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The B Word

By PAUL KRUGMAN

O.K., here it comes: The unthinkable is about to become the inevitable.

Last week, Robert Rubin, the former Treasury secretary, and John Lipsky, a top official at the International Monetary Fund, both suggested that public funds might be needed to rescue the U.S. financial system. Mr. Lipsky insisted that he wasn't talking about a bailout. But he was.

It's true that Henry Paulson, the current Treasury secretary, still says that any proposal to use taxpayers' money to help resolve the crisis is a "non-starter." But that's about as credible as all of his previous pronouncements on the financial situation.

So here's the question we really should be asking: When the feds do bail out the financial system, what will they do to ensure that they aren't also bailing out the people who got us into this mess?

Let's talk about why a bailout is inevitable.

Between 2002 and 2007, false beliefs in the private sector — the belief that home prices only go up, that financial innovation had made risk go away, that a triple-A rating really meant that an investment was safe — led to an epidemic of bad lending. Meanwhile, false beliefs in the political arena — the belief of Alan Greenspan and his friends in the Bush administration that the market is always right and regulation always a bad thing — led Washington to ignore the warning signs.

By the way, Mr. Greenspan is still at it: accepting no blame, he continues to insist that "market flexibility and open competition" are the "most reliable safeguards against cumulative economic failure."

The result of all that bad lending was an unholy financial mess that will cause trillions of dollars in losses. A large chunk of these losses will fall on financial institutions: commercial banks, investment banks, hedge funds and so on.

Many people say that the government should let the chips fall where they may — that those who made bad loans should simply be left to suffer the consequences. But it's not going to happen. When push comes to shove, financial officials — rightly — aren't willing to run the risk that losses on bad loans will cripple the financial system and take the real economy down with it.

Consider what happened last Friday, when the Federal Reserve rushed to the aid of Bear Stearns.

Nobody expects an investment bank to be a charitable institution, but Bear has a particularly nasty reputation. As Gretchen Morgenson of The New York Times reminds us, Bear "has often operated in the gray areas of Wall Street and with an aggressive, brass-knuckles approach."

Bear was a major promoter of the most questionable subprime lenders. It lured customers into two of its own hedge funds that were among the first to go bust in the current crisis. And it's a bad financial citizen: the last time the Fed tried to contain a financial crisis, after the collapse of Long-Term Capital Management in 1998, Bear refused to participate in the rescue operation.

Bear, in other words, deserved to be allowed to fail — both on the merits and to teach Wall Street not to expect someone else to clean up its messes.

But the Fed rode to Bear's rescue anyway, fearing that the collapse of a major investment bank would cause panic in the markets and wreak havoc with the wider economy. Fed officials knew that they were doing a bad thing, but believed that the alternative would be even worse.

As Bear goes, so will go the rest of the financial system. And if history is any guide, the coming taxpayer-financed bailout will end up costing a lot of money.

The U.S. savings and loan crisis of the 1980s ended up costing taxpayers 3.2 percent of G.D.P., the equivalent of $450 billion today. Some estimates put the fiscal cost of Japan's post-bubble cleanup at more than 20 percent of G.D.P. — the equivalent of $3 trillion for the United States.

If these numbers shock you, they should. But the big bailout is coming. The only question is how well it will be managed.

As I said, the important thing is to bail out the system, not the people who got us into this mess. That means cleaning out the shareholders in failed institutions, making bondholders take a haircut, and canceling the stock options of executives who got rich playing heads I win, tails you lose.

According to late reports on Sunday, JPMorgan Chase will buy Bear for a pittance. That's an O.K. resolution for this case — but not a model for the much bigger bailout to come. Looking ahead, we probably need something similar to the Resolution Trust Corporation, which took over bankrupt savings and loan institutions and sold off their assets to reimburse taxpayers. And we need it quickly: things are falling apart as you read this.