Money & Business

Bailout, Take II: What the Feds Do Next

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OK, so that didn't work.

After a bunch of all-nighters in Washington and some premature back-slapping, we're right back where we were a couple of weeks ago, after Lehman Brothers declared bankruptcy and the government lent AIG $85 billion. There's no one-size-fits-all bailout plan, after all. That $700 billion in taxpayer money remains under lock and key. Glum investors are now the ones bailing out, fleeing stocks and bonds and seeking safer ground.

But there are still some levers the government can pull. Working through the mess just won't be as orderly or predictable as it would if there were a single plan and a big pot of money. Here's what's likely to happen next:

Another try at a big bailout plan. A lot of those constituents who have been calling Congress to complain about rescuing fat cats are going to rethink their indignation as they watch the stock markets—and their own portfolios—sink. Lawmakers who voted against the bailout plan are going to have to explain why they're letting the markets collapse. The more uncomfortable voters get, the more likely Congress will be to pass some kind of sweeping relief plan. This is far from over.

More piecemeal bailouts. Before the big $700 billion bailout plan even existed, the Fed and the Treasury Department were already patching leaks in the financial system—one trouble spot at a time. The idea behind an umbrella bailout plan was to overhaul the whole system, establishing public standards and treating every ailing company more or less the same, before a bunch of leaks became a gusher. That would have eliminated the guesswork over whether a struggling company meets the criteria for a rescue—like AIG—or falls short, like Lehman Brothers.

Now we're back to guessing. The feds still have the wherewithal to lend money, buy bad assets, or take other measures to keep ailing companies afloat. What they don't have is a single plan that applies to all companies and the authority to soak up vast amounts of bad assets. So those weekend meetings at the New York Fed, with supplicant CEOs pleading for help, are likely to continue.

More failed companies. Duke University finance Prof. Campbell Harvey predicts there could be 750 to 1,000 bank failures over the next six months because of billions in bad assets stemming from the housing meltdown. Scarce credit also threatens other types of companies that are already struggling and desperately need capital, such as the Detroit automakers and some of the airlines. The government will be able to deal with some of those companies one at a time, but without a comprehensive plan, others will fall through the cracks.

Manic markets. Investors were hoping that a big bailout plan would offer some predictability about how the government will deal with struggling companies. Their crystal ball is once again very dark. That means wild swings in stock prices as big investors try to get out of the market ahead of bad news, and get back in if it looks like the feds will ride to the rescue. One of the most volatile sectors is likely to be regional bank stocks as investors worry that banks like Sovereign Bancorp and National City might be the next to fail.

Patchwork regulation. There's already a system in place for dealing with failed banks—led by the FDIC—but that may not be enough to handle the damage that's unfolding. Even without a big bailout bill, Congress may have to set up a new agency to deal with dozens or hundreds of bank failures, one similar to the Resolution Trust Corp. formed in the late 1980s. We could see a whole slew of lesser regulations, too, like restrictions on certain lending practices and higher federal coverage limits on bank deposits.

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Send an E-mail to flowchart@usnews.com. The global economy is mysterious, even scary. Chief Business Correspondent **Rick Newman** connects the dots. In addition to his writing for U.S.News, Rick is the co-author of two books: Firefight: Inside the Battle to Save the Pentagon on 9/11, and Bury Us Upside Down: The Misty Pilots and the Secret Battle for the Ho Chi Minh Trail. Tell him what concerns you: flowchart@usnews.com.

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Continued government intervention. The Federal Reserve continues to pump huge sums of money into the global banking system in a desperate effort to prompt banks to loosen their grip on loans to companies, consumers, and one another. For now, that seems to be having little effect as banks absorb the startling news from Washington and hunker down. That may lead the Fed to pump out even more money and take other important steps, like cutting interest rates. Sooner or later, that will probably help loosen things up. Until then, however, it's apparently up to the markets to fix themselves. Plan accordingly.

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