UK

Nuclear option nearer as old remedies falter

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With ammunition in the magazine of monetary policy running low, talk of a fiscal silver bullet to clean up the mortgage mess is gaining ground among bankers.

A wholesale bail-out of the financial system via the taxpayer would be controversial. The idea that after years of record profits, banks should have a portion of their losses nationalised is the type of moral hazard that regulators, as well as people on Main Street, abhor.

The next few weeks will determine whether the Federal Reserve's latest liquidity measures can grease the cogs of markets that have in effect ground to a halt.

Another measure is easier capital limits for Federal home loan banks and the government-sponsored mortgage giants Fannie Mae and Freddie Mac. Hopes that this measure will translate into big buying of mortgages will be tested next week.

Pockets of the unregulated markets for mortgages, credit and derivatives, which were created by banks, remain severely impaired. Not only have banks lost confidence in each other and their clients; it also seems that the old remedy for market stress - bargain hunting when asset prices slump - has lost its appeal.

This explains why the Fed has resorted to a series of liquidity measures that are designed to give banks' stretched balance sheets some breathing room. Forced sales of assets beget lower market prices, and a vicious downward spiral that blows back on a balance sheet.

This week the first auction of Treasuries for a wide range of other assets held by banks generated much less demand than expected. Countering that, however, direct borrowing by banks from the Fed's discount window rose sharply.

The Fed has also aggressively cut interest rates and largely cast aside concerns about inflation and the dollar. This naturally makes holding cash and Treasuries less attractive. Money market funds are squawking. Ultimately, low rates should force investors to seek higher-yielding assets that no one is really buying at the moment.

And yet the mantra among vulture funds and long-term investors at the moment is: "Why buy today, when the price is likely to be lower in the future?" There is a worry that this mood will colour the investment decisions of even the likes of Fannie and Freddie.

One intriguing aspect of the turmoil since last August has been the vast amount of money sitting on the sidelines waiting to find a home. Indeed many big banks have already received capital injections from sovereign wealth funds, which are now nursing losses.

In past banking crises, capital injections arrived during the third act of the drama. Having jumped the gun this time, and having watched the disaster for Bear shareholders, future providers of funds will probably be more prudent.

All of which could entail a grim slog for banks, markets and the economy. The longer banks endure a credit crunch, the more the risk of a nasty recession for Main Street grows. Bankers argue that the entire system is in peril, and there is plenty of truth to this.

Wall Street has spent a generation wooing consumers with easy credit. Never have the ties between the balance sheets of banks and homeowners been so close, in spite of that mirage called securitisation.

Given the dominant role of finance in the modern economy, where living without a credit card is unthinkable, tough times beckon if markets have really lost their self-healing powers, as bankers say. The longer house prices keep falling and foreclosure rates rise, the more this negative loop between banks and consumers will tighten.

Hence the call for the so-called nuclear option of the taxpayer buying mortgages. Its proponents say this fiscal move would help moderate the credit crunch that is cutting down bankers and consumers.

In addition, it is an election year. An expansion of the taxpayer's role as the ultimate buyer of risky assets cannot be ruled out.

Ideally it would be better for everyone if the market's self-healing powers finally prevail. But the traditional monetary policy response - cutting rates - looks good only when a new bubble can be inflated, such as tech stocks or housing.

For now the sheer scale of financial and personal debt makes pushing the fiscal red button a growing possibility.

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