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OP-ED COLUMNIST

Wall Street Voodoo

By PAUL KRUGMAN

Old-fashioned voodoo economics — the belief in tax-cut magic — has been banished from civilized discourse. The supply-side cult has shrunk to the point that it contains only cranks, charlatans, and Republicans.

But recent news reports suggest that many influential people, including Federal Reserve officials, bank regulators, and, possibly, members of the incoming Obama administration, have become devotees of a new kind of voodoo: the belief that by performing elaborate financial rituals we can keep dead banks walking.

To explain the issue, let me describe the position of a hypothetical bank that I'll call Gothamgroup, or Gotham for short.

On paper, Gotham has $2 trillion in assets and $1.9 trillion in liabilities, so that it has a net worth of $100 billion. But a substantial fraction of its assets — say, $400 billion worth — are mortgage-backed securities and other toxic waste. If the bank tried to sell these assets, it would get no more than $200 billion.

So Gotham is a zombie bank: it's still operating, but the reality is that it has already gone bust. Its stock isn't totally worthless — it still has a market capitalization of $20 billion — but that value is entirely based on the hope that shareholders will be rescued by a government bailout.

Why would the government bail Gotham out? Because it plays a central role in the financial system. When Lehman was allowed to fail, financial markets froze, and for a few weeks the world economy teetered on the edge of collapse. Since we don't want a repeat performance, Gotham has to be kept functioning. But how can that be done?

Well, the government could simply give Gotham a couple of hundred billion dollars, enough to make it solvent again. But this would, of course, be a huge gift to Gotham's current shareholders — and it would also encourage excessive risk-taking in the future. Still, the possibility of such a gift is what's now supporting Gotham's stock price.

A better approach would be to do what the government did with zombie savings and loans at the end of the 1980s: it seized the defunct banks, cleaning out the shareholders. Then it transferred their bad assets to a special institution, the Resolution Trust Corporation; paid off enough of the banks' debts to make them solvent; and sold the fixed-up banks to new owners.

The current buzz suggests, however, that policy makers aren't willing to take either of these approaches.

Instead, they're reportedly gravitating toward a compromise approach: moving toxic waste from private banks' balance sheets to a publicly owned "bad bank" or "aggregator bank" that would resemble the Resolution Trust Corporation, but without seizing the banks first.

Sheila Bair, the chairwoman of the Federal Deposit Insurance Corporation, recently tried to describe how this would work: "The aggregator bank would buy the assets at fair value." But what does "fair value" mean?

In my example, Gothamgroup is insolvent because the alleged $400 billion of toxic waste on its books is actually worth only $200 billion. The only way a government purchase of that toxic waste can make Gotham solvent again is if the government pays much more than private buyers are willing to offer.

Now, maybe private buyers aren't willing to pay what toxic waste is really worth: "We don't have really any rational pricing right now for some of these asset categories," Ms. Bair says. But should the government be in the business of declaring that it knows better than the market what assets are worth? And is it really likely that paying "fair value," whatever that means, would be enough to make Gotham solvent again?

What I suspect is that policy makers — possibly without realizing it — are gearing up to attempt a bait-and-switch: a policy that looks like the cleanup of the savings and loans, but in practice amounts to making huge gifts to bank shareholders at taxpayer expense, disguised as "fair value" purchases of toxic assets.

Why go through these contortions? The answer seems to be that Washington remains deathly afraid of the N-word — nationalization. The truth is that Gothamgroup and its sister institutions are already wards of the state, utterly dependent on taxpayer support; but nobody wants to recognize that fact and implement the obvious solution: an explicit, though temporary, government takeover. Hence the popularity of the new voodoo, which claims, as I said, that elaborate financial rituals can reanimate dead banks.

Unfortunately, the price of this retreat into superstition may be high. I hope I'm wrong, but I suspect that taxpayers are about to get another raw deal — and that we're about to get another financial rescue plan that fails to do the job.

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