PressRepublican.com
The Online Community and News Source for Clinton, Essex and Franklin Counties of Northeastern New York

Economic bailout switches tactics

COLIN READ, Everybody's Business

December 24, 2008 11:26 am

— (Editor's note: Part II of Colin Read's column about turmoil in the financial markets will appear next week.)
I write this column each Wednesday. This Wednesday was like every other of late. We received dramatic news from an optimistic Treasury Secretary Paulson about the $700 billion Troubled Asset Relief Program (TARP), and the stock market took its usual 5 percent plunge.

TARP was controversial from the start. Congress debated extensively a bailout plan, but failed to pass it first time around. We then heard speeches from the president and others about the almost complete obliteration of international capital markets. Congress capitulated and narrowly passed a relief program of unprecedented size to address this serious problem.

The rhetoric at the time was the absolute necessity to remove toxic assets from the balance sheets of major lenders and banks so they can be liquid again and begin to extend new credit.

Were the credit markets in dire straits? In a word, yes. One measure of credit supply and demand is the TED spread. This important measure of credit-market health is the difference between the rate that major banks will make short-term loans to each other and the rate one would earn on short-term government treasury bills. A couple of things compounded the historically high TED spread of late.

The first reason why TED has been at record-breaking levels is because the yield on three-month Treasury bills plunged so low. Treasury bills are the gold standard of safe investment. Indeed, they are so safe and trustworthy that many investors like us pulled their money out of the stock market and parked it in money market and bond funds. This high demand for treasury bills forced the return on these bills down to levels rarely seen before. As a matter of fact, the return on treasury bills even dropped below zero briefly, meaning some were willing to pay the government to keep their cash in a safe place.

The second problem was the unwillingness of banks to lend to each other in the short term. This rate, the London Inter Bank Offered Rate (LIBOR), is usually about half a percentage point above the rate for three month Treasury bills. At its recent high, LIBOR crept up to almost five percent, creating a record high TED spread that also approached five percent.

I am glad to say that TED is back to normal — kind of. The LIBOR has come down significantly, for a couple of reasons. One is because of real movement in Europe and London to free up lending through their quick and more effective versions of TARP. The other is a somewhat reduced demand for investment borrowing as firms begin to lay off workers and work off inventories. And the return on treasury bills is nearly back to normal because those who would park their assets in bonds have, by and large, done so by now.

The bellwether TED spread did not decline because of the U.S. TARP. Actually, Treasury Secretary Paulson's administration had done little to absorb the troubled assets or inject cash into credit markets. If the credit

market is no longer in crisis because Europe has acted, credit demand is declining, or there is little new money flowing into the bond market, what are we to do with the $700 billion Congress authorized?

We could strengthen the economy by creating new investment, spending and jobs. A second thing we could do is to stabilize a plunging housing market that jump-started this recession in the first place. Or we could bail out a manufacturing sector, under the proviso that they do not again make the same poor manufacturing decisions that ensured their current obsolescence.

Or not. Instead, we could give the money to big banks and insurance companies, whether they are failing or not, and whether they helped get us into this mess or not. Secretary Paulson's theory is that this will give us confidence in banks. And perhaps some of the money will be used for big banks to buy out the small vulnerable banks that will be ineligible for these bailout funds, ironically enough.

There is no denying that such injections will be good for the balance sheet of major banks. It is not yet obvious if this will translate into increased lending by these banks. Indeed, one of the largest banks encouraged to borrow from the TARP explicitly stated that they intend to tighten, rather than loosen, credit.

In his major policy speech today, Secretary Paulson tried to explain his reasoning to us all. I must profess my ignorance because I still fail to see the logic.

Perhaps I am too blinded by what I see as an opportunity squandered to directly stimulate the economy through infrastructure improvements. I do accept the argument that such investments into our productive future will need to be deep and will be slow to take effect. However, it is clear that this recession will also be deep and we will be slow to recover. The opportunity for a quick tax-rebate fix is long past, or more correctly, too little and too late. Instead, we must plant some deep roots so we can place on firm foundation a recovery that remains well down the road.

Maybe what we really need to do is to sit down, take a deep breath, and make a plunge that is very well thought out and cannot help but make a solid contribution to recovery. I hope whatever is left of the TARP funds could be directed to the most productive use. I fear it will not.

Colin Read is the Dean of the School of Business and Economics at SUNY Plattsburgh and has taught economics for 25 years. His current book, "Global Financial Meltdown: How We Can Avoid the Next Economic Crisis" is coming out this month by MacMillan Palgrave. He can be reached at economicinsights@gmail.com.

Copyright © 1999-2008 cnhi, inc.