Please think this over.

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Here are some choice words from the Treasury's LEGISLATIVE PROPOSAL FOR TREASURY AUTHORITY TO PURCHASE MORTGAGE-RELATED ASSETS

> The Secretary is authorized to purchase, and to make and fund commitments to purchase, on such terms and conditions as determined by the Secretary, mortgage-related assets from any financial institution having its headquarters in the United States.
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> Decisions by the Secretary pursuant to the authority of this Act are non-reviewable and committed to agency discretion, and may not be reviewed by any court of law or any administrative agency.

When I first read those words in an e-mail, I thought it was an Internet joke. I was sure the Treasury Secretary would be explaining exactly how he would acquire these assets, since the Devil is in the details. Instead, the Secretary merely wants authority to do whatever he wants. He doesn't even give us a mission statement, or any metrics for the success of this venture.

I have lots of questions about this and I am sure you have many more:

- How is the Treasury going to determine the values of those illiquid mortgage-backed securities when Wall Street has failed to do so? Surely their values depend on future home prices and future mortgage default rates. How is the Treasury going to forecast home prices and default rates? Will these forecasts be made public?
- How is the Treasury going to avoid the winner's curse: paying more for these assets than anyone else is willing to? More importantly, how can this plan help the financial institutions unless Treasury does pay more for these securities than their current private market auction value, and even more than their current book value, thus in effect making a capital infusion into the banking system?
- Isn't there a big risk here for many financial institutions that by standard accounting rules are required to value their mortgage-backed-securities at "market prices" rather than internal prices, if there is a market. Once the Treasury starts buying these illiquid assets, there is a risk of major accounting losses that will raise more insolvency problems rather than less.
- Is Treasury going to buy these securities from firms that are well-capitalized and don't need the help as well as from firms that are on the brink of insolvency? In other words, is this a way to rescue the mismanaged firms and keep the poorly performing management in place? If it doesn't do that, what help can the plan offer?

- What exactly is the definition of a "financial institution" from which the Treasury will buy mortgage-backed securities? Does it include pension funds, and mutual funds? How about the loan I gave my neighbor that he now refuses to pay back? Am I a financial institution? I would like to be included in this too.
- How much in losses from this speculative enterprise can taxpayers reasonably expect? What systems will be put in place to limit the losses? Who will be held accountable for losses that exceed the limit? Who besides the taxpayers will have skin in the game?
- Why not just make a one-time Federal capital infusion into all the troubled banks, and let them do with the mortgage-backed securities whatever they like? That would leave the corpses in the hands of those who know where they are buried.[1] Wouldn't that be a more honest and more efficient way of doing this bailout? Or maybe we should just nationalize the whole banking system? (I don't mean that!!!)
- Perhaps most importantly, have we thought at all about the unintended consequences of this government intervention into the capital markets? The Secretary pays a lot of lip service to the moral hazard problem but a much bigger one is the pound of flesh. Don't think for a minute that Wall Street can walk away with $700 billion of the taxpayers' money without draconian consequences. We may be opening up a regulation nightmare that will make Sarbanes-Oxley look like a walk in the park.

But the Treasury offered no details. Absolutely none. So we are left to guess.

Didn't we just do this? Didn't we rush pell-mell to solve a huge problem, giving open-ended authority to our executive branch, only later to wish we had thought it over more carefully? Do we really want to give the Secretary of the Treasury $700 billion to do as he or she sees fit?

I don't like this half-baked plan. I don't think it is going to work. I don't think it addresses the root problems. Worst of all, it shakes the very foundations of our government's relationship with the private sector, setting us on a completely new course in what may be a politically irreversible way.

Here is my take on the problems we face, and what are the proper treatments. I offer these thoughts not because I know for sure. Mostly I want to remind us all that there are other ways to spend $700 billion of the taxpayer's money. Let's talk about this. Let's not rush to get it done by Friday.

Looking backward, home buyers paid too much, and lenders wrote contracts that exposed them to the homeowners' losses. With home values declining by something like $2 trillion, we are in a mad scramble to divide the loss between homeowners, lenders and taxpayers. In the meantime, homeowners and lenders are exercising their last line of defense: denial. Many homeowners are refusing to sell their homes at prices that can

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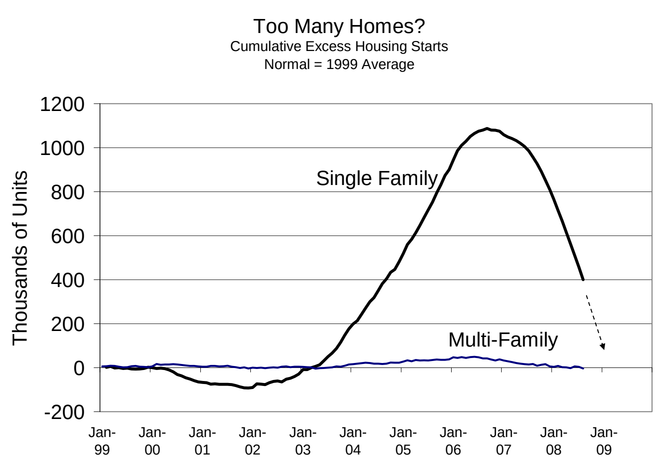
[1] Steve Liesman, CNBC, on Meet the Press, Sunday, September 21, 2008

attract buyers. Many lenders are refusing to sell their mortgage-backed securities at prices that can attract buyers.   All this denial gets in the way of the normal price-discovery process, leaving stranded assets held by owners who think they are worth more than potential buyers.

Nonetheless, our financial institutions are doing a pretty good job. Our financial markets are supposed tell us how wealthy we are. This year the large drop in equity valuations is sending a pretty clear message: we are not as wealthy as we thought.   That seems adequately accurate; no big problem there. Our financial markets also provide credit to consumers and businesses to help grow our economy.   Outside of housing the economy is doing pretty well, and there is no clear evidence of a credit crunch seriously impinging on either business spending or consumer spending even though Wall Street pundits for more than a year have been ringing out loud alarm bells about an imminent credit contraction. Though business spending and consumer spending are a bit weak, that weakness properly reflects the fundamentals of the economy and is not a symptom of a credit crunch. So what's the problem, Mr. Secretary?

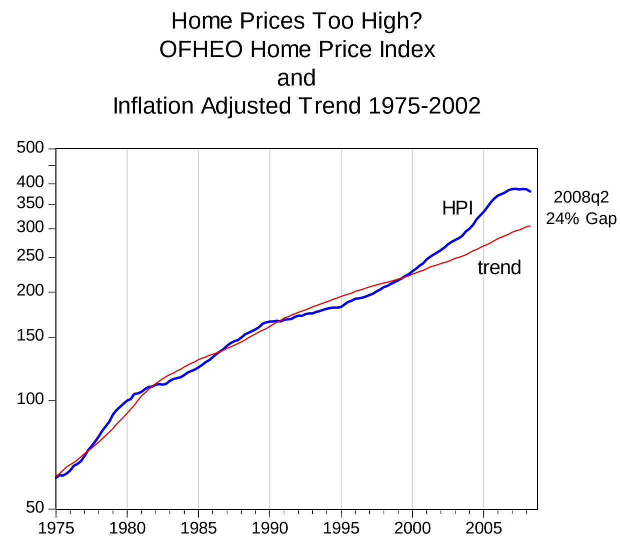
I too am very worried about the next couple of quarters.   We have not had the amplifying effect of massive layoffs, but there are some ominous signs.   But if business spending or consumer spending in the future is substantially curtailed by a credit contraction, couldn't we have a government program that directly encourages whatever spending problem shows up. If business spending weakens, could we try a tax credit for business investment? If jobs are declining, what about a tax credit for firms that hire more workers?   Why this round-about doubtful solution that for sure helps the Secretary's friends on Wall Street and maybe not much else.

We need all to understand that the "root" problem isn't bad mortgages as the Treasury Secretary and the President allege; the root problem is declining home prices caused by a combination of overbuilding and excessive appreciation. To formulate an appropriate response we need first to form an opinion regarding the amount of overbuilding and the amount of home price declines that are likely to occur in the future and the rates of foreclosure that will occur at those prices. The values of those mortgage backed securities that Secretary Paulson is so anxious to buy on our behalf depend completely on the future foreclosure rates and on the future underlying values of the foreclosed homes that taxpayers soon enough will own.   What can be expected with regard to prices and home building?



High rates of homebuilding from 2004 to 2006 gave us about a million more single-family homes than suggested by historical rates of building, illustrated to the right. Since 2006, plummeting rates of building have reduced that home overhang to about 400 thousand units, and we should be back on trend in the stock of homes very early in 2009.

A rough calculation of the remaining excess in home prices can be made by extending the 1975-2002 inflation-adjusted trend in the OFHEO home price index to 2008q2 and comparing that with the actual index. That suggests a remaining overvaluation of 24%. Using the 2008q2 rate of decline in home prices, -5%, and the inflation rate of 2%, it will take a little less than three years for home prices to get back to trend. It seems likely going forward that the inflation rate will be higher and the rate of home price decline greater. It is also the case that some of the excess is a consequence of the low rate of interest. Still it doesn't seem reasonable to expect this pricing problem to be solved nationwide before the end of 2009 at the earliest when home prices are likely to be down another 10% at least.



The data thus suggest that the overbuilding problem is going to be behind us early next year, when the stock of single-family homes will be back to normal, but the price declines for new and existing homes are likely to go on for at least another year or two.

Those declining home prices are going to cause more losses for homeowners, lenders and taxpayers. Taxpayers need to decide how much of those losses they are prepared to absorb, if any, and they need to put in place mechanisms that will directly and clearly transfer the losses from homeowners to taxpayers. The Paulson plan transfers to taxpayers an indeterminate level of losses that are buried already in the books of the lenders. I cannot see how that helps homeowners at all, except for the argument that it averts a severe credit contraction that might make life miserable for all of us. Surely we can think of cheaper, more direct, more effective ways to deal with any excessive credit contraction that does emerge.

One honest way to transfer the losses directly to the taxpayers would have the Treasury buy homes directly at inflated prices and rent them to deserving Americans. Though the Treasury Plan involves buying mortgage backed securities at inflated prices, keep in mind that foreclosures will then turn the homes over to Uncle Sam. For $700 billion, the Treasury could purchase 2.3 million homes at an average price of $300,000. That is way more than is necessary. A half a million should be enough to unclog the system. Uncle Sam could purchase foreclosed homes, mow the lawns, fix the broken windows and rent them out to deserving families. That would help the other homes in the neighborhood sell at favorable prices.

The overbuilding problem will be corrected long before prices stabilize, but the continuing declines in home prices will make it impossible to build the homes we need, and the consequent underbuilding will lay the foundation for the next housing mania. To get the builders up and running early next year, we need a tax rebate for the purchase of new homes, beginning soon.

When prices get back in line with fundamentals, there are likely to be continuing price declines because the housing market works pathologically. A normal market works because demand curves are downward sloping, but for homes demand curves can be upward sloping. Declining prices in many regions are not bringing buyers back to the market. Price declines are creating the expectation of more price declines to come, and encouraging prospective buyers to postpone their decisions, which causes more price declines, and eventually overshooting of prices. When prices get back to normal and buyers have not returned, that's when we need to find ways to bring the buyers back. That's when we need to offer big temporary tax credits to first-time buyers**.**

So that's my $700 billion plan:

1. Immediate relief for homeowners who don't like the price the market is offering: Have Uncle Sam do the buying. (If that sounds ridiculous, think again about the Paulson Plan.)
2. A tax rebate for the purchase of new homes commencing in January this year.
3. A temporary tax rebate for first-time buyers of either new or existing homes that is timed differently in different regions of the US.