

The Political Economy of the US Bank Bailouts: A Keynesian Critique of the Uncertainty and Liquidity Crises

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Of the maxims of orthodox finance none, surely, is more anti-social than the fetish of liquidity, the doctrine that it is a positive virtue on the part of investment institutions to concentrate their resources upon the holding of 'liquid' securities. It forgets that there is no such thing as liquidity for the community as a whole.

John Maynard Keynes (1936: 155)

Introduction

In this chapter I address the US response to the problems in the banking sector which were revealed by the financial panic. For some observers these are problems of liquidity (Geithner 2009) which have resulted in a catastrophic loss of demand and "excessive liquidity discounts" (US Treasury 2009c). For others these are deeper problems of insolvency (Richardson & Roubini 2009).³ How the crisis is interpreted is central to how it is responded to. According to the US Department of the Treasury the financial crisis has a number of inter-linked aspects; it "is a crisis of confidence, of capital, of credit and of consumer and business demand." (US Treasury 2009a). The troubled real estate-related assets "congesting" the US financial system are identified as being at the heart of the crisis (US Treasury 2009c). The bursting of the bubble triggered wide-spread deleveraging and forced fire sales. The falling prices resulted

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³ A further, deeper interpretation of the crisis is as a crisis of accumulation. I thank Or Raviv for highlighting the importance of not overlooking this point in the collective discussions about financialisation and the crisis. This chapter takes this up through focusing on Keynes's notion of liquidity preference.

in traditional sources of liquidity exiting the secondary markets and exacerbating the negative spiral of falling prices, deleveraging and liquidity. The Treasury (2009c) identifies the problem as a liquidity problem with assets suffering from “excessive liquidity discounts”. In addition to the liquidity discounts on these assets has reducing banks’ ability to raise new capital it is the “lack of clarity about the value of these legacy assets has made it difficult for some financial institutions to raise new capital.” The following will draw on the work of John Maynard Keynes to assess the political economy of the US bank bailouts.

The financial crisis and economic recession are not just about sub-prime mortgages; sub-prime turned out to be the trigger, but it didn’t have to be. Housing is emblematic of the entire financial system characterised by: increased personal and corporate indebtedness; sustained by asset price inflation and lax or bad lending (sometimes criminally so); increased leverage; securitisation and the lend-to-distribute model; fraud, dishonesty, greed, *laissez-faire* and self-regulation; all justified and sustained by a belief in economic and financial science and certainty.

What has happened from 2007 onwards underlines the importance of confidence and the fear of uncertainty. The seizing up of the financial markets in October 2008 was mainly due to the spreads in the UK and US interbank and other short-term money markets from September 2008. The consequences of the bubble deflating has set off a vicious downward spiral of deleveraging, declining asset values triggering forced write-downs because of mark-to-market rules, and then forced sell-offs because of pro-cyclical regulation, pushing prices down yet further, and so on. Plus, large-scale defaults and economic recession add further downward pressure.

Since the breaking of the global financial crisis and the onset of economic recession there has ostensibly been a significant shift in political thinking. Individual governments have rediscovered a commitment to interventionist economic policy and calls for greater international cooperation, rethinking financial and economic regulation, as well as reforming the international institutions that govern the financial system have become commonplace. While these have been long-standing concerns among some academic commentators and advocacy groups the financial crisis has brought them centre stage. Domestically, various governments around the world—most notably the US and UK—have been forced to broker deals and provide support for failing institutions considered systemically important. A series of rescue packages were hastily put together for, e.g., Bear Stearns, Fannie Mae and Freddie

Mac, Merrill Lynch and AIG. Initially, these were on an ad hoc basis and addressed individual actors within the markets, but by September 2008—with the Dow Jones index posting a record one-day fall of 770 points (7 per cent)—it was clear that these problems were far more structural than individual cases of failure and the problems were not going to go away by themselves. A more systematic response was necessary. This emerged in the form of the Troubled Asset Relief Program (TARP) which was proposed by then Treasury Secretary Henry Paulson. The bailout plan was designed to target the illiquid and toxic assets sitting on the balance sheets of financial institutions. The plan was to authorise the US Treasury to purchase up to US\$700 billion worth of mortgage-backed securities. After initially being rejected by a vote in the House of Representatives, on 3 October 2008 the House voted to enact the bill into law as the Emergency Economic Stabilization Act of 2008. The initial plan has evolved somewhat since Paulson's announcement.

The historic election of President Obama increased expectations for change. The old TARP was reassessed. The Financial Stability Plan, announced by US Treasury Secretary Timothy Geithner in February 2009, is aimed at the “uncertainty, troubled assets and capital constraints of our financial institutions as well as the frozen secondary markets” (US Treasury 2009a). There are a number of different aspects to the Financial Stability Plan: (i) the Capital Assistance Program which involves the stress tests to see whether banks need extra capital as a cushion and is aimed at helping banks secure private or government capital; (ii) Consumer and Business Lending Initiative which offers financing to restart lending for small businesses and personal loans for cars, credit cards and student loans; (iii) the Making Home Affordable Program which offers mortgage refinancing to reduce foreclosure rates and address falling house prices, (iv) and finally the Public-Private Investment Program (PPIP). The PPIP is targeted at removing the toxic assets clogging up the balance sheets of financial institutions with the hope that this will allow banks to raise private capital again and kick-start lending. The problem is one of uncertainty and valuation. In sum, the crisis has resulted in “declines in secondary market liquidity” and the lack of available funding in the markets has led to “excessive liquidity discounts” (US Treasury 2009c).

This is the ‘new interventionism’; yet it is an interventionism brought about by necessity and is little more than a default policy position. The chapter will analyse the US authorities’ diagnosis and response, focussing on the PPIP. At the time of writing (early June 2009) the future of the PPIP is unsure. On 3 June 2009, the

FDIC announced the loans part of the PPIP had been postponed. The stress tests showed that under somewhat distressed conditions banks could service current toxic assets. As such, private capital can again be raised. Supporters of the latest interventions cite this as a measure of its success in restoring confidence.⁴ Nevertheless, it does not matter for the argument here. The program and its design offer an object lesson in the philosophy behind the new interventionism; i.e. a retained belief in market rationality and a commitment to market-based solutions. Plus, while we have seen an apparent return of confidence—and while confidence and ‘animal spirits’ *are* important—as long as deeper structural flaws and imbalances remain the current crisis has a number of acts left to play.

Outline of the Argument

The most important conclusion we can draw from the current market and economic turmoil is that we cannot return to the *status quo ante*. However, despite the apparent shift in language, moralising, public opinion, and seemingly even the economic paradigm, everything currently points to business as usual. This is because there is an underlying commitment to fixing what when wrong *in* the market.

The popular focus on individual instances of greed and malfeasance is understandable but unhelpful; they are little more than bread and roses. It serves to distract from the more fundamental problems that serve to structure and reproduce economic relations. A political economy approach to the crisis interrogates the underlying processes organising society. The bank bailouts have redistributive consequences that are highly regressive. Redistribution and the problems of inequitable outcomes *are* a matter for political economy. However, the aim of the current chapter is to focus on the inside of the bailout plan, and to focus on its economic and epistemic aspects, to show how such outcomes are justified.

The ‘new interventionism’ is far from the initial hopes for a large-scale rethinking of regulation of finance and the relationship between the financial economy and society. The old ways of thinking—belief in market rationality—not only remain but are being re-institutionalised through the banking bailouts. Following Keynes, we should

⁴ It seems that concerns about government intervention are limiting private sector interest; banks are quite willing to forego the large potential profits in return for retaining future independence. Furthermore, it appears that banks do not want to sell—not that people won’t buy. This is because banks would be forced to book large losses because of the marked down price, even with the government’s support.

interpret the problem of liquidity quite differently from Bernanke, Geithner, et al. It is a structural and political problem not just a technical short-term one. It demands a political economy approach, not just a narrowly political *or* economic one. The US authorities mistakenly view money (and thus liquidity) through a transactions lens. They ignore the qualities of money as a store of value and thus alternative motives for holding money than exchange. The argument made here is that, in the real world of Keynesian uncertainty as opposed to the abstract models of mainstream economics, risk is not calculable neither are secure market values. Uncertainty is *always present*, not just now.

At the heart of the banking bailouts—in addition to liquidity and uncertainty—lies the problem of value and valuation. The initial TARP intervention was designed to just try and get the toxic assets off the balance sheets of the banks. Hence, the TARP tried to *remove* the problem of hard-to-value assets and the valuation problem. However, the PPIP tries to *resolve* the problem of hard-to-value assets. By restarting the market (through public subsidies) and getting private actors to carry out the price discovery process, the PPIP tries restore market valuations. The consequence of this is that it not only locks in market prices, but ‘market values’. Hence the program is serving a constitutive as well as a regulative function (Rawls 1955, Searle 1995).

Unfortunately, the valuation problem is actually two-fold. It is not just a problem of technical uncertainty caused by illiquidity as Paulson, Bernanke, and Geithner interpret it, and thus resolvable. It is a much more fundamental problem of intersubjective ambiguity (Best 2005). It is a problem *of* the market not just *for* the market. The belief that liquidity is the solution to this uncertainty ignores some of the central insights of Keynes and post-Keynesian economics. The wrong interpretation of uncertainty leads to the wrong interpretation of the liquidity problem. Following Keynes, this fetish of liquidity is deeply anti-social. The real liquidity problem is a much more long-term problem of insufficient investment. The chapter concludes by emphasising the need to return to Keynes’s vision for international monetary re-regulation beyond just banking reform.

The Restoration of Keynes

As part of this ‘new interventionism’ there has been a noticeable return to the great English economist John Maynard Keynes. By the end of 2008, as Peter Clarke (2009) noted in the *Financial Times*, “For about 30 years Keynes’s reputation

languished. Then, in about 30 days, it has apparently been restored.” Keynes is indeed back. These days it is difficult to avoid references to Keynes by politicians, economists, pundits, bloggers and the media more generally. Rightly feted as the man who interpreted the problems of the Great Depression, copies of *The General Theory* are being pulled off shelves, dusted down or reprinted. It appears to be something of the new orthodoxy that Keynes holds the key to navigating the current financial and economic problems. For example, writing in the *New York Times*, Greg Mankiw (2008) is clear that “If you were going to turn to only one economist to understand the problems facing the economy, there is little doubt that the economist would be John Maynard Keynes”. And the practical policy significance of this is real. Keynes (1936: 383) was famous for noting how practical men “who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.” Not so Alistair Darling who invoked Keynes when announcing the UK Treasury’s decision to fast-track future budgeted spending at the end of October 2008 (Hennessy 2008). Similarly, the Obama Administration’s stimulus is clearly framed and understood in Keynesian terms.

This is a welcome turn. But is also based on a very superficial understanding of Keynes; there is much to disagree with in the way in which Keynes has been wheeled-out, caricatured, and invoked. It is striking how much of the discussion of Keynes is with respect to fiscal stimulus and how little is in relation to the monetary and financial side of the economy. Popular commentators, politicians and economists alike have reduced Keynes to a one-trick pony. The superficial understanding of Keynes means that Keynesianism is little more than a logic for increased government expenditure. The fact that, *ceteris paribus*, in order to keep GDP (Y) from falling in a situation of private thrift (falling $C + I$) public expenditure (G) needs to rise, is a valuable point of macroeconomic accounting. But what else does the work of Keynes offer in terms of identifying the key economic and political challenges that governments, private actors and international institutions face? His work offers many further insights into the organisation of capitalism, international institutional design and regulation. This chapter is part of a larger argument on the return to the language of Keynesianism in the wake of the financial crises and the ongoing global economic downturn. The broader argument is that the return to Keynesian language is very different from a return to the work and thought of John Maynard Keynes.

What Went Wrong? A Keynesian Interpretation

The fact that the Keynes currently being invoked is a superficial caricature is—unfortunately—hardly a surprise. This is a long-standing issue in economic thought. Paul Davidson has consistently argued that Keynes was never properly understood nor incorporated into economic theory (e.g. Davidson 2007). Joan Robinson infamously reserved the term “bastard Keynesianism” for the Neoclassical Synthesis of Paul Samuelson. And more recently Peer Steinbrück, the German finance minister, labelled the belief that the solution lies in a fiscal stimulus plan as “crass Keynesianism”; denouncing the sudden switch from supply-side policies to deficit spending as “breathhtaking” (Theil 2008).

So, what would Keynes do? His system of thought was deeply rooted in a moral foundation. While this was most manifest in a commitment to eradicate unemployment and inequality, these are parts of a bigger vision of the economy being subservient in a civilised society (Fitzgibbons 1988). He was clear about the purpose of any economic system: “If there is no moral objective in economic progress, then it follows that we must not sacrifice, even for a day, moral to material advantage” (Keynes (1930 [1963]): 307). Reading essays such as Keynes’s 1930 ‘Economic Possibilities for our Grandchildren’ and its passages on the “disgusting morbidity” of loving money as a possession and the need to go “out of the tunnel of economic necessity into daylight” leaves one in no doubt about his view of the purpose of economics and the economy ((1930 [1963]): 359-362). This must be restored.

His moral vision drove a practical and pragmatic side, one that endeavoured to understand the real world as it was, and he rejected the abstract world of unrealistic models and assumptions. The two key problems for Keynes were unemployment—when people can and want to work—and the gross inequalities of wealth and income. In this light, the whole purpose of *The General Theory*, written against the backdrop of the Great Depression, was to address “the outstanding faults of the economic society in which we live ... its failure to provide full employment and its arbitrary and inequitable distribution of wealth and incomes” (Keynes 1936: 372). At the heart of the *General Theory* (1936) was the message that it was possible for the economy to become stuck in an equilibrium of low economic activity and high unemployment. While this is his most famous insight, in order to understand the foundations of his economic framework it is necessary to elaborate on two key concepts: the role of

uncertainty and the nature of money. These are the keys to understanding Keynesian economics (Davidson 2007).

Uncertainty and Money

Keynes's economics is the economics of uncertainty. For Keynes, uncertainty is "the pivot of the actual economic system" (Fitzgibbons 1988: 80). This uncertainty manifests itself in a couple of noticeable ways relevant to the financial and economic spheres: (1) in the markets it leads to the use of 'conventions' and thus a "so flimsy a foundation" for certain knowledge about value and the future, and (2) it makes people crave cash, i.e. 'liquidity preference'. For Keynes the financial system was central. Employment is driven by changes in sentiment within the markets; falls in asset prices drive down investment and thus employment. Hence he was particularly interested in how uncertainty played out in the financial markets and affected investment decisions.

Bill Gerrard makes the case that Keynes provides "the outline of a theory of the effects of *fundamental uncertainty* on economic behaviour" (2003: 239-240, original emphasis). Keynes asked, "How do we manage in such circumstances ... to behave in a manner which saves our faces as rational, economic men?" (1937: 214). Keynes's answer is via the use of conventions. Conventions are tacit agreements or rules that "the existing state of affairs will continue indefinitely". The convention that the present will continue into the near future offers the agents the stability needed to make a Benthamite calculation about an investment decision. This matters. As Fitzgibbons (1988: 82) notes, "The tendency to discount contingency outside the convention subtly preserves values that are partly based upon a self-deception." This self-deception has two very particular consequences. First, it serves to rationalise the underlying calculus and thus the very possibility of making that calculus. Paul Davidson (2002) calls this the ergodic assumption: that the future will, on average, be like that past. Second, the aggregate consequence of this "practical theory of the future":

has certain marked characteristics. In particular being based on so flimsy a foundation, it is subject to sudden and violent changes. The practice of calmness and immobility, of certainty and security, suddenly breaks down. New fears and hopes will, without warning, take charge of human conduct. The forces of disillusion may suddenly impose a new conventional basis of valuation. All these pretty, polite techniques, made for a well-panelled Board Room and a nicely regulated market, are

liable to collapse. At all times the vague panic fears and equally vague and unreasoned hopes are not really lulled, and lie but a little way below the surface. (Keynes 1937: 214-215)

This is obviously a precarious situation. As Keynes (1936: 153) notes, “It is not surprising that a convention, in an absolute view of things so arbitrary, should have its weak points. It is its precariousness which creates no small part of our contemporary problem of securing sufficient investment”. To explain why uncertainty leads to the problem of securing sufficient investment one also needs to see how much Keynes’s ideas also pivot on his view of money.

Lord Skidelsky called Keynes “the poet of money” (Davidson 2002: 13). For Keynes (1936: 293) the “importance of money essentially flows from its being a link between the present and the future”. The peculiar and essential properties of money, as this link, mean that it has a role as a *liquid* store of wealth. In classical economic theory money is neutral and merely acts a token in lieu of bartering. However, once one includes the reality of uncertainty and the role of expectations into the analysis then the “peculiar” properties of money begin to matter. Keynes argues that in addition to the transactions and speculative motive for holding money there is also the precautionary motive. He describes it thus: “our desire to hold money as a store of wealth is a barometer of the degree of our distrust of our calculations and conventions concerning the future” (Keynes 1937: 216). In the economy the essential properties of money mean that it is held as a liquid asset rather than being used to purchase real capital goods. Hence we see the failure of effective demand and investment (Davidson 2002). It is uncertainty that drives this.

By ‘uncertain’ knowledge, let me explain, I do not mean merely to distinguish what is known for certain from what is only probable. The game of roulette is not subject, in this sense, to uncertainty; nor is the prospect of a Victory bond being drawn. Or, again, the expectation of life is only slightly uncertain. Even the weather is only moderately uncertain. The sense in which I am using the term is that in which the prospect of an European war is uncertain, or the price of copper and the rate of interest twenty years hence, or the obsolescence of a new invention, or the position of private wealth-owners in the social system in 1970. About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know. (Keynes 1937: 213-214)

Hence, uncertainty does not only result in the fragility of conventions, values, and market stability, but once combined with the nature of money then it gives rise to liquidity preference. Actors attempt to defer economic decision making and evade the consequences of “unknowledge” (Shackle 1983).⁵ Navigating an environment that is inherently uncertain and not only unknown but *unknowable*, creates demand for stores of value that are liquid. (Brown 2007: 436). Investors hedge against this uncertainty by demanding liquidity.

Securitisation and Liquidity Illusion

Traditionally liquidity has been equated with money or cash, but important changes in the structure of finance means that new understandings of liquidity are necessary (Nesvetailova 2008). Securitisation and financial engineering is the process of converting illiquid claims to future cash flows to liquid tradable assets. It was the repeal of Glass-Steagall with the 1999 US Financial Services Modernization Act that opened the gate for the large-scale reproduction of the originate-to-distribute model (this had already started in the late 1970s). Securitisation serves a number of purposes. It is partly about the ability to transfer and spread risk. It is partly about profitability; securitisation allows holders of debt to access future cash flows in the present (Edmunds 1996). But crucially, from a Keynesian point of view, it’s about liquidity.

A strong claim can be made that the current crisis is one that has been driven by securitization. Much has been written on the principal-agent problems of securitisation, i.e. the mortgage-originating bank no longer has as much incentive to worry about possible future defaults. But, following Keynes, it is the illusion of liquidity created by financial innovation that has been most pernicious. As Keynes (1936: 155) noted, while individual agents may well feel as if their portfolio is liquid, “there is no such thing as liquidity for the community as a whole.” In a similar vein Avinash Persaud writes evocatively of ‘liquidity black holes’, which are “episodes where liquidity suddenly disappears” (2002: 4). Essentially this refers to the volatility of liquidity. A market appears liquid when you buy it, but just as you want to sell, it becomes illiquid if everyone wishes to do the same. Persaud highlights how

⁵ And thus we return to Keynes’s most famous insight; when individuals and businesses lack confidence in the future (lacking in ‘animal spirits’) they tend to save and underspend (Keynes 1936: 162). The desire of individual consumers to hold back from spending now is what Keynes called the “paradox of thrift”: what appears individually rational is collectively disastrous.

liquidity requires a diverse market not just a large or deep one. So, in a situation where all market participants want to go the same way in a market—no matter how deep—liquidity suddenly disappears.

Anastasia Nesvetailova (2008) presents a useful critical review of the role of liquidity illusions in the current crisis. In it she highlights how “liquidity illusions originate in the process of financial innovation” (2008: 5), that and the obscurity of financial practices. Drawing on both Keynes and Hyman Minsky, she underlines how perceptions of liquidity hide the deeper fragilities of finance; making markets look safe, allowing households and firms to leverage more than they should and refinance debts that would otherwise appear distressed.

To recap, the essential fact of uncertainty leads investors to hold money or liquid assets for the precautionary principle. This explains the attractions of securitization, as it increases the liquidity of individual investors and apparently the market as a whole. The reality is that this is merely the illusion of liquidity—once everyone wants to sell, liquidity dries up very suddenly. Given this, it is not surprising that the crisis is interpreted as a liquidity problem.

What is Being Done? The US Bank Bailouts

Keynes once reputedly remarked that if you owe your bank a thousand pounds, you have a problem: owe it a million, and it has.

*The Economist*⁶

As intimated in the introduction, the bank bailouts have highly regressive redistributive consequences. Yet, despite this, it is still necessary to save the banking system.⁷ What seems clear is that without a functioning banking system there is little chance of the economy improving. The official line from the Federal Reserve is that the fiscal stimulus will not work against a background of continuing bank deleveraging.

⁶ *The Economist*, ‘The borrowing boom’, March 24, 1979

⁷ Note there is a difference between saving the banking system and saving the banks or particular banks or bankers. There’s something of the Dr Strangeloves about the bank bailouts.

In terms of the interventions so far, there has been large and internationally coordinated interest rate cuts. But by early 2009 monetary authorities had to move beyond conventional monetary policy with interest rates effectively at zero. Mervyn King came out on 20 January 2009 to admit that monetary policy was effectively no longer working and the UK was moving towards quantitative easing, which it did on 5 March. Likewise, after announcements in November 2008, the US Federal Reserve announced that it would start pumping money into the economy by buying debt in mid-March 2009. What Keynes would have recognised is that despite all the capital being pumped into the banking system, banks won't lend, businesses and consumers either can't or won't borrow. The problem is that this does nothing to stop hoarding and the nominal interest rate cannot effectively be negative; the liquidity trap (Hicks 1937, Krugman 2000).

Anna Schwartz—famous for her and Milton Friedman's interpretation of the causes of the Great Depression (Friedman & Schwartz 1963)—argues that Bernanke is fighting the last war. Schwartz is at pains to underline how the current crisis is not a crisis of liquidity, but that it's a crisis of uncertainty. Schwartz identifies the problem on the asset-side of the banks' balance sheets as: "all these exotic securities that the market does not know how to value." (Carney 2008). This has been recognised. In his well-trailed speech at the LSE, Ben Bernanke (2009) noted that:

A continuing barrier to private investment in financial institutions is the large quantity of troubled, hard-to-value assets that remain on institutions' balance sheets ... The presence of these assets significantly increases uncertainty about the underlying value of these institutions and may inhibit both new private investment and new lending.

In order to tackle this uncertainty the IMF (2009) has called for systematic "balance sheet cleansing". But this merely serves to raise the next logical question of how to do so. A range of options have been suggested from nationalisation / receivership to a good bank / bad bank solution (IMF 2009, Bernanke 2009). Indeed, balance sheet cleansing was what the Troubled Asset Recovery Plan was originally designed to do. The TARP was designed to purchase \$700 billion of 'troubled assets', i.e. the distressed and hard-to-value assets, in order to help secure economic stability. The logic was simple enough; clear bank balance sheets of toxic assets in order to get banks lending again. Deleveraging meant that toxic assets became an economic deadweight halting the ability of banks to lend.

The problems with the original TARP are numerous. One, it has suffered from a lack of accountability: for example Paulson's original draft infamously read "Decisions by the Secretary pursuant to the authority of this Act are non-reviewable and committed to agency discretion, and may not be reviewed by any court of law or any administrative agency."⁸ Since then the Congressional Oversight Panel (2009a) has reported that it cannot see where the money is going. Two, as a consequence it has rightly generated enormous distrust among taxpaying citizens. Moreover, it has been poorly designed (or changed from its original purpose) to the point where there is no upside, without equity in the banks it's a poor deal. Robert Reich (2009) has called it "lemon socialism" and Joseph Stiglitz has called the proposal "cash for trash" (Kennedy 2009). Three, its execution has been very haphazard. Under Paulson the TARP changed from its original purpose (which was approved by Congress), to buy distressed assets off banks' balance sheets, to buying preferred shares in banks. Four, it is effectively an extremely regressive redistributive program serving to subsidise the source of the problem. Elizabeth Warren, chairwoman of the TARP congressional oversight board, in a Senate hearing told the Senate Banking Committee that Paulson had overpaid financial institutions by around \$78 billion via the TARP; with the Treasury paying \$254 billion in 2008 in return for stocks and warrants worth about \$176 billion (Congressional Oversight Panel 2009b). While this is evidence of the gaming of the bailout and the regressive outcomes, it also underlines the key problem the TARP couldn't solve: how to value distressed assets.

The dilemma at the heart of any such bank bailout is valuation. The difficulty in valuing toxic assets is two-fold. First, they are often extremely complex. Second, there is virtually no functioning market for them. This is the uncertainty highlighted by the Federal Reserve, Schwartz and Bernanke. The problem is interpreted as one of liquidity (both as a cause and a consequence). Under current market conditions (of uncertainty and lack of credit), no one wants to purchase the distressed assets thus the price falls ('further' than it should). The original TARP aimed to take this uncertainty directly off the banks' balance sheets, the revised version tried to recapitalise banks in order to provide capital. The US authorities hoped restoring capital ratios allow banks to lend once again rather than hoarding cash.

But, as highlighted by Warren, a likely outcome is paying the wrong price for the assets. There is essentially a dilemma facing the Treasury. The dilemma appears

⁸ For the original text of the plan see: http://www.nytimes.com/2008/09/21/business/21draftcnd.html?_r=1&ref=business

deep, intractable, but essentially straight-forward. If the TARP paid too little for the assets and essentially undercapitalises the banks, it is in danger of bankrupting the financial system and reinforcing deleveraging and insolvency. If, on the other hand, the assets are valued too highly, it is an excessive subsidy with the cost borne by the taxpayers. And, crucially, over the longer-run it serves to lock-in the inflated and unrealistic prices generated in the bubble period and maintains a bloated financial system.

It is this problem—valuation—that the new team at the US Treasury targeted in early 2009. It believed that the twin problems of uncertainty and liquidity were resolvable *if* the problem of valuation could be resolved. The logic behind the Geithner Plan was to first provide a market valuation for the toxic assets. Having a market price will restore confidence and serve to add further liquidity into the market. Thus, finally, restarting lending. Here uncertainty is interpreted as a consequence of illiquidity. If liquidity can be restored to the markets then we will see uncertainty clear up. Contra Keynes, uncertainty is viewed as a temporary problem that can be fixed.

The Financial Stability Plan and the Public-Private Investment Program

On Tuesday 10 February 2009, President Obama's Treasury Secretary, Timothy Geithner, announced the administration's response to the financial crisis: the Financial Stability Plan (Geithner 2009). Geithner announced that, of the remaining \$300 billion TARP funds, \$50 billion would be used to mitigate foreclosures and the rest would be used to help fund private investors' purchases of toxic assets from banks. The announcement received some notoriety due to its poor reception (the S&P 500 fell by nearly 5 per cent on the announcement); both commentators and the market responded negatively because of the perceived lack of details.

Yet, Geithner's announcement contained a couple of *key* principles which are of fundamental importance in understanding the political economy of the response to the crisis. At the heart of the Financial Stability Plan was a public-private partnership, which would first "provide government capital and government financing to help leverage private capital to help get private markets working again". Second, in turn, the partnership with "private capital and private asset managers [will] help provide a market mechanism for valuing the assets" (Geithner 2009).

On 23 March 2009, the US Treasury released further details on the Public Private Investment Program. The announcement and White Paper restated the administration's diagnosis of the crisis and the details of the program's response. Toxic assets—now termed 'legacy assets' in the Plan—"create uncertainty around the balance sheets of these financial institutions, compromising their ability to raise capital and their willingness to increase lending." (US Treasury 2009b). The Treasury identifies two types of assets: legacy loans which sit on banks' balance sheets and make it difficult for them to raise private capital and lend, and legacy securities which are trading below where they should be "in normally functioning markets" because of the highly illiquid state of the secondary markets. As such, the PPIP is divided into two programs which draw on joint-financing from the Treasury, the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve to leverage private sector investment to purchase the different types of toxic (legacy) assets (shown in Figure 1 below).

The Legacy Loans Program will combine an FDIC guarantee of debt financing along with private sector and Treasury equity capital. The FDIC will auction off pools of loans where the highest bidder forms a Public-Private Investment Fund to purchase the mortgages. The FDIC—after conducting an analysis of the mortgage pool which they will use as collateral—leverage the pool at a 6-to-1 debt-to-equity ratio, the Treasury provides 50 per cent of the equity funding leaving the private investor to provide the other 50 per cent (i.e. one fourteenth of the winning bid). For the legacy securities a similar provision of leverage is made available to private investors to purchase eligible assets (e.g. RMBS, CMBS and ABS) through financing from the Federal Reserve and Treasury via the Term Asset-Backed Securities Loan Facility (TALF) alongside equity capital from the Treasury. The Treasury will match each dollar of private capital as a co-investment and in addition provide loans of another 1 or 2 dollars per dollar in the initial private investment. Thus, for every dollar of private investment the fund manager will have access to 3 or 4 dollars to purchase legacy securities.

Insert Figure 1 around here

From the above it should be clear just how generous the government's contribution is in its attempts to address the "excessive liquidity discounts". The PPIP is designed to use \$75 to \$100 billion of TARP capital alongside private capital to generate \$500 billion in purchasing power. As such, the *public* element of the partnership is to

provide leverage and therefore boost private investors' confidence and increase private demand for these assets, thus restoring liquidity and "facilitate market-priced sales" of troubled assets. (Treasury 2009c). The *private* element of the partnership is designed to reduce the liquidity discounts *and* facilitate price discovery. It is argued that increased clarity will increase confidence and thus increase new capital from private investors. "A key principle of the chosen approach is to use private capital and private fund managers to help provide a market mechanism for valuing the troubled assets." (Treasury 2009c).

Whereas the original TARP was designed to simply clear the troubled assets off the balance sheets of banks, the new Financial Stability Plan has been designed to directly address the tricky issue of pricing the troubled assets. The Treasury is still faced by the dilemma of having to clear these assets and help those institutions that need it, while not wasting taxpayers' money. The administration argues that ensuring private sector participation will serve a number of purposes. It increases the overall purchasing power and thus increases the impact of taxpayer investments, which also means that it spreads the risk away from the taxpayer as opposed to taking on all of the risk if the government acts alone. But private sector participation also serves a price-discovery purpose. It is argued that competition among private sector investors will limit the likelihood that the government will overpay for the assets. While this is important to an administration that is worried about being seen to either serve financial interests or intervening incompetently, it serves a deeper function too: it helps to restart the market by eliminating 'illiquidity uncertainty'.⁹

Valuation, Uncertainty, and the Fetish of Liquidity

The TARP tried to *remove* the problem of hard-to-value assets and the valuation problem. Whereas, the PPIP tries to *resolve* the problem of hard-to value assets. This is the valuation problem in as seen in Washington D.C. and New York. If the

⁹ While the economic logic is to restore liquidity and enable price discovery, the political logic of the public-private partnership is to suggest to taxpayers that their interests are being protected. The Treasury argues that taxpayers will benefit in any upside but protect them from the downside because of private sector involvement. The market certainly approved of the distribution of the upside and downside risk between private investors and taxpayers as the Dow Jones Industrial Average rose by 7 per cent on the day the details about the PPIP were announced. The use of FDIC and Fed Reserve is because the Obama Administration understands that congress will not approve further necessary funds (Buiter 2009). The executive branch and the Fed have ensured that they do not have to rely on Congressional approval.

value is too high it subsidises the financial system, if the value is too low it bankrupts financial system through enforcing further deleveraging and insolvency. The Treasury's desire to sustain private sector involvement is that it passes on the difficult task of pricing these assets from government bureaucrats to the market. In the White Paper, the Treasury (2009c) state that:

while the plan is designed to help reduce the liquidity discounts contained in legacy asset prices in the near-term, the most important way to protect taxpayers is to ensure that the government is not paying more for assets than their long-run value as determined by private investors. Since TARP funds will be invested alongside private capital on similar terms, this reduces the likelihood that taxpayers will be overpaying.

But this reduces the valuation problem to what we might term a regulative problem. Philosophers have long made the distinction between two types of rules; between those that justify a practice and those that justify a particular action falling under it (Rawls 1955). John Searle (1995) defined the distinction between constitutive and regulative rules. Some rules, he explains, regulate already existing activities, for example driving on the left-hand side of the road. The rule prescribes the correct (or forbidden) behaviour under specific conditions. But driving exists independently of this rule. Whereas other rules literally constitute an activity thereby making it possible. For example, without the rules of chess there can be no activity of chess playing. The actions of moving the pieces around the board become meaningless. As such, the constitutive element of social rules is clearly more fundamental.

Like rules, market prices serve two functions. They provide a common metric of value to carry out a transaction (a particular action). This is the regulative function of prices. Secondly, market prices also secure a common agreement on the possibility of accurately defining the underlying value of assets. A true assessment of the PPIP should understand that it is designed to work at the constitutive level, not just at the technical / regulative one. The superficial (and mainstream) interpretation of the valuation problem is about how to find the 'right' prices / value. The more fundamental interpretation of the valuation problem is how to deal with assets which cannot be valued. The Geithner solution is clear. The market, when 'fixed'—with some subsidies—can do so.

The reason why the valuation problem is only recognised as a regulative problem, not a constitutive one, is a function of how uncertainty is viewed. It is here that Jacqueline Best's (2005, 2008) work on ambiguity is extremely useful. Best (2005)

makes the distinction between technical and intersubjective ambiguities.¹⁰ Technical ambiguities are the result of uncertainty and insufficient information, in the sense that Geithner et al. understand the problem afflicting the markets: illiquidity uncertainty. On the other hand, intersubjective ambiguities are the result of differences in interpretation which are the inevitable outcomes of social and linguistic processes. This second sense—which Best draws from Keynes—means that uncertainty can never be fixed, only managed.

The ultimate aim of the PPIP is to restore certainty, or rather the illusion of certainty. The problem the financial sector faces (or thinks it faces) is the *temporary* suspension of certainty—once enough participants know where the risk lies in the system and how to value it fairly the uncertainty and excessive liquidity discounts will evaporate. Yet, the system has always been, and always will be, fundamentally uncertain. But once financial market participants think that they can calculate (and thus value) this risk normal service will be resumed. This is precisely what the PPIP is trying to achieve. This is clear evidence of the old paradigm; trying to specify value and risk on the assumption that the market can do it rationally.

The Structural Liquidity Problem

The problem of uncertainty, in the sense that Keynes understood it, as radical and social, has not been and cannot be solved, only managed (Best 2008). This has very real and deleterious consequences in terms of securing sufficient investment. The problem of radical uncertainty and intersubjective ambiguity is—as Keynes noted—the precautionary motive for holding money, liquidity preference. This is a very different liquidity problem than the one identified by Geithner et al. In fact, Geithner’s solution makes the structural liquidity problem worse.

The conclusion of this chapter is that following Keynes’s work on how financial markets work allows us to reappraise the problem of liquidity and assess the potential success and flaws of the US Administration’s Financial Stability Plan and the philosophy behind it. In sum, the liquidity issue is not the short-term one of a liquidity crunch, but the long-term one which produces the fetish of liquidity. It is clear that the Financial Stability Plan is trying to reinstate the status quo ante. The

¹⁰ Best (2005) also has a third form of ambiguity: contested ambiguities, which are the result of fundamental and persistent conflicts. However, this is of less interest for the current argument than the distinction between technical and intersubjective ambiguities.

US Treasury (2009b) note how important it is to restore the liquidity provided by securitisation:

In our financial system, 40 percent of consumer lending has historically been available because people buy loans, put them together and sell them. Because this vital source of lending has frozen up, no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses – large and small

Liquidity might, possibly, temporarily solve the problems of a frozen market and thus the problem of technical uncertainty. But not the problem of intersubjective uncertainty. In fact, it will just make matters worse because of liquidity's anti-social nature. Keynes (1936: 51) noted that "In the absence of security markets, there is no object in frequently attempting to revalue an investment to which we are committed." But, as Keynes continues, markets *do* do this; allowing individuals *but not the market as a whole*, to revise their commitments. Too great a demand for liquidity means that resources do not get used productively. Keynes was concerned with the fact that capital would not be invested in productive enterprise and would fail to result in generating employment. Instead, the *rentier* interests of speculation and retaining liquidity would be the opportunity cost. As Matthew Watson (1999) has argued, the valorisation of capital has meant that short-term liquidity positions have crowded out longer-term positions. Watson's argument is that the concentration of capital in speculative markets undermines the policy autonomy of governments (Watson 2007). Additionally, this functional mobility of capital undermines long-term investment. Instead policies should aim to restore "the full circuit of capital" (Watson 1999: 65 & 70). Until this full circuit can be restored labour and productive capital will be underutilised.

The logical solution is to take the toxic assets off the market completely. Nationalising the banking system would solve the immediate valuation problems. Indeed, around the time of Geithner's announcement of the Financial Stability Plan, Alan Greenspan came out saying that nationalizing banks is the "least bad" policy option. In a *Financial Times* interview he noted that temporary government ownership would "allow the government to transfer toxic assets to a bad bank without the problem of how to price them." (Guha & Luce 2009). Longer-term efforts to reverse the originate-to-distribute model and push for the return of

intermediated lending make sense. And a return to a new version of Glass-Steagall should be a priority in order to protect markets with possible liquidity problems.¹¹

Conclusions: Global Keynesianism

The decadent international but individualist capitalism, in the hands of which we found ourselves after the war, is not a success. It is not intelligent, it is not beautiful, it is not just, it is not virtuous—and it doesn't deliver the goods. In short, we dislike it and we are beginning to despise it. But when we wonder what to put in its place, we are extremely perplexed.

John Maynard Keynes (1930: 760)

The market breakdown is seen as a problem of excess, a bubble that has burst which has resulted in a temporary misalignment or a deviation from a normal equilibrium. What this view misses is that this is a problem fundamental to markets; the nature of uncertainty—radical and intersubjective—makes it so. The enduring market mentality of the ‘new interventionism’ as characterised by PPIP misses the fact that this is not just a short-run liquidity crunch. Financial actors prefer liquidity because of this uncertainty. And this itself leads to a long-term liquidity problem with poor incentives for productive, socially-beneficial investment.

This crisis was never just a problem within the financial system, isolated from the wider economy; there are clear linkages to declining personal income in and the large imbalances in the global economy. Turning to Keynes, we can identify a number of clear causes of the crisis: domestic inequality (income inequality is now around levels last seen just before the Great Depression); market instability driven by uncertainty and speculative tendencies; poor financial regulation; and global imbalances. The anti-social fetish of liquidity is true both domestically and internationally (in the form of foreign exchange reserves).

The importance of an international or global solution is easily underlined when considering the much vaunted Swedish example. The Swedish model of bank nationalisation worked because (1) it was done well, (2) the banking system was relatively small, (3) the Swedish currency weakened by some 25% or so favouring exports, and (4) this devaluation along with debt-fuelled consumption elsewhere to

¹¹ Indeed, Paul Volcker is on the record as being in favour of the re-imposition of Glass-Steagall.

pull the economy up via the manufacturing sector. So, it's not just about saving the banks, nor is it just about the US economy. The response has to be global and coordinated.

While the US *could* devalue the US\$ it would cause systemic problems elsewhere. Moreover, the current stimulus plan and the part of the bank bailout which is earmarked for making new loans for cars and mortgages will merely serve to reproduce global imbalances. There is a need to return to the issue of international monetary reform and the recognition that the responsibility for adjustment is borne by the creditors as well as the debtors. Returning to Keynes, there is the case for international monetary reform along the lines of the international Clearing Union (ICU) suggested by Paul Davidson (2007).

Keynes's vision for the international economy was a clear one and one that makes sense in a world where capital has been shown to be speculative and destabilising, and large global payments imbalances persist and threaten global expansion. According to International Monetary Fund data, the total foreign currency reserves of emerging markets run at some 20 times the amount available to the IMF. This is because the emerging market economies have built up huge currency reserves as a form of insurance against the "sudden stops" of capital inflows that characterised the crises of the late 1990s. The preference for liquidity rather than spending is the nub of the problem in the world economy. All the focus on Keynesian fiscal expansion is not staying true to Keynes at all. Keynes argues that the adjustment must come from the surplus countries. Replacing private overconsumption and increased debt with public overconsumption and increased debt simply perpetuates global imbalances (Pettis 2009).

Keynes's original plan was to create a single supranational central bank and currency, the *bancor*. Following Paul Davison this is probably neither feasible nor desirable in the 21st Century (Davidson 2002: chapter 14), but other solutions are, in particular an international clearing union. Davidson's International Clearing Union would set up an institutionalised international monetary order. There would be one-way convertibility between an International Money Clearing Unit (IMCU) and domestic currencies, all public and private international transactions would clear through it. There would be a fixed exchange rate which would reflect changes in wages and a basket of domestic prices (Davidson 2002: 235). Domestic governments would retain autonomy over monetary, fiscal policy and capital controls in order to control

net international flows. Any build of excessive surpluses would have to be redistributed via goods purchases, foreign direct investment, and official development aid. And finally, any permanently excessive surpluses would be taxed at 100% and redistributed. Such a system would prevent a lack of global effective demand (a problem of excessive idle reserves or financial crises and contagion).

As Paul Davidson—writing in July 2006—noted in the last two lines of his recent book on Keynes, “when, not if, the next Great Depression hits the global economy, then perhaps economists will rediscover Keynes’s ... analytical system that contributed the golden age of the post World War II. For Keynes, however, it will be a pyrrhic victory.” (Davidson 2007). It is—unfortunately—worse than that. For as long as we fail to interpret Keynes’s oeuvre more fully, the decadent international but individualist capitalism, in the hands of which we continue to find ourselves will continue to not deliver the goods. As Lord Skidelsky (2003) finished his biography of Keynes: his ideas “will live so long as the world has need of them”.

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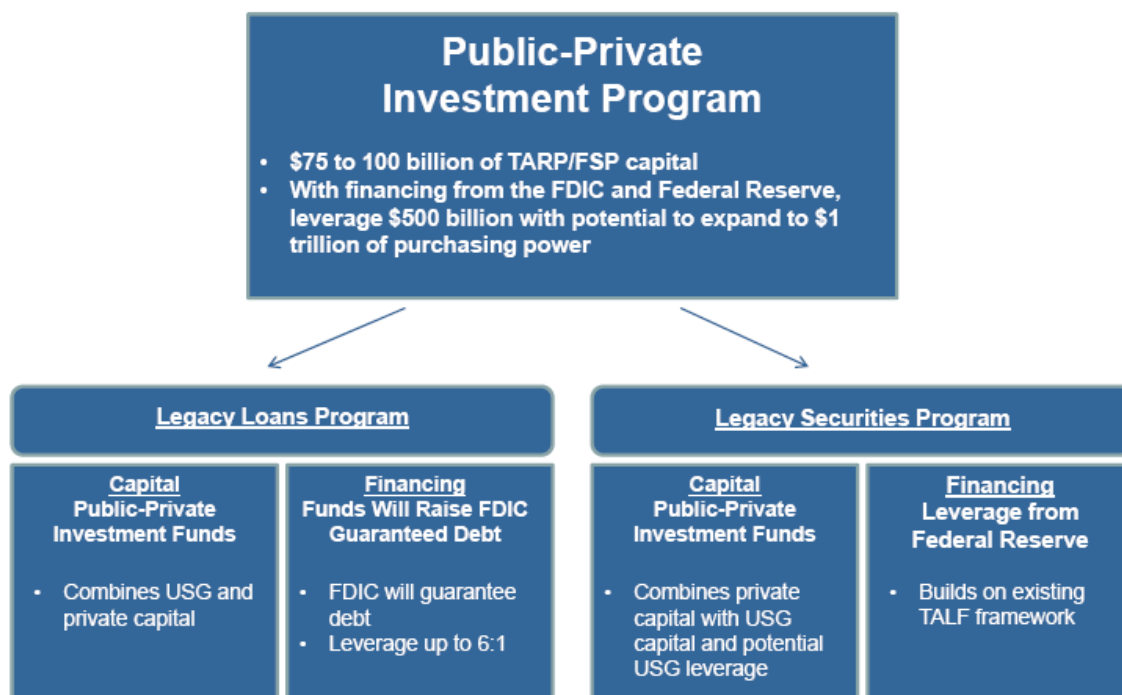
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Figure 1: Structure of the Public-Private Investment Program



Source: US Treasury (2009b) 'Fact Sheet: Public-Private Investment Program'