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Bear Stearns rescue was easy part of crisis management
By John Plender
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So Bear Stearns is back in business under new ownership after decisive intervention by the Federal Reserve. Existing home sales in the US are suddenly picking up. Banks' shares are, mirabile dictu , upwardly mobile in Europe. In one bound we appear to be free.
But not for long, in my judgment. It is, admittedly, positive for short-term market confidence that the Fed has demonstrated an unambiguous urge to throw everything that can be thrown at the credit market problem. Yet, its actions so far constitute the easy part of crisis management, if anything in central banking can be called easy.
In essence, the Bear Stearns rescue addressed a liquidity problem. Bear was an important counterparty to just about everybody who mattered in the global financial system. Many, perhaps most, of those who mattered simply lost confidence in the bank. Yet, the fact that JPMorgan Chase was prepared to offer $2bn-worth of its paper for Bear suggests it reckoned the bank was nonetheless solvent.
Even so, this is not just a crisis of liquidity. This week's housing market numbers are cheering but there remains a huge overhang of newly built inventory, which guarantees that prices will continue to fall, thereby raising further questions about the value of all manner of mortgage-backed paper that is no longer traded because markets have dried up.
Many households now have negative equity in their homes, which is becoming more negative as house prices continue to slide across the nation in spite of sales picking up. These are people for whom the Fed's lower policy rates are tantalisingly remote because banks are widening their margins and teaser rates taken on in good times are giving way to market reality. Meantime, the rot spreads from subprime to prime.
Small wonder yesterday's data on US consumer confidence were dreadful. For this is where the credit squeeze most obviously hits the real economy: households will be doing precious little to drive economic growth this year or next.
Another potential driver is the corporate sector, whose balance sheet appears to be in reasonable shape. But a solvency tank trap looms there via pension funds. The flight to quality in the markets causes pension liabilities to swell because discount rates are lower. And the pain is exacerbated by the decline in equity markets.
Big banks around the world are not immune from this problem any more than they are from declines in house prices. There is more capital raising to be done to mitigate balance sheet strain and there could be more again after that as regulators demand an extra pound of flesh under pressure from angry politicians.
Where will it all end? Not before banks, investors and regulators can put realistic values on the securitised

products in a broken financial system, which is the nub of the solvency issue. For that to happen, the housing market has to stabilise. Hence the moves to grant Fannie Mae, Freddie Mae and the Federal Home Loan Banks a looser capital regime so they can pump liquidity into the mortgage market and the market for mortgage-backed securities.

Yet, these are huge markets that will not be easily propped up. There remains the possibility that governments and central banks will end up investing heavily in mortgage-related products in the attempt to establish a base from which active trading can recommence.

The sudden burst of optimism in equity markets at the start of the week contrasts, once again, with perceptions in debt markets. Three-month US Treasury bills started the week yielding little more than 0.5 per cent, showing a huge Depression era-style gap against the new Fed funds rate of 2.25 per cent. After the extreme turbulence last week, equity investors were entitled to a little fun before reality started to return yesterday in the US. But these differing perceptions in the markets will probably give way to a progressive convergence that will bring a painful adjustment on the equity side of the equation. And Bear Stearns will not, I promise, be the last institution that proves too interlinked to fail.