Market Manipulation, Nationalized

The Fed and Treasury are putting their heads together to find a solution. They need to figure out first what the problem is beyond the symptoms we see. It is, however, a first step. Managing expectations at a time like this is as important as material policy.

It looks like they propose a system wide solution since their ad hoc measures are not working and the fairness of their process or lack of it has been called into question. It doesn't mean that ad hoc solutions won't be found for Goldman Sachs and Morgan Stanley. It certainly buys them time for a more orderly solution.

On the subject of bailouts, the US cried foul when Malaysia established currency controls, when HK spent 15 billion USD (1997 prices, in a much smaller market than it is today), to fend of the speculators, when Malaysia's Khazanah bailed out the banks by buying their assets.

Academic purity reacts to all this by pointing out that:

Singapore did nothing during the 1997 crisis but emerged from recession ahead of Malaysia.

Bailouts sew the seeds of the next crisis.

The Greenspan put which was responsible in great part for the current crisis is now replaced by the Paulson put.

The intentions of the current plan look highly domestically focused and internationally myopic.

The intentions of the current plan look highly market focused and economically myopic.

The reality is that:

-Singapore was a sound economy and Malaysia wasn’t. Malaysia emerged stronger than Thailand which took the IMF’s prescribed hard medicine.

-Bailouts sew the seeds of the next crisis if lessons aren’t learnt. Bailouts are necessary so that there is enough residual industry to face the next crisis.

-The Paulson put has higher theta and omicron compared to the Greenspan put.

-It is likely that any bailout plan will be negative for the USD which would be positive for terms of trade

-It is likely that any bailout plan will be inflationary.

On the subject of banning shortselling, it will have the effect of:

-Impairing market efficiency by limiting the feasible set, this is mostly an academic objection.

-Forcing investors to sell long positions to scale risk instead of hedging whenever they want to reduce market exposure. This will have practical consequences.

-Making it hard for option holders and writers to hedge positions. The uncertainty that the restrictions introduce to derivative markets is significant.

-Lowering liquidity in the markets at a time when market liquidity is an important factor in the crisis.

Some conjecture:

The creation of some agency to purchase distressed assets from financial institutions has to be paid for. It will have to be paid for by the government. The government will have to raise cash. They will have to issue debt. Who will buy this debt?

They could just auction new debt and see what the free market thinks of US sovereign risk. Given that the faith of the US government in the free market is not all that strong these days, its likely that they will need a backstop. Foreign investors may not be willing to take USD risk. US investors whether healthier corporates or individuals through asset management companies may not be willing to take that risk either. The financial institutions in receipt of aid may be asked to be that backstop resulting in a de facto swap of US Treasuries for risky assets. System wide, this would only defer the liabilities, not crystallize them. It would, however, reflate the financial institutions, providing them income bearing risk free assets in exchange for toxic waste, without relying on external price discovery.