OPINION

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The American financial system is in deep trouble. Regulatory moves to guaran-
tee money market funds and the conversion of Morgan Stanley and Goldman Sachs into bank holding companies, and the Trea-
sury's asset purchase pro-
posal have staved off a crisis for now. These hurried ac-
tions have also bought us some time to consider what would be a rational way to revitalize the system.

Any plan has to fulfill at least three more objectives: It has to have a real chance of pre-
venting the deep and prolonged recession that is likely to ensue if the financial sys-
tem is not recapitalized. It should strive to achieve that first objective at the lowest possible costs to the U.S. taxpayer. And it should not bail out the existing investors to avoid sowing the seeds for the next crisis.

The Treasury plan to buy distressed se-
bund markets, thus allowing financial insti-
tutions to sell their assets, and, of course, this means they will make fewer loans, even to the healthy portions of the economy. The credit crunch will only gradually occur if it im-
lies lower corporate investment, less com-
mercial and residential construction, fewer starts on new office and condo projects, and in general, a much slower pace of economic growth. To avoid this contraction, levered financial institutions need more capital so that they can continue lending.

The plan to purchase distressed assets from, of course, financial insti-
tutions in three indirect ways. By paying above the market value for illiquid as-
sets (paying the hypothetical “held-to-ma-
turity” value), the Treasury hopes to indi-
cirectly recapitalize institutions. By creating a market for those assets we hope to estab-
lish prices to be established, it hopes other pri-

vate players will enter the market, “liqui-
dating” the market. Treasury also probably hopes that once the illiquid assets are off balance sheet, institutions will be able to raise capital, and will become more willing to lend.

These are sound intentions, but possi-
bly inconsistent. Paying a hypothetical “held-to-maturity” price will not help the market discover the true price that traders, who don’t have the government’s long-term horizons, are willing to pay. Moreover, it is not clear how that hypothetical price will be established through com-
petitive auctions. Finally, of course, in the event of overpaying (though they get the benefit of a sounder econ-
omy), with little or no direct help from the private sector.

There are many additional ways in which things could go wrong. The institu-
tions with the most toxic assets are the ones that have made the worst decisions, and are likely to be the closest to default. While they may get the most relief from selling assets, they are unlikely to turn around and expand their lending quickly (nor should they, given their record). In contrast, relatively healthy financial institutions that probably have the greatest ability to expand lending may not be the ones getting much of the additional capital in the Treasury plan for they have few illi-
quid assets to sell.

Modifications to the Treasury plan could achieve much of the objectives we see. As the chairman of the Federal Reserve, Ben Bernanke, has suggested, the taxpayer can get “contingent equity” from sellers that is equal to 12% of any losses on the gover-
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