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Scrambling to Clean Up After A Category 4 Financial Storm

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You know you're in a heap of trouble when the lender of last resort suddenly runs out of money.

Having pumped $100 billion into the banking system and lent $115 billion more to rescue Bear Stearns and AIG, the Federal Reserve was forced to ask the Treasury yesterday to borrow some extra money to replenish its coffers. If there was any good news in that, it was that investors here and abroad were eager to help out, having decided that the only safe place to put their money is in U.S. government securities. Indeed, demand was so brisk at one point yesterday that, for an investor, the effective yield on a three-month Treasury bill was driven below zero, once the broker's fee was figured in.

This is what a Category 4 financial crisis looks like. Giant blue-chip financial institutions swept away in a matter of days. Banks refusing to lend to other banks. Russia closing its stock market to stop the panicked selling. Gold soaring $70 in a single trading session. Developing countries' currencies in a free fall. Money-market funds warning they might not be able to return every dollar invested. Daily swings of three, four, five hundred points in the Dow Jones industrial average.

What we are witnessing may be the greatest destruction of financial wealth that the world has ever seen -- paper losses measured in the trillions of dollars. Corporate wealth. Oil wealth. Real estate wealth. Bank wealth. Private-equity wealth. Hedge fund wealth. Pension wealth. It's a painful reminder that, when you strip away all the complexity and trappings from the magnificent new global infrastructure, finance is still a confidence game -- and once the confidence goes, there's no telling when the selling will stop.

But more than psychology is involved here. What is really going on, at the most fundamental level, is that the United States is in the process of being forced by its foreign creditors to begin living within its means.

That wasn't always the case. In fact, for most of the past decade, foreigners seemed only too willing to provide U.S. households, corporations and governments all the cheap money they wanted -- and Americans were only too happy to take them up on their offer.

The cheap money was used by households to buy houses, cars and college educations, along with more health care, extra vacations and all manner of consumer goods. Governments used the cheap money to pay for services and benefits that citizens were not willing to pay for with higher taxes. And corporations and investment vehicles -- hedge funds, private-equity funds and real estate investment trusts -- used the cheap financing to buy real estate and other companies.

Two important things happened as a result of the availability of all this cheap credit.

The first was that the price of residential and commercial real estate, corporate takeover targets and the stock of technology companies began to rise. The faster they rose, the more that investors were interested in buying, driving the prices even higher and creating even stronger demand. Before long, these markets could best be characterized as classic bubbles.

At the same time, many companies in many industries expanded operations to accommodate the increased demand from households that decided that they could save less and spend more. Airlines added planes and pilots. Retail chains expanded into new malls and markets. Auto companies increased production. Developers built more homes and shopping centers.

Suddenly, in early 2007, something important happened: Foreigners began to lose their appetite for financing much of this activity -- in particular, the non-government bonds used to finance subprime mortgages, auto loans, college loans and loans used to finance big corporate takeovers. What should have happened at that point was that the interest rate on those loans should have increased, demand for that kind of borrowing should have decreased, the price of real estate and corporate stocks should have leveled off, takeover activity should have slowed and companies should have begun to cut back on expansion.

Mostly, however, that didn't happen. Instead, the Wall Street banks that originally made these loans before selling them off in pieces decided to try to keep the good times rolling -- and, significantly, keep the lucrative underwriting fees pouring in. Some used their own "AAA" credit ratings to borrow more money and keep the loans on their own balance sheets or those of "structured investment vehicles" they created to hide these new liabilities from regulators and investors. Others went back to the foreigners and offered to insure those now-unwanted takeover loans and asset-backed securities against credit losses, through the miracle of a new kind of derivative contract known as the credit-default swap.

As a result, when the inevitable crash finally came, it wasn't only those unsuspecting foreigners who bought those leveraged loans and asset-backed securities who wound up taking the hit. It was also their creators -- Bear Stearns, Merrill Lynch, Citigroup, Lehman Brothers, AIG and others -- who made the mistake of doubling-down on their credit risk at the very moment they should have been cutting back.

We are now nearing the end of the rocky process of uncovering the full extent of the credit losses of the major Wall Street banks and hedge funds. But as Robert Dugger, an economist and partner in a leading hedge fund likes to points out, the markets have only just begun to force some financial discipline on the majority of U.S. households that relied on borrowed money to maintain their lifestyles.

With nobody willing to finance those lifestyles, there are really only two choices.

One is to turn to Uncle Sam to keep the economy and the financial system afloat. Unlike businesses, households and Wall Street firms, the Treasury can still borrow from foreign banks and investors at incredibly attractive rates. And by acting as an intermediary, the Treasury and the Federal Reserve have shown a newfound willingness to use those funds to keep the housing market and the financial system from totally collapsing.

Last spring, the government borrowed $165 billion to send tax rebates to households in an effort to boost consumer spending. Now, some Democrats want to create a new agency that would use money borrowed by the Treasury to recapitalize troubled financial institutions by buying some of their unwanted loans and securities at discounted prices. The same strategy was used successfully during the Great Depression and the savings and loan crisis of the 1990s, and even some Republicans are warming to the idea.

In the end, however, there is only so much the government can borrow and so much the government can do. The only other choice is for Americans to finally put their spending in line with their incomes and their need for long-term savings. For any one household, that sounds like a good idea. But if everyone cuts back at roughly the same time, a recession is almost inevitable. That's a bitter pill in and of itself, involving lost jobs, lower incomes and a big hit to government tax revenues. But it could be serious trouble for regional and local banks that have balance sheets loaded with loans to local developers and builders who will be hard hit by an economic downturn. Think of that, says Dugger, as the inevitable second round of this financial crisis that, alas, still lies ahead.