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The “Paulson Plan” and its Implications

Raymond Woo Weng Pong

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The US government’s plan to inject US\$ 700 billion into the financial sector may have improved sentiment among investors and monitoring authorities in Wall Street. However, the “Paulson Plan” will likely provide only short-term benefits without solving the crisis’ root causes. It might even create long-term damage to the US’ economic and strategic position.

IS THE US\$ 700 billion plan by the US government to buy up bad mortgage-related debt -- also termed as “toxic debt” from Wall Street financial institutions (FIs) -- a case of “cutting one’s nose to spite one’s face”? Several clues indicate that the so-called “Paulson financial rescue plan”, or Paulson Plan for short, appears to be doing precisely that: It strives to solve problems with a short-term plan, while neglecting or even worsening the fundamental economic and security repercussions of the 2008 financial crisis over the long-term.

A Lifeline for Wall Street in Times of Crisis

The subprime crisis in the US has directly led to plunging property prices and a collapse of confidence in the financial sector. The upshot is the controversial US\$ 700 billion “Paulson Plan” to restore market confidence, devised by Henry Paulson, the Secretary of the Treasury, in consultation with Ben Bernanke, Chairman of the Federal Reserve and President Bush, announced on September 19..

Years of carelessness, greed, lack of transparency by Wall Street financial institutions (FIs) and reputational intermediaries like credit rating agencies have been worsened by neglect by the monitoring authorities. The cumulative effect is a toxic brew of overleveraging and over-lending in a large part due to the derivatives market. Unfortunately, Wall Street is still having its day in the sun in Washington. The current thinking among monitoring authorities is that, large investment banks and securities firms are “too big” to fail. If allowed to do so, they will rattle confidence in the economy even further.

Advantages of the Plan

One of the advantages of the plan is that the massive bailout deals with the fundamental problem of

the lack of liquidity as borrowers cannot finance their loans anymore due to the collapse of US property prices, leading to low equity among FIs. It is definitely better than the approach of nationalizing the FIs one-by-one, which might not solve the fundamental problem of illiquidity across the board. With a boost in funds, there will be a restoration of confidence in the sector, which can lead to more equity growth and higher investment.

Secondly, the bailout will enable the government to impose more discipline in the sector, such as executive pay limits and the right of judicial review, congressional oversight and the right to audit. Goldman Sachs and Merrill Lynch are already voluntarily applying for a change of status to that of corporate banks, which entails more regulation by the authorities than that of investment banks. Also, that status would ensure greater certainty of investment returns, thus procuring more foreign investment for its stocks. An imposition of discipline might lead to even more widespread restructuring in Wall Street, while relieving the pressure of toxic debt on FIs.

Negative Implications of the Plan

However, the pros of the bailout might be only short-term, while the negative implications of the plan might be long-term. There is a risk that the effects of the plan would be insidious and cause irreparable damage to the US economy and even its strategic standing in the world.

Firstly, the bailout plan will increase foreign indebtedness and lead to the US' strategic decline vis-à-vis countries like China. The stimulus US\$ 3.2-trillion budget will increase the budget deficit in 2009 to over US\$ 482 billion. The higher the deficit, the more the US will be indebted, increasingly to external funds. US debt in the hands of foreign governments in 2008 is 25% of all national debts, nearly double from that of 13% in 1998.

Furthermore, as of April 2008, its erstwhile emerging rival China has invested US\$ 502 billion in US Treasury bonds, second only to Japan's US\$ 592 billion. Putting even more pressure on the Federal budget with such a large-scale bailout plan will lead to dependence on China and other countries, a dangerous development from the perspective of national security.

Secondly, the bailout plan will cost the US credibility in its promotion of free trade and market-based economy. When Malaysia imposed capital controls in 1997 to shield its currency from the Asian financial crisis, the US, together with the Bretton Woods institutions, was the loudest in condemning this move on the principle of free-market economics.

Although the US had then arranged for the bailout of the Long-Term Credit Management (LTCM), it was a buy-out by a consortium of major banks and other FIs, rather than an outright nationalization with tax payers' money like the Paulson Plan. Confidence in the US economic model might be eroded among Asian and other countries. Regions like ASEAN and South America are more likely to become more protectionistic.

Lastly, it does not solve, and might even aggravate the more fundamental problem of moral hazard, which has direct implications for regulations on FIs. In other words, FIs might undertake even riskier and irresponsible actions in the future because the thinking of being "guaranteed" by Washington is ingrained in Wall Street. Since bailouts attenuate the need for personal responsibility, complacency might set in even on the Federal Reserve when bust turns to boom again.

This might result in weaker regulations on risky financial products like derivatives or mortgage-related debts, as well as less transparency from FI's and credit rating agencies. Critics have stated that the Fed has not learned the lessons of the LTCM episode. Roger Lowenstein, in an article in the New York Times, asserted that the basic problem of lack on regulation in regards to leverage and debt was the cause that brought down both LTCM 10 years ago and Lehman Brothers in 2008.

Some Lessons

One major lesson from the current financial crisis is the need for more vigilance on the issue of over-leveraging. To decrease reliance on debt, investment banks can be structured in a way that they have deposits or other funds to back up their businesses, such as making them investment arms of corporate banks rather than as stand-alone firms.

Finally, to avoid a similar crisis in future, a culture of transparency, accountability towards minority shareholders as well proper FI internal guidelines for the equity and leverage of FIs should be encouraged. However, it is doubtful that the bailout would help the financial sector advance towards the above ideals. It might be at best short-term, at worst piecemeal.

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