



## **The Baseline Scenario 2008-10**

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Update this newspaper

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## Financial Crisis and the Real Economy

James Kwak | 01 Oct 2008

One of the biggest questions about the financial crisis – one heard from Capitol Hill to radio talk shows to casual conversations with friends – is why it matters for ordinary people. One major reason a significant proportion of public opinion is against the rescue plan is the general failure to make the connection between panics in the financial sector and the ordinary lives of everyday people; simply saying that the plan is necessary to prevent (or moderate) a recession smacks too much of “trust me” to be credible.

The connection is that much of the ordinary activity in the real economy relies on credit – think no further than the volume of purchases made using credit cards. (Although banks have been reducing credit limits, there is little risk for now that credit cards will stop working overnight.) And in today’s conditions, when many financial institutions are potential victims of liquidity runs, lending has virtually ground to a halt. The New York Times has an [article today](#) about the impact that the current crisis is having on local governments suddenly unable to raise money for ongoing projects such as highway repairs and hospital expansions. Across the country, local governments issued \$13 billion in fixed-rate bonds in the first half of September – and \$2 billion in the second half. A sudden 87% drop in a major source of municipal funding is a very real impact of the financial crisis, and one that will necessarily result in both fewer services and fewer jobs for taxpayers.

## Wake Up and Smell the European Coffee

Simon Johnson | 02 Oct 2008

At a Brookings panel today and even more so on a LA-based NPR radio show (“To the Point,” KCRW) just now, the impact on the “real economy,” i.e., people and businesses outside the financial sector, was the issue of the day. And people are beginning to understand the serious consequences of our financial system problems, with or without the Paulson Plan becoming law this week.

Here’s what I suggested at Brookings this morning, for the US, which is pretty close to what is in our Baseline Scenario, First Edition:

1. Tell everyone that their deposits are safe. Explain that no one has ever lost a penny when the FDIC has been involved and, de facto, they always pay all depositors, even those with over \$100,000. I recommend removing the deposit insurance cap. In other words, do what it takes to stop the run.
2. Then work on bank recapitalization, right away (I think you can see the consensus moving in this direction already this week; I’ll try to post on the emergent schemes tomorrow)
3. And deal directly with the underlying troubled mortgages (again, I hear ideas emerging fast; give that a couple more days before I do a survey)
4. And get ready to provide a substantial fiscal stimulus. But don’t even think about this unless you have done 1, and much of 2 is in place, and the programs to deal with 3 are on their way.

Perhaps the overlooked issue of the week was the speed with which the crisis is clearly going global, with now a long list of European countries having banks in trouble. Europe also needs to stop the run on their banks before it gets out of hand.

One sensible way to do this would be with a large Europe-wide fund to inject capital and receive preferred equity in banks, on terms advantageous to taxpayers. Yes, this is point 2 above, on steroids. Of course, they have to deal with underlying domestic mortgages in Ireland, the UK and Spain (but not yet in other countries). The danger in Europe is that they don’t have as much fiscal space as the US (so point 4 is an issue) and their central bank is stuck with a mandate (i.e., just worry about inflation) that would have been nice to have in the 1970s, but may not be quite so appropriate today.

The severity of the global recession is going to depend, in large part, on the speed with which governments in Europe can organize swift, comprehensive and decisive support for their banking systems. And, following that, it will depend on exactly how the process of deleveraging (this is jargon essentially, meaning reduced lending by the financial sector) is handled.

The latest news from Europe (timely, thanks to the Financial Times): there will not be an immediate systematic rescue. It's the French who seem to have understood what is really going on. Unfortunately, as of now, their European partners have not yet woken up to the new realities. In particular, Germany and perhaps the UK seem to stand in the way of a more systematic approach. This has dangerous implications for the US.

Days to the election: 34

## Don't Cry (or Cry Out) for the ECB

Simon Johnson | 02 Oct 2008

I would like to express some sympathy for the current predicament of the European Central Bank (ECB). They will undoubtedly come in for a great deal of criticism in the weeks ahead, particularly following their refusal to move interest rates today – if our Baseline Scenario view continues to hold.

But you have to keep in mind that they, unlike the Fed, have a very explicit mandate focused on just one variable: inflation. It is true that there is some scope for interpretation both broad and narrow. The broad scope exists because, for example, if actual growth slows below what is called “potential growth” (a very elusive number), inflation will decline eventually. So when you think about what inflation should be, you are really thinking about where growth is relative to potential – and this is what interest rates can affect (keep in mind all these effects are lagged, i.e., take between one and two years to work their way through the system). And the narrow scope means there is some choice over exactly what inflation measure you aim for and whether you can look at other things (such as money supply). This quickly slips into monetary theology and I'm not going there, at least today.

In any case, the ECB has a pretty clear mandate and it also has a board on which almost all countries that belong to the eurozone get to vote (there are now slightly more members than seats). The management of the ECB comprises the best minds in the business, with impressive experience in the private sector, academia and central banking.

But the basic point comes down to this. The ECB is in Frankfurt. And the real deal is that it represents all that is great and good about post-1945 German monetary policy, with its emphasis on trampling on inflation at every opportunity. This worked well for Germany for a long time and it might even be a good idea now (although I'm a bit skeptical).

The problem is that it is very unclear that this focus on fighting inflation will be appropriate for all eurozone countries. Spain and Ireland are clearly slowing down. The latest data, put out by the European Commission, points to recession in France and Italy.

But the ECB was given a job to do. They have a clear mandate, and they are not supposed to be flexible (unlike the Fed). And the German authorities are watching. The ECB will cut interest rates only when they see eurozone-wide recession definitely “in the data”. Of course, by then

it will be too late. But they are really only doing their job. And there is nothing in their job description about preventing the world from slipping into depression.

# Your Money Is Not Going to Go Poof

James Kwak | 03 Oct 2008

Readers of this blog will already know that we believe that (a) the credit crisis of the past two weeks is serious, (b) there is a real risk of a global recession, but (c) there are practical steps that governments can take to minimize the damage to the economy. Several of my friends have asked me what this means for them. And I wanted to repeat here what I told them: nothing cataclysmic is going to happen to your money.

First, let's start with deposit insurance. In general, your checking accounts, savings accounts, and CDs are guaranteed by the FDIC up to \$100,000 per account holder per bank, and that is likely to go up to \$250,000 shortly. Some people have been pulling money out of banks even though they are below this limit, because they don't know about the insurance, don't trust it, or don't want to deal with the hassle. Now this is something with which I have personal experience. I had a CD (<\$100K) at IndyMac Bank when it failed earlier this year. The FDIC took over the bank over the weekend and by Monday everything was exactly the same as on Friday: same web site, same call centers, same CD account, everything. The only change was that the name had changed from IndyMac Bank to IndyMac Federal Bank. I didn't have to file a claim or even call anyone. My CD is still there, earning interest (at 4.15%, by the way). So if you have an insured account, you shouldn't worry about it. (Some people have pointed out that the FDIC could run out of money if too many banks fail, but it's a certainty that the government would put more money in the FDIC in that case.)

Second, you may have investments in stocks or bonds. Individual securities could be wiped out, and some have been already; not only did Lehman shareholders lose their money, but bondholders lost most of their money, too. But stocks are ownership shares in real companies, and most companies are not going to stop operating overnight. They will continue to buy, build, and sell whatever they buy, build, and sell today. Some will go bankrupt, as always happens, and some will lose value, but some will gain value. And it's not likely that every company in the U.S. will lose all of its value at the same time. So you should be diversified, but you should always be diversified.

Third, there are your debit and credit cards. As long as you have money in your bank account, you will still be able to get at it using your debit card. It is unfathomable that a bank would need cash so

desperately that it would block access to deposit accounts (and remember, those accounts are insured). When banks are at risk of failing, they want to preserve as much value as they can to sell to an acquirer. A large part of the value is the base of depositors and the ongoing banking operations. As for credit cards, it is possible that banks will gradually reduce the amount of credit they have extended by offering fewer cards, tightening the terms, reducing credit limits, and even unilaterally canceling some people's cards. This could affect some people. But again, there is no reason why the credit card system as a whole would fail.

Now, if there is a recession, and that is certainly a possibility, it could have serious consequences for you: you could lose your job, your rate of salary increases could go down, your house could continue to lose value, your investments could lose value, and so on. As we've said, there are concrete steps that governments can take to minimize the duration and severity of any recession. In any case, you're not going to wake up one day and find out that your money is gone. (Unless you keep your money under your mattress, in which case someone might steal it.)



## Bailouts and Moral Hazard

James Kwak | 03 Oct 2008

### *Hazardous Morals*

As Daniel Henninger noted in the Journal today, moral hazard is hot right now. This is the stick that commentators of all political affiliations use to beat the Fannie/Freddie bailout, the Paulson rescue plan, any proposal to restructure mortgages, or any other government action that has the effect of protecting someone from his bad decisions.

The concept of moral hazard originated in the insurance industry, and describes the problem that people who are well insured are more likely to take unwise risks. (For example, if you have comprehensive insurance on your car with no deductible, you may not bother locking the doors.) In the current context, the argument is that if the government bails out financial institutions by taking troubled assets off their hands, they will not have an incentive to be more careful in the future. In this usage, moral hazard becomes suspiciously similar to moral indignation pure and simple: many people feel instinctively that banks that took excessive risks deserve to go bankrupt, and the bankers who made lots of money on the way up should lose their jobs. (These people often also believe that homeowners who can't pay their mortgages should lose their houses).

The problem of moral hazard is real. And moral hazard should be taken into account when designing any rescue packages and, more importantly, when the time comes to rewrite the regulation of the financial sector. But there are several reasons why it should not be allowed to simply veto any government action.

1. Moral hazard is most important in a repeated or continuous context. When you buy an insurance policy at the beginning of the year, you know if you are fully covered, or if you will be responsible for some proportion of the losses you incur, and you behave accordingly. It applies less clearly to retrospective bailouts like the current plan, where it is not clear that a similar situation will ever arise again. For example, perhaps one of the behaviors we want to discourage is leverage ratios of 30 to 1, like those at Bear Stearns and Lehman. Well, there are no more investment banks, and commercial banks have much lower leverage limits. Besides, there is another way to discourage undesirable behavior: regulation.

2. As Martin Wolf argued in the FT in the long-gone days of the Fannie/Freddie bailout, the moral-hazard argument to punish the shareholders has the perverse effect of discouraging private capital. Given widespread fears that many banks are undercapitalized, it would be a good thing if they could raise capital in the private markets rather than from the government, like Goldman Sachs did with Warren Buffett. But if the government is planning to take the moral high ground and let banks collapse, then no one will step up with the capital.
3. Most importantly, there is something fundamentally illogical about the moral hazard argument. If we bail out the banks now, it goes, then they will behave in harmful ways in the future. But right now we are facing the greatest danger to the financial system since the Great Depression. What future harm are we worried about that is more serious than the potential harm we are facing right now?

“While I find helping these banks highly distasteful, moral hazard concerns should be put aside temporarily when the whole short term credit system is close to a complete collapse.” Those words were written by no less a free-market advocate than Nobel Laureate Gary Becker.

## Financial Crisis and the Real Economy, Part 2

James Kwak | 03 Oct 2008

The impact of the financial crisis on the real economy can be divided into two periods: before September 15 and after September 15. Before 9/15, it was clear that we were in an economic slowdown, beginning with the construction industry, and that troubled assets on bank balance sheets would probably lead to a long-term decline in lending, which might push the economy into recession. Since Lehman failed on 9/15, this general problem sharpened into a short-term credit crunch, in which various parts of the credit markets have stopped functioning or come close to it. Still, though, people want to know, what does the credit crunch mean for me?

Bloomberg reported that almost 100 corporate treasurers held an emergency conference call yesterday to discuss the challenges they are facing rolling over lines of credit with their banks. In some industries, lines of credit are the lifeblood of even completely healthy companies. They operate like home equity lines of credit: you draw down money when you need it (like to make payroll), and you pay it back when your customers pay you back. (In most business-to-business transactions, money changes hands some time *after* goods are delivered; hence the pervasive need for short-term credit.)

Now, however, banks are demanding much higher interest rates, lower limits, and stricter terms when lines of credit expire, or are even pouncing on forgotten clauses in contracts to force renegotiations of terms. Lines of credit are priced in basis points (a basis point is 1/100th of a percentage point) over LIBOR, a rate at which banks lend to each other. One company saw the price for its line of credit rise from 90 basis points to 325 basis points over LIBOR, which is itself running at high levels. The banks aren't doing this because they think their borrowers are in any danger of not paying them back; they're doing it because they want to hold onto the money because they are afraid of liquidity runs. "These are very different circumstances than many of us have dealt with before," said one treasurer. "We're all having to learn every day about provisions that were buried in documents executed 15 years before."

This is how fear in the banking sector translates very quickly into higher costs and less cash for healthy companies in the real economy. Fortunately there are clear steps that Washington can take to bolster

confidence in the banking sector, which will cause the flow of money through the real economy to pick up.

## Bailout Passes; Hard Work Begins

James Kwak | 04 Oct 2008

Our position has been that the Paulson Plan is imperfect but is still a valuable first step toward restoring confidence in the financial markets, and so we are glad that it passed today. One remarkable development over the last two weeks has been a shift among both economists and the public from thinking the plan was an application of massive force to thinking that the plan is a relatively small part of the long-term solution. As discussed in our most recent baseline scenario, the next steps are to work on financial sector recapitalization, housing market stabilization, and fiscal stimulus (and, of course, regulation).

At the same time, though, implementing the Paulson Plan will be a major task, and one that will require oversight both from Congress and from government-watchers. Not surprisingly, Treasury is already moving to use fund management firms as outside contractors in buying securities. There are some valid practical reasons for this, but it creates the potential for conflicts of interest that we warned about in an earlier op-ed on governance; fortunately, the final bill includes much more emphasis on transparency of contracting than did the original proposal. Pricing the assets will be perhaps the trickiest problem, whether it be through reverse auctions (which can be difficult to implement) or through direct negotiations with banks. Price will determine how many warrants the government gets in participating companies, which are another improvement in the final bill. Finally, although the plan specifies multiple forms of oversight, figuring out how to make that oversight effective in a fast-moving environment will be difficult.

So while passing Plan A was a good thing for the financial sector and for the real economy, making it work will require a good deal more effort both inside and outside the Beltway. And the sooner work starts on Plan B, the better.

# The Financial Crisis and Entrepreneurship

James Kwak | 04 Oct 2008

If anyone is looking for a silver lining, Michael Fitzgerald has a post called “Bad Times Are Good Times for Entrepreneurs,” and I couldn’t agree more. On September 14, 2001 – at the trough of the technology meltdown, at the beginning of a recession, and on a day when the stock market was not even open because of the 9/11 attacks – I quit my job and co-founded Guidewire Software. It was a great time to start a company for a number of reasons:

- There were talented people looking for new opportunities.
- The ordinary costs of doing business (space, equipment, etc.) were depressed.
- As a private company, you don’t have to worry about quarter-to-quarter performance. Your investors (if you have them) will have a long-term perspective.
- Most importantly, when you first start a company, you aren’t expected to sell anything, so the fact that no one is buying doesn’t matter. Your jobs are to research your market, research your potential customers, design your product, build your product, and (if you need it) raise money. Depending on the industry you are in, all of this can take a couple of years. Even then, if the recession isn’t over yet, you are selling to a small number of early adopters, who will not be making decisions based on the overall state of the economy. It will be even longer before you have the kind of sales volume that is susceptible to changes in the economic cycle.
- This didn’t apply to us, but if there is enough dislocation in the economy, it is bound to create new business opportunities that can be captured by startup companies.

Guidewire today is a leading provider of software to insurance companies with customers in Russia, Brazil, Japan, the United Kingdom, Australia, and New Zealand, in addition to the United States and Canada. Seven years from now there will undoubtedly be dozens or hundreds of successful companies that were started in the wake of the credit crisis.

## G7 at Bat

Simon Johnson | 04 Oct 2008

All eyes turn to Washington this week for the annual meetings of the International Monetary Fund (and World Bank), which will include the finance ministers of the world (up to 185 of them, plus entourages).

Naturally, before these events there is another meeting that – arguably – is where the real decisions are taken. This is the meeting of the G7 finance ministers, which by tradition takes place in the US Treasury on Friday (with the broader meetings being Saturday through Monday). To remind you, the G7 is the club of the largest industrialized countries: the US, Canada, Japan, France, Germany, Italy, and the UK.

Some people regard the G7 as the group that is really in charge of the world. But as you probably noticed by now, no one is really in charge. Still, the G7 's voice carries considerable weight on many issues.

This is a particularly important week for the G7 for three reasons. First, the world economy is in worse shape and heading in a more dangerous direction than at any time in the recent past. Old hands cast their minds back to 1982 for anything comparable in terms of global circumstances. But 1982 was the beginning of an emerging market crisis, involving default and devaluation in Latin America, Eastern Europe and various other middle and low-income countries scattered around the world. Now we have a crisis in the core of the system, clearly in the US and Europe and quite possibly more widely.

The second reason to look to the G7 is that, this time, they really can do something. Their main policy tool is the communique, which is a joint statement that you should look for late on Friday. This will tell you what they think is going on, and what should be done and by whom. Of course, the language will be fairly indirect, but at least in this instance it should not be too hard to interpret. The statement is not binding on anyone, but it will give us an indication of whether they are on the same page.

The third point is that prominent members of the G7 seem already to be on different pages. The four European members had an unusual pre-meeting today in Paris, and their messages seem to be about the need for more regulation, looser accounting rules, and a change in the compensation system for executives so they take less risks. We'll see what is the US position by the time we reach Friday; we guess there will be less than full convergence.

At least on one point, there is already a large gap in views opening up. The Europeans still want to rescue banks on a case-by-case basis, whereas the US has definitively switched to a systemic approach of some kind. Given the gravity of the situation, we prefer the US position at this point, and none of the current European proposals seem to bolster confidence: the problem in Europe was not lack of regulation, but rather failure to enforce existing regulation (fact: European banks bought a lot more collateralized debt obligations than anyone realized); looser accounting rules would open up a massive can of nontransparent worms (a lack of transparency helped get us into this mess, and it's not clear how less transparency will get us out), and executives in all kinds of incentive systems took on, in retrospect, way too much risk recently.

The G7 could, speaking together, help to decisively break the crisis of confidence that still – at the end of last week – gripped financial markets. The indications at this moment, however, are that this unfortunately will not be the case.



## Financial Crisis for Beginners

James Kwak | 05 Oct 2008

Our goal is to provide analysis and commentary that are valuable not only to economists and policymakers, but also to a general audience. This is especially important today now that the workings of our financial system have become vitally important to, well, everyone. But I realize, as a couple of readers have noted, that our posts often assume familiarity with a specialized vocabulary. To some extent this is unavoidable, because we want our posts to be short, and we don't want to explain what a credit default swap is every time we use the term. But it's a problem.

So we're introducing a page called [Financial Crisis for Beginners](#) that includes information and resources for people who want to get up to speed on mortgage-backed securities, collateralized debt obligations, bank balance sheets, and the other concepts that people toss around all the time these days. It doesn't presume any prior knowledge, and it even includes links to episodes of *This American Life*. So if you're at all confused, check it out.

## Fish Soup

**Simon Johnson** | 06 Oct 2008

Lech Walesa, electrician turned President of Poland, famously quipped that, “it is easier to make fish soup from fish than vice versa.” He was talking about moving from quasi-socialism to a more market-based economy, but the same thought struck me when I read today’s announcement that the British Chancellor of the Exchequer will soon put in place a bank recapitalization scheme.

My first reaction was positive, particularly as this is something we have been arguing for. But then I began to wonder if the scale would be sufficient, if it would be combined with measures to restructure mortgages for people with negative equity (an important upcoming issue for the UK), and if it would be supported with a sufficient fiscal stimulus.

I don’t know if the market was having similar thoughts, but as I write (very early on Monday, Oct. 6) it seems like more people are thinking in terms of a global recession scenario (e.g., oil is approaching \$90 per barrel). Once people see the need to deleverage (reduce the amount they borrow) and reduce their risks, it is hard to get them to go the other way. Measures that would have been preemptively brilliant 6 months ago, may now have very little or zero effect.

Increasingly, it seems like only a decisive package of measures will turn things around. And even then, such a package may not be easy to adopt until the situation is considerably worse than it is today.

Days to the US Presidential Election: 29.

## The Baseline Scenario, 2nd Edition

Simon Johnson | 06 Oct 2008

Our weekly baseline scenario is divided into three parts: updates since last week; our analysis of the current situation; and our policy proposals. First-time readers should begin with the analysis and continue with the proposals; returning readers may want to just read the updates and the proposals. (Or download the complete baseline in PDF.)

Despite what seemed at times to be a week filled with news, we think events remain track within our Baseline Scenario from last week. A big global contraction of credit is underway and a severe recession is in the cards almost everywhere. Governments continue to respond too slowly and too partially to this. Europe in particular remains largely in denial (amazing though that may seem after 10 days of bank failures).

Overall, however, our message remains reassuring. Policy can turn the situation around quickly, if it is applied in a decisive manner (see our policy proposals). We are optimistic that political leaders will eventually rise to the occasion.

You have probably heard the term, “Living on Internet Time,” which means to experience life at a hectic pace. I’m afraid we are now living on Financial Market Time, which is like Internet Time, but with teeth. It would be better if political leaders could step up sooner rather than later.

## Financial Crisis – Reader Questions, 10/6/08

James Kwak | 06 Oct 2008

Since launching a week and a half ago, we've gotten far more attention and input than we expected. Thank you for your attention, your participation, and your comments. In addition to some of the comments I answered directly on the post in question, I answered some more below. I'll try to do this periodically. I apologize if I didn't get to your question; there are just too many to respond to all of them.

**Update:** I'm restructuring some of the blog to use fewer pages, so I copied the contents of the old page below. To do this I had to copy-and-paste the comments, but they are all still there.

For reasons of space, I'll have to paraphrase some of the questions.

**1. Why not use the bailout money to buy houses outright, which will also prop up the mortgage-backed securities everyone is worried about?**

The proposal addresses one of the huge issues facing us in the wake of the bailout plan, which is that it does little for struggling homeowners and little to slow down the growing wave of foreclosures. We think that something major does need to be done in this area, but our preference is more in the area of restructuring mortgages or forcing (or encouraging, depending on your political persuasion) banks to rent homes back to delinquent homeowners. An outright purchase plan would be very difficult politically because it feels like a massive government intervention in the real economy. (I have also heard an argument that buying houses outright doesn't actually help the mortgage-backed securities, because effectively you have foreclosed on the homeowner, even if the new owner will be nice to him or her.) The theory of the Paulson plan is that it is more efficient to buy hundreds of billions of dollars' worth of securities than to buy millions of real houses. Another theory is that by effectively buying the mortgages, the government will have leverage to force (or encourage) the people servicing those mortgages to behave in ways that are good for homeowners and for the economy as a whole. I think we need a specific plan stating what we want to happen, rather than simply encouraging Treasury to use its powers for good, but that's a longer discussion for another time.

**2. Have the authorities considered what resources it would take to keep the short term credits sound in all this? That would seem more**

**important, and more effective, than shoring up the mortgage backed securities market.**

I don't know if the authorities have considered this, but it is a very important point. If what we are facing is truly a pure liquidity run based on a crisis of confidence, then simply demonstrating that there is a buyer (the government) for one class of assets may not be enough. Put another way, now that the crisis of confidence has expanded from mortgage-backed securities to everything on a bank balance sheet, a solution focused primarily on MBS no longer addresses the real problem. The truly overwhelming solution would be simply to guarantee all of the liabilities of some set of banks deemed to be healthy, which should (I say "should" because very little is certain any more) put an end to any runs on those banks – at the cost, of course, of putting the taxpayer on the hook should they turn out to be unhealthy. I believe this is what Ireland did last week for some of its banks. Again, I'm not a policymaker, but I think this is an idea that should at least be considered.

**3. What about transparency? ... Would bringing additional required disclosure on the nature of the opaque assets be of benefit, and how could these disclosures be made to drive an orderly resolution of the troubled entities? At some point, the walking dead institutions will either have to be recapitalized or cleared. The more order the system can put in this unwinding, the less collateral damage that can be inflicted on the underlying economy.**

In the long term, I think that more transparency is pretty much an unqualified good. If each bank knew more about what every other bank was exposed to, there would be less of the situation we saw over the last two weeks, when no one knew what third-party risks their counterparties might have. I've heard the objection that transparency will be bad for bank trading operations, but my feeling about that is, roughly, "tough."

In the short term, though, I'm not sure it will do a lot of good. First, there is the problem you point out that it will only hasten the death of insolvent banks. Second, it might not even be enough to save a healthy bank. Having assets greater than liabilities is not enough to survive these days; you also have to be able to prove that you can raise sufficient short-term money to cover your maturing liabilities, and that isn't a certainty no matter how high-quality your assets are.

As we said in an earlier op-ed, the Paulson plan is at least partially a bet that the government can pay a high enough price to bail out the

banks without losing too much money on the other end. We would have preferred that the government do two separate transactions: a purchase at fair market value (that is, not very much) and then an explicit recapitalization to provide any additional money needed by the bank.

**4. What do you think of the US's political system ability to manage and respond to the crises? The House only passed the bill on the 2nd round, after billions of goodies were added. What happens if this does not do the trick and Treasury has to go back?**

Great question. One of the arguments for the Paulson plan was that it would show that the government was taking the problem seriously and was able to mount a concerted response. Instead, you could argue, we saw how a combination of ideological rigidity and popular backlash could hold a bill hostage.

On balance, however, I'm cautiously optimistic. The negotiations over the bill did produce a lot of improvements, and the more the public learned, the more they liked the plan. The major risk right now is that many people probably think that the bailout bill that was passed will be sufficient, while most economists have adopted the view that further steps are necessary. Therefore, our political leaders need to start laying the groundwork now by (a) setting the expectation that more will have to be done and (b) talking about what those steps will be. Fortunately, the Democratic majority (which is almost certain to survive the elections) is likely to be supportive of mortgage restructuring and fiscal stimulus, which are two important steps. A lot will obviously depend on who the president is.

**Comments** (copied from the original page)

*Matt Korner, 10/7/08:*

Has anyone discussed the possibility of nullifying the credit-default swaps and other derivatives contracts? They are legal creations, after all, and the government can decide to prevent them from being enforced fully. Such a move could reinstate the status quo and institute regulations ex post facto.

*James Kwak, 10/7/08:*

It's a plausible idea that we might be better off if CDS and other derivatives didn't exist in the first place. (Many people would disagree, but I won't try to express an opinion here.) However, I think that nullifying these contracts after the fact would have two problems. First, the government is legally limited in its ability to unilaterally undo

contracts. It can do so under certain circumstances, such as bankruptcy, but I'm not sure what it would take to nullify a contract between consenting parties who are both still solvent. (At this point, the contract favors one or the other, and the party "in the money" will not want the contract nullified.) Second, it would have a destabilizing effect, because for every bank on the losing end of such a contract, there is another who is counting its gains on the contract. More likely, each bank has many contracts on both sides, so it would be impossible to predict what would happen.

*Nadine MacLane, 10/8/08:*

Does anyone know if CDS's are still being written? If not, how long will it be until they all expire, since I understand that they provide a guarantee for a limited period of time.

Is it sufficient to keep the house of cards from falling until the majority of the CDS's expire (assuming that most of them are still associated with credit given to solvent companies)?

*James Kwak, 10/8/08:*

5 years is a typical maturity for a credit default swap (if you hear about the credit default swap "spread" for a company, it is usually for 5 years, on senior debt). And they still can serve a useful purpose, so they are still being bought and sold in the market. So they are not going to go away anytime soon.

On the plus side, you are right that most CDS are on the debt of companies that are generally healthy. The goal of policymakers is – or should be – to restore enough confidence in the financial system that banks do not become susceptible to sudden defaults, which will reduce the chance that many of these insurance policies will ever have to be cashed in. At the same time, a bank recapitalization program would increase the chances that, should they have to pay out on the insurance, the banks involved will actually have enough money.

As for the house of cards – a major test will come on Friday when an auction will determine the price at which CDS contracts on Lehman debt will settle. If those swaps can be unwound without causing collateral damage that will be a major relief.

*Nadine MacLean, 10/8/08:*

I have one more question. The CDS (Credit Default Swap) panic was born of the CDO (Collateralized Debt Obligations) crisis. Your explanation

on the “Financial Crisis for Beginners” page is great, it adds more dimension to the issue.

But, at a basic level, I read elsewhere that 21% of the loans made were sub-prime. Assuming all of them fail, there’s still the house as an underlying asset. Assuming the house decreases in value by 47% (chosen by convenience), that equates to a 10% loss over all mortgages.

If I was at the back of the line for my piece of the security pie, I’m out of luck, but for most of the pie, the money is still coming in. What am I missing, or where are my numbers wrong?

*James Kwak, 10/9/08:*

Those are good questions. I can think of three responses, but there may be more.

First, I recommend the Marketplace video on CDOs that is listed on the Financial Crisis for Beginners page. That video shows how slices of CDOs were used to create secondary CDOs. (A primary CDO is a collection of mortgages; a secondary CDO is a collection of CDOs.) In the secondary CDO, it’s possible that even the people at the front of the line will not get any money from the underlying mortgages.

Second, a given CDO does not necessarily include mortgages of all types. There are CDOs that were built entirely out of subprime mortgages. In that case, the total cash flow into the CDO (in your example) is only 53%, not 90%. (Still, though, you would think the first people in line would be fine, if it’s a primary CDO.)

Third, you may just be right. Some people – including Ben Bernanke, a couple of weeks ago – have argued that these CDOs will be worth much more, if held to maturity, than investors are willing to pay for them today. The financial panic is definitely depressing the prices of these things on the open market. The problem is that if I’m a bank holding these assets, even if I think they will be worth 70 cents on the dollar if I hold onto them, I may need to raise cash right now, and for that purpose they are useless.



## The Bailout and the Stock Market

James Kwak | 06 Oct 2008

One week ago, the House rejected the bailout bill and the Dow fell more than 700 points. That fall was a major reason why public opinion shifted from heavily against the bailout to confused, and why the bill passed on Friday. On Friday, though, the Dow fell another 150 points, and today at 1 pm Eastern it's down another 500 or so.

Before panicking, though, we have to consider what this means. Broadly speaking, we are faced with two related crises, each of which is approximately represented by a different market. The first is a global economic slowdown that people have been talking about for months. The second is the acute credit crunch that hit after Lehman went bankrupt on September 15.

Fears of a global economic slowdown are reflected in the stock market. Stocks are claims on the future cash flow of companies, and companies do better during economic growth periods than during recessions. When sentiment shifts from the belief that we will see a short, mild recession to the belief that we will see a long, harsh recession, the stock market goes down. By contrast, the acute credit crunch is reflected in the credit market in the record-high prices that banks are charging to lend to each other and to ordinary companies.

Although you and I and most people with investments have more money in the stock market than in the credit market, the stock market is more a gauge of sentiment than an independent force in the economy. Lower stock prices make it more expensive for companies to raise equity capital, but most companies raise more money by issuing debt than by issuing stock. And when people's investments go down, they tend to spend less, but only a little; if their 401(k) goes down by \$10,000, they don't cut back on spending by \$10,000. The credit markets, by contrast, have direct and immediate effects on how companies behave; in an extreme case, no credit can mean no cash with which to make payroll. (See the posts tagged "real economy" for a couple examples of this.)

Now the credit and stock markets are related, because when the credit market freezes up, people's expectations about the future turn downward, and hence stock prices fall. Ironically, all the attention the credit crisis has gotten over the last three weeks has undoubtedly hurt stock prices because of all the talk about potential dire consequences. (As

Simon advised me, if you write a post entitled “your money is not going to go poof,” as I did, 20% of your readers won’t see the “not.”)

So in this context, what does the fall in the stock market mean? Probably two things. First, people are only beginning to realize that Europe is in big trouble – given its difficulty in coming up with coordinated economic policy, perhaps bigger trouble than the U.S. Because U.S. companies operate in a global economy, that will hurt all companies. Second, it means that more people are realizing that the Paulson plan is only a partial solution, which is something we (along with many other people) have been saying for a while.

As long as the credit market remains tight, fears of recession will remain high, and stock prices will suffer. The important question is when the credit market will loosen up. Right now it looks like there are still enough open issues with the Paulson plan (what price, which securities, how fast) that lenders are still waiting and seeing. In the long term, though, the stock market will only turn up when people believe there is a credible plan for fighting the recession in the real economy.

## Incrementalism

Simon Johnson | 07 Oct 2008

Let's say you face a pervasive loss of confidence in your financial institutions, the stock market just fell 7 percent, depositors are (needlessly) rattled and a certain small country is talking about something that sounds ominously like a significant default (it's Iceland on line 2). What do you do?

Your instinct might be to go for a broad bold package of measures, throwing a great deal resources in to strike at the root causes of the problems at the same time as addressing some of the more painful symptoms. But that is because (and part of why) you are not a leading economic policy official in a G7-type industrial country.

These officials are outstanding individuals, who take their jobs seriously, work hard, have the highest standards on all dimensions, and are very smart. But they have been trained, just as their mentors were, and their mentors before them, to make macroeconomic policy in small steps. The best way to unsettle the markets, they have learned, is to be overly bold. Macro management, the mantra holds, needs a steady hand and an unblinking eye. And policy changes should be incremental: 25 basis points (that's 0.25%) is a much favored step in interest rates, up or down.

All of this is completely reasonable and makes a lot of sense in ordinary times. And the times have been ordinary on almost every day over the past 60 or so years. In fact, if you spend time with long-time practitioners, they are hard pressed to find a close parallel to the circumstances of the past 3 weeks.

And this is the point. Someone who has had every kind of experience in the US market over the past 35 years, up and down, boom and bust, is in all likelihood not at all prepared for the situation we now face. What we are seeing now in the United States and, just as amazing, in Western Europe is the kind of situation that, in our lifetimes, has only been seen in middle-income "Emerging Markets" open to capital flows.

It is, of course, the capital flows that make the difference. If you build an economy in which financial services are large relative to other economic activity and have a high ratio of debt-to-equity (check that box for the US and Western Europe), you are vulnerable to "jumps" downward in confidence. Of course, you can also get confidence to jump upwards, but this is not so easy. (This is the fish soup problem.)

Now, I do think that officials in the G7 and other rich countries will eventually figure out what they need to do. They will take their time, organize big packages (along the lines we are suggesting, at least roughly), and they will show up eventually with overwhelming financial force. But the odds on this happening soon are slim. They need more discussion among themselves (which they do a lot), more analysis (they read everything), more reports (very important for shifting the consensus) and – above all – much more by way of downward movement in markets. We will get there, but not tomorrow and, I'm afraid, not this week.

Days to the election: 29

## Simon on C-SPAN Tuesday Morning

**James Kwak** | 07 Oct 2008

My co-author, Simon Johnson, will be on C-SPAN's Washington Journal show tomorrow (Tuesday) morning from 7:30 to 8:30 in the morning, U.S. Eastern time. He'll be discussing – what else? – the global credit crisis. It's a call-in show, so you'll be able to submit questions live.

**Update:** You can see now watch the show online [here](#).

## Federal Reserve Invokes Emergency Powers?

James Kwak | 07 Oct 2008

As has been widely reported, the Federal Reserve announced today that it will start buying commercial paper directly from issuing companies. (Commercial paper, as expertly explained in last weekend's episode of *This American Life*, is a short-term IOU that companies issue when they need to smooth out the short-term fluctuations in their bank balances; the issuer promises to pay \$1 million in 7 days' time and, for example, gets \$999,000 from the lender immediately.) Highly experienced journalists have described this action as using the Fed's "emergency powers," although the Fed was itself careful not to use the word "emergency" in its press release. Rather, the terms and conditions released this morning cite the authorization of Section 13(3) of the Federal Reserve Act. That section reads as follows (bold emphasis added; you don't need to read it carefully, there won't be a quiz):

### 3. Discounts for Individuals, Partnerships, and Corporations

In **unusual and exigent circumstances**, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank: *Provided*, That before discounting any such note, draft, or bill of exchange for an individual, partnership, or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.

("Discounting" just means that the Fed can loan the holder or issuer of the commercial paper a little less than the face value of the paper.)

So while the phrase "emergency powers" can be frightening, this doesn't mean that martial law has been declared, or its financial equivalent; just that the Fed identified an "unusual and exigent circumstance" in the market. By this action, the Fed is intervening in the

short-term credit market for ordinary companies directly; previously, its actions had been devoted to encouraging banks to provide short-term credit to those companies. We can infer from this that the Fed has decided that the previous strategy wasn't working, at least not well enough. Because it bypasses the banking sector altogether to provide credit to the real economy, this should reduce borrowing costs for companies, which is a good thing. (The downside is that theoretically it creates exposure for the government, and hence the taxpayer, if any issuers default on their commercial paper.)

Still, though, this latest Fed action points out two concerns. First, the Fed still appears to be reacting to events as they arise rather than plotting a strategy to get ahead of the crisis and stop it in its tracks. (A set of steps that might stop a crisis of confidence, if announced in one fell swoop, could fail to have that effect if spread out over several weeks or months.) Second, there is no Congress in session, and there won't be until after the election at the earliest. The election is only four weeks away, but as we have seen markets can shift significantly from one day to the next. Today's action can be seen as a signal that the Fed will do whatever it takes to keep credit flowing until Congress can reconvene and develop a more fundamental set of solutions. Which is a good thing, assuming that Bernanke doesn't run out of tools in his magic toolbox.

## European Response to the Financial Crisis

James Kwak | 08 Oct 2008

Just a couple weeks ago, European finance ministers were insisting that the credit crisis was an American invasion that they were adequately prepared to repel, with German Finance Minister Peer Steinbrueck insisting that an American-style rescue plan was not required in Europe because the financial crisis was an “American problem.” As we’ve learned over the past few weeks, things change very fast. Although European leaders now appreciate the seriousness of a crisis that threatens their economies every bit as much as the American one – perhaps more, judging by the number of bank bailouts over the last few days – they have not been able to implement solutions even on the scale of the Paulson plan. The on-line Economists’ Forum of the Financial Times published (Tuesday morning in the US) a new op-ed by Peter Boone and Simon Johnson describing the challenges facing European policymakers and presenting some concrete solutions – including interest rate cuts and bank recapitalization, for starters.

**Update:** Martin Wolf’s latest column for Wednesday’s paper, just out (Tuesday evening in the US), takes similar positions. In the column, Martin discusses how the deepening crisis over the last week has led him to change his position. Many in European leadership positions follow Martin’s views closely, so hopefully his forceful arguments will have an immediate effect.



## Simon on NPR Planet Money Today (10/8)

James Kwak | 08 Oct 2008

Simon Johnson will be on NPR's Planet Money podcast today. Planet Money is a new, daily podcast focusing on the financial crisis, and is one of the best places for friendly, accessible reporting on daily events. You can find the podcast feed on the NPR web site, or you can look for Top Podcasts in iTunes. (Planet Money is currently #1, which means it has displaced my favorite radio show, This American Life.) Today's episode will be available after 5 pm U.S. Eastern time. Once it's up, I'll put a direct link on this post.

**Update:** The podcast is up, and you can listen to it here. Simon is about 12 minutes in, but he is preceded by Amir Sufi, who does a good job describing the relationship between the credit crunch and the ongoing slowdown in the real economy.

## Interest Rate Cuts vs. Recapitalization

James Kwak | 08 Oct 2008

*Global rate cuts: attacking the symptom?*

After yesterday's move by the Fed into the commercial paper market, today's big news is a global interest rate cut, including the Fed, the European Central Bank, and the Bank of England, among others. The effect of an interest rate cut should be to reduce borrowing costs across the board, which is a good thing for the real economy. However, the rate cut may not have a direct impact on the crisis at the heart of the financial system, which is that banks are not lending to each other. To put this in perspective, the spread between 3-month inter-bank lending rates and 3-month Treasury bill rates – a measure of how willing banks are to lend money to each other, as opposed to socking it away in risk-free Treasury bills – is running at about 4 percentage points. Ordinarily, it should be about 0.5 percentage points. As a matter of simple arithmetic, a 0.5 percentage point cut in central bank interest rates is small compared to a 3.5 percentage point increase in risk premia. As long as lenders are afraid their borrowers could go bankrupt, lowering the cost the lenders pay for money will only slightly lower the price that they charge for money.

Still, though, today's move is a valuable signal that the world's central bankers are on the same page and that they will do whatever they can to fight the crisis. And the good news may have come from the United Kingdom, where the government announced a straight-up bank recapitalization plan, in which 25 billion pounds will be used to buy preferred shares in eight banks, and another 25 billion pounds will be allocated to buy shares in those or other banks. Banks that have more capital are less likely to go bankrupt, making other players more willing to lend to them. As we've pointed out before, the Paulson Plan may have the indirect effect of increasing bank capital (because we expect Treasury to overpay for the securities it buys under the plan), but uncertainty over how that will work has diluted its impact on the markets. Explicit bank recapitalization is a more direct way to attack the problem.

## **Decisive, United Action**

**Simon Johnson** | 08 Oct 2008

Events of the past several days have convinced us that the state of the global economy is getting worse and we have revised our analysis and proposals ([online](#)) accordingly. In short, coordinated, large-scale actions by the U.S. and Europe, including bank recapitalization plans and guarantees of banks' obligations, are necessary to limit the spread of a crisis that threatens to trigger national defaults in vulnerable countries around the globe.

## **Simon on Diane Rehm Show Today (10/9)**

**James Kwak** | 09 Oct 2008

Simon will be a guest on the Diane Rehm Show (WAMU, syndicated on NPR) from 10 am to 11 am (U.S. Eastern time). This is a call-in show, so you'll be able to ask questions of the panel at 1-800-433-8850 or [drshow@wamu.org](mailto:drshow@wamu.org).

**Update:** You can now listen to the show [here](#).

## **More Economists for Coordinated Recapitalization and Debt Guarantees**

**James Kwak** | 09 Oct 2008

The Center for Economic and Policy Research has rushed out, and I mean that in the best sense of the term, a survey of economists' recommendations for the world's economic policymakers and, specifically, for the meeting of G7 finance ministers this week. The economists who contributed to the 40-page [report](#) (once there, click on the title to download the PDF), while presenting a range of views, generally agree on the need to recapitalize the banking sector and, with some dissent, to guarantee short-term bank liabilities in order to calm fears in the financial markets. They also agree on the urgent need for coordinated action across countries. These are positions we have been advocating on this site, and we are glad to see many other people on the same page.

## Paulson's Bank Recapitalization Plan

James Kwak | 09 Oct 2008

The big news today is that Henry Paulson claims to have found, in the \$700 billion TARP package passed last Friday, the power to invest some of that money directly in banks to shore up their capital. As one of the people who actually read the bill (OK, I skimmed most of it), I was puzzled by this, because my reading (like everyone else's) was that Treasury would only be allowed to take equity stakes in companies who participated in the sale of troubled assets to Congress. However, if you look at the comments by Congressmen in the [Time article](#) and on [Calculated Risk](#), you'll see that there are statements in the Congressional record saying that the intent of the bill is to allow direct equity purchases. A curious fact that you learn in law school is that, in interpreting a bill, it is not just the words of the bill that matter; the record of committee and floor discussions can also be used in interpreting a bill. So it seems like, in this case, Congress consciously inserted language into the discussion in order to give Treasury this power, or Treasury is seizing on some passages in the discussion to claim that power.

At this point this is unlikely to generate too much controversy, because most people involved, including the authors of this blog, think it would be a good thing for Treasury to take some of the \$700 billion and invest it directly in recapitalizing banks (which is what the UK is doing). Of course there will be issues of detail to be worked out, and the Treasury Secretary has an awful lot of discretion in this matter, but this is definitely a step forward.

Oh, and I should mention: Planet Money broke this story [first](#).

## Mortgage Restructuring at Countrywide

James Kwak | 09 Oct 2008

We and other commentators have been saying that in addition to shoring up banks, there needs to be something for the homeowners at the bottom of the food chain. This will need to be a priority for Congress when it convenes in November (as it absolutely must, at this point) and for the next president. However, today, there may have been a small step in the right direction. Bank of America (which bought Countrywide) announced a “homeownership retention program” for customers of Countrywide, which was one of the most aggressive subprime lenders during the housing bubble.

The agreement, which was negotiated with several state attorneys general (who have been investigating Countrywide’s allegedly predatory lending practices), includes several provisions that offer hope to struggling homeowners:

- Restructuring of first-year payments to target 34% of household income
- Interest rate reductions
- Principal reductions for some types of loans
- Waivers for some loan modification and prepayment fees
- Partial moratorium on foreclosure proceedings for borrowers who may be eligible for the program
- \$220 million in assistance for homeowners facing foreclosure

The program is supposed to go into effect on December 1. In total, it is expected to provide \$8.4 billion in payment relief to homeowners. Of course, a lot will depend on how it is implemented, but at least this time (as opposed to the largely ineffectual HOPE program announced a while ago) there will be a set of attorneys general monitoring the program.

One major potential stumbling block is that “some loan modifications ... will require investor approval” – meaning that if a mortgage has been securitized, all of the people who own bits and pieces of that mortgage may have to approve any modifications. This is why systematic government intervention is necessary to force people – if necessary and legal – to participate in loan modifications that do benefit all parties (investors get more than they would get in case of foreclosure; homeowners get to stay in their houses, perhaps just as renters; communities are not devastated by foreclosures). But while waiting for that to happen, this can’t hurt. Most importantly, it shows the

recognition (under pressure, of course) by a major player that it is not going to get all of its money out of its borrowers, and that it is better off trying to find a win-win solution.



## A Viewer's Guide for the G7 (Crisis) Meeting Today

Simon Johnson | 10 Oct 2008

For the reasons I laid out last weekend, the G7 meeting of finance ministers today could be pivotal. The G7 and their close allies are the epicenter of the global crisis, and they most definitely have the financial resources and combined brainpower needed to turn things around, starting with bold, decisive action today.

They cannot do it with a Business-as-Usual approach, and there are already signs that some of them (US, UK) are inching in a more dramatic and even coordinated direction. It would be unreasonable to expect them to make one gigantic leap today to a complete solution. Even if major players now think this is the only sensible way to go, such a sudden move would be inconsistent with how G7 governments operate internally or interact with each other. Nevertheless, there will be unmistakable signs today, in their communique and related communications, regarding how long we will have to wait for decisive action.

Here are three things to look for:

1. The extent of recriminations. These are obviously unproductive at this stage. If the German finance minister (Peer Steinbrueck) can refrain from saying negative things about the United States, that would be encouraging.

2. Statement of the problem. Jointly and separately the language used to describe the severity of the situation is important. In the Business-as-Usual approach, officials hate to use negative language about the direction of the economy, for fear it would be self-fulfilling.

3. Detail on next steps. Ideally, there will be a road map, with a timetable on when different countries will adopt various kinds of measures. If all they can agree on is a vacuous statement of principles, we are in trouble.

**Update (by James):** PRI's The World led off Friday's show with a discussion of the G7 and IMF meetings, including an interview with Simon.

## Henry Paulson, Meet Warren Buffett

James Kwak | 10 Oct 2008

Bank recapitalization is in the air, which tends to prompt at least two responses: (a) what's bank recapitalization? or (b) this is socialism!

Bank recapitalization is when an external entity buys new equity shares (stock, as opposed to bonds) in a bank in exchange for cash. The effect is to boost the bank's assets without increasing its liabilities; since one worry about the banking sector is that it does not have enough capital (that is, it may not have enough assets to balance its liabilities), this is a good thing. (If the bit about capital, assets, and liabilities is confusing, see [Financial Crisis for Beginners](#).) Of course, there's no such thing as a free lunch, and in this case the bank's existing shareholders get diluted, because they don't own as much of the bank as before. But, in general, it's better to own part of a bank that exists than a larger part of a bank that no longer exists.

Bank recapitalization could be as simple as this: the government (meaning the taxpayer) gets the same kind of deal that Warren Buffett got when he invested in Goldman two weeks ago. In that deal, Buffett paid \$5 billion for preferred stock at \$123 per share. The preferred stock pays a 10% dividend, meaning that Buffett gets \$500 million per year from Goldman's cash flow. He also got warrants that give him the right to buy up to \$5 billion worth of common stock at \$115 per share. At the time the deal was announced, Goldman common stock was trading at \$125. Even though Goldman closed at \$101 yesterday (and has fallen so far today), Buffett is still getting a 10% yield from the \$500 million dividend, and if Goldman goes up he stands to make a lot of money from the warrants.

Buffett was able to get this deal because Goldman needed capital and there weren't many people lining up to provide it. Today, Henry Paulson is in the same situation: as the only game in town, he can negotiate favorable terms for the taxpayer. Note that this does not have the perverse incentives of buying troubled assets, where if he gets a good bargain for the taxpayer, he risks hurting the banks (because they need to sell their assets at reasonable prices to remain solvent). In this case, the bank gets the same amount of new capital in any case, and the only people who get hurt are the existing shareholders. This should also be a relatively easy concept for policy makers to explain to the American public.

Preferred shares are the typical vehicle for this type of investment for two reasons. First, they have superior rights to common shares, so they can have special dividends, and in case of bankruptcy they have priority over common shares (although that may not mean much). Second, they can be designed with special properties. One controversy is whether the government should be able to vote with its shares; many free-marketers think that would constitute undue and risky government interference in actual bank operations. Assuming that is a problem, the preferred shares could be created without voting rights.

Greg Mankiw, former chairman of the Council of Economic Advisors under the current President Bush (and known to generations of students as author of a popular macroeconomics textbook), and no fan of government intervention, has proposed that the government co-invest with private investors like Warren Buffett so they benefit from the same terms that the private investor gets, while avoiding the complications of Treasury negotiating the deal and then controlling a large stake in the bank. While it's not clear there are any private investors at this moment, this could be a good way to respond to the "socialism" charge.

## G1 vs. G7 vs. G20?

**James Kwak** | 10 Oct 2008

We already know that at least some people in major European countries (Peer Steinbrueck, this means you) are mad at the U.S. for “causing” the global financial crisis. But while many of the rest of the G7 are at least complicit – European banks were buying large piles of the same mortgage-backed securities that set off the crisis in the U.S. – many of the world’s less-developed countries may be even madder at the U.S. Henry Paulson has called a meeting of the G-20, which includes some of the larger economies outside the G-7, for this weekend. The hope is that it will help dampen strife between rich and less rich countries, all of whom are being affected by the crisis.

## G7/IMF: What's Going On

Simon Johnson | 11 Oct 2008

As we've discussed previously, this weekend's meetings of the G7 and the IMF are crucial to halting the financial crisis. This weekend, we'll be updating you on events as they happen.

**Update (Friday evening):** The G7 statement is pretty much a general set of principles with which it would be hard to disagree, with very little by way of specifics and really nothing that we hadn't seen before. Mr. Paulson's statement today was similarly vague, although Treasury continues to signal that it will launch some sort of recapitalization program. I know they want to exude calm and confidence, but the sense of urgency that had building in the last couple of days seems to be slipping away from them.

**Update (Saturday morning):** Reaction from around the world is mostly disbelief. Could it really be the case that the G7 does not understand that trade credit is under pressure everywhere, that financing for new projects is drying up, and that Iceland's experience sends a dangerous signal to investors? Our piece in the Washington Post Outlook section lays out the very real dangers. Unless the G7, separately and jointly, act more decisively by the end of Sunday (yes, tomorrow), I'm afraid that next week could be quite difficult.

**Update (Sunday morning):** Reliable sources indicate that the eurozone member countries, who are due to meet today at the invitation of President Sarkozy, may well be able to announce agreement on some sort of parallel bank recapitalization scheme(s). It is also hard to imagine that the US will let the day go by without a major announcement. But it will take a great deal of detail in order to be credible at this point. And the question of who is and is not given a place on the Great Ark for Bankers will be much on our minds.

## Global Crisis: Latest Analysis and Proposals

James Kwak | 11 Oct 2008

Our latest analysis and proposals have been published by the Washington Post (print edition Sunday) in an article by Peter and Simon entitled "The Next World War? It Could Be Financial." If the world's leading financial powers cannot agree on a coordinated response, it could be "every nation for itself" – a repeat, on a larger scale, of the emerging markets crisis of 1997-98. We propose six concrete steps that policy makers – beginning with the G7 and IMF meetings this weekend – can take to limit the risks of such an outcome.

Feel free to comment with criticisms or suggestions.

## Zimbabwe and the Financial Crisis

James Kwak | 11 Oct 2008

*Or, yet another reason why the financial crisis matters ...*

In Zimbabwe, site of some of the deepest suffering in the world today, Robert Mugabe reneged on a power-sharing deal with Morgan Tsvangirai and the opposition party. Sure, he might have done it anyway, but it's a lot easier when the world's attention is elsewhere and every major power has other things to worry about. We rarely comment on non-economic issues, but in hard times, you can watch for more and more behavior like this.

Please comment if you've seen other cases of politicians using the crisis as cover for things they might not try otherwise.

## Paulson Sends Fannie and Freddie to the Rescue

James Kwak | 11 Oct 2008

Many readers will see that as an ironic title, but I don't mean it that way. Federal regulators have directed Fannie Mae and Freddie Mac to buy \$40 billion per month in troubled mortgage-backed securities – the same ones targeted by the \$700 billion bailout bill. As with the Paulson plan, price is still a question mark – too low and it does no good, too high and it will create losses for Fannie and Freddie – but we see this as a positive step. Fannie and Freddie were effectively nationalized, so we can think of them as part of the Treasury department at this point. One major question about the Paulson plan is whether \$700 billion is enough to have a major impact on the market. Using Fannie and Freddie to increase the overall size of the program does increase taxpayers' potential exposure, but it also increases the chances of having a meaningful effect on confidence in the financial sector. Buying assets this way may be especially important now that it seems much of the original \$700 billion will go to direct bank recapitalization – which, we think, is a better use of that money.

While this is a step in the right direction, it still smacks of the incrementalism that has dogged the government's response to this crisis. We may have reached the point where only a general guarantee of bank obligations will do the trick.

Let us know if you see other tools that Treasury picks up to attack the problem.



## The Financial Crisis: What Can You Do?

James Kwak | 11 Oct 2008

On Wednesday, one of our readers posted the following comment: “This website offers hope. Is there a way readers can help the cause?”

I’ve been thinking about that ever since, and I don’t have a good answer. The key decisions are being made by the central bankers and ministers of finance (we call ours the Secretary of the Treasury) of about ten countries, and most of the decisions they make are at their own discretion.

But I can’t avoid noticing that here in the United States we are less than a month away from a general election, which is the principal mechanism by which the public can affect the policies of our government. I watched the presidential debate on Wednesday, intending to write about the candidate’s positions on the financial crisis, but frankly there was nothing to write about. The most newsworthy moment was when, asked if the economy would get much worse, both candidates said no – which was, let’s say, wishful thinking.

It would be a good thing if the thousands of politicians up for election in a few weeks would acknowledge that we already have a serious economic problem, and that the current credit crunch is making that economic problem bigger. It would be good if they could talk about how they will get the credit markets flowing again and, once that problem is solved, how they will limit the damage of falling housing prices and stimulate the real economy. And it would be good if they could identify the reasons why this crisis came about and talk about how our financial system should be modified or regulated in the future.

As a voter and a constituent, those are questions you can ask your elected representatives. I have no experience in electoral politics and am not asking you to call or email anyone. But if you are so inclined, those are some questions you might ask.

## **When's the Make-Up Test? Tomorrow.**

**Simon Johnson** | 12 Oct 2008

**Saturday, October 11, 10pm.**

The world's finance ministers sat for several tests this weekend, and it's not yet clear how they did. If we set the bar low enough (i.e., no public criticism of each other), they did OK. The Italian finance minister did threaten not to sign the communique on Friday afternoon, but this was not particularly meaningful (think about it: if Italy walked out of the G7, how would the markets view Italian risks on Monday morning?) Everyone else was reasonably polite.

But if we were hoping for specific steps to be announced, then Friday's list of principles from the G7, and the ensuing vague statements of support from other sets of finance ministers on Saturday have really not taken us very far.

Still, there is time for a make-up test (or two) on Sunday. The US Treasury is undoubtedly working on some detailed measures to shore up parts or, hopefully, all of the banking system. Eurozone member countries will be meeting in France on Sunday afternoon, presumably to see how far along they can bring the Germans – particularly with regard to systematic bank recapitalization. It remains unclear whether anyone in the eurozone will support the British ideas of blanket bank guarantees at this point. And it is far from clear if the British will introduce the kind of overall package that in our view could turn the corner, even in a local sense.

The goal, as you know, is to get a clear strategy in place and well communicated by the time the stock market in Tokyo opens at 8pm (US East Coast time) on Sunday. Let's see how they do.

## Reader Question Roundup

James Kwak | 12 Oct 2008

In addition to answering questions in the comments on each post, we try to do a weekly roundup of questions that may be of general interest. Some are in comments we didn't get to, some in emails. Please continue giving us questions – they help us understand what is important to our readers.

### **What can we (readers) do to help?**

This one got its own post all to itself.

### **Three questions from a prescient reader**

One of our readers goes by “pk” on our blog. On September 27, he sent us an email asking three questions:

1. Is the size of the bailout (independent of the technical aspects) sufficient?
2. Will what has happened in the US be repeated across the globe?
3. If economies come unhinged across the globe, what are the geopolitical implications?

Since that date, the general consensus is that original bailout was too small (at least on its own), and we have clearly seen the U.S. experience echoed in other countries. And the third question is the subject of our Washington Post article. (pk also predicted a global interest rate cut, which has since happened; in my comment, I said that would be nice but not sufficient to stem the crisis, which I still stand by.)

### **What are credit default swaps?**

We got a few requests for an explanation, which I have since added to the Financial Crisis for Beginners page. There were also questions about when they will expire, or even potentially making them illegal.

Credit default swaps are a form of insurance, and as such can play a valuable function. The two most commonly cited problems with them are (a) the fact that they can be bought independent of the underlying securities and (b) they are completely unregulated, so you can have no assurance the seller will actually be able to pay them off. My opinion is that they need to be regulated – and there are already discussions of creating transparent exchanges for them. They did not cause this crisis on their own, and at this point the crisis has reached a point where magically making them disappear would not solve our problems.

**On credit default swaps – what was the thinking behind selling insurance products to people who didn't own the insured asset? Maybe the answer is "because they could, and there was no one there to stop them, and they got filthy rich doing it."**

I think that's exactly right. I could make an argument that allowing more people to participate in the market provides more liquidity and hence more pricing efficiency. But I'm not sure I see any compelling reason for it, given the trouble you can create for yourself. The other argument would be if that you use regulation to eliminate this kind of gambling, it will only show up someplace else – which may be true.

**How much of this downward spiral is unfettered panic? I realize that there is a real decrease. But like speculators who drive a price up, I see the same happening in reverse. Any there any signs to be able to better judge this?**

Probably a lot of people are interested in how far the stock market will fall, where it "should" be, and when it will start going up again. We try to scrupulously avoid anything that might be interpreted as personal finance advice, because we don't have any particular expertise in that area. But for those interested in this question, I can point you to an article by David Leonhardt – a smart financial journalist – in the New York Times. He points out that, based on P/E ratios, stocks are below their long-term average now. However, he also points out that, in market declines, the market often swings well below the long-term average before rebounding.

## Next Up: Emerging Markets

**Simon Johnson** | 12 Oct 2008

In Washington this weekend, there seems to be remarkably little realization of the difficulties already facing emerging markets. Even if things start to go much better in and for the G7 in the next 48 hours, you cannot easily get back to the situation before Iceland's banks failed and effectively Iceland was left to its own devices. And, of course, it is impossible to return to where we were before the series of unfortunate events surrounding Lehman and AIG.

But what exactly does this imply for various kinds of emerging markets? Countries with clear pre-existing vulnerabilities were already in trouble last week, those with any kind of small cracks in their economic armour are now being tested, and even the apparently invulnerable may come under pressure. According to our analysis, now published in Forbes.com, this will be a stress test like no other.

## **Baseline Scenario, 10/13/08 – Policy**

### **Baseline Scenario: Policy, October 13, 2008**

By Peter Boone and Simon Johnson, copyright

(For an explanation of the baseline scenario and our analysis, go [here](#).)

#### **The U.S.**

The key weapon that the United States possesses is that the U.S. balance sheet is credible. The U.S. is not going to lose its AAA rating. The U.S. balance sheet cannot save everyone in the world, but if necessary it can be used to draw a line in the sand and restore confidence.

Today, according to the spreads on credit default swaps – which measure the expected probability of default – investors believe a handful of large and medium-sized banks are safe. However, these safe names may appear at risk in the future. The government needs to have a plan to protect today's safe banks from self-fulfilling credit panics if necessary.

The US plan should include at a minimum the following measures:

1. For a limited period, the FDIC should extend its deposit guarantee to all deposits at regulated financial institutions. The full extent of this coverage and how smoothly it works for depositors can be better communicated. Depending on the circumstances, a temporary guarantee for all bank obligations may be desirable.

2. The US Treasury should establish a preferred equity injection program for core financial institutions (regulated entities including commercial banks, savings and loans, and credit unions), and present them with two options for meeting capital requirements. First, they can go to private markets. Second, they can access the Treasury window, which is available for only a limited period of time. The Treasury will accept all applications that meet two provisions: after the new issue of preferred shares to the government, the institution would be well capitalized even in stress situations (e.g., a severe recession); and the pricing of this equity injection makes sense for taxpayers as an investment. This would put banks under a great deal of pressure to raise more capital, but whether they do it through shares that are bought by the Treasury or through private markets is up to them. We would use all the \$700bn in the Troubled Asset Relief Program (TARP) for this purpose.

3. A major fiscal stimulus package is needed to help restore confidence back to the economy, and to encourage businesses not to postpone

investment plans. Counter cyclical programs to help consumers always make sense in this kind of situation. We would recommend cash payments and rebates to households and short term investment tax credits to businesses. This is a major way to help both homeowners and renters. Note that implementing a fiscal stimulus package without recapitalizing the financial system would have a much lower chance of success and reduce the fiscal space that may be needed down the road to support the financial system.

4. Housing is a critical component of rebuilding confidence in financial markets. In a credit cycle driven recession, it is easy to imagine that house prices could fall below some longer term measure of fundamental value. Therefore direct measures need to be taken that will break the cycle of foreclosures and fire sales that is now driving down prices. Managing that process will be a major task for the next 2-3 years. Starting this process now may also be essential to the political legitimacy of any decisive approach.

The main objection to this approach will come from people who worry a great deal about “moral hazard” in the banking system, meaning that if we bail out banks, this will encourage further risk taking. Moral hazard is an important potential problem in any financial market. Because people believe that something may be bailed out, the pattern of investment is distorted and the market becomes less efficient. But at this point, we need to stop the credit crunch in order to begin moving back in the direction of a more efficient allocation of capital. In a short-term crisis of this nature, moral hazard is not the preeminent concern.

In the long term, however, in designing the financial system that emerges from the current situation, we should work from the premise that moral hazard will be important in regulated financial institutions. And we should aim to design, down the road but quite soon, a system with less pervasive and less damaging moral hazard-related problems than the system that now needs to be saved.

## **Europe**

European policy makers were initially being slow to respond. While Americans recognized the danger of a rapidly spreading crisis of confidence, Europeans seemed more preoccupied with avoiding the inflation of the 1970s. More recently, however, European policymakers have begun taking action. A decisive European policy response will be critical to limiting the scope of the recession.

Today, markets and events are predicting a major global recession. The Dow Jones Basic Materials Index has fallen 32% since end August. This index reflects the future profitability of basic materials producers, and so predicts a major decline in commodity prices. The price-earnings ratios of European and UK stocks, now near historic lows, are only reasonable if we believe a major earnings recession is upon us. The rise of credit default swap (CDS) spreads, especially for the financial sector, also indicates that major banks around the world are in danger.

Because of the global credit crisis, inflation is not a serious risk. Despite the perverse but short-lived increase in commodity prices this year, we will now see sharply falling prices. Across most countries in Europe we will see sharply falling housing prices. Companies are now reducing investment and spending plans due to the high cost, or lack, of debt and desire to build cash balances. Today's weak unions will not have bargaining power in this environment; workers will not want to risk losing their jobs when faced with negative equity in their houses. There simply will not be room for workers to demand high wages nor companies to pay, and hence a wage price spiral as in the 1970s is most unlikely.

### **Emerging markets**

The most vulnerable countries in the current crisis are in emerging markets. Just like highly leveraged banks, highly leveraged countries – such as Iceland – are vulnerable to the flight of capital. Countries that got rich during the commodities boom are also highly vulnerable to a global recession.

The flight to safety is already destabilizing banks around the world. Despite India's small external debt, its largest private-sector bank suffered a deposit run and lost half of its value. Liquidity contractions have affected banks in Russia, Brazil, and other emerging markets. And for companies that can get credit, the cost has skyrocketed. Gazprom, despite reasonable debt levels and the world's largest natural gas reserves, has seen financing costs rise from 7% to 11.5% over the past year. For Gazprom, debt servicing costs will restrict expansion; for many smaller companies, the result will be bankruptcy.

Financial sector tremors will send shockwaves through emerging market economies. While wealthy nations can use their balance sheets to shore up banks, many other countries will find this impossible. Like Latin America in the 1980s, or emerging markets after 1997-98, the withdrawal of credit after a boom can lead to steep recessions and major



internal disruptions. This, in turn, will dampen economic activity in North America and Western Europe. Four sets of countries stand to lose.

1. The over-leveraged. With bank assets more than ten times its GDP, Iceland cannot protect its banks from a run. Other countries that borrowed heavily during the boom face a similar situation. Some smaller East European nations have large current account deficits and central bank reserves that are low relative to (high) private sector gross debt levels.

2. The commodity-dependent. Oil has already fallen below \$80 per barrel from its high above \$140, and demand continues to fall. All other major commodities will fall for the same reasons. Commodity exporters facing sharply reduced revenues will need to cut spending and let their currencies depreciate. But managing this transition will be difficult.

During the boom, Russia's government built up \$550 billion in reserves and reduced public debt. At the same time, however, the non-public sector borrowed \$450 billion, with many more loans probably going unreported. If the ruble depreciates, these foreign-denominated loans will drive many companies into bankruptcy. The government has transferred \$200bn of reserves to the private sector to pay off foreign loans, while spending more to support the ruble instead of letting it depreciate. This is the challenge facing other commodity exporters.

3. The extremely poor. Sub-Saharan Africa, which was a beneficiary of the commodity boom, will be hit hard by the fall in commodity prices. At the same time, wealthy nations are likely to slash their foreign aid budgets. The net effect will be prolonged isolation from the global economy and increased inequality.

4. China? With its massive foreign reserves and rapidly rising domestic demand, China seems well positioned to weather the crisis. However, China alone is unlikely to meaningfully offset the global recession. Despite producing no more than 1/10th of the world's GDP, China has a voracious appetite for commodities, consuming 37% of the world's steel, largely due to infrastructure investment. The boom is likely over.

The world's attention is currently focused on the G7. But crises in the rest of the world will inflict damage on G7 economies, increase global inequality, and create geo-political instability.

Highly leveraged countries are at risk of substantial private or public defaults. They need to assess their ability to cover their debts and decide which entities to protect and which to let fail. If necessary, they should

commit to early Paris Club and London Club negotiations to restructure external national debts, and encourage private sector entities to begin negotiations with creditors.

Commodity exporters should let their currencies depreciate instead of spending reserves to slow down the adjustment process. Devaluation will be necessary to bring imports and exports back into balance.

The IMF can work with countries needing fiscal and balance of payments support. It is already signaling that it will reduce the detailed conditions for which it is so well known, and increase its flexibility. The G7 should support this, and make additional resources available. One widely expressed view is that currently the IMF could save only 2 ½ Icelands.

Finally, despite their domestic challenges, wealthy nations also need to do their part. We are going to recapitalize our banks and exercise greater control over them. We need to make sure they continue to deal with emerging market banks. We should also avoid cutting our aid to the world's extremely poor.

### **Conclusion: Time to prepare bigger programs**

We believe the U.S. economy, along with many other parts of the world, is entering a recession precipitated by housing markets but primarily caused by an extreme loss of confidence in global credit markets. The withdrawal of credit undermines previously solvent leveraged institutions, causing unnecessary economic damage, and inhibits consumption and investment plans. While the initial housing shock may have generated a moderate decline in growth, the credit shock will have a much larger impact.

Once confidence is gone, it is extremely difficult to restore. Creditors need to be confident they can get their money back, but the list of entities where they feel secure is declining at a rapid rate. This is not a case of efficient markets, but a self-fulfilling series of credit panics causing significant economic damage.

The global financial outlook continues to worsen. The United States has been forced to shore up Wall Street and European governments are bailing out numerous commercial banks. Even more alarmingly, the country of Iceland is presiding over a massive default by all its major banks. We're now likely to see substantially more defaults and credit panics in smaller countries and emerging markets. This troubling development points not only to an even more painful recession than

anticipated, but also to the urgent need for international coordination to avoid something worse: all-out financial warfare.

With his appeals for assistance turned down by European countries, Iceland's prime minister, Geir Haarde, commented on Monday that it is now "every country for itself." This smacks of the financial autarchy that characterized defaulters in the 1998 financial crisis in Asia, when countries changed the rule of law to benefit domestic constituents over foreigners.

This is a natural outcome of chaotic times. Most of the time, financial war of this kind is painful and costly. It will lead to decades of lower international capital flows and could have other far-reaching effects on politics and global peace. Unless the leading industrial countries take concerted action, there's a very real danger that we will all suffer more.

If governments don't respond with sensible, coordinated policies, there's a risk of financial war. Here are six steps toward avoiding "every country for itself," building on our proposed approach for the US and on our earlier suggestions for Europe (some of which have now been adopted).

1. The world's leading financial powers – at a minimum the United States, United Kingdom, France and Germany – should jointly announce national plans to require recapitalization of banks – i.e., restructuring their debt and equity mixture – so that they have sufficient capital to weather a major global recession. How this is done can be determined internally by each nation, but this should be a common goal, so that citizens and companies can again trust their banks.

2. If confidence continues to wane, countries should also announce a temporary blanket guarantee on all existing bank deposits and debts. This will in effect promise creditors that they can safely expect the institutions to function until the recapitalization takes place, and it will help prevent the large flows of funds that could occur as some banks or countries conduct recapitalizations earlier than others. This blanket guarantee should only be temporary (e.g., for six months).

3. The monetary authorities of these countries need to lower interest rates dramatically. Europe, Canada and the United States recently announced a coordinated 0.5 percent reduction in rates. This is a good start, but only a start. More will be needed, and it won't stop the credit crunch within or across countries. The events of the last nine months have set us on course for a global recession, in which commodity prices will continue to fall and demand will remain weak. Inflation will be low

and deflation (falling prices) is a risk. More interest rate cuts will be needed.

4. The monetary authorities also need to remain committed to pumping liquidity into the financial system as long as credit markets and interbank lending remain weak. This should be promised for at least one year.

5. All industrialized countries and most leading emerging markets should commit to a sizable fiscal expansion (at least 1 percent of GDP), structured so as to work within the local political environment, to offset the coming large decline in global demand.

6. Many families worldwide are going to have negative equity (i.e., mortgages larger than the value of their homes) due to declining home prices. There are going to be large-scale recriminations against lenders and politicians. The most affected nations, including the United States, the UK, Ireland and Spain, urgently need to develop scaled-up programs to provide relief for homeowners both to offset real hardship and to prevent a vicious downward cycle in home prices.

It's important to prepare properly: partial and piecemeal actions will no longer work. Actions by one country alone, and the current pattern of small steps announced frequently, are no longer credible enough to change the tide: Markets need to be jolted out of their panic. It's worth bringing a sufficient mass of economic power to bear, in a very comprehensive program, to unfreeze the markets.

There is also a need to let prices move to a level supported by the market, which unfortunately means that wealth is likely to decline further. The events of the last six months will almost surely cause a recession, and large downward revisions in earnings estimates are a near certainty. As we saw after the Asian crises, this can mean that stocks, bonds and other assets become very cheap, and it take a long time for values to recover. Fiscal expansion and help to homeowners will reduce the pain from these losses, but it's important to be clear that the success of the program should not be measured by rising asset prices.

Finally, it's important for everyone to recognize that we are well past the days where even dramatic steps could have stopped the panic and prevented a major recession. A successful program will not prevent recession, and we will still see many personal, corporate and perhaps even national bankruptcies. Once the genie of panic and uncertainty is unleashed, it takes years to put it back in the bottle. What we need to do

is prevent a chaotic collapse arising from incomplete policies, lack of credibility and international financial warfare.

## Baseline Scenario, 10/13/08 – Analysis

### Baseline Scenario: Analysis, October 13, 2008

By Peter Boone and Simon Johnson, copyright

Published weekly, The Baseline Scenario is divided into two parts: analysis (this post) and policy (a [separate post](#)). In the analysis section, we first explain how we have updated (or not) our views, based on the major developments of last week. Then, we state our overall view of how the global economy got into its current situation and where this is likely heading. Readers who remember what we said last week can just look at the updates and then go to policy). The [policy section](#) reports our current view on policies in the US and elsewhere.

Please note that we do not currently publish our upside and downside risk scenarios in detail.

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### Updates

#### Europe recapitalizes

The most important recent development is the – at least partial – shift in European government attitudes during the past few days. Over the weekend Europe announced a bank recapitalization program, along national lines. As we prepare to publish, key details remain vague, but it appears they are trying to provide guarantees only at the margin (for new debt, etc). Presumably this is because the total balance sheets involved are too large for the governments to take on blanket guarantees.

Each country will have a different plan and how these will mesh together remains unclear. It is also unclear why these plans were not announced with and coordinated within the G7 on Friday, the communiqué of which was vague. Exactly what the European Central Bank will do also remains unclear. And surely there are unaddressed gaps between these country-based approaches.

There will also be an end of mark-to-market accounting in Europe, which seems unfortunate. Reducing transparency is not obvious as an exit strategy in this environment.

The continental European moves follow steps by the British last week towards recapitalization. These resulted in lower credit default swap spreads for British and European banks (i.e., lower probability of default, in the market view), but LIBOR actually increased (i.e., interbank lending

problems did not get better). There were some signs that international trade credit was drying up on Friday, notwithstanding these policy moves.

The main result of these measures is that we can be somewhat more confident that a major financial panic causing the downfall of many European banks will not occur soon. However, although these moves mark a substantial change, it is not clear how this changes the (downward) trajectory of the real economy or turns around equity valuations in a sustained manner. Banks still need to deleverage in a major way and government equity injections will dilute existing shareholders. It is true that there should be more confidence in being a creditor to a European bank, but markets already thought they would get bailed out by European governments, so the gain in this regard is limited.

The grim reality is that most European nations cannot truly afford to bail out their banks if a serious recession occurs. For example, the assets of Royal Bank of Scotland are similar to the UK's entire GDP. If the UK's recession proves deep, markets will start to question whether the UK government can afford to finance these banks. It will be tempting to either default, or let inflation rise to erode the value of liabilities. The probability of default for sovereigns in Europe has risen significantly (although it still remains low) over the past 10 days.

### **America follows Europe**

The US is also moving towards bank recapitalization, but more slowly, and it is unclear if a comprehensive program is the top priority. It is true that the number of financial institutions in the US adds a level of complexity, and that there are various ways to treat nonbank financial institutions, each with its own drawbacks. The treatment of insurance companies remains a particularly important unclear part of the overall puzzle.

However, the US strategy also seems hung up on the original mission of the Troubled Assets Relief Program, which was to buy mortgage-backed securities (MBS). As this program is due to start in about a month, it now seems neither here nor there.

The US already has Fannie Mae and Freddie Mac buying up distressed mortgage-backed securities, to the tune of about \$40bn total per month. It is not clear why this has not been scaled up faster, particularly as it is much easier to run than the not-yet-designed TARP auctions. Fannie and

Freddie are capable of restructuring quite a large volume of MBS, if this were to become their top priority.

The US strategy for Morgan Stanley and Goldman Sachs remains unclear. For Morgan Stanley, a sale to foreigners (Mitsubishi UFG) with backstop from the Fed seems to be signaled, although it is not clear how this will play politically. Something similar might happen with Goldman Sachs. If those don't work, conservatorship is still possible. This is an important event to watch: if creditors are made whole, it will provide some badly needed additional confidence in bond markets. As of Friday, Morgan Stanley's long-dated bonds were trading at 50-60 cents on the dollar.

Once Morgan Stanley and Goldman Sachs are put to bed, there will be plenty more finance-related firms to come. The market knows that GMAC, Ford, GE and several other quasi-financial companies are at risk. Very recently, there has been a concerning rise in credit default swaps of large insurance companies: Prudential Financial now prices in a nearly 60% chance of default within five years, and other major insurance companies are at risk.

The US government was early to provide fiscal stimulus to the economy. There is now talk of additional assistance: Congressional leadership seems interested in a lame duck session, in part to put through a modest fiscal package (\$100-150bn).

### **Outside the US and Europe**

The situation around Iceland and the default of its banks seems to point the way for emerging markets that previously relied heavily on capital inflows or commodity exports. Unless a country has a sufficient balance sheet and a very large amount of reserves, there will be selective defaults and large devaluations. It is hard to see how the IMF or anyone else can provide resources on a sufficient scale to make a difference. Some countries in Eastern Europe and Latin America are clearly showing signs of risk.

The Russian situation may indicate the future path for other emerging markets. The government's assumption is that everything will be fine because oil will be at least \$60 per barrel oil as planned in their 2009 budget. Up to now, there was widespread agreement that this was a conservative assumption. But it now looks like oil could fall a lot more, and the equity prices of global oil companies are already indicating this.

Russia is perceived as having a significant potential mismatch problem between very short term liabilities and longer term assets. This is



complicated further by large private sector debt in foreign currency. The government may be moving toward deciding which companies they will save. Hopefully, for the companies they do not support, it will be possible to have an orderly workout. There is a real danger that the substantial reserves will be used now, to defend the exchange rate, rather than being saved for later, when they could be more use.

It is quite evident that foreign and domestic banks are changing their strategy in Russia, going for “quality rather than growth.” This will likely be the pattern much more generally, and points clearly to a major slowdown in growth across almost all markets.

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**Overview** (includes material from previous editions, edited partly in the light of reader comments). Readers familiar with this material should skip to the latest policy implications.

In order to figure out how to combat the current economic crisis, it is important to understand what kind of crisis we are dealing with. The conventional wisdom is that we are dealing with a housing crisis (falling housing prices) magnified by excessive leverage. But this puts the emphasis in the wrong place, and fails to grasp the key dynamics of the crisis.

### **More than a housing crisis ...**

Problems in the U.S. housing market triggered a global crisis of confidence in global financial institutions, but the housing problems themselves were not big enough to generate the current financial collapse.

America’s housing stock, at its peak, was estimated to be worth \$23 trillion. A 25% decline in the value of housing would generate a paper loss of \$5.75 trillion – similar to the losses observed in the 2000-2002 decline in stock prices, and not far off the losses as a share of GDP due to the 1987 stock market crash. With an estimated 1-3% of housing wealth gains going into consumption, this could generate a \$60-180 billion long-term reduction in total consumption – a modest amount compared to US GDP of \$15 trillion. The resulting decline in the US dollar, which boosts exports, and the offsetting fiscal stimulus, would probably have reduced the overall shock by at least half. We should have seen a serious impact on consumption, but, there was no reason to a priori believe we were embarking on a crisis of the current scale or entering a deep recession.

### **... not just too much leverage**

But, conventional wisdom continues, this fall in housing prices was magnified by leverage, causing financial institutions to collapse. But this is also not a compelling argument. There is no magical point at which an institution becomes too leveraged. The range of leverage at institutions varies enormously: typical commercial banks have assets which are 10-12 times their equity, while some investment banks recently had assets that were 30 times their equity. However, to the extent investment banks offer loans secured against underlying, liquid securities, those loans are more “secure” than typical commercial bank loans.

Credit in the economy, relative to the size of incomes, has been growing over the last 50 years, and it is hard to know when exactly the US had “too much” credit. Even if we assume that credit was overextended, today’s crisis was not a foregone conclusion. There are two possible paths to resolution for an excess of credit. The first is an orderly reduction in credit through decisions by institutions and individuals to reduce borrowing, cut lending, and raise underlying capital. This can occur without much harm to the economy over many years.

The second path is more dangerous. If creditors make abrupt decisions to withdraw funds, borrowers will be forced to scramble to raise funds, leading to major, abrupt changes in liquidity and asset prices. These credit panics can be self-fulfilling; fears that assets will fall in value can lead directly to falls in their value.

Although leverage itself did not cause the current crisis, now we can see how leverage can be calamitous: all leveraged financial systems, regardless of the level of leverage, have the ability to collapse far more sharply than prior fundamentals would deem plausible.

### **How a crisis of confidence spreads**

We have seen a similar crisis at least once in recent times: the crisis that hit emerging markets from Thailand to Korea to Russia to Brazil in 1997 and 1998. For countries then, read banks (or markets) today. In both sets of cases, a crisis of confidence among short-term creditors causes them to pull out their money, leaving institutions with illiquid long-term assets in the lurch.

The crisis started in June 1997 in Thailand, where a speculative attack on the currency caused a devaluation, creating fears that large foreign currency debt in the private sector would lead to bankruptcies and recession. Investors almost instantly withdrew funds and cut off credit to Malaysia, Indonesia and the Philippines under the assumption that they

were guilty by proximity. All these countries lost access to foreign credit and saw runs on their reserves. Their currencies fell sharply and their creditors suffered major losses.

From there, the contagion spread for no apparent reason to South Korea – which had little exposure to Southeast Asian currencies, and even participated in the IMF bailout of Thailand – and then to Russia. At the time, Russia was emerging from recession and had little exposure to Asia. However, Russia was funding deficits through short-term rouble bonds, many of which were held by foreign investors. When short-term creditors panicked, the best efforts of the government and the IMF could not prevent a devaluation (and a default on those rouble bonds). GDP fell 10% the following year, and creditors suffered in one of the largest single national defaults in history. After Russia, the story repeated itself in Brazil. In December 1998 Brazil let the currency float, leading to a sharp depreciation within one month.

In each case, creditors lost confidence that they could get their principal back and rushed to get out at the same time. In such an environment, leverage is not a necessary ingredient for a financial collapse; any institution that borrows short and lends long is vulnerable to such an attack. However, the contagion often spread despite little real economic links. The victims had one common trait: if credit were cut off they would be unable to find funding. The decision of credit markets became self-fulfilling, and policy makers around the world seemed incapable of stopping these waves.

### **How did we get here?**

In this context, the evolution of America's crisis seems remarkably similar to the emerging markets crisis of a decade ago.

America's crisis started with creditors fleeing from sub-prime debt in summer 2007. Rapidly rising default rates made clear these were poor investments. Investment-grade debt – often collateralized debt obligations (CDOs) built out of sub-prime debt – faced large losses. The exodus of creditors caused mortgage finance and home building to collapse.

The second stage began with the Bear Stearns crisis in March 2008 and extended through the bailout of Fannie Mae and Freddie Mac. As investment banks evolved into proprietary trading houses with large blocks of illiquid securities on their books, they became dependent on the ability to roll over their short-term loans, regardless of the quality of their assets. In other words, they became like emerging market

economies in 1997. And in a matter of days, despite no major news, Bear Stearns was dead.

However, while the Federal Reserve and Treasury made sure that Bear Stearns equity holders were penalized, they also made sure that creditors were made whole – a pattern they would follow with Fannie and Freddie. In effect, the government sent the message that creditors could safely keep their counterparty risk with large financial institutions – implicitly encouraging banks to continue lending to each other.

The third stage, beginning two weeks ago with the failure of Lehman and the “rescue” of AIG, marked a dramatic and damaging reversal of policy. Once Bear Stearns had fallen, it was natural that investors would focus on Lehman; and again, as confidence faded away, Lehman’s stock fell and its ability to borrow money evaporated. This time, however, the Fed let Lehman go bankrupt, largely wiping out creditors.

AIG was a less obvious candidate for a liquidity run. Despite large exposure to mortgage-backed securities through credit default swaps, no analysts seemed to think its solvency was truly in question. This changed almost overnight, not because of any fundamental changes, but simply because the markets decided that AIG might be at risk. As with Lehman, Treasury and the Fed sent the message that creditors would not be protected. The \$85 billion loan was not only granted at the usurious rate of LIBOR plus 850 basis points but secured by AIG’s most valuable assets, leaving senior debt trading at a 40% loss.

This decisive change in policy probably reflected a growing political movement in Washington to protect taxpayer funds after the Fannie Mae and Freddie Mac actions. In any case, though, the implications for creditors and bond investors were clear: RUN from all entities that might fail – even if they seem too big to fail, even if they appear solvent. As in the emerging markets crisis of a decade ago, anyone who needs access to the credit markets to survive might lose access at any time. The next targets were obvious: the previously invincible Morgan Stanley and Goldman Sachs, each with \$1 trillion balance sheets and a assets-to-equity ratios of 24 and 30, respectively (in the second quarter), saw large jumps in their credit default swap rates. Citibank, with its \$2 trillion balance sheet, also experienced a major fall in its share price.

As a result, creditors and uninsured depositors at all risky institutions are finding means to pull their funds – shifting deposits to Treasuries, moving prime brokerage accounts to the safest institutions (read JPMorgan), and cashing out of securities arranged with any risky

institutions. The sudden rise of LIBOR (for interbank lending) matched by a fall in short-term US Treasury rates illustrates the shift of funds from banks to Treasuries. These sudden changes in liquidity invariably lead to stress: the collapse of one money market fund (traditionally seen as safe and attracting retail customers), and the pending collapse of more, sent the U.S. Treasury into crisis mode.

Like a decade ago, the credit market shock waves spread quickly throughout the world. In Europe, interbank loan rates and EURIBOR rates shot up, and banks from Bradford & Bingley to Fortis were nationalized. Further afield, Russia and Brazil each saw major disruptions in their interbank markets and Hong Kong experienced a (small) bank run.

### **Creditor beware**

There is general fear around the world that any leveraged institution might fail. Capital and solvency don't matter, just whether the company can survive if short-term credit is cut off or borrowing rates sharply rise. JPMorgan obviously thought Bear Stearns was not insolvent when they paid \$10 per share in the fire sale; Lehman fell when it still had a reported book value per share of \$27.29; and the fall of AIG seems clearly due to a liquidity run. The problem is simple: there are just too few entities with a large enough balance sheet to stop liquidity runs. Once a liquidity run succeeds, liquidation destroys a large portion of the value, and creditors lose out. Self-fulfilling collapses can dominate credit markets during these periods of extreme lack of confidence.

There is a second aspect of these collapses. When companies fall, the survivors benefit: JPMorgan obtained Bear Stearns and Washington Mutual at fire-sale prices; Bank of America hauled in Merrill Lynch; Barclays and Nomura divided Lehman's assets; Warren Buffett negotiated a sharp deal with Goldman Sachs; Mitsubishi-UFG is doing the same with Morgan Stanley; and it looks like Wells Fargo will win the bulk of Wachovia. While the conventional wisdom views this as healthy, in reality this leads to predatory behavior by health companies. The acquirers have an incentive to wait, let a company fall, and then scoop up the assets, with the blessing of Treasury and the Fed. This is standard market behavior, without any collusion or conspiracy.

In this context, there are two critical questions. First, what happens next? And second, what can we do about it?

### **What's next?**

The events of the last few months could be setting the stage for a major global recession. In the face of uncertainty and higher credit costs, many spending and investment decisions will be put on hold. We will surely see US and European consumption decline along with housing prices. With credit default swap rates and interest rates rising around the world, companies will prefer to pay down debt and reduce spending and investment plans. State and municipal governments will see lower tax revenues and so cut spending. In the United States, we can no longer rely on exports to provide much cushion, as growth and spending around the world have been affected by the flight from credit.

There are two ways to end a crisis in confidence in credit markets. The first is to let events unfold until so much deleveraging and so many defaults have occurred that entities no longer rely on external finance. The economy then effectively operates in a “financially autonomous” manner in which non-financial firms do not need credit. This is the path most emerging markets took in 1997-1998. Shunned by the world investment community, it took many years for credit markets to regenerate confidence in their worthiness as counterparties. Today, the U.S. is still far from such a scenario.

The second is to put a large balance sheet behind each entity that appears to be at risk, making it clear to creditors that they can once again safely lend to those counterparties without risk. This should restore confidence and soften the coming economic recession.

The policy makers of the world’s financial powers have chosen the second route, as evidenced by the statements made at this weekend’s G7 and IMF meetings. However, so far they have failed to act swiftly and decisively enough to stem the panic. The original Paulson plan (to purchase mortgage-backed securities) was not enough. \$700bn is a relatively small fraction of the amounts in question. More than a week after passage, many details remain unclear.

The consensus seems to be shifting toward more drastic steps, including explicit bank recapitalization (since discovered in the Paulson plan) and guarantees of bank obligations. The coming week will see the announcement of many specifics, and will reveal whether these are able to restore confidence in the credit markets.

As the wealthiest nations protect their banking sectors, damage will spread to emerging market economies. Iceland is already facing default, either by its banking sector or by its government. Capital flight to the safety of the G7 will trigger major deleveraging in overextended

countries around the world. Falling commodity prices due to the coming recession will also hurt many exporting countries.

Additional decisive, well-timed measures will be needed to restore confidence, and these should be thought out and prepared in advance. See our [policy proposals](#) for details.

## Bank Recapitalization Monday

James Kwak | 13 Oct 2008

Those of you reading the news may be having trouble keeping all of this morning's events straight. Here's a quick summary:

1. The UK announced specific plans to recapitalize three of its largest banks – RBS, HBOC, and Lloyds TSB – with up to 37 billion pounds of government money. Separately, Barclays announced plans to raise money independent of the government. This seems to be the implementation of a plan that was announced last week.
2. Mitsubishi finally closed its deal to invest \$9 billion in Morgan Stanley, gaining a 10% dividend on its shares (similar to Buffett's investment in Goldman). This deal, which had been pending for weeks and some had given up for dead, will help boost confidence in Morgan Stanley. Note that unidentified sources have claimed that the US government promised to protect Mitsubishi's investment; it's not clear if that's part of the final deal.
3. The Federal Reserve and several of its counterparts announced an expansion in the supply of credit to banks around the world in US dollars. The Fed said it will make available as many dollars as the other participating central banks need. They will then lend the money out to their banks against whatever collateral is appropriate under their rules. This is another move to increase liquidity in the financial system; however, for several weeks now it's been apparent that liquidity alone is not enough to solve the problem.
4. Following yesterday's agreement in principle, major Eurozone countries are announcing their rescue plans today, including both bank guarantees and recapitalization. Germany announced 400 billion euros to guarantee bank loans and 80 billion euros for recapitalization; France announced 320 billion for loan guarantees and 40 billion for recapitalization; Spain passed legislation providing 100 billion for loan guarantees and allowing the government to recapitalize banks by buying shares. I believe Italy is expected to make an announcement soon.

In summary, governments are taking the kind of steps that are necessary to halt the crisis. Loan guarantees and bank recapitalization are two of the steps we have been advocating. However, the jury is still out on whether they are coordinated and decisive enough. The much-followed TED spread (a measure of banks' willingness to lend to each



other) is only down by 7 basis points, although that may in part be due to the fact that the bond market is closed in the US today due to a holiday. All eyes are now on Washington, where a more definitive bank recapitalization plan is widely expected. Neel Kashkari, Paulson's point man on the crisis, said today only that "We are designing a standardized program to purchase equity in a broad array of financial institutions." (He said a lot of other things on a broad range of other topics.) Finally, this burst of support for wealthy countries' banks could have unintended effects on emerging markets, as we discussed previously.

**Update:** Austria, the Netherlands, and Italy are also on board.

## US Bank Recapitalization: Waiting for Kashkari

James Kwak | 13 Oct 2008

The US stock market soared upward today, partly on the announcements by every major European country that they will be protecting their banking sectors, but largely on the expectation that the US will take similar measures – namely, bank recapitalization and loan guarantees – in the next couple of days. A fair amount of attention was drawn to the following statement by Neel Kashkari this morning:

4) Equity purchase program: We are designing a standardized program to purchase equity in a broad array of financial institutions. As with the other programs, the equity purchase program will be voluntary and designed with attractive terms to encourage participation from healthy institutions. It will also encourage firms to raise new private capital to complement public capital.

However, a couple things should be pointed out. First, this was #4 out of 7 initiatives that Kashkari's team is working on, including buying mortgage-backed securities, buying whole mortgages, insuring MBS, etc. So as I said on WNYC this afternoon (clip may not be up yet), this isn't really new information. Second, the program is voluntary. This means that bank shareholders can take it or leave it; if they don't like the terms the government is offering, they can choose to stay out on the thin ice and hope it doesn't break. I'm not saying the government should be forcibly nationalizing banks, but this does raise a potential issue. Third, it is designed only for "healthy institutions," which raises the question of who is healthy today. Perhaps the idea is to shore up a few major banks and let them buy up assets from the others – a plausible strategy – but it isn't clear.

Luckily, word is that something will be announced tomorrow, so we won't have long to wait. If you get any early leaks, please share.

## **Solving the Financial Crisis on MIT Podcast**

**James Kwak** | 14 Oct 2008

Simon discusses the financial crisis and some possible solutions on an MIT podcast (11 min.).

## Bank Recapitalization Arrives in the U.S.

James Kwak | 14 Oct 2008

As you have no doubt heard by now, the U.S. joined most of Western Europe in announcing a bank recapitalization plan and additional guarantees on bank obligations this morning. The key details are:

- \$250 billion of TARP money will go to the program, with about \$125 billion already allotted to 8 banks (9 including Merrill) who were given take-it-or-leave-it offers yesterday.
- The government will generally put in between 1% and 3% of assets held by a participating bank.
- Most if not all banks will be eligible; it's not clear what happens if the \$250 billion is oversubscribed.
- The government gets non-voting perpetual preferred shares (no conversion to common), callable after 3 years, with a 5% dividend, increasing to 9% after 5 years.
- The government also gets warrants to buy common shares up to 15% of the preferred investment.
- Although the shares are non-voting, participating companies have to follow Treasury guidelines on executive compensation and corporate governance.

In addition, the government announced a blanket deposit guarantee on non-interest-bearing deposits and a 3-year guarantee of new senior debt issued by banks.

This is definitely at least two steps in the right direction. Nevertheless, some concerns to think about are:

1. Is it enough money? 1-3% of assets isn't much if we are worried about additional writedowns. Besides the writedowns we expect on mortgage-backed securities, a recession will increase losses on all types of loans. Fortunately I don't see any reason why more of the \$700 billion couldn't go into this program if warranted.
2. Couldn't we have gotten a better deal? Buffett got a 10% dividend and more warrants at a cheaper price on his Goldman investment. However, this plan was structured to protect the interests of existing shareholders to maximize the chances that banks would participate, which may have been the right tradeoff.
3. How do we make sure the banks behave sensibly in the future? By getting non-voting shares – as opposed to the UK plan, which will allow the government to appoint bank directors – Treasury has

given up one form of control, presumably to avoid charges that the government is meddling in bank operations. This just means that regulation will be especially important.

Although the stock market is moving sideways, the credit market seems to be mildly positive: yields on 3-month T-bills are up 20 basis points (meaning that less money is fleeing to quality) and the TED spread is down 33 basis points (meaning banks are more willing to lend to each other).

## Recapitalization for Beginners

James Kwak | 14 Oct 2008

Because it's the hot topic of the week, and I've used the phrase about 87 times so far, I've added a section to the Financial Crisis for Beginners page on bank recapitalization. There's also a new link in the radio section on how to track the credit crisis.

Let us know if there are other topics that you think need an introductory treatment.

## Nationalization?

**James Kwak** | 15 Oct 2008

See here for a range of views (including Simon's). On balance, the government owns some shares – and it twisted some arms to get them – but the percentages are pretty low, it has no voting rights, the conditions are pretty light (basically just the limits on executive compensation), and the bottom line is that the banks got a pretty good deal relative to what they might have hoped for from private investors. Some will no doubt complain of socialism, but these investments give the government limited if any influence over bank operations.

Of course, the government still has the power of regulation, which most people expect (and hope) will be greatly strengthened.

## The Bailout: Yes, But Will It Work?

James Kwak | 15 Oct 2008

Every week, it seems, we see a new high-water mark for government intervention in the financial sector, culminating (?) in today's announcement that the government is buying \$125 billion of preferred stock in nine banks, with another \$125 billion available for others. The recapitalization, loan guarantees, and expanded deposit insurance are the most aggressive steps taken yet in the U.S. and were all on our list of recommendations.

I think it is highly likely that today's actions will boost confidence in the banking sector. First, the banks involved have fresh capital; second, they can raise new debt more easily thanks to the loan guarantees; and third, because the U.S. government is now a major shareholder, it is even less likely that the government will let one of them fail. I could be wrong, but I think worries about bank defaults, at least for participating banks, will start to recede.

The next question, however, is what the impact will be on lending to the real economy, and here the outlook is less certain. In a press conference today, Paulson said, "The needs of our economy require that our financial institutions not take this new capital to hoard it, but to deploy it." However, it's not clear that he has the tools to compel the banks to increase lending. The terms of the investment are relatively favorable to the banks – 5% dividend, no conversion to common, no voting rights (unless the dividends are not paid for several consecutive quarters). So the self-interested thing for banks to do may be to take the cash and pay down higher-yielding debt on their books. Hopefully as the financial system returns to normal banks will go back to doing what they usually do, which is lend money.

All that said, I think we're still in better shape than two days ago.

Some people have asked me how you can tell if the bailout, or anything else the government is trying, is working, since the stock market is largely noise. I'm no expert here, so I'll point you to a couple of other measures of the credit market that people have recommended. One is the TED spread (3-month LIBOR minus 3-month T-bills; explanation here), a measure of banks' willingness to lend to each other as opposed to buying Treasury bills, which came down today (which is good). The blog Calculated Risk also recommends a few metrics you can look at.





## **Not Bad, Mr. Paulson ...**

**James Kwak** | 15 Oct 2008

Peter, Simon, and I wrote an op-ed for today's Washington Post reviewing the latest version of the U.S. bailout (already serially discussed on this blog). Our verdict? Pretty good, perhaps not enough money, and the lack of government control over the banks only emphasizes the need for better regulation in the future.

## Where Do We Go from Here?

James Kwak | 16 Oct 2008

(Which is, of course, a song from the great Buffy episode, “Once More, with Feeling.”)

After the last week, it was a relief to have a relatively slow news day, at least compared to the preceding days, to catch our breath and take stock of things (and get over my cold). American and European policy makers decided they needed to use overwhelming force to stop the panic in its tracks. It will take some time to see if they used enough; the credit markets have certainly not opened up, although some indicators have gotten marginally better (the TED spread is slightly down; T-bill yields are slightly up).

There are two directions things could go. First, it is possible that the credit markets will not come unstuck, and even more force will be required; blanket loan guarantees (for all bank obligations) and large recapitalizations (more than 3% of assets) would then be called for. Second, and more likely, we think, credit will gradually start flowing again. But even in that case, the global economy will be far from out of the woods. Here are the top issues that will still need to be faced:

- Implementing the Paulson plan, including both bank recapitalization and, if still included, asset purchases. This will require dealing with all of the issues of governance and pricing that we have commented on previously.
- Containing the damage of falling housing prices and foreclosures. Asset prices do need to fall to reasonable levels – trying to prop them up at artificially high levels will only hurt the economy in the long run – but limiting an overcorrection and limiting the collateral damage have to be priorities.
- Stimulating the real economy. Even if the credit crunch eases in, say, the next few weeks, the last month has already done significant damage to the global economy (which was already in the midst of a slowdown). For starters, just think of all the uncertainty and anxiety that have been generated in the last month, and the impact that will have on spending and investment by consumers and businesses. The fall in the stock market will also add to the negative wealth effect of falling housing prices.
- The international dimension and emerging markets. We could be moving to a situation where core banks in wealthy countries are

considered safe, while banks in emerging markets are still considered shaky. This could trigger a repeat, on a larger scale, of the emerging markets crisis of 1997-98. And severe economic dislocation can always have political consequences as well.

- **Update:** How did I forget ... financial sector regulation?

These are some of the major issues we will be thinking about over the next few weeks and months (and possibly years). Let us know what else you think should be on the agenda.

## The Last Six Weeks, Summarized

James Kwak | 16 Oct 2008

One of our goals is to help increase understanding of the financial crisis, so that people can understand the policy choices facing our countries today. Doug Diamond and Anil Kashyap have done two guest posts on the crisis for the Freakonomics blog: one on September 18, just after the announcement of the Paulson plan, and one just yesterday. These aren't quite explanations for beginners – they presume some understanding of debt, equity, credit default swaps, and so on – but they summarize and explain some of the key developments relatively clearly, and also lay out their opinion of the current U.S. recapitalization plan.

## Which Stimulus Package?

James Kwak | 17 Oct 2008

As I mentioned yesterday, stimulating the real economy must be one of Washington's top priorities once the credit crunch begins to ease. The debate over how to do that is well underway. The Democratic Congressional leadership is preparing a stimulus package including increasing money for states and cities to replace their plummeting tax revenues, increased or extended unemployment benefits, increased food stamp aid, and public works (infrastructure) projects. All of these steps would have the effect of increasing spending by consumers and governments with the goal of dampening the recession, although public works projects could take months if not years to have an impact. One goal of the plan is to get money to people who are likely to spend it – hence the emphasis on lower-income people and cash-strapped local governments – to get it into the economy as quickly as possible.

Both presidential candidates are also talking about stimulating the economy, although their proposals are wrapped up in their broader campaign themes almost to the point of incoherence.

Barack Obama's plan, released on Monday, includes immediate tax rebates, an extension of unemployment benefits, penalty-free withdrawals from 401(k) plans, increased funding to offset winter heating costs, \$25 billion for state and local governments, emergency lending for small businesses, tax credits and tax cuts for small businesses, and \$25 billion for infrastructure spending. (I'm both proposals dealing specifically with the financial sector and proposals that will obviously only have long-term effects.) Like the Congressional plan, the primary emphasis is on getting more money into the hands of people who will spend it quickly, although again the infrastructure funding could take a while to flow into the economy.

On Tuesday, John McCain announced a new set of proposals, including tax reductions on IRA withdrawals for seniors, reduced capital gains taxes, increased deductions of capital losses, and a suspension of the tax on unemployment benefits. Apart from the last, these tax reductions will benefit people in proportion to the amount they withdraw from their IRAs, the amount of their capital gains, and the amount of their capital losses – all of which mean people with more money will get more benefit. While there are arguments for this type of policy, it would probably slow the rate at which tax reductions turn into

spending on goods and services. Of course, the centerpiece of McCain's economic plans these days is his proposal for the government to buy whole mortgages from lenders and investors. Here, there has been a lot of confusion over whether the government would pay face value or market value for those mortgages (sound familiar? it's the same debate we had over the Paulson asset purchase plan), and hence whether the plan would essentially be funded by taxpayers or by forcing investors to take losses. In either case, the net stimulus would probably be relatively small, since homeowners who previously could not afford their mortgages would now barely be able to afford their mortgages and hence would have little additional income for consumption. (Granted, the goal of the plan is to decrease foreclosures and to prop up mortgage-based securities.)

There is also a debate over the stimulus (which we will probably join soon) among a panel of economists over at the National Journal, where even the representative of the American Enterprise Institute says the case for a fiscal stimulus is "overwhelming."

So start thinking about what you think should be in the eventual package.

## Credit Crunch Easing?

James Kwak | 17 Oct 2008

There is some evidence that the mood in the financial sector is very cautiously optimistic. The TED Spread is down 18 basis points to 3.89%, from a high of 4.64% a week ago. (This is 3-month LIBOR minus 3-month T-bills, and hence a measure of banks' willingness to lend to each other rather than to the U.S. government.) Still, it may take weeks for banks to have cash in the places they need it and feel comfortable loaning money again.

The highly informative and frequently updated blog Calculated Risk (link also in our sidebar) is doing a daily post on this and other credit market measures, so if you're addicted you may want to go there.

True junkies may prefer Across the Curve, which focuses exclusively on credit markets, including some you've never heard of.



## Can We Afford the Bailout?

James Kwak | 17 Oct 2008

Even the most casual observer will have realized that the U.S. government is laying out a lot of money to combat the financial crisis. Which raises the obvious question: can we afford it?

The first important thing to keep in mind is that the U.S. government, unlike every other government in the world, has the ability to borrow virtually unlimited amounts of money. The U.S. dollar is still the world's reserve currency, and Treasury bonds are still the risk-free asset of the global economy. In times of crisis, when smaller countries find it harder to raise money, the U.S. actually finds it easier, because investors are ditching whatever risky assets they are holding and buying U.S. Treasury bills and bonds instead. Currently, the U.S. is paying virtually no interest on short-term borrowing (and probably negative interest in real terms).

The second thing is that, while 12-figure numbers are thrown around routinely, these large numbers do not all amount to pure losses. The \$700 billion for the Paulson plan was initially intended to buy mortgage-backed securities which would eventually be resold, probably at a loss, but not necessarily a huge one. In the current form, \$250 billion of that money is going to buy preferred shares in banks that (a) pay a 5% dividend and (b) will also be resold, in this case probably at face value (if the banks don't buy them back after 3 years, the dividend goes up to 9%). On the other hand, guaranteeing the obligations of Fannie and Freddie, and new bank debt, also create additional potential exposure, but in each case it's not as if the government has to borrow additional money now. In each case, the financial institutions being guaranteed have assets to match those liabilities, and the calculated expectation is that only a small proportion if any of these guarantees will ever be triggered.

So as others have put it, the government is in some ways acting as a bank. It is borrowing money by issuing more Treasury bonds to a market that wants lots and lots of Treasury bonds, and hence the cost of borrowing is not going up. Then it is using the money to buy financial assets from financial institutions. For the government, these assets may go up or down in value. For the financial institutions, they now have the cash that the private credit markets are unwilling to lend to them. In the

current situation, this is an excellent use of the government's unique borrowing power.

Still, the inevitable stimulus package will require yet more money, either in increased spending or reduced tax revenues. Some will no doubt protest that this is an unsupportable expansion of an already large and growing national debt. And it is true that the more money we borrow, the closer we come to the point where foreign investors and central banks may start looking for safe havens other than the U.S. dollar. But given that we are facing what could be the worst recession in thirty years – and given that the \$100 billion stimulus implemented earlier this year wore off after one quarter – the government needs to err on the side of providing too much rather than too little stimulus. If there ever was a time for deficit spending (and I realize that there are people who think there is never such a time), this is it.

Besides, you don't have to believe me; you can believe the latest Nobel Prize winner.

**Update:** The Economist points to two stories on the growing consensus that increasing the national debt is the way to go.

## Sentiment

**Simon Johnson** | 18 Oct 2008

I've spent quite a bit of time over the past week talking with people caught up in the financial crisis, one way or another. Some of these people are deeply involved in finance, while others are quite far from finance but now see many more connections that they previously realized.

Three thoughts keep reappearing in these conversations:

1) People's expectations have definitely been shaken up. For some it was the original Paulson proposal (\$700bn to be used at his discretion), coming only days after he and Mr. Bernanke said that the economy was "fundamentally" fine – by which they meant we would dodge a recession. For others it was President Bush's first speech on the subject, in which he said that if Congress did not pass the relevant legislation (now called the TARP), there would be very bad consequences. And for others it was the dramatic sequence of events last weekend, from the meeting of the G7 to the abrupt U-turn on bank recapitalization, first by the Europeans and then by the US. In any case, pretty much everyone I've talked now understands that we are no longer facing "business as usual".

2) At the same time, there is still great confusion about what is going on, precisely why, and what are the options going forward. I think this confusion is quite general, and I regard myself as no exception. In fact, as one of my colleagues at the Peterson Institute for International Economics wisely noted last week, "if someone says they are not confused by the current situation, they are not leveling with you." As a result, we start to think about changing things we do, but it is reasonable to hesitate before taking real action. I was asked earlier this week (for a weekend show produced by Marketplace, which will air on Saturday) what I am doing differently, compared with a month or a year ago. The answer is nothing much, at least in terms of investment or spending, at least for now.

3) And it's the "at least for now" part that is worrying. Obviously the "authorities" (jargon for the people who run the country) in G7 and other industrialized countries woke up to the true situation about 5 or 6 days ago, and they took what is – for them – dramatic action. I have never seen them move so far so fast, and we have tried to recognize and applaud those moves at every opportunity. But now we wait, holding

our breath, to see the effect on confidence. I look at the US and European stock markets, as does everyone else, and my mood swings with it. But I also look at what is happening in credit markets, particularly in emerging markets. This does not look encouraging. I think it is time to work seriously on measures that will reduce the costs of and speed the recovery from what appears to be a serious imminent global recession. This is now our priority; to help, please post your ideas as comments here.

## **The G8 called but they didn't leave (much of) a message**

**Simon Johnson** | 18 Oct 2008

On Wednesday, a colleague drew my attention to the fact that the G8 had issued a statement on the global economy from Grand Rapids, Michigan. I quickly glanced at their points and thought they didn't add much beyond what had been said at various G-numbered, EU-type, and other subgroups over the weekend: we're doing a lot, things will get better, trust us, etc.

Still, I was impressed that the G8 had got together quickly and, of course, the fact that Russia had joined hands with the G7 (this is how you get to 8) might be significant given the strains currently apparent in Russia and apparently looming elsewhere. So the following morning I opened the Wall Street Journal to learn more about the form of their meeting and background on the context, including any supplementary communication of messages (i.e., any such statement usually comes with spin.)

To my surprise, I found no mention in the Journal that day (sorry if I missed it; let's say it wasn't an article the front page, and if it was in the short highlight points, it was in very small print.) I had an opportunity on Friday to ask someone who tracks the White House closely, and he confirmed the statement came after a phone call or series of calls involving President Bush (who was visiting Michigan) and generally was not much of a news event.

Now, I wouldn't want to make too much out of this particular incident. And I do think that, overall, policymakers at the G7 level and their close colleagues elsewhere have had a better week. But I do begin to wonder if people are relying on G7-G8 stewardship of the global economy as they have in the past.

And rule #4 in the crisis manager's handbook is quite clear: when you have nothing to say, say nothing.

## Slouching Toward Recession

James Kwak | 18 Oct 2008

In any other week, the blizzard of bad real-economy news this week would have been a major story. Not this week, though, when the bailouts announced on Monday and Tuesday left the economic world in a state of cautious optimism and the stock market actually closed up for the week (admittedly, after a terrible previous week). Let's just summarize:

- Construction: Housing starts in September were 31% down from a year before, lower than expected, and building permits were down 38%.
- Retail spending fell 1.2% month-over-month in September, after declines in the previous months.
- Industrial production fell 2.8% month-over-month, far more than expected.

And remember, the acute phase of the credit crisis only began in the middle of September when, in the space of four days, Lehman failed, AIG was bailed out, and Paulson and Bernanke announced that we were all in serious trouble. The mood of general panic that set in then and only began to dissipate this past week is only partially reflected in these figures. In case anyone isn't sure why these numbers matter: when consumers buy less, and companies produce less, that's when companies lay people off.

I don't think I'm frightening anyone here, since just about everyone thinks that we're already in a recession. I just want to reiterate the point that even if the credit crisis begins to lift, the preceding slowdown in the real economy has become a major problem that will need major action to solve. Hence the importance of the discussion of fiscal stimulus that is kicking into gear among both economists and politicians.

## Emerging Market Developments

James Kwak | 18 Oct 2008

One of our readers raised some good questions about emerging markets on [another post](#), and I've been planning to give you a brief update about events outside the G7, especially since we've been warning about potential problems.

First, according to Satyajit Das on [Planet Money](#), Iceland's stock market has lost 80% of its value, its currency has lost 95% of its value, and people are beginning to wonder if the country will have enough foreign currency to import enough food. In Iceland, as many people have reported, the main issue is a rapid de-leveraging as a banking sector that grew rapidly using foreign borrowing collapses as credit dries up.

Second, [Hungary and Ukraine](#) are looking for aid packages – Hungary received 5 billion euros from the European Central Bank, Ukraine was looking for \$14 billion from the IMF. Dominique Strauss-Kahn, the managing director of the IMF, said, "Many countries seem to be experiencing problems because of the repatriation of private capital by foreign investors or the reduction of credit lines from foreign banks." In other words, in a global credit crisis, people don't want to lend to emerging markets. (The FT also published more analysis of Eastern Europe by [Stefan Wagstyl](#).)

Finally, Newsweek has a story about the crisis in [Pakistan](#). While domestic political instability certainly predates the financial crisis, now the economy is also under pressure. One problem: "Whereas the previous government was able to finance its current account deficit through privatization proceeds, bonds issues, and foreign direct investment, these channels have dried up with Pakistan's security woes and the global credit crisis." As of today, Pakistan is potentially looking to the IMF for an [aid package](#). I assume most American readers know why instability in Pakistan is a bad thing.

One common thread is that, when lenders stop lending, emerging markets are among the first to lose access to money. Iceland is perhaps the most extreme case, where entire economy had the characteristics of an overleveraged Wall Street bank. But other countries with significant foreign-currency debts are suffering from crises of confidence by external lenders who want to get their money out before everyone else does.

Besides potentially causing steep domestic recessions and severely reducing the purchasing power of local populations, emerging market

problems spill back into wealthy countries in at least two ways. First, as banks (or countries) default on their debt, lenders in those wealthy countries have one more asset they have to write down on their balance sheets. Second, the fewer strong economies out there, the fewer people available to buy our exports. Finally, the other thing we should be concerned about is political instability. Economic crises – especially after periods of increasing prosperity (see Alexis de Tocqueville) – have a way of triggering political crises in which unsavory authoritarian governments, or at least anti-Western, anti-capitalist governments, come to power. Let's hope it doesn't come to that this time.



## Recession in China?

James Kwak | 19 Oct 2008

OK, that may be a bit of a stretch. But there's little doubt that the global recession will take its toll on China's double-digit growth rates.

One (emailed) response to our recent Washington Post op-ed criticized us for overlooking the role of China (although we did discuss China in the following Forbes article). In particular, the reader said, "it is my opinion that China holds all of the cards and I believe they will likely play some of them early in the next U.S. administration" – this because of China's role in financing the U.S. deficits by investing in Treasuries. This may be true in the long run, although of course China cannot try to damage the U.S. economy without also crippling its own export-dependent economy. More immediately, though, China is facing an old-fashioned slowdown of its own.

All Things Considered did a story this past week on the impact of the global slowdown on Chinese exporters. One figure jumped out at me: 80% of the toy factories in Guangdong province have closed.

Also, the Baltic Dry Index, a measure of bulk cargo shipping costs and hence of global demand for heavy stuff (largely commodities) has fallen off a cliff this year (see the second chart in that post) – one reason why the Shanghai Composite Index is down more than 60% this year.

China is a place I won't claim to understand. But as we all know, the Chinese government relies on an unsteady equilibrium in which it uses economic growth to legitimize the political system and convince the growing middle classes not to question the political order. Tocqueville's observation (which I alluded to in my previous post) about the tendency of political strife to arise not out of prolonged abject misery, but when increasing expectations are dashed, could turn out to be particularly appropriate for China.

**Update:** Thanks to Randy for his comment (below). I fixed the error regarding the Baltic Dry Index.

**Update:** The Economist has a post with almost the same title as this post – but no question mark.

# Regulating the Financial Sector: A Modest Proposal

James Kwak | 19 Oct 2008

Building a new regulatory structure for the financial sector to replace the current, completely discredited regulatory structure will be a major task for the next administration and congress. However, at present there is a wide range of opinion over what needs to be done – believe it or not, there are those out there who think that what we need is less regulation rather than more. We'll be pointing out serious proposals that we find out there. Note that linking does not necessarily constitute endorsement.

James Crotty and Gerald Epstein of the University of Massachusetts have put forth their nine-point plan for financial system regulation ([abstract online](#), or [download the PDF](#) – it's only 13 pages). Most economists (though perhaps not most people) would classify them somewhere on the heavy-handed end of the spectrum. The nine points, in summary, are:

1. Restrict or eliminate off-balance sheet vehicles
2. Require due diligence by creators of complex structured financial products (so if you create a CDO, you have to understand all the stuff in it)
3. Prohibit the sale of financial securities that are too complex to be sold on exchanges
4. Transform financial firm incentive structures that induce excessive risk-taking (so people who get big bonuses in good years have to pay them back in bad years)
5. Extend regulatory over-sight to the "shadow banking system" (hedge funds, private equity, special investment vehicles)
6. Implement a financial pre-cautionary principle (like with drugs, innovations have to be approved first)
7. Restrict the growth of financial assets through counter-cyclical capital requirements (um ... read the proposal yourself)
8. Implement lender-of-last-resort actions with a sting (punish the people responsible when you bail out their companies)
9. Create a bailout fund financed by Wall Street (use a securities transaction tax to create a bailout fund to use next time)

I'm skeptical about 4 and 8 – human ingenuity is perhaps nowhere so unparalleled as in the creation of executive compensation schemes designed to avoid any possible constraint. 3 and 6 will be extremely controversial and can be seen as infringements on freedom of contract, at

least where “sophisticated” investors are concerned. 9 is also controversial, although a variant of it was actually in the \$700 billion bailout bill. But it doesn’t hurt to start thinking about it now.

## Capitalism = Government Intervention

James Kwak | 19 Oct 2008

OK, that may be an overstatement. When I was in graduate school, I was a “reader” (meaning I graded exams) for a course on recent US history taught by Richard Abrams. What I took away from that course was that virtually all government intervention in or regulation of the economy was done at the request of some part of the business community – most often entrenched incumbents lobbying the government for protection from new entrants.

Colleen Dunlavy of the University of Wisconsin has a blog post about the history of government intervention in the economy. Most critics of government intervention take one or both of two positions: (a) it doesn’t work or (b) it’s un-American (read: socialist). Dunlavy pretty much destroys argument (b) and, along the way, gets in some blows to argument (a). It’s useful reading as we head into a season of expanded government intervention and regulation in the financial sector.

## **Baseline Scenario, 10/20/08**

### **Baseline Scenario, October 20, 2008**

By Peter Boone, Simon Johnson, and James Kwak, copyright of the authors

[Download PDF](#)

The Baseline Scenario is our periodic overview of the current state of the global economy and our policy proposals. It includes three sections:

1. Updates that have caused us to modify the baseline since the last version
2. Analysis of the current situation and how we got here
3. Policy proposals

Please note that we do not currently publish our upside and downside risk scenarios in detail.

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## **UPDATES**

This edition of the Baseline Scenario has been extensively updated to reflect recent events, in particular the adoption by the world's leading economic powers of the first two of our proposals in our original Baseline Scenario.

### **Europe and the US recapitalize**

Last week was a momentous week in the financial crisis, with Europe and the US taking their largest steps yet to stem the credit crunch. On Monday, the UK implemented its bank recapitalization plan, and several European countries announced plans for recapitalization and loan guarantees. As we found out that night, Henry Paulson spent the day twisting the arms of nine US bank CEOs, and the next morning the US announced that \$250 billion of TARP money was going into recapitalization.

### **Is the credit crisis easing?**

There are real signs that the credit crisis is easing, at least as far as interbank lending is concerned. LIBOR is coming down, Treasury bill yields are going up, and the market for high-quality commercial paper has started to come back to life. To track this on a daily basis, try Calculated Risk or Planet Money. (However, although banks are finding it slightly easier to raise money, mortgage rates have actually gone up.)

### **The real economy continues slowing**

A barrage of economic indicators shows the economy slipping further into recession, at least in the US.

### **Emerging market problems deepen**

The other major development of the week has been the increasing problems faced by emerging markets, even potentially China.

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## **ANALYSIS (largely rewritten this week)**

### **The roots of the crisis**

For at least the last year and a half, as banks took successive writedowns related to deteriorating mortgage-backed securities, the conventional wisdom was that we were facing a crisis of bank solvency triggered by falling housing prices and magnified by leverage. However, falling housing prices and high leverage alone would not necessarily have created the situation we are now in.

The problems in the U.S. housing market were not themselves big enough to generate the current financial crisis. America's housing stock, at its peak, was estimated to be worth \$23 trillion. A 25% decline in the value of housing would generate a paper loss of \$5.75 trillion. With an estimated 1-3% of housing wealth gains going into consumption, this could generate a \$60-180 billion reduction in total consumption – a modest amount compared to US GDP of \$15 trillion. We should have seen a serious impact on consumption, but, there was no a priori reason to believe we were embarking on a crisis of the current scale.

Leverage did increase the riskiness of the system, but did not by itself turn a housing downturn into a global financial crisis. There is no basis on which to say banks were too leveraged in one year but were safe the year before; how leveraged a bank can be depends on many factors, most notably the nature and duration of its assets and liabilities. In the economy at large, credit relative to incomes has been growing over the last 50 years, and even assuming that credit was overextended, today's crisis was not a foregone conclusion.

There are two possible paths to resolution for an excess of credit. The first is an orderly reduction in credit through decisions by institutions and individuals to reduce borrowing, cut lending, and raise underlying capital. This can occur without much harm to the economy over many years. The second path is more dangerous. If creditors make abrupt decisions to withdraw funds, borrowers will be forced to scramble to raise funds, leading to major, abrupt changes in liquidity and asset

prices. These credit panics can be self-fulfilling; fears that assets will fall in value can lead directly to falls in their value.

### **A crisis of confidence**

We have seen a similar crisis at least once in recent times: the crisis that hit emerging markets in 1997 and 1998. For countries then, read banks (or markets) today. In both cases, a crisis of confidence among short-term creditors caused them to pull out their money, leaving institutions with illiquid long-term assets in the lurch.

The crisis started in June 1997 in Thailand, where a speculative attack on the currency caused a devaluation, creating fears that large foreign currency debt in the private sector would lead to bankruptcies and recession. Investors almost instantly withdrew funds and cut off credit to Malaysia, Indonesia and the Philippines under the assumption that they were guilty by proximity. All these countries lost access to foreign credit and saw runs on their reserves. Their currencies fell sharply and their creditors suffered major losses.

From there, the contagion spread for no apparent reason to South Korea – which had little exposure to Southeast Asian currencies – and then to Russia. Russia also had little exposure to Asia. However, Russia was funding deficits through short-term ruble bonds, many of which were held by foreign investors. When short-term creditors panicked, the government and the IMF could not prevent a devaluation (and a default on those ruble bonds). GDP fell 10% the following year. After Russia, the story repeated itself in Brazil. In December 1998 Brazil let the currency float, leading to a sharp depreciation within one month.

In each case, creditors lost confidence that they could get their principal back and rushed to get out at the same time. In such an environment, any institution that borrows short and lends long is vulnerable to such an attack. The victims had one common trait: if credit were cut off they would be unable to find funding. The decision of credit markets became self-fulfilling, and policy makers around the world seemed incapable of stopping these waves.

### **The current crisis**

The evolution of the current financial crisis seems remarkably similar to the emerging markets crisis of a decade ago.

America's crisis started with creditors fleeing from sub-prime debt in summer 2007. As default rates rose, investment-grade debt – often collateralized debt obligations (CDOs) built out of sub-prime debt –

faced large losses. The exodus of creditors caused mortgage finance and home building to collapse.

The second stage began with the Bear Stearns crisis in March 2008 and extended through the bailout of Fannie Mae and Freddie Mac. As investment banks evolved into proprietary trading houses with large blocks of illiquid securities on their books, they became dependent on the ability to roll over their short-term loans, regardless of the quality of their assets. Given sufficient panic, it can become impossible to roll over those loans. And in a matter of days, despite no major news, Bear Stearns was dead. However, while the Federal Reserve and Treasury made sure that Bear Stearns equity holders were penalized, they also made sure that creditors were made whole – a pattern they would follow with Fannie and Freddie. As a result, creditors learned that they could safely continue lending large financial institutions.

This changed on September 15 and 16 with the failure of Lehman and the “rescue” of AIG, which saw a dramatic and damaging reversal of policy. Once Bear Stearns had fallen, investors focused on Lehman; again, as confidence faded away, Lehman’s ability to borrow money evaporated. This time, however, the Fed let Lehman go bankrupt, largely wiping out creditors. AIG was a less obvious candidate target. Despite large exposure to mortgage-backed securities through credit default swaps, no analysts seemed to think its solvency was truly in question. Overnight, however, without any fundamental changes, the markets decided that AIG might be at risk, and the fear became self-fulfilling. As with Lehman, the Fed chose not to protect creditors; because the \$85 billion loan was senior to existing creditors, senior debt was left trading at a 40% loss.

This decisive change in policy reflected a growing political movement in Washington to protect taxpayer funds after the Fannie Mae and Freddie Mac actions. In any case, though, the implications for creditors and bond investors were clear: RUN from all entities that might fail, even if they appear solvent. As in the emerging markets crisis of a decade ago, anyone who needed access to the credit markets to survive might lose access at any time.

As a result, creditors and uninsured depositors at all risky institutions pulled their funds – shifting deposits to Treasuries, moving prime brokerage accounts to the safest institutions (read JPMorgan), and cashing out of securities arranged with any risky institutions. The previously invincible Morgan Stanley and Goldman Sachs saw large



jumps in their credit default swap rates. Washington Mutual and Wachovia vanished. LIBOR shot up and short-term US Treasury yields fell as banks stopped lending to each other and lent to the US government instead. The collapse of one money market fund (largely because of exposure to Lehman debt), and the pending collapse of more, sent the US Treasury into crisis mode.

At the same time, the credit market shock waves spread quickly throughout the world. In Europe, interbank loan rates and EURIBOR rates shot up, and banks from Bradford & Bingley to Fortis were nationalized. Further afield, Russia and Brazil each saw major disruptions in their interbank markets and Hong Kong experienced a (small) bank run. From late September, credit markets around the world were paralyzed by the fear that any leveraged financial institution might fail due to a lack of short-term credit. Self-fulfilling collapses can dominate credit markets during these periods of extreme lack of confidence.

### **The response**

There are two ways to end a crisis in confidence in credit markets. The first is to let events unfold until so much deleveraging and so many defaults have occurred that entities no longer rely on external finance. The economy then effectively operates in a “financially autonomous” manner in which non-financial firms do not need credit. This is the path most emerging markets took in 1997-1998. Shunned by the world investment community, it took many years for credit markets to regenerate confidence in their worthiness as counterparties.

The second is to put a large balance sheet behind each entity that appears to be at risk, making it clear to creditors that they can once again safely lend to those counterparties without risk. This should restore confidence and soften the coming economic recession.

Governmental responses to the crisis were fitful, poorly planned, and abysmally presented to the public. The US government, to its credit, was the first to act, while European countries boasted they would be little affected. Still, though, Paulson and Bernanke had made the mistake of insisting right through the Lehman bankruptcy that the system was fundamentally sound. As a result, their rapid reversal and insistence that they needed \$700 billion for Paulson to spend however he wished was greeted coldly on Capitol Hill and in the media.

The initial Paulson Plan was designed to increase confidence in financial institutions by transferring their problematic mortgage-backed

securities to the federal government's balance sheet. The plan had many problems, ranging from uncertainty over what price the government would pay for the assets to questions about whether it would be sufficient to stop the crisis of confidence. Our initial Baseline Scenario, on September 29, recommended passing the plan and supplementing it with four additional measures: the first two were unlimited deposit insurance and an equity injection program for financial institutions.

After the Paulson Plan was passed on October 3, it was quickly overtaken by events. First the UK announced a bank recapitalization program; then, on October 13, it was joined by every major European country, most of which also announced loan guarantees for their banks. On October 14, the US followed suit with a bank recapitalization program, unlimited deposit insurance (for non-interest-bearing accounts), and guarantees of new senior debt. Only then was enough financial force applied for the crisis in the credit markets to begin to ease, with LIBOR finally falling and Treasury yields rising, although they are still a long way from historical levels.

### **Dangers for emerging markets**

Although the US and Europe have grabbed most of the headlines, the most vulnerable countries in the current crisis are in emerging markets. Just like highly leveraged banks, highly leveraged countries – such as Iceland – are vulnerable to the flight of capital. Countries that got rich during the commodities boom are also highly vulnerable to a global recession.

The flight to safety is already destabilizing banks around the world. For companies that can get credit, the cost has skyrocketed. These financial sector tremors are sending shockwaves through emerging market economies. While wealthy nations can use their balance sheets to shore up banks, many other countries will find this impossible. Like Latin America in the 1980s, or emerging markets after 1997-98, the withdrawal of credit after a boom can lead to steep recessions and major internal disruptions.

Four sets of countries stand to lose.

1. The over-leveraged. With bank assets more than ten times its GDP, Iceland cannot protect its banks from a run. Other countries that borrowed heavily during the boom face a similar situation.
2. The commodity-dependent. Oil has already fallen below \$80 per barrel, and demand continues to fall. All other major commodities will fall for the same reasons. Commodity exporters facing sharply

reduced revenues will need to cut spending and let their currencies depreciate.

3. The extremely poor. Sub-Saharan Africa, which was a beneficiary of the commodity boom, will be hit hard by the fall in commodity prices. At the same time, wealthy nations are likely to slash their foreign aid budgets. The net effect will be prolonged isolation from the global economy and increased inequality.
4. China. The global slowdown has already had a major impact on several sectors of China's manufacturing economy. The collapse in the Baltic Dry Index shows that demand for commodities and manufactured goods is plummeting. While China's economic influence will only grow in the long term, a global recession could cause a severe crimp in its growth.

The world's attention is currently focused on the G7. But crises in the rest of the world will inflict damage on G7 economies, increase global inequality, and create geo-political instability.

### **The current situation**

Today, although it is by no means assured, it seems relatively likely that the financial panic will gradually ease and the successive collapse of many large banks in the US and Europe will not occur. However, the resumption of interbank lending alone will not be enough to reverse the downward trajectory of the real economy. Banks still need to deleverage in a major way and there are doubts about how much lending to the real economy will pick up. For example, mortgage rates in the US actually increased since the recapitalization plan was announced. In a worst case scenario, even some wealthy countries may not be able to absorb the losses sustained by their banks. The US will have to worry not just about its banks, but also about some insurance companies and quasi-financial companies such as GMAC, Ford, and GE.

Before the severe phase of the crisis began on September 15, the world was already facing an economic slowdown. The credit crisis of the past month and the lingering uncertainty seem certain to produce a global recession. In the face of uncertainty and higher credit costs, many spending and investment decisions will be put on hold. US and European consumption decline along with housing prices. With interest rates rising around the world, companies will pay down debt and reduce spending and investment plans. State and municipal governments will see lower tax revenues and cut spending. No country can rely on exports

to provide much cushion, as growth and spending around the world have been affected by the flight from credit.

Recent economic indicators in the US show significant deterioration in the real economy. Because these indicators are from the entire month of September, they probably understate the effect of the acute credit crunch of the second half of the month, which we will not fully appreciate October data appear in the middle of November.

The damage will be particularly acute in emerging market economies. As the wealthiest nations protect their banking sectors, investors and lenders will be less likely to put their money in countries perceived as risky. Iceland is already facing default, either by its banking sector or by its government. After Iceland, the psychology of fear is likely to take over as creditors try to guess which country will be next, just as in 1997-98. Unless a country has a sufficient balance sheet and a very large amount of reserves, there will be selective defaults and large devaluations. It is hard to see how the IMF or anyone else can provide resources on a sufficient scale to make a difference. Some countries in Eastern Europe and Latin America are clearly showing signs of risk.

Falling commodity prices due to the coming recession will also hurt many exporting countries. Even Russia, with its large foreign currency reserves (and vast oil and gas reserves) may have a significant mismatch problem between short term liabilities and longer term assets. This is complicated further by large private sector debt in foreign currency. The government may be moving toward deciding which companies they will save. Hopefully, for the companies they do not support, it will be possible to have an orderly workout.

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## **POLICY PROPOSALS**

### **The G7**

So far, the US response has included major increases in liquidity, the \$700 billion TARP program, the dedication of \$250 billion of that money to bank recapitalization, unlimited deposit insurance, guarantees of new senior bank debt, a program for the Fed to buy commercial paper directly, an interest rate cut, and the usage of Fannie and Freddie to buy \$40 billion per month of mortgage-related securities. Put together, this seems to have stopped the panic from worsening, although it certainly has not yet dissipated.

The US and other leading economic powers will have to continue to fight on several fronts for months if not years to come. We recommend the following program of steps:

1. Ensure sufficient capital. While the credit markets have reacted with cautious optimism to the initiatives announced last week, they must still be implemented successfully to have their desired impact. In the US, we recommend dedicating all \$700 billion of the TARP money for bank recapitalization, because \$250 billion may not be enough as a percentage of the assets involved. Purchasing mortgage-backed securities, if necessary, can be done by Fannie and Freddie. Treasury and the Fed will also need to find a meaningful way to encourage recipients of government capital to use the money to increase lending to the real economy while maintaining healthy capital levels.
2. Lower interest rates. The monetary authorities of these countries need to lower interest rates dramatically. Europe, Canada and the United States recently announced a coordinated 0.5 percent reduction in rates. This is a good start, but only a start. More will be needed, especially in Europe, where a historical focus on inflation fighting risks having the wrong effect. We are on course for a global recession, in which commodity prices will continue to fall and demand will remain weak. Inflation will be low and deflation is a risk.
3. Maintain liquidity. Monetary authorities need to remain committed to pumping liquidity into the financial system as long as credit markets and interbank lending remain weak. This should be promised for at least one year.
4. Fiscal stimulus. A major fiscal stimulus package is needed to help restore confidence back to the economy, and to encourage businesses not to postpone investment plans. All industrialized countries and most leading emerging markets should commit to a sizable fiscal expansion (at least 1 percent of GDP), structured so as to work within the local political environment, to offset the coming large decline in global demand. We would recommend cash payments and rebates to households and short term investment tax credits to businesses. This is a major way to help both homeowners and renters.
5. Contain the damage in housing. In a credit cycle-driven recession, housing prices can fall below their fundamental value just as they rose above it during the boom. Direct measures need to be taken

to break the cycle of foreclosures and fire sales that is driving down prices and causing collateral damage to communities. The goal should not be to prop up housing prices at artificially high levels, but to find outcomes that are better for both homeowners and lenders than foreclosures, large write-offs, and blighted neighborhoods that harm all homeowners.

In addition, these nations also need to determine how their financial sectors should be regulated in the future. Most economists and policy makers agree that the crisis was aggravated by some failure of the regulatory system. While there are disagreements over what that failure was, it is certain that a new regulatory system will be built.

### **The international arena**

The risk for the global financial system is the prospect of financial war. With his appeals for assistance turned down by European countries, Iceland's prime minister, Geir Haarde, said it is now "every country for itself." This smacks of the financial autarchy that characterized defaulters in the 1998 financial crisis in Asia, when countries changed the rule of law to benefit domestic constituents over foreigners.

Most of the time, financial war of this kind is painful and costly. It will lead to decades of lower international capital flows and could have other far-reaching effects on politics and even global peace. Unless the leading industrial countries take concerted action, there's a very real danger that we will all suffer more.

Highly leveraged countries are at risk of substantial private or public defaults. They need to assess their ability to cover their debts and decide which entities to protect and which to let fail. If necessary, they should commit to early Paris Club and London Club negotiations to restructure external national debts, and encourage private sector entities to begin negotiations with creditors.

Commodity exporters should let their currencies depreciate instead of spending reserves to slow down the adjustment process. Devaluation will be necessary to bring imports and exports back into balance.

The IMF can work with countries needing fiscal and balance of payments support. It is already signaling that it will reduce the detailed conditions for which it is so well known, and increase its flexibility. The G7 should support this, and make additional resources available. One widely expressed view is that currently the IMF could save only 2-1/2 Iceland's.

Finally, despite their domestic challenges, wealthy nations also need to do their part. We are going to recapitalize our banks and exercise greater control over them. We need to make sure they continue to deal with emerging market banks. We should also avoid cutting our aid to the world's extremely poor.

### **Conclusion: The need for coordination**

We believe the US economy, along with many other parts of the world, is entering a recession precipitated by housing markets but primarily caused by an extreme loss of confidence in global credit markets. The withdrawal of credit undermines previously solvent institutions, causes unnecessary economic damage and constricts consumption and investment plans. Once confidence is gone, it is extremely difficult to restore. This is not a case of efficient markets, but a self-fulfilling series of credit panics causing significant economic damage.

The outlook for the global economy continues to worsen. While the US and several European countries are likely to go into recession, we are also likely to see substantially more defaults and credit panics in smaller countries and emerging markets. These developments point out the urgent need for international coordination to limit the depth of the recession and avoid international financial warfare.

The last month has shown that partial and piecemeal actions will no longer work. Small steps announced frequently, especially by a single country acting alone, are neither credible nor powerful enough to make much of a difference. It's worth bringing a sufficient mass of economic power to bear, in a comprehensive program, to make an impact on the markets.

There is also a need to let prices move to a level supported by the market, which unfortunately means that wealth is likely to decline further. As we saw after the Asian crises, this can mean that stocks, bonds and other assets become very cheap, and it may take a long time for values to recover. Fiscal expansion and help to homeowners will reduce the pain from these losses, but it's important to be clear that the success of the program should not be measured by rising asset prices.

Finally, we are well past the days where even dramatic steps could have prevented a major recession. Under any scenario, we will see many personal, corporate and perhaps even national bankruptcies. Once the genie of panic and uncertainty is unleashed, it takes years to put it back in the bottle. What we need to do is prevent a chaotic collapse arising

from incomplete policies, lack of credibility and international financial warfare.



## Orientation

James Kwak | 20 Oct 2008

**On sale now:** Our book, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown*, is on sale! Christopher Dodd is reading it. Excerpts from the beginning and the end. What the title means.

**See or hear us:** Upcoming in-person events. Colbert and MSNBC.

**Like the site?** Get free updates via email, RSS, Twitter, or Facebook (and tell your friends).

## Banks Can Borrow Money; You, Not So Much

James Kwak | 20 Oct 2008

The TED spread is down again today to 3.20 (down from 4.64 at its peak ten days ago). This means that banks are beginning to lend money to each other, which means we are less likely to see serial bank failures and a complete collapse of the financial system. This is good.

However, all is not rosy. Mortgage rates unexpectedly shot up last week – from 5.87 to 6.38 percent for a 30-year fixed-rate mortgage in the US – in a demonstration of the law of unintended consequences. Apparently, what happened was this. During the panic, investors lent money only to the US government, not to banks. However, since the nationalization of Fannie Mae and Freddie Mac, they have been regarded as as safe as the US government, and hence benefited from abnormally low funding costs. As banks become more attractive places to lend money – particularly because of the government guarantee on new senior debt, which means existing debt gets safer (banks can issue new guaranteed debt and use it to pay off the existing debt) – Fannie and Freddie become relatively less attractive. So their borrowing costs go up, and because they play an enormous role in the US mortgage system, mortgage rates go up.

The short-term jump is probably not something to get too worried about, since it basically corrects an anomalous feature of the last few weeks. However, it points out a larger problem. The Fed and Treasury are like firefighters. They decided that the top priority was preventing a collapse of the financial sector, and I agree with that priority. But now that banks are beginning to lend to each other, the next priority is resuscitating the real economy, and for that banks will have to lend to real people and real companies. We aren't there yet.

## Korea Joins the Bailout

James Kwak | 20 Oct 2008

South Korea was one of the major casualties of the 1997-98 “emerging markets” crisis. I put “emerging markets” in quotes because, at the time, Koreans were very proud that their country had the 11th-largest economy in the world. Today it is 13th, by nominal GDP.

Yesterday South Korea announced its version of the bailout plan that is sweeping the world – \$30 billion in foreign currency reserves made available to its banks, and a \$100 billion guarantee on new foreign debt of its banks. But in Korea, the stakes are higher than in the US and other G7 countries. Korea is another of those countries whose banks’ have a disproportionately high level of foreign currency obligations. Rolling those over suddenly got a lot harder in the last month, for reasons we all know; now as creditors fear that banks may not be able to pay them off, the currency declines, making them even harder to pay off, and so on. The central government has \$240 billion in foreign currency reserves, but that may or may not be enough to support its banking sector, which has \$235 billion in foreign liabilities.

Korea is important not just because my family is from there, but because it is so big, economically – three times as big as Iceland, Hungary, and Ukraine put together in GDP terms. If the crisis spreads to countries of Korea’s scale, it’s not clear that the IMF has the resources to bail them out (and an IMF bailout would be enormously unpopular in any case).

## Reader Question Roundup, 10/20/08

James Kwak | 20 Oct 2008

Besides the questions we get in comments, we got a bunch in email last week because of our op-ed in the Washington Post. (By the way, I'm behind in responding to comments on the blog, so if you see one you can answer, by all means go for it.)

Here are a few.

### **1. Is mark-to-market accounting part of the problem? Should it be replaced by discounted cash flow valuation?**

In my opinion, maybe and no. (For those who don't know, market-to-market accounting means that I have to hold assets on my balance sheet at the value for which I could sell them today, based on comparable transactions in the market. The alternative would be to allow me to use my internal projections for long-term cash flows to determine what my assets are worth.) People see mark-to-market as part of the problem because, on this view, banks are being forced to write down assets below what they are "really" worth, giving them paper losses and, more importantly, reducing their capital. Assume Bank A and Bank B are holding the same security (say, a CDO). Bank A has liquidity problems and has to sell that security at a "fire sale" and only gets 20 cents on the dollar. However, Bank B is convinced the thing is really worth 50 cents on the dollar. Nevertheless, Bank B is supposed to write it down to 20 cents on its balance sheet.

First, I generally tend to the belief that if 20 cents is what it traded for on the market, that's what it's worth. For many of these securities, the idea that there are no buyers is not really true, or at least it wasn't true before September 15; there were lots of private equity firms who would be happy to buy at low enough prices.

More importantly, whatever the problems with mark-to-market, the alternative is worse. The alternative is to let banks use their own internal valuation models to decide what their securities are worth. Nominally I suppose these models would be overseen by auditors, but ... I don't think I need to finish that sentence. I just think the incentive structure is all wrong to allow banks to value their own assets. Maybe there are people out there who can suggest more sophisticated alternatives that avoid this problem.

### **2. I've seen this question in a few forms in email and in the comments. Basically, it goes like this: Yes, in the short term a reduction**

**in spending will be painful. But isn't what we need in the long term after decades of living beyond our means (at least in the US)?**

We are going through a de-leveraging, in which the amount of money available relative to the amount of assets we have will go down. In the US, the most visible sign of that has been the housing market, where falling prices have crimped households' ability to spend. I agree that, for our long-term economic health, those asset values have to fall down to where they "should be" (and I'm not going to try to predict where that is). However, I think there are better and worse ways of getting to that outcome. One way would be that credit completely dries up, everyone who is delinquent on a mortgage gets foreclosed on, companies lose access to short-term credit and dump assets to meet payroll (or go out of business), credit card limits get slashed, and so on.

Imagine that your credit card banks revoked your cards. For most people even with good credit, this would mean they would have to come up with the cash to pay off the balances, perhaps by selling stocks. Even for people (like me) who pay off their balances in full every month, this would amount to a one-time reduction in my cash, because I could no longer count on deferring a couple thousand dollars' worth of purchases by 30 days. Imagine the same thing happening to almost every company in the country, which would suddenly have to build up two months' worth of cash reserves to replace the short-term credit it used to lose. Needless to say, the dislocation would be tremendous, and asset values would probably fall far below their long-term values.

The alternative is a more gradual decline to a sustainable level of debt and spending that avoids most of these dislocations. Imagine instead your bank reduces your credit limit by a few hundred dollars each month, and you know that in advance so you can plan for it by either slowly liquidating assets or slowly reducing your spending. The hope is that this will prevent asset values from crashing too far on the downside. Now it's not obvious how we make this preferred scenario happen, but I just want to point out that there are different ways to unwind the leverage that our economy has been built on.

**3. (Paraphrasing ruthlessly:) Given that the taxpayer is now bailing out the financial sector, shouldn't this change the relationship between the government and the banks? How can we be sure the money won't just be stolen? Why are people from Wall Street running the bailout? How can we be sure banks won't just repeat the egregious practices that created this mess?**

Great questions to which I don't have a great response. I think I can say honestly that we were very early to point out the governance and incentive issues with the original bailout plan. The oversight was much improved in the final bill, thanks to the efforts of people like Barney Frank, but still it largely involves Congressmen having hearings after whatever has been done is done. I think that transparency is vitally important here. There are thousands of highly qualified economists, lawyers, and other people who could spot corruption if they could see the details of the deals that will be done between the government and the banks; the more information that is provided, the better.

To some degree, people from Wall Street are running the bailout because they are the only ones with the expertise to do it. The problem is that we are dealing with highly arcane securities invented on Wall Street, and even most financial economists would agree that they do not have the ability to properly value those securities. This is a problem. This is one reason we recommended using private sector auctions to set the values and then have the government pay those prices; it's also a reason that we and others recommended bank recapitalization as a better use of the money. Recapitalization does not solve the problem entirely, though. One can argue that the terms of the deal announced last week are too generous to the banks. (I think they were generous, but I think Paulson had to offer them because he needed the first nine banks to accept immediately; the government could not have forced them to agree against their will.) In any case, I would expect either McCain or Obama to shake things up as a show of providing additional oversight, but I also expect them to turn to Wall Street veterans as well.

As for the last question, we need more and better regulation. There is a debate now over whether the regulatory structures were lacking, or whether it was just that the individual regulators were asleep on the job. Christopher Cox at the SEC, in particular, seems to have done absolutely nothing (except prohibit naked short-selling, which arguably was already illegal). For a particularly aggressive regulatory proposal, see the one by Crotty and Epstein.

## Sign of the Apocalypse: The TED Spread Gadget

James Kwak | 21 Oct 2008

Back in the glory days of 1999-2000 (I was in Silicon Valley at the time, and for us that was the real boom, not this housing thing everyone else likes to talk about), otherwise reasonable people would spend an inordinate amount of time checking stock tickers on their computers. It was probably one of the things, along with email, that first made the Internet a mass phenomenon. (For you kids out there, no, we didn't have YouTube.) Well, in a perverse, bizarro-world echo of those times, now you can track the TED Spread using a Google gadget (you can add it to your iGoogle home page, or, I believe, to Google Desktop). So now you can distract yourself at work worrying about the fate of the financial system, without even having to go to Bloomberg.

By the way, it's at 2.56, down from 4.64 on October 10. So the first battle is going well, although there are many more to fight.

(Thanks to Planet Money for catching that.)

## Why Banks Won't Lend – My Theory

James Kwak | 21 Oct 2008

Some people have said that Americans go to hockey games to see fistfights and go to NASCAR races to see car crashes. This thought occurred to me over the past few days while reading The New York Times online. If there were a New York Times index, it would indicate that the financial crisis is over. I can't recall the last time a financial crisis-related story was at the top of the home page. (Today's Fed intervention into money markets may have been on top, but by the time I got there the lead story was Kirk Kerkorian selling stock in Ford.) Instead, we're back to the presidential election and Iraq. For a while there, it seemed like we might have the car crash to end all car crashes in the financial system, with banks failing left and right. Now, it looks like we've just got a boring old recession, where millions of people will lose their jobs. Move along.

But even if the multi-car pileup has been averted, the cars are still just barely limping around the track. The problem seems to be a lack of fuel – credit, in this case. Andrew Ross Sorkin in that same New York Times points out that banks are taking their money and stuffing it into a mattress instead of lending it to companies. (Yves Smith at naked capitalism says that consumers are doing the same thing, which, while personally wise, is not the best thing for the economy.) Now, banks only make money by lending money. So why aren't they lending?

My homespun theory: Banks are run by people, notably CEOs. CEOs are people like the rest of us (just richer and, often but not always, fatter). They are motivated by two main things: (1) making a lot of money and (2) not looking like an idiot. Maximizing profits for their shareholders is far down the list. Boards of directors are primarily motivated by (2), not looking like an idiot (and getting sued). In good times, when people underestimate risk, this leads to lots of leverage and juiced-up profits. In bad times, both motivations produce behavior that may be irrationally conservative from the standpoint of the shareholders. A CEO with a \$5 million base salary who knows this year is going to be terrible and that he won't get much of a bonus has no incentive to increase profits. He does have an incentive to make sure his bank stays in business – so he keeps getting that base salary – which means being as conservative as possible with cash. He also has no desire to go bankrupt and get hauled in front of a Congressional hearing (motivation #2), which again means being as conservative as possible.



Ironically, this is the flip side of option-based compensation. In the boom, it encouraged people to take too much risk in order to boost stock prices in the short term. In the bust, when my options are underwater, I don't care about the stock price – I just want to stay in business so I can keep drawing my base salary and hang on until the next boom. (And I will almost certainly go to my board and ask them to reprice my options, but that will have to wait until they're not mad at me.)

Note that this is irrational behavior for the company as a whole. As a shareholder, I want the bank to take some risk, and I am willing to accept some risk that it will go bankrupt; otherwise I would just invest in Treasury bonds. I can diversify away most of that risk by buying stocks in other companies. The problem is that the people running banks have very concentrated incentives that lead them to behave in ways that are not good for shareholders.

Is there a solution? I don't know. In some countries, the government would take control of banks (at least by choosing the executives, like at AIG), but Paulson explicitly chose not to buy voting shares, and that was probably necessary to (a) get the banks to agree to the recapitalization and (b) maintain support in Washington and among the public at large, which is still deeply distrustful of direct government intervention. Basic microeconomics says that competition will lead some banks to start lending and take market share from others, but in an oligopolistic situation (I believe the nine banks that were bailed out first have about 60% of all banking assets in the country), that may not happen. Some form of government guarantees for loans may work, although I'm not sure what the details would be. We may have to wait for greed to once again take over from fear in the heads of those CEOs. Luckily, it always happens.

## **Want to Be on NPR?**

**James Kwak** | 21 Oct 2008

One of my life's ambitions is to be on *This American Life*. Now you can do the next best thing. NPR's excellent Planet Money podcast is looking for people to talk about their personal economic situations; the hosts, joined by my co-author Simon Johnson, will talk about how you fit into the global economy and the financial crisis. It's all explained [here](#).

## From Your Far-Flung Correspondents, at MIT

**Simon Johnson** | 22 Oct 2008

I spent most of the last two days teaching some special sessions on the global crisis at MIT and doing final preparations for a couple of courses that will start next week.

Three relevant points strike me from interacting with students, faculty and other members of the MIT community, which – as you might guess – is a very international set of people.

First, everyone now understands this is a truly global crisis. The ramifications are already apparent in places that, even a month ago, you would have thought quite distant from the US financial sector, such as small business in India or Australian real estate (the link is of course credit). There is very little that can, in some sense, shock any more: Chinese growth could stall, credit may tighten further, European medium-term prospects are already being called into question, and so on.

Second, very few people yet see the complete picture. We all have some pieces clear in our minds, but it's only when we talk – particularly in a free-wheeling classroom discussion – that we begin to see how it all fits together. It's only when you engage with someone from Iceland, or a person with money in a UK bank, or a student whose income is in a depreciating currency, that you really begin to realize the scale and interconnectedness of the problem.

Third, I'm struck and encouraged by the calmness that follows a really open discussion. People are worried, but talking about the problems helps them get perspective and start thinking about strategies. How exactly are they going to cope, what should they do differently, and where will they see the impact on this or that business?

All of this makes me think that we can usefully contribute to each other's understanding by talking (and arguing) through more dimensions of the crisis and its impact. In that spirit, we will open up our classroom over the next two months, to bring your views and questions to MIT and vice versa. We're still working on the exact details of how best to do this (and we're very open to suggestions), but as much as possible it will be through this website. Tell me if it helps.

## Nobel Laureates Debate Financial System Regulation

James Kwak | 22 Oct 2008

The Economist is hosting a debate on financial system regulation between no less than two Nobel Laureates, Myron Scholes and Joseph Stiglitz. (Be sure to read the opening statements before the rebuttals, or it may not make sense.) The debate is less over specifics than over the general question of how much regulation there should be. They may be lying low right now, but there will surely be legions of executives and economists arguing that we actually need less regulation in order to foster financial innovation.

The Economist recruited Scholes to defend this view, but unfortunately he puts on a rather tepid defense. I read his arguments three times and I think they boil down to this: Crises stem from too much leverage, and therefore bank capital requirements should be increased. (He also says, however, that “Determining the amount of leverage to be used by financial institutions is a business decision.”) If banks need additional capital in a crisis, it should be provided by the government and priced accurately. In his rebuttal he also proposes a new accounting framework, potentially implemented by a regulator, that provides a more accurate assessment of the risk faced by a financial institution. So, as far as I can tell, it boils down to: (a) higher capital requirements; (b) government capital in times of crisis; and (c) better accounting. For the rest, we can count on existing laws against things like fraud. Unfortunately, the only evidence he provides for the thesis that “more regulation is bad” is that economic growth was lower from the 1930s to the 1970s, which he calls an era of regulation, than since the 1970s, an era of deregulation. (Like everything in history, economic growth levels are overdetermined, meaning that you can find a dozen different explanations of any given historical phenomenon.)

Stiglitz doesn't do such a great job proving the “more regulation is good” thesis, either; his evidence is that countries with “strong regulatory frameworks” are less likely to have financial crises. But Stiglitz gets at the basic question: is unbridled financial innovation good or bad? Does it really lower the cost of capital enough to compensate for the costs of crises like the current ones? Which innovations are good and which are bad? Can we get the good ones without the bad ones?

If we just take the case of mortgages and mortgage-backed securities (this is me and not Stiglitz), which innovations contributed to increasing

home ownership in a sustainable way, and which put people in mortgages they had no chance of affording? I think most people would say that mortgage securitization was a good thing because it lowered borrowing costs without compromising underwriting standards. At the other extreme, most people would say that option ARM mortgages that reset to high interest rates and had prepayment penalties were not a good thing for either party. I don't see how higher capital requirements would have solved the latter problem; better accounting might have helped if it discouraged banks from keeping the things on their books (but many were already doing their best to sell them instead of keeping them on their books).

Steve Randy Waldman has a list of what he thinks were good innovations and bad innovations. I don't agree with everything on the lists, but at least he tried.

In Stiglitz's view, we need regulation to compensate for the information asymmetries that enable the sophisticated to prey on the unsophisticated, and to compensate for the screwed-up incentive structures that are too common within companies. He doesn't go into great detail on the actual mechanisms, although he does favor a "financial products safety commission" (also recommended by Crotty and Epstein).

Stiglitz also mentions but does not solve the tough problem of regulatory capture – what happens when regulatory bodies become advocates for the industry they are supposed to be regulating, often because the regulators themselves are drawn from that industry and intend to go back to it after their stint in Washington. What do you do if you have regulators who don't want to regulate?

Anyway, this is where I think the debate needs to start.

## Lehman CDS Settle; World Doesn't End

James Kwak | 22 Oct 2008

Yesterday was the last day for settlement of credit default swaps linked to Lehman debt. One of the fears raised in the dark days of September was that the failure of a bank like Lehman would create hundreds of billions of dollars of liabilities for companies that had sold insurance on Lehman debt, and that market participants had no way of knowing who was good for that money, because many sellers were hedged and might be counting on payment from another seller, who might be counting on ...

Well, the financial system is still standing. While we won't know who lost money until the next quarterly earnings are announced, no one defaulted on the CDS. In part, this was due to the fact that as Lehman bonds fell in value, sellers of CDS had to post collateral to buyers, so a lot of the losses had already been recognized. (I believe AIG was an exception to this, because they had a AAA bond rating and hence did not have to post collateral until they were downgraded.) Perhaps things would have been worse without the many liquidity-increasing steps the Fed took over the last month; if you have to raise cash in a hurry, it is far easier to get it from the Fed now than it was in the past. In any case, it appears we have one less thing to worry about, at least for now.

## Credit Crunch: Did We Make It All Up?

James Kwak | 22 Oct 2008

There is a paper by three economists at the Federal Reserve Bank of Minneapolis that is getting a lot of attention on the Internet today. (How often can you write that sentence?) V.V. Chari, Lawrence Christiano, and Patrick J. Kehoe set out to debunk four myths about the financial crisis:

1. Bank lending to nonfinancial corporations and individuals has declined sharply.
2. Interbank lending is essentially nonexistent.
3. Commercial paper issuance by nonfinancial corporations has declined sharply and rates have risen to unprecedented levels.
4. Banks play a large role in channeling funds from savers to borrowers.

In short, they are saying that despite all the hand-wringing about banks not lending to consumers and businesses, it just ain't true, and even if it were, most lending isn't done by banks anyway. The implication, to simplify somewhat, is that we are in a media storm of hype that may itself have negative effects.

While I would love to believe this, I don't think they make the case conclusively. A few quibbles (for this to be understandable, you may have to look at the original paper):

1. Total bank credit has not decreased (Figure 1): This measure includes everything on the asset side except vault cash, so any shift from, say, corporate bonds to T-bills is not reflected here.
2. Lending has not decreased (Figures 2-4): First, total lending is a sticky number. When a bank has loaned you money for 30 years to buy a house, they can't call it in. Similarly, it takes time to reduce credit limits on credit cards. Lehman failed on September 15. Assume it took a week for banks to change their underwriting guidelines in the field (and that would be extraordinarily fast). It takes time for a loan application to flow through the system. How big an impact would you expect to see by October 8, when the authors pulled the data? I would be more convinced by a chart of new lending than one of total loans outstanding. Second, the chart says nothing about duration; one very real possibility is that banks are lending money for short durations but not for long ones.

3. Interbank lending is not down that much (Figure 5): Again, this conflates overnight lending with 3-month lending. There is a big gap in LIBOR between those durations right now (although it is smaller than a week ago).
4. Non-financial commercial paper is not down that much (Figure 6): This one shows a drop from 9/15 to 9/29 and then no data after that, so I'm not sure. Again, a fair amount of longer-duration commercial paper would not have expired yet, so the number is inherently sticky. Also, it hides any shortening of durations.
5. Commercial paper rates are not up (Figure 7): The chart hides a huge jump in commercial paper rates for lower-grade companies. The spread for A2/P2 companies versus AA companies is 4.45 percentage points, up from historical levels of 20 basis points and just 80 basis points this summer. (Thanks to Calculated Risk for this indicator.)
6. Banks provide less than 20% of the lending to nonfinancial companies (the rest is in bonds held outside of banks): Yup, this is true. But it ain't so easy to issue new bonds these days, either.

Besides, like most people, I know that I should be convinced by data, but I place an irrational weight on conversations I have with other people. I just talked to my contractor (bathroom remodel), and he said that he's been having a tough time all year. One client recently backed out of a job because her bank wouldn't lend her the money because the equity in her house had dropped. So there. (Yes, I know this paragraph is completely irrational.)

I certainly haven't proven that they are wrong. It's possible that there is different data that will prove them right. In particular, if they could show me Figures 2-4, for a few more weeks, showing just new lending activity, I might be convinced. And I want them to be right. But I think it's too early to blame it all on the media.

**Update:** Mark Thoma at Economist's View and Free exchange (The Economist) also think think the Minneapolis Fed paper isn't all it's cracked up to be.



## Where Did All the Money Go?

**James Kwak** | 22 Oct 2008

I've added a new section to the Financial Crisis for Beginners page trying to answer the question of where all that money we used to have has gone to, using an economy of just three people.

If there are other topics you'd like explained simply, please let me know.

## Argentina on My Mind

Simon Johnson | 23 Oct 2008

In the various measures of vulnerability for emerging markets (middle income countries open to capital flows) that are now being examined and re-examined carefully, Argentina does reasonably well. Its banking system does not appear to be highly exposed to problems in the US and Europe, and its macroeconomy – while not in great shape by any means – is far from being among the most dependent on continued capital inflows from abroad.

Argentina does produce and export a lot of commodities, and these prices are falling, so this creates a potential difficulty for government finances. Still the government's proposed response is a stunner: President Cristina Fernandez de Kirchner announced Tuesday that she plans to take over (i.e., nationalize) 10 private pension funds (the Argentine Congress would have to approve this; we'll know soon how that will go). The pension funds hold a great deal of government debt, so grabbing them would presumably get the government off the hook for that debt. But what about people's pensions?!?

Most importantly, does this indicate that governments around the world feel they can break contracts and expropriate property freely just because all economies have encountered some sort of trouble and many industrialized countries are "recapitalizing" something? If the global crisis is becoming a smokescreen for confiscation, then our problems just got a lot worse.

## We Have Problems; Emerging Markets Have Big Problems

James Kwak | 23 Oct 2008

The increasing damage the global financial crisis is inflicting on emerging markets has been getting a lot of attention lately (those are four separate links, for those with time on their hands), much of it very thoughtful. I would like to immodestly point out that my co-authors Simon and Peter were early to call this one (along with Nouriel Roubini, no doubt), in an op-ed in Forbes.com back on October 12.

That aside, it seems more and more likely that we are witnessing a repeat of 1997-98, just on a grander scale. Credit default swaps on Russian sovereign debt are trading at over 1,000 basis points, which essentially means that investors think the country is more likely to default than not – this just months after the high price of oil seemed to make Russia a dominant regional economic power, and just weeks after Russia was negotiating to lend money to Iceland (as of a couple days ago, it was still possible that Russia would participate in the IMF bailout of Iceland). Argentina, as Simon pointed out earlier, has the honor of being the first country to expropriate private property under the cover of the financial crisis. The Economist published a chart showing CDS spreads on sovereign debt across Eastern Europe showing that Ukraine, the Baltics, Hungary, Romania, and Bulgaria are all at risk. (Many of those spreads are already much higher than in the chart: Ukraine at 2617 bp, Russia at 1038, Turkey at 775, the Baltics between 650 and 1000.) Hungary in particular is showing eerie echoes of 1997-98, as the government takes emergency steps, including increasing interests rates by three full percentage points, to combat speculators betting that the currency will fall – a battle that few countries were able to win a decade ago.

I won't go into more details; you can read the news yourself. Perhaps the starkest sign of the emerging markets crisis is what Bjorn Malmquist, an Icelandic reporter, said to Planet Money: "Everybody is wondering when the IMF is going to come and help us" – this after widespread speculation that the IMF had become just one among many sources of money in times of crisis.

For those wondering what is going on: The basic dynamic is that nervous lenders are refusing to roll over loans to countries seen at risk of default (or companies in those countries), which can become self-fulfilling. Even where governments built up foreign currency reserves to

prevent precisely this problem, like in Russia, they have been undermined by private sectors that gorged themselves on foreign debt. It's similar to the crisis of confidence that hit banks in the wealthy countries, with the added twist of floating currencies. When creditors fear that, say, Hungary will default on its foreign debts, demand for forints dries up, because the only place you can invest forints is in Hungary; when demand dries up, the forint loses value, which means that from the perspective of Hungary, all of those debts get bigger and even harder to pay off. As a side effect, this means that currency speculators can make money by betting on which country will come under pressure next, as happened in serial fashion in 1997-98. Which country comes under attack at a given time can therefore be somewhat arbitrary and not necessarily correlated with the underlying solvency of the banking sector or the government.

As Simon and Peter said in their op-ed, the risk is that the global economy degenerates into financial war, where countries look out for their own economies at the expense of others. Within the developed world, coordination has been pretty good, after a rocky start. However, Brad Setser points to one disturbing thing. In granting unlimited swap lines with central banks in the UK, the Eurozone, Switzerland, and Japan, did the Federal Reserve unwittingly create a split between haves and have-nots in the global economy? As G7 become more attractive places to put your money, emerging markets become relatively less attractive, exacerbating the problem.

Emerging market countries can probably be protected through sufficient application of financial force, in the form of loans from the IMF, the ECB, or other sovereign governments (just like shoveling cash into a bank perceived as risky can make it seem less risky). But the IMF doesn't have enough money for the scale of the problem, and bailing out emerging markets hasn't made it to the top of the G7 agenda (understandably). Establishing the mechanisms to combat such crises in the future will need to be one topic for the international summits that will occur during and after this crisis.

One more thought: Americans may ask why we should care, given all of our domestic problems. In my previous post I pointed to the case of Pakistan, where financial crisis may create even more political instability. More broadly, though, I think it's a certainty that we will be blamed for any economic misery that occurs in the wake of this crisis, since the conventional wisdom is that we exported it to the rest of the world. That's one more thing our national reputation needs.



## **“Bailing Out” Homeowners Through Mortgage Restructuring**

**James Kwak** | 24 Oct 2008

On Capitol Hill today, attention turned back to where this all started – delinquent mortgages. Sheila Bair of the FDIC is working on a program to encourage lenders and servicers to restructure mortgages by partially guaranteeing post-modification mortgages that meet certain criteria. Christopher Dodd is also considering new legislation in November to help homeowners. Here at the blog, we made intervention into the housing market one the four proposals in our first Baseline Scenario way back when in September, and we are planning to publish something more detailed in the next several days. But first, I wanted to lay out the nature of the problem.

Remember the wave of indignation that accompanied the “bailout of Wall Street” last month? Judging by some emails and comments I’ve seen, it could be even worse when it comes time to “bail out” delinquent mortgage holders. Much as people hate the idea of bailing out Wall Street “fat cats,” for some the idea of bailing out their neighbors – especially the neighbors in the new McMansion – is even worse. I think for some people it’s the idea that someone else is getting away with something that they could have done but chose not to (buying too big a house, in this case); by contrast, most people recognize they had little chance of becoming the CEO of an investment bank. OK, now that I’ve opened myself up to a flood of nasty comments, on to the substance.

I think that indignation is misplaced. Let’s take a simple example. Henry the Homebuyer buys a house for \$200,000. He puts down \$20,000 and borrows \$180,000 from Lisa the Lender. The interest rate resets one year later and now Henry can no longer afford the monthly payments; at the current interest rate he can only cover a \$150,000 mortgage. Unfortunately, the house has lost 30% of its value and is now worth only \$140,000. Assume Henry wants to stay in the house.

At this point, Henry has zero equity. Lisa has a mortgage asset with a face value of \$180,000 but that is really only worth about \$100,000. Her only recourse is to foreclose, in which case she will gross \$140,000, but after all the fees she will probably net something like \$100,000. So what should they do? They should renegotiate the mortgage on some terms that Henry can afford and that are worth more than \$100,000 to Lisa. This isn’t a bailout; this is good business. And, frankly, apart from Henry and Lisa, it’s none of anyone else’s business.

So why isn't this happening? Transaction costs, broadly speaking:

1. Cost of renegotiation
2. Difficulty of figuring out how much Henry can pay
3. Difficulty of figuring out who can pay a reduced amount and who can't pay any amount
4. Fear that people who can pay their mortgages will start pretending they can't to renegotiate their mortgages
5. Securitization, which results in the loan being managed by a servicer who may not have the legal right to renegotiate the mortgage in a way that affects the rights of the investors, who may even be hard to identify
6. Etc.

Some of these challenges are bigger than others. #2 and #3, for example, are what lenders are supposed to be good at in their ordinary business. #5 may be one of the trickiest, because the way mortgages were pooled and then divided, the interests of different members of the pool may differ. (Michael Barr and James Feldman have an idea of how to get around that problem, appended to a proposal they made in April.)

Getting around these problems may require government intervention; given how few mortgages have been modified, it's probably safe to say that it requires government intervention. Some will call this a bailout, and yes, whatever program is implemented may result in a few extra dollars going into one pocket or another. But think about what's happening here. A house lost \$60,000 in value. Henry and Lisa both made bad decisions. The point of mortgage restructuring is to agree on a way to split that loss. The overriding policy goal is to avoid foreclosure if at all possible, which creates an additional loss to all parties on the order of \$75,000. That is an eminently reasonable goal of government action.

## I Like the G20 ' s Chances, But They Need To Update Their Website

Simon Johnson | 24 Oct 2008

It is pretty common these days, at least in Washington, to pour scorn – or at least cold water – on the idea that a global summit could have much impact on the crisis. I would count myself among the skeptics with regard to a mega-meeting with 100+ countries around the table, and it does seem like at least one of those meetings is scheduled for December or thereabouts.

But, in addition, President Bush has invited G20 heads of government to meet at one of his places (exact location TBA) on November 15. The G20 convenes the ministries of finance and central banks of 19 countries, and sensibly adds the European Union (represented by both the European Commission and the European Central Bank.)

The countries are the G7 (club of large rich countries), plus another industrialized country (Australia), plus 11 leading emerging markets, representing all continents: 3 from Latin America, 1 from Africa, 1 from the Middle East, 4 from Asia, and 2 that span continents (Turkey and Russia). The G20 claims 2/3 of the world's population and 90% of world GDP, so it has plenty of economic and intellectual firepower. In terms of financial centrality needed to address the current crisis, I would prefer to have at the table also Switzerland (but they don't like to join things), Hong Kong and Singapore. However, these three countries are included in one or more "G7 and friends" regular meetings at the OECD and the Bank for International Settlements, so they are in regular conversation with some key members of the G20.

And it's the regular conversation that matters. The principals (ministers and governors) meet once a year, ordinarily. But their deputies meet twice a year, and it's at – and in the run up to – these technical meetings that most of the work gets done. These deputies know each other well and can work together. Constructive proposals can be hammered out, starting with the next ministerial meeting in Sao Paulo on November 8-9. And the fact that G20 heads of government will now start meeting (dinner is on November 14; mark your calendars) is most significant. Almost always, once a group like this meets, it can agree on its own importance and the need for another meeting.

The chair of the G20 rotates between "regional grouping" and has a great deal of agenda-setting power. The chair for 2009 is... the UK. This



is a great forum for Gordon Brown to advance his Bretton Woods II ideas, and for others to put more immediate recession fighting ideas on the table.

Still, the G20 definitely needs to rework its website. The current version shows no sense of dynamism, global reform or even having read the newspapers recently. May I suggest a weekly podcast?

## Waiting for G7 Currency Intervention: It Won't Be Long

**Simon Johnson** | 24 Oct 2008

Major currencies are on the move, big time, since yesterday. The yen has risen to 91 yen per dollar (from 97) today. The euro has fallen to nearly 1.25 dollars per euro (from 1.29). You get the picture.

The G7 needs to slow down the disorderly run into the dollar. This run is in danger of snowballing into a panic - as people fear further rises in the dollar (and falls in their local currency), they rush to buy more dollars (to cover debts in dollars and also to shift their portfolios), and so on.

Coordinated intervention, announced over the weekend most likely, will involve selling dollars, selling yen, buying euros and pounds. This can calm things, by showing there are no one way bets. (Will the Chinese be involved?)

But the global deleveraging (reduction in lending worldwide) will continue. And this seems to involve more of a move into dollars than we previously thought. So how long can even the most coordinated intervention hold the line?

**Update:** Typo fixed to clean up an inconsistency. Sorry for any confusion.

## Smoke in the Eurozone

James Kwak | 24 Oct 2008

So far, rising spreads on credit default swaps have accurately predicted what sectors of the global economy would run into trouble next. The sharp rise in spreads on emerging market countries' debt is old news. But recently, CDS spreads have been rising for countries that are part not only of the EU but of the Eurozone, such as Greece, Portugal, Ireland, and even Italy. The basic fear is that these countries may not be big enough to bail out their banks, so risk has spilled from the private sector into the private sector. The need for flexibility in monetary policy (currently ceded to the European Central Bank), the pain of a severe recession, and the increase in nationalist politics that often accompanies economic misery could lead one or more countries to abandon the euro. The costs of abandoning the euro would be very high, but it is a scenario that has changed from unthinkable to merely unlikely.

There are steps that policy makers can take now to reduce the threats of national defaults and of a fragmentation of the Eurozone. We discuss the situation and our policy proposals in a new op-ed in [The Guardian](#).

## Emerging Markets: The Differences from Last Time

James Kwak | 24 Oct 2008

Arvind Subramanian has a new article on the financial crisis in emerging markets. He focuses on some of the differences between the 1997-98 crisis and the present day. For one, increased global trade makes emerging markets more susceptible to economic conditions in wealthy nations – and, as we all know, those conditions are considerably worse now than ten years ago.

## Financial Crisis 101 ... by Paul Krugman

James Kwak | 24 Oct 2008

Paul Krugman has a reputation as an angry liberal polemicist. But he's also very good at giving clear, simple explanations to some basic questions about the financial crisis. His recent interview with Terry Gross on Fresh Air covers a lot of fundamental topics and concepts, such as where the money for the bailouts comes from. Advanced readers probably won't learn much, but newcomers could find it very helpful.

## Hedge Funds, An Impression

Simon Johnson | 25 Oct 2008

I try to read four newspapers before the day really starts, and also look through a couple of on-line sites. I skim the lead economic stories and randomly dig all the way through the paper to the end of some business/financial stories.

Sometimes the news jumps off the page, and sometimes it seeps through. Now, about two hours after looking at today's weekend papers, I realize that something is stuck in my mind, rather like a tune that you can't get rid of.

I read, in at least two places, various versions of the following proposition.

1. Hedge Funds, if they get into trouble, will not be rescued by the government
2. Big Hedge Funds are not in trouble

Statement #1 is presumably false. There is no way that any responsible government could let a large Hedge Fund fail at this point. The system is too fragile and the risks too obvious. In fact, the Europeans ratcheted up the pressure in this regard during the week, with their increasingly undiplomatic condemnations of the US for not saving Lehman. (Just wait until they figure out what really happened in the "rescue" of AIG.)

Statement #2 is interesting. I'm not taking a view either way on this; I much prefer to be agnostic and see what the data bring in. But I did note a story that mentioned that the US government had been asking financial institutions about their exposure to particular (named in the story) Hedge Funds.

Now, I don't know about you, but when a representative of the federal government comes to my house, shows me identification and asks questions about a neighbor (yes, it has happened), I start to wonder – what exactly is this neighbor doing to attract the attention of the government (a notoriously distracted organization, except when it is very focused)?

I worry about the US crisis managers, particularly at the Treasury, who used to like to catch dominoes, until they found out how dangerous that could be – because you tend to knock over other dominoes. Then they switched to broader, more systemic and systematic approaches,

which we have called for and applauded here (most recently, on Friday, they adopted the recommendation – from us and others – to recapitalize insurance companies). I really hope these crisis managers are not going back to their old ways.

## Worry Global, Talk Local

Simon Johnson | 25 Oct 2008

The global picture continues to worsen and Friday was a pretty bad day. I took part in a good summary discussion hosted by Jeff Brown on the Lehrer NewsHour last night. The topics ranged from the rising dollar to falling oil prices to Treasury's investments in insurance companies to loan modifications for homeowners.

But I don't think anyone should throw up their hands, abandon their personal strategies, or think that any part of the sky is falling. Here's why.

Planet Money, the NPR podcast, is starting a series talking to people all around the country about how the crisis is and is not affecting people there. Yesterday, Adam Davidson, and Laura Conaway, and I spent two hours talking with nearly a dozen people. To a person they were nervous – hence their interest in talking – but every one of them impressed me with their thoughtfulness and resilience, built around smart long-range plans and a lot of support from family and friends. And the first discussion that Planet Money aired, yesterday afternoon, was downright inspiring – in terms of how Sophia Suhu faces the future.

All this further suggests that it's healthy and reassuring to talk openly about potential personal implications, how to cope in contingencies, and where we all go from here.

Now, I have to go to work more to make sure my MIT course on the crisis (starts Tuesday) builds on and feeds into this network of helpful conversations around the world.

**Update:** listen to more on global economic developments and some of the policy responses that can still make a difference (fiscal stimulus and, the way things are heading, currency intervention by the G7) from John Ydstie's report on NPR's Weekend Edition, Saturday morning (today).



## The Bank Lending Debate

James Kwak | 25 Oct 2008

For those who spend too much time reading economics blogs, there was a bit of a stir in the last few days over a paper by three economists at the Minneapolis Fed, which essentially said that bank lending to the real economy had not been affected by the supposed credit crisis. There were articles on the topic by Alex Tabarrok, Free Exchange, Mark Thoma, me, Tyler Cowen, Alex Tabarrok again, Free Exchange again, and Tyler Cowen again, among others. My main issue was that the charts in the paper said nothing about new lending, and my guess was that changes in new lending practices would take time to show up in measures of aggregate lending. (Other people raised more sophisticated issues, for example that companies were racing to draw down lines of credit after September 15 out of fear they might not be around for much longer.)

I want to point out one more source of information that might shed light on this question. Every quarter the Federal Reserve conducts a Senior Loan Officer Opinion Survey which asks how bank lending practices have changed over the past three months. In the July survey, every single measure of either willingness to lend or loan spreads (price of loan, less cost of funding) was at or above the tightest values (least willingness to lend, highest prices) seen in the last twenty years. Granted, these are measures of change in lending practices, but they still show a rapid shift in sentiment at banks. The October survey should be underway now, and it's hard to see how it won't look even worse.

## Insurance Companies Line Up for Treasury Bailout

James Kwak | 26 Oct 2008

One of the big stories on Friday and Saturday was the expansion of the Treasury recapitalization program to insurance companies. The Washington Post is acting as if it's a done deal, while the Times and the Journal said only that it was being considered.

Insurance is one of the industries I know pretty well, as my company made software exclusively for property and casualty insurers, and I must admit I didn't expect the crisis to show up in insurance so quickly.

To date, the crisis has mainly hit companies that lend long and borrow short – banks, and financial institutions that behave like banks – who found it difficult to roll over their short-term liabilities. Insurance companies have virtually no short-term debt, because they have a continuous stream of cash flowing in from the premiums their customers pay every month. Most of the “liabilities” on an insurer's balance sheet are unpaid loss expenses, meaning claims that haven't been paid yet or haven't been reported yet. Furthermore, insurance companies are generally assumed (although perhaps not correctly) to be relatively conservative in their investments, since they can predict their loss payouts with reasonable accuracy and buy bonds with maturities to match those payouts. (AIG, the big exception, got in trouble primarily because it was selling credit default swaps, not because of its traditional insurance operations.)

However, the problems are showing up on the asset side of insurers' balance sheets. In an economic slowdown, an “ordinary” company – one that buys or manufactures stuff and sells it to other people – is vulnerable to declining demand and hence falling sales. An insurance company is vulnerable to falling asset values, because at any moment most of its money is parked in securities of various kinds.

I'm going to look in detail at the balance sheet of one large insurer, which I chose because they are big, my company has no relationship with them, and I have no inside information about them. And on second thought I decided not to name them because I don't want anyone to draw the conclusion that I think they are risky; I just can't tell, because even reading the notes to the financial statements you can't tell exactly what they are holding. As of June 30, 2008 they had well over \$100 billion in investments. Of that, only 4% was in direct mortgage loans and 2% in hedge funds, venture capital, and other exotic asset classes. 30%

was in equities and 57% in fixed-maturity products – bonds – and 95% of the bonds were investment-grade or US government. So on the face of it you would think they were pretty safe.

However:

- Equities, as we know, have fallen over 30% (S&P 500) since the end of June
- 21% of the bonds were commercial mortgage-backed securities, including CDOs
- Another 12% were residential mortgage-backed securities, other mortgage-backed securities, collateralized mortgage obligations, or collateralized loan obligations
- 14% were bonds of financial institutions, which have been at the center of the financial storm
- 29% were other corporate bonds, which lose value as recession worries increase

Looked at another way, 23% of the fixed-income securities were Level 3, which basically means that they could only be valued using internal models. (In addition, they had credit default swaps with a face value over \$6 billion, but in the majority of those swaps they were buying protection.)

With a portfolio like that, it's entirely possible that the insurer has taken significant losses over the last month and a half. Because insurance policies are promises to make payments if customers suffer losses, insurers are regulated and required to maintain a sufficient capital margin; if their assets fall too far in value, they get nervous about that capital margin, hence the desire to get some from Treasury.

This still leaves open the question of whether the taxpayer should bail out insurers. The argument to do so is that, like banks, insurers play an important role in funding the real economy. Insurers take in vast amounts of cash from consumers and businesses – total premiums in the US are over \$1 trillion per year and insurance company assets are over \$4 trillion – and redistribute out the money to companies, primarily by buying their bonds. While we think of bank lending as the way that companies get credit, direct bank loans are overshadowed by the bond markets. If insurance companies start hoarding cash for fear of investing it – or start failing – that that money will not be available for the rest of the economy.

Of course, there's a question of where it all stops; you could construct a similar (though not quite as strong) argument for bailing out just about

anything, and I believe the auto companies are looking for their piece. But it's hard to deny that insurers play an important role as financial intermediaries in the US.

## So Much Going on ...

James Kwak | 27 Oct 2008

One of the challenges of the current financial crisis/credit crunch/recession/whatever you call the mess that we're in is that there are so many things going on at once – stabilizing the financial system, housing, economic stimulus, regulation, emerging markets crisis, now incipient currency crisis, ... Luckily, there are many other smart commentators out there working weekends when we all should be spending more time with our families.

On the topic of regulation and economic stimulus, Mark Thoma cites and expands on Larry Summers, who argues that we need to not just give the economy a boost in the short term, but take advantage of the opportunity to take steps – both investments and regulation – to boost productivity in the long term.

Mark Thoma (again) and Yves Smith both provide roundups and analysis of the currency crisis, which Simon raised a couple of days ago. Quick summary: it could be bad.

So if you can't sleep, there's plenty to read and worry about. (Or you could watch the World Series.)

## Starting to Wonder About Internal G7 Dynamics, Just A Little

Simon Johnson | 27 Oct 2008

The G7 did speak on major exchange rates, over the weekend, as expected. But they only spoke about the yen's "recent excessive volatility." This was about the least they could say under the circumstances, and it is not clear that it will do anything – other than encourage further flows into the dollar.

Why did they not mention the dollar, the euro, and the British pound? One possibility is that they are happy with the appreciation of the dollar and the depreciation (falling value) of the euro and the pound. This would be a bit strange, given that dollar depreciation – from 2002 through the summer – was considered by the G7 to be a reasonable component of the global adjustment process that would put current accounts onto a more sustainable path (yes, notwithstanding "strong dollar" statements from the US.) The dollar was getting close to what the G7 (and the IMF, who do a lot of the technical work in this regard) saw as a plausible "medium-term" value, at least as measured against a broad basket of currencies. Now the dollar has taken off (i.e., rising in value against almost all currencies). How does that help with anything?

It could be the case that the Europeans like the depreciation of their currencies, as this will help cushion the recession. The falling value of the euro makes interest rates cuts in the eurozone less likely, because the European Central Bank (ECB) will see the depreciation of the euro as helping the real economy and also increasing (their) fears about inflation. But given the ECB's obsession, even today, with inflation – and thus its unwillingness to cut interest rates, come what may – it might be that depreciation is the eurozone's best short term hope (as well as its likely medium term future, as sovereign risks materialize for smaller countries).

Still, it would be odd if no one at the G7 table isn't already raising the dangers of deflation (falling prices), particularly in the US – I'm looking at the representative of the Federal Reserve at this point. Commodity prices are falling worldwide and now the price of imports into the US will decline sharply. If this feeds into low prices (i.e., a lower price level, not just slower inflation) then short-term, of course, US consumers benefit. But if lower prices lead to lower wages, then just think what that does to anyone's ability to pay their mortgage or any other debt – these are almost always fixed nominal amounts.

When people talk about avoiding the mistakes of the Great Depression, they mean in large part not allowing prices and wages to fall. And the faster and further that the dollar appreciates, the more likely we are to worry about deflation.

What then are the internal G7 dynamics? Based on what we saw, and didn't see, this weekend, I would guess that recriminations and nonconvergent policy views prevail. The spirit of cooperation we saw around bank recapitalizations, just two weeks ago, must have evaporated. We may not want to rely on the G7 to lead the way. Can I interest anyone in a G20 summit?

## Economic Stimulus and Investing for the Long Term

James Kwak | 27 Oct 2008

With recession news getting worse every day (here's one depressing roundup), there is a high likelihood that the Congress will pass an economic stimulus plan either in a lame-duck session in November or immediately after reconvening in January. General sentiment seems to be against tax rebate checks (Martin Feldstein summarizes the argument that the vast majority of the rebates went into savings, not consumption) and in favor of fast-acting measures like extended unemployment benefits and direct aid to state and local governments to replace lost tax revenues. In addition, however, we (and Larry Summers) think that now is the time to invest in long-term economic productivity, for example through infrastructure projects, in part because we are probably looking at a long recession. Our thoughts are presented under Simon's name and picture on the National Journal's Economy Blog, which is hosting a discussion of the stimulus package. Note that even the participant from the American Enterprise Institute favors a stimulus package of between \$300 and \$500 billion.



## Currency Crisis for Beginners

James Kwak | 28 Oct 2008

(One of our objectives is to help non-specialist readers understand what they are reading in the news. Instead of appending everything onto the very long [Financial Crisis for Beginners](#) page, I'm going to start doing individual posts and linking from that page to the posts. Advanced readers can choose to skip the "beginners" posts – or they can help improve them through comments.)

In honor of Paul Krugman, recent Nobel Prize winner and "inventor" of the currency crisis, we seem to be experiencing a global currency crisis. This may prompt the question: what is a currency crisis?

Different countries (or regions, like the Eurozone) use different currencies. These currencies generally float against each other, meaning that their relative prices are set by traders on foreign exchange markets, although sometimes they are fixed (meaning just that the central bank acts on the market to keep its exchange rate where it wants it). Changes in exchange rates are normal and are driven by a number of factors, such as interest rates in different countries: a higher interest rate creates demand for a currency, and as with most things higher demand leads to a higher price (meaning that currency has greater value). More generally, a currency's value should be related to the long-term attractiveness of the economic opportunities available in that currency.

There is no exact quantitative definition of a currency crisis, but it generally involves a sudden and rapid fall in the value of one or more currencies. It is more likely to happen in an emerging market economy that has borrowed a lot of money in foreign currency. (If I'm a big American institutional investor, I may not want to buy bonds denominated in Russian rubles, because I don't know what the ruble will be worth in the future, but I may be willing to buy bonds denominated in dollars or euros.)

Like the various crises of confidence we have been discussing, one nasty thing about a currency crisis is that the fear of one can be self-fulfilling. Let's say country A has a high level of foreign currency debt, either in its public or private sector. At some point, for some reason (recession fears, for example), the people holding that debt get worried that the country may not be able to pay off that debt. They start selling stocks and bonds in country A's currency, the aardvark, and converting their assets back into "hard currency" (dollars, euros, yen, pounds –

things that are unlikely to collapse in value). That drives down the aardvark – because more people are selling it than buying it – which makes it even harder for country A to pay off its foreign currency debts (since they just went up relative to the aardvark), which makes other investors panic and sell, and so on and so on. These dynamics can be amplified by the actions of currency speculators, who will sell a currency short if they think it is ripe for a currency crisis, and may therefore trigger the crisis (thereby making themselves a lot of money).

Currency crises can do lasting damage to countries suffering them. Loss of foreign investment hurts the real economy, often triggering a recession. Devaluation of the local currency makes imports much more expensive, reducing the standard of living. The policy measures required to boost a currency's value – increasing interest rates (to attract investors) and reducing deficits (to restore confidence in your ability to repay your debts) – are the opposite of what you ordinarily want to do during a recession.

Currency crises can also be bad (though less so) for the countries on the other side whose currencies are appreciating. Having your currency appreciate makes it harder to export goods and services, which can dampen economic growth. More generally, having your trading partners collapse is never a good thing.

Local governments sometimes try to combat currency crises by intervening on foreign exchange markets to support the value of their currencies (by buying their own currency and selling hard currency). Countries build up foreign exchange reserves for precisely this purpose. However, this has rarely been successful, because few countries have sufficient reserves to counteract an entire world full of pessimistic investors, plus the hedge funds betting on the currency's fall. Stabilizing currencies in the midst of crisis usually requires intervention from G7 countries with deep pocketbooks or potentially the IMF – actors with the credibility to stop a run on a currency, perhaps even without having to shell out hundreds of billions of dollars. This weekend the G7 announced that it was “concerned” about the recent appreciation of the yen, hoping that this warning shot would stop people from betting on the yen (and against a whole host of other currencies). If this fails, some of the G7 countries will probably start intervening directly to sell yen and buy euros, pounds, and other currencies that have been falling.

## Economic Stimulus Proposals: The Data, Please

James Kwak | 28 Oct 2008

Economic stimulus is in the air. (Simon, in fact, is testifying on the subject before the Joint Economic Committee later this week.) Menzie Chinn at Econbrowser has a data-heavy post today on multipliers – the impact on GDP of in different types of stimulus (tax rebates, tax cuts, unemployment benefits, etc.). He concludes that the stimulus should include extended unemployment benefits, aid to state and local governments, and infrastructure spending. To the counterargument that infrastructure spending takes too long to have an impact, he shows multiple GDP forecasts, all tending to show a protracted recession (and, note, getting worse with each update). If you read one article about the stimulus, read this one.

(Like Simon argued in the National Journal, but with more data.)

## MIT Global Crisis Class: Outline

**Simon Johnson** | 28 Oct 2008

Note: pasted below is the material I am handing students at 4pm today (Tuesday, October 28), as a guide to what to expect from this class. We hope to webcast the second class, next week, Tuesday, November 4; details to follow. Other forms of interaction will depend on interest expressed by you and by the students.

Professor: Simon Johnson

TA: Amanda Peyton

### **One Page Summary of Syllabus for 15.976, Special Seminar in Management**

Real-time Deep Dive into the Global Crisis as It Evolves

Tuesdays, 4pm-7pm; H2 of fall semester; in E51-345. There will be a break around 5:30pm so people can go to other events as needed. The first half of each class will be a lecture or structured interaction. The second half will be a broad ranging set of discussions. You are welcome to propose topics.

The world is entering a deep financial and economic crisis from which we are unlikely to soon emerge. All of our preconceptions about the nature and location of growth around the world need to be reevaluated. This course will build on what you know about macroeconomics and finance. It will also engage you with the broader debate about these issues outside MIT. No prerequisites.

All readings are available on: <http://BaselineScenario.com>. Be sure to check there under the category of "Classroom". But also look at regular updates to our Baseline, our latest policy proposals and generally follow postings as they go up; you can sign up for updates or subscribe (all free). Posting comments on the website is strongly encouraged.

Sloan Professional Standards apply. Ask if you have any doubts about appropriate behavior. Parts or all of some sessions may be recorded. Official website: <http://stellar.mit.edu/S/course/15/fa08/15.976/>. Also a good resource: <http://www.iie.com/realtime/>.

**Tuesday, October 28:** In the Deep End – Saving the Eurozone

Lecture: Latest developments

Discussion: Cracks in the global landscape. Engaging with the world, through the web.

**November 4:** The Fiscal Stimulus and Other Policy Responses

Lecture: What can policy do? [See my testimony to the Joint Economic Committee, Oct 30]

Discussion: Understanding how the crisis became global.

**November 11:** No class (MIT holiday)

**November 18:** The G20 Summit (which will be held November 14-15 in Washington, D.C.)

Lecture: Summit outcomes.

Discussion: After the US election, now what?

*Tentative schedule is below here. This will be revised as events warrant. Suggestions for guests to invite, in person or by phone, are very welcome:*

**November 25:** Europe in the Headlights

**December 2:** Emerging Markets (focus on India and China)

**December 9:** Developing countries (with Gates Foundation involvement)

**December 16** (final session): What(ever) next for the global economy?

*Update (November 30): Class was not held on November 25.*

## MIT: Class #1 on Global Crisis

**Simon Johnson** | 29 Oct 2008

Here are the slides I used in the first class, which ran from 4pm to 7pm yesterday. Tell me if anything about them is unclear.

We went in the deep end.

1. The global crisis is having an impact everywhere – including, the students tell me, making conditions harder for microfinance in Africa or India (I asked: how far flung are the implications?).

2. The bank (and other) recapitalizations have helped, but they have also created additional vulnerabilities. We talked a great about what is happening in the eurozone, and the kind of policies which can turn that situation around.

3. And right now the risks for emerging markets are serious. Of course, many of them have sizable reserves and the IMF can help (and is helping). But scale of this change of sentiment and capital movement out of emerging markets and into ... mostly the dollar (and US Treasuries in particular) threatens to overwhelm all normal flood barriers.

If you have questions for the MIT students, please post them here. We'll discuss in class, and get back to you as effectively as possible.

## Financial Crises, Political Consequences

James Kwak | 29 Oct 2008

Hard economic times have political consequences, many of them unfortunate.

In Argentina, we've already seen the government nationalize the private pension system in what many believe to be a naked grab for cash with only a distant relationship to the rule of law.

In Russia, a central government with a war chest of over \$500 billion in foreign currency reserves (at least when the crisis started) now has the power to determine which of the billionaire oligarchs will survive and which will be bankrupted. Yesterday the government provided \$2 billion (WSJ, subscription required) to the Alfa Group, Mikhail Fridman's conglomerate, to avoid save him from giving up his 44% stake in a cellular carrier to Deutsche Bank. On Friday, another billionaire will have to come up with \$4.5 billion to avoid giving up 25% of the metals company OAO Norilsk Nickel to Western banks including Merrill Lynch and Royal Bank of Scotland, and will likely turn to the government.

Arguably the government's power in this situation is analogous to the powers the US has granted to the Treasury Department to choose winners in the financial sector. Still, given the other things we know about Russian politics, it is not too far-fetched to see government money used to protect Vladimir Putin's political allies, impoverish his opponents or nationalize their assets, and keep Russian assets out of Western hands. (Whether the government will have enough money for the job is another question.)

Another likely reaction of governments faced by financial and economic crisis is a return to (or, in many cases, an increase in) protectionism. Richard Baldwin describes how the current state of global trade agreements makes this not only possible but likely, further hurting the global economy.

Finally, there's (still) Zimbabwe, forgotten by the world, where power-sharing talks are still going nowhere.

## Things That Don't Make Sense, Airline Edition

James Kwak | 30 Oct 2008

We now interrupt our global crisis programming to bring you news from the rest of the economy . . .

Earlier today, the Department of Justice approved the merger of Delta and Northwest, which I believe closed later this evening. In its statement, the Antitrust Division blessed the merger, saying:

the proposed merger between Delta and Northwest is likely to produce substantial and credible efficiencies that will benefit U.S. consumers and is not likely to substantially lessen competition. . . .

Consumers are also likely to benefit from improved service made possible by combining under single ownership the complementary aspects of the airlines' networks.

Now, for literally years, every expert on the airline industry has been saying that the industry needs less competition, less capacity, and higher prices (bad for consumers), and consolidation is the way to achieve that end. Put another way, if Delta and Northwest actually believed the DOJ's statement, they wouldn't have bothered merging in the first place.

I'm not saying that the DOJ should have blocked the merger – not being an expert on the airline industry (although I am an expert on flying on airlines), I defer to those who say mergers are necessary for the health of the industry. But since when did the DOJ become their PR firm?



## IMF Creates Special Boarding Lane for 1st-Class Countries

James Kwak | 30 Oct 2008

One of the subplots of the global financial crisis has been the return of the IMF to center stage: \$15.7 billion for Hungary, \$16.5 billion for Ukraine, and \$2.1 billion for Iceland, with talks continuing with Pakistan and other countries. The Hungary bailout, for example, looks a bit like the old IMF, which insisted on higher interest rates and fiscal austerity in exchange for loans. These conditions attached to past bailouts have made many countries reluctant to turn to the IMF; in South Korea, for example, domestic hatred of the IMF (the emerging markets crisis of 1997-98 is known as the “IMF crisis” in Korea) makes accepting money from it politically impossible.

In order to loan money quickly to countries that need it, the IMF today announced a new \$100 billion Short Term Loan Facility offering three-month loans to countries that are deemed to be financially sound (public and private debt at sustainable levels) but are being buffeted by the financial crisis anyway. These loans will have essentially no conditions, and can be used to bolster foreign currency reserves to protect against currency crises, to recapitalize financial institutions, or for other purposes.

This should be a step in the right direction, but raises two issues. First, the IMF only has about \$200 billion in lending capacity, and with over \$30 billion allocated to Iceland, Hungary, and Ukraine, and \$100 billion for “healthy” countries, it could be approaching that limit fast. G7 countries have already committed trillions of dollars to their domestic economies; \$200 billion for the rest of the world could run out quickly, and raising more money from member nations would be politically difficult right now. (The US in particular is never keen to help out international organizations.)

Second, the new lending facility draws another line between the haves and the have-nots of the global economy. (The first line was drawn by the Federal Reserve in deciding who got swap lines – and, by the way, the Fed just made \$30 billion each available to Brazil, Mexico, South Korea and Singapore.) Countries with the IMF’s seal of approval get loans with no conditions; other countries get the conditions that have been so unpopular in the past. This is more than a normative issue: in a financial crisis, falling on the wrong side of the line can exacerbate the problems faced by a country or a bank, because it saps confidence

further and accelerates capital flight. The IMF has promised not to reveal the names of countries that are rejected for its no-condition loans in order not to destabilize them further, but speculators will speculate. And countries that do not qualify will harbor the same resentments of the IMF (and the perceived global economic order) as ever.

(IMF for Beginners, by The Big Money (from Slate).)

## Homeowner Bailout Around the Corner?

Simon Johnson | 30 Oct 2008

News sources are reporting more details on the possible mortgage restructuring plan for distressed homeowners first mentioned by Sheila Bair in her Congressional testimony last week. The basic outlines of the plan are:

- Lenders would agree to reduce monthly payments to be affordable, perhaps based on a percentage of the homeowner's income. The reduction could be achieved by reducing the interest rate, reducing principal, or extending the term.
- If the amount the homeowner could pay would result in a mortgage worth less than the foreclosure value of the house, the loan would not be modified and the lender could foreclose.
- The government would then partially guarantee the new mortgage and absorb part of the loss if the homeowner defaulted.
- The numbers of 3 million homes and \$600 billion in total mortgage value are being thrown around.

This is roughly consistent with the principles we outlined earlier: the lender gets more than it would have gotten in foreclosure, the homeowner is better off than being on the street, the community benefits because there are fewer foreclosures. There are three key issues that still need to be negotiated.

1. How much will homeowners be expected to pay? Too much, and the lenders will not have to write down their loans very much, and the government will be on the hook for risky mortgages; too little, and the lenders will not participate.
2. How do you solve the securitization problem, that is, the current inability of many servicers to modify loans that are owned by other parties? This may require a new law in and of itself (one suggestion here).
3. How do you decide which homeowners are eligible? If people who are delinquent get cheaper mortgages and people who are struggling but paying on time don't, the latter will scream. It is still in the interests and hence within the rights of the lender, the delinquent homeowner, and the government to do the deal, but that won't reduce the indignation.

There are also a couple of enhancements to the program that could be considered. First, shouldn't the government – by which we mean the

taxpayer – get something for its guarantee (besides the satisfaction of knowing that it's doing what's best for the country)? The homeowner and the lender are both better off than they would be otherwise (homeowner on the street, lender forced to foreclose), and the government is worse off (because some of these new mortgages will fail). The government could get a share in the future appreciation of the house, for example.

Second, to protect against default by the homeowner on the new mortgage, the government could secure the loan against his or her future earnings, because the government already has an enforcement mechanism it can use: the IRS. This would protect the taxpayer's interests.

Finally, one note of caution. Loan modifications should work for some proportion of delinquent homeowners, but there are probably millions of homeowners who have no chance of paying any mortgage on their houses that would be acceptable to their lenders. People with option ARMS who made minimum payments and then saw their mortgage rates reset upward by several percentage points will not be able to pay anything close to what lenders will require not to foreclose. In conjunction with any mortgage restructuring plan, there also has to be a plan to manage the flow of properties onto the market, because a flood of foreclosures will only cause prices to plummet further. It seems like there are so many things to do, but that is the price of the situation we are in.

**Update:** Here's another proposed solution to the securitization problem.

## Testimony Before Joint Economic Committee, Today

Simon Johnson | 30 Oct 2008

Here is the written testimony I submitted to the JEC. In my verbal presentation this morning (5 minutes only, strictly enforced) I stressed the following.

1. The global economy is slowing fast, and likely faces an unprecedented (since 1945) recession. The pressures on emerging markets are intense, and inflexibility in Europe in both policy (Eurozone, I'm talking about you) and labor markets (for almost all the European Union) creates serious macroeconomic vulnerability at this stage.

2. In the US, significant (OK, also unprecedented) countercyclical policies have now been put in place. In particular, the Fed is running through its anti-deflation playbook (which Mr Bernanke was kind enough to publish back in 2002). We have no idea how to properly measure the scale, let alone the impact, of this increase in: liquidity, contingent liabilities, actual or potential direct lending to almost everyone in the US, and, via unlimited swap lines to some central banks and new \$30 billion swap lines to four emerging markets, to many institutions around the world.

3. So deciding what to do with fiscal policy is very hard. In other industrialized countries, you can rely on "automatic stabilizers" to a greater degree than in the U.S., meaning that their government spending (and deficit) increases in recession because unemployment benefits and the like are more generous. In the U.S., we have to make a conscious decision. And that decision needs to be made soon, within a month or so, because any fiscal stimulus works only with a time lag – and the more you want to do things that definitely raised GDP (like infrastructure), the longer the time lag.

So my recommendation is... (well, read the testimony; the numbers are on the first page; detailed recommendations follow on how to spend, for both immediate impact and longer-term benefits).

Comments welcome – there is still a long way to go, in terms of legislation design and implementation.

**Update:** If you want to see the actual session courtesy of C-SPAN, go here. (Note there were 8 speakers and the session was two hours long.)

## Martin Feldstein: Stimulus Should Be Big

James Kwak | 30 Oct 2008

Conservative economist and deficit hawk Martin Feldstein is arguing that we need an economic stimulus package now (immediately after the election) that is big (\$100 billion won't cut it) and long. OK, he didn't explicitly say it should be long, but he did say this:

Previous attempts to use government spending to stimulate an economic recovery, particularly spending on infrastructure, have not been successful because of long legislative lags that delayed the spending until a recovery was well underway. But while past recessions lasted an average of only about 12 months, this downturn is likely to last much longer, providing the scope for successful countercyclical spending.

This is basically what we said in the National Journal and what Simon said in this morning's testimony. I'm not claiming that Feldstein listens to what we say (I strongly doubt it). But his op-ed emphasizes the fact that most economists from across the political spectrum are on the same page on this issue.

**Update:** "Business executives and Republicans" are on board, too.

## U.S. Economy Saved (Temporarily) by Defense Spending

James Kwak | 31 Oct 2008

As you probably know by now, GDP declined at an annual rate of 0.3 percent in the 3rd quarter (July-September). Menzie Chinn has a good post at Econbrowser breaking down the components of the GDP numbers. One number jumped out at me: defense spending contributed 0.9 percentage points of GDP growth. Put another way, if defense spending had remained flat in Q3, GDP would have declined at an annual rate of 1.2 percent.

Now, there may be very valid reasons for an uptick in defense spending. For one thing, our military's equipment is being depleted by the wars (and in some respects the equipment was insufficient to begin with). But I'm not sure we can count on it in future quarters – or that we want to count on it.

## Financial Crises and Democracy

James Kwak | 31 Oct 2008

Lorenzo Bini Smaghi, a member of the Executive Board of the European Central Bank, gave a thought-provoking speech in Milan last week. In particular, he focused on the role of democratic politics in responding to the financial crisis and, more broadly, in how governments manage their economies. Smaghi begins with the premise that it was a mistake to let Lehman fail in mid-September (not everyone agrees with this, but many people do), thereby triggering the acute phase of the credit crisis. He then asks why this happened.

As subsequent events have shown, in particular when the first rescue package was rejected by the US Congress, opposition to providing the financial sector with public funds came not only from within the government, but also from parliament. The Members of the US Congress, many of whom face voters at the beginning of November, feared that such a decision would compromise their re-election. There was opposition to rescuing Lehman Brothers, therefore, not only from within the Administration, but also from Congress and, more broadly, from public opinion. In other words, the decision was largely the result of a democratic process.

For Smaghi (and for many others), however, the systemic importance of the financial sector meant that it was actually in the interests of US citizens to bail out Lehman and, later, much of the financial sector.

The financial sector is different from other sectors, precisely owing to the systemic and contagion effects that a crisis would have on all the other sectors. It is thus in the interests of the individual citizen to support the decision to rescue a bank in difficulty, as the individual interest coincides with the public interest.

Smaghi continues by investigating why the public is opposed to a rescue of the financial system that is actually in its own interests.

My opinion is that this doesn't require investigation, as there is little reason to expect people to vote in their own economic interests since, in most cases, thick screens of political rhetoric make it extremely difficult for them to identify where their interests lie. To take the most obvious example of the moment: According to the non-partisan Tax Policy Center, Barack Obama's tax plan will be better for the bottom four quintiles of the income distribution, and John McCain's plan will only be better for the top quintile (see the figure on page 41); yet more



Americans think that Obama will raise their taxes than that McCain will (50% to 46%), thanks to the constant repetition of the “spreading the wealth” sound bite (note how the numbers have reversed in just the last two weeks). If governments make the right economic choices on occasion, it is sometimes in spite of popular opinion but, most often, because the public does not have a strong opinion on the topic. (How many people get worked up about the Fed Funds rate, at least in normal times?)

In some respects, it may actually be good that the economy is being overseen by a lame-duck administration that is largely free to ignore public sentiment, and therefore has been able to ditch its vocal anti-regulatory ideology in favor of a series of pragmatic steps that, collectively, constitute the largest direct government intervention into the economy in my lifetime. There are certainly aspects of the intervention that reflect the free-market instincts of the players concerned, such as the outsourcing of TARP to banks and asset management firms and the relatively gentle recapitalization program. But on the whole, it is an exercise of government power in the economy that until a few months ago was anathema to the conservatives in the administration.

This lurch to the center has also been profoundly disorienting for the McCain campaign, which has tried to straddle the field by, on the right hand, arguing that the answer to the crisis is cutting earmarks and reducing spending, while, on the left hand, proposing an even more aggressive intervention in which the government would buy up and refinance mortgages directly. The conventional wisdom is that the financial crisis has helped Obama because “the economy” is a traditionally Democratic issue. But another interpretation is that, in a time of economic crisis, Americans are looking for pragmatic, centrist, even technocratic policies from their leaders, which Paulson and Bernanke have been trying to provide; in this environment, McCain’s brand – the warrior, the maverick – tends to work against him.

**Update:** On the topic of reducing spending, it turns out that the Obama campaign has been far better than the McCain campaign at controlling its own costs. Coming from a company that is fanatical about keeping costs down, I’m impressed.



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