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Op-Ed Columnist

The Big Squander

By PAUL KRUGMAN

Earlier this week, the inspector general for the Troubled Asset Relief Program, a k a, the bank bailout fund, released his report on the 2008 rescue of the American International Group, the insurer. The gist of the report is that government officials made no serious attempt to extract concessions from bankers, even though these bankers received huge benefits from the rescue. And more than money was lost. By making what was in effect a multibillion-dollar gift to Wall Street, policy makers undermined their own credibility — and put the broader economy at risk.

For the A.I.G. rescue was part of a pattern: Throughout the financial crisis key officials — most notably Timothy Geithner, who was president of the New York Fed in 2008 and is now Treasury secretary — have shied away from doing anything that might rattle Wall Street. And the bitter paradox is that this play-it-safe approach has ended up undermining prospects for economic recovery. For the job of fixing the broken economy is far from done — yet finishing the job has become nearly impossible now that the public has lost faith in the government's efforts, viewing them as little more than handouts to the people who got us into this mess.

About the A.I.G. affair: During the bubble years, many financial companies created the illusion of financial soundness by buying credit-default swaps from A.I.G. — basically, insurance policies in which A.I.G. promised to make up the difference if borrowers defaulted on their debts. It was an illusion because the insurer didn’t have remotely enough money to make good on its promises if things went bad. And sure enough, things went bad.

So why protect bankers from the consequences of their errors? Well, by the time A.I.G.’s hollowness became apparent, the world financial system was on the edge of collapse and officials judged — probably correctly — that letting A.I.G. go bankrupt would push the financial system over that edge. So A.I.G. was effectively nationalized; its promises became taxpayer liabilities.

But was there any way to limit those liabilities? After all, banks would have suffered huge losses if A.I.G. had been allowed to fail. So it seemed only fair for them to bear part of the cost of the bailout, which they could have done by accepting a “haircut” on the amounts A.I.G. owed them. Indeed, the government asked them to do just that. But they said no — and that was the end of the story. Taxpayers not only ended up honoring foolish promises made by other people, they ended up doing so at 100 cents on the dollar.

Could things have been different? Some commentators argue that government officials had no way to force the banks to accept a haircut — either they let A.I.G. go bankrupt, which they weren’t ready to do, or they had to honor its contracts as written.

But this seems like a naïve view of how Wall Street works. Major financial firms are a small club, with a shared interest in sustaining the system; ever since the days of J.P. Morgan, it has been common in times of crisis to call on the big players to forgo short-term profits for the industry’s common good. Back in 1998, it was a consortium of private bankers — not the government — that put up the funds to rescue the hedge fund Long Term Capital Management.

Furthermore, big financial firms have a long-term relationship, both with the government and with each other, and can pay a price if they act selfishly in times of crisis. Bear Stearns, the investment bank, earned itself a lot of ill will by refusing to participate in that 1998 rescue, and it's widely believed that this ill will played a major factor in the demise of Bear Stearns itself, 10 years later.

So officials could have called on bankers to offer a better deal, for their own sake, and simultaneously threatened to name and shame those who balked. It was their choice not to do that, just as it was their choice not to push for more control over bailed-out banks in early 2009.

And, as I said, these seemingly safe choices have now placed the economy in grave danger.

For the economy is still in deep trouble and needs much more government help. Unemployment is in double-digits; we desperately need more government spending on job creation. Banks are still weak, and credit is still tight; we desperately need more government aid to the financial sector. But try to talk to an ordinary voter about this, and the response you're likely to get is: "No way. All they'll do is hand out more money to Wall Street."

So here's the real tragedy of the botched bailout: Government officials, perhaps influenced by spending too much time with bankers, forgot that if you want to govern effectively you have retain the trust of the people. And by treating the financial industry — which got us into this mess in the first place — with kid gloves, they have squandered that trust.