Shock Forced Paulson's Hand; A Black Wednesday on Credit Markets; 'Heaven Help Us All'

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When government officials surveyed the flailing American financial system this week, they didn't see only a collapsed investment bank or the surrender of a giant insurance firm. They saw the circulatory system of the U.S. economy -- credit markets -- starting to fail.

Huddled in his office Wednesday with top advisers, Treasury Secretary Henry Paulson watched his financial-data terminal with alarm as one market after another began go haywire. Investors were fleeing money-market mutual funds, long considered ultra-safe. The market froze for the short-term loans that banks rely on to fund their day- to-day business. Without such mechanisms, the economy would grind to a halt. Companies would be unable to fund their daily operations. Soon, consumers would panic.

For at least a month, Mr. Paulson and Treasury officials had discussed the option of jump-starting markets by having the government absorb the rotten assets -- mainly financial instruments tied to subprime mortgages -- at the heart of the crisis. The concept, dubbed Balance Sheet Relief, was seen at Treasury as a blunt instrument, something to be used in only the direst of circumstances.

One day later, Mr. Paulson and Federal Reserve Chairman Ben Bernanke sped to Congress to seek approval for the biggest government intervention in financial markets since the 1930s. In a private meeting with lawmakers, according to a person present, one asked what would happen if the bill failed.

"If it doesn't pass, then heaven help us all," responded Mr. Paulson, according to several people familiar with the matter.

Accounts of the events surrounding this week's unprecedented federal interventions are based on interviews with Bush administration and Congressional officials, as well as investors.

In the past two weeks, the relationship between government and the markets has been redefined. The Bush administration has become responsible for a major chunk of the U.S. housing market through its seizure of mortgage giants Fannie Mae and Freddie Mac. It has entered the insurance business in a big way after taking control of American International Group Inc. Regulators allowed one investment bank to fail and helped usher another into a fast merger. And on Friday, Mr. Paulson announced plans for the largest intervention yet -- a federal plan to purge financial institutions of their bad assets, with a likely price tag of "hundreds of billions" of dollars.

The panic had formed quickly. On Monday morning, Lehman Brothers Holdings Inc. filed for bankruptcy protection. On Tuesday, the government took control of AIG. It was by far the worst disruption investors and policymakers had seen since the credit crisis gripped world markets last summer, and threatened the most dire market malfunction, some worried, since the crashes of 1929 and 1987. The tailspin threatened to put an already stumbling economy deep into recession.

"These markets are unhinged," T.J. Marta, fixed-income strategist at RBC Capital Markets said Wednesday afternoon. "This is like a fire that has burnt out of control."

For some assets, there were no buyers at any price. The weekend's tumult set off a cascade of fear among investors who buy bonds of all stripes, crucially those who buy the shortest-term obligations of companies and financial institutions, called commercial paper. This market feeds borrowers' most immediate needs for working capital.

Though U.S. authorities were alarmed, the situation they were facing didn't yet resemble that of the 1930s. For one thing, easy credit from the Fed had helped keep the economy afloat; in the early 1930s, the Fed kept credit tight. "Nothing in the New Deal relies on monetary policy the way we're relying on it today," said David Hamilton, a New Deal historian at the University of Kentucky. Indeed, the Fed's mistakes back then -- in tightening, not loosening monetary policy -- are considered a key reason for the depth and severity of the consequent depression.

The current turmoil is also more contained, noted Colin Gordon, a professor of 20th-century American history at the University of Iowa. "At least for the moment . . . the crisis is confined to the large New York houses," he said. "You don't have panic on Wall Street resulting in banks closing in Iowa City."

On Monday and Tuesday, nonetheless, many investors were gripped by fear. Markets such as those for credit-default swaps -- in which investors buy and sell protection against default on a borrower's debt -- were paralyzed by questions about how the Lehman bankruptcy would hurt their business. Stock investors pummeled the share prices of Morgan Stanley and Goldman Sachs Group Inc., the two remaining big stand-alone Wall Street investment firms. Participants in the credit- default-swap market, who need a trading partner for every transaction, didn't know whom to trust.

"The market was signaling that the stand-alone investment banking model doesn't work," says Tad Rivelle, chief investment officer at Metropolitan West Asset Management, which manages $26 billion in fixed-income assets. "We were on the verge of putting every Wall Street firm out of business."

Instead, investors flooded the safest investment they could find, short-term government debt. This drove the yields of short-term Treasury bonds to zero, meaning investors were willing to accept no return on their investment if they could guarantee getting their money back.

On Tuesday, the once-$62.6 billion Reserve Primary Fund, a money- market fund, saw its value fall below $1 a share because of its investments in Lehman's short-term debt. Money-market funds, which yield a bit more than basic cash accounts by buying safe, short-term debt instruments, strive to keep their share prices at exactly $1 -- and "breaking the buck" isn't supposed to happen.

Money-market funds are where corporate treasurers put rainy-day funds, where sovereign wealth funds park their excess dollars and where Mom-and-Pop investors stash savings. Now, money-market funds were selling what they could and hoarding cash to meet what they thought might be extraordinary levels of redemptions from investors, said one commercial trading desk head.

On a Tuesday conference call, staff from Treasury, the Federal Reserve and Federal Reserve Bank of New York hashed out the plan to bail out AIG. But they also began to discuss what more could be done to stem the broader fallout. Some Fed officials saw the AIG takeover not as a potential turning point for the market -- as the rescue of Bear Stearns Cos. had seemed to be in March -- but as the beginning of a bigger and worsening problem.

"We're treating the symptoms and we need to treat the cause," one Treasury staffer told colleagues.

Mr. Paulson agreed. "Confidence is so low we're going to need a fiscal response," he told staff. In other words, the government's usual monetary policy tools, such as interest rates, wouldn't be enough. It would have to pony up some money.

Mr. Paulson spoke with Mr. Bernanke and Federal Reserve Bank of New York President Timothy Geithner to discuss a systematic approach. The three agreed that buying distressed assets, such as residential and commercial mortgages and mortgage-backed securities, from financial companies could offer some relief.

Trust in financial institutions evaporated Wednesday when investors stampeded out of money-market funds. Putnam Prime Money Market Fund said it had shut down after a surge of requests for redemptions.

In three days, the Fed had pumped hundreds of billions of additional cash into the financial system. But instead of calming markets and helping to suppress interest rates, short-term interest rates had gone haywire. Most strikingly to some Fed staff, its own federal-funds rate, an interbank lending rate managed directly by the central bank, repeatedly shot up in the morning as banks sat on cash. The financial system was behaving like a patient losing blood pressure.

Fed staff discovered that one reason the federal-funds rate was behaving so abnormally was because money-market funds were building up cash in preparation for redemptions, leaving hoards of cash at their banks that the banks wouldn't invest.

U.S. depositary institutions on average held excess reserves of $90 billion each day this week, estimates Lou Crandall, chief economist at Wrightson ICAP. This is cash the banks hold on the sidelines that does not earn any interest. That compares with an average of $2 billion, he says, noting he estimates banks held $190 billion in excess cash on Thursday, as they feared they'd have to meet many obligations at the same time.

Through Wednesday, money-market fund investors -- including institutional investors such as corporate treasurers, pension funds and sovereign wealth funds -- pulled out a record $144.5 billion, according to AMG Data Services. The industry had $7.1 billion in redemptions the week before.

Without these funds' participation, the $1.7 trillion commercial- paper market, which finances automakers' lending arms or banks credit- card units, faced higher costs. The commercial-paper market shrank by $52.1 billion in the week ended Wednesday, according to data from the Federal Reserve, the largest weekly decline since December.

Without commercial paper, "factories would have to shut down, people would lose their jobs and there would be an effect on the real economy," says Paul Schott Stevens, president of the Investment Company Institute mutual-fund trade group.

Officials also watched as the market for mortgage-backed securities disappeared. The government's seizure of Fannie Mae and Freddie Mac, they had hoped, would reinstill confidence in this market. But yields on mortgage-backed bonds were rising as trading evaporated, nearing levels reached before the government's takeover, which would likely translate into higher mortgage rates for consumers. Borrowers with adjustable-rate mortgages, meanwhile, were in trouble: The cost of many such loans is based on Libor, or the London interbank offered rate, which had soared as banks stopped lending to one another.

On Wednesday in Mr. Paulson's office, with its photographs of birds and other wildlife taken during family trips, top advisers stayed close at hand. Watching market quotes, they participated in an ongoing conference call via speakerphone with the Federal Reserve and New York Fed.

Mr. Paulson wanted Congress to bless a plan that would allow Treasury to create a new facility to hold auctions and buy up distressed assets from financial institutions headquartered in the U.S. Without Congressional approval, Treasury could expand programs to buy mortgage-backed securities through Fannie Mae and Freddie Mac, but that wouldn't be enough to address the broadening problems.

The Fed, meanwhile, was supposed to be a lender of last resort to banks. It wasn't built to fix all these problems, and the snowballing crisis worried Fed officials.

"This financial episode is one where a huge part of the problem is outside of the banking system," said Frederic Mishkin, a Columbia University professor who recently left the Federal Reserve as a governor. "We're in a whole new ball game."

On Thursday, Messrs. Paulson and Bernanke decided to ask Congress for authority to buy up hundreds of billions of dollars of assets. In the afternoon, Mr. Paulson, Mr. Bernanke and Securities and Exchange Commission Chairman Christopher Cox briefed President Bush for 45 minutes.

Mr. Paulson told Mr. Bush that markets were frozen and many different types of assets had become illiquid, or untradeable. Messrs. Paulson and Bernanke told the president that the situation was "extraordinarily serious," according to a senior administration official.

"We need to do what it takes to solve this problem," Mr. Bush replied.

That evening, during the meeting with Congressional leaders, Mr. Bernanke gave a "chilling" description of current conditions, according to one person present. He described the frozen credit markets, busted commercial-paper markets and attacks on investment banks. The financial condition of some major institutions was "uncertain," he said.

"If we don't do this, we risk an uncertain fate," Mr. Bernanke added. He said that if the problem wasn't corrected, the U.S. economy could enter a deep, multi-year recession akin to Japan's lost decade of the 1990s, or what Sweden endured in the early 1990s when a surge in bad loans plagued the economy and sent unemployment to 12%.

One lawmaker asked whether the solution will prevent bank failures. Mr. Paulson said it will stabilize markets. "But we'll still see banks fail in the normal course," he said.

On Friday, Mr. Paulson announced plans for a sweeping program to take over troubled mortgage assets. "The federal government must implement a program to remove these illiquid assets that are weighing down our financial institutions and threatening our economy," he said at a press conference. He said he would work with Congress over the weekend to get legislation in place next week.

During a round of briefings on Friday, Messrs. Bernanke and Paulson chilled lawmakers with their dire warnings about the cost of inaction. They had already taken additional steps, including new measures to unfreeze money-market mutual funds and an SEC plan to temporarily ban short-selling.

Speaking that afternoon, House Financial Services Chairman Barney Frank, the Massachusetts Democrat, tagged the rescue of AIG as the tipping point. "It didn't have the broader calming effect," Rep. Frank said. "They tried it the free-market way, they tried it the big intervention way -- and the result was on Wednesday, the world was falling in on everybody's ears."

Greg Hitt, Diya Gullapalli, Louise Radnofsky, Sarah Lueck and Michael R. Crittenden contributed to this article.