Liquidity shortages: Some solid facts

It is unclear whether the US Treasury’s bailout would solve a funding liquidity problem or an insolvency problem. If it accomplished the former, that would be good. If it did the latter, that would not be good.

When short-term dislocations in the financial markets arise from liquidity shortages, an infusion of capital, either from the government or private sources, can reverse the fall in asset prices and restore the health of financial institutions.

The current financial turmoil is more complicated because of several factors. To begin with, financial institutions need to deleverage their holdings of “troubled” assets, mostly linked to housing mortgages. The financial institutions which bought these assets at “market” prices underestimated their risk and overpaid. The worsening economic situation suggests that these assets are not likely to become valuable in the near future.

The extent of exposure in the financial sector to these troubled assets is so huge that the US government has concluded that markets or private capital alone cannot and should not be relied on to sort them out. A large financial firm selling these assets at low prices could have systemic effects leading to the insolvency of many other firms. For example, if a private fund bought mortgage-backed securities from a failing bank at 20 cents on the dollar, accounting rules would require other institutions holding the same or similar securities to mark down the value of their holdings to 20 cents on the dollar. This “mark to market” process could quickly become a self-fulfilling death spiral. As part of its response to the crisis, the US government now allows firms to use other information to value illiquid assets on their books rather than marking them down to fire-sale prices.

We are also witnessing a freeze in the market on short-term financing. Companies which used to borrow short-term by issuing commercial papers are no longer able to do so as lenders have become extremely cautious. Even banks have become less willing to lend to other banks in the interbank market, thus raising interest rates on such borrowings.

Hence, to stabilise the financial system and rebuild investor confidence, the US Treasury proposes to bail out financial institutions by buying their troubled assets. There might be lessons here from the Japanese government’s bailout of the country’s troubled banks in the 1990s.

The Japanese crisis was started by the bursting of its property and stock market bubbles of the 1980s. Tokyo invested in insolvent banks, delayed the resolution of massive bad debts and failed to make fundamental reforms in lending practices or close down insolvent firms. This worsened the banking crisis and led to Japan’s “lost decade.”

What is unclear about the US Treasury’s current bailout plan is whether it would solve a funding liquidity problem or an insolvency problem. If it accomplished the former, that would be good. If it did the latter, that would not be good.