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Paulson Plan: 'Truly Idiotic'

Economist Rips Efforts To Stimulate Economy; 'This Isn't Complicated'

By DENNIS K. BERMAN

Charles Calomiris is angry.

Hank Paulson's plan to save the economy? "Truly idiotic," says Mr. Calomiris, the Henry Kaufman Professor of Financial Institutions at Columbia University's Graduate School of Business. "This whole thing has been complete nonsense. We did it in the 1930s 10 times better than this. This isn't complicated."

Mr. Calomiris has long advised governments, banks and private investors on financial crises, so Deal Journal caught up with Mr. Calomiris to talk over the current state of the financial world.

Deal Journal: What is going on out there? The Citigroup
<<http://online.wsj.com/public/quotes/main.html?type=djn&symbol=c>>
bailout isn't a good sign of confidence in the overall financial system, is it?

Mr. Calomiris: The key thing we've learned during the downward spiral of confidence is that you have to deal with the problem in the mortgage market directly. There are probably 18 million subprime and Alt-A mortgages out of 57 million total. Probably half will end up in foreclosure. In the middle of a financial crisis, we're using half-measures designed in an inappropriate way, and we don't accompany them with other measures. This has just been a completely mismanaged policy response.

DJ: There is this perception that we can "fix" the price of individual mortgages. But shouldn't the price of homes find its natural equilibrium?

Mr. Calomiris: The market price is not decreed by God. The market price is an outcome of a variety of things. Recapitalizing the banks is helpful for giving them breathing room and for providing credit in the meantime. But it doesn't resolve the problem.

The problem is the completely opaque distribution of losses because no one knows how to value these mortgage losses. The way to solve the problem is from the bottom up.

DJ: How can we do that?

Mr. Calomiris: There's loss-sharing to encourage write-downs of mortgages. It was done in Mexico in 1995.

You also could have the government offer to buy any mortgage for 40 cents on the dollar.

Third, we could refinance all healthy mortgages at 5%, at 30-year fixed financing.

DJ: So what is the matter with some of Mr. Paulson's latest ideas?

Mr. Calomiris: Warrants are a bad idea. They dilute common stockholders, and make it harder to design common equity. It's been a design flaw all along. ... In terms of ways that truly recapitalize a bank, they're truly idiotic.

If you want to increase the net worth of a bank, make that coupon as low as possible and require matching common-stock issues. If you learn you can't do [the common-stock match] then you have to decide whether to do a common-stock injection, an assisted merger or close the bank.