Rescue package fails to impress

Timothy Geithner's poorly explained economic measures left the markets seriously underwhelmed.

Story Anthony Hughes
NEW YORK

Asked about US Treasury Secretary Timothy Geithner's financial rescue package this week, JPMorgan Chase chief executive Jamie Dimon channelled Albert Einstein in offering some free advice to the government.

"Keep things as simple as possible, but no simpler" than they need to be, Dimon said.

Unfortunately for Geithner and President Barack Obama, solving the financial crisis and restoring the economy is a task that would test even the famous physicist's deep problem-solving abilities.

The past week should have been a great step forward for markets and the new administration.

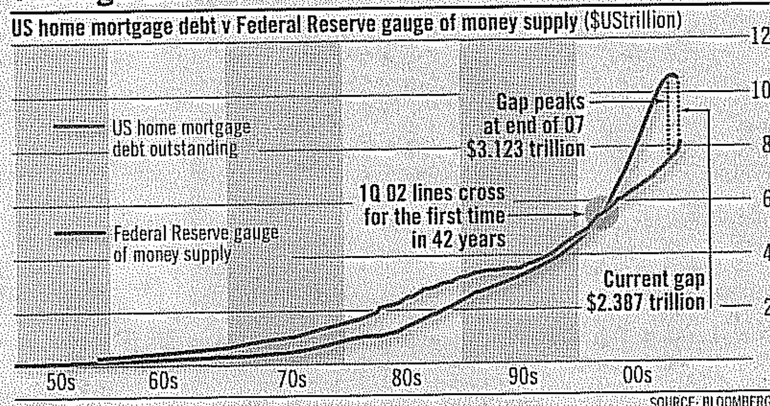
Not only did Geithner unveil his "son of TARP" financial rescue plan, but the new administration finished the week on course to winning Congress's blessing for a $US789 billion ($1.2 trillion) fiscal stimulus package.

Instead, investors found themselves in familiar territory – back in their shells fretting that Washington had only a loose grip on what is needed to repair financial markets and equally dubious that the stimulus would provide any quick respite from a quickly deteriorating economy.

The lack of details in the financial rescue plan particularly disappointed investors, but that may have not been the only reason for the tepid reaction. Cynics also noted the plan would not be as blatant a Wall Street handout as that favoured by Geithner's predecessor, Henry Paulson.

Through the roof

US home mortgage debt v Federal Reserve gauge of money supply ($UStrillion)



SOURCE: BLOOMBERG

The centrepiece of the Geithner plan, a public-private investment fund to lure hedge funds into buying toxic assets and finding a market price for illiquid securities, fell short of Wall Street's preference for a government-funded bank that would buy the assets directly.

Treasury's explanation of how the fund would work took up just five paragraphs, with no details on how the risks would be shared between taxpayers and the private sector and nothing on what sort of cheap financing deal the hedge funds would get. Geithner's message to markets was: "I'll get back to you", which investors saw as "we haven't worked it out yet".

While selling it as a comprehensive plan, he also portrayed it as less of a direct impost on taxpayers, who will take on less direct risk. But they could be excused for seeing things differently. As Deutsche Bank's Joe LaVorgna said, ridding toxic assets from balance sheets was the most important remedy for the economy and its financial plumbing.

Without it, the economy will continue to worsen, unemployment will rise and the government's tax revenue base will fall further.

"Ultimately, the taxpayer will pay one way or another, either through greatly diminished job prospects and/or significantly higher taxes down the line to pay for the massive debt issuance required to fund current and prospective fiscal spending initiatives," he said.

By week's end, investors remained as confused as ever.

The new administration hasn't found it easy to straddle the debate about the best way to stimulate the economy. Exactly how a stimulus works remains the subject of never-ending ideological debate.

Given the Bush administration's $US168 billion in tax rebates last year seemed to do little to turn the economy around, doubts about whether even a much larger stimulus will open consumers' wallets abound.

Obama has evoked Keynesian economics by talking about the "multiplier effect" of measures, while the administration's thesis on how spending hundreds of billions could revive the economy is contained in a paper prepared by Obama's economic advisers, Christina Romer and Jared Bernstein.

It applies a rule of thumb that every 1 per cent of GDP equates to 1 million jobs to get to a job creation figure of 3.7 million jobs.

Obama's speeches have, however, changed the job creation target over time from 2.5 million jobs to as many as 4 million jobs, taking into account the need to create more jobs to offset recent monthly falls in payrolls across the economy of more than 500,000.

IHS Global Insight economist Nigel Gault forecasts that the US economy will still contract by 2.7 per cent this year, even taking into account the effect of the stimulus. He says this reflects the inventory overhang in the economy, a 1 per cent fall in consumption and a very low level of housing starts averaging 550,000 this year.

While the stimulus results in a big rise in government spending, this is offset by the parlous state of many states and municipalities across the country that are cutting back on services to try to contain their own ballooning debt.

Gault assumes that the stimulus package results in $US600 billion being spent by the government over the next two years, including about $US168 billion in personal tax cuts, $US97 billion in corporate tax cuts, $US93 billion in "personal transfers" such as extended unemployment benefits and $US153 billion in transfers to state and local governments. About $US280 billion would filter into the economy in 2009 and $US323 billion in 2010, without which the economy would contract by an extra 1 per cent each year.

"It is a very large package and sufficient to make a difference, but not sufficient to stop the worst recession since WWII," Gault said.

On the jobs front, IHS predicts it will create 2.5 million jobs, but not clawing back all of the 3.6 million jobs lost in the past year.

Yet another headache for policymakers is that this mammoth spending means Americans face a $US1.6 trillion budget deficit this year, which could put pressure on interest rates and the US dollar if overseas buyers of Treasury bonds start fretting about the long-term health of the US economy and demand higher rates of interest.

At the moment, that hasn't been a problem as risk-averse investors have flocked to the relative security of bonds, though 10 year Treasury yields have risen from their lows in the past month.

But Gault argues that the deficit mightn't be the problem often cited, since the US government will get some money back as banks repay recent capital injections (more than $US300 billion) and will probably raise taxes at some point in the coming years.

By week's end, investors remain as confused as ever as to whether the government's do-what-it-takes attitude to economic policymaking will succeed.

Merk Investments' Axel Merk says: "We may be able to sum up our current policies as 'we don't know what we are doing, but we are doing a lot of it'."

More trouble at the door

If the US housing market cannot be stabilised soon, the already frail banks will be hit hard again.

Story Robert Guy

It seems apt that Federal Reserve board member Elizabeth Duke will deliver a speech in Arizona next week on initiatives to stabilise the ailing US housing market. The state in the south-west of the country is part of the "sun belt" that sweeps from southern California across to Florida, but in more recent times has come to epitomise the nuclear winter that has descended across the real estate landscape after the meltdown in home prices.

Duke will have plenty to talk about when she steps up to the lectern in Phoenix after US Treasury Secretary Timothy Geithner unveiled tentative plans to short-circuit the nexus between the weak housing market and crippled financial system that threatens to drive the world's largest economy deeper into recession.

The savage US housing slump has been identified as the root cause of the financial crisis, and a $US50 billion ($77 billion) measure to stem a rising tide of foreclosure sales will be welcomed as unemployment hovers at a 17-year high.

While the Obama administration moves to shore up confidence with plans to inject up to $US2 trillion into the system, many economists are concerned that banks will be the weak link in the government's efforts unless the housing market is stabilised.

New waves of mortgage "resets" are due in the next two years, so many economists are bracing for yet more weakness in the property market and more instability in the already frail banking industry.

The latest report from the National Association of Realtors highlights the brutality of the slide in housing values, estimated at an average of 12.4 per cent in 2008. This is the largest annual decline since the numbers were tracked in 1979.

The hardest hit regions have been communities in the sun belt. Some suburbs in southern California, Nevada, Arizona and Florida are reporting drops of more than 30 per cent.

There are a number of issues feeding into economists' concerns about the destabilisng interplay between the housing market, mortgage financing and the banking industry.

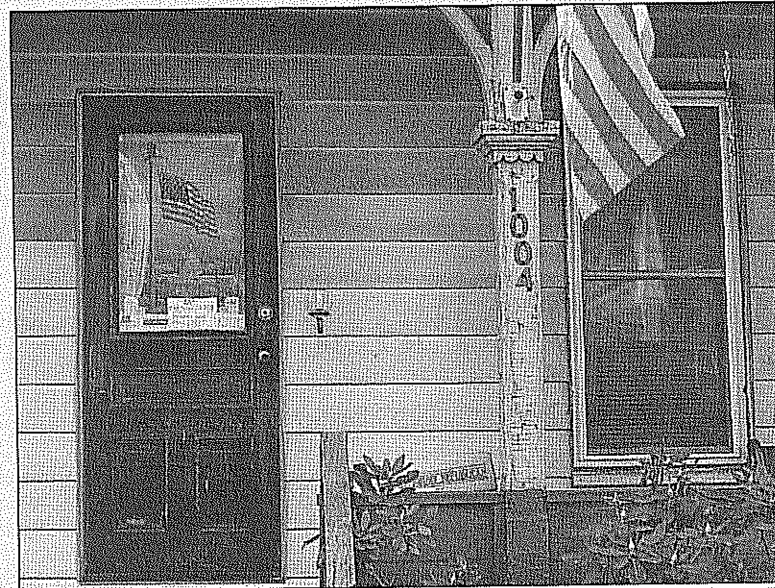
For many, the big concern is the expected wave of mortgage "resets" expected to hit home owners this year. They fear the move to higher interest rates on Alt-A loans and option adjustable rate mortgages (ARMs) may wreak as much havoc on the banking system as the sub-prime sector did last year. (Alt-A loans are considered more risky than prime loans and less risky than sub-prime, but they have been abused to the point they are sometimes referred to as liar loans.)

Banks worldwide took write-downs of more than $US1 trillion to account for the falling value of securities backed by mortgages, many of which were sub-prime.

The world's major financial institutions have never recovered, despite heavy licks of government support.

Worryingly, some experts fear Alt-A and option ARMs resets will be more troublesome to the capital-starved banking industry. Moody's Investors Service recently said it would revise upward the loss estimates on 90 per cent of securities backed by Alt-A loans.

Option ARMs are latently toxic as many allowed home owners low teaser rates for a couple of years, with the unpaid principal over those years added to the total value of the loan. There are concerns that many home owners will be forced to pay higher interest rates than when they signed up to low teaser rates at a time when they have lost their jobs and live in a home with negative equity.



Home sweet homes . . . but owners face steep 'mortgage resets' in the next two years. Photo Getty Images

The Alt-A market is estimated at up to $US1 trillion. A small rise in delinquencies could have significant consequences for banks or financial institutions holding complex securities backed by loans to borrowers caught in the middle ground between "prime" and "sub-prime".

Not that prime mortgages offer any shelter from the storm. Delinquencies and defaults on prime mortgages are creeping higher. It is estimated there are about $US500 billion of securities backed by prime "jumbo" loans, which are mortgages with a value that exceeds the upper threshold – of up to $US625,000 in some cases – of those home loans that can be bought by government-backed mortgage financiers Fannie Mae and Freddie Mac. The trouble from mortgages going sour is likely to be complicated by the weakness in house prices.

While cashed-up investors have shown a willingness to step into the market, foreclosure sales by banks wanting a quick disposal are comprising a growing proportion of the sales.

Real estate experts are concerned the "shadow" inventory of houses in foreclosure on top of the already massive inventory of unsold homes means that prices are likely to decline at least another 10 per cent.