An Experiment of Great Uncertainty

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We are now experiencing a painful deleveraging resulting from widespread insolvency in financial institutions, which in turn was caused by an immense volume of loans made on the hope that strong economic growth, rising housing prices and easy short-term credit would continue for many years. The resulting bubble has now collapsed into a severe recession.

The resolution of the savings and loan financial debacle offers a proven record of success.

Secretary Geithner has now proposed a new multifaceted plan — on top of the several so far — to resolve this financial debacle. The plan contains several major elements: an immense expansion in size and scope of the Fed’s not-yet-implemented consumer lending program to hopefully “jump start” new loans for auto, student loan, credit card and now commercial real estate backed assets, and ultimately perhaps even for corporate debt; a hoped-for public/private partnership bank to acquire toxic assets; a stress test against a more severe downturn for banks receiving capital injections; foreclosure relief for struggling homeowners by reducing monthly payments. Add to that major restrictions on financial institutions receiving government capital, from essentially no dividends to executive pay limits to extensive disclosure of operational information (not just to regulators, but to the public).

While each component has its pros and cons, taken as a whole, the plan leaves great uncertainty over its feasibility, cost, effectiveness, timing, and ultimate glide path back to normalcy from these immense, now ubiquitous, government lifelines. The financial markets voted a resounding no on the plan.

The most encouraging thing Mr. Geithner said was that they will learn as they go. Mr. Geithner (and Mr. Bernanke) will need to learn fast. The current plan may best be described as an experiment. On what terms will private capital be willing to partner with the public (thus far government restrictions have driven private capital out)? Nobody knows, although conceptually having private decision makers in charge is a good thing. The foreclosure relief will be devilishly tricky to implement without causing millions more delinquencies.

A more direct, forceful, quicker resolution of the insolvent financial institutions analogous to the Resolution Trust Corporation that I helped create and oversee to resolve the savings and loan financial debacle would have been far better received, given its track record of success.

We have a massive problem growing larger and a slow political dance over who among us, and when, is going to bear the cost of having socialized these losses. That may be understandable, even politically inevitable, but is only making things worse.