Skirting *Depression*

A blow-by-blow account of the financial crisis—as it could have been. Would letting Lehman, AIG, and Citi all fail have produced a 13 percent U.S. unemployment rate?

BY JOHN M. BERRY

"Virtually every large financial firm in the world was in significant danger of going bankrupt... (B)ased on my experience as a policymaker, I knew that if the global financial system were to collapse, in the sense that many of the largest firms were to fail, and the financial sector essentially stopped functioning, I knew that the implications of that for the global economy would be catastrophic. We would be facing, potentially, another depression of the severity and length of the Depression in the 1930s."

—Federal Reserve Chairman Ben S. Bernanke

The United States and the world have avoided such a catastrophe, suffering instead over the past two years the worst recession since the 1930s. But it was a near thing.

Many actions by the Federal Reserve and Bush administration economic officials contributed to the country's escape from that potential depression. Some other moves, such as the handling of Fannie Mae and Freddie Mac, hurt far more than they helped. And of course inadequate regulation and supervision left the financial system vulnerable to the crisis in the first place.

But suppose, just suppose, that two critical decisions in September 2008 had gone the other way.

First, Bernanke and his colleagues on the Federal Reserve Board could have decided that they didn't have the authority to loan $85 bil-

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lion to American International Group, the world's largest insurance company. After all, AIG not only wasn't a bank, it wasn't even a financial institution regulated in any significant way by the federal government.

Second, the U.S. House of Representatives could have refused, not just once but twice, to pass U.S. Treasury Secretary Henry Paulson's $700 billion proposal to aid major financial institutions by buying many of the so-called toxic assets that were threatening their solvency. A combination of deep general anger at big banks and substantial conservative opposition came close to dooming the bailout plan as it was.

There's no way of knowing, of course, exactly what would have happened if the Fed had been more cautious and if skeptical members of Congress had refused to agree to bail out Wall Street—and in a larger sense, the U.S. economy. What follows is one of many possible versions of what might have happened, and it isn't pretty.

A FRIGHTENING ALTERNATIVE HISTORY OF THE FINANCIAL CRISIS

The U.S. economy began weakening slowly in late 2007 after the financial crisis began, but by the middle of 2008 many economists thought the country might suffer at worst a mild recession. However, the unemployment rate had gone up more than a percentage point, to 6.1 percent, when Lehman Brothers Holdings abruptly declared bankruptcy on Monday, September 15. Because of doubts about its viability, Lehman, an investment bank, could no longer fund itself. Treasury and Federal Reserve officials had tried frantically to find a buyer, but Paulson had refused to make any government money available to help a deal along. That weekend Bank of America, a possible Lehman buyer, snapped up Merrill Lynch instead.

The unexpected failure shocked the world financial system. Investors began to shed risk however they could as institutions hunkered down to ride out the storm. Stock prices fell sharply and many types of credit simply dried up.

A few days earlier, officials had learned that AIG was also running out of cash. On September 15, rating agencies lowered AIG's long-term credit rating, and a bank consortium backed away from approving a large loan that might have kept it going. The downgrade allowed a number of major financial institutions, including Société Générale, Goldman Sachs, Deutsche Bank, and Merrill Lynch, to demand AIG post collateral under terms of credit default swap contracts. With the downgrade, evaporation of the large bank loan, and the sudden jump in risk aversion, AIG could not roll over some of its $20 billion in outstanding commercial paper. A massive loan from the Fed became AIG's only hope, and when the Fed refused to step in, as the story goes in this alternative history, bankruptcy was unavoidable.

That fateful week, the U.S. government had let two very large financial companies fail, which after the Fed-assisted sale of Bear, Stearns the previous March, no one had expected. After all, too-big-to-fail had been the 2008 mantra. The shock was compounded by the fact that the slow-moving bankruptcy proceedings would keep creditors from knowing the extent of their losses for months if not years.

Suddenly it was hard to be sure which of the world's large financial firms were still solvent. Lehman had operations and a host of counterparties in a number of countries, and AIG's more than one hundred insurance subsidiaries were scattered across the globe. Financial regulators quickly moved to protect their own citizens by restricting the movement of assets by subsidiaries to parents in other nations.

Also on September 16, the Reserve Primary Fund, the original money market mutual fund, announced that losses on Lehman Brothers securities forced it to "break the buck"—that is, it couldn't maintain the $1 per share par value that is the mainstay of that industry. The announcement started a run on money market funds, which did not carry government insurance. At the end of the week, Treasury was forced to offer to guarantee balances in such funds that agreed to pay a fee, using its Exchange Stabilization Fund, intended for use in currency market intervention. But with world financial markets in chaos, and the AIG bankruptcy filing causing more losses for the funds, the run continued in this altered retelling of the story.

As the emergency unfolded, Paulson and Bernanke agreed that the situation had moved beyond what the central bank could handle. A large amount of money was needed to keep a number of the country's biggest financial

institutions afloat, money that Congress would have to authorize. President Bush backed Paulson's proposal for a $700 billion fund to acquire troubled assets from large banks, an indirect method of injecting capital into the banks. The two presidential candidates, Senators John McCain of Arizona, the Republican, and Barack Obama of Illinois, the Democrat—also supported the proposal.

While Paulson was negotiating with Congress in late September, the Office of Thrift Supervision put Washington Mutual Bank, the nation's largest thrift institution, into receivership with the Federal Deposit Insurance Corp. FDIC Chairman Sheila Bair announced the bank had been sold to JPMorgan Chase, the strongest of the country's big banks. But none of the creditors of WaMu's holding company were protected and it went into bankruptcy.

At that point, the notion of too-big-to-fail began itself to fail. Would the creditors of other bank holding companies be left holding the bag if a large bank failed? The unthinkable no longer seemed unimaginable. Even if the government wanted to prevent a failure, did it have the resources? The Fed was supposed to loan only to solvent institutions and against good collateral. Unless Congress produced a pot of money for Paulson's Treasury, there was no way to provide an ailing bank with significant amounts of capital.

President George W. Bush seemed paralyzed.

The problem was, the public didn't understand just how unhinged the financial world had become. Yes, stock prices were falling, as were home prices, but the latter had been going down for months. The calamity wrought by the cascading failures had only just begun to do great additional damage to the real economy. Besides, many people and many members of Congress felt the banks had brought their troubles on themselves and didn't deserve help.

By early October, the Senate had been persuaded a bailout was necessary. Nevertheless, the House twice rejected the plan. The first House vote drove the Dow Jones industrials stock index down by nearly 800 points.

The second vote rejecting the plan (in this alternative history of the financial crisis) drove the Dow down by another 1,500 points.

The rejection laid bare one of the vulnerabilities of American democracy in the face of an emergency: the president could request, even demand action from the legislature, but he could not force acquiescence.

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In Britain in contrast, Prime Minister Gordon Brown directed Alistair Darling, his chancellor of the exchequer, to take stakes in three of the five largest British banks at a cost of $62.5 billion. In a parliamentary system, there was no separate legislative branch to tell the executive, "No!"

Meanwhile, the AIG bankruptcy, in this altered retelling, meant that the hedges many major financial institutions thought they established by buying credit default swaps had evaporated. None of the institutions had realized they had collectively all sought hedges in the same company whose managers had never allocated nearly enough capital to cover the enormous risk it had taken on. But the damage from the bankruptcy was far greater than that. Regulators in many states began investigations to determine whether AIG insurance subsidiaries were still sufficiently creditworthy to be allowed to underwrite new policies.

This rocked the life insurance industry. States rely on cooperative agreements allowing their regulators to call on other insurance companies for money to cover the obligations of any company unable to meet them on its own. In our imagined history, the public began to pull back, not just from companies carrying the AIG logo but other insurance companies as well. In many instances, owners of whole life policies had accumulated cash values, and the policyholders moved to cash them in or borrow against them. Those who had been contributing to annuities, particularly those tied to stock prices, began to drop them. Overall, this public reaction led to a huge drain on insurance companies, forcing them to dump some of their investments into crashing markets.

The contagion continued to spread to other types of financial instruments, including so-called stable value funds offered by various investment funds as an option for individual 401(k) accounts. AIG and other insurance companies guaranteed that stable value funds would pay a certain rate of interest. If the actual return fell short, the insurance company was to make up the difference. But not if it was bankrupt. So something supposed to be stable suddenly wasn't.

As institutions everywhere became more and more risk-averse—in this alternative world without TARP and bank bailouts—borrowers got squeezed. Banks trimmed credit lines or cancelled them for both consumers and businesses. As the decline in payroll employment accelerated, frightened households slashed their spending so much that the economy contracted in the last three months of 2008 at what turned out to be more than a 10 percent annual rate, the worst decline since the credit controls fiasco in the spring of 1980.

Businesses, faced with collapsing sales and often unable to get credit, cancelled pending orders for goods and laid off workers. Previous plans for expansion or just replacement of worn out equipment were dropped.

In the White House, President George W. Bush seemed paralyzed. Paulson knew the country faced the worst economic crisis since the Depression, but he was unable to muster support in Congress for any new plan to deal with it. Not unlike the circumstances at the end of the Hoover presidency in 1933, everyone was waiting for a new president to deal with the disaster.

Obama was elected handily and the Democratic majority in both the House and Senate grew significantly, though neither would take over for more than two months. At least the inauguration wasn't delayed until March, as it was in Roosevelt's day.

The Fed's interest rate targets had been dropped almost to zero, but that wasn't enough to begin to stabilize the economy. If inflation had been higher, perhaps 3 percent, the Fed could have pushed real rates below zero. With the world economy going into the tank, however, inflation was nowhere to be seen. The Fed had hit what is known as the zero bound, just as Japan did in its "lost decade" of the 1990s. Furthermore, because the central bank did not have the legal authority (acquired in reality through the Emergency Economic Stabilization Act of 2008) to pay interest on excess bank reserves, there was no ready way for the Fed to push more cash into the financial system via so-called quantitative easing.

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Meanwhile, time was running out for some of the nation's largest financial institutions.

As doubts mounted about whether any large institution was really too big to be allowed to fail, some key sources of the institutions' financing began to dry up. The biggest banks live and die on the basis of whether they can attract relatively cheap money in the form of wholesale liabilities, not federally insured retail deposits. Since no one could be sure that unsecured creditors wouldn't be left empty-handed—as they were when WaMu went down—some of the banks began to resemble Lehman Brothers writ large.

With the government—in this version of the story lacking a TARP—still having no way to provide equity capital to banks, the Office of the Comptroller of the Currency, the agency that supervises national banks, was forced to take over Citibank, which could no longer fund itself, putting it into an FDIC receivership. The unthinkable had happened.

President Bush's father, President George H. W. Bush, had said in his memoirs that one reason in the first Gulf War he didn't have coalition forces push on to Baghdad and oust Saddam Hussein was that the United States would have owned the country and had to run it. Some economists and politicians had opposed Paulson's $700 billion plan to assist troubled banks on the grounds that the better answer was to nationalize such institutions—as Sweden did its handful of banks in 1992. Now the world would see if the government could run Citi (as we ponder what might have been).

In late 2008, Citi had nearly $2 trillion in assets, more than 300,000 employees, and, like AIG, did business in more than one hundred countries. As Citi teetered, some of the tens of thousands of companies with which it did business had pulled away. But a huge, complex institution remained with counterparties throughout the financial system. To avoid a total collapse of the system, federal officials decided they had no choice but to have the FDIC do what couldn't

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they had no choice but to have the FDIC do what couldn't be done before the takeover: guarantee all of Citi's debts, whether owed by the bank or the bank holding company.

At a stroke, that decision restored much of the potency of too-big-to-fail, saving Bank of America and several other banks that had been likely to follow in Citi's wake. Still, that wasn't nearly enough to mend a fractured financial system or the rapidly contracting economy. Those chores were going to take years.

Officials in other countries were aghast and angry that the U.S. government could have let Lehman, AIG, and Citi all fail. Generally bank and insurance supervisors stepped in to make sure that assets in subsidiaries of those companies weren't siphoned off to help their parents. In Mexico, as our imagined story goes, the government seized Citi-owned Banamex, the country's second-largest bank, because its laws prohibit any foreign government holding a stake in a Mexican bank. That was a blow to the receivership because Banamex accounted for about 15 percent of Citi's profits.

The federal government's guarantee of Citi's liabilities was believable only because the FDIC had the right to draw up to $500 billion from the Treasury as a backup for its otherwise woefully insufficient Bank Insurance Fund. Actually, regulators knew that amount wouldn't be enough to deal with all the bank losses facing the fund. What was still needed was a way to halt the contagion, and officials remained convinced that the cheapest route was to inject capital into banks in return for an equity stake.

With the economy reeling, Citi's shareholders wiped out and other big banks also in serious trouble, and the election over, Bernanke, Paulson, and Obama's economic advisers decided they had to make another run at Congress in this alternative history. Bush and Obama together asked congressional leaders to convene a lame duck session to address ways to bolster the economy. The public's anger hadn't gone away; if anything it had intensified. But many constituents had demand their representatives do something to reduce the pain.

Obama's advisers had weeks earlier begun work on a program intended to stimulate the economy, a combination of government spending increases and some tax cuts. And money had to be available to keep the hated banks afloat. The news that the unemployment rate had passed 8 percent in November, and was projected to reach double digits within two or three months, lent some urgency to the debate on Capitol Hill. Before Christmas the legislation, including money to assist banks, passed (about three months later than in reality).

Fortunately, some important protections for Americans were in place that weren't there in 1932: federal deposit insurance, unemployment compensation, food stamps, Medicare and Medicaid, agricultural price supports, Social Security and Supplemental Security benefits, and defined benefit pension plans—with a government insurance backup if needed. In some cases, the administrative network for obtaining benefits was all but overwhelmed by the rush. Food stamps were a particular problem.

The economy, in our alternative history, didn't bottom out until late 2009 and the jobless rate kept climbing for another year, eventually topping out at more than 13 percent.

Of course, such programs could only partially cushion the crises' impact on household wealth and income. They could not replace millions of jobs lost as thousands upon thousands of companies failed, stock prices dropped, and house prices kept tumbling.

So the first quarter of 2009, in this imagined history with no AIG rescue and no bank bailout, was almost as bad as the previous quarter with payroll jobs disappearing. By the spring, however, the downward spiral began to ease as the added federal spending came on-line and the financial system began to stabilize with more capital in the banks. Unemployment was so high, though, that the payroll taxes that support Social Security and Medicare were trimmed temporarily to encourage businesses to add workers.

The economy, in our alternative history, didn't bottom out until late 2009 and the jobless rate kept climbing for another year, eventually topping out at more than 13 percent. The government's debt-to-GDP ratio was projected to surpass 100 percent and its long-term fiscal situation, in poor shape before the crisis, looked dire indeed. (The reality is frightening enough: The White House currently projects a 77 percent debt-to-GDP ratio by 2020.)

The country—assuming no bailouts and no TARP—as a whole was much poorer and many of those who lost their jobs likely would never regain the financial standing they had lost. Some would never find full-time work again.

In the end, it wasn't a replay of the 1930s Depression. It only came close. ◆