

Save the Banks

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As Obama begins his fourth week as the 44th President of the United States, the economy is deteriorating rapidly, some of its major banks are failing, and his advisors are developing recovery plans. The central role of banks in this crisis motivates two basic questions about the government's response: Should tax payers pay to fix the banking system? If so, how?

Should taxpayers save banks? People are losing their jobs, their savings, and their homes. The average tax payer did not cause banks to fail and has probably never heard of credit default swaps, Fitch, or collateralized debt obligations. Yet, the average tax payer is facing an estimated bill of \$20,000 each to save the banks. Are there good economic reasons for using tax payer money in this way?

Yes. Well-functioning banks are crucial for a successful economy and we are unlikely to have well-functioning banks for a long time unless the government gets involved. Virtually all businesses need banks. For example, imagine that you borrow a \$100,000 to start a business on Thayer. Further imagine that the business is going great. With the earnings, you pay the interest on the loan, your workers, your rent, and you have enough left over to pay yourself a nice salary that allows you to take out a mortgage for your house. Now, imagine that the bank experiences problems and demands that you pay back the loan, but you do not have \$100,000. You sell the business's equipment, fire the workers, stop paying rent, and fall behind on your own

mortgage. Your unemployed former workers reduce their expenditures, further damaging the economy.

Moreover, without a well-functioning banking system, potential entrepreneurs cannot initiate new projects. Difficult times create opportunities. As entrepreneurs exploit these opportunities and start new businesses, the economy begins to recover. Yet, the absence of a well-functioning banking system will stymie the ability of entrepreneurs to start new business and ignite the recovery. Put differently, the US economy is founded on private entrepreneurship, and private entrepreneurship is founded on a well-functioning banking system. The current banking system is broken.

While these arguments suggest that a well-functioning banking system is crucial for economic success, they do not necessarily imply that taxpayers should pay to fix the banking system. Why not simply allow bankrupt banks to go bankrupt?

The reason for using tax payer money to help in saving the banks is that it will take a long time for the market to fix the banking system, which will cause the economic crisis to worsen and severely delay new entrepreneurial activity. A slow bankruptcy in which bits and pieces of financial firms are sold to disparate buyers is particularly problematic because finance is based on information. When a financial conglomerate is broken up and sold quickly to raise money to pay creditors, the intangible assets associated with knowing clients and markets are degraded, if not completely lost, further impeding the financial system from funding existing businesses and new entrepreneurs.

But, does saving the banks mean saving existing shareholders and creditors?

One way to save the banks is to boost the value of bank assets, and thereby help existing equity and bond holders. This was and remains the core strategy of both the

Bush and Obama Administrations. For example, as part of the proposed public/private investment fund, the government will subsidize the purchase of bank assets by private entrepreneurs, which will boost bank balance sheets, enriching current bank stock holders. As another example, the Federal Reserve has guaranteed many bank liabilities, which directly helps bank creditors, and indirectly helps bank equity holders by allowing banks to borrow less expensively than they otherwise would. Similarly, the Federal Reserve has guaranteed many bank assets, which further boosts the value of bank equity. As a final example, the government paid an enormous premium, when it purchased bank equity in November, which directly aided bank equity holders and creditors

One problem with this strategy involves fairness. Is it appropriate to use tax dollars to enrich the owners and large creditors of banks that helped trigger the current crisis? Or, as Obama argued: “We do not disparage wealth, we do not begrudge anyone for achieving success and we certainly believe success should be rewarded. But, what makes people upset and rightfully so are executives being rewarded for failure.”

Beyond fairness, the strategy of saving banks by protecting existing owners and creditors will hinder the creation of a well-functioning banking system, which is the core reason for using tax payer funds to save the banks in the first place. Well-functioning banks require owners and creditors with lots of their own wealth on the line. It is the fear of losing money that incentivizes owners and creditors to induce banks to behave prudently. They must know that they can lose. In other words, individual investors in

banks must fail now to save the very financial system that we need for sustaining growth in the future.

In summary, yes, it is in the public interest to use some tax payer funds to restore our banking system to financial health, but tax payer funds should only be used after bank shareholders and uninsured creditors have experienced substantial losses. Indeed, a healthy banking system going forward requires that we not bailout existing shareholders and creditors.