The Daily Dish

Politics and Policy in Emergency Rescues

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Eakinomics: Politics and Policy in Emergency Rescues

At the heart of the 2007-08 Great Recession were bad mortgages. There were people – largely on the coasts – who had bought homes at the peak of the housing bubble. When prices collapsed, people were "underwater" because the mortgage debt exceeded the value of the houses. There were other people – largely in the interior – who needed cash and took out second mortgages on their homes. When the crisis came they, too, had mortgage debt that exceeding their house values.

On top of these basic mortgage loans was built an amazing superstructure of complicated financial assets – mortgage-backed securities (MBS), tiered securities returning different risky portions of the MBS, and an alphabet soup of other derivatives. They shared one common flaw: if the mortgages stopped getting paid, there was no cash, and the complex financial architecture came tumbling down. We lived through the day-by-day throes of that unwinding and the damage it did to financial services and ultimately the Main Street economy.

I was on the McCain presidential campaign and designed numerous plans that had the following basic logic. Take the non-performing mortgages and replace them with ones suitable for the new (lower) house values. Pay off the non-performing one in full using the proceeds of the new loan, and fill in the difference with taxpayer dollars. This would have cost hundreds of billions of taxpayer dollars.

Notice, however, that pouring the money in at the source of the problem yields two benefits. First, the homeowners stay in their homes and out of financial distress. Second, every mortgage performs in the end; the derivatives built on those mortgages perform in the end, the balance sheets of every bank and financial institution remain sound in the end, and there is no reason to visit a credit crunch and financial distress on Main Street.

It was brilliant (if I do say so), and it was widely despised. Many people were in homes and not underwater; they did not want their dollars used to "bailout" someone who had not been as prudent. The Tea Party movement literally sprang from outrage over this kind of a program. In the end, Congress and the administration went other, less effective, ways.

It seems to me that we are in the same kind of moment. In this crisis, ground zero for the crisis is firms, large and small, that were perfectly sound but now have no customers and no revenue. And when the restaurant has to close up, the bakery and food suppliers are next. We are seeing a cascading impact whereby one revenue stream after another is drying up. If it continues, eventually it will mean that loans are not repaid and the Main Street distress will take down the banks and Wall Street as well. As before, the quickest remedy would be to provide businesses with grants or loans on the condition that they do not lay anybody off. The grants and loans would keep the business intact; the continued payroll would keep workers and their families intact.

But the idea of a “bailout” to firms is a political anathema to some. They would rather help people than big business, or so the talking points go. But putting the money into families does not preserve the businesses or their jobs.

In the normal course of events, it is hard to make good policy politically advantageous. We like to think that in a crisis politics is less important and “doing the right thing” is at a premium. Is it?