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The Big Bang of Bailouts

World leaders have spent trillions on confused, inadequate rescue plans. They need to spend more.

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It is now frighteningly clear that the world's dramatic financial rescue efforts are both unprecedented in scope and creativity, and wholly inadequate. Despite the round-the-clock labor by exhausted officials on a number of continents, the medicine is not taking. We stand on the threshold of a calamity that goes well beyond the rupture of the banking system and the deepening of a global recession and that leads to major political instability and conflict. The needed response is a big-bang global bailout that is even bigger than what we have seen so far, one that puts governments in front of the contagion rather than always one step behind, and that is large and sweeping enough to restore confidence.

To be sure, no one can accuse governments of dithering. In the United States, Ben Bernanke and Hank Paulson have orchestrated a series of rescue measures that now number more than a dozen so far this year, from the $200 billion bailout of Fannie Mae and Freddie Mac to the $1.4 trillion guarantee for bank-to-bank loans. But that's the problem. Depending on how you add up these measures, the total reaches as high as $8 trillion, a figure that represents more than half of U.S. GDP and is, according to Barry Ritholtz, author of the forthcoming "Bailout Nation," more than the sum of every major U.S. federal project in the past century, including the invasion of Iraq, the New Deal and the Marshall Plan to save Europe after the war. Indeed, it is more than the total the United States spent on World War II—$3.6 trillion in today's dollars.

Europe's combined effort has been just as aggressive. A new study by Independent Strategy of London puts the total spent by the nine leading European economies on various moves just to shore up wobbling banks at $3.36 trillion, versus $3.35 trillion by the United States. While the Bush administration's March stimulus package came to 1 percent of U.S. GDP, France, Germany, Italy and many other European nations have already produced packages that are relatively larger. And nearly every central bank on the planet has dropped interest rates so fast and so far that the banks can no longer use this basic weapon to get their economies moving.

It's very clear what happens next. More piecemeal, inadequate rescue attempts are the order of the day. The U.S. and European authorities are preparing 11-figure bailouts for their automobile industries, when experts already say that Detroit, in particular, will need at least 12 figures. Asian nations including China and India are joining the list of those trying to inspire consumer and company spending with tax cuts, or vast outlays of taxpayer cash on new building projects. The incoming Obama administration plans to spend $500 billion more on similar stimulus measures; Japan is debating a $50 billion plan; and the EU just approved $264 billion.

Yet economic conditions continue to deteriorate. Tight credit is slowing growth, which is raising unemployment and sapping consumer and investor confidence, which is scaring banks into restraining credit further. In such an intertwined downward spiral, all numbers are quickly out of date, but all point down.

The Christmas season now looks set to be the worst period for the U.S. economy since 1991, contracting at an annual rate close to 3 percent. The IMF continues to revise downward its projections for the global economy, and now expects 2.2 percent growth in 2009, down from more than 5 percent in the past four years, with rich nations falling into negative territory, and emerging markets—including China—growing much more slowly than before. For the global economy, most experts consider less than 2 percent growth a worldwide recession, because poor nations need some growth to create jobs for expanding populations. The World Bank just added its voice to those forecasting global recession, projecting barely 1 percent growth in 2009, and the sharpest contraction in developing nations since the Great Depression.

It wasn't long ago that most economists thought strong emerging markets could hold up the global economy, but now most developing countries are casualties of the crisis, as commodity prices plunge and consumer demand dries up. And there is no sign that the root of the global problem—the fact that banks lent way too much money to too many people and companies that were not worthy—is anywhere near solved. So far, banks have written off nearly a trillion dollars in losses, but estimates of the bad loans still on their books run about $1.7 trillion.

On the financial front, the recent rescue of Citigroup shows how the financial sector's problems are metastasizing. Subsidizing the September sale of Merrill Lynch cost the U.S. Treasury $38 billion; bailing out AIG in September and October cost $123 billion. The bill for Citigroup could come to $326 billion, and no one can be sure how many more major government interventions will be necessary, because no one knows how many toxic assets are still in the system and bank lending is months, maybe years, from returning to normal.

All leading indicators point south. Orders for Japanese machine tools, which are a strong indicator of how much companies are willing to spend on upgrading their plants, are dropping at the fastest rate since the early 1980s; world trade is projected to contract by more than 2 percent next year after several years of growth well above 4 percent per year; cross-border investment is likely to be down 50 percent this year compared with 2007 and will continue to dry up. The projections of rating agencies Moody's and Standard & Poor's for loan defaults are sharply up, including junk bonds whose risk premiums are at all-time highs.

The fundamental issue is fear. Despite the colossal problems in the U.S. economy, the dollar continues to strengthen, which just shows that investors fear other markets even more. Billions of dollars are flowing into three-year U.S. Treasury bills, whose interest rate is zero, so investors are merely trying to minimize losses, not make money. Clearly, the governments have not succeeded in restoring calm. Their efforts look improvised, confused and ineffective to the average consumer or investor. The poster child for this problem is the $700 billion Troubled Asset Relief Program in the United States. The bitter congressional debates over the program and its shifting purpose—from buying toxic assets to injecting cash—has left the public feeling that Washington isn't quite sure what it is doing. For many weeks now, the Treasury and the Fed have appeared to be constantly on the brink of unveiling yet another new program, leaving the impression that even they don't believe the current ones will work.

The second reason that the rescue efforts have failed is that no one was prepared for a crisis of such magnitude. Indeed, as the 9/11 Commission said about the terrorist strikes on New York and Washington, the reason the United States wasn't prepared was a lack of imagination. Previous crises—including the Latin American debt crisis of the early 1980s and the Asian financial crisis almost two decades later—were far less global in impact and far less complex in terms of the link between banks and the real economy. Indeed, an argument can be made that finance ministries and central banks are fighting this 21st-century conflagration with antiquated tools and 20th-century institutions. Postwar agencies like the World Bank and IMF have yet to rally the global effort that is required.

The question now is whether the current approach—gradually upping the ante and experimenting with new rescues— should be allowed to run its course, or whether a dramatic escalation is required. The argument for staying the course is that the

billions already committed to the financial rescue are working their way through the system, and will eventually revive markets, perhaps sooner than anyone thinks. Global finance is very resilient, and there is, in any event, no dodging the pain of the credit crunch.

Against this line of reasoning is the possibility that, just as experts have underestimated the swift descent of the world economy, they may be underestimating the social and political fallout. Some of these explosive problems are already on the horizon. The beggar-thy-neighbor trade policies that worsened the Great Depression have current echoes in the accusations that China is now manipulating its currency to promote its exports, that a bailout of Detroit will discriminate against Japanese automakers, or that some national stimulus packages are designed to favor domestic producers. Blocking world trade and investment would all but ensure a 1930s-scale downturn, with dire consequences for all the recent progress made toward establishing market economies, building democratic governments and reducing world poverty. Last week the World Bank announced that 155 million people have been pushed into poverty in 2008. There are already signs that economic distress is increasing nationalist fervor and political instability in hot spots including Pakistan, Turkey, Ukraine, the nations of Central Asia, Thailand and Iran.

The risks are too great not to move more boldly. President-elect Barack Obama is the only world leader who would have a chance of marshaling the global effort that is required, and he has to consider plans much bigger than anything he, or any member of his team, has publicly proposed so far. The U.S. stimulus package would have to be big enough to allay any doubts that the United States is not going to risk failure: $1 trillion (about 7 percent of GDP) over two years is the right order of magnitude, not $500 billion over the next two years, as Obama has proposed. Despite the plans for grand infrastructure projects and the greening of American society, it is vital that an overwhelming amount of the stimulus be dispersed quickly and in a way that gives Americans confidence that the deterioration of their lives and economic security will be stopped. This would entail a heavy emphasis on significant and permanent tax cuts for the middle class, meaningful extension of unemployment compensation and serious funding for job training and retraining.

Unfortunately there is no way to finance a massive stimulus without going into deeper deficit and incurring extraordinary levels of debt. However, this is a better solution than watching the global economy collapse. It's true that we would run the risks of serious inflation, but at the earliest this would be a problem a few years from now, when economic activity really picks up, and we will have to confront the problem then. But to worry about those inflation problems now would be Hooveresque.

The United States cannot act alone. Europe and Japan, as well as big emerging markets like China, India and Brazil, would need to make efforts of similar magnitude relative to the size of their economies, although the specific directions might differ by country. The total spent on stimulus should amount to $4 trillion, or about 7 percent of global GDP, a roughly sevenfold increase over current efforts.

To get this done, Obama would need to call the G20 together as soon as he is inaugurated on Jan. 20. If the United States pulls out the stops to ramp up growth and others do not follow, Washington would come under heavy pressure to restrict access to its energized market on the part of foreign exporters that want a free ride. National treasuries and central banks also need to do more to prop up the financial system: the U.S. Treasury and the Fed are working on plans to expand credit to consumers and homeowners, and that is certainly the right track so long as the programs are big enough. In addition, it is time to cleanse the system of toxic assets in the way the U.S. Treasury first intended. More injections of equity will be necessary to recapitalize the banks, too. Obama should announce in his Inaugural speech a one-year moratorium on housing foreclosures, a major political and psychological boost to the economy that would help stop the rot.

At the January G20 meeting President Obama should get the EU, India, Brazil and China in a room and hammer out a trade deal for the stalled global negotiations called the Doha round. The wrangling has gone on for the better part of a decade. Ending it on a positive note would be a first step in showing the world that we are determined to maintain an open global economy.

One of the big problems plaguing global markets now is that no one knows where the trends are leading. Are we headed for government domination of markets—more toward Chinese state capitalism than American-style free markets (at least as they were a year ago)? Is the financial system going to be characterized almost entirely by behemoth commercial banks that are risk-averse, or will there be room for institutions that will be able to take the chance of financing the great innovations of the

future? When the dust settles, will there be a new global monetary authority or financial regulator?

Under ordinary circumstances, it might be enough to let the market settle these questions. But these are not those times. Uncertainty is the enemy of stability and growth. Governments are, like it or not, in charge. Obama needs to push for a G20 consensus toward a vision on all these issues, all at once. This is a tall order, to be sure, but the crisis is proving that even efforts unprecedented in size and scope are too small when delivered one at a time. The world needs a sweeping shock to the system.

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