After the Bailouts, Washington's the Boss

By Bob Davis, Deborah Solomon and Jon Hilsenrath

Dec. 28, 2009 11:59 pm ET

President Obama, with Congressional financial committee leaders and his economic team in February.
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In 2008 and 2009, Washington strove to save the economy. In 2010, Americans will get a clearer picture of how Washington has changed the economy.

Only as the recession recedes will it become fully evident how permanently the state's role has expanded and whether, as a consequence, a new, hybrid strain of American capitalism is emerging.

One thing is clear: The government is a much bigger force in today's U.S. economy than it was before the financial crisis. "The frontier between the state and market has shifted," says Daniel Yergin, whose 1998 book "Commanding Heights" chronicled the ascent of free-market forces starting in the 1980s. "The realm of the state has been enlarged."

To prevent crumbling housing and credit markets from sinking the broad economy, the Bush and Obama administrations and the Federal Reserve spent, lent and invested more than $2 trillion on one initiative after another. If you owned a credit card or a money-market fund, had a savings account, bought a Dodge pickup or even a hunting rifle, or borrowed to buy a home or finance a small business, odds are good that the U.S. stood behind you or the firm that served you.

Washington pumped $245 billion into nearly 700 banks and insurance companies and guaranteed almost $350 billion of bank debt. It made short-term loans of more than $300 billion to blue-chip companies. It propped up life insurers and money-market funds.

It bailed out two of the three U.S. auto makers. It lent billions trying to jump-start commercial-real-estate, small-business and credit-card lending. In two February stimulus bills enacted a year apart, the government committed $955 billion to rouse the economy.

Today the U.S. government, directly or indirectly, underwrites nine of every 10 new residential mortgages, nearly twice the percentage before the crisis. Just last week, the Treasury said it would cover an unlimited amount of losses at mortgage giants Fannie Mae and Freddie Mac through 2012.

Those who defend this robust interventionism and those who decry its effects are vying to shape the nation's take on the events of the past 16 months.

Lawrence Summers, President Barack Obama's chief economic adviser, says the intervention was essential, short-term therapy, not a reinvention of capitalism. "Our overarching goal was to save an economy that was near the abyss, where depression looked like a real possibility," he says. By that measure, he sees success: "The kind of financial and economic collapse that looked very possible last fall appears remote right now."

The bailouts "were designed to be, and have proved to be, temporary," Mr. Summers says. "There is no aspiration of any kind to change the private-sector basis of our economy."

Even so, he says government won't return to its pre-crisis form. "The way our financial system was operating was much more fragile than many had supposed. Those events point up a need for substantial changes in the way in which we regulate the economy and regulate finance," he says.

John Taylor, a former Bush Treasury official who is now a Stanford University economist, says the government's role will be far greater than Mr. Summers suggests. "While we may be past the emergency, we're still in a mode that will create similar interventions for quite a while, even for minor emergencies," he says. "We have a bailout mentality in this country."

One concern: Even if the government withdraws, business will expect bailouts in the next crisis, and that will inspire another round of cavalier risk-taking. "If we don't re-regulate the banking system properly, we'll either get very slow growth from overregulation, or another financial crisis in just 10 to 15 years," says Kenneth Rogoff, a Harvard University economist and co-author of a new book on financial crises since the Middle Ages.

The story isn't over yet.

Although the economy is growing, unemployment remains a very high 10%. It is far from clear how strongly the economy will grow when the adrenaline of stimulus is withdrawn.

In finance, the recovery has been striking. Since bottoming on March 9, the Dow Jones Industrial Average is up 60%, and financial stocks have more than doubled. Yields on junk bonds, issued by companies with the highest risk of default, have fallen from almost 17 percentage points above yields on Treasury bonds in March to about 6.5 points higher now. That signals both an improving economy and a renewed investor appetite for risk.

Most big banks appear back on their feet. Of the $245 billion invested in bank shares by the Troubled Asset Relief Program, more than $175 billion has been repaid. Since the Treasury tested the financial strength of 19 large financial firms in May, they have raised $136 billion in equity capital and borrowed $64 billion without U.S. guarantees.

But the strengthening of the big banks may be distorting the market. Although smaller banks have long had a higher cost of funds than big ones, the gap has widened. The gap averaged 0.03 percentage point for the first seven years of the decade, but it jumped to a 0.66-point disadvantage for smaller banks in the four quarters ended Sept. 30, estimates Dean Baker of the Center for Economic and Policy Research, a liberal think tank. That suggests investors think the government would bail out big banks, but not small ones, if crisis erupted anew, he says.

Not all of the rescues look successful. The U.S. had to redo its initial bailouts of giant insurer American International Group Inc. and of GMAC Financial Services, which was once a car-finance and mortgage firm and is now a bank holding company. Both remain unable to raise private capital.

The intervention comes with long-lasting costs, among them huge budget deficits that could eventually push up inflation and interest rates.

The International Monetary Fund estimates U.S. government debt will swell to the equivalent of 108% of annual economic output in 2014, from 62% in 2007, absent politically difficult steps such as raising taxes or cutting benefit programs. As federal debt climbs, an ever-greater fraction of the budget goes just to pay interest, much of it to overseas creditors. The bill will worsen if interest rates rise from their current low levels.

Interest on the debt cost $182 billion in the fiscal year ended Sept. 30. Robert Pozen, chairman of MBS Investment Management, worries that within a decade, the interest bill could rival the defense budget, which was $637 billion last year.

The interventions also carry political costs. Their chief architects -- Fed Chairman Ben Bernanke, Treasury Secretary Timothy Geithner and former Treasury chief Henry Paulson -- say saving Wall Street was essential to saving Main Street. Many Americans, and a vocal group of lawmakers, disagree.

Only 21% of Americans polled by The Wall Street Journal and NBC News in December said they trusted the government to "do what is right," versus 64% shortly after the attacks of Sept. 11, 2001. In Congress, there is growing support for having the Government Accountability Office review the Fed's monetary policy, a move the Fed says would crimp its independence.

For some businesses, Washington now looms larger, affecting everything from the choice of executives to the fate of car dealerships. U.S. Bancorp has repaid its TARP money, but CEO Richard Davis nonetheless checked with Fed regulators in December to make sure it would be all right for the Minneapolis-based bank to raise its dividend. "We are still awaiting this guidance," Mr. Davis said in a statement announcing that the bank would retain its dividend level for now.

Bank of America Corp. also has repaid its aid, freeing itself from the condition lenders hate most about the bailouts: Treasury oversight of executive pay. Even so, it sought the Treasury's advice on a pay package before hiring a new chief executive.

President Obama, accompanied by, from left, Economic Adviser Christina Romer, Mr. Geithner and Mr. Summers. ILLUSTRATION: ASSOCIATED PRESS

The bank was considering paying $35 million to $40 million to hire Robert Kelly, CEO of Bank of New York Mellon Corp., much of it to buy out his unvested shares and options. The Bank of America board wanted to know how that would go over in Washington. Treasury paymaster Kenneth Feinberg told the bank that if it were still under his purview, he would reject the package. Around the same time, President Obama publicly bashed "fat cat" bankers.

With those two signals, the talks with Mr. Kelly fizzled, according to officials involved with the decision. The bank instead promoted an insider, Brian Moynihan, who had been working to repair the bank's reputation in Washington.

It thus chose a more politic man to lead it, post-crisis, than departing CEO Kenneth Lewis, who in a March meeting with the president had said he wouldn't "suck up" to federal economic aides, according to people familiar with the exchange. Mr. Moynihan, by contrast, told Obama aides in October that Bank of America wanted to work with the White House to achieve U.S. policy goals in areas like small-business lending and foreclosure prevention. As for his pay, Mr. Moynihan asked that it be determined later.

In the insurance business, some of the strong are complaining that the U.S. is warping the market by keeping the weak on life support.

Edmund "Ted" Kelly, chief executive of Boston-based insurer Liberty Mutual Group, points to the case of competitor Hartford Financial Services Group Inc. After acquiring a thrift and qualifying as a bank holding company, Hartford got $3.4 billion of TARP funds in June.

Liberty Mutual says it didn't ask for cash, and doesn't see why Hartford got any. "Nothing would have happened to the economy if Hartford failed," Mr. Kelly said. Hartford declined to comment.

The nature of post-crisis capitalism will depend in part on how the administration and Congress wield their new power. Inside Washington, there is profound ambivalence about this. Should the government, for instance, be an activist shareholder demanding change, like a Carl Icahn, or a passive one like an index mutual fund?

Herbert Allison, who left the private sector to run TARP, says, "We can't wait to get out of these investments. We don't view ourselves as a long-term investor." But in the here and now, the government is torn between its roles as shareholder and guardian of the public interest.

At Fannie Mae and Freddie Mac, where the Treasury holds warrants allowing it to acquire stakes of nearly 80%, the administration has put public interest first. It has instructed their regulator to have them administer efforts to cut monthly mortgage payments for millions of Americans to avert foreclosure.

The disagreements over how to wield power over business are playing out both within the Obama administration and between the administration and Congress -- as is happening now in the auto industry.

The White House forced out a CEO of General Motors in March, and crafted car-maker bankruptcy restructurings that drew howls from some creditors. But it later lightened its hand. It appointed a board of private-sector directors and let that board oversee GM. The board, six months later, was able to fire a subsequent CEO without getting prior White House approval, according to Treasury officials.

Congress isn't so willing to surrender its leverage. That was clear when GM and Chrysler decided to terminate about 3,400 dealers. Many turned to their lawmakers, and Congress got involved, prompting the companies to reinstate about 110. But the dealers felt that was insufficient.

GM's frustration with the process boiled over at a mid-November meeting in the office of Sen. Richard Durbin (D., Ill.). GM's usually cool-headed chief lobbyist, Ken Cole, was too agitated to sit, say several participants. When Tammy Darvish, an executive of a dealership in Silver Spring, Md., pressed Mr. Cole about whether it would cost the company any money to reinstate a terminated dealer, the GM team started to pack their briefcases and threatened to walk out, according to Ms. Darvish and a government participant in the meeting. They say the GM team stayed only at the insistence of congressional staffers.

Congress later enacted a provision giving axed dealerships broadened grounds to appeal in arbitration procedures -- broader than the White House or car companies sought.

A spokesman for GM declined to comment on the dealers meeting or Mr. Cole. But the auto maker, now 60% federally owned, said the arbitration law will hurt its efforts to turn a profit and repay the government, which has invested roughly $50 billion in the company.

—Dan Fitzpatrick contributed to this article.

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