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How to Start the Healing Now

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The most amazing paradox of 2008 is the continued growth of the U.S. economy and the sorry state of the U.S. financial markets. Despite major financial-market problems, real GDP has increased by 2.1% in the year ended in the second-quarter -- 3.1% if we exclude housing. Not everything is great, but we all must agree that the economy has remained remarkably resilient.

This paradox works both ways. Financial problems have not yet dragged down the economy, but it is also true that the economy is not the cause of financial-market problems. Most of the loans that have been going bad in recent months would have gone bad even if the economy had been growing twice as fast. So what is to blame for the "worst financial crisis since the Great Depression"?

The answer seems simple. Mark-to-market accounting rules have turned a large problem into a humongous one. A vast majority of mortgages, corporate bonds, and structured debts are still performing. But because the market is frozen, the prices of these assets have fallen below their true value. Firms that are otherwise solvent must price assets to fire-sale values. Not only does this make them ripe for forced liquidation, but it chases away capital and leads to a further decline in asset values.

For example, the prices of assets on the books of Washington Mutual, when it was bought by J.P. Morgan at a fire-sale price, were cited as a reason to mark-down the assets on the books of Wachovia. This, some say, forced the FDIC to arrange its sale to Citibank.

The same is true of what happened to Fannie Mae and Freddie Mac, which had positive cash flow when they were nationalized by the Treasury. Here's something you won't believe: Fannie Mae and Freddie Mac have not drawn a dime from the Treasury's \$200 billion facility that was created to bail them out. It was the use of mark-to-market accounting that allowed Treasury to declare them bankrupt. On a cash flow basis, they were solvent.

Mark-to-market accounting causes so much mayhem because it forces financial firms to treat all potential losses as if they were cash losses. Even if the firm does not sell at the excessively low price, and even if the net present value of current cash flows of these assets is above the market price, the firm must run the loss through its capital account. If the loss is large enough, then the firm can find itself in violation of capital requirements. This, in turn, makes it vulnerable to closure, nationalization or forced sale.

Because the government has been so aggressive with the use of these capital regulations, private capital

has been scared away. Just about the only transactions taking place in the subprime marketplace have been sales to private equity firms that do not have to mark assets to market prices. Their investors agree to commit capital for the long haul, and because they are able to bend the current holders of these assets over the knee of the accounting rules they get prices that virtually guarantee a huge profit.

Despite all this evidence, the government has yet to provide relief from mark-to-market accounting. However, the Financial Accounting Standards Board will meet today to discuss potential changes. One thing it ought to consider is that the Treasury plan tips its hat to the problem by acknowledging that its goal is to put a floor under distressed security prices. Warren Buffet understood this and invested in Goldman Sachs before the law had passed, but with full expectation that it would. Other investors will follow. There is no shortage of liquidity in the world.

Nor would relaxing mark-to-market rules temporarily in the U.S. -- let's say for three years, for troubled assets issued between 2003 and 2007 -- undermine our standing internationally, as some allege. If a \$700 billion bailout fund

and the takeover of Fannie Mae, Freddie Mac and AIG have not already undermined foreign confidence, then nothing will. On the same day the bailout bill failed in the U.S. House of Representatives, the dollar soared.

Another argument is that changing the accounting rules is like sweeping the problem under the rug, which could lead to a Japanese-style decade of lost growth. However, back in the 1990s, Japan took six years to get real overnight lending rates below zero. It also increased tax rates. This was what caused Japan's lost decade -- a policy-induced deflationary recession, not just an unwillingness to book losses.

But it took the Federal Reserve only six months to cut real rates

below zero, starting last September, and U.S. tax rates are unlikely to be hiked anytime soon. Even Barack Obama says he would not raise taxes in tough economic times. As a result, the U.S. is not anywhere near the kind of environment that would allow that to happen. Nor will relaxing mark-to-market rules allow losses to be hidden or ignored. Basing prices for illiquid assets on cash flows would still reflect impairment, but not allow them to dip down to fire-sale levels.

Once private investors know they cannot be taken out by accounting rules and illiquid markets, their cash will flow freely. And if the real issue is to find a proposal that will help fix the problems in our financial markets urgently, then the

current Treasury plan fails the test. Because of government bureaucracy and legal issues, the first purchases by the Treasury plan will not be made for at least two weeks and possibly four weeks. Mark-to-market accounting changes could start the healing overnight and prevent the U.S. from moving further away from free-market capitalism.

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