There is little political enthusiasm for further support to the banking sector. One reason is that banks that received money in the initial rescues do not seem to have turned around and increased the volume of lending. Yet without the resumption of bank lending, monetary and fiscal stimulus are unlikely to be effective. And for banks to lend, more intervention may first be needed.

To see why, we need to understand why banks are so reluctant to lend. One possibility is that they worry about borrower credit risk, though this needs to be extreme to justify the complete cessation of term lending. A second is that they may worry about having enough resources to meet the demands of their own creditors, if they lock up funds in long term lending today. Yet, the many central bank lending facilities that have been opened across the world should assuage these concerns, especially for the banks that are large and well capitalized.

Perhaps, however, it is not just the fear of being short of funds to meet creditor demands that drives the reluctance to lend, but the fear of being short of funds if investment opportunities get even better. Citicorp CEO, Vikram Pandit, said as much when he indicated that it was cheaper to buy loans on the market than to make them. And buying may get cheaper still!

Take, for example, the real possibility that a large indebted financial institution faces runs as Lehman did, and starts dumping loans in the market. Not only will the price of those loans fall if there are only a few entities with the spare funds to buy them, the scramble to borrow at that time by other distressed entities will ensure that it will be very hard for any institution that does not already have funds to get them. Anticipating the prospect of such future fire sales (of loans, financial assets, or institutions), it is understandable that even strong banks will restrict their lending to very short maturities, and not lock up liquidity in term loans.

This may also explain why markets for some assets have dried up completely. Some distressed banks clearly possess large quantities of mortgage backed securities. They hope that the prices of these securities will rise in the future, saving them from failure, and are reluctant to sell those assets today. At the same time, buyers feel they could potentially buy at even lower prices down the line. While there is a price today that reflects those expectations, it is not a price that the distressed banks want to sell at.

There is therefore an overhang of illiquid, potentially insolvent, financial institutions over the market, whose holdings could be unloaded if they run into difficulties. For some institutions, low prices would render them insolvent. And for others, low prices would be a tremendous buying opportunity, whose prospective return dominates returns from lending today. Political exhortations to lend can have some, albeit limited, impact. However, a voluntary resumption of lending will necessitate reducing both fears and potential opportunities.

There are three possible ways the overhang can be reduced. First, the authorities can offer to buy illiquid assets through auctions and house them in a government entity, much as was
envisioned in the original Troubled Asset Relief Program. This can reverse a freeze in the market caused by distressed entities that are unwilling to sell at prevailing market prices. The fact that the government is willing to buy in the future (and now) should raise prices today because it reduces the possibility of low prices in a future fire sale. Moreover, once sufficient distressed entities sell their assets, prices will rise simply because there is no longer a potential overhang of future distressed fire sales. Both effects can lead to increased trade in illiquid assets today, and unlock lending, though it may require significant outlays.

A second approach is for the government to ensure the stability of significant parts of the financial system that holds illiquid assets through the recapitalization of entities that have a realistic possibility of survival, and the merger or closure of those that do not. For those entities that are closed down, this will mean moving illiquid assets into a holding entity that will dispose them off slowly over time. One problem is the authorities might have to intervene in weak institutions in the unregulated “shadow” financial system, especially if a large portion of the assets are held in this still hemorrhaging sector (the public appetite for a bailout of hedge funds is rightly small).

The third approach is a mix of the first two, where the authorities buy illiquid assets, even while cleaning up the regulated financial sector, focusing particularly on resolving regulated entities that are likely to become distressed. Note that this differs substantially from the current approach where well-capitalized entities are given even more capital, which does not deal with the overhang of illiquid assets that more distressed entities hold. Unless the regulated levered financial system is systematically audited, with weak entities stabilized through capital injections, asset purchases, or mergers, or liquidated quickly, the overhang of distressed institutions will persist for a long while, constraining lending.

One of the lessons from Japan’s experience in the 1990s is that the sooner the authorities bite the bullet and clean up the financial system, the sooner the economy will be on its road to recovery. The longer they stay paralyzed, hoping it will right itself, the higher the eventual cost of cleanup will be.

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