OP-ED COLUMNIST

Cash for Trash

By PAUL KRUGMAN
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Some skeptics are calling Henry Paulson's $700 billion rescue plan for the U.S. financial system "cash for trash." Others are calling the proposed legislation the Authorization for Use of Financial Force, after the Authorization for Use of Military Force, the infamous bill that gave the Bush administration the green light to invade Iraq.

Paul Krugman

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There's justice in the gibes. Everyone agrees that something major must be done. But Mr. Paulson is demanding extraordinary power for himself — and for his successor — to deploy taxpayers' money on behalf of a plan that, as far as I can see, doesn't make sense.

Some are saying that we should simply trust Mr. Paulson, because he's a smart guy who knows what he's doing. But that's only half true: he is a smart guy, but what, exactly, in the experience of the past year and a half — a period during which Mr. Paulson repeatedly declared the financial crisis "contained," and then offered a series of unsuccessful fixes — justifies the belief that he knows what he's doing? He's making it up as he goes along, just like the rest of us.

So let's try to think this through for ourselves. I have a four-step view of the financial crisis:

1. The bursting of the housing bubble has led to a surge in defaults and foreclosures, which in turn has led to a plunge in the prices of mortgage-backed securities — assets whose value ultimately comes from mortgage payments.

2. These financial losses have left many financial institutions with too little capital — too few assets compared with their debt. This problem is especially severe because everyone took on so much debt during the bubble years.

3. Because financial institutions have too little capital relative to their debt, they haven't been able or willing to provide the credit the economy needs.

4. Financial institutions have been trying to pay down their debt by selling assets, including those mortgage-backed securities, but this drives asset prices down and makes their financial position even worse. This vicious circle is what some call the "paradox of deleveraging."

The Paulson plan calls for the federal government to buy up $700 billion worth of troubled assets, mainly mortgage-backed securities. How does this resolve the crisis?

Well, it might — might — break the vicious circle of deleveraging, step 4 in my capsule description. Even that isn't clear: the prices of many assets, not just those the Treasury proposes to buy, are under pressure. And even if the vicious circle is limited, the financial system will still be crippled by inadequate capital.

Or rather, it will be crippled by inadequate capital unless the federal government hugely overpays for the assets it buys, giving financial firms — and their stockholders and executives — a giant windfall at taxpayer expense. Did I mention that I'm not happy with

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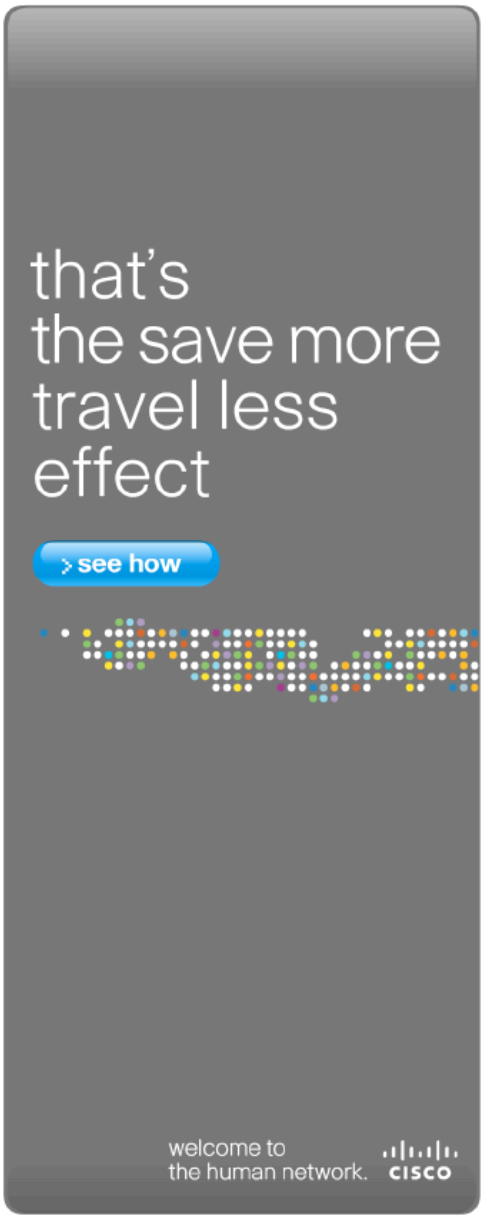

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this plan?

The logic of the crisis seems to call for an intervention, not at step 4, but at step 2: the financial system needs more capital. And if the government is going to provide capital to financial firms, it should get what people who provide capital are entitled to — a share in ownership, so that all the gains if the rescue plan works don't go to the people who made the mess in the first place.

That's what happened in the savings and loan crisis: the feds took over ownership of the bad banks, not just their bad assets. It's also what happened with Fannie and Freddie. (And by the way, that rescue has done what it was supposed to. Mortgage interest rates have come down sharply since the federal takeover.)

But Mr. Paulson insists that he wants a "clean" plan. "Clean," in this context, means a taxpayer-financed bailout with no strings attached — no quid pro quo on the part of those being bailed out. Why is that a good thing? Add to this the fact that Mr. Paulson is also demanding dictatorial authority, plus immunity from review "by any court of law or any administrative agency," and this adds up to an unacceptable proposal.

I'm aware that Congress is under enormous pressure to agree to the Paulson plan in the next few days, with at most a few modifications that make it slightly less bad. Basically, after having spent a year and a half telling everyone that things were under control, the Bush administration says that the sky is falling, and that to save the world we have to do exactly what it says now now now.

But I'd urge Congress to pause for a minute, take a deep breath, and try to seriously rework the structure of the plan, making it a plan that addresses the real problem. Don't let yourself be railroaded — if this plan goes through in anything like its current form, we'll all be very sorry in the not-too-distant future.

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