bank runs occur.

Buying up assets at inflated prices, halting mark-to-market, and reducing interest rates to zero will not reduce the problem assets on bank balance sheets enough to avoid further massive writedowns.

Conclusion
In sum, most available evidence suggests bank writedowns will be massive — perhaps larger than the present capital base of the U.S. banking system. While, present measures of recapitalizing and bailing out faltering institutions and buying up toxic assets may prove adequate to prevent further writedowns and capital erosion, I would rather err on the side of caution.

Caution dictates an aggressive response — one which should include

> nationalization or liquidation of a significant number of banking institutions. Anything less is wishful thinking, the consequences of which could be very dire indeed.

Of course, whether or not the banks should be liquidated (the free market solution) or nationalized (the government intervention approach) is subject to debate. But regardless, it should now be obvious that the Geithner-Summers-Bernanke plan to prop up asset prices is not only crazily expensive, but it is a failed approach.

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