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ECONOMIC VIEW

It’s Hard to Thaw a Frozen Market

By TYLER COWEN

REAL estate bubbles have burst before, without bringing such trouble to the financial system. What is distinctive today is the drying up of market liquidity — the inability to buy and sell financial assets — caused by a lack of good information about asset values. The American economy is suffering from an old conundrum: that liquidity is there when you don’t need it, but missing when you do. The results have been a form of financial gridlock.

If you think that traders have been well informed of late, take another look at the wild path of Bear Stearns shares: A year ago, the stock was selling for $170 a share. At the close on March 14, just before the deal by which Bear Stearns was to be bought by JPMorgan Chase, Bear had a book value of $80 a share — and a share price of $30. The JPMorgan transaction, arranged two days later, valued the company at about $2 a share. Since then, the shares have been trading above $2, which in part reflects the possibility of the deal breaking up.

Every step of the way, the pricing of the stock has surprised the market — and yet Bear Stearns is a firm with a lengthy history, not an Internet start-up or a biotech whose value is based on a new but untried wonder drug.

To understand the depths of the current crisis, let’s go back to an apparently unrelated episode in economic thought: the socialist calculation debate. Starting in the 1920s, Ludwig von Mises, the leader of the so-called Austrian School of Economics, charged that socialism was unable to engage in rational economic calculation. Without market prices, he reasoned, no one knows how much economic resources are worth.

The subsequent poor performance of planned economies bore out his point. For instance, the Soviet Union did a poor job of producing consumer goods and developing innovative industries. In the absence of well-functioning markets for capital goods, these mistakes festered, rather than being rectified by the independent judgments of individual entrepreneurs.

The irony is that the supercharged capital markets of the American economy are now — at least temporarily — in a somewhat comparable position. Starting in August, many asset markets lost their liquidity, as trading in many kinds of junk bonds, mortgage-backed securities and auction-rate securities has virtually vanished.

Market prices have been drained of their informational value and thus don’t much reflect the “wisdom of crowds,” as they would under normal circumstances. Investors are instead flocking to the safest of assets, like Treasury bills.

The absence of trading is a big problem. Financial institutions have been stuck holding illiquid assets, whose value cannot be easily determined. Who wants to lend to the institutions holding them? No wonder there is a credit crisis and a general attitude of wait and see.
This gridlock is especially harmful because leverage is so high, and financial institutions are so interconnected through swaps and loans. Institutions that rely so heavily on debt are precarious and need up-to-date information about valuations. When they don’t have it, markets freeze up. This is what has taken policymakers by surprise and turned a real estate crash into a much bigger financial problem.

You might wonder why asset prices don’t simply fall enough so that someone buys them and trading picks up again. First, many bank managers would rather postpone the day of reckoning; why seek “fire sale” prices when you might lose your job for doing so? Second, only so many financial institutions have the size and expertise to buy up low-quality assets in large quantities. One scary fact about the Bear Stearns situation is how few buyers were waiting in line.

So what now? Regulators should apply capital requirements consistently to the off-balance-sheet activities of financial institutions. This will limit dangerous leverage, contain contagion effects and make the system less dependent on the steady flow of good information.

In the shorter run, economists are generally in three camps when it comes to strategies for recovery.

The fundamentalists argue that housing prices need to fall, and rapidly, so that mortgage-backed securities can be valued more accurately. Then trading can resume and financial gridlock will be undone. Advocates of a bailout, by contrast, argue that this process would be a disaster. In their view, the solvency problems are too great and the market is too skittish for the foreseeable future, so the government needs to buy up mortgage securities to prevent catastrophe.

The third group, the “wait and see” faction, finds the first two alternatives unpalatable. This group hopes that if the Fed pumps enough liquidity into banks, the passage of time will improve market information, ease worries and lead to a resumption in asset trading.

No matter your point of view, real-world events are likely to intervene and force an outcome. The Fed and the Treasury have been forced into a mode of emergency response and daily improvisation, not long-term planning. Sooner or later, trading in the illiquid assets is likely to resume, but the major question in all of this is the eventual cost.

That cost won’t be measured only in terms of bailouts and guarantees. The longer this crisis mode drags on, the more the entire reputation of American capital markets will suffer.

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