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THE NATION

Too Big to Fail?

By PETER S. GOODMAN

IN the narrative that has governed American commercial life for the last quarter-century, saving companies from their own mistakes was not supposed to be part of the government's job description. Economic policy makers in the United States took swaggering pride in the cutthroat but lucrative form of capitalism that was supposedly indigenous to their frontier nation.

Through this uniquely American lens, saving businesses from collapse was the sort of thing that happened on other shores, where sentimental commitments to social welfare trumped sharp-edged competition. Weak-kneed European and Asian leaders were too frightened to endure the animal instincts of a real market, the story went. So they intervened time and again, using government largess to lift inefficient firms to safety, sparing jobs and limiting pain but keeping their economies from reaching full potential.

There have been recent interventions in America, of course — the taxpayer-backed bailout of Chrysler in 1979, and the savings and loan rescue of 1989. But the first happened under Jimmy Carter, a year before Americans embraced Ronald Reagan and his passion for unfettered markets. And the second was under George H. W. Bush, who did not share that passion.

So it made for a strange spectacle last weekend as the current Bush administration, which does cast itself in the Reagan mold, hastily prepared a bailout package to offer the government-sponsored mortgage companies, Fannie Mae and Freddie Mac. The reasoning behind this rescue effort — like the reasoning behind the government-induced takeover of Bear Stearns by J. P. Morgan Chase just a month before — sounded no different from that offered in defense of many a bailout in Japan and Europe:

The mortgage giants were too big to be allowed to fail.

Big indeed. Together, Fannie and Freddie own or guarantee nearly half of the nation's $12 trillion worth of home mortgages. If they collapse, so may the whole system of finance for American housing, threatening a most unfortunate string of events: First, an already plummeting real estate market might crater. Then the banks that have sunk capital into American homes would slip deeper into trouble. And the virus might spread globally.

The central banks of China and Japan are on the hook for hundreds of billions of dollars worth of Fannie's and Freddie's bonds — debts they took on assuming that the two companies enjoyed the backing of the American government, argues Brad Setser, an economist at the Council on Foreign Relations.

Commercial banks from South Korea to Sweden hold investments linked to American mortgages. Their losses would mount if American homeowners suddenly couldn't borrow. The global financial system could find itself short of capital and paralyzed by fear, hobbling economic growth in many lands.

Nobody with a meaningful office in Washington was in the mood for any of that, so the rescue nets were readied. The treasury secretary, Henry Paulson Jr., announced that the government was willing to use taxpayer funds to buy shares in Fannie and Freddie. The chairman of the Federal Reserve, Ben Bernanke, said the central bank would lend them money.

The details were up in the air as the week ended, but some sort of bailout offer was on the table — one that could ultimately cost hundreds of billions of dollars. Whatever the dent to national bravado, or to the free-enterprise ideology, the phrase "too big to fail" suddenly carried an American accent.

"Some institutions really are too big to fail, and that's the way it is," said Douglas W. Elmendorf, a former Treasury and Federal Reserve Board economist who is now at the Brookings Institution in Washington. "There are no good options."

Still, there are ironies. Since World War II, the United States has been the center of global finance, and it has used that position to virtually dictate the conditions under which many other nations — particularly developing countries — can get access to capital. Letting weak companies fail has been high on the list.

Mr. Paulson, who announced the bailout, made his name as chief executive of Goldman Sachs, the Wall Street investment giant, where he pried open new markets to foreign investment. As treasury secretary, he has served as chief proselytizer for American-style capitalism, counseling the tough love of laissez-faire. In particular, he has leaned on China to let the value of its currency float freely, and has criticized its banks for shoveling money to companies favored by the Communist Party in order to limit joblessness and social instability.

All through Japan's lost decade of the 1990s and afterward, American officials chided Tokyo for its unwillingness to let the forces of creative destruction take down the country's bloated banks and the zombie companies they nurtured. The best way out of stagnation, Americans counseled, was to let weak companies die, freeing up capital for a new crop of leaner entrants.

But as Japan's leaders engaged in bailouts and bookkeeping fictions to keep banks and companies breathing, they offered those words of justification now heard here: The companies were too big to fail.

In 2002, the government engineered the rescue of Daiei, a huge, debt-laden grocery chain. In 2003, it injected some $17 billion into Resona Bank to keep it upright. Each time, Japan's leaders said failure was not an option. It would pull too many others into a downward spiral.

Today, among strict adherents of laissez-faire economics, the offer to bail out Fannie and Freddie is already being criticized as a trip down the Japanese path of putting off immediate pain while loading up the costs further along.

For one thing, this argument goes, taxpayers — who now confront plunging house prices, a drop on Wall Street and soaring costs for food and fuel — will ultimately pay the costs. To finance a bailout, the government can either pull more money from citizens directly, or the Fed can print more money — a step that encourages further inflation.

"They are going to raise the cost of living for every American," said Peter Schiff, president of Euro Pacific Capital Inc., a Connecticut-based brokerage house that focuses on international investments. "The government is debasing the value of our money. Freddie and Fannie need to fail. They are too big to save."

Using public money to spare Fannie and Freddie would increase the public debt, which now exceeds $9.4 trillion. The United States has been financing itself by leaning heavily on foreigners, particularly China, Japan and the oil-rich nations of the Persian Gulf. Were they to become worried that the United States might not be able to pay up, that would force the Treasury to offer higher rates of interest for its next tranche of bonds. And that would increase the interest rates that Americans must pay for houses and cars, putting a drag on economic growth.

Meanwhile, as American debts swell and foreigners hold more of it, nervousness grows that, some day, this arrangement will end badly. The dollar has been declining in value against other currencies. Some foreigners have begun to hedge their bets by buying more euros.

"Obviously, this is going to come to an end," Mr. Schiff said. "Foreigners are not charitable organizations, and they're going to demand that we pay them back."

No single country owning large amounts of dollar-based investments is inclined to dump them abruptly; nobody aims to start a panic. But fears have begun to grow that one day a country may get spooked that another is about to dump its dollars — and that could trigger pre-emptive panic selling.

"Foreigners could decide it's just not worth the risk and sell," says Andrew Tilton, an economist at Goldman Sachs. "The really dire scenarios have become a lot more likely than they were a year or two ago."

Still, as Mr. Tilton and others are aware, one fundamental reality continues to offer assurances that foreigners will still buy American debt: In the global economy of the moment, the United States itself is too big to fail.

The logic for that assurance goes like this:

The American consumer has for decades served as the engine of world commerce, using borrowed cash to snap up the accoutrements of modern living — clothes and computers and cars now manufactured, in whole or in part, in factories from Asia to Latin America. Eliminate the American wherewithal to shop, and the pain would ripple out to multiple shores.

Globalization, in other words, allowed China and Japan to amass the fortunes they have been lending to the United States.

But globalization also emboldened American capitalists to take huge risks they might have otherwise avoided — like borrowing to erect forests of unsold homes from California to Florida, delivering the speculative disaster of the day. They were operating with bedrock confidence that money would never run out. Someone would always buy American debt, delivering more cash for the next go.

And this same interconnectedness appears to have reassured regulators in Washington about the health of the American financial system, as they declined to intervene against highly speculative lending during the real estate boom. Mortgages were being distributed to investors around the globe, and so were the risks, the regulators reasoned. Anyone who bought into that risk would have a strong interest in seeing that the American financial system stayed upright.

In other words, in the estimation of people in control of money, the United States cannot be allowed to collapse, just as Fannie and Freddie cannot be allowed to fail. Too much is riding on their survival.

The central truth of that logic still seems to be apparent as the Treasury keeps finding takers for American debt.

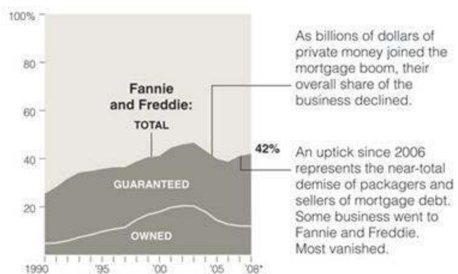
So the government offers its rescue of the mortgage companies, and foreigners keep stocking the government's coffers. "They don't want the U.S. to go into the worst downturn since the Depression," Mr. Tilton says.

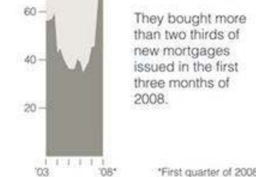
But all the while, the debt mounts along with the costs of an ultimate day of reckoning. Debate grows about the wisdom of leaning on foreign credit, and about how much longer Americans will retain the privilege of spending and investing money that isn't really theirs.

Bailouts amount to mortgaging the future to stave off the wolf howling at the door. The likelihood of a painful reckoning is diminished, while the costs of a reckoning — should one come — are increased.

The costs are getting big.

Titans of American Housing





Sources: Office of Federal Housing Enterprise Oversight (left); Inside Mortgage Finance (right)

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