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IS BAILOUT AN ANSWER TO GLOBAL FINANCIAL CRISIS?

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Abstract

The financial system in the USA, identified as the largest economy in the world, with a strong and robust financial system, has been in the eye of a storm in the past two years and more so in the recent months. To control this, US Govt. has adopted a bailout plan (The Emergency Economic Stabilization Act of 2008) to spend up to US$700 billion to purchase distressed assets, especially mortgage-backed securities, and make capital injections into banks. But, experience with financial crisis in other countries suggests that success is by no means guaranteed. Also this has become the hottest topic of debate between government officials, public, politicians, financiers and economists. All of them have different point of view on this. Like, according to some economists, the plan is a subsidy to investors at taxpayers' expense. Investors who took risks to earn profits must also bear the losses. Not every business failure carries systemic risk. The government can ensure a well-functioning financial industry, able to make new loans to creditworthy borrowers, without bailing out particular investors and institutions whose choices proved unwise.

So this paper tries to explain about the *bailout plan of US Govt*., objectives of bailout plan, how it will work. How such bailout plans helped other country economies? What is the *rationale* of bailout plan and amount of such bailout plan adopted by different countries? Is the US bailout plan efficient to control global financial crisis? Is it possible for government to adopt other measures in this regard?

Keywords: *- Bailout, Global Finance, Investor issues.*

1. INTRODUCTION

The proposed solution to current financial crisis, which is viewed as the most serious since the Great Depression, is the mortgage bailout. But this originates many questions. First and most important is: *Will it work?* What is its purpose and, will it actually work to fulfill that purpose? And others are; will it prevent the recession? Why and whether it will work? Is there any requirement for more regulations? Is it fine to privatize profits and nationalize losses?

2. BACKGROUND

There is a set of debate for and against this bailout. Before proceeding further it is necessary that on what backgrounds this debate arises [1].

2.1 FOR THE DEAL

Global financial stability: the plan is aimed at bringing calm to an extremely volatile global financial system. The world's richest nations, the Group of Seven (G7) say the package will, "protect the integrity of the international financial system".

i. *Investor wellbeing:* Investors worldwide need a shot of confidence. As billionaire investor Warren Buffett put it: the plan was "absolutely necessary" to help pull the financial system out of an "Economic Pearl Harbor".

ii. *Global slowdown:* All sides agree that we want to avoid recession in the world's biggest economy and the knock-on effect that would have for countries that rely on America for trade.

iii. *Job security:* Safeguarding jobs across the economy and preventing bankruptcies that "threaten American families' financial well-being" according to US Treasury Secretary Henry Paulson.

iv. *Credit freeze:* Keeping funds flowing through the money markets so that financial institutions are happy to lend to each other, to businesses and to consumers is vital for any functioning economy.

v. *Toxic profits:* The $700bn cost of mopping up banks' toxic debts may seem a high price, but when authorities eventually

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sell these assets in the future, their value may have risen enough to make a profit.

2.2 AGAINST THE DEAL

i. *Taxpayer burden:* The government plans to buy up mortgage-backed assets at its "maturity" value, which is well above the current market value. If the value of these assets does not recover in the next few years, it will get expensive for taxpayers.

ii. *Ballooning state debt:* The plan would swell the budget deficit, which could fuel inflation, economists warn (Mr. Paulson has asked to raise state borrowing to $11.3 trillion, from $10.6 trillion).

iii. *True cost of the deal or how long is piece of string?* Since authorities would have the power to buy almost any asset at any price and sell it at any future date, it is almost impossible to calculate the real cost of this deal.

iv. *Bankers' big pay:* There are worries about controlling the mega-bucks bosses earn at the very banks being bailed out - given the view that it was Wall Street "that got us into this mess in the first place".

v. *The phenomenal power of US Treasury Secretary Henry Paulson:* The rescue plan is his baby and he will control how the $700bn is spent.

vi. *Too much exposure:* Some congressmen object that they want the government to have the right to take a minority stake in any firm that is being bailed out, which would give the state the right to purchase stock in companies in the future.

vii. *Governance:* The plan is a twice-yearly report - critics insist on greater oversight and reporting.

viii. *Main Street versus Wall Street:* There are calls for this package to be extended to help ordinary Americans who are at risk of losing their homes.

3. THEMES FROM BAILOUTS

From the many bailouts over the course of the 20th century, certain principles and lessons have emerged that are consistent: [2]

- Central banks provide loans to help the system cope with liquidity concerns, where banks are unable or unwilling to provide loans to businesses or individuals.
- Let insolvent institutions (i.e., those with insufficient funds to pay their short-term obligations) fail in an orderly way.
- Banks that are deemed healthy enough (or important enough) to survive require recapitalization, which involves the government providing funds to the bank in exchange for preferred stock, which receives a cash dividend over time.
- If taking over an institution due to insolvency, take effective control through the board or new management, cancel the common stock equity (i.e., existing shareholders lose their investment), but protect the debt holders and suppliers.
- Government should take an ownership (equity or stock) interest to the extent taxpayer assistance is provided, so that taxpayers can benefit later. In other words, the government becomes the owner and can later obtain funds by issuing new common stock shares to the public when the nationalized institution is later privatized.
- A special government entity is created to administer the program, such as the Resolution Trust Corporation.
- Prohibit dividend payments, to ensure taxpayer dollars are used for loans and strengthening the bank, rather than payments to investors.
- Interest rate cuts, to lower lending rates and stimulate the economy.
- Strong oversight.

4. JUSTIFICATION

The mortgage bailout has both a social purpose and a more personal purpose. The social purpose is simple: to avert a total economic meltdown. First, there is a chain of loans that runs throughout USA economy and if the mortgage defaults rise too high and too fast, the impact on USA economy will be unlike anything they've experienced since the Great Depression. In an economy that is based on an increasing pile of debt, when someone can't pay off his loans to a second person who then can't pay off his loans to a third person who then can't pay off his loans to a fourth person (and so on), people who expected money to be there have their security blankets taken from them and may even have to scramble just to get by. Some say that we can handle this consequence because we have spread

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the risk, but spreading the risk when the risk has continued to increase means that the whole system is at risk!

The problem for everyone is that when all of this money is wiped out of the system, those people who were depending on the money to be there might end up in dire economic straits. And at the very least, they will no longer be consumers of nonessential products. That means a loss of business, which means a loss of jobs, which means even more people defaulting, and so on. Every one is the part of this system, and when its well-being is so fragile and on the verge of collapse, we can be sure that all of us have a vested interest in solutions that help those who are on the edge of a personal collapse. That leads to the more personal reason for the mortgage bailout. That's why it is not the time of blaming others or to make debates in this regard. It is the time when every one has to think about how to handle the crisis. As in case of insurance, loss of one is being shared by others. Similarly this problem is not only of USA or of its citizens or of a single country only. This is a global problem, which is affecting all over the world and this gives rise to many questions and teaches a lesson, how to avoid ourselves from such situations. When there were a lot of analysts, CEO, Economists, businessmen, and then why such situation arose. This is not a new problem in front of USA or us, this happened in past also.

The personal reason for the mortgage bailout is also a spiritual reason for those who believe in God. Do you think that God created this Earth for people to be born without a place to live (or at least the land and resources to build a place to live). We did something important by coming together into societies. Instead of fighting over the resources that we needed to survive and thrive we made a commitment to learn to make use of them for the benefit of all as well as to put together all of our talents to be more effective at doing so. The question is how exactly to work together most effectively.

So the social, personal, and spiritual reasons for the mortgage bailout seem very compelling. But having a reason doesn't necessarily mean you have the right method for fulfilling that reason. *The question is: Will it work? And the answer is… it depends on how we do it.*

The present action does address the short-term problems of liquidity crisis and mid-term problem of dealing with bad assets, but on the longer-term regulatory issue, there is no strategic plan in place and that is really problematic. What is required is a complete overhaul of present regulations and not just more regulations. Moreover, the government rushed to rescue these firms without trying many of the private sector solutions. So under these circumstances, we can assume that an unfettered market is not the best option and some regulation is necessary to avoid such major crisis arising in the future [3].

More than the bailout, a complete overhaul of the financial system is needed for the long-term benefit of the country's economy and the tax-paying citizens. A detailed study needs to be carried out for the reason behind the failure and changes that need to be brought in. Bail-out will always be a step to triumph over the failure in a short span but the Government should make such regulations and chuck that can avoid such crisis in future. This USA Subprime crisis teaches a lesson to all of us that government intervention is must. We can't totally depend upon free economy. As in case of USA, the government has to intervene at the cost of taxpayers. If the government of USA had adopted such measures by looking at its past then this might not happen. The financial markets must be carefully re-regulated, not over-regulated or wrongly regulated.

This downfall of such huge companies is not just a failure of the financial system, but also a massive leadership failure across the financial services landscape. This type of leadership lapse dates back to 1980s when companies began to align executive compensations with shareholders interests. Excessive interest in personal financial goals as against the larger interest of the organization is one of the root-cause of this debacle. Another point is that many managers choose not to lead at all. They believe that if they hire smart people, give huge incentives for personal results, the management of the firm would take care of itself. Under such circumstances, taking risks to achieve personal goals even if that puts others or organization in danger seems acceptable. These particular leadership failures have been a major cause of this full-scale meltdown of US financial sector.

If we consider the Keynesian theory then this bailout plan is more admirable than any other plan. According to Keynesian economics the state should stimulate economic growth and improve stability in the private sector - through, for example, interest rates, taxation and public projects. The theories forming the basis of Keynesian economics were first presented in The General Theory of Employment, Interest and Money, published in 1936. In Keynes's theory, some micro-level actions of individuals and firms can lead to aggregate macroeconomic outcomes in which the economy operates below its potential output and growth. Many classical economists had believed in Say's Law, that supply creates its own demand, so that a "general glut" would therefore be impossible. Keynes contended that aggregate demand for goods might be insufficient during economic downturns, leading to unnecessarily high unemployment and losses of potential output. Keynes argued that government policies could be used to increase aggregate demand, thus increasing economic

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activity and reducing high unemployment and deflation. Keynes's macroeconomic theories were a response to mass unemployment in 1920s Britain and in 1930s America. Keynes argued that the solution to depression was to stimulate the economy ("inducement to invest") through some combination of two approaches:

- A reduction in interest rates.
- Government investment in infrastructure - the injection of income results in more spending in the general economy, which in turn stimulates more production and investment involving still more income and spending and so forth. The initial stimulation starts a cascade of events, whose total increase in economic activity is a multiple of the original investment.

5. ALTERNATIVE PROPOSALS

Suggested alternative approaches to address the issues underlying the financial crisis include: mortgage assistance proposals try to increase the value of the asset base while limiting the disruption of foreclosure; bank recapitalization through equity investment by the government; asset liquidity approaches to engage market mechanisms for valuing troubled assets; and financial market reforms promoting transparency and conservatism to restore trust by market investors. [4]

5.1 Mortgage assistance

The Mortgage Assistance Scheme provides short-term help for people experiencing temporary difficulties with their home loan repayments because of an unavoidable change in circumstances. For example, this may be due to unemployment, accident, illness or some other crisis. Mortgage assistance is not a grant but a loan to be repaid at a future time. Mortgage assistance is provided as a loan that is paid directly to the home lender. The loan is usually payment of home loan arrears and/or a subsidy towards your home loan repayments for a certain period of time.

5.2 Bank Recapitalization

Economist, New York Times columnist and Nobel laureate Paul Krugman recommended that, instead of purchasing the assets, equity capital could be provided to the banks directly in exchange for preferred stock. This would strengthen the financial position of the banks, encouraging them to lend. Dividends would be paid to the government on the preferred shares. This would be similar to what happened during the S&L crisis and with the GSE bailout. This avoids the valuation questions involved in the direct purchase of MBS. This is an approach based on the 1990s Swedish banking rescue.

5.3 Asset Liquidity

Christopher Ricciardi, former Merrill Lynch banker, wrote a letter to Treasury Secretary Henry M. Paulson Jr. proposing alternatively that the government should be backing some troubled assets to encourage private investors to purchase them — as opposed to the direct purchase of troubled assets from financial institutions.

Investor Warren Buffett believes the government should pay market price for the assets rather than an artificially high hold-to-maturity price. The market price would be determined by selling a portion of the assets to private investors [5].

6. Lessons from Last Meltdowns

Based on the Japan experience, Japanese analysts believe that actions to date have been insufficient. They say that in addition to the U.S. Treasury Department's plan to spend $700 billion buying bad assets from banks, the government also needs to recapitalize banks using taxpayer money. Only then will confidence in the financial system return, ending the current paralysis in lending that threatens the entire economy. "Taking nonperforming loans out of the balance sheets is not enough," says Jun Saito, director general of the economic-research bureau for Japan's cabinet. "What we've learned [in Japan] from the 1990s is that we need recapitalization"[6].

Other Asian governments faced challenges similar to Japan's during the Asian financial crisis of 1997-98. In South Korea, for example, the government bought bad loans from banks and also injected government money into their balance sheets. Several banks were nationalized. Governments across the region also shut down financial institutions deemed too weak to survive or warrant a government bailout. In August 1997 Thailand closed 42 finance companies. Indonesia closed 16 banks in October 1997, and Korea closed 14 merchant banks that December, according to Merrill Lynch. This separating the wheat from the chaff helped to speed economic recovery because it made clear which institutions were solid and could be trusted. The clear message from Asia is that more intervention is needed to restore the financial system [7].

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We can also look at the effectiveness of bailouts in EUs. Governments in the EU frequently bailout firms in distress by granting state aid and suggesting that bailouts help only in delaying the exit instead of preventing it. The number of failing bailouts could be reduced if European control was tougher. Also these bailouts decisions favored public firms, even though public firms did not outperform private ones in the survival chances. [8]

If we lookout at the positive effects and consequences if government does not intervene of bailout, then we can better estimate the benefits of this plan.

6.1 Positive Effects of Bailout Bill

- Create a market for illiquid mortgage-backed securities can be valued and traded
- Setup regulatory oversight on how these toxic assets are valued and disposed of
- By taking mortgage-backed securities off of companies and banks books, credit and capital will begin to flow again.
- Possible Profits

6.2 Potential Consequences If Govt. does not intervene

- Increase Panic in the Market since Dow Jones lost 700 points the day after first bailout bill was rejected. Businesses not being able to get loans

- Could lead to massive lay offs.
- GDP could decrease
- Ultimately could cause a recession
- Worldwide Economic Crisis
- Other countries are experiencing credit crunches and declines in equity as well.
- If US companies have less access to funding they will not be able to conduct business or invest in other parts of the world to the same extent, which will hurt foreign markets.
- Because of US businesses slowing production, the importation of raw materials will decrease, which will cause a decline in foreign profits.

7. CONCLUSION

Based on the above discussion, it can be judged that the scenario of financial sector is harsh. Such crisis situations do require some desperate measures as has been taken by the federal government. It also provides us a retrospective view to analyze what went wrong and avoid such failures in the future. So though the meltdown is surely for real, it's by tackling it properly that the financial sector can come up with greater strengths in the future.

In short, the proposed bailout plan can be redesign on the basis of above-mentioned facts, which are as follows:

- ***No overpaying for troubled assets***: The Treasury's authority to purchase troubled assets should be limited to doing so at fair market value.

- ***Addressing undercapitalization problems directly***: Because the purchase of troubled assets at fair market value may leave financial firms severely under-capitalized, the Treasury's authority should be expanded to allow purchasing, again at fair market value, new securities issued by financial institutions in need of additional capital.

- ***Market-based discipline***: to ensure that purchases are made at fair market value, the Treasury should conduct them through multi-buyer competitive processes with appropriate incentives.

- ***Inducing infusion of private capital***: to further expand the capital available to the financial sector, and to reduce the use of public funds for this purpose, financial firms should be required or induced to raise capital through right offerings to their existing shareholders [9].

Because the Treasury's plan would infuse capital through overpaying for troubled assets, it would impose massive costs on taxpayers and might not channel-needed capital to its most valuable uses. The proposal put forward in this paper would do a far better job both in terms of protecting taxpayers and in terms of restoring financial stability. Because focus in this paper is on the financial sector problems that the Treasury proposal seeks to address, it has been abstracted from the problem of the housing market. It is generally recognized that the financial sector's problems are in part due to the "correction" in the housing market. Nonetheless, the assumption underlying the Treasury's plan is that government intervention

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should focus on the financial sector. The Treasury (now) recognizes that the problems of the financial markets should not be left to the market to sort out but rather require government intervention. However, once this intervention brings stability and liquidity to financial firms, the Treasury believes, the problems of the housing market can still be left for market forces to sort out. Unfortunately, however, the housing market is not a coasian setting in which such adjustments can occur without much cost. Thus, additional government intervention in connection with the housing market may be warranted alongside the intervention in the financial markets that has been the focus of this short paper.

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