

## Low-Tech Archive of The Baseline Scenario for November 2008

Known problems:

- Block quotes are not indented, so they don't look like quotations.
- Some media may not appear properly.

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Nov 30, 2008 8:46 PM

### [Greg Mankiw Channels Keynes](#)

from [The Baseline Scenario](#) by James Kwak

I am struck by the degree of consensus among mainstream economists about how to deal with the current recession. Greg Mankiw, Chairman of President Bush's Council of Economic Advisors from 2003 to 2005, wrote a [New York Times op-ed](#) arguing for a Keynesian response to the recession - which is what Summers, Stiglitz, and all the other Democrats are calling for.

It's also a wonderfully clear exposition of the challenge, considering in order the logical possibilities for increasing aggregate demand. Mankiw doesn't quite come out and endorse an increase in government spending, although he does say it's the only component that can plausibly be increased (as opposed to consumption, investment, and net exports). He holds out some hope for expansionary Federal Reserve policy. In any case, it's a quick read and worth it.

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Nov 30, 2008 8:35 PM

### [Oh, It's Nice to Have the World's Reserve Currency](#)

from [The Baseline Scenario](#) by James Kwak

When times are tough, governments have to borrow money. Luckily for us Americans, we can borrow it for free (for now at least - I know this isn't going to be true forever): 3-month Treasuries have a yield of 0.01%, and even 3-years are at 1.25%, both below the

rate of inflation. (By the way, even if you don't have Bloomberg, you can get Treasury yields at [Yahoo! Finance](#) among other places.)

By contrast, the UK and Italy recently had [unexpected trouble](#) selling 3- and 4-year bonds, respectively, having to offer 10 basis points over similar existing debt. Mind you, this isn't Iceland and Hungary we're talking about here, but two members of the G7. Basically, investors are getting worried that deep recession (which crimps tax revenues) and large bailout packages, piled on top of existing debt, are creating the risk that at some point governments will either default on their debt or, in the case of the UK (which still controls its currency), inflate it away. The same concern can be seen in credit default swap spreads (remember [Friday's post](#)?). Italy's have climbed from single digits for most of 2007 and 40 bp in the summer to 141 bp.



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Nov 30, 2008 7:09 AM

### [Waiting for the European Central Bank, And Waiting](#)

from [The Baseline Scenario](#) by Simon Johnson

The European Central Bank is widely expected to cut interest rates, [perhaps by 50 basis points](#) (half of a percentage point), this week. They could, of course, follow the lead of the Bank of England or the Swiss National Bank and go for a much larger cut (150 basis points and 100 basis points respectively on their most recent rounds). But they probably won't and not because the economic outlook in the eurozone looks so different from those other parts of Europe or because the [ECB's Governing Council](#) knows something we don't or because their interest rates are already low (actually, at 3.25%, they are definitely on the high side.)

The difference really lies in two factors: extreme views about inflation, and the nature of decision-making within the ECB. Belief that a resurgence of inflation is always imminent is, of course, Germanic but not limited to Germany. Within the 15 central banks represented on the ECB's Governing Council, there will always be at least one or two who see unions as looking for an excuse to push up wages. We can debate whether or not this view is correct under today's circumstances, but that is irrelevant - these inflation hawks still appear to strongly hold such beliefs.

Of course, there are inflation hawks among all groups that make monetary policy. But the consensus-seeking process at the ECB is such that even just a few such people can serve as an effective brake on rapid action. The existence of such views has plainly not prevented the ECB from taking dramatic action on some fronts (e.g., in terms of liquidity provision the ECB arguably moved farther and faster than the Fed last year), but for core monetary policy issues - i.e., [when the price stability "mission" is at stake](#) - a couple of outliers can really slow things down (particularly if one or more are [members of the Executive Board](#).)

if the ECB puts through a fairly standard interest rate cut, then it is Business As Usual in the eurozone. Combined with the rather anemic (or largely smoke and mirrors) fiscal stimulus in the EU, on top of Europe's well-known labor market inflexibility (i.e., it is hard to reduce your wage costs, even if business turns down sharply), then the eurozone is in for a rough ride.

If the ECB surprises the market with a dramatic interest rate cut, at least we will know they are firmly in catch-up mode. But even then, I'm afraid it is probably too late to have much effect on the recession in 2009. Under the best of circumstances, interest rate moves affect the real economy with a lag of at least a year. And the current disruption in the credit market is far from helping monetary policy be effective.

While we will no doubt look back on this crisis as having its epicenter in the U.S., it's the lack of coherent policy response (monetary, fiscal, regulatory) in Europe over the past year that has really helped turn this into a sustained global crisis.

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Nov 29, 2008 9:29 PM

### [Synthetics and School Boards](#)

from [The Baseline Scenario](#) by James Kwak

OK, remember Felix Salmon's [explanation of synthetic CDOs](#) from my previous post? Good, because you're going to need it.

Earlier this month, [Planet Money and The New York Times](#) collaborated on a story about how five Wisconsin school districts may have blown \$200 million - \$165 million of which was borrowed - on an investment that no one involved, including the investment banker selling the deal, seems to have understood. The details aren't entirely clear from the main Times article, but by looking up a couple of other Planet Money posts, I'm pretty sure it went something like this:

1. 5 Wisconsin school boards took \$35 million of their own money and borrowed another \$165 million from Depfa.
2. They used the \$200 million to buy a tranche of a synthetic CDO created by Royal Bank of Canada.
3. Royal Bank of Canada took that money, and presumably money from other people as well, and created that synthetic CDO by selling insurance (using credit default swaps) on \$20 billion worth of corporate bonds. The synthetic CDO was like an ordinary CDO in that it had cash flows coming in - premium payments on the credit default swaps. The up-front money (including the schools' \$200 million) was needed as collateral. It's not clear how senior the schools' tranche was, but the Times says that most if not all of the \$200 million in collateral will be lost, so it was probably pretty junior.
4. If there were no defaults, the schools would have netted \$1.8 million per year - a 5.1% return.

We've all made bad investment decisions. I don't want to pick on the Wisconsin schools for choosing a bad investment, but for something else: having the wrong investment goal.

There's a corporate finance principle which says, in essence, that companies shouldn't be making risky financial investments that their shareholders could make on their own. Making risky investments in their business can be justified, but otherwise they should return the excess cash to shareholders and let them invest it on their own. The same principle should hold with greater force for local governments. If you have a \$35 million surplus and for operational reasons you want to keep it, it should be invested in something safe. If "something safe" doesn't give you the return that you think you need, then you should raise taxes, issue bonds, or cut back on your plans.

Now, structured financial products can play a role in reducing your risk. In general, derivative trades have a "safe" side and a "risky" side. For example, if you buy a call option, you are on the safe side: you are paying a fixed amount, and you may enjoy an unlimited gain. However, if you sell a call option, you are on the risky side: you are gaining a fixed amount, but you may face an unlimited loss. Credit default swaps are similar in that one side gets a guaranteed but small stream of payments, but faces a very large but unlikely loss. So it makes sense for a local government to use derivatives to hedge some other exposure it has - but not to basically write call options or credit default swaps for other people.

This may seem unutterably obvious, so why do I bother bringing it up? Well, apparently it is still going on. [Bloomberg](#) has a story about how local governments and agencies are still using derivatives to boost their short-term cash flows. The most common technique seems to be interest rate swaps, in which the government gets paid at a fixed rate and pays at a floating rate (with more complex variants, of course). Again, these have the property that the inflows are fixed but the outflows are not, which means they are the reverse of a hedge. And like many derivatives, they are zero-sum contracts: someone on the other side of the trade thinks that he is going to make money on it, which means that your risk-adjusted expected return should be zero. Actually, they are less-than-zero-sum contracts, because the investment banks in the middle always get their fees. When is this going to stop?

(Wait a second, you may say: If governments shouldn't be taking on open-ended positions, then what is the federal government doing? That's different, though: in their case, they are taking on open-ended positions in order to further the public interest in a broad sense, not to get a higher return on their money. For example, the FDIC is guaranteeing bank debt in order to ensure the health of the financial sector, not because it thinks it can make a quick buck. Reasonable minds can differ about how effectively the government is serving the broad public interest, but most of us think they have to try.)

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Nov 29, 2008 3:16 PM

[Synthetic Bonds and CDOs for Beginners](#)

from [The Baseline Scenario](#) by James Kwak

Felix Salmon has a great introductory post on [synthetic bonds and CDOs](#).

I have a post I want to write about synthetics and inappropriate investments in general, but I have to find an hour to write it.

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Nov 28, 2008 11:00 PM

### **Credit Default Swaps, Herald of Doom (for Beginners)**

from [The Baseline Scenario](#) by James Kwak

No, this isn't another article about how credit default swaps (CDS) have ruined or are going to ruin the economy. It's about one of the nice side benefits of CDS: the habit they have of pointing out who is going to get into trouble next. And it has pretty Bloomberg charts!

As everyone probably knows by now, a CDS is insurance against default on a bond or bond-like security. If you think about it for a while, you will realize that this means the price of the CDS reflects the market expectation that the issuer will default.

The price of a credit default swap is referred to as its "spread," and is denominated in basis points (bp), or one-hundredths of a percentage point. For example, right now a Citigroup CDS has a spread of 255.5 bp, or 2.555%. That means that, to insure \$100 of Citigroup debt, you have to pay \$2.555 per year.

CDS exist for various durations and on many different kinds of debt. If someone doesn't specify the duration or the type of debt, he is usually referring to a 5-year CDS on senior debt. That means that the contract will be open for 5 years, during which one party (the insured) pays premiums and the other (the insurer) promises to pay off if Citigroup defaults. If there is no default within 5 years, the insurer gets to keep the premiums.

Look at it from the standpoint of the insurer. If Citi doesn't default, I get  $\$2.555 \times 5 = \$12.775$ . If Citi defaults immediately, I have to pay \$100. That implies that I think there is about a 12.8% chance that Citi will default (ignoring the time value of money).



Actually, my expectation of a default is actually somewhat higher, for a couple of reasons. First, if Citi defaults 4-1/2 years from now, I have to pay \$100, but I've collected the \$12.775 in the meantime (assume premiums are paid at the beginning of each year for simplicity), so my loss is only \$87.225. Second, in any case I don't have to pay the full \$100; I only have to pay \$100 minus the value of the security, which is unlikely to be zero even in the case of a bankruptcy. For example, Lehman bonds were only worth 9 cents on the dollar (so insurers had to pay out 91 cents), but Washington Mutual bonds were worth 57 cents. So my net loss will be lower, which means that my expectation of a default is higher. (The expectation is the money I expect to gain if there is no default, divided by the net amount I expect to lose if there is a default.)

Luckily, Bloomberg can calculate all of this for you, and right now they say the chance of a Citigroup default in the next 5 years is 16.2%. (That's using a recovery rate of 40 cents on the dollar, but you can type in whatever rate you want.) You can see the valuation on the right side of the screen below.

GRAB
CurncyCDSW
1<GO> to save Deal, 2<GO> to save curve source
CPU:299

Deal
Send to VCON
Curves
View
Ref. Obligation
Bond Hedge
Forward CDS Matrix
Amortization

**Deal Information** RED Pair:189BFDAA2
**Spreads** Date

7)Reference: Citigroup Inc
Counterparty:
Deal#:
Ticker: /
Series:
Privilege: U User
Business Days: US GB
Settlement Code: USD
Business Day Adj: 1 Following
Currency: USD
BUY Notional: 10.00 MM
Amortizing: N
Effective Date: 11/29/08
Knock Out: N Month End: N
Maturity Date: 12/20/13
Day Count: ACT/360
Payment Freq: Q Quarterly
First Cpn: 3/20/09
Pay Accrued: T True
Next to Last Cpn: 9/20/13
Curve Recovery: T True
Date Gen Method: T IMM
Recovery Rate: 0.40
Debt Type: 1 Senior
Deal Spread: 255.500bps
9)Upfront Fee: 0.00%

**Calculator** Mode: 1 Calc Price
Valuation Date: 11/29/08
Model: JPMorgan
Cash Settled On: 12/ 3/08
Price: 100.00000000
Repl Sprd: 255.500 bps
Principal: 0.00
Sprd DV01: 4,290.17
Accrued: 0.00
Days: 0
32) Sprd KRR
Market Val: 0.00
IR DV01: .00

Curve Date: 11/28/08
Benchmark: S 23 MMid
US BGN Swap Curve
Sprds: C Contributor AAsk
101214 USD Senior IMMI
Par Cds Spreads Default
Flat: N (bps) Prob
6/22/09 328.200 0.0306
12/21/09 328.200 0.0569
12/20/10 307.399 0.1008
12/20/11 282.500 0.1344
12/20/12 262.399 0.1620
12/20/13 255.500 0.1927
12/21/15 251.699 0.2552
12/20/18 245.199 0.3345
Frequency: Q Quarterly
Day Count: ACT/360
Recovery Rate: 0.40

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000
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OK, that's interesting, but why call credit default swaps heralds of doom? Because CDS have shown the ability to identify what financial institutions (or countries) are going to get into trouble next. When the market starts getting nervous about a company and thinks it is more likely to default, insurance on that company's debt starts getting more expensive. And this tends to happen before you start reading about that company in the newspaper.

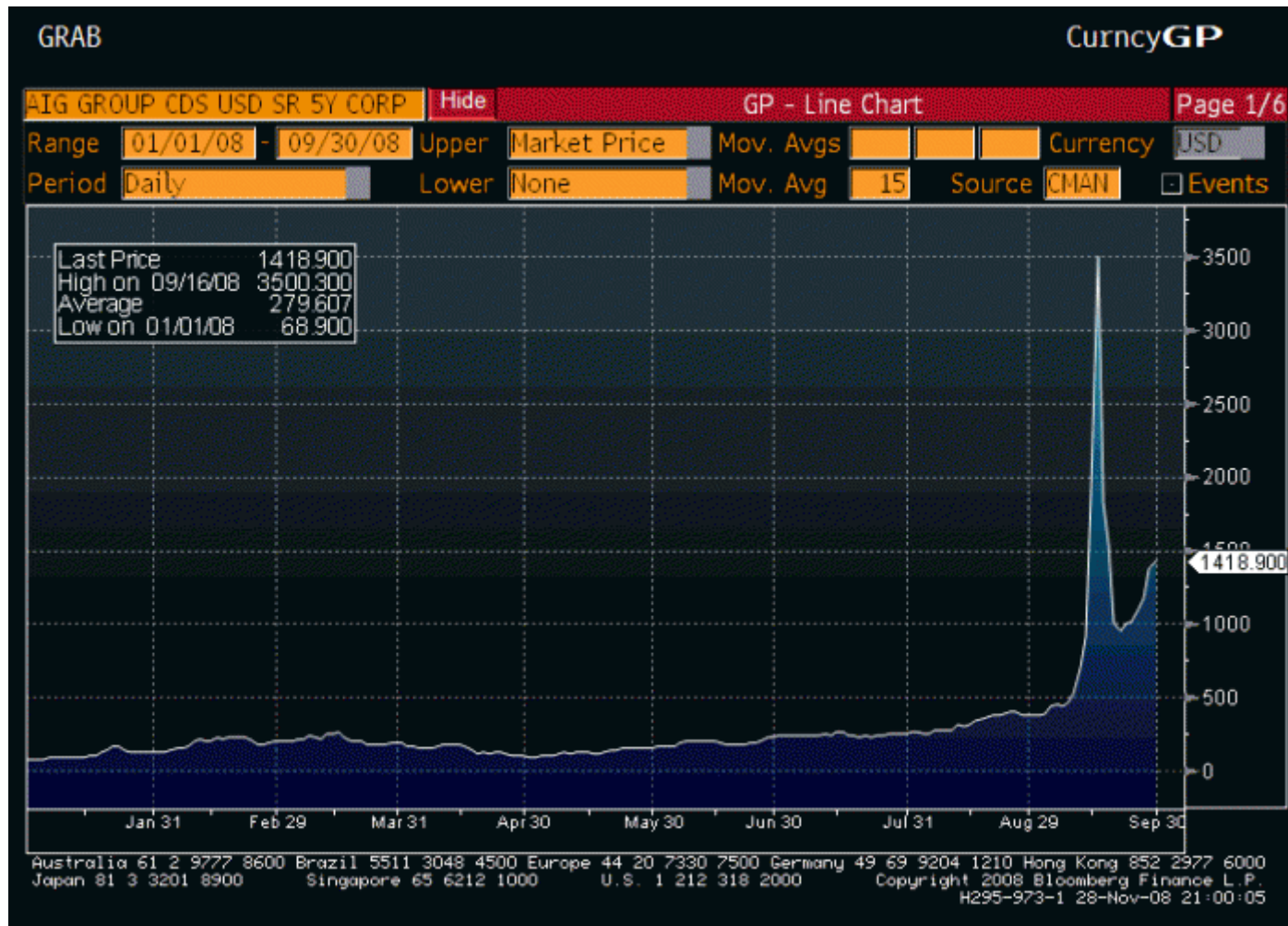
Here are a few examples, in which I compare CDS prices to my home-grown "mainstream media" indicator, which is when the first article appeared in the New York Times saying a company was in danger of failure (as opposed to just taking writedowns along with every other bank). This is not scientific, because really you would want to compare the company's CDS curve to an index of other companies in the industry to separate out sector-wide trends, but you get the point.

This is the chart of Bear Stearns's CDS. Note that the price started climbing steeply in late February. The [first Times article](#) about Bear Stearns's troubles was published on March 11, referring to the plunge in the stock price the previous day.





This is AIG. It looks like an instantaneous spike in mid-September, but the price had been climbing steadily, from double digits in May to 300 bp in mid-August to 430 bp on September 4. The [first Times article](#) appeared on September 12, again describing events on September 11. By September 10, however, CDS spreads were already up to 517 bp.



And this is Iceland. In the middle of 2007, Iceland's CDS were priced below 10 bp. They spent most of July and August this year in the high 200s, passed 300 in mid-September, and reached 395 bp on Friday, September 26. Iceland only reached the attention of the mainstream media on Monday, September 29 ([Times article](#) the next day, in which Iceland barely got a mention).



So whose CDS spreads are climbing now? That will have to wait for another, or several other, posts.

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Nov 27, 2008 5:34 PM

[And a Volcker on Top](#)

from [The Baseline Scenario](#) by James Kwak

Or a Volcker in a pear tree, if you prefer.

Quick, name the current head of Council of Economic Advisors. Or the head of the National Economic Council. Stumped?

The head of the CEA is Edward Lazear, a former economics professor at Chicago and Stanford GSB. The head of the NEC is Keith Hennessey (I had to look that one up), a former, um, tester for Symantec (a software company), research assistant at a think tank, staffer for a Senate committee, and staffer for Trent Lott, with a masters in public policy from the Kennedy School. (That's according to Wikipedia.) They are being replaced by Christina Romer and Larry Summers, respectively, two of the most prominent and respected economists in the world.

And now, for an encore, Obama has named Paul Volcker, now the most respected chairman of the Federal Reserve in recent memory, the hawk who choked off high inflation in the early 1980s, as head of the new Economic Recovery Advisory Board.

Does having an all-star lineup of economists and public servants guarantee a sound economic strategy? No, of course not. After all, you should have only one economic strategy, and we know about kitchens and too many cooks. But Obama is clearly trying to project the impression that he is bringing overwhelming firepower to bear on the problem, in an effort to bolster confidence in the markets. He is also signaling that his administration will follow a centrist, or at most moderate Democratic line. (Volcker first joined Treasury under Nixon, and was appointed Chairman of the Fed by Carter and then re-appointed by Reagan; Geithner is an independent.)

Remember those charges of socialism in the last weeks of the election? The few socialists out there are sure to be disappointed.

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Nov 27, 2008 5:22 PM

### [International Implications of the Citigroup Bailout](#)

from [The Baseline Scenario](#) by Simon Johnson

The Citigroup bailout was a good deal for Citi shareholders (who wouldn't appreciate a big transfer from the taxpayer during this holiday season?) and a great deal for Citigroup management. But it also has three global implications that perhaps have not yet been fully thought through.

1. The Citi deal shifts pressure from US financial institutions, at least for a while. But to the markets it raises the question: who or what is next? And the indications again point to the eurozone. Credit default swap spreads indicate increasing differentiation between Germany on the one hand and, say, Greece (or Ireland or Italy or Spain) on the other hand. I don't want to single out Greece, but the recent [IMF Article IV Report](#) has some very interesting debt path simulations (the report's Figure 3) - if you update these in the light of current global circumstances, you can see why Greece may well need a bailout before too long (remember: their government debt is in euros and cannot be inflated away, unlike in the US or UK, for example.) The market view is that some European governments could not really afford the generous bank bailouts they provided in October.

2. For all the increased discussion among politicians and academics about reforming the global system, to preempt the next crisis, why would the most powerful people on Wall Street want this? The Citi deal shows that the clout of the US financial industry has, if anything, actually increased over the past eighteen months. "Wall Street owns the upside and the taxpayer owns the downside" is an old saying which seems more appropriate now - and on a bigger scale - than ever. There is no harm in proposing changes to deficient national regulatory systems and international, rather creaky, Bretton Woods structures. But strong forces just found out that these structures are completely compatible with rather juicy bailouts (and there may be more to come), so don't expect rapid or meaningful real reform.

3. If we are now at the next stage of bailouts and of figuring out who can afford to do the bailing, then existing resources - in and around the IMF - for helping emerging markets are really not enough. The G7's strategy proposal to emerging markets is clearly: "finance, don't adjust (much)," i.e., keep on growing one way or another. This might or might not be a good idea, but it will only work if backed by enough official loan support when needed - this is what many countries will need to sustain a current account deficit or offset capital outflows and keep growth on track. IMF available resources, even with the recent loan from Japan, are only around \$200bn. You really cannot save many banks/countries with that amount of money these days - the IMF lent [over \\$40bn this month alone](#).

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Nov 26, 2008 1:32 PM

### **[\\$7.8 Trillion and Counting](#)**

from [The Baseline Scenario](#) by James Kwak

The New York Times has an arresting chart on the government's [new financial commitments](#) made during the financial crisis. According to the Times, the government has committed \$3.1 trillion as an insurer, \$3.0 trillion as an investor, and \$1.7 trillion as a lender. Wow, you may think, that's a lot of money. US GDP is about \$14 trillion per year; the budget deficit in recent years has been running in the half-trillion range. But wait, there's more: the Times omits roughly \$5 trillion in guarantees made by Fannie Mae and Freddie Mac that are now officially on the government balance sheet (although they were always implicitly there).

All that said, though, there's a big difference between these "commitments" and ordinary government spending. Ordinary government spending simply evaporates into the economy: for example, Medicare expenses go to pay for people's health care, and the government will never get them back. Making financial commitments is what banks and other financial institutions do, and they do it because they expect to get their money back. What we are seeing is the growth of a massive financial institution within the government. This one's primary goal is the public interest - in this case, the health of the economy - rather than getting its money back. But still, it should get most of the money back.

Let's start with the insurance programs. Half of the Times's \$3.1 trillion number is the \$1.5 trillion guarantee on new senior unsecured bank debt announced by the FDIC in October. Under that program, the FDIC is charging an insurance premium to banks of 0.75% of the debt issued. (I heard that banks are trying to negotiate this down, but I don't know where that stands.) So the FDIC's eventual losses will not be \$1.5 trillion (the maximum amount of debt guaranteed), or even the fraction of that debt that defaults, but that fraction minus the insurance premium on all the debt, minus any return the FDIC gets on the premiums in the meantime. Who knows, the FDIC might even make money.

Of the \$3.0 trillion in investments, the biggest chunk is the \$1.6 trillion the Fed made available to buy commercial paper directly from issuers (big companies). Commercial paper pays interest, and it is historically among the safer of investments; this is a big part of what money market funds traditionally invest in. The rate of defaults on commercial paper will certainly go up during the recession, so there is a chance that the Fed will lose some money on this deal. But it should only be a small fraction of the \$1.6 trillion. Another chunk of the investments is the capital injections that Treasury is making into banks; while there is some risk that some of that money will not be paid back, the money invested is earning 5% per year (8% for the latest Citigroup tranche).

Of the \$1.7 trillion in loans, most of this is new facilities made available by the Fed to offer short-term loans against a wide variety of collateral. The vast majority of these loans will be paid back; for those that will default, the Fed will be able to sell its collateral, probably at a loss (since the whole point of this program was to give people a place to put their illiquid, impaired assets). So again, expected losses should be low.

I don't have anything close to the data you would need to forecast the actual losses, but my wild guess would be the low hundreds of billions. (I am not particularly hopeful about



the guarantee on \$306 billion in toxic Citigroup assets, for example.) The ultimate magnitude of that loss depends, more than anything else, on the overall state of the economy over the next 3-5 years.

I wouldn't say there is no reason to worry about the vast amounts of money the government is putting on the line. And you can have legitimate concerns about the influence this means the government has in the economy, or the ability of the government to manage this volume of assets and programs. But when you see a number like \$7.8 trillion, it's important to bear in mind what it means.

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Nov 25, 2008 3:01 PM

### [Signs of Monetary Expansion](#)

from [The Baseline Scenario](#) by James Kwak

There was a new theme buried in today's announcements about purchasing \$600 billion in mortgage-backed assets \$200 billion in assets backed by other debt including student loans, credit cards, car loans, and small business loans. The [New York Times](#) story included these two paragraphs (emphasis added):

The action by the Federal Reserve on buying mortgage-backed securities brings the full force of monetary policy to bear on the credit markets. Having already reduced the benchmark federal funds rate to just 1 percent, **the central bank is now effectively using what economists call "quantitative easing" to reduce the costs of money.**

Instead of trying to reduce overnight lending rates in the hope of influencing longer-term interest rates for things like mortgages, the Fed is directly subsidizing lower mortgage rates. **It is doing so by printing unprecedented amounts of money, which would eventually create inflationary pressures if it were to continue unabated.**

The [Bloomberg](#) article has a similar passage, indicating that this is a message the Fed is consciously putting out, while taking care to deny that they are trying to increase inflation (emphasis added)

**The Fed won't be removing cash from other parts of the financial system to make up for the purchases,** government officials told reporters on a conference call. They rejected any comparison with Japan's so-called quantitative easing effort to combat

deflation, saying that the Fed's objective is to buttress credit markets rather than ramp up money.

What does this mean? It looks like the Fed will be buying securities either by wiring cold, hard cash to sellers, or by increasing their account balances at the Fed itself, without simultaneously selling Treasuries (or asking the Treasury Department to issue new Treasuries) to sop up an equivalent amount of cash. This ordinarily would run the risk of increasing inflation, but with short-term prices falling, arguably a bit of inflation is just what we need, as [Simon and Peter argued yesterday](#).

(If you found the last paragraph confusing, see my [Federal Reserve for Beginners](#) post.)

More economics bloggers trying to be funny: [Free Exchange](#) reported on today's \$800 billion worth of announcements and concluded with this sentence: "So, you know, hopefully that will work out."

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Nov 25, 2008 6:29 AM

## **[Bank Recapitalization Options and Recommendation \(After Citigroup Bailout\)](#)**

from [The Baseline Scenario](#) by Simon Johnson

By Peter Boone, Simon Johnson, and James Kwak ([pdf version is here](#))

### **Summary**

1. Debt and equity prices for U.S. banks at the close on Friday, November 21, indicated that the market is testing the resolve of the government to support the banking system. Allowing major banks to fail is not an option, as was made explicit in the G7 statement in mid-October. Significant recapitalization will be necessary to stem the pace of global deleveraging (the contraction of loans and sale of assets by banks around the world). However, the administration's strategy is not clear.
2. While full bank recapitalization is not a panacea, it is an important part of the policy mix that will get us through mid-2009, at which point a broader set of expansionary fiscal and - most important - monetary policies can begin to take effect.
3. The response this weekend by the U.S. authorities in providing financial support to Citigroup is a partial, overly generous, and nontransparent recapitalization, including a

large guarantee for distressed assets - which is very close to the asset purchases that Treasury only last week said it would not do. This U-turn confuses the market (again), leaves the fate of other major banks unclear, and implies much larger contingent liabilities and little upside for the taxpayer. This approach will be difficult to repeat multiple times because of likely political backlash.

4. The most important goal now is to put in place a stable, transparent set of rules for bank recapitalization, with sufficient political support and limits on the scope for further policy changes. Mr. Paulson's seemingly haphazard approach has become a part of the system problem.

5. While all recapitalization options have problems, the "least bad" is requiring firms to raise more capital and, for those that cannot, injecting capital through substantial purchases of common stock by the government. These can be managed through a special purpose agency or control board, which is designed to keep credit from becoming politicized and to sell the equity stakes when market conditions are sufficiently supportive.

6. Another TARP-type round, on slightly tougher terms than October, may serve as an emergency stop-gap measure, but it will not solve the underlying problems and any positive effects could be short-lived.

Below, we briefly review the current situation, discuss important considerations in any scheme, and then run through what appear to be viable alternatives. Finally, we make our own "least bad" proposal.

## **1. Current Situation**

We published a broad assessment of the situation and policy options early on November 20 (Thursday) on [WSJ.com](http://WSJ.com). On Thursday and Friday the outlook deteriorated significantly. Citigroup received the most attention, but credit default swap (CDS) spreads increased throughout the banking sector, suggesting that we (again) face a system problem.

U.S. authorities responded with a Citigroup bailout on Sunday night. The terms of this bailout are startlingly generous. Essentially Citi is partitioning off \$300 billion of "bad" assets, and the government is absorbing 90% of the losses on these assets after the first 9.5%, in exchange for non-convertible preferred stock; this amounts to buying Citi's troubled assets at a high price, since they are probably being handed over using book values as of September 30, which means those assets have already fallen in value. Treasury is also injecting \$20 billion under similar terms to the first TARP round. This looks like a great deal for shareholders (and Citi's stock gained 57% on Monday).

Unfortunately, this is far from a definitive solution to problems at Citi, let alone in the banking sector overall. Although Citi may be able to claim a larger amount of new capital, it only receives \$20 billion in cash, and it faces up to \$29 billion in losses on the

guaranteed assets and an unknown amount of losses on the remainder of its assets (over \$2 trillion, including off-balance sheet entities). Creditors need to see something sustainable and scalable to the entire system. The potential hole in U.S. financial balance sheets remains large.

### *Insolvency of the banking system*

The underlying problem is that the banking system is severely undercapitalized if we mark to market banks' loan portfolios. The recent sharp fall in bank stock prices reflects rapid deterioration in asset prices on secondary markets and growing concerns that banks are already, in reality, insolvent. For example, AAA subprime debt issued in first half 2006 fell in value by 23% during the last month. This was previously considered "safe" subprime debt. Commercial backed mortgages and consumer debt fell sharply in November. Banks have also not provisioned for the implied losses in their hold to maturity portfolios. For example, Citigroup has provisions equal to 1.2% of total (on balance sheet) assets.

In the medium term, the best thing for the banking system will be overall macroeconomic improvement, which will improve expectations for the assets on bank balance sheets. In this context, an aggressive stimulus package can reduce the amount of money that will be required to protect core banks.

### *Inconsistent policy*

American banks have been hurt by the inconsistent policy responses to bankruptcies so far. Despite being more leveraged, having less Tier 1 capital, and being backed by weaker sovereigns, the cost of funding to European banks (measured by credit default swaps) has remained relatively low because creditors are confident the governments will recapitalize banks without hurting the value of debt. Citigroup's default swap rose to 492 basis points on Friday, implying a high risk of default over the next five years. Even after Monday it was still priced at 249 bp.

By contrast, European banks such as Barclays and UBS default are substantially below US levels, at 147 and 160 basis points respectively. This US-Europe difference reflects nervousness that future US bailouts may be similar to those of Lehman or AIG, in which creditors lost a substantial amount. Because the US government lacks a clear, stable strategy for dealing with banks both now and in the future when they have capital shortfalls, creditors do not understand exactly what risk they are taking.

## **2. Elements for Any Potential Recapitalization Scheme**

Direct recapitalization is the purchase of common or preferred equity by the government (as TARP has been used since mid-October). An indirect approach would involve the government buying troubled assets (as in the original TARP proposal). Here are some issues to consider for each element of these potential approaches.

### *Equity Injection*

The market capitalization of the major banks is now so low that any recapitalization program in which the government buys common equity at market prices will effectively lead to nationalization. For example, if the government provides Citigroup with new equity equal to 33% of book value (\$41bn at end 2Q), the government will receive a majority of the equity. If the government injects similar new equity into Bank of America (pre-merger with Merrill) or JPMorgan it would own 30-45% of the bank.

If the government takes preferred equity, it would need to be at a fairly low (below-market) coupon in order to ensure that the banks can afford to pay the coupon without depleting capital. Since the coupons on preferred equity reduce future cash flows of the bank, these payments increase the cost of borrowing for the bank compared to common equity. It should be possible to provide a mix of common and preferred for some banks, but if the problem worsens, the balance will need to shift towards common equity.

It is impossible to know how much equity is needed given the current economic uncertainty. The more severe the coming recession, the more equity will be needed; any deflation would exacerbate the problem by causing the value of collateral at banks to fall. If we err on the side of providing a large amount of capital, the government will be the major source of capital to most banks. In any case, there needs to be a satisfactory pricing mechanism for common stock.

Some alternatives for common equity pricing are:

1. Price the capital well below market in order to avoid taking large ownership stakes in banks. This would be a major gift to shareholders and probably cause bank equities to rally sharply, easing access to capital in the equity markets.
2. Price the capital at market, but with a clause which permits the banks to buy back the equity at a reasonable return to the government in, say, five years time. This would help ensure that the taxpayer gets a decent return, while also leaving upside for bank shareholders if the banks can repay the government. The main negative is that it could encourage excess savings by banks in order to conserve capital to repay the government at the end of the five years. In this scenario, the government would then have temporary control of most of the banking sector.
3. Price the capital at market and own effective controlling stakes in most large banks. The government would get full value today for taxpayer money at market prices. It would leave the government with effective control of most of the banking sector.

### *Injecting Capital By Buying Assets*

The government could inject capital into banks by buying assets from banks. By removing nontransparent, illiquid assets, asset purchases should increase confidence in



bank solvency. However, the government would take more risk since pricing of these assets would be unclear.

One means of reducing the risk of losses would be requiring contingent equity allocations to the government which are triggered if the assets do not achieve a reasonable return for the government over five years. This would mean that the government does not effectively control banks initially; however, in reality the government would still be a major source of capital.

*Overall: Reducing Uncertainty is Key*

Whatever form of recapitalization is chosen, a long term strategy with a credible structure is needed to remove uncertainties caused by policy U-turns. Clear, credible institutional structures for recapitalizing banks would allow all authorities to have a clear understanding as to what the obligations of taxpayers are. It would also provide markets with a clear statement as to how the government plans to deal with banks now and in the future, and it would reduce the uncertainty that has resulted from changes in policy direction.

One possibility is to create an entity similar to the Resolution Trust Corporation which is mandated to recapitalize banks via a chosen scheme. The key point is that the RTC was rules-based. (Of course, it was for financial institutions that had failed or had been taken over, and the situation today is not at that stage.)

The existing TARP program is an example of what not to do. The leeway provided to Treasury gives market participants and banks little understanding as to what terms will be, who has access, etc. TARP is fine for emergency temporary relief, but a clear formal structure is needed in the future.

### **3. Specific Options**

Three specific options are below. In each case we are assuming that the regulators initially determine whether the bank is a going concern. If they are, clear rules need to be published to determine the extent and terms of access to funds.

#### **OPTION ONE: EXPAND THE TARP PROGRAM AND MAKE IT PERMANENT**

The most simple and least obtrusive solution would be to continue with TARP but make the program far more clear about terms for funds, who is eligible, application procedures, etc. The government could provide equity to banks via preferred shares at a low interest rate, and a small number of warrants. TARP is cheap financing for banks, so shareholders will benefit. New terms could be added to make small improvements to the program, such as prohibiting shareholder dividends or requiring specific lending commitments. Because the shares are non-convertible, this avoids the prospect of government control.

It is critical in this option that the program be made permanent; otherwise, it is only a stop-gap solution. For example, Treasury just gave Citigroup \$20 billion. However, investors might plausibly believe that Citi is looking at \$100 billion in future writedowns, and will have to come back again and again. If the market does not have confidence that the government will be willing to buy preferred shares on the same terms for as long as is necessary, it will continue to have doubts about Citigroup's future.

Potential problems:

1. Financial institutions which do not receive TARP funds are at a disadvantage, so by choosing who does and does not receive funds the Treasury is picking winners and losers.
2. Some banks will need more funds than others to survive. Banks that require a large amount of funds may not be able to afford the 5% (or 8%) interest on the preferred shares; payments may have to be accrued but delayed for some period of time.
3. Subsidized assistance to banks can distort incentives if the program lasts for a long time.
4. Perhaps most importantly, taxpayers are effectively subsidizing the recipients since funds are at attractive terms, which weakens political support.

#### OPTION TWO: PROVIDE COMMON EQUITY TO RECAPITALIZE BANKS

Another simple option is to continue with a version of TARP in which the government buys common equity at or below market prices. This approach prices the assistance appropriately, so taxpayers will be better remunerated. The government could then decide whether it wants to appoint independent directors to the board to represent its interests. In the UK the government will not appoint directors; however, there are clear signs that the Treasury aims to influence the decisions of state-controlled banks. It would make sense to create an independent institution that manages the shareholdings on behalf of the taxpayer, as an investor, with a mandate to sell all stakes within, say, ten years. Based on European experience, this would provide confidence that the banks will be safe from default, and so reduce funding costs to banks.

Potential problems:

1. While an independent institutional structure to manage shareholdings will reduce conflict with politicians, the structure of governance is not very attractive.
2. There is a danger that credit will become politically directed and that this will lead to substantial new problems down the road.

3. Given the current market values of major banks, this could quickly constitute effective nationalization, which may undermine political support. Creating an independent institution to manage the government's stakes will help defuse this charge.

4. Government support will ensure that share prices will not go to zero, which will put a floor under share prices. However, because this option does dilute existing shareholders - and because it is not especially generous - it could hurt the share price of participating banks.

### OPTION THREE: CREATE A NEW RESOLUTION TRUST CORP MANDATED TO PROVIDE EQUITY TO BANKS IN RETURN FOR ASSETS

A third option is to create a new Resolution Trust Corporation with a mandate to buy assets from banks; this would be similar to the original TARP concept. In order to protect taxpayers from mispricing (perhaps the biggest single gap in the original proposal), the RTC could demand contingent compensation through an equity issue. For example, it could receive warrants to purchase shares in the banks, at 1 cent per share, equal in value to the assets purchased. These warrants would be returned to the bank once the assets are sold by the RTC if the assets earn a minimum return (say 7% per year). If the assets do not earn that return, the bank can pay in enough cash to reach the target return; if the bank does not pay the cash, the RTC sells the warrants to achieve that return. The RTC would appoint an independent asset manager to manage those assets, with a mandate to sell them after five years, but before ten years, from the purchase date.

For example, suppose the RTC buys 5% of Citigroup's assets. It would pay \$100bn for these assets, and the RTC would receive warrants on 83% of Citigroup's equity (based on the market value at Friday's close). In five years' time it would be more clear what these assets are truly worth. If the assets generate more than a 7% return, then Citigroup does not have to do anything. If the assets generate less than a 7% return, Citigroup can pay enough cash to get the RTC to 7% and the RTC will return the warrants. If Citigroup does not make the payment, the RTC can sell the 83% stake to strategic investors.

The main advantage of this scheme is that it permits banks to remove toxic and illiquid assets from their portfolios, while providing taxpayers with substantial protection against losses with the contingent equity. The equity also means there is less concern about pricing, since the government can always sell equity to cover losses after five years. It also gives banks the opportunity to avoid large dilutions if the economic situation turns out well, while if the economy is weak they will have made share issues at current market prices to finance losses on the assets they sell to the RTC.

#### Potential problems:

1. The asset purchases do less for capital ratios than direct capital injections, so more funding is needed. In some case the equity needs are so large that it would only make sense to combine this with capital injections.

2. The large contingent share issue which overhangs banks may make it more difficult to access equity markets, at least until there is greater clarity regarding the underlying asset values and solvency of banks' balance sheets.
3. This scheme is relatively complex and hard to explain. Under today's circumstances, it may not garner sufficient political support.

#### **4. Our Recommendation**

A large-scale, well-defined, rules-based recapitalization program for U.S. banks is urgently needed. However, repeating TARP on its original terms is unlikely to have political support, and the latest Citigroup bailout is too small, is too nontransparent, and has too little value for taxpayers to be scalable. A comprehensive asset purchase scheme with protection for taxpayers is promising on paper, but is too complex for the moment and will not get political support.

In order to create long-term confidence in the banking sector, major banks should be required to raise a substantial amount of equity, either from the private market or from the government. For banks that raise capital from the government, the taxpayer will need to put in so much money relative to the existing market value of banks that effective government control over banks will result. It would be better to be honest about this and immediately set up structures to limit political influence over credit. In addition, this recapitalization program will require the release of the second \$350bn tranche of TARP money.

Bank recapitalization will not solve the larger economic and financial problems, and even a massive fiscal stimulus will, at this point, only have limited effects. (A more coordinated fiscal stimulus within the G7 would be better, but there is little sign that Europe is moving in this direction.) Only a substantial further easing of monetary policy, with the explicit goal of creating inflation, offers a reasonable prospect of avoiding a deep and long recession, or worse.

If comprehensive bank recapitalization cannot work in the current political environment, another TARP round (on tougher terms compared with October, but still fairly generous terms to existing equity holders) could serve as a stop-gap measure until the new administration takes office. But it should not be confused with a real solution.

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Nov 24, 2008 4:40 PM

[How to Create Inflation](#)

from [The Baseline Scenario](#) by James Kwak

Simon and Peter argued in Real Time Economics earlier today that we need some inflation (see the [post just before this one](#)) - not only because deflation is bad, but also because it helps protect asset values, including the assets for which the government is now on the hook.

James Hamilton at Econbrowser has [a plan](#) for how to create some inflation (he suggests a target of 3%). And if that doesn't work, he has [an even more clever plan](#).

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Nov 24, 2008 9:29 AM

### **[The Inflation Is Coming, The Inflation Is Coming \(?\)](#)**

from [The Baseline Scenario](#) by Simon Johnson

Citigroup management gets a great deal; you and I not so much. Consensus on right sizing the fiscal stimulus increases by about \$100bn per week. The rest of the world drags its feet on anything approaching an appropriate set of monetary and fiscal policies (yes, I'm talking about the eurozone again.) Where does this all point?

It points to inflation. Inflation has many drawbacks and brings its own serious risks, but inflation is better than the alternative which, as President-Elect Obama said on Saturday, is now a deflationary spiral (falling wages and prices). The policymakers are going all in and the question now, [we argue in a piece on WSJ.com this morning](#), is whether inflation still lies within their reach.

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Nov 24, 2008 12:48 AM

### **[Citigroup Bailout: Weak, Arbitrary, Incomprehensible](#)**

from [The Baseline Scenario](#) by James Kwak



According to the [Wall Street Journal](#), the deal is done. Here are [the terms](#). In short: (a) the government gives Citi \$20 billion in cash in exchange for \$27 billion of preferred on the same terms as the first \$25 billion, except that the interest rate is now 8% instead of 5%, and there is a cap on dividends of \$0.01 per share per quarter; and (b) the government (Treasury, FDIC, Fed) agrees to absorb 90% of losses above \$29 billion on a \$306 billion slice of Citi's assets, made up of residential and commercial mortgage-backed securities. (If triggered, some of that guarantee will be provided as a loan from the Fed.) There is also a warrant to buy up to \$2.7 billion worth of common stock (I presume) at a staggeringly silly price of \$10.61 per share (Citi closed at \$3.77 on Friday).

The government (should have) had two goals for this bailout. First, since everyone assumes Citi is too big to fail, the bailout had to be big enough that it would settle the matter once and for all. Second, it had to define a standard set of terms that other banks could rely on and, more importantly, the market could rely on being there for other banks. This plan fails on both counts.

The arithmetic on this deal doesn't seem to work for me (feel free to help me out). Citi has over \$2 trillion in assets and several hundred billions of dollars in off-balance sheet liabilities. \$20 billion is a drop in the bucket. [Friedman Billings Ramsey](#) last week estimated that Citi needed \$160 billion in new capital. (I'm not sure I agree with the exact number, but that's the ballpark.) Yes, there is a guarantee on \$306 billion in assets (which will not get triggered until that \$20 billion is wiped out), but that leaves another \$2 trillion in other assets, many of which are not looking particularly healthy. If I'm an investor, I'm thinking that Citi is going to have to come back again for more money.

In addition, the plan is arbitrary and cannot possibly set an expectation for future deals. In particular, by saying that the government will back some of Citi's assets but not others, it doesn't even establish a principle that can be followed in future bailouts. In effect, the message to the market was and has been: "We will protect some (unnamed) large banks from failing, but we won't tell you how and we'll decide at the last minute.)" As long as that's the message, investors will continue to worry about all U.S. banks.

The third goal should have been getting a good deal for the U.S. taxpayer, but instead Citi got the same generous terms as the original recapitalization. 8% is still less than the 10% Buffett got from Goldman; a cap on dividends is a nice touch but shouldn't affect the value of equity any. By refusing to ask for convertible shares, the government achieved its goal of not diluting shareholders and limiting its influence over the bank. And an exercise price of \$10.61 for the warrants? It is justified as the average closing price for the preceding 20 days, but basically that amounts to substituting what people really would like to believe the stock is worth for what it really is worth (\$3.77).

How does this kind of thing happen? A weekend is really just not that much time to work out a deal. Maybe next time Treasury and the Fed should have a plan before going into the weekend?

**Update:** Bloggers start trying to be funny, world to end soon:

- [Calculated Risk](#) (on the aborted plan to divide Citi into a “good bank” and a “bad bank”): “Hey, I thought Citi WAS the bad bank!”
- [Tyler Cowen](#) (on the same plan, which morphed into the government’s guarantee of the “bad bank” part of Citi): “Didn’t Paulson tell us just a few days ago that TARP wasn’t needed after all? Doesn’t this mean that Paulson should speak less frequently?”

**Update 2:** I made a mistake in the original post: although the government is getting \$27 billion “worth” of non-convertible preferred stock, it is only paying \$20 billion in cash. \$7 billion is being granted as the fee for the government guarantee. Thanks to Nemo for catching this. (Note to self: No posts after midnight!)

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Nov 23, 2008 3:04 PM

## **Federal Reserve for Beginners**

from [The Baseline Scenario](#) by James Kwak

We had a [comment](#) last week asking for an explanation of, roughly, what it is that the Federal Reserve does, so I thought that would be a good topic for a Beginners post. (For a complete list, [go here](#).) This would have been a relatively easy question to answer a year ago, but since then it’s gotten considerably more complicated. Like all Beginners articles, I’m going to make a number of simplifications, for example generally treating the Federal Reserve as one big bank (it’s really twelve different banks). I’m also going to ignore many of the Fed’s functions; for example, the Federal Reserve is itself a bank regulator, but I’m not going to discuss that.

The Federal Reserve (Fed) is itself a bank, with assets and liabilities. Most but not all banks (by assets, not by number), including all the biggest ones, have accounts at the Fed, and those accounts have money in them. The Fed attempts to affect the behavior of the banking system through the policies governing the way it interacts with those banks. In recent history up to the current crisis, the most important tool of the Fed was its “open market operations” through which it influences the Fed funds rate.

The Fed funds rate is the interest rate at which banks lend money to each other overnight. It gets its name from the fact that the banks lend each other money by transferring it between their accounts at the Federal Reserve. You can think of this as the most

fundamental kind of lending in the financial sector: if a lot of depositors take out their money from some bank on the same day, it needs more money, so it borrows it from another bank via its account at the Fed. The Fed funds rate matters because, in ordinary circumstances, it is the short-term cost of money for banks, and therefore influences the cost at which they lend money out to everyone else.

Because lending between banks is a private transaction, the Fed cannot dictate the Fed funds rate. Instead, it attempts to influence the rate by controlling the amount of money in the system. The Fed's open market operations consist of buying and selling U.S. Treasury securities. When the Fed buys Treasuries from banks, it pays for them by crediting those banks' accounts at the Fed. This increases the amount of money in those accounts, which lowers the price of money, meaning that the Fed funds rate goes down. Banks can exchange the amounts in their Fed accounts for "real," paper money at any time, so this is how money is added to the economy. (Selling Treasuries does the reverse and makes the rate go up.) Another way to look at this is that the Fed cares about the amount of money in the system, and the Fed funds rate is the metric it uses to keep track of the amount of money.

As I said, for the last couple of decades this has been the primary policy instrument of the Fed. However, during the current crisis the Fed has arguably been more active in another role: as the lender of last resort.

Before the crisis, the Fed already had something called the "discount window," which was a virtual teller window where banks could borrow money overnight at the "discount rate." The discount rate is higher than the Fed funds rate - the idea being that banks should try to borrow from each other first before coming to the Fed. As a result, lending via the discount rate was historically minimal. However, as banks became increasingly unwilling to lend to each other, the Fed kept widening the discount window to make it easier for banks to get funding. I admit I needed Wikipedia to remind me of all of the new flavors:

- The Term Auction Facility lends short-term money to banks at a rate set by an auction. Loans must be collateralized, meaning that the bank must give securities to the Fed until it pays the loan back.
- The Term Securities Lending Facility is similar, except instead of money (increases to accounts at the Fed) the Fed is lending out Treasury securities; again, these loans are collateralized.
- The Primary Dealer Credit Facility, created at the time of the Bear Stearns collapse/bailout/acquisition, allows primary dealers (the banks that transact Treasury securities directly with the Fed) to borrow money, again in exchange for collateral.
- The Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, created immediately after the Reserve Fund broke the buck in the wake of the Lehman collapse, was intended to provide a market for commercial paper sold by money market funds, to help protect those funds against liquidity runs.

- The Commercial Paper Funding Facility, created a few weeks later, allowed the Fed to loan money directly to non-financial firms by buying their commercial paper (technically speaking I believe the Fed loans the money and takes the commercial paper as collateral), in order to get short-term funding to those firms (since the usual buyers had left the market).

The net effect of these changes has been to allow a broader range of institutions to borrow money from the Fed by handing over an ever-widening range of collateral, including many securities for which there is virtually no market. In effect, Ben Bernanke decided that the economy was not going to run out of liquidity on his watch. If this sounds vaguely like the original TARP plan, it should, since it means that institutions can hand over illiquid securities in exchange for cash or Treasuries; however, the big difference is that these are all short-term loans, which means that after some period of time (one day, or maybe 90 or 120 days at the upper end) the institution has to pay off its loan and take the illiquid securities back.

Now, to the question that I'm sure some of you have: Where does all this money come from? Ordinarily, if the Fed is taking in lots of securities and lending out lots of money, it does so by increasing the balances in banks' accounts at the Fed, which creates money (and, therefore, inflation). In this case, however, for each billion dollars the Fed lends out into the economy, the Treasury Department is selling a billion dollars' worth of securities, thereby sucking the same amount of money out of the economy (and into its account at the Fed). So, yes, this is being paid for by issuing more U.S. government debt, but if things ever settle down and the amount of Fed lending goes back down, the Fed (or Treasury - not sure here) should have the money to vacuum up that debt, assuming that institutions pay back their loans or their collateral is good.

(I got this last explanation from [James Hamilton](#) at Econbrowser, who is a good source for people who want to further plumb the mysteries of this topic.)

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Nov 22, 2008 11:46 PM

### [The Citigroup Betting Pool](#)

from [The Baseline Scenario](#) by James Kwak

I've been catching up with my family and not on top of the news the last 24 hours or so - wasn't there a time that the financial world shut down on weekends? - but for those of you who may not have a feed reader clogged with economics blogs (first, good for you), I

wanted to point out some of the various outcomes you may want to bet on when it comes to Citigroup. Some people are betting that a deal (bailout, FDIC takeover, merger) may be announced as soon as this weekend. I doubt it, because Citi shouldn't have a liquidity problem per se; now that the Federal Reserve is accepting pocket lint as collateral, Citi can keep functioning even after the markets have completely lost faith in it. The problem is that no one believes its assets are still worth more than its liabilities, so everyone expects the endgame will come (in one form or another) sooner or later. The big questions are whether no one will get wiped out, shareholders will get wiped out, or shareholders and creditors will get wiped out.

- [Mark Thoma](#) has an overview with excerpts from some other posts.
- The wildest idea is that Citi might [merge with Goldman or Morgan Stanley](#), although this is only floated by unnamed analysts. What such a merger would accomplish is unclear to me. (Although various people have come up with [the name](#) for a Goldman-Citi merged entity.)
- [Felix Salmon](#) has a quick rundown with a lot of links (some of which I reproduced below); he thinks that at least creditors will not get wiped out to avoid a repeat of Lehman.
- [John Hempton](#) explains how creditors might be wiped out and why it would be a bad thing.
- [Brad DeLong](#) says to the government: go ahead, just buy the whole thing. With the change, buy a cup of coffee.

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Nov 22, 2008 10:17 PM

### [Dawn of A New Interregnum](#)

from [The Baseline Scenario](#) by Simon Johnson

According to the official [website of the President-Elect](#), there are 59 days until inauguration. Let's call it nearly two months. The good news is that President-elect Obama has begun to name his economic team, the line up looks strong, and they have plenty of time to get their plans in place. The bad news is that the banking system may not have that much time.

We are now obviously in a delicate political phase, in which the Bush Administration is winding down and the Obama Administration does not yet have real power. This matters because the US banking system is in a worse than delicate phase. Contrary to the statements of Mr Paulson earlier this week, core US banks do not appear to be stabilized.



The fall in equity prices this week was a cause of serious concern, and we discussed the causes and potential (unpleasant) cures in [our WSJ.com article on Thursday morning](#). Since then the situation has only deteriorated, seen most clearly in the credit default swap (CDS) spreads for major banks, which moved up through Friday.

This increase in CDS spreads means that the market believes the probability of some banks defaulting has gone up. This is striking because the Federal Reserve at this point can make sure these banks never run out of liquidity. So what is going on?

Partly people in the market are not sure that all parts of all (global) banks will be saved. And partly they don't know where the money for a bailout would come from. This is not just about whether TARP is or is not available to recapitalize banks, it is also about the not-so-good relationship between Congress and the outgoing administration.

Ask yourself this. If the Bush Administration felt the need to raise, say, \$1trn - see this week's [much cited FBR report](#) on the capital needed by the banking system - and sought approval Congress in December, how well or badly would that conversation go at this point? Could the new Obama team help? What about when the new Congress arrives in the first week of January - would that make any difference?

We are in an awkward stage, facing major economic problems and with a potentially distracted executive branch. We need to find some new ways to handle this transition between presidents. And fast.

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Nov 21, 2008 4:43 PM

### **[When Will the Stock Market Stop Falling?](#)**

from [The Baseline Scenario](#) by James Kwak

The stock market has clearly not had a good week. The Dow Jones average was down 5.3%, the S&P 500 was down 8.4%, and it would have been much worse if the markets hadn't jumped at the end of the day today, allegedly because Tim Geithner will be named Treasury Secretary (which [I called](#), but it wasn't that gutsy a call). Yesterday the S&P closed at less than half its high of October 2007. For a chart of the carnage, see [Calculated Risk](#) (click on the chart for a larger version).

At this point, stock prices are clearly beyond the short-term liquidity crisis that hit financial institutions in September, and deep into recession territory. That is, share prices

will not respond particularly sharply to tactical steps such as individual bailout plans, because the big question is how long and how bad the recession will be. The problem this week was not that all the news was bad, but that all the news was worse than expected. The stock market prices in current expectations about the future, so if a report is bad but not as bad as predicted (say, unemployment goes up but less than forecast), the stock market should go up.

This week:

- New unemployment claims were higher than expected
- The Consumer Price Index fell more than expected
- The manufacturing survey of the Philadelphia Fed was worse than expected
- The Leading Indicators index of the Conference Board fell more than expected
- Oil futures fell below \$50 (indicating that expectations of demand are falling)

Partially as a result, Goldman revised its [economic forecast](#) down, saying that the economy will contract at an annual rate of 5% this quarter, 3% next quarter, and 1% the quarter after that, which is worse than any forecast I've seen (although I certainly don't see all of them).

For the stock market to stop falling, new data has to come in that is better than expected. Of course, guessing when that will happen is a fool's errand.

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Nov 21, 2008 3:31 PM

### [Video of Tuesday's MIT Class](#)

from [The Baseline Scenario](#) by James Kwak

The flash video recording of Simon's Tuesday class on the global crisis is available [here](#). The class agenda is available [here](#).

Keep your eyes open for future live webcasts where you can send in comments and questions.

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Nov 20, 2008 9:09 PM

### **[To Bail or Not To Bail, Banking Edition](#)**

from [The Baseline Scenario](#) by Simon Johnson

This was a bad day for the market and a very bad day for banking; the credit default swap spread for at least one major bank rose above 400 basis points - a level of implied default probability that we have not seen since mid-October.

Mr. Paulson suggested earlier this week that the government's Troubled Asset Relief Program (TARP) take a break from bank recapitalizations, through at least January 20th ([listen to today's NPR story](#)). After today, I seriously doubt this is a good idea. And I sincerely hope that the administration is preparing (another) policy U-turn.

Potentially more sustainable approaches are suggested in [my previous post \(and the associated WSJ.com article\)](#). Don't be shy. Congress in particular needs to hear your suggestions - post them here or call your favorite representative. Just don't urge inaction.

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Nov 20, 2008 11:23 AM

### **[Banks At Serious and Immediate Risk, Again](#)**

from [The Baseline Scenario](#) by James Kwak

Despite the shot of confidence provided by the recapitalization program in mid-October, equity prices and CDS spreads indicate investors are getting nervous about banks again - and some may even be betting that they will fail, or at that equity holders will be wiped out. As the recession deepens, banks' assets (not only mortgage-backed securities, but loans in all forms) are falling in value, increasing the chance that the government will need to step in again with more capital. Peter and Simon have a guest post at [Real Time Economics](#) (WSJ) on the options - none of them pretty - that the government has.

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Nov 20, 2008 10:48 AM

### [To Bail or Not To Bail, GM Edition](#)

from [The Baseline Scenario](#) by James Kwak

For those who can't get enough of the GM topic, Economix (NYT) has links to posts [for and against bankruptcy](#). Right now it's 10-5 in favor of bankruptcy, although I'm not sure that Mitt Romney's vote should have the same weight as those of, say, Martin Feldstein, Gary Becker, and Paul Krugman.

However, the bankruptcy/bailout dichotomy leaves out what I think is the best solution: a government-brokered reorganization, which may or may not require bankruptcy - a prepackaged bankruptcy, as it's sometimes called. This would be very different than just letting GM go into Chapter 11 and hoping for the best, especially given the lack of debtor-in-possession financing these days (thanks to the commenters who pointed this out). Andrew Ross Sorkin, for example, argues for a prepackaged bankruptcy, and even Romney calls for a "managed bankruptcy" (without many details) - yet they are lumped in with the others, like George Will, who argue against any government intervention. (See the link above for all the links to individual posts.) So I don't think 10-5 is a very accurate count.

**Update:** Five professors who really are experts on the auto industry (and one of whom is a colleague of Simon at Sloan) have a highly readable paper with [their proposal](#) out. They favor a non-bankruptcy restructuring plan that is overseen by the government and also has some provisions to ensure that the reorganization is in the public interest, such as increased fuel efficiency standards and a prohibition on paying dividends to shareholders.

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Nov 19, 2008 2:19 PM

### [Written Testimony to Senate Budget Committee Today](#)

from [The Baseline Scenario](#) by Simon Johnson

My written testimony is now attached: [testimony-simon-johnson-for-senate-budget-on-nov-19-2008](#)

Comments welcome!

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Nov 19, 2008 7:56 AM

### **Testimony This Morning: Senate Budget Committee**

from [The Baseline Scenario](#) by Simon Johnson

Wednesday morning, starting at 10am, I'm on a [panel testifying to the Senate Budget Committee](#) about the need for a fiscal stimulus. The other witnesses are Mark Zandi and John Taylor.

I'll post my written testimony after the hearing. I expect to make three main points in my verbal remarks:

- 1) We are heading into a serious global recession, caused by and in turn causing a process of global leveraging (i.e., reduction in lending and borrowing). We have never seen this kind of deleveraging - synchronized around the world, fast-moving, and with an unknowable destination.
- 2) I do not think we can prevent this deleveraging from happening. Nor do I think we should even try to keep asset prices high (or at any particular level). But in the United States we have the ability to mitigate some of the short-run effects and to lay the groundwork for a sustainable, strong recovery. One sensible tool to use in this context is fiscal policy. I lean towards smart spending programs, but as the economy continues to worsen, I think some kind of temporary tax cut could also help - it can potentially have relatively quick effects. (Note: contrary to those who think that if tax cuts are saved by consumers, they are somehow "wasted," I would point out that anything that improves consumers' balance sheets is both good for them and for the financial institutions that lend to them.)
- 3) But there is a real limit to how far we can go with fiscal policy (and with other policy measures). Irresponsible budget policies would not be a good idea - we need to continue a process of fiscal consolidation; it is most vital that people around the world remain confident in the U.S. government's balance sheet. Some of the highest numbers now

being proposed for a fiscal stimulus are probably too high and a mega-stimulus could be counterproductive if it undermines confidence.

I'm proposing a fiscal stimulus of roughly 3% of GDP, to be spent over several years. Given the uncertainties involved, this seems like reasonable middle ground - it's enough to make a difference, but doesn't promise a miracle; it can be spent sensibly and at an appropriate speed; and it will not undermine our ability to consolidate the U.S. fiscal position (i.e., bring government debt onto a sustainable path) over the medium-term.

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Nov 18, 2008 7:34 PM

### [More Things to Worry About](#)

from [The Baseline Scenario](#) by James Kwak

The morning after the election, I wrote a post on our country's [long-term priorities](#). #3 on the list was retirement savings.

While the retirement savings problem predates the current crisis, the decline in the value of financial assets has made it tougher all around. One reader pointed me to a particular aspect of the problem I wasn't aware of. Earlier this year, the Pension Benefit Guaranty Corporation (PBGC) shifted its asset allocation from 15-25% equities to 55% equities. The PBGC, which is part of the federal government, guarantees private-sector pension plans and is funded by premiums paid by those plans; if a company's pension fund goes bankrupt, the obligations are shifted to the PBGC. This, as Zvi Bodie and John Ralfe [pointed out back in February](#), is particularly problematic for the PBGC, because then an economic downturn has a triple impact on the fund: first, as equity values fall, company pension funds face larger funding gaps; second, as companies go bankrupt, their pensions get shifted to the PBGC, increasing its liabilities; third, as equity values fall, the PBGC's assets fall, increasing its funding shortfall. Bodie and Ralfe argue that increasing the proportion of equities may increase the expected return, but only at the cost of increased risk, in any timeframe.

(By contrast, because the Social Security Trust Fund is invested in Treasury bonds, it should be doing OK. Long-term concerns about Social Security funding, of course, are still valid.)

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Nov 18, 2008 6:50 PM

### [Emerging Markets Snapshots](#)

from [The Baseline Scenario](#) by James Kwak

GM, mortgage restructuring, and the G20 have sucked up most of the attention recently, but the crisis continues to take its toll around the world. A few vignettes:

- In Ukraine, [industrial production](#) in October fell by 7.6% from September (that's not an annualized rate) and 19.8% from October 2007.
- Russia's [second-largest coal company](#) reported that its Q4 sales would be only one-third the planned level - and that payments from its steelmaker customers since September were only 21% of the value of shipments.
- Credit default swap spreads on Greek sovereign debt are up over 160 bp - higher than at the previous peak in mid-October. (Note that Greece is in both the EU and the Eurozone.)

On the "plus" side, Pakistan and the IMF agreed on a [\\$7.6 billion loan](#), ensuring economic stability in a particularly important part of the world - at least for a few months. Pakistan's government says they need a total of \$10-15 billion.

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Nov 18, 2008 3:00 PM

### [Session Outline: MIT Global Crisis Class, at 4pm today](#)

from [The Baseline Scenario](#) by Simon Johnson

[link to webcast is here](#)

Outline of session; November 18, 2008

**The Global Crisis, class #3**

Relevant links, including background material and tracking of all relevant developments available through <http://BaselineScenario.com>. Details of session after the jump -

Our guest for the first half of class is Jeff Shames, who teaches finance at MIT Sloan.

Update on the crisis worldwide

1. Latest market views on U.S. housing
2. Where are major global banks heading and why (e.g., Citi)?
3. Current pressures on insurance, Russia, Greece, etc; what are the other vulnerabilities?

*Global finance dimensions:* conversation (by phone) with Peter Boone, of Effective Intervention and Centre for Economic Performance, London School of Economics

The case for and against bailing out General Motors

1. Could GM operate in Chapter 11?
2. What would be the broader consequences of reorganization through bankruptcy in the auto industry?
3. What is likely to happen? Is it more about politics or economics?

Assessment of the G20 meeting in Washington, November 14-15<sup>th</sup>

1. Any real progress on coordinated fiscal stimulus or other short-term macro policies?
2. More funding for the IMF from Japan. Anything else in the works?
3. Who were the big winners?
  - i. Mr. Sarkozy? Is the coming wave of regulations procyclical?
  - ii. Mr. Brown? Who will provide the global early warning system?
  - iii. Emerging Markets? Which ones and why exactly?
  - iv. Mr. Obama? In what sense?

What would you recommend as a broad economic strategy for Mr. Obama's administration, to deal with the crisis and manage a strong recovery? How long will it take?

The latest round of debate on fiscal stimulus in the United States (see also my testimony to the Senate Budget Committee, tomorrow). What would you say?

No class on Tuesday, November 25. ***Next class is Tuesday, December 2<sup>nd</sup>, when it will start at 4:30pm and run until 7pm.***

**Update:** [Flash recording](#) of class.

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Nov 18, 2008 6:59 AM

### **[G20 Aftermath, For MIT Global Crisis Class](#)**

from [The Baseline Scenario](#) by Simon Johnson

If you are only going to read one thing ahead of [our class today](#) (4pm Boston time), please take a look at my [op ed on the G20 and potential aftermath](#), which appeared on Forbes.com yesterday. Depending on how leaders and the private sector play their cards in the next few weeks, I think this summit could have made things substantially worse in the short-term.

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Nov 17, 2008 2:34 PM

### **[MIT Global Crisis Class, Tuesday November 18th](#)**

from [The Baseline Scenario](#) by Simon Johnson

Join us for the next live webcast of my MIT class on the global crisis. Details after the jump...

From 4pm to 7pm Boston time, we'll talk about (1) GM, to bailout or not, and how this fits with the likely direction of the US economy; (2) the G20 meeting this weekend, including what happened and why; (3) the overall flow of the crisis around the world and back to the United States. I'll be testifying on Capitol Hill on Wednesday, and will try to preview some of the more relevant points in class.

You can find background reading for any of these topics on <http://BaselineScenario.com>: just look at relevant tags (e.g., G20), search for the keywords, or look under the category "Classroom."

For part of the class our guest will be [Jeff Shames](#), a very experienced investor.

As before, you can post your questions here, and we'll try to deal with them during class; we keep an eye on the website during the session.

Our technical team sends the following information...

The live webcast will be in RealMedia format. Here's the link to the webcast:

[http://web.mit.edu/webcast/sloan/2008/simon\\_johnson/sloan-financial\\_crises-simon\\_johnson-E51345-18nov2008-1600-350k.ram](http://web.mit.edu/webcast/sloan/2008/simon_johnson/sloan-financial_crises-simon_johnson-E51345-18nov2008-1600-350k.ram)

RealPlayer version 8 provides all required functionality for viewing this webcast. Here's a link that provides some verification resources for viewers of RealMedia content:

<http://web.mit.edu/smcs/help/realhelp.htm>

A recording will be available to download later in the week, probably on Thursday.

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Nov 17, 2008 1:26 PM

### **Mortgage Restructuring Is Not Enough**

from [The Baseline Scenario](#) by Simon Johnson

Let's be honest with ourselves. Even if the outgoing Bush team or the incoming Obama administration can work out a scalable nationwide mortgage restructuring scheme, we will still have a housing problem in the U.S.. Specifically, we should expect a high proportion of restructured mortgages to default again within a year. In [a piece that appeared on Bloomberg this morning](#), Alex Stricker and I suggest that a more centralized process is needed to manage the flow of foreclosed properties onto the market, and we discuss some alternative ways to implement this idea.

There may be better ways to do this and we are completely open to suggestions - please post as comments here. We only insist that this is one dimension of U.S housing that needs further careful consideration.

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Nov 17, 2008 5:32 AM

### [Proposed Solutions to the Securitization Problem](#)

from [The Baseline Scenario](#) by James Kwak

We've gotten a number of questions about mortgage restructuring proposals, both in email and in comments. One reader asks: "How does one get around the securitization problem? The Treasury seems to be able to change rules with the sweep of a wand lately, why not the REMIC [Real Estate Mortgage Investment Conduit] rules too?" Tom K also raises this issue in a [comment](#).

I doubt that Treasury could unilaterally modify the rules governing the securitization trusts (in which a loan servicer manages a pool of loans on behalf of the many investors who own a share of that pool). Despite the ease with which Treasury seems to be flinging money around and the, um, liberties they seem to be taking with the terms of the TARP legislation, Treasury can't really force anyone to do anything, legally. For example, Treasury has no authority to force a bank to accept a recapitalization, which (in my opinion) is why the recapitalization terms are relatively generous: they did not want to take the risk of the core banks turning them down.

The securitization issue raises similar legal barriers. A bit of background: To generalize, the loan servicer has a legal obligation to act in the interests of the investors in the loan pool; if it doesn't, it opens itself up to lawsuits. Now, if all of the investors have the same interests, and the service restructures a delinquent mortgage in a way that provides more value than a foreclosure, then everyone is happy. There are (at least) three problems, however. The first is a coordination problem: getting all of the investors to agree that they are happy. The second is a problem of conflicting interests: because a typical CDO is structured so that some investors get the first payments and some get the last, a mortgage modification could help the interests of some investors and hurt the interests of others. The third is a tax problem: for technical reasons, a mortgage restructuring could be treated as a new loan, which creates a tax liability (this is a REMIC rule).

This is why I think this will require legislation, and even that could be challenged as an expropriation of property.

- The Center for American Progress has a [proposal](#) to modify the REMIC rules and an explanation of why they think it would work.
- John Geanakoplos and Susan Koniak have [another proposal](#) to use government-appointed blind trustees to make restructuring decisions and thereby protect servicers from liability to their investors (this would also require legislation).

- Thomas Patrick and Mac Taylor have [yet another proposal](#) (thanks, Tom K) to use Fannie Mae and Freddie Mac debt to pay off all performing securitized mortgages at face value and refinance them with 30-year, fixed-rate mortgages. (I don't fully understand this plan: it seems to involve paying face value for \$1.1 trillion in mortgages, many of which are certain to default in the future, and forcing banks to pay face value for \$400 billion in mortgages that are already delinquent, and also forcing banks to accept some of the losses on the government's \$1.1 trillion. But I don't want to draw conclusions based on a newspaper description.) This one shouldn't involve legal issues, but it will require legislation, because of the amount of money involved.
- Then there's the idea of allowing bankruptcy judges to modify mortgages on owner-occupied houses, which would also protect the servicer from liability. But this would be a slow, inefficient way of solving the problem.

If there are other ideas out there, please suggest them.

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Nov 16, 2008 10:00 PM

### [Creative Response to the Credit Crunch](#)

from [The Baseline Scenario](#) by James Kwak

What to do when you don't have \$233.95 to pay your bill. From [Geekologie](#).

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Nov 16, 2008 5:00 PM

### [Systemic Risk, Hedge Funds, and Financial Regulation](#)

from [The Baseline Scenario](#) by James Kwak

One of our readers recommended the [Congressional testimony](#) by Andrew Lo during last Thursday's session on hedge funds. Lo is not only a professor at the MIT Sloan School of



Management, but the Chief Scientific Officer of an asset management firm that manages, among other things, several hedge funds. He discusses a topic - systemic risk - that has been thrown around loosely by many people, including me, and tries to define it and suggest ways of measuring it. He recommends, among other things, that

- large hedge funds should provide data to regulators so that they can measure systemic risk
- the largest hedge funds (and other institutions engaged in similar activities) should be directly overseen by the Federal Reserve
- financial regulation should function on functions, such as providing liquidity, rather than institutions, which tend to change in ways that make regulatory structures obsolete
- a Capital Markets Safety Board should be established to investigate failures in the financial system and devise appropriate responses
- minimum requirements for disclosure, “truth-in-labeling,” and financial expertise be established for sales of financial instruments (such as exist, for example, for pharmaceuticals)

Lo also has a talent for explaining seemingly arcane topics in language that should be accessible to the readers of this site. The testimony is over 30 pages long, but it’s a good read. Here are a couple of examples to whet your appetite.

On the incentives within an investment bank:

Consider, for example, the case of a Chief Risk Officer (CRO) of a major investment bank XYZ, a firm actively engaged in issuing and trading collateralized debt obligations (CDO’s) in 2004. Suppose this CRO was convinced that U.S. residential real estate was a bubble that was about to burst, and based on a simple scenario analysis, realized there would be devastating consequences for his firm. What possible actions could he have taken to protect his shareholders? He might ask the firm to exit the CDO business, to which his superiors would respond that the CDO business was one of the most profitable over the past decade with considerable growth potential, other competitors are getting into the business, not leaving, and the historical data suggest that real-estate values are unlikely to fall by more than 1 or 2 percent per year, so why should XYZ consider exiting and giving up its precious market share? Unable to convince senior management of the likelihood of a real-estate downturn, the CRO suggests a compromise—reduce the firm’s CDO exposure by half. Senior management’s likely response would be that such a reduction in XYZ’s CDO business will decrease the group’s profits by half, causing the most talented members of the group to leave the firm, either to join XYZ’s competitors or to start their own hedge fund. Given the cost of assembling and training these professionals, and the fact that they have generated sizable profits over the recent past, scaling down their business is also difficult to justify. Finally, suppose the CRO takes matters into his own hands and implements a hedging strategy using OTC derivatives to bet against the CDO market. From 2004 to 2006, such a hedging strategy would likely have yielded significant losses, and the reduction in XYZ’s earnings due to this hedge,

coupled with the strong performance of the CDO business for XYZ and its competitors, would be sufficient grounds for dismissing the CRO.

In this simple thought experiment, all parties are acting in good faith and, from their individual perspectives, acting in the best interests of the shareholders. Yet the most likely outcome is the current financial crisis. This suggests that the ultimate origin of the crisis may be human behavior—the profit motive, the intoxicating and anesthetic effects of success, and the panic selloff that inevitably brings that success to an end.

On the role of regulation in a free-market economy:

Why are fire codes necessary? In particular, given the costs associated with compliance, why not let markets determine the appropriate level of fire protection demanded by the public? Those seeking safer buildings should be willing to pay more to occupy them, and those willing to take the risk need not pay for what they deem to be unnecessary fire protection. A perfectly satisfactory outcome of this free-market approach should be a world with two types of buildings, one with fire protection and another without, leaving the public free to choose between the two according to their risk preferences.

But this is not the outcome that society has chosen. Instead, we require all new buildings to have extensive fire protection, and the simplest explanation for this state of affairs is the recognition—after years of experience and many lost lives—that we systematically under-estimate the likelihood of a fire. In fact, assuming that improbable events are impossible is a universal human trait (see, for example, Plous, 1993, and Slovic, 2000), hence the typical builder will not voluntarily spend significant sums to prepare for an event that most individuals will not value because they judge the likelihood of such an event to be nil. Of course, experience has shown that fires do occur, and when they do, it is too late to add fire protection. What free-market economists interpret as interference with Adam Smith's invisible hand may, instead, be a mechanism for protecting ourselves from our own behavioral blind spots.

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Nov 16, 2008 9:40 AM

### **[G20 Summit: Just Disappointing or Potentially Dangerous?](#)**

from [The Baseline Scenario](#) by Simon Johnson

Initial reactions to the G20 summit are fairly positive, in the sense that the [communiqué](#) and associated press conferences conveyed (a) there was no open acrimony, (b) the body

language was broadly supportive of countercyclical policies, and (c) there may now be a serious international regulatory agenda.

None of this is really new and it could all have been arranged by finance ministers (probably over the telephone), but I agree there is some useful symbolism in having heads of industrialized and emerging market governments convene for the first time (ever?) on these kind of issues.

I will admit to disappointment that no more explicit commitments were made to fiscal stimulus. I thought the British and the French were heading in this direction, and that they could create some momentum in the right direction. If Europeans (or anyone else) would like to compete for a “special relationship” with the US after January 20th, they might consider coming to the next summit with substantial fiscal package in hand (as will President Obama).

If the latest rounds of global economic diplomacy were the Olympics, then China gets gold in the fiscal stimulus category, Germany gets silver, and the UK (so far) is the distant bronze - but the UK does get one more throw next week. Not the ordering of world economic leadership that one would ordinarily expect, but perhaps that's a good thing.

In the category of “largest cash contribution designed to save the world from serious disruption”, Japan easily finishes first - their \$100bn pledge to the IMF this week was timely, targeted and hopefully not temporary. Sadly, there were no other entrants in this category. Perhaps the chemistry and cooking at the White House dinner on Friday will prompt further contributions in the near future?

But there is, unfortunately, another way to read [the communique](#) - as a government or international official, for whom this text really is a set of instructions to be implemented. The whole first part of the document is generic and definitely not new, so - as an official - one's eye skips through that quickly. The real issue is the deliverables in the plan of action, with a pressing deadline at the end of March (this is pretty much like saying “do it tomorrow” to an official). This is where we - an official reader is thinking - must concentrate our immediate attention and efforts. And most of these specific actions are about tightening regulation on and around credit, or beginning processes that definitely point towards many dimensions for this kind of tightening - accounting standards, hedge funds, risk disclosures, financial sector assessments, credit rating agencies, risk management and stress testing models, international standard setters, sanctions for misconduct, reporting to supervisors in different countries, and more.

There is, of course, nothing wrong with making regulation more effective. This is surely needed - in both the US and Europe, and probably elsewhere - to help lower the odds of another global financial crisis developing in the future.

But we are still not out of this crisis. And tightening regulations quickly in the midst of a worldwide credit crunch is one good way to make sure that credit contracts further and

faster. Lending standards naturally tighten in a crisis; the issue to address going forward is how to prevent standards from loosening too much in the next boom - but this is at least several years down the road. I'm in favor of starting early, but I do not like precipitate action just because you want to look busy and you could not agree on the more pressing issues, such as fiscal policy, support for the IMF, shoring up the eurozone, and so on.

It is true that one (among many) of the stated principles is: "Mitigating against procyclicality in regulatory policy." But that is a general statement that is not mapped into operational requirements - except that the IMF and FSF should work together on this, which is a good way to make sure it doesn't happen. What officials have to deliver on, by the end of March, is substantive progress with regards to tougher and tighter regulation of credit. There is a real danger that this action plan - within such a short time frame - can actually make the global downturn dramatically worse.

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Nov 16, 2008 1:11 AM

### [Root Causes of the Current Crisis](#)

from [The Baseline Scenario](#) by James Kwak

We've gotten a fair amount of criticism over on our latest Baseline Scenario post for not correctly identifying the causes of the financial crisis. I understand the criticism that we don't identify the one single, crucial cause, because historical events like this are always overdetermined: there are always multiple plausible explanations, and with a sample size of one there's no way to know which explanation is correct. (It reminds me a key issue in torts, where you distinguish between cause-in-fact and proximate cause ... well, never mind. It's a fascinating subject, but a bit off-topic here.)

Anyway, luckily for all of us, today's [G20 communique](#) reveals the "Root Causes of the Current Crisis." In case you missed it:

(I've inserted my own numbers to count what I consider separate causes, as opposed to descriptions of what happened.)

During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and (1) failed to exercise proper due diligence. At the same time, (2) weak underwriting standards, (3) unsound risk management practices, (4) increasingly

complex and opaque financial products, and (5) consequent excessive leverage combined to create vulnerabilities in the system. (6) Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.

Major underlying factors to the current situation were, among others, (7) inconsistent and insufficiently coordinated macroeconomic policies, (8) inadequate structural reforms, which led to unsustainable global macroeconomic outcomes. These developments, together, contributed to excesses and ultimately resulted in severe market disruption.

To summarize:

1. Naive investors
2. Naive underwriters
3. Bad risk managers
4. Complex financial products
5. Leverage
6. Insufficient domestic regulation (note the lovely phrase “in some advanced countries,” enabling everyone to point at someone else)
7. Insufficient global coordination
8. Insufficient global regulation

There you go.

(We'll have a more comprehensive review of the G20 meeting, probably later on Sunday.)

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Nov 15, 2008 9:40 AM

### **[FDIC Takes Mortgage Proposal to the Public](#)**

from [The Baseline Scenario](#) by James Kwak

Two months after the collapse of Lehman Brothers, there has still been no broad-based action to help restructure delinquent mortgages and slow down the flood of foreclosures; the Fannie/Freddie plan announced earlier this week is a very small first step, because it is limited to a small portion of the mortgages outstanding - those controlled by Fannie and Freddie, which tend to have relatively low default rates anyway.

[Sheila Bair](#), head of the FDIC, said that that plan “falls short of what is needed to achieve wide-scale modifications of distressed mortgages.” Apparently frustrated by the failure of negotiations with the Treasury Department, yesterday the FDIC posted its mortgage modification proposal to its [web site](#) ([Washington Post summary](#)), basically breaking with the rest of the administration and hoping the Congressional Democrats can make it happen.

This plan (which we’ve heard about in some form or another for weeks) would apply to all owner-occupied homes that are at least 60 days past due; mortgages would be reduced so monthly payments are no more than 31% of the borrower’s income. Based on FDIC experience at IndyMac, most of those reductions would be made by reducing the interest rate as low as 3% and extending the term; principal would only be reduced in a small number of cases. (From a net present value perspective, of course, lowering the interest rate and lowering the principal are two ways to get at the same thing.)

Because the government does not have the power to force loan servicers to modify loans, the incentives would be a \$1,000 fee per restructured mortgage and, more importantly, a government guarantee for up to 50% of the loan value in the case of a re-default. Participating servicers would also have to systematically review their entire portfolios for loans eligible for modifications, to prevent them from picking and choosing. The FDIC’s high-level estimates are that 4.4 million loans will become sufficiently past due by the end of 2009, 2.2 million could be modified, and 1/3 of those will re-default; the total cost to the taxpayer would be \$24 billion, mainly for paying off the guarantee on defaults.

The basic principle of the plan is sound: providing a government incentive to get servicers to do something that will help borrowers and the communities they live in. However, I don’t see anything in it that will get around the securitization problem - servicers are legally bound only to act in the interests of the investors who own the bits and pieces of the loan, and some of them may sue if loans are modified in ways they don’t like. Solving that problem will almost certainly take new legislation.

By the way, this is Treasury’s response, according to the [AP](#):

[FDIC] officials want to use part of the \$700 billion bailout of the financial industry to pay for it. But the Treasury Department is opposed to that idea.

Testifying on Capitol Hill Friday, Neel Kashkari, the Treasury Department’s assistant secretary for financial stability, said the intent of the \$700 billion plan was to make investments with the hope of getting the money back. That, he said, was “fundamentally different from just having a government spending program” that would disburse money with no chance of ever seeing any returns.

Is there really a fundamental difference between (a) making investments that theoretically could get a positive return but are really bad investments you are consciously making to shore up the financial system and (b) extending loan guarantees that you know will cost



you some money, but will help stabilize the housing market, increase state and local tax revenues, and keep people in their homes?

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Nov 14, 2008 11:09 PM

### **[The G20 Summit: Europe's Greatest Moment, Or Not? \(And a Quiz\)](#)**

from [The Baseline Scenario](#) by Simon Johnson

[From their pre-meeting](#), it is reasonably clear what Europeans (except probably the British) want from the G20 summit on Saturday: a road map towards a great deal more regulation, together with agreement that the necessary powers and resources will be provided to implement these new rules at some international level (which could be the IMF or the Financial Stability Forum or the G20, or some combination).

And the Europeans are now apparently saying, [on the sidelines](#), that victory - and a concrete action plan - is within their grasp. This, of course, raises our expectations and makes us more prone to disappointment. The White House, on the other hand, has been trying to manage our (and the Europeans') expectations downwards.

While we are waiting to learn the outcome of what is probably still a fairly intense conversation, here is a (relevant) pop quiz.

Below is the list of locations for press conferences to be held by participating countries after the conclusion of the summit, [kindly provided](#) by Planet Money. The question is: which of these countries is not actually a member of the G20? (Answer after the jump)

**European Union & France** — Willard Hotel

**Japan** — National Press Club

**Italy** — Embassy

**Australia** — National Building Museum

**United Kingdom**— Ambasssador's residence

**Canada** — Embassy

**Germany**— Ritz carlton Georgetown

**South Africa** — Park Hyatt Hotel

**South Korea** –Paloma Hotel

**Argentina** — Park Hyatt Hotel

**Mexico** — Embassy of Mexico

**Spain** — Mandarin Oriental Hotel  
**Russia** — The Washington Club

The answer is: Spain. If someone can explain to me how exactly they got invited, I would be grateful. The most plausible explanation is that they are representing the European Union. But if that is the case, why are they having a separate press conference?

This is relevant to the bigger questions of the day, because part of the issue with regard to global governance/regulation (e.g., at and around the IMF) is the overrepresentation of smaller European countries. If the G20 will be the vehicle for moving forward a reform agenda, is it better or worse to have many small European voices at the table?

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Nov 14, 2008 4:25 PM

### **[For Your Weekend Reading Pleasure ...](#)**

from [The Baseline Scenario](#) by James Kwak

There isn't much new information for those who have been following the crisis, but [Michael Lewis](#) is one of the best writers around.

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Nov 14, 2008 1:02 PM

### **[The Bad Private Equity Fund](#)**

from [The Baseline Scenario](#) by James Kwak

What seems like years ago, Simon and I wrote an [op-ed](#) in which we compared the initial proposal that became TARP to a bad hedge fund - a fund whose purpose was to overpay for illiquid securities and thereby shore up banks. Now that the [original plan is dead](#), I think we can say that TARP has become a bad private equity fund, whose purpose is to buy preferred stock on overly generous terms (compare the 5% dividend taxpayers get to

the 10% divided Buffett got from Goldman) in order to shore up banks and bank-like institutions (and maybe others as well). I don't mean "bad" as a criticism here: the purpose of the Treasury Department is to protect and advance the public good, and that goes beyond the profitability of the investments themselves.

However, I do think it's a problem that the goals of this private equity fund haven't been well defined. Right now the bulk of the political pressure seems to be to (a) expand the scope of the bailout to other companies and industries that are being hurt by the recession (which could mean just about everyone) and (b) force bailoutees to do things in the public interest, like increase lending. (See the [New York Times](#) on both of these topics.) So the fund is being torn in two directions. To make a very broad generalization, if you want to increase lending, you should give capital to a healthy bank, like Saigon National (in the NYT article); but if you want to keep the financial system from collapsing, you should give it to very large banks (too big to fail) with balance sheet problems, like [Citigroup](#), and they are not going to increase lending, precisely because they need the money themselves.

Paulson's initial bet, which most but not all observers agreed with, was that the top priority was keeping a handful of core banks - Bank of America, Citi, JPMorgan Chase, Wells - from collapsing. One risk is that to protect that position, they will need more capital for those core banks (especially, apparently, Citi). While these banks were struggling with a liquidity crisis in September-October, now they are struggling with a good old-fashioned recession, in which all sorts of borrowers can't pay them back, so they could be looking at writedowns for many months to come. (Perhaps as a result, CDS spreads on BofA, Citi, and JPMorgan are all up 30-50% from their lows right after recapitalization was announced.)

So I think Treasury needs to be clear on its goals. We know one goal is to protect the core of the system, which will not necessarily increase lending in the short term. From Paulson's recent statements, it looks like one new goal is to increase lending. It's not clear that \$700 billion is enough for both of these goals. And \$700 billion is certainly not enough to bail out everyone out there who will be hurt by the recession, including smaller banks that are unhealthy but not "too big to fail" - who will, therefore, fail.

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Nov 14, 2008 7:24 AM

### [The G20: A Viewer's Guide](#)

from [The Baseline Scenario](#) by Simon Johnson

What would constitute success and what would imply failure at the G20 heads of government meeting (dinner tonight and what is expected to be a five hour session on Saturday)? Here are three possible sets of outcomes:

1. There is a vague statement of principles and some working groups are told to get busy. This would be my baseline view of what is going to happen. I'm not sure such an outcome would justify the carbon emissions generated by bringing 19+ heads of government (and some large entourages) to Washington - a conference call would have probably sufficed. But, as long as they agree to meet again reasonably soon (yet surely after January 20th), perhaps we may see the beginning of a process in which industrialized countries engage more productively on global economic and governance issues with large emerging markets.
2. In terms of upside, it would be great to see progress - perhaps more on the sidelines than in the main communique - on three main points. (For more on why these measures would be helpful, please see our [latest baseline](#) and, if you want even more, follow the links provided there.)

First, more fiscal stimulus from various countries could be announced. China, Germany and now it seems the UK have put something on the table. [We're still waiting for the French](#) - perhaps they are waiting for a dramatic moment. But this US administration seems to be backing away from further stimulus, as well as away from supporting key, potentially systemic parts of the economy.

Second, more funding for the IMF could be put in place, at least on an interim basis. I really do not buy the argument, now heard in some official circles, that "the money will be there if the IMF ever needs it." Have we learned nothing from the spectacular failure of a case-by-case-over-a-weekend approach to financial institution problems in US and Europe?

Third, serious discussion of the problems within the eurozone, and what can be done to head these off, could take place. I think some Europeans wanted this summit (and it was their idea) largely to show their domestic audiences that they can have global impact. Well, they certainly can have big - negative - global impact, if they don't act quickly to shore up the eurozone.

3. In terms of downside, I would be afraid of some sort of public argument or spat. There may be a temptation for some countries to generate sparks. This could have political value for some electorates, but the effects on market confidence would not be good. I hope that whatever happens in the National Building Museum (the site of the plenary session) stays in the National Building Museum.

We should have some indications of how things are going by the end of Friday (today). Any big announcements will probably be floated or previewed in some way by 11pm Washington time. We'll know a lot more after the end of the formal meeting, mid-

afternoon Saturday, when we'll see the final communique. Then, of course, come the press conferences and the spin.

And, in case anyone has forgotten the lessons of October 10th-12th (when the Europeans did a spectacular last minute U-turn on bank recapitalization), most of Sunday - US time - is also available. So feel free to go home and announce major new policy initiatives. But it's not all of Sunday, as Asian markets open in the early evening US East Coast time, and their initial reaction can influence the broader passing of market judgment on Monday.

As we learn relevant things during the weekend, we will post the details; just subscribe - it's free - to our [feed](#) or [email updates](#) if you are interested (see top right corner of our home page for details).

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Nov 14, 2008 12:33 AM

### [Yet More on GM](#)

from [The Baseline Scenario](#) by James Kwak

My two earlier posts on the [auto industry](#) and [GM](#) have been among the most-commented-on posts in our brief history. For those who want a crash course on GM's problems and whether or not bankruptcy is a possible solution, I strongly recommend two podcasts from Planet Money.

- [Kimberly Rodriguez](#), an economist, talks about the importance of the industry, but also the problems with simply giving GM an operational loan.
- [Steve Jakubowski](#), a bankruptcy lawyer, explains the risks of GM entering Chapter 11 (if you're curious about the market for debtor-in-possession financing, listen to this), but also explains how a "prepackaged" bankruptcy, possibly funded by the government, could work.

Simon also tells me he talked through the arguments on both sides of the GM issue in his latest installment for the [MIT Sloan podcast](#). (I haven't had time to listen to it yet.)

If there's a consensus between them, I'd say it's that some kind of brokered solution is better than either simply leaving GM alone or simply handing them a loan without strings attached. (It is possible, however, that a loan might be necessary just to buy enough time to broker the solution.)

The [New York Times](#) is reporting that it could all be academic, since Senate Republicans and President Bush are opposed to doing anything for GM, and GM could be unable to pay its bills by the time Obama takes office.

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Nov 13, 2008 11:03 PM

### [Other Good Sources of Information and Perspectives](#)

from [The Baseline Scenario](#) by James Kwak

Since the article about Simon in the [WSJ](#) earlier today, we've been getting a large number of first-time visitors. On the chance that some of you are new to the economics blogs, I wanted to suggest a few other sites you might also want to check out. We are nowhere close to the be-all and end-all of information about the global economy or the current crisis, and in any case the more perspectives you get, the better.

- [Planet Money](#) is an excellent, excellent podcast for people who are relatively new to the world of economics and the financial crisis, and for people who commute and can listen to it in their cars. I listen to it for fun.
- [Real Time Economics](#) (Wall Street Journal) gives you rapid coverage of economic issues as they arise.
- [Calculated Risk](#) and [naked capitalism](#) are good sources for near-real-time news about the crisis and the economy in general. Calculated risk has a particular focus on housing and mortgages; naked capitalism has incisive commentary from one side of the political spectrum.
- [Econbrowser](#) is more technical and data-oriented; more advanced readers will like this one.
- [Economist's View](#) and [Marginal Revolution](#) provide in-depth articles applying economics to broad range of phenomena.
- And [James Surowiecki](#) has a blog!

Of course, we would love it if you would come back here often (or sign up for [email subscriptions](#)). But I wanted you to know some of your options.

(Feel free to add other suggestions in the comments.)

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Nov 13, 2008 7:03 PM

### [MIT Class on GM, G20 and Good News \(if any\)](#)

from [The Baseline Scenario](#) by Simon Johnson

Our next MIT class on the global crisis will run Tuesday, 4pm-7pm; live webcast available through a link on this site or directly through MIT Sloan. Likely topics include:

- Where do we stand in terms of the overall financial crisis? Is it over yet?
- General Motors: to bail out or not bail out?
- The G20 Summit: good, bad or was it surprisingly ugly?

And we'd be happy to discuss other topics that you suggest here.

The class from last week is [available to download](#) (there was no class this week due to the holiday).

***Update:** you can preview some of the (GM and G20) issues under consideration in [my podcast](#) from MIT Sloan today.*

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Nov 13, 2008 5:12 PM

### [America Is Best Country](#)

from [The Baseline Scenario](#) by James Kwak

When I was in college, the college humor magazine did a brilliant spoof of USA Today, complete with a silly poll in the lower-left-hand corner of the front page. According to their mock poll, Americans thought that the United States was the best country in the world, with about 92% of the vote.

I was reminded of this today by President's Bush's [speech today](#), which the Wall Street Journal summarized as "[Bush Defends American Capitalism](#)." The thrust of the speech was, indeed, that American-style capitalism is the best economic system there is, and that the current global crisis should not lead to a reaction against free markets.



I consider the second half of that sentence a fairly unobjectionable position. Saying that we need transparency, cooperation, and economic growth are also fairly unsurprising. However, I wouldn't say Bush's arguments that American capitalism - our curious mix of free-market ideology, lobbyist-driven politics, and widespread private sector capture of regulatory agencies - is the best possible expression of free markets is very convincing. Look at what he compares us to:

Meanwhile, nations that have pursued other models have experienced devastating results. Soviet communism starved millions, bankrupted an empire, and collapsed as decisively as the Berlin Wall. Cuba, once known for its vast fields of cane, is now forced to ration sugar. And while Iran sits atop giant oil reserves, its people cannot put enough gasoline in its — in their cars.

It's also curious how Bush trots out those red herrings, like "authorities in every nation should take a fresh look at the rules governing market manipulation and fraud." Sure, I'm against market manipulation and fraud, too, but saying they were a significant part of the global crisis is misdirection akin to calling the corporate scandals of the beginning of the decade (Enron, WorldCom, etc.) the fault of "a few bad apples." The vast majority of the behavior of people who were selling mortgages, securitizing mortgages, rating securities, and trading credit default swaps was completely, 100%, tell-it-to-Santa-Claus legal.

Then there's the disingenuous argument par excellence:

History has shown that the greater threat to economic prosperity is not too little government involvement in the market, it is too much government involvement in the market. (Applause.) We saw this in the case of Fannie Mae and Freddie Mac. Because these firms were chartered by the United States Congress, many believed they were backed by the full faith and credit of the United States government. Investors put huge amounts of money into Fannie and Freddie, which they used to build up irresponsibly large portfolios of mortgage-backed securities. And when the housing market declined, these securities, of course, plummeted in value. It took a taxpayer-funded rescue to keep Fannie and Freddie from collapsing in a way that would have devastated the global financial system.

The idea that Fannie and Freddie were the cause of the crisis is [simply false](#), at least in the form it usually takes, and one I'd hoped I'd heard the last of once the Presidential campaign was over. During the peak of the subprime boom, Fannie and Freddie were buying a smaller and smaller share of subprime loans in comparison to private sector institutions. Fannie and Freddie got into trouble because they were private companies using their implicit government guarantee to fund risky investments in search of higher profits; the problem was not too much government, but management and shareholders making a quick buck off the government.

For the record, I'm for free markets, not socialism. But I'm not for a lame-duck president making campaign speeches when what we need are real solutions.

**Update:** Hey, [Felix Salmon](#) agrees with me on this. He even uses the word “disingenuous” in roughly the same place that I do.

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Nov 13, 2008 11:08 AM

## **[India in the Global Economy](#)**

from [The Baseline Scenario](#) by James Kwak

One of our commenters pointed out that we have failed to say anything about India, despite its large and growing importance in the global economy. Simon’s colleague Arvind Subramanian (whom we have linked to before, including this morning) has a new opinion piece, originally posted at the [Peterson Institute](#).

### **India and the G-20**

The upcoming G-20 summit meeting in Washington provides an opportunity for India to help shape the new global economic architecture in line with its strategic and economic interests. India should propose short-term, crisis response actions to help limit the economic downturn; advance a clear, medium-term agenda; and push for a political commitment by all countries to keep markets open and prevent trade barriers from going higher.

Although the G-20 has been in existence for nearly a decade, this is the first G-20 summit meeting, and many participants will be looking to Prime Minister Manmohan Singh, a respected economist in India and throughout the world, for a particular contribution.

What does India bring to the G-20 table? As a long-time spokesperson for the G-77, India has a record of assuming a leadership role. But in the past, this role was often used to assert India’s right to retain sovereignty. In the words of Strobe Talbott, the former diplomat who now leads the Brookings Institution, India has been on many issues a “sovereignty hawk,” protecting its own interests at the expense of global cooperation on issues ranging from nuclear proliferation to trade. But with India’s growth, and in an era of globalization, its interests—and its perception of its interests—have changed. India now has a keen stake in sustaining an open global trading system. Accordingly, its leadership should now be harnessed for a different cause. Moreover, India has begun to realize that it needs to contribute to sustaining this system rather than assuming that the status quo can be taken for granted. But trading partners are wary of India, viewing India’s role in the trade negotiations as unhelpful. It would be a singular achievement if

India can manage to reassure G-20 participants on this score. In short, leadership comes naturally to India. The question is going to be the cause for which India harnesses this leadership role.

As [Aaditya Mattoo of the World Bank and I have argued](#) [pdf], for India the medium-term agenda should include: First, reforming the financial architecture, including by strengthening the International Monetary Fund's capacity to respond to crises and enhancing its legitimacy through radical governance reform to give greater say to the emerging powers. Second, securing the future openness of the trading system, which would require a commitment to go beyond completing the current Doha agenda in two ways: deepening rules in existing areas (especially services) and developing rules in new areas (to deal with undervalued exchange rates, cartelization of oil markets, investment restrictions and environmental protectionism). Third, reforming the makeup of the bodies involved in global decision-making, including the creation of a more representative membership than the G-7.

*Arvind Subramanian is a Senior Fellow, Peterson Institute for International Economics and Center for Global Development, and Senior Research Professor, Johns Hopkins University*

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Nov 13, 2008 11:08 AM

## [The Quest for Global Balance](#)

from [The Baseline Scenario](#) by James Kwak

Even with all the chaos in the US economy these days, the G20 summit approaching this weekend is bringing the global financial system to the top of the agenda, at least for the few days. One of the issues of the past few weeks has been volatility in currency prices as (most) countries with overvalued currencies and large current account deficits see their currencies fall. The flip side of this situation is countries with undervalued currencies and large current surpluses - most notably, China. Arvind Subramanian presents one solution in the [Financial Times](#): treat undervalued currencies as a form of trade barrier and manage them through the WTO.

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Nov 13, 2008 12:18 AM

## [Not with a Bang but a Whimper](#)

from [The Baseline Scenario](#) by James Kwak

Two days ago, in my [post about AIG](#), I had the following passage:

In mid-October, Treasury committed \$250 billion to explicit recapitalization, but to all intents and purposes seems committed to using some of the other \$450 billion to buy those same toxic assets - at what price is still unclear. (Why they would still bother doing this is also unclear, for that matter.)

I meant to expand on that throwaway parenthesis, but I was busy all day today and didn't get around to it. By the time I got home, I found out that Henry Paulson had scrapped the idea of buying troubled assets altogether (something we've [favored for a while](#)), saving me the effort of arguing against it.

Unfortunately, after reading [Bloomberg](#), [The New York Times](#), the [Wall Street Journal](#), and the text of [Paulson's remarks](#), I can't figure out what they're doing with the remaining money instead. The main emphasis of the news articles was on the new idea to create a new entity, seeded by TARP money, to lend money against consumer loans, in order to stimulate demand for those loans and hence consumer lending. But this was just one of three possibilities that Paulson mentioned: the others were additional recapitalizations (potentially with a public-private structure, or expanded to a broader range of financial institutions) and a loan-modification program.

While I agree with [Andrew Ross Sorkin](#) that it's a good thing Paulson was able to change his mind about buying illiquid assets, I would feel better if he knew what he was changing his mind to.

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Nov 12, 2008 7:01 AM

## [Health in a Global Crisis: Another MIT Course](#)

from [The Baseline Scenario](#) by Simon Johnson

The global financial crisis began (and continues) in relatively rich places, like the US and Western Europe, and it has obviously spread to previously fast growing middle-income countries, often known as “emerging markets.”

We are also beginning to see significant effects in lower-income developing countries.

Part of this is just now becoming evident in their macroeconomies. Many of these countries are net sellers of commodities to the outside world, so they are seeing a fall in export revenue (albeit from generally high initial levels) and speed of this decline is more than a little worrying - this is the kind of shock that often throws countries' public finances and other macro policies into some disarray. In addition, while we do not yet have hard evidence on aid flows, these typically go down when a donor country hits any kind of economic speed bump, and almost all donors are now experiencing big slowdowns. (Yes, I know that some poor countries, and many poor people, were also [hit hard by high food prices](#) earlier in the year.)

We find ourselves working these issues directly in a course at MIT Sloan on Global Health Delivery, in which students work in teams trying to help health care projects in poor countries (this year Africa is the focus) - we are usually invited to work on a business-type aspect of these projects. (It's part of a larger set of courses, developed over the past decade, known collectively as Global Entrepreneurship Lab, or G-Lab, in which many of our students work around the world with entrepreneurial people, who invite us in to help solve specific problems. We've worked on health issues before, but this is the first time an entire section - about 50 students from all over campus - has focused just on health for low income situations.)

The course has a [public blog](#), run by Anjali Sastry (head of the course), and I refer you to that and to [Global Health at MIT](#) for more details on what we are doing and with whom we work (e.g., the [Global Health Delivery](#) people at Harvard have been immensely supportive and engaged).

I'd like to flag one key issue, which happens to be the topic of class today. We have no trouble finding good projects and we work with amazing doctors and other medical professionals. But one question they usually have is: how do we scale up? The projects we see help thousands of people, but the need is to help tens of thousands or more.

What is the right way to scale up, when patients don't have much money, when perhaps you don't want people to pay for health care (it likely costs them a lot just to get to the clinic), and when the government never has much money? The readings for today's class are about [Smile Train](#), [aid effectiveness](#), and the WHO's work on [scaling up](#). But we are looking at more, still small-scale models to see how exactly they could become more general - through being better run, or using money more effectively, or raising more money (remember: this is not a classroom exercise; these are the questions that leaders in this part of the global health field are asking us to work on).

And now add a global economic and financial crisis on top of all this.

Send us any relevant ideas, through comments here or through the course [blog](#), and we (and the students) will report back on what exactly we learn from the hands-on project work, which reaches its most intense phase in January.

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Nov 11, 2008 7:42 PM

### [Russia Tries to Stop Ruble from Falling, Gives Up](#)

from [The Baseline Scenario](#) by James Kwak

The emerging markets rout continues: Russia, she of the \$500 billion war chest of foreign currency reserves, spent 19% of those reserves trying to fight off a currency devaluation. Today, Russia didn't quite give up the fight, but [conceded some ground](#), widening the allowed trading range and at the same time increasing interest rates. Just goes to show: fighting those nasty currency speculators rarely works, if ever.

(Thanks to [Free Exchange](#) for catching this.)

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Nov 11, 2008 1:31 PM

### [An Economic Strategy for Obama](#)

from [The Baseline Scenario](#) by James Kwak

Barack Obama has been getting a mountain of unsolicited economic advice; here's [one selection](#). In case he needs more to read, we posted our long-term recommendations on the WSJ [Real Time Economics](#) blog today. In short, we see a long-term challenge - and opportunity - to shift resources from the financial sector and into what is colloquially called the "real economy." This will require, among other things, investment in education, openness to immigration, consolidated financial regulation, and assistance for workers affected by restructuring.

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Nov 11, 2008 11:39 AM

## [Why Not Let GM Go Bankrupt?](#)

from [The Baseline Scenario](#) by James Kwak

GM is mounting a massive PR campaign to convince Washington that a GM bankruptcy would be catastrophic to the national economy, resulting in the loss of millions of jobs, costing taxpayers over \$100 billion, and plunging the economy into a depression (whatever that is). In addition to Nancy Pelosi and Harry Reed, [Barack Obama](#) has now called for an auto bailout.

I don't want the US auto industry to go away. Yes, if GM and every one of its suppliers and dealers stopped operating tomorrow, that would cost hundreds of thousands or millions of jobs. But it's not clear to me why bankruptcy would have the same effect. Ordinarily, when a company goes bankrupt - especially a big one - it goes right along doing whatever it was doing before, except now it doesn't have to pay off all its creditors, and its operations are monitored by a court. The bankruptcy process is intended to find a reasonable outcome for all of the stakeholders that reflects the order of priority of their claims, but also (in the case of a company as big as GM) reflects the public interest. Airlines, for example, have been going in and out of bankruptcy for years in order to force their unions to negotiate long-term cost reductions, and even use the threat of bankruptcy as a negotiating tool.

If GM were to go bankrupt, one possibility is that it would emerge in a stronger form, perhaps with a lower cost structure and with some of its debt converted into equity. Another possibility is that it would be broken up and sold to other companies, both domestic and foreign, who would continue doing most of what GM does today. In any case, it is likely that shareholders would get nothing (but they've already lost most of what they put in), management would be fired, and workers would lose something (through job cuts or reduced pay or benefits), but the nightmare scenario that GM is trying to scare us with would not occur.

Now, I have heard vague claims from the auto industry that GM cannot operate in bankruptcy, but I fail to see why not. The only reason I can think of is that consumers might be hesitant to buy a car from a bankrupt company (warranty concerns?), but for years consumers have been buying cars from companies that are at serious risk of bankruptcy, so I don't really buy that. What am I missing? I mean that seriously: if you know the answer, please let me know.



The other alternative would be a government bailout that has the same salutary effect as bankruptcy: wipe out the shareholders, replace the management, write down the debt, add new capital, lower the cost structure, preserve most though probably not all of the jobs, and ensure the new entity is profitable as a going concern. The government holds all the cards right now and should not be afraid to negotiate such a deal. Under this option and under bankruptcy ordinary shares will become worthless - which, arguably, they should - which is why Deutsche Bank just reduced its price target for GM to \$0.

The one thing I would not understand is a no-strings-attached \$25 billion loan to the automakers that does nothing to address their long-term problems. But help me out if you can explain what I am missing.

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Nov 10, 2008 9:49 PM

### [Fed Chairman Bernanke Confident ...](#)

from [The Baseline Scenario](#) by James Kwak

... that the US dollar will remain stronger than ...

... the nickel.

(From the [Onion News Network](#). I'm not sure which video it's in - it was in the ticker at the bottom of the screen.)

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Nov 10, 2008 9:49 PM

### [Baseline Scenario, 11/10/08](#)

from [The Baseline Scenario](#) by James Kwak

## **Baseline Scenario, November 10, 2008**

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

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

1. [Analysis](#) of the current situation and how we got here
2. [Policy](#) proposals

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

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## **ANALYSIS**

### **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 January 1999 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. Continued interest rate cuts and liquidity measures by the Federal Reserve and its counterparts have been just enough to ensure a slight easing in interbank credit markets. However, the supply of credit to the real economy remains constrained.

### **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 have ensured that we are now in 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 are declining along with housing prices, with a major fall in US personal consumption in Q3. 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 many of 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 until October data appear in the middle of November. Consumer confidence is already at record lows. The recent unemployment report showing a net loss of 240,000 jobs in October will probably only get worse in the next few months.

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. So far, Iceland, Hungary, and Ukraine have required bailouts from the IMF, sometimes joined by other entities such as the European Central Bank, and Pakistan is in negotiations with the IMF. Argentina has taken the extreme step of nationalizing its private pension system, most likely in an attempt to avert a national default. 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. Credit default swaps show that several countries in Eastern Europe and Latin America are at risk of default.

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.

Even China is showing the negative effects of the global recession. With a risk that growth could fall below 6% this quarter (from 11-12% over the past few years), the Chinese government recently announced a \$600 billion stimulus plan, spread over two years, in an effort to keep the economy growing fast enough to absorb a growing labor force.



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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 recent initiatives, 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. While the United States has little room to lower rates, the UK and the Eurozone still have room for additional reductions. The recent 0.5 percentage point reduction by the ECB, in particular, is particularly worrying, as it indicates that the ECB is having a hard time shedding its inflation-fighting instincts to fight the global recession. With a global recession, falling commodity prices, and weak demand, 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. In the US, we recommend a [stimulus of \\$450 billion](#) (3% of GDP), including extended unemployment benefits, expanded food stamp aid, direct aid to state and local governments, and short- and long-term infrastructure spending, at least.
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. We recommend a significant expansion in the IMF's lending capacity, perhaps up to [\\$1 trillion](#).

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. The upcoming G20 meeting is an opportunity for concerted action by both developed and emerging market countries to combat the global recession.

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

We believe the US economy, along with many other parts of the world, is in a major recession precipitated by housing markets but deepened 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. Even after the credit panic subsides, it will leave in its wake the worst global recession in decades.

The outlook for the global economy continues to worsen. While the US and several European countries are already in 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 two months have 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.

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Nov 10, 2008 2:05 PM

### **[The Overpayment Begins](#)**

from [The Baseline Scenario](#) by James Kwak

Way back in the heady days of September, we criticized the original version of TARP because it seemed designed to ensure the government would [overpay](#) for toxic assets. Instead, we recommended splitting the transaction into two parts: (a) buy the assets at market (cheap) prices, and (b) explicitly recapitalize the banks. In mid-October, Treasury committed \$250 billion to explicit recapitalization, but to all intents and purposes seems committed to using some of the other \$450 billion to buy those same toxic assets - at what price is still unclear. (Why they would still bother doing this is also unclear, for that matter.)

Until now.

Today's government re-re-bailout of AIG ([WSJ article](#); [Yves Smith commentary](#)) can be hard to follow, but one provision is the creation of a new entity with \$5 billion from AIG and \$30 billion from the government to buy collateralized debt obligations (CDOs). The goal is to buy CDOs that AIG insured (using credit default swaps), because if those CDOs are held by an entity that is friendly to AIG, that entity will no longer demand collateral from AIG. The theory is that in the long run these CDOs will not default and that the new entity will make money on the deal.

The rub is that this entity is planning to pay 50 cents on the dollar for these CDOs. This has two problems. First, 50 cents is almost certainly more than these CDOs are worth on their own (hence the title of this post). If they were really worth 50 cents on the dollar, AIG wouldn't be having the problems it is having posting collateral; like the original TARP plan, this is an unfounded bet that the market is mispricing these assets. Second, and more bafflingly, the CDS contract is presumably separate from the ownership of the CDO; that is, buying the CDO from the counterparty doesn't eliminate AIG's obligation to pay if the CDO defaults, and hence doesn't serve its stated purpose. If, on the contrary, the CDS contract is contingent on the counterparty holding the CDO, then the CDO is worth a lot more than 50 cents to the counterparty, because it is insured for 100 cents by AIG - and we all know the government isn't going to let AIG default on those swaps. And no sane counterparty would sell for 50 cents.

Supposedly Treasury had enough time to think about how AIG should be bailed out and this is a better bailout than the original. If it is, I must be missing something.

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Nov 10, 2008 7:41 AM

[China's Stimulus, the IMF's Forecast, and France's G20 Agenda](#)

from [The Baseline Scenario](#) by Simon Johnson

What exactly is on the table for the [G20](#) heads of government meeting in Washington at the end of this week? One possibility is some sort of synchronized or joint fiscal policy stimulus in most G20 member countries. (Yes, I know that the [communiqué](#) from this weekend's meeting of finance ministers and central bank governors was somewhat on the vague side.)

How likely is such a cross-country stimulus? Well, the IMF's [revised forecast](#) for global growth, released last Thursday, has been widely interpreted as merely confirming that the world economy is slowing down (and fast - it is remarkable to knock nearly a percentage point off the global growth projection, just a month after the last forecast went final.) But the forecast can also be read as a reflection of the Fund's [exhortation to fiscal expansion](#) and, in some parts, as an indication of where some parts of the G20 may be headed. For example, China's growth for 2009 is now projected at 8.5%, which struck me as too high when the forecast came out. Lucky for me that I dawdled in writing a critique, because [China's fiscal stimulus](#), announced over the weekend, makes higher growth somewhat more plausible.

The IMF is allowed, by its own rules, to include in the forecast fiscal (and other) policy moves that it knows to be "in the bag," even if they have not yet been publicly announced. But it can't base the forecast on just probable or potential policy changes. If the IMF knew about China's package (as it almost surely did 3 days in advance), then this is built into the forecast.

So what else can we infer about imminent policy changes from the forecast, if we read it sort-of backwards in this fashion? The thing that really struck me was what the forecast says about Europe, particularly France.

According to the forecast, headline growth in 2009 will be roughly the same in the U.S. and the Eurozone (minus 0.8 vs. minus 0.7). But the IMF's headline numbers are annual average growth rates, which are more affected by what happens at the beginning of a year (and actually, if you care about technicalities, by what happens at the end of the previous year). To see the Fund's view on economic dynamics within a year, you need to look at 4th quarter over 4th quarter projections, which are in the last two columns of their [Table 1.1](#).

These show that the U.S. will decline by 0.5% in 2009, but the Eurozone will be flat ("—" in IMF table parlance means zero; I worked at the Fund for nearly 4 out of the past 5 years, but I could never get a straight answer on why they don't write the rather more obvious "0.0".) This says that the Eurozone will recover faster than the US, which - given the problems with European banks, consumer confidence, housing and (most important) exposure to the ever-vulnerable East/Central Europe - is not so very obvious.

Furthermore, of the four major Eurozone economies, the forecast shows declines for three: Germany, Spain, and Italy (by the way, for Italy this Q4 on Q4 forecast for 2009

definitely looks too high). So who saves the day? According to the forecast, it is France, with growth of plus 0.2% Q4 on Q4. (Perhaps helped by Belgium and the Netherlands, but this is hard to believe, given the state of their banks.)

Such a positive statement about France is striking and more than a little at odds with where things are currently going (e.g., the IMF is projecting minus 0.4% for France in 2008, Q4 on Q4).

But it would make sense if France has tipped its fiscal hand, and is indicating something big and bold is in the works (the European rules against big budget deficits have, in case you didn't notice, now been effectively waived). Perhaps it is something that will be announced in the run-up to the G20 meeting? Could it be a fiscal package that will capture the imagination of the world, develop further the friendship with China, put pressure on the outgoing Bush administration, be warmly welcomed by newly elected Democrats, somewhat eclipse Gordon Brown, and (try to) make it clear that France has the credibility needed to dominate the international economic policy agenda?

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Nov 9, 2008 4:14 PM

### [If You've Got It, Flaunt It](#)

from [The Baseline Scenario](#) by James Kwak

Other countries can only drool with envy. China today announced a [\\$586 billion stimulus package](#) - that's 17% of 2007 GDP. Spread through the end of 2010, it's still more than 7% of GDP per year. By comparison, the US stimulus package earlier this year was just over 1% of GDP, and after causing a small uptick in spending in Q2 it vanished into the sea of bad news; our recent proposal was for 3% of GDP, and that was at the higher end of the range.

Of course, the stakes for China are very high. GDP growth ranged between 11 and 12% in 2006 and 2007, but the IMF recently cut its [estimate for 2009](#) to 8.5% (down from the 9.3% estimate just a month ago), and according to the [New York Times article](#) the annualized rate for this quarter could be as low as 5.8%. While these are growth rates that the developed world hasn't seen for decades, the huge population migration from countryside to city requires high growth simply to keep unemployment in check. So the Chinese government brought out the heavy economic artillery.

The current crisis has proven, if it needed any proof, that even China is susceptible to the fortunes of the global economy. If it can lead to greater participation by China in the global financial system, including institutions like the IMF, that would be one positive outcome.

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Nov 9, 2008 4:14 PM

### [Simon on FLYP](#)

from [The Baseline Scenario](#) by James Kwak

FLYP, which I can only describe as an online multimedia magazine, has a “cover story” entitled “[Now What?](#)” on the challenges the country faces and various perspectives on what the Obama administration should do about them. Simon is interviewed (in video) for “pages” 7 ([domestic economy](#)) and 10 ([global financial system](#)), but there are also sections on foreign policy, energy, the environment, health care, and so on.

(I should add that FLYP is very slick and well-produced - you might enjoy browsing around the other stories and issues, although the user interface is not particularly intuitive.)

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Nov 8, 2008 9:46 PM

### [The Paulson Legacy](#)

from [The Baseline Scenario](#) by James Kwak

With the footsteps of a new Treasury Secretary audible around the corner, Henry Paulson’s days running the country are essentially at an end. The best he can do now is delay whatever changes the Obama administration will make.



Looking back over the last two months, Paulson's record (and that of the rest of the Bush administration) in combating the greatest financial crisis of our lifetimes is poor, though not catastrophic. The one thing that can be said in his favor is that the financial system did not completely collapse and Ben Bernanke's supposed warning in the dark hours of September 18 that "we may not have an economy on Monday" did not come to pass. We have said on this site that stabilizing the financial system was job one, and the patient is stable.

But weighed against that success is an array of failures. The many years of deregulation that helped bring on the crisis, to be fair, predated Paulson's tenure, and extended back into the Clinton administration. But the insistence that everything was fundamentally sound through the first half of September covered for a failure to do anything about highly visible problems with subprime loans, Alt-A loans, bond insurers, selected hedge funds, and some investment banks. The handling of Lehman and AIG have been widely credited with triggering the acute phase of the crisis, when no one would lend money to any bank. The initial bailout proposal was autocratic in conception and poorly designed, and the way it was pitched to Congress and to the American people triggered a wave of panic that has yet to subside and that in itself did significant damage to the economy. The delay in taking the steps that many people ([including us](#)) called for and that ultimately broke the fever gripping the financial sector - such as expanded deposit insurance, loan guarantees, and explicitly bank recapitalization - let the panic continue for weeks longer than necessary.

While the patient was saved, he is still far from health. While major banks are no longer failing on a weekly basis, lending to the real economy remains minimal, and the administration's strategy amounts to encouraging banks to lend money. There has still been nothing done on housing (rumor is that Treasury is fighting against Sheila Bair's mortgage modification proposal). Treasury has yet to buy a single mortgage-backed security, but is still pressing ahead with the original plan that few people believe is still necessary (given that banks now have unlimited deposit insurance, loan guarantees, and government capital). Apart from the swap lines extended to a limited set of central banks by the Fed, the government has been conspicuously silent on the ever-deepening emerging markets crisis.

Some people have wondered why Paulson was so set on the original plan to buy mortgage-backed securities instead of what he ended up with, which was bank recapitalization. I think the answer is pretty simple. The economic ideology of the Bush administration was that free markets are always best. When the markets failed, the idea was to surgically correct a flaw in the market for mortgage-backed securities. They believed the underlying problem was the lack of buyers for MBS, and that if the government stepped in as a buyer the market would correct and the problem would solve itself. This belief that markets ultimately work themselves out, and therefore only need small nudges in the right direction, is why the administration's actions have been a step behind and two sizes too small throughout this crisis.

We're still seeing this today in President Bush's resistance to a new stimulus proposal and insistence that we just need to let the "aggressive and decisive measures" already taken to have their full effect. The next administration, while believers in the virtues of free markets, are likely to be less convinced that free markets are always the solution and more willing to flex the muscles of government when necessary. And they are more necessary than they have been in decades.

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Nov 7, 2008 6:22 PM

### **Dueling Federal Reserve Banks!**

from [The Baseline Scenario](#) by James Kwak

A few weeks ago, three economists at the Federal Reserve Bank of Minneapolis set off a debate among Internet-addicted economists by claiming that, in essence, lending to the real economy was just fine and anyone who said there was a credit crisis was wrong. (See my [initial reaction](#), as well as [links to the original paper and several perspectives](#).) Now we have been treated by four economists at the Federal Reserve Bank of Boston, who argue that there was, in fact, a [credit crisis](#). In particular, they say:

- “the aggregate figures in [the original paper] do not reveal the weakening in new lending”
- lumping together AA and A2/P2 commercial paper hides the problems for A2/P2 issuers
- lumping together all durations hides the fact that commercial paper shifted from longer durations to shorter durations
- even though most corporate lending is via bonds, not direct bank lending, households and small businesses rely heavily on banks

and similar points. Take a look; some of the charts are fascinating.

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Nov 7, 2008 6:22 PM

### **419,000 Jobs Vanish**

from [The Baseline Scenario](#) by James Kwak

[240,000 jobs lost in October](#); September revised from 159,000 to 284,000; August from 73,000 to 127,000. That's 419,000 jobs less than we thought we had a month ago. It's 651,000 less than there were three months ago. And because we need 140,000 new jobs each month just to keep place with population growth, that's over 1 million fewer jobs than the economy would need to maintain unemployment where it was three months ago. Unfortunately, everyone expects this quarter and next quarter to be worse than last quarter. On top of that, unemployment is a lagging indicator: because of the transaction costs in firing and hiring workers, companies exhaust their other cost-cutting opportunities before laying people off, and they don't hire again until they are certain that the economy is growing again.

More than [22% of the unemployed](#) have been out of work more than six months, which is usually when unemployment benefits expire. For this and other reasons, only 32% of the unemployed were receiving state benefits in October. These are more reasons to expand unemployment benefits in multiple directions, at the very least for a limited time period. Alan Krueger has described the other ways our [unemployment insurance system](#) is broken.

Unfortunately, there is fear that President Bush (remember him?) will veto the stimulus package, including extended unemployment benefits, that the Democrats want to pass in November, thereby accomplishing nothing except delaying it by two months. Sigh.

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Nov 7, 2008 6:22 PM

### [Recession in Silicon Valley](#)

from [The Baseline Scenario](#) by James Kwak

Silicon Valley is often touted as an example of what is best about American capitalism - entrepreneurial, risk-taking, innovative, hard-working, and sometimes fabulously successful. Of course, it is also periodically criticized as a land of con men and get-rich-quick schemes.

Sequoia Capital, perhaps the most venerated VC firm in the Valley, held a “secret meeting” in October to discuss the impact of the credit crisis and economic downturn on the technology industry and startup companies. The [slides have been leaked](#), beginning with a tombstone with the words “R. I. P. Good Times.” (By the way, those of you not from the business world - particularly those with academic backgrounds - may find the presentation amusing for the way it combines large amounts of incommensurate data with an extreme scarcity of verbs, thereby avoiding the need for a coherent argument. My favorite is slide 42. But believe me, this is far better than most business presentations.)

One of the first employees of my company has a much more original and intelligent perspective on [what the recession means for Silicon Valley](#).

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Nov 7, 2008 6:42 AM

### [AIG, Credit Default Swaps, and “Risk Management”](#)

from [The Baseline Scenario](#) by James Kwak

Since the Lehman credit default swaps settled [without the sky falling](#), there has been a small wavelet of support for the once-obscure financial instruments that are widely blamed for amplifying the effects of the financial crisis, including a Forbes.com op-ed entitled “[Credit Default Swaps Are Good for You](#).” I happen to agree that CDS can play a useful role in enabling bond investors to hedge against the risk of default, and thereby make it easier for some institutions to get credit. But it’s a bit premature to proclaim that all is well and good in swapland.

Most obviously, there is the troubling matter of AIG, which has recently received additional scrutiny from the likes of the [New York Times](#) and the [Wall Street Journal](#) (subscription required). AIG has already burned through most of its initial \$85 billion loan from the government, has drawn down half of a separate \$38 billion loan for its securities lending business, and recently got permission to sell up to \$20 billion of commercial paper to the Fed. (And remember, when negotiations over the AIG bailout began around September 12, the company was saying it only needed \$20 billion.)

Most of the cash has gone to post collateral for CDS deals in which AIG was guaranteeing various bonds against default. As the risk of default goes up, counterparties demand collateral (cash, or cash-like securities); the amount of collateral they want goes up with the likelihood that AIG would have to pay out on a default. (The WSJ article sheds some light on the negotiations that other banks had over collateral; Goldman Sachs,

when it couldn't get as much collateral as they wanted, hedged themselves by buying insurance on AIG's debt, which is a clever move I wouldn't have thought of.) If AIG hadn't been bailed out, its counterparties would be looking at tens of billions of dollars in losses in the form of write-downs on their CDS portfolios, because a bankrupt AIG could not be counted on to pay off on those contracts. Not knowing who was bearing those losses would have increased the fear that for several weeks was paralyzing the credit markets. So arguably, the potential damage of CDS was only contained precisely because the government elected to bail out AIG.

Now, how did the brilliant minds at AIG Financial Products - and they are, or were, brilliant - get into this situation? Like every other financial institution in these markets, they were using models - models, in this case, that estimated the probability of default on the various bonds AIG was insuring by "selling" credit default swaps. The WSJ article says that AIG was (a) using default-prediction models to determine the likelihood that it would ever have to pay out on credit default swaps, but did not have models (until it was too late) for two other risks: (b) the risk that increasing probability of default (as reflected in CDS spreads) would trigger collateral calls by counterparties, and (c) the risk that increasing probability of default would show up as write-downs on AIG's balance sheet.

I don't buy this distinction. Risks (b) and (c) occur precisely because the underlying bonds are becoming more likely to default. In order to distinguish risk (a) from risks (b) and (c), you have to have a theory that (1) the probability of default of the underlying bonds is separate from (2) changes in prices of the credit default swaps on those bonds - but (2) is nothing more than the market's assessment of (1). This amounts to saying that your default-prediction model is right and the market is wrong, even when the market is composed of other banks with similar models; that's not an argument you're likely to win.

More fundamentally, there is a question about how valid even the best of these models are. In the last two decades, a new discipline of risk management has been developed in the financial sector. The basic approach is to estimate the variance of the values of the different assets that make up a portfolio, and the variance of the events that can affect the values of those assets, taking into the account the correlations between all of these values and events (that is, the chances of GM defaulting and Ford defaulting are not independent events). Once you've done that, you can estimate the likelihood of your portfolio losing X% of its value; if you don't like the answer you get, you can use hedging strategies to reduce that likelihood. (This movement toward risk management modeling was so successful that the 2004 Basel II Accord recommended that banks be allowed to use their internal models in determining their own capital requirements.)

The problem is that, in general (most of these models are proprietary secrets, so I can't speak with complete confidence), these models are fed by historical data - because, by definition, that's the only data you have. So estimates of price volatility or of other events are based on past experience - experience that may only cover a very short period of time, especially where new and complex financial instruments are concerned. More importantly, even a long period of time is not relevant if there is a fundamental difference

between the period your data is from and the current moment. To sum this up: Let's say housing prices have never declined by 30%. You can't assume they won't fall by 30% in the future, for two reasons. First, it could be that they only fall by 30% every 100 years, and you only have 50 years' worth of data. Second, it could be that in the past housing prices couldn't fall by 30%, but the world has changed in a significant way, and now housing prices can fall by 30%.

As a result, early in the crisis (back in 2007), you would hear people saying that they were seeing "six-standard-deviation" events, or events that should only happen every hundred thousand years. This is just a silly thing to say. As a statistical matter, if your model says that some event was virtually impossible, it is generally more likely that you made a mistake than that an extremely unlikely event occurred.

In any case, the scale of the losses that have occurred in the last year and a half, and the pronounced failure of every financial institution to anticipate them - see the successive earnings calls of every large US bank in 2007 - are as good proof as we will ever find that their risk management models simply didn't work. If something called a "risk management" model doesn't work under the most extreme conditions, what's the point of having it?

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Nov 6, 2008 9:42 PM

### [Downloadable MIT Class on the Global Crisis](#)

from [The Baseline Scenario](#) by Simon Johnson

You can now download the video of our November 4th (Tuesday) class. The class covered a range of topics, [as advertised](#) (although I always like a class to jump around as students and guests make good points.) The highlights from my perspective were:

1. Our conversation with Laura Conaway and Dan Costello, from Planet Money, which really emphasized how crisis of confidence in the financial system became a huge shock for consumers. This both provided a human dimension and motivated our discussion of the economics around a potential fiscal stimulus and the finance around the G20 meeting.
2. Our interaction with Arvind Subramanian, from the Peterson Institute for International Economics, about what emerging markets could and could not aim to achieve at the fast-approaching G20 meetings. This pushed us to look at the issues from a perspective other than that of the US or Western Europe.

3. The role-playing discussion, in which students argued (on behalf of a chosen country) what they would and would not offer at the G20 summit. This really brought out how hard it will be to make substantial progress. At the same time, it offered some glimmers of hope - the students were trying hard to find space in which they (and their countries) could cooperate.

Here is the link for the WindowsMedia stream:

[http://web.mit.edu/smcs/sloan/2008/simon\\_johnson/sloan-simon\\_johnson-financial\\_crisis-E51345-04nov2008-1600.asx](http://web.mit.edu/smcs/sloan/2008/simon_johnson/sloan-simon_johnson-financial_crisis-E51345-04nov2008-1600.asx). (You may have to use Internet Explorer to use that link.)

Again, our technical advisers recommend WindowsMedia player version 9 or later (to provide all needed playback functionality). MIT has a support page for Windows Media that should help if you have trouble: <http://web.mit.edu/smcs/help/wmplayerhelp.html>

Comments of all kinds are of course welcome. We will repeat broadcast other crisis-related class sessions if there is sufficient interest (but not otherwise).

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Nov 6, 2008 1:42 PM

### [More Interest Rate Cuts](#)

from [The Baseline Scenario](#) by James Kwak

Having woken up to the fact that inflation is not the thing to be worrying about, the UK, Eurozone (European Central Bank), and Switzerland all [cut interest rates](#), the Bank of England by a completely unexpected 1.5 percentage points to 3.0%. Disappointingly, the ECB only cut rates from 3.75% to 3.25% (we earlier recommended an [immediate cut to 2.0%](#)), although Jean-Claude Trichet did leave open the possibility of further cuts in the future.

In the US, the low Fed funds rate (currently 1.0%) limits the potential benefit of further rate cuts. Europe still has a ways to go; so far, with the UK and the Eurozone set to contract in 2009, there's no evidence that they couldn't go further.

**Update:** What [he said](#). (He, in this case, being James Surowiecki of The New Yorker.)

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Nov 6, 2008 12:36 PM

### [The Race for Treasury Secretary](#)

from [The Baseline Scenario](#) by James Kwak

For those of us following the current economic crisis, Barack Obama's most important cabinet choice will be his Treasury Secretary pick. Although nothing to be sneezed at, the position has historically been less prominent than the portfolios of State and Defense, but the news of the last six weeks and the urgency created by the current recession make it critical at this moment. The names being floated in a variety of articles on the Internet are, in rough order of likelihood:

- Tim Geithner, head of the Federal Reserve Bank of New York and a key player in every government action involving Wall Street so far
- Larry Summers, President Clinton's last Treasury Secretary and a prominent academic economist
- Jon Corzine, former head of Goldman, former senator, and now governor of New Jersey
- Paul Volcker, former chairman of the Federal Reserve
- Sheila Bair, head of the FDIC
- Robert Rubin, also a Clinton Treasury Secretary, also a former head of Goldman, and currently board member of Citigroup

Less likely names floated include Warren Buffett, billionaire investor; Jamie Dimon, CEO of JPMorgan Chase; and Paul Krugman, 2008 Nobel Prize winner in economics and an outspoken liberal columnist and Bush administration critic.

The main thing all of the leading candidates have in common is that they are centrists and pragmatists (not a socialist among them, as far as I can tell). There is no reason to believe any of them would reverse the major steps taken by Henry Paulson so far, although several would likely move more aggressively for mortgage relief and broad-based economic stimulus. This is generally a good thing. While Paulson can be accused of some major missteps, and of so far failing to unblock lending to the real economy, his one achievement has been to restore some confidence to the banking sector, and the impact of a wholesale change in policy direction could be highly unpredictable.

My personal opinion, based on nothing, is that the Wall Street connection rules out Corzine and Rubin, and his comments about women while president of Harvard rule out



Summers, so I would bet on Geithner, who has knowledge of Wall Street but does not have the political taint of having made a fortune on Wall Street.

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Nov 5, 2008 3:41 PM

## [Economic Priorities](#)

from [The Baseline Scenario](#) by James Kwak

Even as we celebrate tonight, we know the challenges that tomorrow will bring are the greatest of our lifetime — two wars, a planet in peril, the worst financial crisis in a century. Even as we stand here tonight, we know there are brave Americans waking up in the deserts of Iraq and the mountains of Afghanistan to risk their lives for us. There are mothers and fathers who will lie awake after the children fall asleep and wonder how they'll make the mortgage or pay their doctors' bills or save enough for their child's college education. There's new energy to harness, new jobs to be created, new schools to build, and threats to meet, alliances to repair.

The road ahead will be long. Our climb will be steep.

[Full transcript here.](#)

We've been talking for a while now about the short-term economic priorities facing the United States: financial system stabilization, economic stimulus, mortgage restructuring, and re-regulation of the financial system (domestic and international). But even before the current economic crisis, our country was also facing some major challenges that the Obama administration will have to tackle.

In my personal opinion, the top four long-term challenges facing our country are, in order:

1. Global warming: We know with a high degree of certainty that the world is getting warmer, and that this could have catastrophic effects that we can only partially foresee today. Moving our economy from carbon to sustainable energy sources will require a transformation of large parts of the economy.
2. Terrorism and nuclear proliferation: While the probability of a nuclear attack by terrorists is extremely low, at present that probability is only going up. This is not particularly an economic issue.

3. Retirement savings: Despite all the attention Social Security has received, it is dwarfed by the looming Medicare deficit. In addition, there is evidence that private sector sources of retirement income will not fill the gap that they are expected to fill. First, many defined-benefit pension plans (both private and public) may not be sufficiently funded, because of accounting regulations that allow them to assume optimistic rates of return. (The events of the last six weeks, of course, did not help.) Second, many people's individual retirement savings are sorely insufficient. I've seen estimates of the average retirement savings balances of people in their 50s ranging from \$50,000 to \$140,000 - and that was before the recent stock market crash, which probably took 15-20% off the average portfolio. And even for people with houses, the housing crash has constrained their ability to live off of them.
4. Health care: Approximately 50 million Americans are uninsured today, and the number will only go up as people are laid off and companies cut health care costs during the recession. In addition, objective indicators show that health outcomes in the US are worse than in most of the developed world.

These challenges will be tougher to solve than the immediate challenges of fixing the financial system and restarting economic growth. Let's hope that the Obama administration can start solving them.

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Nov 5, 2008 12:40 PM

### [Now the U.S. Election is Over - On to the G20 Agenda](#)

from [The Baseline Scenario](#) by Simon Johnson

Sorry to interrupt your presidential election celebrations or commiserations, but it's time to get back to work on the global crisis, which unfortunately is far from being over. The G20 summit is fast approaching (November 14-15th) and - to say the least - the agenda needs to focus more on some immediate problems. Reuters' MacroScope has a [piece from me today](#) on arguably the most pressing issue: money.

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Nov 4, 2008 11:36 PM

## Doggies Win

from [The Baseline Scenario](#) by James Kwak

If you voted to [ban greyhound racing](#) in Massachusetts, [thank you](#).

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Nov 4, 2008 3:28 PM

## MIT Global Crisis Class, #2 (Election Day Special)

from [The Baseline Scenario](#) by Simon Johnson

November 4, 2008: below is the (rough) structure for today's class, as handed out to students. Remember, you can watch a [webcast live](#) (4pm Boston time), and a recorded version should be available for download on Thursday.

### **The Global Crisis, class #2**

Relevant links, including more about our guests, and other additional material are available through <http://BaselineScenario.com>.

1. Crisis, What Crisis?
  - a. Credit conditions in the US and around the world
  - b. Forecast for the real economy in Europe
  - c. Current pressures on emerging markets

*Human dimensions:* conversation (by phone) with [Laura Conaway](#) and Dan Costello, of NPR's [Planet Money](#)

2. Case for a fiscal stimulus in the United States (see my [testimony to the JEC](#) of Congress)
  - a. Likely severity and length of recession

- b. Size of fiscal stimulus that makes sense
  - c. Composition of the stimulus ([an election issue...](#))
3. Agenda for the G20 meeting in Washington, November 14-15<sup>th</sup>
- a. Conversation (by phone) with [Arvind Subramanian](#), Peterson Institute for International Economics
    - i. [What should emerging markets aim for](#) in the short- and long-term?
    - ii. What can they realistically expect to get?
  - b. What does the United States want, and why? (We'll think through some election scenarios)
  - c. Who wants what within Europe? How much power do they have?

*We play a game, with assigned roles. Let's see how we do relative to the real economic diplomats.*

4. Open discussion
- a. Other issues raised [via the website](#)
  - b. Where does the world economy go from here?

No class on Tuesday, November 11 (MIT holiday). ***Next class is Tuesday, November 18<sup>th</sup>.***

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Nov 4, 2008 8:26 AM

### **[The Economics of Elections](#)**

from [The Baseline Scenario](#) by James Kwak

In honor of Election Day, we bring you a slight change from our usual programming.

There has been a lot of talk about the use of futures markets to predict elections. The granddaddy of election markets (in the US) is the [Iowa Electronic Market](#). The one that gets the most attention these days is [Intrade](#). I used to trade on the IEM during the primaries and made a decent return in just a few weeks, mainly by betting that people would overreact to news. (For example, when Huckabee (remember him?) spiked - I believe he was in the lead on IEM at one point - it was a pretty easy bet that at some point before the convention he would come down to zero.) But then I did a bet on the general election and forgot to close it out at the right time, so on balance I lost a few bucks. (The maximum you can put into IEM is \$500, so we're not talking big sums here.)

[FiveThirtyEight.com](#) takes a different approach: they take polling data as inputs, and then run multiple simulations of who will win each state election. A given survey has a midpoint (say, Obama 47 - McCain 45) and an error distribution around that midpoint. By doing repeated simulations, you estimate how often each person would win that election, based on expected variance around the midpoint. If you do this for all states at once, you get an estimate of what the electoral vote tally will be. I don't know if they account for correlations in the error across different states - the fact that if McCain does 2 points better than expected in Pennsylvania, he is likely to do better than expected in Ohio, too (the two are not independent outcomes). They should take this into account. (I don't know because I haven't read the website other than the predictions.)

The problem with both of these approaches is that they take polling data as their inputs - so if there is a problem with the polls (the [Bradley effect](#), for example), they will produce inaccurate results. Polling markets partially compensate for this, because they incorporate people's expectations of how accurate the polls are. But given the prominence of the polls, I doubt they can correct for polling inaccuracy.

Not surprisingly, economists have developed predictive models for presidential elections based on economic conditions. Mark Thoma provides an excerpt of one (and a link to the whole paper) [here](#). These are statistical models that compare election outcomes to various economic variables at the time of the election. The problem with these models is that presidential elections are overdetermined: the sample size is small enough that you can find many different series of data that seem to predict outcomes accurately, like the [Washington Redskins](#) predictor. All of these cute predictive models are based on the same fallacy: with hundreds of sports teams to choose from, and the thousands of ways you can slice the data, it would be remarkable if you didn't find one that seemed to be a perfect predictor of presidential elections. Economic models are better (though not perfect), because they are based on variables that you would expect should have an impact on election results.

Happy Election Day.

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Nov 3, 2008 6:50 PM

## [Recession for Beginners](#)

from [The Baseline Scenario](#) by James Kwak

(For the complete set of Beginners articles, see the [Financial Crisis for Beginners](#) page.)

So, it looks like we're in a recession. What's a recession?

A recession is a period when overall economic activity contracts. In most times, overall economic activity increases, for two reasons. First, each year there are more people in the workforce, because the population of the US, like most but not all countries, is increasing. Second, most years, the average person is able to produce a bit more than in past years because of improvements in technology, processes, and so on. For a recession to occur, per-capita economic activity has to decline more than enough to compensate for population growth.

How is economic activity measured? The most common (and official) measure is gross domestic product (GDP), which is the aggregate value of all the goods and services produced or provided in the country. GDP is calculated by adding up private consumption (all the stuff that ordinary people buy), capital investment (factories, houses, etc.), government spending, and net exports (exports minus imports).

Why does GDP matter? Because GDP measures all the stuff that we produce, it also, roughly speaking, measures all the stuff that we can have as consumers. I say "roughly speaking" because, in the short term, we can consume more than we produce, by importing more than we export. But in the long term, while it may be possible to maintain a reasonable trade deficit indefinitely, it's tougher to finance increases in consumption - what we need to have a higher standard of living - through ever-increasing imports. So if we want our children to lead better (material) lives than we do, we need GDP to increase.

Why do recessions happen? There are many, many reasons, but every recession is overdetermined - you can point to multiple explanations of why it happened, so you can never isolate one specific cause. One important thing, however, is that however they start, recessions are self-reinforcing. As consumers spend less, businesses sell less, so they need to reduce costs, so they lay people off or reduce hours, so consumers have less money, so they spend less, etc. As business profits decline, stock prices fall, so people feel less wealthy, so they spend less, etc. As people have less money, housing prices fall, so people can get less money from their home equity lines of credit, so they spend less, etc. As people make less money, state and local tax revenues fall, so those governments have less money to spend, reducing government spending, etc. And so on.

There is another self-reinforcing factor at work that may be particularly pronounced this time around. The more people hear about a recession (or a global economic crisis), the more worried they get, the less they spend, etc. And this is one reason why many economists are worried about this quarter (October-December). We arguably have never before seen the concentration of bad news, amplified by the always-on nature of the contemporary news media, that we saw between the Lehman bankruptcy on September 15 and the bank recapitalization announcement of October 15. Very little of that impact showed up in the Q3 (July-September) personal consumption figures, which were already bad; given how jittery many people are about spending (on which I've already expressed [my opinion](#)), this quarter could be much, much worse.

What can you do about a recession? As you might guess, there is a wide variance of opinion on this question. However, the following three options cover most of the spectrum:

1. Stimulate demand. If consumers and businesses won't spend enough, the goal is to get them to spend more, or to otherwise compensate for their lack of spending. This can be done via tax rebates, increased welfare benefits, or other measures that put more money in people's pockets, or through increased government spending. In either case, the goal is to break the self-reinforcing cycles described above.
2. Stimulate supply (aka "supply-side economics"). The goal is to increase incentives to produce stuff by reducing tax rates on things like income and capital gains. This is different from stimulating demand because the focus is not on putting money in people's pockets so they will spend it, but on giving people the incentive to produce more.
3. Reduce interest rates. In general, reducing interest rates makes it easier for people and businesses to get credit, which increases their purchasing power and therefore their spending and investment.

One problem we have today is that there is little additional benefit to get by reducing interest rates. First, interest rates that the government has control over are already extremely low (the federal funds rate is currently 1.0%). Second, the availability of credit seems to be constrained more by banks' low capital ratios and fear of risk than by the price of money.

That leaves government action to stimulate demand or stimulate supply. I separately discussed the [stimulus plans](#) of Barack Obama and John McCain. Roughly speaking, Obama favors stimulating demand; McCain, stimulating supply.

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Nov 3, 2008 5:50 PM

## Participate in MIT Global Crisis Class (Webcast)

from [The Baseline Scenario](#) by Simon Johnson

Hopefully (technology permitting), Tuesday at 4pm (Boston time) you will be able to watch class #2 of our special seminar on the global crisis, through this link:

[http://amps-web.mit.edu/public/sloan/2008/simon\\_johnson/live/04nov2008/](http://amps-web.mit.edu/public/sloan/2008/simon_johnson/live/04nov2008/)

The goal is to give you a sense of the discussion at MIT, and also to let you participate - you can post questions here either in advance or during the class (we'll monitor the webpage); or you can send by email (baselinescenario at gmail dot com).

The topics will be:

1. Where do we stand in the overall crisis at this moment? (Including what central banks have been doing, particularly since last week)
2. What is the case for a fiscal stimulus in the U.S.? Here we'll discuss my testimony to the Joint Economic Committee of Congress, posted [here](#). If you can read one thing in advance of class, please look at this.
3. What will be (and should be) the agenda for the G20 meeting in Washington on November 14-15? On this, we will talk with Arvind Subramanian, a leading strategist on emerging markets' economic diplomacy.
4. And there will plenty of time for an open discussion based on topics that students want to air.

Our technical advisers strongly recommend that I mention the need for Windows Media Player. Version 9 or later will provide all needed functionality. MIT has a support page for Windows Media that should help potential viewers see if they are ready:

<http://web.mit.edu/smcs/help/wmplayerhelp.html>

We'll provide you the link for the resulting on-demand version after the class (probably on Thursday).

Broadcasting the class in this way is an experiment. Whether it's a one-off or something we try to repeat will depend very much on your reactions and responses. Please post here or send me email (baselinescenario at gmail dot com).

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Nov 3, 2008 8:49 AM

### [Is an Even Bigger Health Crisis Next?](#)

from [The Baseline Scenario](#) by Simon Johnson

If there is a doctor in the house, or someone who knows where to track these kinds of statistics, please confirm or deny the following (which I got from two doctors, but the plural of anecdotes is not necessarily data...): visits to hospital emergency rooms in the U.S. are down sharply since mid-September?!

This strikes me as odd for the following reasons.

1. You would expect health (both actual and perceived) to worsen with the kind of stress that comes in economic crisis. This was definitely the experience in parts of East-Central Europe in the 1990s, and arguably it has happened elsewhere during similarly intense episodes.
2. Visits to the emergency room obviously can be expensive if you don't have insurance, but the stories I hear suggest that visits are down also for people with insurance.

Could it be that the fall in consumption, picked up in the 3rd quarter GDP numbers that came out last week, is not just about going out less, buying fewer clothes, and staying away from imported goods? Is it possible that we are actually taking less good care of ourselves and - quite likely - storing up more health problems for the not-too-distant future?

Comments on this important issue would most welcome.

**Update (November 4):** Laura Conoway, of Planet Money, has dug into this more - what [she hears](#) through the American College of Emergency Room Physicians is that visits are not down, but people are really struggling to afford insurance and medication.

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Nov 3, 2008 7:04 AM

### [Help the Doggies!](#)

from [The Baseline Scenario](#) by James Kwak

Massachusetts ballot question 3, the Greyhound Protection Act, will end greyhound racing, a “sport” that rests on systematic cruelty to animals. Greyhounds are confined in tiny cages for 20 or more hours per day, and over 800 dogs have been injured in the last six years. We can do better.

If you live in Massachusetts, please vote yes on 3. If you care about animal cruelty and know people who live in Massachusetts, please ask them to vote yes on 3. For more information, see the [Yes on 3](#) website.

Thanks,

James

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Nov 3, 2008 5:45 AM

## **[Financial Crises and Democracy, Part Two](#)**

from [The Baseline Scenario](#) by James Kwak

We have [several times](#) emphasized the need for a large economic stimulus package to limit the extent and damage of the recession that we are almost certainly in already - a need recognized by economists from [Nouriel Roubini](#) to [Larry Summers](#) to [Martin Feldstein](#). More recently, I speculated on the relationship between [democratic politics and economic policy](#) in a time of crisis. Well, as just about everyone in the world knows, things are coming to a head.

Whether we get a large economic stimulus package in the US - the economy whose health affects, for better or worse, just about everyone in the world - could very well depend on who is elected on Tuesday. For a summary of their short-term economic proposals, [see here](#).

If Barack Obama is elected, we are likely to see a large stimulus package. It would probably include the measures that many economists are favoring, including extended unemployment benefits (and suspension of tax on those benefits), immediate cash aid to

state governments, increased home heating cost aid, and infrastructure spending. These measures will have a direct impact on the economy by increasing spending now, while increasing it in ways that are necessary (keeping poor people alive) or that are productive long-term investments (infrastructure). Some of his other suggestions will have a more limited impact on the economy, such as a cash tax rebate, or are more or less irrelevant to the economy, such as relaxing the minimum distribution requirements for retirees.

With John McCain, we are not likely to see a stimulus package - or, more accurately, the package we see will be built around tax cuts that are not likely to have a direct economic impact. His proposals include: reducing taxes on retirement account withdrawals; increasing capital loss write-offs; reducing long-term capital gains tax rates; exempting unemployment benefits from taxes; also relaxing minimum distribution requirements; extending all of the Bush tax cuts; and reducing corporate tax rates. Except for the tax cut on unemployment benefits, these proposals suffer from the basic problem that undermined the last stimulus package this spring: in tough economic times, people take their tax rebates (or tax cuts, or cash you give them in any form) and stuff it under their mattresses, or pay down debt. McCain's plan also includes the famous (or infamous) proposal for the government to buy up and refinance mortgages directly. (Obama favors increased loan modifications and legislation to eliminate some of the legal barriers to modifications.) But while that could potentially help homeowners and lenders, it doesn't increase economic activity any.

(For an explanation of why different programs have different marginal impacts on GDP, see [Menzie Chinn's post](#).)

That said, given the way legislation is passed in Washington, the final package is likely to differ from either person's proposals, whoever is elected. But the next major step that our government takes to combat the financial and economic crisis will depend directly on the outcome of Tuesday's election.

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Nov 2, 2008 12:28 PM

### **[Should the Government Bail Out the Auto Industry?](#)**

from [The Baseline Scenario](#) by James Kwak

Over in the real economy, perhaps the biggest story is the impending and highly likely merger of GM and Chrysler, in which GM would swap its 49% stake in GMAC, its consumer finance company, to Cerberus (which owns the other 51%), in exchange for

Chrysler, which is currently owned by Cerberus. It seems that the deal may hinge on financial assistance from the government, at least according to [six governors](#) attempting to pressure the dynamic duo of Paulson and Bernanke to help out. Until Thursday, GM was seeking \$10 billion from the Treasury Department's \$700 billion bailout fund - yes, the same one that has been used to recapitalize banks - but Paulson's preference is that GM tap a \$25 billion low-interest loan program set up by the Energy Department in September.

It's easy to [argue for bailing out the auto industry](#), with its hundreds of thousands of factory workers, as opposed to the financial sector and its Wall Street bonus babies. (It's less easy to argue for bailing out Cerberus, which is a private equity firm.) But I want to point out one difference.

The business of a bank is borrowing and lending money. Banks currently face two problems. The first is a crisis of confidence: people who lent them money aren't sure they will get it back, because no bank - no matter how sound - could pay back all its creditors at once. (The whole point of a bank is to borrow short and lend long.) If this were the only problem, government deposit insurance and the new loan guarantees would take care of it, and the banks would be fine. The second problem is a potential solvency crisis: it's possible that banks' assets have declined in value to the point where they are worse less than, or not much more than, their liabilities. The answer here is recapitalization: giving the banks more capital, in exchange for ownership shares. If you give banks enough capital to offset the losses on their assets, there's no general reason to believe they can't go forward and make profitable loans, especially with the cost of money as low as it is. They don't have to do anything particularly intelligent or risky with the money; it's just to compensate for past mistakes. If you do have a reason to believe that a specific bank will not have a viable business in the future (for example, its whole business was subprime lending), you don't recapitalize it - and we know that Paulson has been turning at least some banks down.

The auto business, like most businesses, is more complicated. You have to design and manufacture cars that people want, and for which people will pay more than they cost to manufacture. You have huge investments in fixed assets (factories that can't be easily converted to new uses), technologies (hybrid engines, or the lack thereof), and human capital that constrain your ability to develop new products and offer them at competitive prices. In this kind of business, it's possible that no amount of cash will make a company viable going forward. GM is currently losing about \$1 billion of cash per month, according to analyst estimates. If you loan GM \$10 billion (or make a \$10 billion capital injection), and nothing else changes, all that means is GM survives for 10 months longer before everyone gets laid off. The \$10 billion loan only makes sense if that money, or those extra 10 months, will enable GM to somehow become a profitable company on a going-forward basis.

This is a different kind of question than you have to ask about a bank before recapitalizing it. Bank of America and JPMorgan may need more capital in the future to compensate for the deterioration of their past loans, but few people expect that they won't

be able to make money in the future. With GM, there is a real question as to whether it can become a profitable company at all. The story is they just need to buy time until the Chevrolet Volt comes out, but there's not a lot of evidence that by the time it does, it will be competitive with whatever Toyota and Honda have engineered by then.

I'm no expert on GM, so I'll leave it there. It's possible that GM is on the brink of a turnaround and it just needs \$10 billion more in loans. I really hope that's true. (And in any case, the Energy Department has already allocated \$25 billion in low-interest loans for US auto manufacturers.) The point I want to emphasize is that the criteria to use in deciding whether to bail out GM are different than the ones to use in evaluating banks - and have nothing to do with which one we have warm and fuzzy feelings about.

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Nov 2, 2008 11:28 AM

### **[JPMorgan Joins Mortgage Restructuring Party](#)**

from [The Baseline Scenario](#) by James Kwak

JPMorgan recently announced a [program to offer loan modifications](#) to 400,000 homeowners with a total of \$70 billion in mortgages. The program is roughly similar to one [announced by Bank of America](#) as part of a settlement with state attorneys general of investigations into Countrywide (acquired by B of A): JPMorgan is offering to convert option ARM mortgages, one of the most poorly-conceived and worst-performing products of the housing boom, into fixed-rate mortgages at lower rates and potentially with lower loan balances. From the WSJ article:

The mortgages affected by J.P. Morgan's program represent 4.7% of the home loans it owns or that are serviced by one of the bank's units, EMC Mortgage Corp. While the program to give these mortgages easier terms is likely to cost J.P. Morgan billions of dollars in interest payments and loan fees, it is also likely to save the bank from the costly and lengthy process of foreclosing homes and selling them.

This is more evidence that banks see mortgage restructuring as being in their own economic interests, for reasons I've described [earlier](#). (As an aside, Yves Smith wonders why banks are [only offering modification programs now](#), when it seems like the government is about to act.) Unfortunately, it's also more evidence that modifying whole mortgages owned by one bank is easier than modifying securitized mortgages owned by many parties who may have competing interests; this program is only aimed at mortgages owned by JPMorgan, which are a tiny fraction of the volume serviced by that bank.

Given the small scope of the program, government action is still almost certainly necessary. But private action has at least one advantage over government programs. When the government acts to encourage loan modifications for delinquent mortgage holders, millions of “responsible” homeowners who are not delinquent on their mortgages will scream. No one expects private sector banks to do anything other than act in their own interests, and so they don’t have to worry about being seen as fair.

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Nov 1, 2008 10:12 PM

### [To Buy or Not To Buy ...](#)

from [The Baseline Scenario](#) by James Kwak

Judging by the traffic on the [Planet Money blog](#), many people are wondering if now is the time to be spending money. On the one hand, we hear that the economy is crashing because of a decline in consumer spending. On the other hand, we hear that the economy is crashing, which frightens us to consuming less and saving more for the rainy days ahead. Real economists worry about these things, too - see [Paul Krugman](#) and [Tyler Cowen](#), for example. But at the end of the day, all economists can do is speculate and watch what happens, because aggregate consumption is just the sum of hundreds of millions of individuals making their own purchasing decisions.

I’m not a personal financial advisor, but I think this can be broken down logically. Let’s assume that, before the current downturn, you chose with your level of spending (and, by implication, your level of saving) rationally. Then there are three main reasons why you might want to reduce spending today: (1) you don’t have the purchasing power you need to maintain your spending; (2) you are going to lose your job (I know there’s a problem with that statement, and I’ll come back to it); or (3) the assets you are counting on for retirement have fallen enough that you need to increase savings in order to replenish them.

(1) applies if, for example, you were going to remodel your kitchen but you can’t tap your home equity line anymore because you have less equity than you used to, or your bank has cut your credit card limit below the level you need to maintain your spending. In these cases, you have no choice. If, however, your bank just reduced your credit card limit from \$20,000 to \$10,000, but you never use more than \$5,000 of the limit anyway, then this doesn’t affect you.

(3) applies if you are relatively close to retirement and you didn't have a big cushion to begin with. If you were just barely on track to meet your retirement savings objectives, and now your 401(k) has lost 40% of its value along with the stock market, then you may have to boost your savings rate. However, if you are in your 20s (or your 30s, if you spent an inordinate amount of time in school), you probably don't have enough assets to have suffered much losses. What you care about (roughly speaking) is the value of the global stock market when you retire in 2045, which depends on the state of the global economy in 2045, which, one can argue, is pretty much unaffected by whatever happens now. In fact, the fall in asset values may be good for you, because most of your wealth accumulation is ahead of you, meaning you will be able to buy the same assets more cheaply than you could have a year ago. (If you are one of the many people who never earned enough to accumulate much for retirement - and I know this is a huge problem in our society - and are therefore relying on Social Security, then (3) doesn't affect you either.)

(2) applies if you are going to lose your job. But even in a deep recession, not that many people lose their jobs. The forecasts I see are roughly that unemployment will rise from about 6% now to about 8.5% in a bad recession - could be better, could be worse. That means that 2.5% more people will be unemployed than are unemployed now, or 1 in 40 people. (This is a simplification, because more than 1 in 40 people will be laid off, but some people currently unemployed will get jobs, and some people will get laid off more than once, and so on.) The problem is that most people don't know if they will be laid off or not. If you think there is a decent chance that you will get laid off, and that you will have trouble finding a job afterward, then it makes sense to increase your savings to protect against that possibility. But if you are sure that you won't be laid off, or sure that you could find another job relatively easily, then (2) doesn't affect you.

(1), (2), and (3) collectively will apply to a fair number of people. But if you are young, are secure in your job and your employment prospects, and still have enough credit to buy what you want to buy, then I don't see why a recession should cause you to change your habits significantly.

In any case, you shouldn't buy or not buy because of what you think the US economy needs. It's not your responsibility. If collective thrift by the American people threatens to plunge us further into recession, then it's the government's job to compensate by increasing spending, as Krugman argues (and as we've been [repeating on this blog](#)). So do what you need to do for yourself and your family.