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America will need a \$1,000bn bail-out

By Kenneth Rogoff in THE FINANCIAL TIMES

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One of the most extraordinary features of the past month is the extent to which the dollar has remained immune to a once-in-a-lifetime financial crisis. If the US were an emerging market country, its exchange rate would be plummeting and interest rates on government debt would be soaring. Instead, the dollar has actually strengthened modestly, while interest rates on three-month US Treasury Bills have now reached 54-year lows. It is almost as if the more the US messes up, the more the world loves it.

But can this extraordinary vote of confidence in the dollar last? Perhaps, but as investors step back and look at the deep wounds of America's flagship financial sector, the public and private sector's massive borrowing needs, and the looming uncertainty of the November presidential elections, it is hard to believe that the dollar will continue to stand its ground as the crisis continues to deepen and unfold.

It is true that the US government has very deep pockets. Privately held US government debt was under \$4,400bn at the end of 2007, representing less than 32 per cent of gross domestic product. This is roughly half the debt burden carried by most European countries, and an even smaller fraction of Japan's debt levels. It is also true that despite the increasingly tough stance of US regulators, the financial crisis has probably already added at most \$200bn-\$300bn to net debt, taking into account the likely losses on nationalising the mortgage giants [Freddie Mac](#) and [Fannie Mae](#), the costs of the \$29bn March bail-out of investment bank [Bear Stearns](#), the potential fallout from the various junk collateral the Federal Reserve has taken on to its balance sheet in the last few months, and finally, yesterday's \$85bn bail-out of the insurance giant [AIG](#).

Were the financial crisis to end today, the costs would be painful but manageable, roughly equivalent to the cost of another year in Iraq. Unfortunately, however, the financial crisis is far from over, and it is hard to imagine how the US government is going to succeed in creating a firewall against further contagion without spending five to 10 times more than it has already, that is, an amount closer to \$1,000bn to \$2,000bn.

True, the US Treasury and the Federal Reserve have done an admirable job over the past week in forcing the private sector to bear a share of the burden. By forcing the fourth largest investment bank, [Lehman Brothers](#), into bankruptcy and [Merrill Lynch](#) into a distressed sale to [Bank of America](#), they helped to facilitate a badly needed consolidation in the financial services sector. However, at this juncture, there is every possibility that the credit crisis will radiate out into corporate, consumer and municipal debt. Regardless of the Fed and Treasury's most determined efforts, the political pressures for a much larger bail-out, and pressures from the continued volatility in financial markets, are going to be irresistible.

It is hard to predict exactly how and when the mega-bail-out will evolve. At some point, we are likely to see a broadening and deepening of deposit insurance, much as the UK did in the case of Northern Rock. Probably, at some point, the government will aim to have a better established algorithm for making bridge loans and for triggering the effective liquidation of troubled firms and assets, although the task is far more difficult than was the case in the 1980s, when the Resolution Trust Corporation was formed to help clean up the saving and loan mess.

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Of course, there also needs to be better regulation. It is incredible that the transparency-challenged credit default swap market was allowed to swell to a notional value of \$6,200bn during 2008 even as it became obvious that any collapse of this market could lead to an even bigger mess than the fallout from subprime mortgage debt.

It may prove to be possible to fix the system for far less than \$1,000bn- \$2,000bn. The tough stance taken by regulators this past weekend with the investment banks Lehman and [Merrill Lynch](#) certainly helps.

Yet I fear that the American political system will ultimately drive the cost of saving the financial system well up into that higher territory.

A large expansion in debt will impose enormous fiscal costs on the US, ultimately hitting growth through a combination of higher taxes and lower spending. It will certainly make it harder for the US to maintain its military dominance, which has been one of the linchpins of the dollar.

The shrinking financial system will also undermine another central foundation of the strength of the US economy. And it is hard to see how the central bank will be able to resist a period of allowing elevated levels of inflation, as this offers a convenient way for the US to deflate the mounting cost of its private and public debts.

It is a very good thing that the rest of the world retains such confidence in America's ability to manage its problems, otherwise the financial crisis would be far worse.

Let us hope the US political and regulatory response continues to inspire this optimism. Otherwise, sharply rising interest rates and a rapidly declining dollar could put the US in a bind that many emerging markets are all too familiar with.

The writer is professor of economics at Harvard University and former chief economist of the International Monetary Fund

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