Treasury Rewards Waiting

Christopher D. Carroll

Department of Economics
Johns Hopkins University

Maybe it was worth the wait.

Judging from preliminary details, the U.S. Treasury's plan to rescue the financial system is a lot savvier about the relationship between financial markets and the macroeconomy than are the usual-suspects critics from both left and right who are already pouncing on the plan.

Unlike the critics, Treasury has absorbed the key lesson from the last 30 years of academic finance research: *Asset price movements mainly reflect changes in investors' collective attitude toward risk*.

Perhaps the reason this insight has not penetrated, even among academic economists, much beyond the researchers responsible for documenting it, is that it has not been expressed in layman's terms. Here's a try: In the Wall Street contest between "fear" and "greed," fear fluctuates much more than greed (in academic terms, movements in "risk tolerance" explain the bulk of movements in asset prices).

Such extravagant movements in investors' average degree of risk tolerance have proven impossible to reconcile with economists' usual benchmark ways of understanding peoples' attitudes toward risk. One response has been to try to reverse-engineer a "representative consumer" who would actually choose to behave in a way that matches the data, under the assumption that market prices are always a perfect and optimal representation of rational choice. Unfortunately, the reverse-engineered preferences look nothing like what we know of household behavior from a vast literature that observes the indvidual choices made by households in their daily lives (as documented in a variety of microeconomic datasets).

The second response to the market's remarkable fluctuations in risk attitudes is more in tune with Warren Buffett's view, following his mentor Benjamin Graham, that market prices move much more than can be justified by the sober judgment of someone with a long horizon and stable preferences. Buffett has arrived at his current perch more by skepticism about the market than by unblinking faith in its wisdom. As Mr. Buffett has shown, patient investors who buy low and wait for underpriced assets to recover can do very well indeed.

Which brings us back to the Treasury's plan. The details pretty clearly flow from an overarching view that the markets for the "toxic assets" that are corroding banks' balance sheets have shut down in part because in those markets the degree of risk aversion has become not just problematic but pathological. The different parts of the plan reflect different approaches to trying to coax private investors back into the market by reducing their perceived degree of risk to levels that even a skittish risk-shy hedge fund manager might find tempting. The government and the private investor would be partners in a Buffett-like arrangement in which the assets would be held long enough that the investors can expect to receive payments that have justified the waiting.

This motivation sounds suspiciously like some of the arguments for the ill-fated Paulson TARP plan from last fall; but the problem with the Paulson plan was never fundamentally with the idea that there were problems in the market for toxic assets, but with the idea that the right way to fix that problem (and everything else wrong with the economy!) was simply to have the government drastically overpay to buy up the toxic assets from whoever was foolish enough to have ended up holding them. (Maybe this is not really what Secretary Paulson had in mind, but it seems the most sensible interpretation). Instead, the new Treasury plan gives private investors (who know more than Treasury about the likely payoffs of these securities) the pivotal role in competing to set the prices of the securities, via a competitive auction process. The private investors currently on the sidelines are not fools and have no incentive to lose money on the deal. In addition, there is no pretense now (as there was last fall) that the resolution of the toxic assets problem is the sole remedy for our economic woes; it is part of a carefully conceived plan including the stimulus bill, the housing foreclosure mitigation plan, the TALF plan for reviving the market for securitized assets, the bank "stress tests" designed to triage the good banks, the salvageable banks, and the zombie banks; and a host of other measures designed to address other aspects of the crisis. Finally, the new plan's principal goal, fostered in numerous ways, is to induce private investors to come off the sidelines and reengage with the markets, while the Paulson plan's mechanisms for accomplishing that goal were either murky or nonexistent.

When fuller details emerge, it would be useful if the economics profession and the financial community could have a mature conversation about whether the plan could be improved before it goes into operation. For example, it may be necessary to make any bank that participates agree to the sale of *all* their toxic assets, to prevent the kind of cherry picking that has contributed to the shutdown of these markets so far. And there is good reason to be very careful to minimize the possibility of "heads-I-win, tails-the-government-loses" kinds of bets. But broad-brush denunciations are unhelpful, whether they derive from preconceived prejudices of the left (which needs to recognize the important distinction between the greedy expletives who got us here and the wise captains of finance who can help us get out), or the right (which espouses a destructive ideology according to which all government action of any kind is a mistake).

The rest of us should hope that even in the current fervid atmosphere, reasoned argument can win out over impassioned ideology.