

OP-ED COLUMNIST

Crisis Endgame

By PAUL KRUGMAN
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On Sunday, Henry Paulson, the Treasury secretary, tried to draw a line in the sand against further bailouts of failing financial institutions; four days later, faced with a crisis spinning out of control, much of Washington appears to have decided that government isn't the problem, it's the solution. The unthinkable — a government buyout of much of the private sector's bad debt — has become the inevitable.



Paul Krugman

The story so far: the real shock after the feds failed to bail out Lehman Brothers wasn't the plunge in the Dow, it was the reaction of the credit markets. Basically, lenders went on strike: U.S. government debt, which is still perceived as the safest of all investments — if the government goes bust, what is anything else worth? — was snapped up even though it paid essentially nothing, while would-be private borrowers were frozen out.

Thus, banks are normally able to borrow from each other at rates just slightly above the interest rate on U.S. Treasury bills. But Thursday morning, the average interest rate on three-month interbank borrowing was 3.2 percent, while the interest rate on the corresponding Treasuries was 0.05 percent. No, that's not a

misprint.

This flight to safety has cut off credit to many businesses, including major players in the financial industry — and that, in turn, is setting us up for more big failures and further panic. It's also depressing business spending, a bad thing as signs gather that the economic slump is deepening.

And the Federal Reserve, which normally takes the lead in fighting recessions, can't do much this time because the standard tools of monetary policy have lost their grip. Usually the Fed responds to economic weakness by buying up Treasury bills, in order to drive interest rates down. But the interest rate on Treasuries is already zero, for all practical purposes; what more can the Fed do?

Well, it can lend money to the private sector — and it's been doing that on an awesome scale. But this lending hasn't kept the situation from deteriorating.

There's only one bright spot in the picture: interest rates on mortgages have come down sharply since the federal government took over Fannie Mae and Freddie Mac, and guaranteed their debt. And there's a lesson there for those ready to hear it: government takeovers may be the only way to get the financial system working again.

Some people have been making that argument for some time. Most recently, Paul Volcker, the former Fed chairman, and two other veterans of past financial crises published an op-ed in The Wall Street Journal declaring that the only way to avoid "the mother of all credit contractions" is to create a new government agency to "buy up the troubled paper" — that is, to have taxpayers take over the bad assets created by the bursting of the housing and credit bubbles. Coming from Mr. Volcker, that proposal has serious credibility.

Influential members of Congress, including Hillary Clinton and Barney Frank, the chairman of the House Financial Services Committee, have been making similar arguments. And on Thursday, Charles Schumer, the chairman of the Senate Finance Committee (and an advocate of creating a new agency to resolve the financial crisis) told reporters that "the Federal Reserve and the Treasury are realizing that we need a more comprehensive solution." Sure enough, Thursday night Ben Bernanke and Mr. Paulson met with Congressional leaders to discuss a "comprehensive approach" to the

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We don't know yet what that "comprehensive approach" will look like. There have been hopeful comparisons to the financial rescue the Swedish government carried out in the early 1990s, a rescue that involved a temporary public takeover of a large part of the country's financial system. It's not clear, however, whether policy makers in Washington are prepared to exert a comparable degree of control. And if they aren't, this could turn into the wrong kind of rescue — a bailout of stockholders as well as the market, in effect rescuing the financial industry from the consequences of its own greed.

Furthermore, even a well-designed rescue would cost a lot of money. The Swedish government laid out 4 percent of G.D.P., which in our case would be a cool \$600 billion — although the final burden to Swedish taxpayers was much less, because the government was eventually able to sell off the assets it had acquired, in some cases at a handsome profit.

But it's no use whining (sorry, Senator Gramm) about the prospect of a financial rescue plan. Today's U.S. political system isn't going to follow Andrew Mellon's infamous advice to Herbert Hoover: "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate." The big buyout is coming; the only question is whether it will be done right.

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