Bear Stearns Rescue Is `Finger in Dike,' Scholars Say (Update1)

By Elliot Blair Smith

March 16 (Bloomberg) -- With Bear Stearns Cos.' temporary rescue in place, the $200 billion subprime crisis joins the history of government bailouts to preserve jobs, homes and savings when economic disaster looms.

Ever since Treasury Secretary William Gibbs McAdoo shut the New York Stock Exchange for four months in 1914, to prevent foreign investors from cashing out and throwing the U.S. into financial chaos at the outset of World War I, American policy makers routinely have suspended their support for free markets when confronted by economic peril.

``I think the systemic risks dominate right now, which means you've got to put your finger in the dike,'' says William Silber, a finance professor at New York University's Stern School of Business. He is the author of ``When Washington Shut Down Wall Street: The Great Financial Crisis of 1914 and the Origins of America's Monetary Supremacy'' (Princeton University Press, 232 pages, $27.95).

Bailouts can buy time while policy makers try to defuse panic. Last week, the Federal Reserve Bank of New York provided financial support for Bear Stearns, the fifth-largest U.S. securities firm. It faced eroding investor confidence in the fallout from losses related to securities based on mortgages to the least creditworthy borrowers.

Bear Stearns executives were striving today to strike an agreement to sell the firm to JPMorgan Chase & Co. before financial markets open tomorrow, people with knowledge of the talks said.

Emergency Funding

JPMorgan and the Fed said last week they would back New York-based Bear Stearns with emergency funding for an initial period of up to 28 days in the largest U.S. bailout of a securities firm. The deal is part of an agreement that enables the investment bank to borrow from the New York Fed's discount window while all three seek permanent financing or alternatives.

Bear Stearns needed the support in response to ``a multitude of market rumors regarding our liquidity,'' said Chief Executive Officer Alan Schwartz.

Just over 100 years ago, John Pierpont Morgan himself, the namesake of what was then known as the House of Morgan, came to the rescue when panic selling in October 1907 convulsed the New York Stock Exchange and threatened several banks and trusts.

Morgan, 70 and semi-retired, obtained an emergency pledge of $25 million from the U.S. Treasury. He persuaded New York's leading bankers and trust executives to put up another $25 million, after locking them in his library all night, according to ``The House of Morgan: An American Banking Dynasty and The Rise of Modern Finance,'' by Ron Chernow (Atlantic Monthly Press, 812 pages, $45.95).

Roosevelt and Central Bank

By the force of his personality, Morgan restored order to the market. His intervention also convinced Congress and President Theodore Roosevelt of the need for a central bank.

Booms and busts define economic cycles, forming a familiar pattern to historians while surprising investors, policy makers and financiers.

Congress authorized $250 million in loan guarantees to rescue Lockheed Aircraft Corp. in August 1971, over the objections of the late Democratic Senator William Proxmire of Wisconsin. By today's standard, the stakes were small: about $1 billion in potential losses and 60,000 jobs.

The costs have risen steadily since, from the $1.2 billion in loan guarantees Congress provided Chrysler Corp. in 1979 to the $116.5 billion taxpayers spent to resolve the savings-and- loan industry's collapse by 1995.

Long Term Capital

The New York Fed averted a subsequent threat in September 1998 by persuading 14 banks to lend $3.65 billion to help unwind the leveraged trades of the Greenwich, Connecticut, hedge fund Long Term Capital Management. That was roughly equivalent to the $3.6 billion that the New York Fed loaned Chicago-based Continental Illinois National Bank & Trust Co. in 1984, in the largest rescue in U.S. banking history.

Yet the Treasury's shutdown of the New York Stock Exchange in 1914, a year after Morgan's death, remains one of the bluntest interventions by U.S. officials to head off a crisis. It is also one of the largest departures in American history from the capitalist creed of letting free markets sort out problems.

European investors held much of New York City's public debt. As foreigners cashed out, converting their securities to gold, the Treasury realized that its ability to maintain the dollar's link to bullion was being undermined, Silber wrote.

``Treasury Secretary McAdoo succeeded in August 1914 because he did not hesitate to bludgeon the crisis with a sledgehammer,'' Silber said in an interview March 14.

Bank Holiday

The decision served as a precedent for Franklin Delano Roosevelt, who closed the banks for a week on his first day as president in March 1933. When lenders reopened, Silber says, depositors who had stood in line to withdraw their money queued up to put it back in.

On both occasions, Silber says, government policy makers offered more-lasting solutions to ease market fears. In 1914, McAdoo moved to increase agricultural exports, bringing foreign capital into the country. In 1933, Roosevelt offered federal loan guarantees during the bank holiday to stimulate credit.

Founded in 1923, Bear Stearns has 14,153 employees at 34 offices in the U.S. and 14 abroad. It was providing trade execution and clearing services for $288.5 billion in client accounts as of Nov. 30, 2007. Last July, the failure of two of its hedge funds that invested in subprime-related securities initiated a broader selloff that continues.

Representative Ron Paul, a Texas Republican who ran for president this year, told the House Financial Services Committee in February that financial services bailouts would reward bad behavior. Paul doubts the Bear Stearns rescue will prop up the economy, he said March 14.

``It won't work,'' Paul said. ``It's like drug addiction. You feel withdrawal pains, but you save the patient.''

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