Thursday, October 2. 2008

Bailout Explained

Let's cut the BS. The proposed government bailout promises you, the taxpayer, two things: 1) you might get some of the 700 billion the government takes from you back; 2) banks that benefit from the bailout might make you a loan.

If you don't want to read the whole article, here's a quick summary. The proposed government bailout promises you, the taxpayer, two things: 1) you might get some of the 700 billion the government takes from you back; 2) banks that benefit from the bailout might make you a loan.

The argument our politicians are utilizing to sell the public the bailout is as follows:
1) The banks, primarily due to the mortgage crisis, are unwilling or unable to lend money.
2) Our economy relies on loans. When banks can't or won't loan money, a credit crunch results.
3) If the government doesn't intervene, small business, families, etc. will suffer because they won't be able to get loans for cars, houses, business, to meet payrolls, etc.
4) A lack of credit will hurt everyone, therefore, we need to bailout they banks and buy their bad debts so they can make loans again.
So, what does the solution look like?
1) Government increases debt ceiling by 700 billion.
2) You, the taxpayer, now are on the hook for 700 billion. You'll either pay it now through an immediate tax increase, or you'll pay it over time as the 700 billion is rolled into the national debt.
3) The Treasury will now buy bad debt, commercial paper, and other financial instruments that the banks can't sell because: 1) there is no buyer for them, or 2) don't want to sell because they would lose huge amounts of money doing so. Some of the commercial paper and other instruments will be worthless.
4) The government will, in essence, issue you, the taxpayer, an I.O.U., promising to eventually recover all or part of the 700 billion. You may want to be skeptical if you remember what Congress did with the Social Security Trust Fund that they drained to spend on other things.
5) The bank will now, in theory, have bad debt off its books to issue loans. Of course, there is no guarantee they will loan money to you or anyone else, since this is the decision of the bank and will depend on many factors.
Summary:
You, the taxpayer, are being asked to pay 700 billion to buy bad bank debt. In return you receive two promises:
1) The government might recover the 700 billion someday.
2) The bank might make you, or somebody else, a loan.
So, while oversimplified, that's the bailout plan in a nutshell. Are you ready to pony up 700 billion based on these two government promises?
P.S.
1) The bailout doesn't take into account the negative consequences of rewarding the bad behavior of banks, mortgage companies and home buyers.
2) The bailout doesn't consider the negative consequences of malinvestment of capital. Instead of letting the free market allocate resources where they will be used most productively, the bailout allocates resources to those who made wrong bets, or worse cheated.
3) The current bailout doesn't account for commercial real estate, which by several accounts, is as bad or

worse than the residential mortgage market. Banks have lots of bad loans and paper on the commercial real estate market that they haven't dealt with yet.
4) The bailout doesn't take into account the effect of a likely economic slowdown on tax revenues, which will increase the share of the public debt that each taxpayer owes.
3) The bailout doesn't consider the similar economic crises faced by other western nations and the negative consequences on trade - which will hurt our economy as well.
5) The bailout doesn't consider the effects of the government's effort to artificially maintain the inflated prices of real estate. This represents a hidden tax on all people wanting to purchase a home. Instead of being able to buy a house at a lower price and use the money they save for other things, including investing, saving, or making other purchases, this money will be spent on housing, or home purchases will be delayed. The result is that money that could be directed into the residential real estate market, retail, etc. will be directed to banks and other institutions that issue loans, or will be "lost" as potential home buyers stay in current home or rental.
6) The bailout assumes government is smarter than all of the individuals who make up the free market. That sounds like a worse bet than made by the banks during the housing bubble.
7) The law of unintended consequences. Its almost certain there will be unintended bad consequences of the bailout. Austrian Economics would assert that malinvestment and prolonging the housing bubble will only make our economic situation worse, possibly turning a 12-18 month recession into a longer, deeper recession or depression.

For an in-depth look at the bailout and how it fits into the Austrian Theory of the Business Cycle read the Bailout Reader.

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Print Version (2 page) suitable for faxing to Congress.

You can use the following text for the cover sheet of your fax:

The whole bailout amounts to two government promises:

1) The government might pay back 700 billion;
2) Banks, once government buys their bad debt, might make loans to the public that bailed them out in the first place.
Is it worth gambling 700 billion dollars on two maybes?
The full article is attached.

Posted by Terry in General News at 09:23