Ask the oil producers to rescue Wall Street
By Anil Kashyap and Hyun Song Shin
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The fire sale of Bear Stearns, the US investment bank, brings the credit crisis to a new, more dangerous phase. Many market participants seem to be hoping for a short-term miracle from the Federal Reserve to end the turmoil. They will be disappointed.

Bear Stearns could not borrow because its creditor banks and counterparties use modern risk management systems that require them to hold enough capital to meet potential losses on their portfolios. When the “value at risk” of its portfolio rises, a bank must either raise more capital to support the additional risk or shrink the risk (by selling assets, demanding larger “haircuts” – cash safety margins – from investors or not rolling over loans).

As the credit crisis has continued, banks’ measured risks have rocketed. At the same time, banks have suffered losses that have depleted their capital. This combination of factors has brought the US financial system to its knees. Credit lines are being withdrawn as banks try to ratchet down the risks they face. That Bear Stearns could fetch only $2 per share, when a week earlier it was trading at $70 per share, is the best available proof that banks’ appetite for risk-taking has vanished. This could be the beginning of a massive global credit crunch.

Several conclusions follow. First, since the largest intermediaries do not have enough capital to support their measured risks, they will keep trying to shrink their balance sheets unless they can rebuild their capital (or, magically, their perceived risk falls). This explains why the Fed’s liquidity measures such as the term auction facility, the term securities lending facility and the new primary dealer credit facility are likely to be temporary patches that do not stop the distress.

Banks want to shrink risk exposure, not maintain or expand it. Liquidity support by the Fed is an invitation to borrow from the central bank for on-lending to others – that is, to expand balance sheets. On the contrary, the banks and brokers want to contract their balance sheets.

Second, the Fed is not well-equipped to deal with this problem. To create real capital it would need to make outright purchases of impaired collateral at above-market prices. This would amount to a publicly funded shareholder bail-out. This is not the central bank’s job and the Fed knows it.

Third, recapitalising the banks should be the priority. For a start, the suspension of dividends (even by well-capitalised banks) will free up lending capacity. However, this is unlikely to be enough and will take time. New capital needs to be found soon. Existing shareholders will no doubt resist dilution, but they must not be allowed to stand in the way of a solution. These are the very shareholders who allowed their banks to create the current mess, which now threatens to cripple the financial system.

The quickest solution is to identify some buyers before the next spiral down. One obvious set of buyers are the Middle Eastern sovereign wealth funds. They have stepped up once and were burnt on their first wave of investments. But since the January meeting of the Fed’s open market committee, when the central bank made it abundantly clear that it will try everything possible to stave off collapse, oil prices have risen from roughly $92 a barrel to $109 (as of March 18). Other commodity prices have also risen over this period. Given the deteriorating prospects for the global economy over this time, a plausible interpretation is that some of the financing that might have gone to the financial institutions has instead been directed towards buying commodities such as oil. This portfolio reallocation represents a pure windfall for the oil producers.

Middle Eastern oil countries produce roughly 25m barrels of oil a day. If they could be persuaded to recycle $4 a barrel of the $17 price run up since the January Federal open market committee meeting, this would represent $4bn of capital that could be deployed; Bear Stearns was sold for $250m. Admittedly, this is a conversation for Condoleezza Rice, secretary of state, and not Hank Paulson, Treasury secretary, to have. But it is worth recalling that the firms that bailed out Long-Term Capital Management in 1998 in fact profited nicely, and relatively quickly. Conversely, if a full-blown credit crunch ensues, the fallout to the world economy is likely to be large enough to pull the price of oil back down sharply.

Finally, in case our proposal sounds unpalatable, it should be compared with the alternative in which the banking system deteriorates to the point where a public recapitalisation becomes inevitable. Direct government ownership should be the last resort but failure to move soon could make it the only option left on the table.

Anil Kashyap is Edward Eagle Brown professor at the University of Chicago Graduate School of Business. Hyun Song Shin is professor of economics at Princeton University. They are co-authors with David Greenlaw and Jan Hatzius of ‘Leveraged Losses: Lessons from the Mortgage Market Meltdown’

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