

Strategy Matters

Issue 2008 - 14

Economic effects of the US Treasury's plan to buy 'troubled assets'

The US Treasury is asking Congress for the authority to issue up to \$700bn of Treasury securities in order to finance the purchase of 'troubled assets' from banks and other financial institutions.

The Treasury Secretary, Hank Paulson, argues that the purchases are needed to unblock the financial system. As the Treasury sees it, illiquid mortgage assets on banks' balance sheets are preventing them from doing their job of making loans to households and businesses. If the proposal is implemented, therefore, they hope it would lead to an increase the supply of loans.

Judging the likely economic effects of the proposal is difficult because details remain sketchy. In particular, it is not clear:

1. What will be the ultimate size of the plan? It could well end up being more than \$700bn.
2. When will the plan be implemented?
3. Will Congress amend the plan in any significant way? Will they add anything to it?
4. Is the Treasury up to the job of administering it?
5. Exactly what assets will be eligible?
6. What financial institutions will be eligible to participate? This has already changed once.
7. What is the plan for selling assets acquired by the Treasury?
8. How will purchase prices be set? There is talk of a 'reverse auction'.

The last issue is crucial. If the Treasury pays an inflated price for the 'troubled assets', then the capital position of banks will be improved. However, this would, in effect, mean taxpayers

subsidising investors in banks. I doubt Congress will allow this to happen, especially if foreign-owned banks are involved. However, if the Treasury pays too low a price, then there is no immediate improvement in banks' capital position. Indeed, the purchases may lead to realised losses and a weakening in some banks' capital positions. (Although in practice banks may choose not to sell in these circumstances - this is what happened in Japan.)

More generally, it is not clear how the Treasury is going to discover the fair/right/market price for assets that are not homogeneous, are illiquid and are hard to value.

Of course, this does not mean the plan will have no impact on bank behaviour. If it leads to the discovery of the market price for 'troubled assets', then a great deal of uncertainty about the value of banks' assets and their capital positions will be removed. This, together with the improvement in their liquidity as a result of selling 'troubled assets' will put the banks in a better position to go out and seek capital injections. In turn, this should improve conditions in money markets and may allow banks to start functioning more normally – in terms of their role in providing intermediation between savers and borrowers.

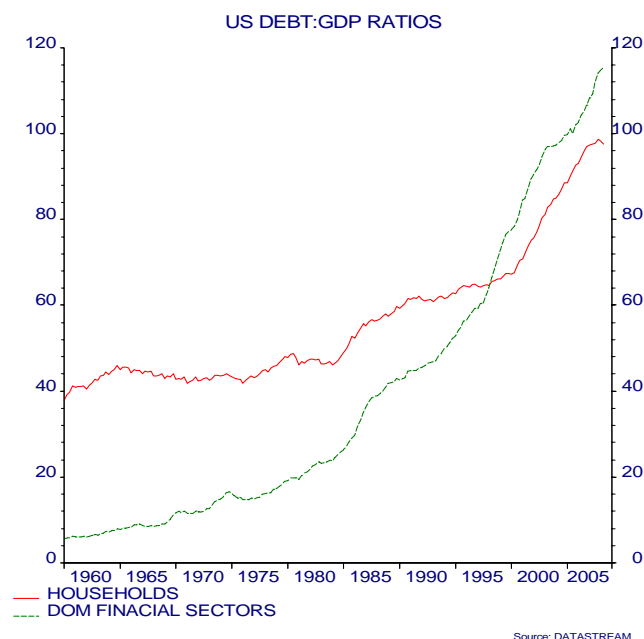
However, this brings us to two more unknowns:

1. Will the banks be able to attract additional capital injections? Taking the troubled assets off the banks' balance sheets should make this easier and there appear to be willing overseas investors. However, investors who injected capital into US banks earlier this year have suffered sizeable losses and it may be a

case of 'once bitten, twice shy'. Ultimately, the Treasury may have to inject the liquidity itself, either through taking a stake in banks or nationalising them (the Swedish solution).

2. Where are banks in relation to their desired loan:capital ratios?. Any injection of fresh capital obviously improves loan:capital ratios, but it may not do so to the point that they are brought down to desired levels. Banks may still decide that they need to continue de-leveraging even after receiving capital injections.

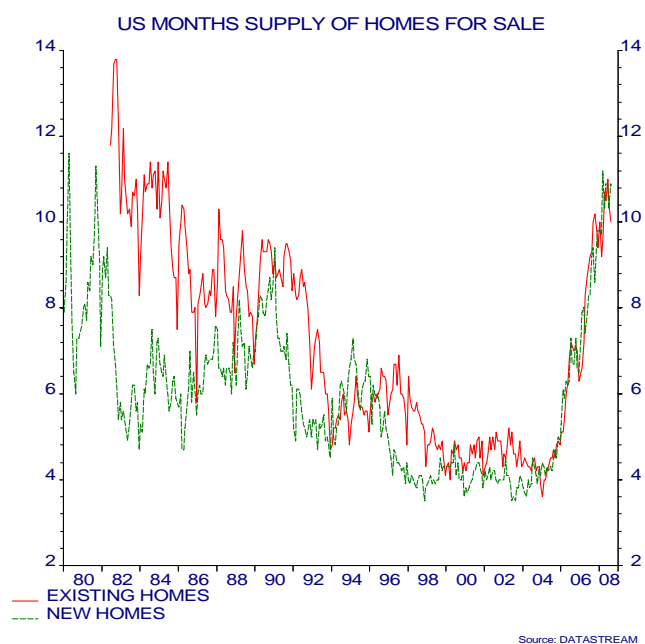
Moreover, increasing the potential supply of lending is one thing; increasing the demand for credit is another. Households are likely to be reluctant to borrow while the price of their main asset – their house – is falling, the risk of unemployment is rising and they have already taken on massive amounts of debt over the last decade. Meanwhile, businesses are likely to be reluctant to borrow when capacity use is falling and the outlook for final demand is extremely uncertain.



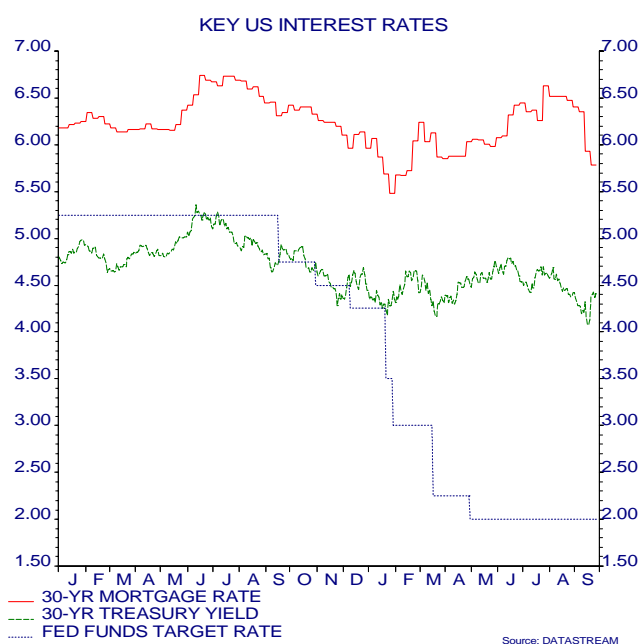
This highlights the missing piece of the jigsaw. It has been said that the authorities need to do three things:

1. Ensure there is no fire sale of 'troubled assets' by failing financial institutions.
2. Inject capital into the financial system.
3. Provide direct help to homeowners to limit/prevent foreclosures.

The Treasury plan addresses the first issue and a resolution to the second may follow automatically, or with further Treasury action. However, there is nothing in this plan to limit the scale of foreclosures and to stabilise the housing market and without that there must be doubts that this is the whole answer.



It is likely that lower – perhaps much lower – mortgage rates are a necessary condition for the resolution of this mess. As part of the bail-out of Fannie Mae and Freddie Mac, the Treasury, acquired the power to purchase (unlimited?) mortgage-backed securities (MBS), so it can, in effect, drive down the MBS yields relative to Treasury yields. However, if it is issuing Treasuries to finance the purchases, then it may be harder to lower the actual level of mortgage rates. This might require the Fed to cut interest rates and/or to move to a quantitative easing policy (i.e. to buy Treasuries).



Putting these doubts aside for the minute, what the Treasury is hoping will happen, in macroeconomic terms, is to kick-start the ‘credit multiplier’. That is, it is hoping that increased lending will lead to increased economic activity, more bank deposits, more lending and so on.

If successful, kick-starting the credit multiplier should, other things being equal, lead to more rapid nominal growth in the economy. On the reasonable assumption that the US economy is operating with a degree of spare capacity at present, this should mean higher real GDP growth, rather than higher inflation.

Are other things equal?

Some economists are making much of the fact that the Paulson Plan will not ‘cost’ \$700bn and that the final cost will depend on the price the Treasury pays for the assets it buys and the price it receives when it sells them (or the return if they are held to maturity). It is even possible that the plan might produce a profit for the taxpayer (and even if it does not, it might still be a good deal if the economy is ultimately stronger as a result of it).

This is all true, but the fact is that the plan envisages selling \$700bn extra Treasuries over the course of the next two years. A reasonable

expectation before the Plan was announced was that the US Federal budget deficit would amount to around \$500bn in both fiscal years 2009 and 2010. We might now expect close to \$1,000bn in FY2009 and \$700bn in FY2010.

Who is going to buy the extra Treasuries needed to finance the plan? There are four options: the US non-bank private sector, foreigners, the Federal Reserve and the US financial system.

If the Federal Reserve prints money to buy the bonds, then it will be running a quantitative monetary policy, as the Bank of Japan did earlier in this decade. That is likely to be accompanied by a very low, or zero, Fed funds rate. I can only imagine this happening if the US faces a real deflation threat – not impossible to imagine at some point over the next two years, but very unlikely in, say, the next six months.

If the US private sector buys the Treasuries, then there will be a powerful countervailing force to the hoped-for boost from the credit multiplier. Sucking \$700bn out of the private sector reduces its consumption and increases its saving by the same amount (this is the first round effect only). In terms of sector balances, the public sector financial balance would deteriorate and the private sector balance would improve. This is what economists call ‘crowding out’. It could happen, for example, because greater Treasury issuance leads to higher Treasury yields, which causes mortgage rates to be higher and so reduced demand for mortgage credit.

If the overseas sector buys the Treasuries, then the overseas sector financial balance improves (i.e. foreigners are saving more in the US). Since the balance of payments must balance, this would have to be accompanied by an increase in the US current account deficit. However, there is no reason to expect exports to drop or imports to increase in this scenario, so the current account deficit will not increase. Therefore, the overseas sector cannot be buyers of the extra Treasuries.

In practice, therefore, the Treasuries seem likely to be bought by the US financial sector. In effect, the Treasury and the financial system will swap assets. As a first round effect, therefore, the level of interest rates should be unchanged, as will be consumption, investment and exports. The economic effects of the plan will come mainly through the credit multiplier.

There may also be other benefits if the Plan is implemented.

First, it may be seen as a demonstration of the authorities' determination to do whatever is necessary to get the financial system functioning again. The effect of this on business confidence should not be underestimated. One of the big risks facing the US economy right now is a downward spiral caused by deteriorating business confidence, job cuts, rising unemployment, household spending cuts etc. If the Plan is seen as diminishing significantly the extreme financial risk to the economy, it may indirectly diminish the macroeconomic risk too.

Second, it may hasten the next fiscal package of tax cuts and/or public spending increases (though the election timetable probably militates against this).

One thing that is almost certainly not going to happen is that other countries are not going to follow the US lead. Arguably, the UK authorities should be thinking very seriously about doing so, but there is no evidence that they are. Meanwhile, there is no pan-European body with the authority to take similar action; it would be down to the governments in Germany, France etc. to act, which will not happen unless things get a whole lot worse.

Finally, some thoughts on the market reaction:

1. A classic case of 'buy the rumour and sell the fact'? The initial reaction was euphoria that something big was being done (although the ban on short-selling may have had an even bigger effect on equity markets). Now the doubts are creeping in about the details – how is the Plan going to work, will it get through Congress and is it enough?

2. Most strategists suggested the Plan would be dollar-positive because it would increase confidence in the US financial system and economy. In fact, the dollar has weakened, not so much, I think, because of doubts about the Plan, but more because people have concluded it involves selling foreigners even more Treasuries. I think this is wrong.
3. Could it be that the markets are telling the US authorities that even this plan is not enough? Are they saying that the root cause of the problem is excessive US consumption relative to income (i.e. too little saving, too much borrowing, too much debt)? Do they think a lower consumption/income ratio, brought about by a US recession, is an inevitable part of the solution to the current crisis.

This is a complex issue and there are still many unknowns, so these are just first thoughts, but my key conclusions are:

1. The plan, in effect, involves the Treasury and the financial system swapping assets – Treasuries for troubled assets.
2. The main economic effect could be to kick-start the credit multiplier – but I do not think it is enough on its own to make the banks willing to lend or households/businesses willing to borrow and de-leveraging is still the most likely outcome.
3. Ultimately, I suspect the Federal Reserve may have to cut interest rates again and it may even have to buy Treasuries too before the housing market stabilises and this whole mess is sorted out.

Tony Dolphin
Director of Economics and Asset Allocation
Henderson Global Investors

This document has been produced based on Henderson Global Investors' research and analysis and represents our house view. The information is made available to clients only incidentally. Unless otherwise indicated, the source for all data is Henderson Global Investors. Any reference to individual companies is purely for the purpose of illustration and should not be construed as a recommendation to buy or sell or advice in relation to investment, legal or tax matters.

Please remember that past performance is not a guide to future performance. The value of an investment and the income from it can fall as well as rise as a result of market and currency fluctuations and you may not get back the amount originally invested. Tax assumptions may change if the law changes, and the value of tax relief will depend upon individual circumstances.

Issued in the UK by Henderson Global Investors. Henderson Global Investors is the name under which Henderson Global Investors Limited (reg. no. 906355), Henderson Fund Management plc (reg. no. 2607112), Henderson Investment Funds Limited (reg. no. 2678531), Henderson Investment Management Limited (reg. no. 1795354), Henderson Alternative Investment Advisor Limited (reg. no. 962757) and Henderson Equity Partners Limited (reg. no.2606646) (each incorporated and registered in England and Wales with registered office at 4 Broadgate, London EC2M 2DA and authorised and regulated by the Financial Services Authority) provide investment products and services. Telephone calls may be recorded and monitored.