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Beware the fallout from the AIG bail-out

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From Mr Daniel J. Aronoff.

Sir, While it is clear that the US Federal Reserve extended a financial lifeline to AIG on Tuesday evening in order to stave off the possibility of the company's default triggering a financial meltdown, the action may cause collateral damage that negates whatever benefits it may have secured.

First, the Fed and Treasury have now committed more than \$350bn of US taxpayer money to bail-outs of financial institutions without specific acts of Congress, even though the authority was granted by prior acts of Congress. Expenditures of this size, undertaken without the explicit approval of the elected representatives in Congress, may spark a populist backlash that brings into question not only the commitments made thus far but also the future independence of the US central bank. There is an argument that, in a democracy, the elected representatives should exercise sole authority to spend vast sums. Thus, the Fed may have placed in jeopardy its future independence.

Second, the rationale for bailing out AIG does not include allowing its present shareholders to benefit from taxpayer largesse. Yet, by allowing shareholders to retain 20 per cent ownership of the firm, that is what has occurred. This will invite accusations that the Fed and Treasury are engaged in crony capitalism and serve to undermine support for private financial markets.

Third, the rationale for bailing out AIG is linked to its interconnectedness to the global financial system, yet only the US taxpayer is undertaking a financial commitment. This will cause many to question the benefits of global financial liberalisation, as it appears to place an inordinate burden on the US.

Finally, the bail-out massively exacerbates problems of moral hazard and raises the question of why AIG has not been placed under Fed regulatory authority. It also raises the question of why, in the aftermath of the Bear Stearns debacle, the Fed and Treasury did not pursue regulatory reform in anticipation of the need to provide liquidity backstops outside the commercial banking sector. Following the failure to address the issue, the risk now is that of a move to overregulate financial institutions.

The era of global financial market liberalisation and central bank independence, which has arguably conferred enormous benefits on humanity, may now be drawing to a close as a result of the credit crisis and the US authorities' response to it. One must wonder whether the putative benefits from the recent actions are ultimately more valuable than what they have placed at risk.

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