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John and Henry

Unfortunately, the wrong Paulson saw the subprime crisis coming long ago

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By Manuel P. Asensio

The worst financial crisis since the Great Depression" seems to have become a standard phrase in press accounts of the economy today. Most economists agree that the United States has fallen into a severe recession. Some think we might be heading into another depression.

The scale and severity of the current crisis is undoubtedly without a recent precedent, but the American economy is far from entering a depression like that of the 1930s. The Great Depression saw the unemployment rate soar past 20 percent. I know of no reputable economist who has predicted unemployment rising so high now. The highest rate since World War II was 10.8 percent in 1982. Our industry and workers are far more productive and better equipped to deal with change. Our knowledge of the drivers of economic activity is far greater.

That said, the stock market indices have lately been at levels not seen since 1997. Credit markets have been severely constricted by the failure of a string of major financial institutions and by the panic those events inspired. Because the losses happened so quickly and with such magnitude, they triggered a deeper, more sustained fear. It is this understandable fear as much as anything else that must be addressed to repair the economy.

Good regulatory and economic leadership is what the markets and the public need to assuage their fears -- leadership far better than what we have seen from the current administration and its treasury secretary, Hank Paulson. Mr. Paulson at first denied the importance of the subprime mortgage crisis and then denied that it would affect the real economy. He was late to address problems and then presented a problematic, discombobulated plan.

Believing the financial system was solid enough to handle it, Mr. Paulson let Lehman Brothers go bankrupt -- by far the largest bankruptcy in U.S. history, 10 times larger than Enron. He was wrong. The Lehman bankruptcy sent stock and bond markets into a tailspin and prompted fears of widespread corporate defaults in all industries, not just those directly affected by the subprime crisis. This one action destroyed an unprecedented amount of Americans' wealth.

Mr. Paulson then managed to get authorization from Congress to spend $700 billion of taxpayer money to support the financial sector by buying troubled assets via the "TARP" program, a plan he quickly abandoned. Instead, he copied the British and decided to recapitalize banks directly, but he put only a fraction of the $700 billion to work.

Last week, Mr. Paulson indicated that he did not plan to spend any more TARP funds until next year. Then this week he reversed course and indicated he may ask Congress for the remaining $350 billion. After going through a frenzy trying to get this money from Congress, Mr. Paulson flip-flopped repeatedly.

It has been said that Henry Paulson could not have been able to predict the crisis, but on that point we might want to bring up another Paulson, hedge fund manager John Paulson (not related to Hank).

By foreseeing the subprime failures, John Paulson reportedly turned $500 million into almost $20 billion for one of his funds in just one year, netting himself a personal profit of more than $3 billion. This ranks among the largest personal fortunes ever made on Wall Street.

I have known John Paulson for more than 20 years and have worked closely with him in the past. As much as John Paulson's unique achievements merit admiration, he did not have and didn't need any particular expertise in the esoteric area of subprime mortgages to see the problem. Nor was his expertise in investing based on macroeconomic forecasts. Indeed, he was a risk arbitrageur, as narrow a focus as there is in the market.

If John Paulson was able to see the crisis coming and convince many investors he was right more than two years ago, why couldn't Henry Paulson?

Unlike his immediate predecessors, Henry Paulson had a financial background and had risen to become CEO of Goldman Sachs, a firm that avoided the subprime debacle. He had all the resources of the U.S. Treasury at his disposal; he was a member of the president's Cabinet with access to all of the information collected by the White House and the Federal Reserve.

Others apparently also saw what Henry Paulson didn't see and earned huge profits from it. Among them was a small-time real-estate operator named Jeff Greene who reportedly made $800 million on a $50 million investment by betting against subprime mortgages. If a real-estate operator without expertise in subprime mortgages was able to foresee the bust, why was the U.S. treasury secretary unable to do so?

Henry Paulson had plenty of time to quantify the problem and develop policies to stop its growth; instead he believed the system could take care of itself.

The idea that ratings agencies and banks would collude to turn one of the nation's most trusted investments -- a residential home mortgage -- into a scheme to earn short-term profits still remains far-fetched to Americans. Developers and home buyers did not know that prices were being distorted by irresponsible speculators and financial firms, who were packaging their bad debts into phony bonds. America's regulators failed them and Henry Paulson refused to believe it.

What the markets and the public need now is the assurance of a leader able to understand the crisis and to act with consistency and measured caution. And so it is with some degree of hope that we look to Barack Obama and his selection of Tim Geithner as treasury secretary.

President-elect Obama and his economic team know the importance of fair regulation and have the competence and the wherewithal to steer us away from another depression. This ought to help ease our fears, which is the first step in charting a course back toward prosperity.

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