

Low-Tech Archive of The Baseline Scenario for December 2008

Known problems:

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

Dec 31, 2008 11:44 PM

Some Questions about GMAC

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

I'm a little late to the GMAC bailout story, but after reading all the newspapers and blogs I usually read, there are still some things I don't understand. I'm particularly confused about the announcement that GMAC will start lending to anyone with a [credit score above 620](#), down from their previous minimum of 700. (The median credit score in the U.S. is 723.)

1. What is the relationship between GM and GMAC? I know that Cerberus owns 51% of GMAC and GM owns the other 49%. I also know that, in order to become a bank holding company, both were forced to reduce their ownership stakes. In any case, GMAC is an independent company that should not be run for the benefit of GM. Its obvious that GM benefits if GMAC reduces its lending standards. But how does GMAC benefit?
2. If a loan to someone with a credit score of 621 was a bad idea on Monday, why was it a good idea on Tuesday? The only theory I can think of under which this makes sense is that GMAC thinks that loans to people with credit scores of 621 are profitable, but they couldn't get the capital cheaply enough until they got their government bailout money.
3. Who is going to pay the bill when these loans go bad? It looks to me like GMAC is making a big gamble by trying to pump up its lending volume with higher-risk borrowers, right in the middle of the worst recession since . . . 1981? the 1930s? (In any case, it won't be able to get anything like the lending volume it used to have, simply because fewer people are buying cars.) Isn't this a situation where a company is choosing a high-risk strategy because its only option is to watch its revenues shrink away to nothing because the demand for credit has plummeted? But if that's the case, how smart is it to go chasing after high-risk borrowers because the low-risk ones are suddenly saving their money? And now that GMAC has gotten the Henry Paulson seal of approval (remember, TARP money was not supposed to go to unhealthy "banks"), I think there's a fair chance they are counting on Treasury to bail them out of their next round of bad loans.

Of course, it could be said in GMAC's defense that they are just doing what Congress wants them to do: take TARP money and use it to make loans more available to consumers. But this goes back to the [fundamental schizophrenia](#) of TARP: it was conceived to keep banks from failing, but most people think its purpose should be to increase credit. And in this case I suspect GMAC's taxpayer money is being used to sell GM cars that people wouldn't buy otherwise, and when it runs out GMAC will be back for more.

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Dec 31, 2008 11:17 PM

[IMF Speaks](#)

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

On Monday, the IMF released a new research "note" entitled "[Fiscal Policy for the Crisis](#)," which sets out recommendations for fiscal policy to address the global economic downturn. The premises of the note are, first, that the financial system must be fixed before it is possible to increase demand and, second, that there is limited scope for monetary policy, leaving fiscal policy as the main weapon. The executive summary provides the main recommendation in short form:

The optimal fiscal package should be timely, large, lasting, diversified, contingent, collective, and sustainable: timely, because the need for action is immediate; large, because the current and expected decrease in private demand is exceptionally large; lasting because the downturn will last for some time; diversified because of the unusual degree of uncertainty associated with any single measure; contingent, because the need to reduce the perceived probability of another "Great Depression" requires a commitment to do more, if needed; collective, since each country that has fiscal space should contribute; and sustainable, so as not to lead to a debt explosion and adverse reactions of financial markets.

When it comes to global economic policy, the IMF is as close to the Establishment as exists. The Federal Reserve may be more powerful, but it lacks the IMF's explicit mandate to oversee the global economy and step in when needed; the MITvard economics department in Cambridge, Massachusetts may have more intellectual prestige, but its members do not have hundreds of billions of dollars to throw around. As a result, the IMF is less likely to come up with radical new ideas than to show where the global consensus is moving.

Seen in this light, the IMF report confirms the general movement toward large stimulus packages composed largely of public spending that has gathered momentum in the capitals of several wealthy nations, and the U.S. in particular. The IMF recommends government spending over tax cuts, on the grounds that households and firms may choose not to exercise any additional purchasing power they get from tax cuts, and also because the time lags necessary to spend lots of money are compensated for by the expected length of the downturn. When it comes to boosting purchasing power, governments should target “those consumers who are most likely to be credit constrained” - the unemployed, the poor, and homeowners facing foreclosure.

There is one potentially controversial area that the IMF touches on: government support for “flagship” domestic industries (such as the auto industry in the U.S. and France). The authors warn against this type of policy because of its “inherent arbitrariness, and risk of political capture,” and perhaps most importantly because “direct subsidies to domestic sectors lead to an uneven playing field with respect to foreign corporations, and could lead to retaliation and possibly trade wars” - the risk [Simon discussed](#) in connection with the French bailout.

The report also raises perhaps the toughest issue in all of this, which is the issue of “fiscal sustainability:” “it is also essential that fiscal stimulus not be seen by markets as seriously calling into question medium-term fiscal sustainability.” Put another way, governments have to spend lots of money to stimulate their way out of this recession, but if they spend too much no one will lend them money anymore. This, of course, assumes that there is such an optimal point, where it is possible for a government to spend enough to get its economy going, but without reaching the point where no one believes it can pay the money back. Striking this balance will be harder for some countries than others, and there is no assurance that it will even be possible for some countries. The U.S. is better off than most, because we have the luxury of the world’s reserve currency, but even so there may be a point at which investors will back away from the dollar.

In short, this is the major risk of fiscal policy, and no one has a perfect answer to it. Right now I think a majority of economists (though not all) are of the opinion that the downturn is so severe that governments should err on the side of too much stimulus and worry about things like inflation, balanced budgets, and interest rates later. From one perspective, they are probably right, because long-term fiscal sustainability depends on economic growth more than anything else. The last time people were painting nightmare scenarios about the U.S. government debt was during the deficits of the 1980s - and a couple of tax hikes (under Bush Senior and Clinton) and a long economic boom took care of that. In putting the emphasis on spending, not on fiscal prudence, the IMF is also largely endorsing the stimulus package that will soon be forthcoming from the Obama administration.

The cynical will also note that these recommendations are more or less the opposite of the fiscal austerity measures imposed by the IMF during the emerging markets crisis of 1997-98. I don’t think that’s a completely fair criticism, however, because the problems

are different - capital flight and government solvency, as opposed to a collapse in demand. But in any case, maybe the IMF learned something.

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Dec 30, 2008 11:26 PM

Human Nature

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

Or, why human beings are bad investors.

Free Exchange has Anthony Gottlieb's recollections of [interviewing Bernie Madoff](#) about financial regulation:

at the time he came across merely as calm, strikingly rational, devoid of ego, and the last person you would expect to make your wealth vanish. I certainly would have trusted him with my money. I cannot say the same of other financial superstars I interviewed. . . . Perhaps it is the most confidence-inspiring ones that you have to look out for.

I couldn't agree more. We human beings have this completely misplaced confidence in our ability to judge people by "looking them in the eye." I recall reading about one study (sorry, I don't remember anything else about it) which showed that hiring managers were more likely to make good hires by selecting solely on the basis of resumes than by interviewing people - because using resumes is completely objective, while interviews allow you to interject your own erroneous beliefs. (I do believe that if you use interviews well - that is, to obtain factual information, like how well someone can actually write a computer program - you can do better than just using resumes; but maybe I'm just fooling myself.)

There are a couple of ways to look at this phenomenon. One is to think about motivations. There are people who are trying to rip you off and people who aren't. The latter have no motivation to try to seem trustworthy, so they don't bother. The former do have that motivation, so they try. Some are bad at it; some, however, are very good at it.

More broadly, what does it mean to appear trustworthy? "Trustworthiness" is just a set of signifiers that are generated by one person and that enter the brain of another person, like a firm handshake or a steady gaze. It's like those luxury car manufacturers who expend effort and cost engineering the sound of the car door closing, because that sound is a signifier for quality. There is some evolutionary process whereby these signifiers got

attached to the concept of trustworthiness in our brain over the history of the species, and maybe the connection was valid at some point. But now that people can reverse-engineer the connection and replicate the signifiers whether or not they are actually trustworthy, our instincts aren't much use anymore.

The only way not to be fooled by your instincts is to rely solely on objective facts. Now, in the Bernie Madoff case, one can object that the only visible "facts" were themselves cooked, and that is true. But that just means we need better policing of things that are presented as facts. And I think the overall point still holds.

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Dec 30, 2008 11:27 AM

French Car Wreck

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

The latest economic data from France [look bad](#). The strategy of keeping official growth forecasts high (despite the evidence) is coming under increasing pressure and there may be substantial revisions to the outlook in the pipeline - once you break through to being more honest, there is some catching up to do.

Even more worrying are the plans apparently under preparation to support the French auto industry. Officially, these plans are still under development ([AP](#)). But from what we can see, including unofficially this week, the next phase of assistance could well be even more problematic than the support provided to the US auto industry which, so far, only got a bridge loan.

It is quite possible that the French fiscal stimulus will morph into an industrial support package. The announcement earlier in December already included an [increased subsidy](#) for buying a new car.

Why would more subsidies for the French car industry be bad? The bigger global danger lurking is tit-for-tat protectionism, and this is unlikely to start with overt tariff increases these days. Rather, countries will look for new pseudo-bailout ways to give their firms a leg up on the competition.

The Chinese, by the way, are [keeping careful score](#), probably with an eye to their own quasi-protectionism down the road (or already, in terms of nudging the renminbi to

depreciate). It's starting to look a lot like the kind of [uncoordinated policy response](#) that can further destabilize the situation.

The G20 had sensible anti-protectionist language in its [November communique](#), but this was rather high level. Clarification from the French/British leadership of the G20 would be most helpful right around now, particularly if supported by transparent statements regarding what kind of auto industry support should or should not be regarded as a step towards protectionism. No doubt the Germans and Japanese would also like some input into this formulation, and the great advantage of the G20 is that the Brazilians, Koreans, Indians and others can also be brought on board directly.

How about starting with a systematic official global tracking of proto-protectionist measures, in whatever form they appear? The G20 website would be a good place to publish this kind of ruthless truth-telling.

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Dec 29, 2008 9:18 PM

Exit Strategy: Inflation

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

We know there is going to be a large fiscal surge in the US (the latest estimate is [a stimulus of \\$675-775bn](#), which is a bit lower than numbers previously floated). This will likely arrive as the US recession deepens and fears of deflation take hold.

The precise outcomes for 2009 are, of course, hard to know yet - this depends primarily on the resilience of US consumer spending and whether large international shocks materialize. But we can have a sense of what happens after the fiscal stimulus has played out (or its precise consequences become clear). There are two main potential scenarios.

First, the fiscal strategy works. In this case, the US pulls out of recession reasonably quickly (perhaps by the second half of 2009). Once this seems likely, the Federal Reserve will want to cut back on its quantitative easing and perhaps even think about raising interest rates. But this will be hard to do for political reasons - the Fed will feel pressed not to quash an incipient recovery, so it will err on the side of keeping interest rates low and credit available on generous terms. At the same time, a great deal of the fiscal stimulus will be working its way through the pipeline for at least two years. The net effect is inflation and presumably a weakening of the dollar (although the latter of course depends on what others are doing around the world.)

Second, the fiscal strategy does not work. In this case, the US recession deepens and we head into a serious global slump. Some more fiscal stimulus might be offered, but faith in its effectiveness will decline sharply. The next policy move in this case is even more quantitative easing (i.e., essentially issuing even more money). This would not usually be appealing, but the global depression would be fed by and feed into serious deflation, and the consensus will shift from “avoid inflation over 2%” to “any inflation is preferable to deflation”. The net effect is again inflation, at least in the US and probably more broadly.

Of course, there are other possibilities. The fiscal stimulus could reflate the economy just enough, i.e., so that growth returns to potential (whatever that is after a crisis of this nature), but not “too much” - so that prices increase but annual inflation never rises significantly above 2%. This scenario seems rather too ideal, and to require too many things to go right, to be high probability.

It is also possible that in a global depression/deflation scenario even the Fed could not make inflation positive. But this also seems to be quite a remote possibility.

So inflation seems hard to avoid, irrespective of how the upcoming fiscal moves play out.

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Dec 27, 2008 1:02 AM

A Short Break

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

I will be taking Saturday through Monday off to spend some time with my family. Hopefully it will be a slow weekend on the economic front.

In the meantime, The New York Times has some overview articles on a few topics we've raised recently:

- The role of [Chinese savings](#) in the bubble
- The collapse in [Japan's export sector](#)
- Germany's reluctance to launch a large [stimulus package](#)

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Dec 27, 2008 12:39 AM

Interest Rates for Beginners

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

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

One of our regular readers and commenters (and a quite knowledgeable one at that) suggested that we provide an overview of interest rates and the relationship between the Federal Reserve and mortgage rates. So here goes.

An interest rate is the price of money. If you buy a 5-year CD from your bank, it will pay you something like 3% annual interest. You are selling the bank the use of your money for 5 years; in exchange, they are paying you 3% of the money each year. I'm guessing everyone knew that already.

The other basic point you need to understand is how a bond works. A traditional bond is a security with a face value, a coupon, and a maturity. Let's take the 10-year U.S. Treasury bond issued on [November 17, 2008](#) as an example. It had a face value of \$100, a coupon of 3.75%, and a maturity of 10 years (a maturity date of 11/15/2018). If you hold this security, this means that you will get the face value (\$100) back on 11/15/2018, and during the intervening 10 years you will earn 3.75% annual interest on the \$100, or \$3.75 per year. (Treasury bonds pay every 6 months, so you would get \$1.875 every 6 months.) Note however that the price to buy this bond is not necessarily \$100. Treasuries are initially sold at auction, and in this case the 10-year bond sold for \$99.727098. This means that investors valued that bond's stream of payments (\$1.875 every 6 months for 10 years, then a flat \$100) at about \$99.73, not \$100. The implicit yield is 3.783%, not 3.75%; that means that if you pay \$99.73 and you get that stream of payments, you are earning 3.783% annually on your investment.

Treasury bonds are highly liquid securities, which means that you don't have to wait 10 years to cash out if you need the money. Instead, you can sell the bond on the secondary market. Right now this bond costs about \$114-10/32, or \$114.31, and the implicit yield is 2.13%. This means that the investor who buys your bond on the secondary market thinks that \$114.31 is the right price for the bond's stream of payments, and that he will earn a 2.13% yield on his investment. (\$3.75 is more than 2.13% of \$114.31, but after 10 years he will only get \$100 back, not \$114.31.) In the news, you would read that the yield on 10-year Treasuries has fallen over the last month. But this doesn't affect the Treasury department directly, because Treasury got its money on the day it auctioned the bonds off (11/17/08). However, the next time Treasury issues a 10-year bond, it will probably earn a yield that is pretty close to the yield on the most recent 10-year bond, so changes in

yields on the secondary market affect the price at which Treasury can raise money in the future.

In general, the price of a bond (and therefore its yield) depends on three factors: the maturity, or the length of time that you are lending money for; the degree of credit risk, or the risk that you won't get paid back; and the supply of and demand for money.

OK, that was the introduction. For discussion, I'm going to divide interest rates into three categories: (1) the Federal funds rate; (2) U.S. Treasury yields; and (3) everything else. Within category (3), I'll spend an extra minute on mortgage rates.

The Federal funds rate

The Federal funds rate is the rate at which U.S. banks lend money to each other overnight. The money in question is the reserves that sit in their bank accounts in the Federal Reserve system. If Bank A has excess reserves at the end of the day and Bank B has a reserve deficit at the end of the day (reserves are the money they have to keep on hand - electronically, at least - in case people ask for it; reserve requirements are set by the Federal Reserve), Bank A will loan the money to Bank B for a period of one day. The rate of interest Bank A will charge is the Federal funds rate.

The Federal funds rate is almost the lowest rate of interest in the economy. (Right now the target for the Federal funds rate is 0.00-0.25%.) This is because the party borrowing the money is a bank that is regulated by the Federal Reserve, and hence unlikely to go bankrupt (put the last few months out of your mind for the moment), especially not in the next 24 hours. Also, there isn't a lot else Bank A can do with the money, so the opportunity cost is low.

In ordinary times the Federal funds rate is the only rate that is set by the Federal Reserve, and the Fed doesn't even set it directly; notice that the loan in question is a private transaction between two private entities. Instead, the Fed influences the Federal funds rate by controlling the amount of money in the system (by buying and selling Treasury securities); the more money available, the lower the interest rates that banks will charge each other. Over the last decade or so, the Fed was able to keep the actual Federal funds rate quite close to its target rate, which is the one that gets announced every six weeks. (This has broken down recently, for reasons I won't get into.)

For more on the Federal funds rate, see [Federal Reserve for Beginners](#).

U.S. Treasury yields

When the Federal Reserve changes the Federal funds rate, its effects ripple out through the economy, but with all sorts of lags and dampening effects. Broadly speaking, interest rates can differ from the Fed funds rate for two reasons: maturity (the amount of time you are lending money for) and credit risk (the risk that you won't get paid back). We'll talk first about U.S. Treasuries, because "by definition" they involve no credit risk.

The Treasury Department raises money by issuing bonds that range in maturity from a few days to 30 years. At the low end, there is virtually no risk of any sort, so the yield is purely a function of supply and demand; if a lot of people have money and nothing else to do with it, yields will be low. There was an auction today for 4-week Treasury bills, and the yield was exactly zero; people are lending money to the government for free.

With a longer maturity, however, there is risk, even when lending to the U.S. government. The main risk is inflation. Because all the payment stream of a bond is fixed in nominal terms, the higher inflation is over the maturity of the bond, the less it will be worth to you in real terms. What matters here is not the current rate of inflation, but investors' expectations of what inflation will be over the maturity of the bond. If investors expect inflation to go up, they will demand higher yields to compensate; even if they expect inflation to remain steady, they will still demand a higher yield for a longer-maturity bond, because the longer maturity means there is more time in which inflation could increase. There may also be some question of whether, over a longer time horizon, the U.S. government is more likely to default on its debt; however, I don't want to get into this, because it starts raising some complex issues (like, if the U.S. government defaults on its debt, what kind of world would we be living in?).

Right now, [yields](#) range from zero on the 4-week T-bill to 2.60% on the 30-year bond. (These are all at or near historic lows.)

Everything else

In the world of economics and finance, Treasury securities are generally considered risk-free. So for any maturity you want to invest in, you always have the option of buying a Treasury bill or bond. In order to be able to borrow money, entities other than the U.S. government have to offer higher yields. The yield of anything other than the U.S. government can be thought of as having two components: the Treasury yield (with a similar maturity) and the spread over the Treasury yield, which is the risk premium (the additional yield that investors demand to compensate for the additional risk of the borrower).

That spread is determined by a few major factors, of which I'll mention three: (a) the creditworthiness of the borrower; (b) whether the loan is secured; and (c) the general state of the economy.

(a) The less creditworthy the borrower, the higher the interest rate, since lenders require additional yield to compensate for the risk of default. For bonds issued by governments and businesses, creditworthiness is generally determined by the bond rating agencies, who look at fundamental factors like projected cash flows and debt burdens to estimate the likelihood of a default. Each agency has a scale of ratings that it uses; the top few rungs are considered "investment grade," and everything else is "junk," which was recently euphemised into "high yield." For individuals, creditworthiness is determined based on your credit score (calculated based on factors such as your past payment history,

current debt outstanding, current credit available, etc.) and other attributes of your financial situation, such as your income and assets.

- (b) A secured loan is one where the borrower pledges collateral to the lender, as in a home mortgage or a car loan. Lenders will accept lower interest rates for these loans than for unsecured loans, such as credit cards.
- (c) The same borrower who pays a low interest rate during good economic times will pay a higher interest rate, or will be unable to get a loan at all, during a recession. In a recession, everyone's risk of default goes up. This is why all sorts of spreads go up in an economic downturn. For example, the spreads on high-yield (junk) corporate debt are [far above their previous record levels](#) at over 20 percentage points. That means that if the yield on a 10-year Treasury is about 2%, the yield on a 10-year junk bond is over 22%.

Mortgage rates

For current purposes, I'm just going to talk about traditional, 30-year fixed-rate mortgages.

Even when it has a nominal 30-year maturity, the average mortgage only lives for about 7 years. For every mortgage that is paid off month after month over 30 years, there are many more mortgages that are prepaid, usually because the mortgage holder refinances or sells the house. So when a bank loans money to homeowners, or an investor buys mortgages or mortgage-backed securities, he is thinking that the maturity will be about 7 years.

As a result, people generally think of mortgage rates as the spread over the 10-year Treasury yield. That is, people investing in mortgages, which have some default risk, have the option of buying 10-year Treasury bonds instead, so mortgage rates contain a spread to compensate for that risk.

If you look at [this chart](#) comparing 30-year fixed mortgage rates to 10-year Treasury yields (among other things), you'll notice two things. First, on a month-to-month basis, the two seem to move together. Second, however, over longer periods of time, the spread can change. In 2006 and the first half of 2007 the spread was a little less than 2 percentage points, but by early 2008 it had widened to a little over 3 percentage points, where it is today. (Some people argue that this is proof that mortgage rates are not related to 10-year Treasury yields. I think that's just a product of how you look at things. Because the spread can change, the two are obviously not linked. But conceptually, I think it still makes sense to think of the mortgage rate as being composed of the Treasury yield plus a changing spread.) The spread has gone up for the reasons we're all familiar with; after a long period of thinking that mortgages were absolutely safe, now lenders and investors think they are risky again, so they are demanding higher yields in exchange for their money.)

You'll note that that chart was intended to make a different point: that the Federal funds target rate does not affect mortgage rates. That's because the Fed funds rate has only a limited impact on the 10-year Treasury. Remember, the 10-year Treasury yield is primarily determined by inflation expectations, and a lower Fed funds target rate is not going to by itself reduce inflation expectations (arguably it would increase them). This is why the conventional wisdom is that the Fed has limited ability to affect long-term interest rates. Recently, however, Bernanke has started talking about the Fed buying hundreds of billions of dollars' worth of mortgage-backed securities in an effort to push mortgage rates down. This isn't guaranteed to work, because the Fed is only a small part of the global market for U.S. mortgage-backed securities, but simply announcing the intention has already brought mortgage rates down significantly.

Mortgage rates are an unusual case because the government has another lever it can use to influence them. Fannie Mae and Freddie Mac make up a large part of the secondary market for home mortgages, in two ways. First, they buy mortgages from lenders. Second, they bundle together mortgages from lenders into mortgage-backed securities, which they then issue back to the lenders (who typically sell the securities to investors). Therefore, the price that Fannie and Freddie are willing to pay for mortgages plays a large role in setting the interest rates that lenders charge borrowers. The [Hubbard-Mayer mortgage proposal](#) that I reviewed a while back is predicated on the observation that the mortgage spread is unusually high (as mentioned above), and it's high because the spread for Fannie and Freddie bonds (their cost of money) is unusually high.

Clarification: Fannie and Freddie want to make profits, which means that the interest rate they charge on mortgages (I know they don't lend directly, but by purchasing mortgages they are effectively doing the same thing as far as interest rates are concerned) has to be higher than the interest rate they pay on their own bonds. Since the credit crisis began, but especially since July, there has been a tremendous "flight to quality" in the bond markets: that is, investors have been selling everything that has even the slightest risk, and buying Treasuries instead. This pushes the yields of Treasuries down and the yields of everything else - including Fannie/Freddie debt- up, widening the spread.

If the Treasury Department can bring down the Fannie/Freddie spread to where it should be, given that Fannie and Freddie are more or less backed by the government anyway, then they will be able to pay more for mortgages, lowering the interest rates that lenders have to charge borrowers.

Clarification: There are at least two ways that Treasury can bring down the Fannie/Freddie spread. The first, which [Krugman recommends](#), is simply to announce that debt issued by Fannie and Freddie is backed by the "full faith and credit" of the U.S. government. That will make it equivalent to Treasuries from a risk perspective. Right now, although Fannie and Freddie are government-chartered and in a government conservatorship (meaning the government is calling the shots), their debt is still not explicitly guaranteed by the government. The second, which Hubbard and Mayer recommend, would be for Treasury to issue additional debt themselves, and then lend the proceeds to Fannie/Freddie at a lower interest rate than they currently have to pay on the

open market. Note that either one of these would reduce the spread, but not solely by bringing down the yields for Fannie/Freddie; Treasury yields would also go up somewhat. First, by increasing demand for Fannie/Freddie debt, this would reduce demand for Treasuries. Second, because Fannie/Freddie debt would be explicitly guaranteed, some people would think that this increases the overall riskiness of the U.S. government as a borrower. Some people would also think that it increases the risk that the government will choose to print money to pay off the debt, which would create inflation - and higher inflation expectations mean higher Treasury yields.

As always, if you see any mistakes I made, please point them out.

Update: Krugman has a nice [chart](#) with the recent spread between mortgages and 10-year Treasuries. He thinks that the spread is too high and that the government can bring it down.

Update: Thanks to the corrections by Jim W and Durable Investor, I changed my incorrect usage of “duration” to “maturity.”

Update: Simon Johnson talked to the [Planet Money](#) guys about the Fed funds rate and other interest rates. The segment starts about 2 minutes in.

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Dec 24, 2008 7:58 PM

What You Can Do

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

On one level, recessions are about numbers, like the post I just wrote about the November statistics. On another level, recessions cause enormous hardship and misery to real families. I know most of us have less wealth than we did a year ago, since two major sources of household wealth - stocks and housing - have fallen steeply in value this year. But even if you don't feel like you can afford to donate as much as usual to charities, there is still something you can do.

Most middle- and upper-income American households have lots of stuff. Many of us, particularly adults, have lots of clothes and other things we rarely or no longer use. You can think of this either as a behavioral phenomenon (people don't like to get rid of things, even if they cause more disutility by taking up closet space than any utility they will ever provide) or as a market failure (it's too much of a hassle to get rid of things, so we keep

them). But if you just take a day, identify the things you will never use again, put them in bags, and drive them to a local shelter, you can help allocate those goods to the people who value them most. Or, as non-economists put it, you can help people. And, of course, you can get a tax deduction (the shelter in my town recommends using the [Salvation Army valuation guidelines](#)), which is itself probably worth more to you than those clothes you will never wear again.

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Dec 24, 2008 7:58 PM

Silver Linings?

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

We got one of our last batches of economic data for this calendar year today, and there may have been a glimmer of good news in there. In the news stories about the November data, I read that personal income went down, but real personal consumption went up, and the savings rate went up, which I found confusing, so I looked directly at the Bureau of Economic Analysis [news release](#).

To summarize (all numbers are November's change from October), personal income went down by 0.2%, and disposable personal income (after taxes) went down 0.1%, but in real terms (after adjusting for inflation, or deflation in this case), disposable personal income went up by 1.0%, which is huge (remember, that's month over month). This was entirely due to falls in food and energy prices (mainly gasoline), since the core price deflator (excluding food and energy) was flat. Of that 1.0% increase in real disposable personal income, 0.6% turned into increased consumption, and 0.4% turned into increased saving, raising the savings rate from 2.4% to 2.8%.

What's good about that? First, since personal consumption is most of our economy, an increase in real personal consumption - even if it is entirely due to the falling price of oil - puts a floor under how much the economy as a whole can contract. Based on the October-November data, [Calculated Risk](#) is estimating that real PCE (personal consumption expenditures) will decline "only" 2.9% this quarter, which is better than consensus forecasts.

Second, the personal consumption data were better than expected, which is what we need if we want the stock market (and consumer confidence) to start heading upward again.

Third, the increase in savings indicates that American consumers are returning to a more sustainable balance between consumption and savings. For the long-term picture, click on the chart in this [Calculated Risk post](#). (What does it say that when I need a nice, clear chart of economic data, I turn to a blog?) Where should the savings rate be? There is no perfect answer to that question, so for now I'm going to defer it to a future post.

On the downside, this bit of good news is not sustainable, for the simple reason that oil prices have to stop falling sometime. And with oil in the \$30s, that time might be right about now. So December gasoline will turn out to be cheaper than November gasoline, but we probably can't rely on any further month-over-month improvements. Furthermore, the rest of the economic picture looks as bleak as ever, so incomes will probably continue to fall even as prices level out. The net effect could be that this quarter (Q4) will be better than forecast, but next quarter and the one after that will be worse. (If you look at the aggregated forecasts on the WSJ's main [Economy page](#), 2009 looks pretty optimistic.)

Looking for other things to be optimistic about, here are a few possible silver linings:

1. Food prices. The run-up in food prices earlier this year threatened hundreds of millions of people with malnutrition or starvation. These are March 2009 corn futures:



However, as James Surowiecki discussed in [The New Yorker](#) last month, we are still a long way from having a reliable food system.

2. Changes in Americans' consumption behavior. There is a good chance that this crisis will frighten many or most people into lower debt levels and increased saving. Given that we were already headed for a potential retirement savings catastrophe before the stock market fell by 40%, this is a good thing. The big question is how to get to a new, higher-savings equilibrium without taking a big chunk out of the economy in the process. More on that later.

3. Shift away from the financial sector. Over the past two decades, the financial sector - first investment banks, then private equity, then hedge funds - has been soaking up a larger and larger proportion of our nation's smartest, most talented, and most ambitious young people. While I am no Luddite when it comes to financial innovation, I do think we were well past the point of zero marginal returns. Even if those would-be masters of the universe go into management consulting instead, I still think our society will be better

off. If all those physicists who turn into quantitative modelers stay in physics, we'll be even further ahead.

4. Investment in productive infrastructure. One thing that amazed me about the long boom of the 1990s and 2000s was that it happened at the exact same time as a decline in the quality of our nation's infrastructure. I was amazed every time I drove through New York - one of the most financially fortunate cities in the world for the last decade - and saw that the bridges and roads were every bit as decrepit as when I grew up there in the 1970s. Now, however, with the Obama Administration looking for things to spend money on, we will finally start investing in infrastructure.

I'm sure there are other silver linings out there, some we won't realize for decades.

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Dec 23, 2008 10:00 PM

Too Small To Fail

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

By now you probably know all you need to know about Too Large To Fail (Citigroup), Too Interconnected To Fail (AIG), and Too Many Potential Job Losses To Fail Before A New Administration Takes Office (GM). Almost all the bailout cases we have seen recently were some combination of the above and they generally shared the characteristic of being large relative to the US and perhaps global financial system. We have become accustomed to bailout increments in the hundreds of billions of dollars, and to periodically reassessing how many [trillions have been committed by the Federal Reserve](#) and others.

Today we received confirmation of something quite different: [a bailout package for Latvia](#). Latvia is a [small country \(2.2m people\)](#) and it is receiving a loan of just \$2.35bn from the IMF. The loan is obviously tiny compared with other bailouts ([Citigroup received at least 10 times as much](#) in November), but it is big in relation to Latvia's economy - in IMF parlance, the loan is 1,200 percent (or 12x) Latvia's quota. Quotas are based on the size of your economy, among other things, and it used to be that 3x quota was a big loan and 5x quota really raised eyebrows. ([Iceland recently broke some records](#) in this regard (official numbers [here](#)), and perhaps we are now in a brave new world where borrowing over 10x quota becomes more standard.)

We can scrutinize the full details of the program when it becomes public, but the press release already makes the key point quite clear,

The program is centered on maintaining Latvia's exchange rate peg while recognizing that this calls for exceptionally strong domestic policies and substantial international financial assistance.

Latvia has laid claim in recent years to having the world's most overvalued exchange rate, which is fixed (or pegged) against the euro. An overvalued exchange rate implies that you import more than you export, thus running a large current account deficit and needing a great deal of capital inflows. Latvia's current account deficit peaked close to 25% of GDP (not a typo: twenty five percent), although it declined significantly over the past year. Capital inflows, of course, are sadly diminished in this environment and the country has consequently been losing reserves at an unsustainable rate (this is [all in the IMF press release](#)).

So Latvia will get a loan from the international community, via the IMF and through various bilateral add-ons, which will not require any adjustment of their exchange rate. This is good news for the Latvian private sector, which has borrowed heavily in euros and which would have great difficulty servicing its debts if there were to be a significant depreciation (i.e., what usually happens in this kind of situation.) But how is this possible?

It's possible because Latvia is receiving an extraordinary level of support, a generous bailout by any measure - with what appear to be pretty easy conditions, i.e., not much of the "adjustment" that countries usually need to do when big credit booms end. Why would anyone do this for Latvia? The answer is (a) it is small, so this is not expensive, and (b) this (hopefully) prevents contagion to other emerging markets that have exchange rate pegs. Even if the risk of contagion is low, the cost of being extremely generous to Latvia is pocket change to the IMF's shareholders. (Although do remember that over-generous and over-long support of exchange rate pegs can end in tears - see [Mike Mussa's book on Argentina](#) for details.)

In effect, Latvia is Too Small To Fail. Or, if you prefer, Too Indebted In Foreign Currency To Devalue.

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Dec 23, 2008 9:15 PM

[All Financial History for Beginners](#)

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

I was really hoping I could recommend *The Ascent of Money* by Niall Ferguson as a kind of catch-all Beginners book, in the spirit of my [Beginners articles](#). Its subtitle is “A Financial History of the World,” after all. But I have to say it fell short of my expectations, although it would still make a nice gift. And although it has 360 pages, the spacing is wide and the margins are big, so you could buy it in the morning, read it in the afternoon, and still wrap it up in time for Christmas.

The book proceeds through a series of historical lessons, one for each major asset class - money (meaning primarily bank credit), bonds, stocks, insurance, real estate, and “international finance.” And there is certainly a lot of fascinating history to learn in there. For example, although I spent seven years dealing exclusively with insurance companies, and I knew about the usage of insurance in early Renaissance Italy, I had never read the story of the Scottish Widows’ Fund, the first true insurance fund designed to be self-financing in perpetuity. Nor did I know how Nathan Rothschild made a fortune betting that UK government bonds would rise in the years after Waterloo (because the government’s need for borrowing would decline). And the book does touch on many of the historical parallels you have probably been reading about during the past few months, from the Great Depression to the S&L crisis to Japan’s lost decade and the emerging markets crisis of 1997-98. Ferguson is also an excellent writer, and even your friends and relatives who are less excited by topics such as bond yields and the money supply will probably find most of it enjoyable going.

But the problem is that the book is just too short. Niall Ferguson made his reputation writing some very big books about considerably smaller topics. Reading this smallish book about an enormous topic, I got the feeling that he wasn’t allowing himself enough pages to deal with each topic in the depth he would have liked. This has two consequences. First, even though he is clearly writing for the general reader, there are places where he doesn’t take enough care to define his terms, and where he is bound to lose large parts of his audience. For example, describing the capital structure of what would become the Mississippi Company, which mixed new shareholder’s capital, *billets d’etat* issued by Louis XIV, and perpetual bonds, he lost me. So if you really want to understand the shift of European governments from confiscatory taxation to borrowing, you’ll need to look elsewhere.

Second, *The Ascent of Money* necessarily treats in just a few pages topics on which entire books - and quite long ones, sometimes - have been written, and if you’ve read those books, you’ll find the summaries here pale by comparison. For example, Ferguson makes Enron (on which see [The Smartest Guys in the Room](#)) into an emblematic bubble company (“the Mississippi Company all over again”), the bubble this time inflated by cheap money, courtesy of the Federal Reserve. I think calling Enron a bubble company is a only part of the story, since much of what it did - dating back to the early 1990s - was accounting fraud that needed no bubble to exist (although the bubble certainly magnified the scale of the take); Pets.com would be more of a pure bubble company. Similarly,

Ferguson's account of Long-Term Capital Management emphasizes the quantitative arbitrage premise of the fund; but the big bet that killed LTCM was not arbitrage by any means, but a one-sided bet against volatility - a bet that was informed by quantitative analysis (volatility was high, so LTCM thought it would go down) but was ultimately a gambler's bet, as described in [When Genius Failed](#).

As for the current crisis, Ferguson had the fortune or misfortune of finalizing the book in May, and so missed out on the events of the last few months. At the time he was writing, it still seemed like the crisis would only hasten the day when China would overtake the U.S. as the world's largest economy ("at the time of writing Asia seems scarcely affected by the credit crunch in the U.S."). Which, of course, only shows how unpredictable the events of the last four months have been, that China is now facing its most serious [labor unrest](#) of the last ten years. Hey, I didn't see it coming, either. As a historian, the narrative he wants to tell is one of a shift in the balance of economic power from the U.S. to China. Of course, it still may happen - we just won't know for a couple of decades, at least.

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Dec 23, 2008 4:35 PM

[Thanks, But We Can Take Care of Ourselves](#)

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

Every once in a while, someone leaves a snarky comment on this blog along the lines of "Well, have *you* ever started your own company?" I usually leave them alone, although occasionally I can't resist responding. In general, I just think that my experience co-founding one company in one industry does not really qualify me to say anything that knowledge and logic wouldn't qualify me to say anyway. In particular, having been through the experience, I can say that the amount of luck you need dwarfs any other attributes you bring to the table, so starting a company is not a particularly useful filter.

But now Michael Malone has managed to aggravate me with an op-ed in the Wall Street Journal called "[Washington Is Killing Silicon Valley](#)." And Silicon Valley being one of the parts of our economy I know particularly well, I feel compelled to respond.

Malone's thesis is that government regulation is threatening the ability of "Silicon Valley," meaning the venture capital-backed entrepreneurs, to start successful new companies. He says that Sarbanes-Oxley, options expensing, and full disclosure

requirements “have managed to kill the creation of new public companies in the U.S., cripple the venture capital business, and damage entrepreneurship.”

Oh, please.

Malone’s evidence is that there have only been 6 venture-backed IPOs in 2008, as compared to over 200 in 1999 and 1996. First of all, when anyone quotes you two random figures from a series, you should be suspicious. There were 73 IPOs in 1998. (My numbers for the 1990s are from a National Venture Capital Association presentation from 2006, and are slightly but not significantly different from Malone’s.) Second, the big fall-off in IPOs was from 2000 to 2001, when the number of IPOs fell from 264 to 41. Why was that? Evil government regulators? No, as I recall vividly, the technology bubble burst; the company I was at, Ariba, saw its shares lose 99% of their value. After the crash, the number of IPOs built back up again, reaching [86 in 2007](#) as the stock market climbed to its all-time highs in October. And why are there so few IPOs this year? Do I really need to spell it out? Given that you’re reading this blog, I don’t think so.

By the way, Sarbanes-Oxley was enacted in July 2002, after venture-backed IPOs had already fallen off a cliff. Stock option expensing was enacted in December 2004 and went into effect in the second half of 2005 or 2006, depending on the company.

Malone’s other evidence (other than bald assertion)? He says that every business plan these days ends by saying “And then we sell to Google,” instead of going public, and that VC firms are underwater. (Yes, these are really just bald assertions, but I’m stretching to find evidence in his article.) It’s hard to see the desire of small software companies to sell out to Google - a company that has a habit of buying small software companies, and that is by all accounts a great place to work - as evidence that Silicon Valley is broken. It’s also a claim that only makes sense if you restrict your field of vision to online software companies - ignoring, for example, the little bubble in “cleantech” that appeared over the past couple years.

If venture capital firms are underwater, there’s a very simple explanation for that. Venture capital firms invest in private companies. Those companies have valuations, even if they aren’t traded daily on markets. Those valuations are closely linked to the valuations of public companies, because private companies are usually valued using multiples: for example, you might say that a software companies is worth 3x or 5x its revenues. Those multiples are “calculated” by looking at comparable public companies. So now that the NASDAQ has fallen by 50%, all of the multiples have fallen by 50%, and the values of all of the VCs’ portfolio companies have fallen by 50% (or they will the next time they think about how much those companies are actually worth).

And he has one quote from an executive at Cypress Semiconductor complaining about accounting regulations. Note that Cypress Semiconductor has been public since 1986. I’m not sure what Malone is trying to prove here, but he does also blame mark-to-market accounting for the failures of Bear Stearns and AIG.

But despite the lack of worthwhile evidence, is there something to Malone's argument anyway? Yes, Sarbanes-Oxley has made it harder to go public, and it is definitely something that companies like mine think about. But it's just a cost of doing business. Every venture-backed startup, once it reaches a certain size, plans on going public, for the simple reason that you can't plan on being acquired, because it isn't under your control. You have to go public. In our case, it just meant we had to be a little bit more serious about our financial infrastructure than we might have in 1999 - which, as I see it, is entirely a good thing, both for us and for anyone who might invest in us in the future.

As for option expensing, though, that's a complete red herring. The new accounting regulation had absolutely no effect on our option granting policies - we didn't discuss it for one second - and I can't imagine it affecting any other Silicon Valley company I would want to work at. First, the option culture is too deeply ingrained. Second, startup companies are run on cash, not accounting statements, and we know that the accounting treatment doesn't affect cash. If you investors think it matters, fine.

Malone lets out what he really cares about toward the end of his op-ed, however: capital gains taxes! He's afraid that Obama will raise capital gains taxes, thereby really dealing a deathblow to Silicon Valley. On his reading, reductions in capital gains taxes under Carter and Reagan "unleashed the PC and consumer electronics booms of the 1980s, just as the Taxpayer Relief Act of 1997 restored the 20% rate and did the same for the Internet economy in the late 1990s." If I were Bill Gates, Steve Jobs, Scott McNealy, Larry Ellison, Jeff Bezos, Jerry Yang, David Filo, Larry Page, or Sergey Brin, I think I might be just a bit insulted. No, wait, I'd be too rich to be insulted.

That argument fails to draw a convincing link between capital gains tax rates and entrepreneurialism. Reagan boosted the capital gains tax rate back up to 28% in 1987, where it stayed until 1997. Some of the companies founded during that dismal, high-tax decade: Netscape, eBay, Yahoo!, Siebel, Amazon, Palm, and most of the companies that went public during the technology boom before the IPO window slammed shut in early 2000. "An increase in the capital gains tax could end most new (nongovernment) job and wealth creation in the U.S. for a generation," Malone warns ominously, while failing to explain why the economy did just fine between 1987 and 1997 (yes, there was a recession in there, but there was also the first half of the longest boom of the postwar period).

Finally, I can say with certainty that capital gains tax rates had absolutely nothing to do with my decision to start a company. I didn't even know what the capital gains tax rate was at the time. Starting a company was an absolutely terrible financial decision - I would have been much better off become a middle manager in some big, sleepy, high-paying company - and the fact that I might someday pay 15% on the gains from stock I assumed was worthless at the time, as opposed to 35% on a salary I didn't have, didn't enter the outer fringes of the calculation.

(No, no, I hear you saying, it's the incentives for the investors that matter, not the entrepreneur's incentives. But I still don't buy the argument, because a lower capital gains tax rate, if it does anything, increases my propensity to invest rather than

consuming - or working, for that matter, and how is that good? It doesn't affect my choice of what to invest in; I am just as likely to invest in gold, paintings, or super-senior CDOs as I am to invest in VC funds.)

So Michael Malone: Don't you worry about Silicon Valley. It will be just fine.

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Dec 23, 2008 12:23 PM

German Finance Minister Confirms What We Have Been Saying

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

The Wall Street Journal's Real Time Economics/Secondary Sources [today juxtaposes](#):

1. Peer Steinbruck, the German Minister of Finance, saying that Germany will not engage in "extensive debt financed-spending or tax-reduction programs."
2. My posting, from yesterday, which makes the point that a big fiscal stimulus in the US strengthens the incentive for our major trading partners to free ride, i.e., not to engage in their own extensive debt financed-spending or tax-reduction programs.

Looks like we are still on at least this part of our [baseline](#).

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Dec 23, 2008 8:45 AM

What About Bank Capital?

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

The Obama team's plans are big and bold on key dimensions. The fiscal stimulus will be one of the largest ever in peacetime. We don't yet know how much support there will be for a housing refinance initiative, but there is no question that [the proposal will be huge](#).

But in this mix the lack of serious discussion (yet) of the need for new capital in the banking system is striking. It could be, of course, that reports on the lack of capital have been greatly exaggerated. And it could also be that a detailed assessment of the capital injections so far might indicate they have had less effect than previously expected - although you have to think about the counterfactual, what would the situation be now without these capital injections?

Most likely, the strategic thinking is along three possible lines here.

- 1) No more capital is needed because the fiscal stimulus will be large enough to turnaround the economy, bringing back growth and gradually steepening the yield curve (so banks can go back to making money the good old-fashioned way; borrow short, lend longer). This is a plausible approach, but risky. There is a great deal that can go wrong or at least delay the positive effects of a big fiscal push, particularly in the current global economic environment - see [my piece on Forbes.com today](#).
- 2) If more capital is needed at any point, it can be provided on the same sort of terms that Citigroup received in November. This seems dubious because I would expect a political backlash if there is an attempt to repeat or scale up this deal. The terms were simply too [unfavorable to the taxpayer](#). And we should probably now move beyond relying on weekend rescues of major financial institutions; too much can go wrong under that kind of pressure.
- 3) If more capital is needed, there is a plan but it is secret for now. This might have some appeal, in the sense that any plan would be controversial and could distort incentives. But Congress would surely appreciate knowing at least the potential scale and strategic direction for bank recapitalization in advance - after all, Mr. Paulson's surprise request to them in September did not go down well initially and did not work out well later. Any sensible plan would presumably involve the commitment of some hundreds of billions of dollars. This would be an investment on which the government can earn a good return, but more details in advance on potential deal structures could help us understand exactly the value proposition for the taxpayer.

Some proposals - after we saw what happened at Citigroup - for recapitalizing the banking system [are here](#). Our approach may not be the answer, and I understand why many on Wall Street would prefer to do things differently. But I do think we need more debate around a plan for recapitalization contingencies, and this should be done sooner rather than later.

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Dec 22, 2008 5:47 PM

[The Perils of Exports](#)

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

The steep decline in U.S. consumer spending is clearly taking its toll on the U.S. economy. But still, the U.S. has one advantage over many of its trading partners. Theoretically at least, our government has the tools it needs to boost domestic demand and thereby increase production. This is not true of the many countries who depend on exports for a large share of their economic growth.

I was taking a tour of the world's news today and came across the following (courtesy of the FT):

- [Japanese exports](#) fell 27% year-over-year in November, the largest fall ever; remember, exports were a major reason Japan finally emerged from its [decade-long slump](#) a few years ago.
- [Thai exports](#) fell 19% year-over-year in November, the first decline since 2002 - and exports make up 70% of GDP. The numbers may have been artificially reduced by political conflict in late November, but political conflict is hardly a good thing in itself.
- [China](#) is looking less and less like the big winner of the global recession and more and more like a significant loser. 10 million migrant workers have lost their jobs by the end of November. In response, "the State Council, China's highest governing body, issued a decree to local governments over the weekend ordering them to create jobs for migrant workers who had returned to their home towns." Prime Minister Wen Jiabao went as far as saying that a government priority is to "make sure all graduates have somewhere constructive to direct their energy" - somewhere other than social protest, that is.

One of the challenges of an export-driven economy is that when your consumers (Americans and Europeans) stop buying, you have few direct tools to get them buying again. There has been speculation that China could take the opportunity to stimulate domestic consumption and shift its economy away from reliance on exports, but that clearly can't happen fast enough. Another trick exporters can use is to devalue their currencies, but that will crimp domestic purchasing power and potentially lead to a round of competitive devaluations, with wealthy countries printing money in an effort to stave off deflation and thereby devaluing their own currencies. In the meantime, everyone will be watching the Obama stimulus plan carefully.

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Dec 22, 2008 8:36 AM

One World Recession, Ready or Not

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

The usual grounds for optimism these days is the fact that the Obama Administration is clearly going to propose a big fiscal package with two components: a large conventional stimulus (spending plus tax cuts); and a big housing refinance scheme, in which the Treasury will potentially become the largest-ever intermediary for mortgages.

These ideas are appealing under the circumstances, but this Fiscal First approach also has definite limitations, for both domestic and foreign reasons.

Most obviously, Congress will reasonably want to impose constraints on the amount of government debt that is issued, particularly absent a longer-term solution for Social Security and Medicare.

In addition, the Administration's big deficit push relies critically on an "easy enough" monetary policy which, at the same time, precludes "too much money, too soon." They need long interest rates to remain low, particularly for the housing scheme to make sense - rates have to come down for borrowers, at the same time as there is sufficient margin to cover credit losses, so it only works if the 10-year Treasury rate is roughly at current levels.

If the Fed eases "too much," then actual or expected inflation will jump. This would reduce real debt burdens and could help reflate the US and global economy more broadly, but the higher interest rates would compromise the fiscal/housing strategy. (If the Fed holds down long rates in the face of sharply rising inflation expectations, then will we will have a crazy credit boom that makes all other bubbles seem relatively sensible.)

On the foreign side, all other governments have an incentive to free-ride on the US fiscal policy. The dollar will tend to appreciate, on top of any strengthening due to safe haven-related developments. Both Europe and leading emerging markets can, in this scenario, hope to recover based on their exports. Sure, they like to criticize the US for its role in placing everyone on fragile growth paths with increasingly hard-to-sustain debt paths, but almost everyone would like - in the short-term - to go right back there.

Again, if the US approach were more slanted towards expansionary monetary policy, this would tend to cause dollar depreciation and it would force the hand of other governments. Either they would ease their own interest rates and potentially increase their supply of money, or their export sectors and growth would suffer further.

Most countries around the world have limited capacity for fiscal expansion, but almost all could engage in a more expansionary monetary policy. This, of course, runs counter to

20 years of orthodoxy in central banking, but nothing is without risks. And that includes the first set of fiscal moves by the Obama Administration in their global economic chess game.

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Dec 21, 2008 9:34 PM

Japan for Beginners

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

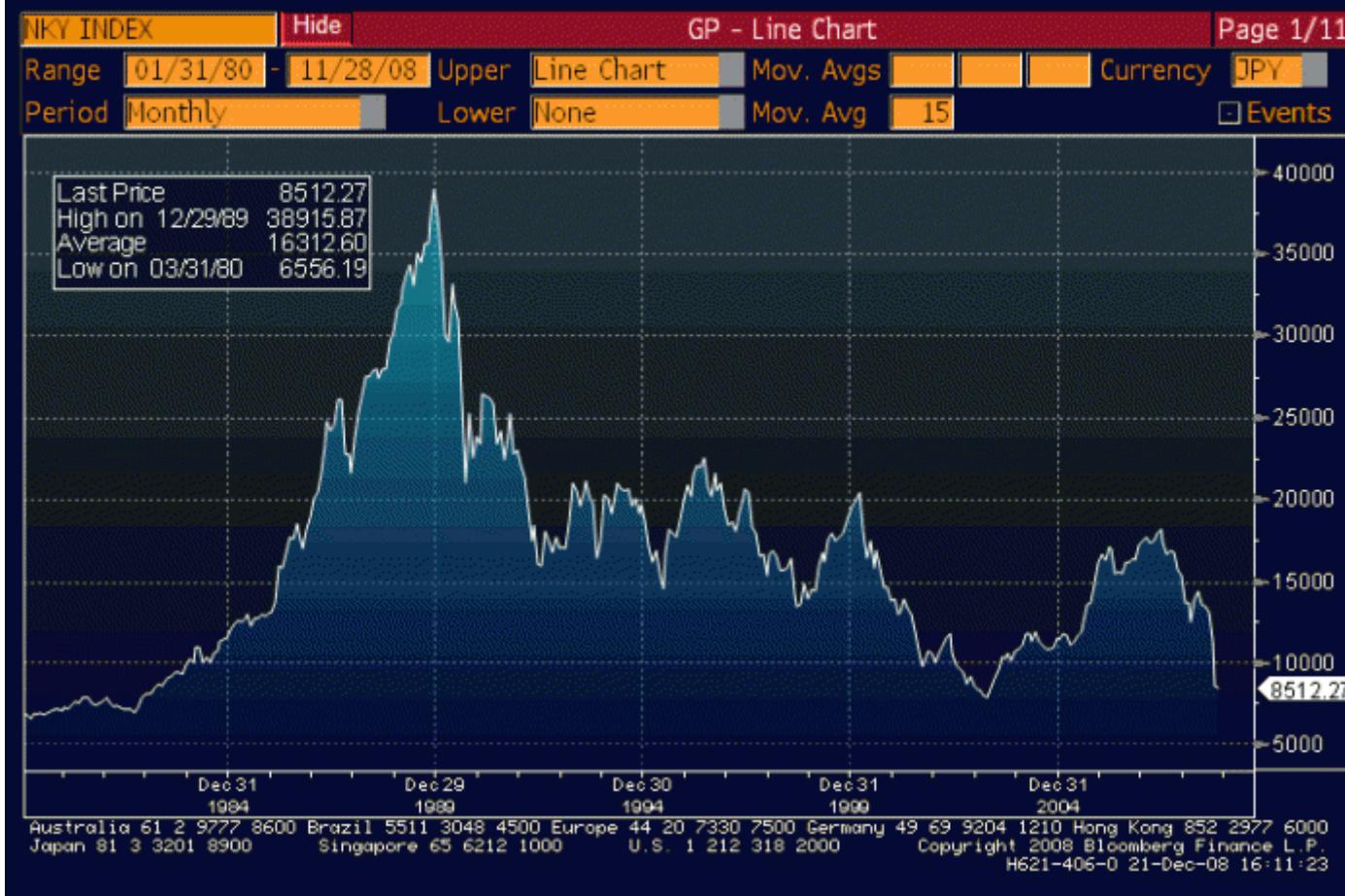
For a full list of Beginners articles, see the [Financial Crisis for Beginners](#) page.

The most common point of comparison for our current economic crisis is, far and away, the Great Depression. The Depression is most often bracketed with some version of the phrase, “but we’re unlikely to see a depression, just a recession,” whatever that’s supposed to mean. And, fortunately for us, with the addition of Christina Romer, we now have two scholars of the Great Depression on our nation’s economic policymaking team.

But in many ways, a more relevant comparison may be the Japanese “lost decade” of the 1990s, when the collapse of a bubble in real estate and stock prices led to over a decade of deflation and slow growth. This is the Nikkei 225 index from 1980 to the present.

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At a high level of generalization, the causes of the bubble were similar to those we have just seen. Loose monetary policy (in late 1980s Japan, and in the U.S. this decade) and high savings levels (by Japanese households in Japan's case, China and oil exporters in ours) created a large pool of money looking for investments to buy. Rising prices encouraged speculation in both real estate and stocks. Poor underwriting standards - due to some combination of government direction of investment and self-dealing within industrial and financial conglomerates - and an unconditional willingness to lend against real estate as collateral meant that banks made hundreds of billions of dollars' worth of loans that were sustained solely by rising prices. When prices fell, those loans lost most of their value, crippling banks' ability to lend to creditworthy borrowers and choking the economy. The lack of credit, combined with the negative wealth effect of collapsing asset prices, dampened economic growth, which averaged 1% per year for the 1990s.

What makes Japan more interesting than the Great Depression is the fact that it happened after the Great Depression, and after all of the academic research into the Depression and what the Fed did wrong. Although there are debates about many of the details, at a high level the conventional wisdom is that the Fed should have loosened monetary policy in

the 1930s, making it easier to borrow money and thereby stimulating the economy. What's interesting about Japan is that despite the benefit of all that academic research - which the Bank of Japan took to heart, lowering short-term interest rates to zero for much of the 1990s - policymakers were unable to restore the Japanese economy to anything like its growth potential for over a decade, and perhaps not even then. Fiscal stimulus was similarly ineffective

One of the major barriers to expansionary policy was the weakness of Japan's banking system. The asset price collapse and economic slowdown meant that increasing proportions of their loan portfolios became non-performing. Because writing down these loans to their true market values would have caused banks to become insolvent, they kept them on their books, rolling them over (extending bad loans indefinitely) in order to avoid having to take writedowns. As a result, the banks were severely undercapitalized and largely unable to engage in new lending. It was only in 1998 or 2003 (depending on whom you ask) that the government got serious about cleaning up the banking sector, letting weak banks fail or forcing banks to accept new government capital.

Of course, Ben Bernanke knows plenty about the lost decade. There are two major differences between the current policy response and the response in Japan in the 1990s.

First, the U.S. government has moved much more quickly to attempt to fix problems in the banking sector. To some extent, the fact that so many of the bad investments are securities rather than loans, combined with mark-to-market accounting, has had the salutary effect of highlighting the problems; banks have already taken close to \$1 trillion in writedowns, although many writedowns may still be hidden on bank balance sheets. This has forced banks' balance sheet problems into the open, leading to the recapitalization programs announced all over the world in October. For now, though, it's not clear if these programs have gone far enough. The small scale of the capital injections (capped at 3% of bank assets or \$25 billion, whichever is smaller) does not seem to have definitely restored confidence in the banking sector (see the re-bailout of Citigroup, for example), and has left many banks in a position of hoarding their cash rather than lending it out.

Second, the Fed has in just a few months acknowledged that its main monetary instrument - the Fed funds rate - is no longer useful, and has instead hinted at a broader program of quantitative easing, through some combination of printing money and buying all sorts of assets to prop up prices and push down yields. This was a major topic of Bernanke's famous [2002 speech](#) on fighting deflation, which was written with the Japanese experience in mind. In that speech, Bernanke implied that Japan's problem in the 1990s was political deadlock that prevented policymakers from taking the decisive steps that were necessary. For better or for worse, we seem to have the political will today to do whatever it takes, and the general consensus is that worries about inflation should be put on hold for now.

That said, we still can't be sure that we won't see a replay of 1990s Japan. First of all, while we have the political will to spend large amounts of money, it's not clear that we

have the political will to shut down insolvent banks; the bailout packages so far have been notable for their attention to the interests of existing shareholders. Second, simply because Bernanke is willing to use a broader arsenal of tools, earlier in the crisis, than was the Bank of Japan doesn't mean those tools will work; we are essentially in uncharted territory for any central bank. Third, Japan managed to create its boom and bust largely on its own, and when it did begin to come out of its lost decade it was largely thanks to exports to a booming world. This time, with more or less the entire world slowing down in unison, there is no external growth engine to bail us out.

The longer this crisis drags on without upticks in personal consumption and inflation, the more comparisons to Japan you are going to see. Let's hope it doesn't come to that.

For more on the Japanese crisis, you could look at these [two books](#) from the Peterson Institute for International Economics, at least sections of which are available online.

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Dec 20, 2008 11:51 PM

We Have a Winner?

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

After seeing dozens of mortgage proposals emerge over the past several months, there are news stories that Larry Summers and the Obama economic team are converging on an unlikely candidate: the proposal by Glenn Hubbard and Christopher Mayer first launched on the op-ed page of the Wall Street Journal on October 2. Hubbard and Mayer published a [summary of the plan](#) in the WSJ last week; a [longer version](#) of the op-ed is available from their web site; and you can also download the [full paper](#), with all the models.

I say "unlikely" not only because Hubbard was the chairman of President Bush's Council of Economic Advisors, but because it doesn't look like a Democratic plan; then again, it doesn't look much like a Republican plan, either. Most plans I have seen have focused on minimizing foreclosures through some form of guaranteed loan modification for delinquent homeowners. Before getting to the policy specifics, though, I want to outline two of the premises, as elaborated in the full paper.

First, Hubbard and Mayer, like many others, have the goal of preventing an overcorrection on the downside (housing prices falling further than where they need to go to be reasonable). But unlike many others, they have calculated where prices need to go, and one of their central arguments is that we are already there, and therefore housing

prices should be propped up right now. This was surprising to me, since I am familiar with Case-Shiller charts like [this one](#) from Calculated Risk (click on the first chart to expand), which seem to show prices still more than 50% above their 2000 levels (nominal prices, but in a low inflation environment). The authors divide cities into three markets - cyclical (San Francisco), steady (Chicago), and recent boomer (Miami), and conclude that (Figure 10): cyclical city prices are 10-20% above their average level of affordability over the last twenty years, but that is consistent with 2% expected annual real appreciation for these highly desirable cities; steady city prices are at their average level of affordability already; and recent boomers still have some way to fall. Looking at the imputed rent-to-income ratio (Figures 6-8), they find that housing prices are already where they should be in most markets.

Second, Hubbard and Mayer argue that housing prices are mainly a function of real mortgage rates. While they acknowledge that other factors took over at the peak of the boom, their model shows that most housing price appreciation through 2005 was due to fundamentals, primarily low mortgage rates. They show the price elasticity of user costs (the cost of owning a home, largely the mortgage) to be between 0.62 and 0.85, which means that a 10% reduction in user costs translates into a 6.2-8.5% increase in housing prices. Right now, they argue, mortgage rates are historically high relative to Treasury bond yields, and those high mortgage rates are pushing housing prices below their long-term levels. (Mortgage rates are only historically high because Treasury yields are world-historically low, but we'll come back to that.)

Given those premises, the policy proposal is simple: force mortgage rates down to 4.5% (by reducing the cost of Fannie/Freddie debt relative to Treasuries), thereby propping up housing prices at a level that Hubbard and Mayer think is sustainable. 4.5% would be 1.9 percentage points above the yield on 10-year Treasuries, but the historical spread is only 1.6% (Figure 9). While many people's first reaction will be that this is simply pumping up the next bubble, they have two responses. First, the price appreciation due to lower mortgage rates will only balance out the additional price depreciation (10-20%) that is currently expected. (I'm not sure I buy this, because forecasts for price depreciation are basically wild guesses moving in a herd; if the Hubbard/Mayer plan has the effect they intend, the current "pessimism" they expect to balance against their cheap mortgages will likely evaporate.) Second, they propose indexing mortgage rates to Treasury yields, so that as the economy recovers and Treasury yields go up, mortgage rates will go up as well. In effect, mortgage rates would become countercyclical.

Now here's the surprising part. In order for these mortgages to rejuvenate the housing market, they have to be available to everyone. This isn't a program for reducing mortgage foreclosures; this is a program for boosting housing sales and refinancings across the board. This does have the nice property of eliminating all those worries about how to prevent solvent homeowners from turning insolvent in order to profit from a bailout. Homeowners with negative equity are almost an afterthought, but they do get two paragraphs on pp. 22-23: these homeowners would get new loans with 5% equity; losses would be split evenly between the government (a new Home Owners Loan Corporation) and the lenders. Lenders would have to accept the deal on all or none of their mortgages.

(There isn't any discussion of how to deal with securitization trusts, but a program like this is sure to include large amounts of legislation, so presumably this is one more bill to pass.)

The goals of the program are to stop the slide in housing prices, stimulate the economy by unfreezing home sales and through the wealth effect of increased housing prices, and stabilize the value of mortgage-backed securities, thereby aiding the financial sector. (Presumably we're past the point where a flood of prepayments will reduce MBS prices any further.)

One question is whether the loans will be sustainable. Hubbard and Mayer say that 1.9% is more than enough because the ordinary spread is 1.6%. But these are not ordinary times, and even if the plan does help turn around the economy, we are probably looking at 1-2 more years of rising unemployment and resulting defaults. Furthermore, conforming mortgages rates are already down to 5.2% (thanks in part to the Fed talking rates down), so Fannie and Freddie could face the problem of getting stuck with riskier mortgages while the private sector keeps the better ones. But in any case there are signs that some version of this plan will be brought to the floor.

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Dec 19, 2008 11:54 PM

When Consumers Get Depressed

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

The Return of Depression Economics, by Paul Krugman, is certain to be one of the most gifted books this holiday season; that's what happens when you combine a Nobel Prize with a massive economic crisis and book with the word "depression" in the title. Here's another reason to buy it for someone, as I found out: it's so short you can read it in a couple of hours before wrapping it up.

The title of the book refers broadly to the recurrence of a need to deal with Depression-style economic threats, a theme that originally (in the 1999 edition) referred to the emerging markets crisis of 1997-98 and the stagnation in Japan caused by the collapse of their housing bubble at the beginning of the 1990s. More particularly, however, it refers to the problems brought on by a collapse in economic demand - "insufficient private spending to make use of the available productive capacity," as Krugman puts it. And it seems clear that that's where we are today. The Case-Shiller index of housing prices reached its peak in real terms sometime in 2006, but the economy

continued to grow until the end of 2007, even as housing prices fell significantly. Although the negative wealth effect of falling housing must have had some effect, people still wanted to spend. When the severe phase of the crisis began in September 2008, it was widely described as a credit crunch, meaning that reductions in the supply of credit were making it difficult for borrowers to get the money they needed, either for investment or consumption. Today, however, as Simon has said before, falling demand for credit may be just as big a problem. People just don't want to borrow money any more, and if that's the case, then increasing the supply of credit (by funneling cash into banks) will have only a limited effect, as we've seen. This is what Krugman finds most worrying about the current situation: the "loss of policy traction," in which even dramatic moves by the Fed have only a limited impact on the real economy.

He doesn't quite come out and say it in so many words, but a lot of Krugman's story has to do with what might be called psychology. He describes how economic crises may be the product of poor governmental policies and weak economic fundamentals - or they may be entirely the product of panics that have the very real effect of destroying wealth and setting countries back for years. Seen from this perspective, the scale of the current crisis may not have any proportional relationship to the fundamental flaws of our economy (or the global economy). It may simply reflect the fact that the scale, liquidity, and leverage of the global financial system have made it possible for panics to have much greater damage than they did in the past. (I know we're still not dealing with anything on the scale of the Great Depression, but while the financial system was simpler then, it also had a simpler flaw - the lack of deposit insurance - and a simpler mistake - the failure to expand monetary policy in response to the downturn.)

The fact that you are reading this blog probably means that you would not learn a lot about the current crisis from Krugman's book (especially if you've already read his article in [The New York Review of Books](#)), but you might learn something about the crisis of the 1990s, and the dynamics of currency crises. In 1997-98, multiple unrelated emerging market countries suffered panics and currency crises, and the response of "Washington" (the U.S. and the IMF) was to demand fiscal austerity - higher interest rates, lower government spending, higher taxes - in exchange for bailout loans. Now, of course, when large parts of wealthy country economies need to be bailed out, few people are calling for austerity; in the U.S., liberals and (most) conservatives differ only on whether the deficit should be increased through government spending or through tax cuts. Ten years ago, perhaps the austerity argument was defensible: in order for countries to gain credibility (and be able to pay back their loans), they needed to improve their government balance sheets. And at the time, the U.S. could be confident that reduced purchasing power in Thailand, South Korea, and Russia would have little effect on our economy. Today, however, the entire world is facing a steep downturn, and an economic stimulus will be most effective if it is roughly coordinated across countries, including emerging markets. So far the IMF appears to be using a gentler hand than last time, although so far most countries are attempting to steer clear unless absolutely necessary. The fact is that preventing an economic collapse in emerging markets will be an important part of our recovery this time, both because of the importance of foreign trade and

because of the amount of cross-border investment (think about the massive inflows into international stock funds in the past ten years).

In any case, it's a quick read, and for those who are nervous about Krugman's politics they make only a very brief entry near the end.

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Dec 18, 2008 5:55 PM

Managing Financial Innovation

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

Financial innovation tends to be a bit of a bad word these days. But while I and many other people are in favor of an overhaul of our regulatory system, that still leaves open the question of how the system should be managed.

A reader pointed me to a 2005 paper by Zvi Bodie and Robert Merton on the "[Design of Financial Systems](#)." They argue that neoclassical finance theory - frictionless markets, rational agents, efficient outcomes - needs to be combined with two additional perspectives: an institutional approach that focus on the structural aspects of the financial system that introduce friction and may lead to non-efficient outcomes; and a behavioral approach that focuses on the ways in which and the conditions under which economic actors are not rational (see my post on [bubbles](#), for example). The paper walks through examples of how to think about some real problems we face, such as the fact that households are increasingly being forced to make important decisions about retirement savings, but generally lack the knowledge and skills to make those decisions. One of their arguments is that while institutional design may not matter in a pure neoclassical world, it does matter in the world of irrational actors: deposit insurance to stop bank runs is an obvious example.

Some of the content may be tough going, but in general the paper offers one perspective on how to think about the relationships between markets, institutions, and individual behavior that make up our financial system.

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Dec 18, 2008 9:07 AM

When Will the G7 Intervene?

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

The dollar is depreciating in eye-catching and headline-grabbing fashion. The [Japanese authorities are signalling](#) that they are prepared to intervene. The G7 ([remember them?](#)) has the established role of coordinated intervention in major currency markets when things get out of hand. So where are they now and when will they come in?

The answer is: you may have to wait a long time. This round of dollar weakening is the direct result of easing monetary policy in the US. The Fed doesn't usually talk about the dollar (leaving this to the Treasury, which has a tradition of obfuscation on the issue), but dollar depreciation is fully consistent with (1) wanting to prevent deflation, and (2) hoping to stimulate growth through exports. The spinmasters would probably also say that actions to restore confidence in the global financial system are reducing demand for dollars as a safe haven, and this is reflected in currency markets.

You may or may not agree with this logic, but from a US perspective there can be little interest in immediate intervention. The Japanese are obviously unhappy when their exchange rate appreciates beyond 95 yen to the dollar, but their G7 partners are pretty unsympathetic at that level - Japan has been running a massive current account surplus (hence its reserves of over \$1trn) and has long been in line for some appreciation. At 85 yen to the dollar, things would start to get more animated, and almost everyone would support intervention at 80.

The dollar-euro thinking is even more interesting. The US (and my former colleagues at the IMF) are obviously pressing for a big fiscal stimulus in Europe. But key European governments are just as obviously demonstrating the desire to free ride, i.e., you put through a hefty fiscal package of \$850bn and I'll get back to growth through selling you more BMWs. While the US will of course observe every diplomatic nicety in this situation, privately the outgoing and incoming administrations must be enjoying the fact that dollar depreciation puts the European Central Bank - and particularly the Germans' export driven economy - very much on the spot.

Personally, I think the euro-dollar rate would have to move much further, probably close to 1.6 dollars per euro, for the intervention conversation to get serious. Of course, if markets become "disorderly" so that prices jump around in an unusual way, there are always grounds for intervening. But, on the other hand, in this situation you can rationalize almost any short-term exchange rate movement as the market adjusting to new fundamentals. And you can look very pointedly at the European Central Bank when you say this.

Dec 17, 2008 2:46 PM

Global Outlook After the Fed Cut

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

I talked yesterday with Steve Weisman, my colleague at the Peterson Institute for International Economics, about where the global economy is likely heading. Steve asked very good questions about U.S. monetary policy and what effects it will have. You [can listen to our conversation here](#).

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Dec 17, 2008 9:31 AM

Expansionary Monetary Policy is Infectious

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

The Federal Reserve's announcement yesterday makes it clear that we should see its leadership as radical incrementalists. They will move in distinct incremental steps, some small and some larger, but they will do whatever it takes to prevent deflation. And that means they will do what it takes to make sure that inflation remains (or goes back to being?) positive. If they need to err on the side of slightly higher inflation, then so be it. This is pretty radical (and a good idea, in my opinion.)

What effect does this have on the rest of the world? Well, if your central bank now sits idly by, most likely you will experience an appreciation of your currency relative to the US dollar. (The caveat, of course, is that if you have a new major domestic disruption in your banks, or another member of your currency union runs into refinancing trouble, you could still experience a depreciation.)

Who is willing to experience a significant appreciation in a slowing global economy, with exporters everywhere already clamoring for assistance? Most central banks will be pressed hard to ease further, either with interest rate cuts or their own version of

“quantitative easing” (known as printing money to you and me). What happens within the eurozone will, in this context, be fascinating - who will support the Germans in arguing that monetary policy should remain relatively tight? What happens if the Germans lose this argument at the level of the European Central Bank’s Governing Council?

In any case, the Fed’s move pushes us in the definite direction of higher global inflation. This is better than the alternative of falling wages and prices, but it comes with risks. Will we be able to control this inflation now or in the near future? What are the consequences of inflation during a severe global recession - which seems unavoidable, even if the Obama Administration has all possible dimensions of expansionary policy firing on all cylinders right away (this was the point in our [latest baseline scenario](#)).

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Dec 16, 2008 12:38 PM

[Angry Europeans](#)

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

I had a heated discussion about our [new baseline scenario](#) yesterday with some angry European politicians. Specifically, the most agitated were from the eurozone and they find our assessment of the risks and likely futures in that region to be unacceptable. In their view, this is an American problem and that is where the impact will be felt.

While we can surely agree that regulatory failings (and more) in the US are at the epicenter of the crisis, we are facing a global problem precisely because other countries’ banks are involved either directly (because they bought a lot of claims on assets that went bad; see your domestic regulators for details on how that happened) or indirectly (because they finance trade with the US/Europe, and this is now slowly markedly). And we should no longer think of this as a supply side problem in the credit market; increasingly, consumers and firms around the world want to spend (and borrow) less.

And here’s the point about Europe - perhaps the reason there is so much anger and even some denial. European governments have a lot of debt - in the case of some weaker eurozone countries, this stands at over 90% of GDP. Fiscal policy did not prepare for a financial sector problem of the current magnitude and the way in which bank recapitalization was handled recently has only exacerbated the underlying solvency issues. As a result, there is very little room for a meaningful fiscal stimulus; if governments attempt even more, there will be issues of confidence. Quite probably there will be pressure for austerity even at current debt levels.

The Europeans really need to get organized to provide more support to weaker EU countries and the weakest eurozone members. Try to deliver this message at every opportunity. If you get shouted down, keep at it.

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Dec 16, 2008 10:56 AM

Community Reinvestment Act Makes Bankers Stupid, According to AEI Research

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

One might have hoped that one collateral benefit of the end of the election season would be the end of the attempt to pin the financial crisis on the Community Reinvestment Act, a 1970s law designed to prohibit redlining (the widespread practice of not lending money to people in poor neighborhoods). Unfortunately, [Peter Wallison](#) at the American Enterprise Institute (thanks to one of our commenters for pointing this out) has proven that some people will never give up in their fight to prove that the real source of society's ills is government attempts to help poor people. Regular readers hopefully realize that we almost never raise political topics here, but sometimes I just get too frustrated.

Many people who are more expert than I in the housing market have already debunked the CRA myth. Here are just a few: [Janet Yellen](#), [Menzie Chinn](#), [Randall Kroszner](#), [Barry Ritholtz](#), [David Goldstein and Kevin Hall](#), and [Elizabeth Laderman and Carolina Reid](#). [Mark Thoma](#) does a good job keeping track of the debate.

One of the main arguments against the CRA-caused-the-crisis thesis is that the large majority of subprime loans, and delinquent subprime loans, and the housing bubble in general, had nothing to do with the CRA; it was done by lenders who are not governed by the CRA, and was done in places like the exurbs of Las Vegas or the beachfront condos in Florida, not poor neighborhoods (which generally saw less price appreciation than average). So Wallison comes up with a new argument: relaxed lending standards, encouraged by the CRA, caused lending standards to be relaxed in the rest of the housing market. Really, I'm not making this up.

I'm going to give you a long quote so I can't be accused of selective quotation:

The key question, however, is the effect of relaxed lending standards on lending standards in non-CRA markets. In principle, it would seem impossible—if down payment or other requirements were being relaxed for loans in minority-populated or other underserved areas—to limit the benefits only to those borrowers. Inevitably, the relaxed

standards banks were enjoined to adopt under CRA would be spread to the wider market—including to prime mortgage markets and to speculative borrowers. Bank regulators, who were in charge of enforcing CRA standards, could hardly disapprove of similar loans made to better qualified borrowers. This is exactly what occurred. Writing in December 2007 for the Milken Institute, four scholars observed: “Over the past decade, most, if not all, the products offered to subprime borrowers have also been offered to prime borrowers. In fact, during the period from January 1999 through July 2007, prime borrowers obtained thirty-one of the thirty-two types of mortgage products—fixed-rate, adjustable rate and hybrid mortgages, including those with balloon payments—obtained by subprime borrowers.”

After some more evidence that rich people were offered (and accepted) new mortgage types, he concludes with this:

Although it is difficult to prove cause and effect, it seems highly likely that the lower lending standards banks were required to adopt under the CRA influenced what they and other lenders were willing to offer to borrowers in prime markets.

At its core, the argument is that the government forced lenders to make bad loans in one market, so they went and decided to make bad loans in other markets. Even conceding some of the premises for the sake of argument, this is illogical. Wallison says “it would seem impossible—if down payment or other requirements were being relaxed for loans in minority-populated or other underserved areas—to limit the benefits only to those borrowers.” It doesn’t seem impossible to me: if you’re running a business, you should be able to understand that you have different target markets, and you have different products for those markets. In fact, if you (the bank) truly thought that you were being forced to make bad loans in one market, you would damned well keep those loans out of your other markets. If lenders are as stupid as Wallison’s argument implies they are, then the entire premise of the American Enterprise Institute - that government should leave businesses alone - starts to look shaky.

You can also tell an argument is shaky when an author says “it is difficult to prove cause and effect.” In areas like business, finance, and economics, where there actually are a lot of data, that generally means that it can’t be proven, or it would have been. Wallison’s evidence is that flexible mortgage products became available to the prime market. (Disclosure: I got an ARM when my wife and I bought our house, and we refinanced it into another ARM.) The most obvious explanation of that phenomenon is not that the CRA induced banks to make those products available to some customers, and that put them on a slippery slope to making them available to all customers, but that bank executives decided to make those products available to all customers. Still hoping to pin this on regulators, Wallison says, “Bank regulators, who were in charge of enforcing CRA standards, could hardly disapprove of similar loans made to better qualified borrowers.” I don’t know where to start here: someone who is against regulation is trying to argue that the CRA tied the hands of regulators who otherwise would have clamped down on flexible mortgages to rich people? I’m in favor of tighter regulation of abusive mortgage products, but I don’t think the CRA is to blame for lack of regulation.

There's no need to grant the premises, either. The root of the problem, according to Wallison, was that the CRA forced lenders to lower standards in one market. The vast majority of subprime loans were made by institutions that were not even governed by the CRA in the first place. If institutions governed by the CRA chose to follow the behavior of those not governed by the CRA, that was their choice, pure and simple. So not only does the argument suffer a mid-air accident, it never gets off the ground.

And there's another reason for that: the large majority of low-income loans made under CRA were traditional fixed-rate loans, not subprime, and they weren't even bad loans. Wallison says:

There is very little data available on the performance of loans made under the CRA. The subject has become so politicized in light of the housing meltdown and its effect on the general economy that most reports—favorable or unfavorable—should probably be discounted.

This is a very clear rhetorical tactic: when you can't find data that you need to support your argument, say the data don't exist, or that they are so politicized that they should be discounted. (This is the “two sides to every story” argument used so effectively by, among others, people who say that global warming is not happening.) Wallison does, however, cite one study:

One of the few studies of CRA lending in comparison to normal lending was done by the Federal Reserve Bank of Cleveland, which reported in 2000 that “respondents who did report differences [between regular and CRA housing loans] most often said they had lower prices or higher costs or credit losses for CRA-related home purchase and refinance loans than for others.”

This is the sentence immediately before the one Wallison cites, plus the one he does cite:

A large proportion of respondents in all bank-size categories reported that CRA-related and other home purchase and refinance loans have very similar origination and servicing costs, credit losses, and pricing on a per-institution basis. However, the respondents who did report differences most often said they had lower prices or higher costs or credit losses for CRA-related home purchase and refinance loans than for others.

Read that first sentence again: a large majority of banks say CRA loans do just fine. This is Wallison's source I'm quoting. This is the best evidence Wallison can find, and presumably (since this is his specialty, not mine) he went looking for it. Not only does the plane not get off the ground, but the airline canceled the flight before boarding.

OK, I've already spent more of my morning on this than I wanted to, and I haven't even gotten to the section on Fannie and Freddie.

Dec 15, 2008 10:25 AM

Baseline Scenario, 12/15/08

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

Baseline Scenario for 12/15/2008: [pdf version](#)

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

Summary

- 1) The world is heading into a severe slump, with declining output in the near term and no clear turnaround in sight.
- 2) Consumers in the US and the nonfinancial corporate sector everywhere are trying to “rebuild their balance sheets,” which means they want to save more.
- 3) Governments have only a limited ability to offset this increase in desired private sector savings through dissaving (i.e., increased budget deficits that result from fiscal stimulus). Even the most prudent governments in industrialized countries did not run sufficiently countercyclical fiscal policy in the boom time and now face balance sheet constraints.
- 4) Compounding these problems is a serious test of the eurozone: financial market pressure on Greece, Ireland and Italy is mounting; Portugal and Spain are also likely to be affected. This will lead to another round of bailouts in Europe, this time for weaker sovereigns in the eurozone. As a result, fiscal policy will be even less countercyclical, i.e., governments will feel the need to attempt precautionary austerity, which amounts to a further increase in savings.
- 5) At the same time, the situation in emerging markets moves towards near-crisis, in which currency collapse and debt default is averted by fiscal austerity. The current IMF strategy is designed to limit the needed degree of contraction, but the IMF cannot raise enough resources to make a difference in global terms - largely because potential creditors do not believe that large borrowers from an augmented Fund would implement responsible policies.
- 6) The global situation is analogous to the problem of Japan in the 1990s, in which corporates tried to repair their balance sheets while consumers continued to save as before. The difference, of course, is that the external sector was able to grow and Japan

could run a current account surplus; this does not work at a global level. Global growth prospects are therefore no better than for Japan in the 1990s.

7) A rapid return to growth requires more expansionary monetary policy, and in all likelihood this needs to be led by the United States. But the Federal Reserve is still some distance from fully recognizing deflation and, by the time it takes that view and can implement appropriate actions, declining wages and prices will be built into expectations, thus making it much harder to stabilize the housing market and restart growth.

8) The push to re-regulate, which is the focus of the G20 intergovernmental process (with the next summit set for April 2), could lead to a potentially dangerous procyclical set of policies that can exacerbate the downturn and prolong the recovery. There is currently nothing on the G20 agenda that will help slow the global decline and start a recovery.

9) The most likely outcome is not a V-shaped recovery (which is the current official consensus) or a U-shaped recovery (which is closer to the private sector consensus), but rather an L, in which there is a steep fall and then a struggle to recover.

[Details after the jump]:

Introduction: Our Baseline vs. the Current Consensus

The current consensus view (e.g., as seen in the World Bank's Global Economic Prospects) is that we are having a serious downturn, with annualized growth for the fourth quarter in the US at minus 4% or worse. But the consensus is that a recovery will be underway by mid-2009 in the US and shortly thereafter in the eurozone. This will help bring up growth in emerging markets and developing countries, so by 2010 global growth will be moving back towards its 2006-2007 rates.

Our baseline view is considerably more negative. While we agree that a rapid fall is underway and the speed of this is unusual, we do not yet see the mechanisms through which a turnaround occurs. In fact, in our baseline view, there is considerably more decline in global output already in the works and, once the situation stabilizes, it is hard to see how a recovery can easily be sustained.

The consensus view focuses on disruptions to the supply of credit and recognizes official attempts to support this supply. In contrast, we emphasize that the crisis of confidence from mid-September has now had profound effects on the demand for credit and its counterpart, desired savings, everywhere in the world.

To explain our position, we first briefly review the background to today's situation. Readers who would like more detail on what happened in and since mid-September should refer to the [previous \(November 10\) edition](#) of our Baseline Scenario. We then review both the current situation and the likely prognosis for policy in major economies and for key categories of countries. While a great deal remains uncertain about economic

outcomes, after the US presidential election much of the likely policy mix around the world has become clearer. We conclude by reviewing the prospects for sustained growth and linking the likely vulnerabilities to structural weaknesses in the global system, including both the role played by the financial sector almost everywhere and the way in which countries' financial sectors interact. In the end we come full circle - tomorrow's dangers can be linked directly back to the underlying causes of today's crisis.

Background

We are in a severe "credit crisis," but one that is frequently misunderstood in four ways.

1. While the US housing bubble played a role in the formation of the crisis and continued housing problems remain an issue, the boom was and the bust is much broader. This was a synchronized debt-financed global boom, facilitated by flows of capital around the world.
2. The boom exacerbated financial system vulnerability everywhere. But the crisis in the current form was not inevitable. The severity of today's crisis is a direct result of the failure to bail out Lehman and the way in which AIG was "saved" - so that senior creditors took large losses and confidence in the credit system was shaken much more broadly.
3. The initial problem, from mid-September 2008, was a fall in the supply of credit. But this does not mean that official support for credit supply will turn the situation around. Now the crisis has affected the demand side - people and firms want to pay down their debts and increase their precautionary savings.
4. There is no "right" level of debt, so we don't know where "deleveraging" (i.e., the fall in demand for and supply of credit) will end. Debt could stabilize where we are now or it could be much lower. Leverage levels are very hard for policy to affect directly, as they result from millions of decentralized decisions about how much people borrow. Anyone with high levels of debt in any market economy is now re-evaluating how much debt is reasonable for the medium-term.

The Situation Today

United States

Households did not save much since the mid-1990s and reduced their savings further this decade, in part because of the increase in house prices; this was the counterpart of the large increase in the US current account deficit. Desired household saving is now increasing. The main dynamic is a fall in credit demand rather than constraints on credit supply in the US.

The US corporate sector is in better shape but, faced with the disruptions of the last three months, is also seeking to pay down debt and conserve cash. Even entities with deep

pockets, strong balance sheets and long investment horizons (e.g., universities, private equity) are cutting back on spending and trying to strengthen their balance sheets.

There are constraints on all three main potential policy responses: fiscal, financial, and monetary.

First, a substantial fiscal stimulus has already been pre-announced by the incoming Obama administration, and this will have broad support in the next Congress. If the stimulus comes in (over 2 years) closer to \$500bn than \$1 trillion, this may be seen as a disappointment relative to current expectations. The constraint, of course, is the US balance sheet. The US balance sheet is strong relative to most other industrialized countries - private sector holdings of government debt are close to 40% of GDP. But the US authorities also have to worry about increasing Social Security and Medicare payments in the medium term, and so are reluctant to accumulate too much debt. The underlying problem is that fiscal policy was not sufficiently counter-cyclical during the boom. The federal fiscal stimulus will be helpful, but it will not be enough to prevent a substantial decline or quickly turn around the economy.

Second, financial sector policy has not been encouraging. Dramatic bank recapitalization is off the table, at least for the time being, because this would imply effective nationalization, which is not appealing to Wall Street. The original TARP terms from mid-October are no longer available, as they were very generous to banks and there is some backlash against bailouts. Also, the latest Citigroup bailout (from mid-November) is not scalable to the entire financial system as this was an even worse deal for the taxpayer. Policies that would directly address the financing of housing are appealing and could help at the margin. But this approach seems unlikely to scale up politically in such a way as to make a macroeconomic difference. This route will take a long time and many modified mortgages will also become delinquent.

Third, monetary policy can still make a difference, particularly as we risk entering a deflationary spiral with falling prices and downward pressure on nominal wages. On December 12, 2008, the inflation swap market implied minus 0.5% average annual inflation for the next five years. Deflation is not yet completely entrenched - over a 30 year horizon, the implied average annual inflation rate is 1.75% - so it is still possible to turn the situation around. However, the dominant view at the Fed remains that deflation is not yet the main issue, and there is no internal consensus in favor of printing money (or focusing on increasing the monetary base).

Generating positive inflation in this environment is not easy. One way would be to talk down the dollar. The fact that this would feed into inflation is not a danger but a help in this context. Unfortunately, this would be seen as too much of a break from the tradition of a "strong dollar" and it would likely upset both Wall Street and US allies. Ultimately, probably later in 2009 (and definitely by early 2010), the US will move to a more expansionary monetary policy and manage to generate inflation. This will weaken the dollar and put pressure on other countries to follow suit - expansionary monetary policy is infectious in a way that expansionary fiscal policy is not.

Eurozone

There is growing pressure on some of the weaker sovereigns that belong to the euro currency union. Greece faces the most immediate problems, as demonstrated both by widening credit default swap spreads and increasing spreads of Greek bonds over German government bonds. The cost of servicing Greek government debt is thus rising at the same time as Greece has to roll over debt worth around 20 percent of GDP in the coming year. Greece has a debt-to-GDP ratio that is close to 100 percent, so there is real risk of default.

In our baseline view, Greece receives a fairly generous bailout from other eurozone countries (and probably from the EU). This, however, does not come early enough to prevent problems from spreading to Ireland and other smaller countries (which then also need to implement fiscal austerity or to receive support). Italy is also likely to come under pressure, due to its high debt levels, and here there will be no way other than austerity. With or without a bailout, Greece and other weaker euro sovereigns will need to implement fiscal austerity. The net result is less fiscal stimulus than would otherwise be possible, and in fact there is a move to austerity among stronger euro sovereigns as a signal. Governments will therefore struggle to dissave enough to offset the increase in private sector savings.

Monetary policy will be slow to respond. The European Central Bank decision-making process seeks consensus and some key members are still more worried about inflation down the road than deflation today. Eventually the ECB will catch up, but not before there has been considerable further slowing in the eurozone.

The current official consensus is that the eurozone will start to recover in mid-2009 and be well on its way to achieving potential growth rates again by early 2010. This seems quite implausible as a baseline view.

United Kingdom

Over the last month, the Bank of England has moved to a pro-inflation policy, with big interest rate cuts and statements that are tending to depreciate the pound. The inflation swap market implies annual average inflation in the UK of 0.8% per year over the next five years. This fits with the fiscal stimulus of the British government, and presumably amounts to effectively inflating away debts.

Still, the UK faces a major problem with falling house prices and a decline in the financial sector. We could think of the UK as a place with one primary export: financial services. This sector has just suffered a major terms of trade shock and will contract globally, so first-order macroeconomic adjustment in the UK is essential. Inflation will be used to cushion the necessary real adjustment.

Japan

The yen has appreciated as carry trades have unwound, so people no longer borrow in yen to invest elsewhere. Corporates are likely to want to strengthen their balance sheets further. Households are unlikely to go on a spending spree.

The government's balance sheet is weak, but it is funded domestically (in yen, willingly bought by households), so there is room for further fiscal expansion. However, this is unlikely to come quickly.

The ability of the Japanese central bank to create inflation has proved limited. Once deflationary expectations are established, these are hard to break. In the inflation swap market, the average annual rate of inflation expected over five years is minus 2.4%, and an astonishing minus 1.0% over 30 years.

Emerging markets

The major increase in savings by China over the past 10 years was primarily due to high profits in the corporate sector. This was the counterpart to the current account. Chinese growth now seems likely to slow sharply.

Pressure on other emerging markets will intensify after Ecuador's default. Some countries will be willing to go early to the IMF, but for others the fear of a potential stigma will lead them to prefer fiscal austerity (and perhaps even contractionary monetary policy) without IMF involvement. The IMF will be helpful in smaller emerging markets, such as in East-Central Europe. But it doesn't have (and won't receive) enough funding to make a difference for large emerging markets, whose problems are due to their own policy mix, particularly allowing the private sector to take on large debts in dollars. Emerging markets will also have no appetite for massive bailout loans.

Larger emerging markets will not suffer collapse, but will have increased (attempted) savings and, as a result, will experience slowdowns. The temptation for competitive devaluation will grow over time; adjusting the exchange rate is easier if there is no IMF program.

But emerging markets cannot grow out of the recession through exports unless there is a strong recovery in the US or the eurozone or both, which is unlikely. Many emerging markets are particularly hard hit by the fall in commodity prices, which could be exacerbated by expected US policies to reduce oil consumption. Commodity prices are likely to fall further.

Political risks in China and other emerging markets create further downside risks. In our baseline, we assume no serious domestic or international disruptions in this regard.

Looking Forward: Structure of the System

Potential for Revising Expectations Upwards

The last few months have shown the importance of confidence. The severity of the current downturn was largely caused by the climate of fear that was triggered by the Lehman bankruptcy and that has yet to dissipate. In a downturn, poor policy choices have the procyclical effect of decreasing confidence further.

Conversely, increased optimism could itself have a significant stimulative effect on the world economy, as the announcement of President-Elect Obama's economic team - which contained no surprises - boosted spirits in the US stock market. While attitudes today are resoundingly negative, in virtually every sector and every country, there is a strong human tendency to want to believe in positive stories and to think that things have improved with a "structural break." Arguably, the US recovered from the collapse of the technology bubble in 2000-2001 by convincing itself that housing prices would rise forever.

There is always the potential for another boom. This is especially true because it is politically difficult to impose regulation to dampen growth; central banks have shown little appetite to take away the famous punch bowl (see Alan Greenspan in particular); and boom environments create rational incentives for the private sector to play along in inflating the bubble of the moment (see Andrew Lo's testimony to Congress, [excerpted here](#)).

However, the answer to a recession should not be to seek out the next bubble. The only real way to protect a national economy in the face of systemic financial problems is with a sufficiently strong government balance sheet (i.e., low debt relative to the government's ability to raise taxes). This requires counter-cyclical fiscal policy during a boom, which is always politically difficult. However, this implies less room for fiscal stimulus now, or a need to put in place measures now that will compensate for the stimulus once the economy has recovered.

What's the real structural problem?

In order to create the conditions for long-term economic health, we need to identify the real structural problem that created the current situation. It wasn't a particular set of payments imbalances (read: US-China), as these can and will change (which does not excuse policymakers who refused to address this issue). It wasn't the failure of a particular set of domestic regulators, as regulatory challenges and responses change over time (which doesn't excuse the specific regulators).

The underlying problem was that, after the 1980s, the "Great Moderation" of volatility in industrialized countries created the conditions under which finance became larger relative to GDP and credit could grow rapidly in any boom. In addition, globalization allowed banks to become big relative to the countries in which they are based (with Iceland as an extreme example). Financial development, while often beneficial, brings risks as well.

The global economic growth of the last several years was in reality a global, debt-financed boom, with self-fulfilling characteristics - i.e., it could have gone on for many

years or it could have collapsed earlier. The US housing bubble was inflated by global capital flows, but bubbles can occur in a closed economy (as shown by [experiments](#)). The European financial bubble, including massive lending to Eastern Europe and Latin America, occurred with zero net capital flows (the eurozone had a current account roughly in balance). China's export-driven manufacturing sector had a bubble of its own, in its case with net capital outflow (a current account surplus).

But these regional bubbles were amplified and connected by a global financial system that allowed capital to flow easily around the world. We are not saying that global capital flows are a bad thing; ordinarily, by delivering capital to the places where it is most useful, they promote economic growth, in particular in the developing world. But the global system also allows bubbles to feed on money raised from anywhere in the world, exacerbating global systemic risks. When billions of dollars are flowing from the richest countries in the world to Iceland, a country of 320,000 people, chasing high rates of interest, the risks of a downturn are magnified, for the people of Iceland in particular .

The prevalence of debt in the global boom was also a major contributing factor to today's recession (although major disruptions could also arise from the busting of pure equity-financed booms). Debt introduces discontinuities on the downside: instead of simply becoming losing money, companies with high debt levels go bankrupt in hard times. Lehman, AIG, and now GM all created systemic risks to the US and global economies because one default can trigger a series of defaults among other companies - and simply the fear of those dominos falling can have systemic effects. Similarly, emerging market defaults can have systemic effects by spreading fear and causing investors to pull out of unrelated by similarly situated countries (and causing speculators to bet against their currencies and stock markets).

Ideally, global economic growth requires a rebalancing away from the financial sector and toward non-financial industries such as manufacturing, retail, and health care (for an expansion of this argument, see our [earlier op-ed](#)). Especially in advanced economies such as the US and the UK, the financial sector has accounted for an unsustainable share of corporate profits and profit growth. However, the financial sector, despite the experiences of the last year, is still powerful enough to resist significant structural reform. While this will not prevent a return to economic growth, it will maintain all of the risks that led to the current situation - in particular, the risk of synchronized booms and busts around the world.

Further reading

Background material

Previous edition of Baseline Scenario: <http://baselinescenario.com/2008/11/10/baseline-scenario-111008/>

Beginners section: <http://baselinescenario.com/financial-crisis-for-beginners/>

Causes of the crisis: <http://baselinescenario.com/category/causes/>

MIT classes on the global crisis, including webcasts:
<http://baselinescenario.com/category/classroom/>

More details on current topics

Auto bailouts: <http://baselinescenario.com/tag/auto-industry/>

Global fiscal stimulus: <http://baselinescenario.com/2008/12/08/global-fiscal-stimulus-will-this-save-weaker-eurozone-countries/>

Latest on official forecasts: <http://baselinescenario.com/2008/12/11/forecasting-the-official-forecasts/>

Citigroup bailout (the second round):

<http://baselinescenario.com/2008/11/27/international-implications-of-the-citigroup-bailout/> and <http://baselinescenario.com/2008/11/24/citigroup-bailout-weak-arbitrary-incomprehensible/>

As it happened

First edition of Baseline Scenario (September 29, 2008):

<http://baselinescenario.com/2008/09/29/the-baseline-scenario-first-edition/>

Testimony to Joint Economic Committee (October 30, 2008):

<http://baselinescenario.com/2008/10/30/testimony-before-joint-economic-committee-today/>

“The Next World War? It Could Be Financial” (October 11, 2008):

<http://baselinescenario.com/2008/10/12/next-up-emerging-markets/>

Pressure on emerging markets (October 12, 2008):

<http://baselinescenario.com/2008/10/12/next-up-emerging-markets/>

Pressure on the eurozone (October 24, 2008):

<http://baselinescenario.com/2008/10/24/eurozone-default-risk/>

Bank recapitalization options (November 25, 2008):

<http://baselinescenario.com/2008/11/25/bank-recapitalization-options-and-recommendation-after-citigroup-bailout/>

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Dec 14, 2008 11:28 PM

The Lawsuits Begin, Part 2

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

Yesterday I mentioned a lawsuit against Goldman Sachs ([article by HousingWire](#)) alleging that Goldman misled investors in its mortgage securitizations. Here's the [complaint](#). It's a fun read.

The allegations are pretty simple. As part of each securitization, Goldman had to produce a registration statement and prospectus. In theory, as any investor knows, you are supposed to read the prospectus before buying a security. The claim is that these statements and prospectuses (someone help me with that plural) contained false statements regarding the underwriting standards used when making the underlying mortgages. The bulk of the complaint (pages 12-28) goes originator by originator and compares the statements made about that originator's lending practices in the prospectus to information that has since emerged about how these lenders actually made loans.

One thing that struck me was how open these prospectuses were about what was going on. For example, here's a passage on Countrywide's "no income/no asset" loans:

Under the Streamlined Documentation Program, appraisals are obtained only if the loan amount of the loan being refinanced had a Loan-to-Value Ratio at the time of origination in excess of 80% or if the loan amount of the new loan being originated is greater than \$650,000. In addition, under the Streamlined Documentation Program, a credit report is obtained but only a limited credit review is conducted, no income or asset verification is required, and telephonic verification of employment is permitted. the maximum Loan-to-Value Ratio under the Streamlined Documentation Program ranges up to 95%. [. . .]

Under the Stated Income/Stated Asset Documentation Program, the mortgage loan application is reviewed to determine that the stated income is reasonable for the borrower's employment and that the stated assets are consistent with the borrower's income. The Stated Income/Stated Asset Documentation Program permits maximum Loan-to-Value Ratios up to 90%.

And so on and so on. Then there are other originators for whom Goldman used language such as the following:

SunTrust underwriting guidelines are designed to evaluate the borrower's capacity to repay the loan, to evaluate the credit history of the borrower, to verify the availability of funds required for closing and cash reserves for fully documented loans, and to evaluate the acceptability and marketability of the property to be used as collateral. SunTrust may

consider a loan to have met underwriting guidelines where specific criteria or documentation are not met if, upon analyzing the overall qualitative evaluations of the loan package, there are acceptable compensating factors that can be used.

I love that phrase, “are designed to evaluate.” Strictly speaking, it means ” our underwriting guidelines are meant to evaluate ability to repay, but they may not . . . and sometimes we don’t follow them anyway.”

I quote these things at length because they go to an issue I’ve discussed before: who is to blame? Originators because they told Goldman they were applying underwriting standards that they weren’t in fact applying? Goldman because it knew the originators weren’t applying those standards but pretended it didn’t know in the prospectuses? Or investors because the prospectuses said exactly what was going on (“no income or asset verification is required . . . SunTrust may consider a loan to have met underwriting guidelines where specific criteria or documentation are not met”) and they bought the securities anyway?

Plaintiffs conclude, “The massive foreclosure rate and extraordinary delinquencies have further confirmed defendants’ misrepresentations concerning the lending practices detailed above.” But this is not strictly true. Massive foreclosures and extraordinary delinquencies are completely consistent with the lax lending practices detailed openly in the prospectuses themselves. But this doesn’t mean that plaintiffs don’t have a case: all they have to prove is that actual underwriting standards did not even live up to the descriptions in the prospectuses, which may turn out to be true.

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Dec 13, 2008 11:27 PM

Causes: Subprime Lending

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

Other posts in this occasional series.

Six months ago, this post would have been unnecessary. Back then, for most people, the crisis was the “subprime crisis:” subprime lending had become too aggressive, many subprime mortgages were going to go into default, and as a result securities backed by subprime mortgages were falling in value. Hedge funds, investment banks, and commercial banks were in danger insofar as they had unhedged exposure to subprime mortgages or subprime mortgage-backed securities (MBS). Still, if you were to stop the

average reader of the New York Times or the Wall Street Journal on the street and ask what caused the current financial and economic crisis, there is a good chance he or she would start with subprime lending.

Asking whether subprime lending caused the crisis raises all the questions about agency and causality that I've raised before. On the agency question, insofar as there was a problem in the subprime lending sector - and few would deny that there was - does the fault lie with borrowers who took on loans they had no chance of repaying, perhaps sometimes without understanding the terms; with the mortgage lenders who lent them the money without doing any due diligence to determine if they could pay them back; with the investment bankers who told the mortgage lenders what kinds of loans they needed to package into securities; with the bond rating agencies who blessed those securities while taking fees from the investment banks; with the investors who bought those securities without analyzing the risk involved; or with the regulators who sat on their hands through the entire process? Note in passing that it may have been perfectly rational, as well as legal, for an investor to buy an MBS even knowing that the loans backing it were going to default, but making a bet that he could resell the MBS before the price fell, under the "greater fool" theory of investing. (It may have been rational for an investment bank to do the same, but not necessarily legal, given the disclosure requirements relating to securities. Goldman Sachs is [being sued](#) over precisely this question.) Readers of this blog know that my opinion is that, although there is blame to be shared along the chain, the greatest fault lies with the regulators, for a few reasons. First, although the desire to make money may cause problems, it can be no more be said to be a cause of anything than gravity can be said to be the cause of a landslide; second, [bubbles are inevitable](#), at least in an unregulated market; and third, there is a difference in kind between the mistake made by an investor, who is foolish and loses some money, and the mistake made by a regulator (or a legislator who votes to reduce funding for regulators), whose job is to serve the public interest.

But that was all the preamble, because today I want to talk about the question of causality.

I think it's generally accepted that the crisis we know today first *appeared* in the subprime lending market, where an increase in delinquency rates triggered a fall in asset values. Those problems were clearly visible [early in 2007](#) (it's impossible to say exactly when they were first visible, because some people had been warning of the problem for years, to little effect), and over the next year the main entertainment in the financial sector was watching banks and hedge funds suddenly realize they had large subprime exposures and either take writedowns or fold. But I think there are three ways to understand the relationship of subprime and the current crisis:

1. Subprime was the first place where various structural problems appeared, but those problems existed elsewhere, where they only appeared later. If the subprime lending boom had never happened, we would still be roughly where we are today. Call this the "canary in the coal mine" theory.

2. Subprime was the first place where various structural problems appeared, and the subprime crisis generated additional pressure that exposed those problems in other areas. For example, subprime concerns caused a pullback in lending, which caused a leveling off in home prices, which caused a reduction in housing construction, which slowed economic growth, etc. Call this the “domino” theory.
3. Subprime was a necessary cause of the crisis. Without subprime, the levels of housing prices, indebtedness, and risk in the system would have been sustainable indefinitely. Call this the “prime mover” theory.

Only under the prime mover theory can subprime truly be said to have caused the crisis. Under the domino theory it played the role of a precipitating but unnecessary cause. Under the canary theory it is just a leading indicator.

In my opinion, subprime was probably the canary, and possibly the first domino. There are various arguments against the prime mover theory:

- The U.S. subprime sector is simply not big enough. Although the numbers have been shifting in the last couple of years, roughly 80% of outstanding residential mortgages in the U.S. are prime; the other 20% is split between subprime and Alt-A. About 50 million homeowners have a mortgage, of which about 7 million have subprime mortgages. The idea that an increase in the delinquency percentage among 7 million U.S. homeowners (total mortgage value about \$1-2 trillion, so losses on foreclosure - assuming a 100% foreclosure rate - about \$0.5-1 trillion) could have by itself caused the largest economic downturn in the world since the 1930s is hard to credit.
- In absolute terms, losses in the subprime sector will be dwarfed by losses in the prime sector. [Credit Suisse](#) is now forecasting 8.1 million foreclosures by 2012, over 5 million of those outside of subprime. Current-month foreclosures among prime mortgages have already [caught up to and passed](#) (see chart on p. 4) foreclosures among subprime mortgages.
- The U.S. and global economies bumped along passably for over a year from the beginning of the subprime crisis. The U.S. recession did begin in December 2007 ([Econbrowser](#) for a good post on recession dating), but most of the numbers don't start [falling off cliffs](#) until the second half of 2008. By the time Lehman went bankrupt in September, it's probably true that all of the bad news about subprime was already priced into the various markets. What's happened since then is new bad news about every other market.

Deciding between the canary and domino theories is tougher. The canary theory is that there were lots of boulders perched precariously on a cliff and subprime was just the first one to fall. The domino theory is that the subprime boulder knocked into a lot of much bigger boulders and knocked them off, but something else could have knocked them off just as easily. The domino theory could go something like this: Subprime caused writedowns and instability in the financial sector and nervousness in the housing market; nervousness in the housing market caused housing prices to start to fall, making it harder to refinance and increasing delinquencies on all kinds of mortgages; expanding

writedowns caused a liquidity run on banks such as Bear Stearns and eventually Lehman; falling house prices and the consequent wealth effect reduced U.S. personal consumption, slowing economic growth; reduced consumption had the usual multiplier effect, reducing incomes and creating a recessionary cycle; the the recession hurt the value of every other type of debt (commercial mortgages, credit cards, etc.), triggering a full-scale banking crisis; and the fear created by the banking crisis led to the sharp downturn in credit and in consumption that put us where we are today.

I think there are at least three arguments for the canary theory and against the domino theory.

First, there is the issue of timing. The subprime crisis took an awfully long time to blossom into a full-fledged global recession and, as I said above, by the time the latter occurred the full scale of the subprime problem was more or less known to everyone. On that principle, the other boulders withstood the bump they got from the subprime boulder.

Second, once we had a housing bubble, it was inevitable that it was going to pop one way or another. So one question to ask is whether subprime lending was the reason for the housing bubble. Even at the [peak](#) of housing prices in 2006, subprime loans only made up about 20% of total mortgage origination volume. (Everyone cites Inside Mortgage Finance, but you have to pay for their data; here's an [NPR primer](#) on subprime with a chart.) Could that 20% have been solely responsible for the bubble? I suppose it's possible, depending on the shape of the supply curve, but count me as skeptical.

Third, there is another good explanation for what pushed all those boulders down. James Hamilton thinks that the economy was structurally fragile, and the shock that knocked the boulders down was the [oil price spike](#).

My view is that we were teetering on the edge of a cliff last summer, and the oil price shock may have been just enough to tip us over the edge. As we did so, the financial disaster that had always been a potential became a reality.

The trouble is, now that the economy is in free fall, it's going to take more than \$2 gasoline to pull us back up.

Ultimately, I think this question (canary or domino) is not definitively answerable, like many historical counterfactual questions, but I'm on the side of the canary.

One final note: Blaming subprime can have a disturbing overtone of blaming poor people for reaching beyond their means. First of all, it's not true that subprime has more than a vague correlation with income. In the words of the late [Tanta](#):

The capacity C of traditional underwriting was, of course, always relative to the proposed transaction. A lower-income person buying a lower-priced property was, you see, not a case of subprime lending; assuming a reasonable credit history, it was a prime loan.

People with quite good incomes and stellar credit histories who tried to buy way too much house got turned down by the prime lenders.

More often, however, people in gentle society realize it's not proper to blame poor people, so they take aim instead at the Community Reinvestment Act and liberal politicians generally for attempting to extend homeownership to people who couldn't afford it. This line of attack was most recently exhibited on the New York Times [op-ed page](#). I will leave the rebuttals to the experts:

- [Mark Thoma](#) (2 separate posts, with additional links)
- [Barry Ritholtz](#) (2 separate posts)
- [Randall Kroszner](#) (cited by Ritholtz)

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Dec 12, 2008 10:58 PM

[**Sign of the Apocalypse: Bush Administration Ready to Use TARP to Bail Out Automakers**](#)

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

I'm probably misusing the word, but I just think it's incredibly ironic that, thanks to the Senate Republicans who blocked the compromise worked out between the White House and the Democratic majority to extend short-term loans to the automakers, the Bush Administration has now [reversed its position](#) and is open to using TARP money to keep GM and possibly Chrysler alive. Who ever thought we would see the day that this administration would prop up the Big 3 - and who thought it would happen because they were forced into it from their right?

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Dec 12, 2008 10:58 PM

[**Free Market Ideology, Epilogue**](#)

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

In the most [recent post](#) in the [Causes](#) series, I expressed a fair amount of agreement with Joseph Stiglitz's criticism of an excess of faith in the free market and the lax regulation that results. With the Bernard Madoff scandal ([New York Times](#); [WSJ](#) has more information but requires subscription), Felix Salmon is asking, [where were the regulators?](#)

(By the way, if you're wondering how the Madoff fraud was possible, remember that a hedge fund is like a bank in the sense that you put your money in and you generally leave it there for a while, and although you may take some out now and then you may also put some more in now and then, and other people are putting it in, and so on. With a bank, not all depositors can get their money out at the same time because it is tied up in long-term loans that the bank can't call in. With Madoff's fund, investors couldn't get their money out because he had, effectively, burned it. They had been getting periodic paper statements showing returns, but there were no real returns, and hence no assets behind that paper.)

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Dec 11, 2008 12:11 PM

[**Forecasting the Official Forecasts**](#)

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

[The IMF is signalling](#) that it will further revise down its global growth forecast. This is after cutting the forecast sharply in October and again in November. Their [latest published view](#) is growth in 2009 will be 2.2% year-on-year, and 2.4% fourth quarter on fourth quarter. [This view is dated](#) November 6, 2008, so you should think of it as reflecting what the IMF knew at the end of October.

I obviously can't predict exactly what the next forecast will look like, as there is a lot of economic ground to cover between now and mid-January. But here are some considerations to keep in mind.

First, the World Bank came out this week with its [Global Economic Prospects](#) forecast. There was a fair amount of attention for their headline number of 0.9% growth for 2009, but this was essentially the same as the IMF's previous number from the end of October - if you dig down through [the IMF's table](#), at the end of all the growth numbers there is a row for "world growth based on market exchange rates," with 1.1% for 2009 (annual

average; the 4th column). So the Bank basically reduced the IMF's global forecast by the minimum plausible amount, given that the last 6 weeks were so nasty.

(Aside: The IMF's core business is market exchange rates, while the Bank is in the business of calculating PPPs. Yet the Bank's headline growth numbers use market exchange rates to weight national growth rates, while the IMF uses purchasing power parities, PPPs. Don't ask.)

Second, there is information in the Bank's forecast for 2010. The Fund will publish its 2010 forecast only in January, and it doesn't have to follow the Bank's lead, but the numbers do indicate what key stakeholders are thinking. And the answer is: a rapid recovery, with annual average global growth of 3% in the Bank's headline number, which would be equivalent to over 4% in the Fund's measure. And remember that annual averages are very much affected by what happens early in the previous year and in the first quarter of the year being "measured" (so 2009 annual averages will likely fall as the 4th quarter of 2008 seems likely to be so bad.) Basically, the Bank is forecasting a rapid rebound in global growth - pretty close to what we had in 2007.

Third, where does the recovery come from? To get at this, you have to use [the interactive feature in the Bank's table](#), which is nice in principle but seems to run slow and is annoyingly vague on which countries are in some of the categories. Industrialized countries ("high income" in Bank terminology) rebound to +2% in 2010 (after contracting by only -0.1% in 2009; in comparison, this group grew 2.6% in 2007); the eurozone grows at +1.6% (after a fall of -0.6% in 2009, and 2.6% in 2007), East Asia and Pacific grows at +7.8% (after a pretty strong 6.7% in 2009, and 10.5% in 2007), and developing countries as a whole grow at +6.1% (after slowing to 4.5% in 2009).

So it's a recovery across the board, probably led by the US but with the eurozone close behind. And the 4th quarter-4th quarter for 2010 implicit here is likely even more positive.

Now I completely that there is an upside scenario in the current situation. But the Bank has produced an optimistic baseline scenario (ask yourself: what is the upside to this, 6% growth in 2010?) This presumably reflects both developing countries wanting to stay positive, e.g., about commodity prices (and justify financing their current account deficits, rather than adjusting) as well as the G7's global strategy, which to date can be summarized as: Don't Worry, Be Happy.

Of course, this could happen. But at least for this Bank view, as they say in the forecasting business, the risks are mostly to the downside.

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Dec 11, 2008 12:19 AM

Causes: Free Market Ideology

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

[Other posts in this occasional series.](#)

Joseph Stiglitz, the 2001 Nobel Prize winner and the most cited economist in the world (according to Wikipedia) has an article aggressively titled “[Capitalist Fools](#)” in *Vanity Fair* that purports to identify five key decisions that produced the current economic crisis, but really lays out one more or less unified argument for what went wrong: free market ideology or, in his words, “a belief that markets are self-adjusting and that the role of government should be minimal.”

The five “decisions,” with Stiglitz’s commentary, are:

1. Replacing Paul Volcker with Alan Greenspan, a free-market devotee of Ayn Rand, as Fed Chairman. (Incidentally, when I was in high school, I won \$5,000 from an organization of Ayn Rand followers by writing an essay on *The Fountainhead* for a contest.) Stiglitz criticizes Greenspan for not using his powers to pop the high-tech and housing bubbles of the last ten years, and for helping to block regulation of new financial products.
2. Deregulation, including the repeal of Glass-Steagall, the increase in leverage allowed to investment banks, and the failure to regulate derivatives (which Stiglitz accurately ascribes not only to Greenspan, but to Rubin and Summers as well).
3. The Bush tax cuts. Stiglitz argues that the tax cuts, combined with the cost of the Iraq War and the increased cost of oil, forced the Fed to flood the market with cheap money in order to keep the economy growing.
4. “Faking the numbers.” Here Stiglitz throws together the growth in the use of stock options - and the failure of regulators to do anything about it - and the distorted incentives of bond rating agencies - and the failure of regulators to do anything about it.
5. The bailout itself. Stiglitz criticizes the government for a haphazard response to the crisis, a failure to stop the bleeding in the housing market, and failing to address “the underlying problems—the flawed incentive structures and the inadequate regulatory system.” (There’s regulation again.)

I have a lot of sympathy for the argument that deregulation was a significant cause of the crisis. Calling it “deregulation” is not entirely accurate, because there are not that many major regulations you can point to that were actually repealed. Glass-Steagall is one, but I’m not sure that was centrally important. Even if commercial banks and investment banks had not been allowed to combine, I still think commercial banks would have made foolish loans, and investment banks would have still bought them to package them into securities. Actually, a lot of the subprime lending was done by specialized mortgage

lenders - not by the hybrid institutions created by Glass-Steagall - until they got bought up at the peak of the boom.

In addition to traditional deregulation, I think there was a failure to enforce existing regulations, and a failure to create new regulations to keep pace with innovation in the financial sector. On paper, federal bank regulators have a great deal of power already. For example, the Office of the Comptroller of the Currency, which regulates national banks, has the following powers (from their [website](#)):

- Examine the banks.
- Approve or deny applications for new charters, branches, capital, or other changes in corporate or banking structure.
- Take supervisory actions against banks that do not comply with laws and regulations or that otherwise engage in unsound banking practices. The agency can remove officers and directors, negotiate agreements to change banking practices, and issue cease and desist orders as well as civil money penalties.
- Issue rules and regulations governing bank investments, lending, and other practices.

The FDIC similarly has the power to examine banks, assessing issues such as capital adequacy, asset quality, and liquidity (those three concepts should be familiar to anyone following the crisis over the last three months). Now, it is true that most people failed to see the huge insolvency risks in the banking sector before they became frighteningly visible this fall. But most people aren't bank regulators, either.

Perhaps more importantly, there was a failure to keep regulation up to date with changes in the financial sector. The event that has gotten the most attention is the passage of the Commodity Futures Modernization Act in December 2000, which, among other things, preempted any regulation of credit default swaps. Another example is the hands-off attitude that was taken toward hedge funds, even as they became a larger and larger part of the financial system, and even after the crisis caused by the near-collapse of Long-Term Capital Management in 1998. Another is the failure of regulators to adapt to the proliferation of new types of subprime lending, recounted in the New York Times article with the great title, "[Fed Shrugged as Subprime Crisis Spread.](#)"

What could better regulation have accomplished? It could have reduced the growth of exploding subprime loans that borrowers had no chance of paying off. It could forced credit default swaps onto exchanges. It could have required greater disclosure by financial institutions of off-balance sheet positions. It could have brought more of the "shadow banking system" into the light. It could have forced banks to increase their capital. It could have prevented AIG from taking huge unbalanced credit default swap positions. In summary, it could have slowed the growth of the bubble and made the systemic risk in the financial sector more visible.

Well, maybe. I don't want to convey the impression that it's possible to have a perfect level of regulation, and there certainly is such a thing as too much regulation. And any

administration that tried to regulate the financial sector more closely would have faced bitter, vicious, well-financed opposition from the industry itself. The truth is we don't know what the consequences of different regulations would have been. Also, even with better regulation, there still would have been [trillions of dollars sloshing around](#), and lots of greedy people trying to divert it their way, and lots of [bubble-prone investors](#). But in general I think Stiglitz is right that we have definitely erred on the side of too little regulation for quite a while now.

Stiglitz also raises the issue of incentive structures, which I think is a special case of the issue of regulation. One of the cardinal principles of undergraduate economics is that firms are rational profit-maximizing actors. This is widely understood to mean that firms act in the best interests of the shareholders who own them. However, in the real world, firms are controlled by their senior executives, who are loosely controlled by the board of directors, who are partially controlled by the CEO and very tenuously controlled by large institutional investors. During bailout season, we've all heard the phrase "capitalizing the upside and socializing the downside" or something to that effect - shareholders get the profits and taxpayers get the losses. But there's another version of this that applies even without a taxpayer bailout.

Stiglitz is right that stock option-based compensation provides disproportionate rewards to executives (relative to shareholders) when stock prices rise and underproportionate risks to executives when stock prices fall. Even though, in general, it's better for everyone for the stock price to go up and worse for everyone for it to go down, the benefits (as a function of stock price) differ for the two groups. This induces executives to take excessive risks and to take steps to boost short-term profits at the risk of long-term losses. But I don't think the solution is government regulation to ban certain forms of compensation, because I just think it won't work; boards of directors can be very creative about finding ways to pay CEOs obscene amounts of money. This is basically a corporate governance problem, and the solution is some form of increased disclosure by companies and increased shareholder rights, so shareholders can more easily replace directors who are complicit in paying CEOs obscene amounts. Both of these things (disclosure and shareholder rights) probably require new regulations or legislation.

It's also important to remember that the U.S. was not the only country that had a housing bubble, and there was plenty of other bubble-like activity around the world, such as huge amounts of lending by Western and Central European banks into Eastern Europe and Latin America. Right now those banks are being burned as much by their emerging market investments as they are by their purchases of U.S. mortgage-backed securities. So when we talk about regulation, we have to remember that we live in a global financial system, and even if there were a virtuous country out there - call it Perfectistan - it would still be hurting today as a result of the downturn of the global economy. But the U.S. is still at the center of it all, for better or for worse.

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Dec 10, 2008 7:02 PM

[Remember Sovereign Wealth Funds?](#)

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

An [interview with Representative Jim Moran in the National Journal](#) reminds me that we haven't heard much about sovereign wealth funds recently. These are the large pools of money (in foreign currency) that were created as a result of large cumulative current account surpluses in some parts of the world (e.g., oil exporters, China, Singapore). They were quite controversial back in mid-2007, with concerns being raised - by Congress and others - regarding various aspects of their operation.

There are still some issues around [the lack of transparency of these funds](#), although a great deal of progress on this dimension has been made (including in and around the IMF) and we learned to worry more about black boxes in other parts of the financial system. But these funds might be coming back as a discussion item; for example: can they, should they, would you want them to, invest in US banks to help speed a turnaround?

Personally, I think the underlying current account surpluses are going to fall - this is one likely implication of [the decline in world trade for next year that the World Bank is forecasting](#) and the counterpart of what must be an increase in US savings (and thus a fall in our current account deficit). The accumulated stocks, in the form of sovereign wealth funds, will remain but they are no longer on explosive growth paths and this should take most of the edge off the conversation. But how open the US remains to various kinds of capital flows - and on what exact terms - will be a prominent issue on the Congressional agenda as we move into 2009. We do, after all, want people to buy the debt we will issue to fund the fiscal stimulus.

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Dec 9, 2008 3:37 PM

[Auto Bailout Update](#)

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

I admit - I have auto bailout fatigue. But given the amount of [virtual ink that has been spilled on this topic](#) here, I think I owe you a place where you can express your thoughts on the current plan.

The [Times](#) says we are close to a vote, although Senate Republicans may block it. Here is the [draft bill](#). The news article says it would take the form of \$15 billion in short-term emergency loans. Reading the bill itself, though, I can't find the number "\$15 billion" anywhere. This is what I read:

1. The President can appoint a person (or persons) to implement the bill, apparently colloquially known as the car czar.
2. Once the bill passes, the car czar can make bridge loans or lines of credit right now. Those loans can be for as much as is needed under the plans submitted to Congress last week.
3. The money is coming from "section 129 of division A of the Consolidated Security, Disaster Assistance, and Continuing Appropriations Act, 2009, relating to funding for the manufacture of advanced technology vehicles," which I'm guessing is the pre-existing bill providing \$25 billion in loans for R&D for fuel-efficient vehicles. That money will be then be replenished. It's not clear whether this creates a \$25 billion cap or not (how many times can the car czar draw on that money after it's been replenished?).
4. The loans are at 5%, increasing to 9% after 5 years. The government also gets a warrant to buy up to 20% of the loan amount in stock, at a price equal to the average price during the 15 days prior to December 2.
5. The short-term loans are conditional on the government, the automakers, and all interested parties (including unions and creditors) being able to agree on a comprehensive, long-term restructuring plan by March 31, 2009. The car czar can extend this deadline by 30 days, but that's it.
6. The car czar has a lot of power to monitor the auto companies and make sure they are meeting the targets of their restructuring plans; if they aren't, he can call in the loans.
7. There are some other fun but peripheral provisions, like getting rid of corporate aircraft, dropping lawsuits against state greenhouse gas regulation, and executive compensation limitations.

The big point is #5 (in my list). In short, this isn't a comprehensive bailout: it's a bridge loan to buy time to come up with a comprehensive bailout. This is roughly what Simon predicted (although I can't remember where). It enables the Bush administration to avoid having a car company fail on its watch, and enables the Democratic majority to say that they are doing something for the automakers, while deferring the hard questions. I assume that all of the controversial questions, like how big a concession the unions have to make, and whether or not it's possible to force creditors to take equity in place of debt, will re-emerge over the next few months.

Of course, we may still have the live TV drama of not quite knowing if the Republicans will provide the needed votes, like we had with the first TARP vote. I would also be

shocked to see President Bush sign a bill that requires car companies to drop their lawsuits against greenhouse gas regulation.

Let me know if I read the bill wrong.

Update: More from [Felix Salmon](#) on why it may be hard to get bondholders to agree to restructuring short of bankruptcy.

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Dec 8, 2008 7:11 PM

To Lend or Not To Lend, Fed Edition

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

This is so brilliant I'm going to just copy Mark Thoma's [entire post](#) right here:

Tim Duy emails:

Discordant headlines in Bloomberg:

[Fed's Kohn Says Regulators Should Encourage More Bank Lending Amid Turmoil](#): U.S. regulators should rise to the "challenge" of encouraging an expansion in bank lending amid a weakening economy and continuing financial-market turmoil, Federal Reserve Vice Chairman Donald Kohn said.

[Fed's Kroszner Urges Banks to Increase Capital Reserves to Buffer Losses](#): Federal Reserve Governor Randall Kroszner urged banks to hold more reserve capital to protect themselves from future "cascading losses," as potential market fixes are "no guarantee" against another credit crisis.

It's nice to see the Fed getting its communication problems under control.

This is the inconsistency I [pointed out](#) in the goals of the financial sector bailout. Banks need new capital to protect themselves against falling values of their existing assets. But if they use the new capital to make new loans, you defeat the purpose of the new capital, because that new capital is no longer helping support the existing assets. These are two separate and somewhat contradictory goals. Note that, according to Bloomberg (see the second link above), financial institutions have taken \$978 billion in writedowns - so far - and raised only \$872 billion in new capital. So while politicians rail against banks that

took TARP money but haven't expanded lending, the banks at least have logic on their side. I've been surprised that no one in Washington that I'm aware of has been willing to point this out.

(And do visit [Mark's blog](#) - it's a great place to get a variety of perspectives, updated throughout the day.)

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Dec 8, 2008 2:07 PM

[Global Fiscal Stimulus: Will This Save Weaker Eurozone Countries?](#)

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

Finally, the global economic policy ship begins to turn. We are now seeing fiscal stimulus package announcements every week, if not every day. And packages that we previously knew about are re-announced for emphasis and with an expanded mandate. In all likelihood, we are looking at a fiscal stimulus in the order of 1-2 percent of world GDP, which is exactly what the IMF has been calling for. Is this a modern miracle of international policy coordination?

The problem is - the IMF started calling for this in January 2008 when, with the benefit of hindsight, it would really have made a difference. Fiscal policy is slow. Even when everyone wants to move fast, when you can get the legislation through right away, and when there are "ready to go" projects, infrastructure spending will take at least 6-9 months to have perceptible effects in most economies.

In the US we have some additional ways to boost spending, most notably as support to local and state governments, extending food stamps and the like (see my recent [testimony to the Senate Budget Committee](#) for further illustrations), and in most other countries that kind of government activity comes by way of "automatic stabilizers," i.e., it happens without discretionary packages of the kinds that make headlines. Still, the general point holds - the big fiscal stimulus package you put in place today is a bet on how the economy will be doing in a year or so. And a year ago would have been a good time to start - remember that the NBER has just determined that the US recession actually started in December 2007 (but they were able to make the call only now, demonstrating how hard it is to forecast the present, let alone the future.)

My concern today, however, is not about the appropriateness of the overall package in the US, China or other emerging markets - in a crisis, erring on the side of "too much, too

late" is better than "too little, too little." The problem is that in Europe we need not just a general fiscal stimulus (and more interest rate cuts), but also specific targeted measures that will provide appropriate, largely unconditional support to [governments with weaker balance sheets](#) (read: Greece, Ireland, Italy, but don't exclude others from consideration).

Monetary policy was consolidated in Europe (i.e., there is one currency for the eurozone) but fiscal policy substantially was not. This imbalance is going to be addressed, one way or another, and perhaps under great stress. Much progress has been made towards sensible policies in the US and some parts of Europe over the past two months, and calamity can still be avoided. Let us not fall at the final hurdle.

Update: I talked with Madeleine Brand of NPR about some of these issues earlier today; [audio recording and transcript are here](#).

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Dec 7, 2008 11:54 PM

[**Causes: Maybe People Are Just Like That**](#)

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

This is the second in my new occasional series of reflections on some of the root causes of the global economic crisis. As is probably evident from the [first one](#), I'm not going to try to identify *the* cause of the crisis, or even render particularly analytical judgments about the relative importance of various contributing factors. Instead, I'm more just presenting and thinking about some of the forces that were at work.

One of the singular features of the last decade was the U.S. housing bubble (replicated elsewhere, such as the U.K. and Spain, but nowhere on such a grand scale), which was accompanied by a broader though not quite as frothy bubble in asset prices overall, including the stock market. One of the standard explanations is that bubbles are created when greed takes over from fear: people see prices rising, and at first their fear of getting burned keeps them on the sidelines, but as the bubble continues and other people get rich their own greed increases until it wins out over fear, and they buy into the bubble as well. As a result, some say, we are bound to have bubbles periodically, especially when new investors (young people), who have never experienced a crash, come into the market.

There is psychological research that not only backs all of this up, but goes even further and says that bubbles are a virtual certainty. Virginia Postrel has an article in [The Atlantic](#) that centers on experimental economics research by people such as Vernon Smith and

Charles Noussair. In one experiment, investors trade a security that pays a dividend in each of 15 periods and then vanishes; the dividend in each period will be 0, 8, 28, or 60 cents with equal probability, so the expected dividend is 24 cents, and there is no time value of money (the whole experiment takes an hour). Despite the fact that the fundamental value of the security is absolutely, completely, easily knowable, bubbles develop in these markets . . . 90% of the time. When the same people repeat the same experiment, the bubbles get gradually smaller; but simply change the spread of dividends and the scarcity of the asset, and the bubbles come back with full force (so much for experienced investors).

The implication is that if you put people in front of a market that is behaving a certain way, you are going to get a bubble. It's not simply a question of not understanding the fundamentals, or getting suckered by real estate brokers, or trying to keep up with the Jones's new McMansion (although all of these can help amplify the bubble); people are just wired to create asset price bubbles. The fact that we have so few of them is probably a reflection of the size of asset markets (it takes longer to get millions of investors bought into a bubble than a few dozen) more than anything else.

Certainly there are things that we (or policymakers, rather) can do about bubbles. If they see a bubble building, they can try to talk it down, or try to make money more expensive, or start selling lots of the thing that is appreciating quickly. But this hinges on two things: the ability to spot the bubble, and the will to do something about it. It's not helpful to have a belief on principle that asset prices are always rational, because then you will never do anything about them. (As an aside, perhaps one solution would be to have some form of market intervention that is automatically triggered when some class of assets accelerates beyond a predetermined threshold - precisely to eliminate the ability of policymakers to convince themselves that "things are different this time.")

But the broader point, I think, is that it's not that useful to say the bubble happened because people were stupid, or greedy, or irresponsible. Yes, people can be stupid, greedy, and irresponsible, but you have to take people the way they are; mass psychological reeducation is not an option. And even if you could reeducate them to the point where they all fully understood the assets they were trading, there would still be bubbles. The issue to focus on is what regulatory policies or systemic changes can limit the incidence and cost of bubbles. (There's an argument to be made that individuals should not be managing their own investments, since on average they just destroy value. But in an individualist, free-market society like ours, that argument will never fly.)

Besides the greed of the common man, though, much more has been made of the greed of the Wall Street banker. One argument, heard often around the time of the voting on the initial bailout bill, was that the financial crisis was caused by greedy bankers (and mortgage brokers, and hedge fund managers, and anyone else involved in the securitization chain) who created exotic new financial instruments and took on excessive risks in order to make lots of money for themselves. This has never satisfied me as an explanation. As I read somewhere, greed is like gravity. (I tried to look that phrase up to see whom to attribute it to, but apparently it's a commonplace with no known source.)

Blaming a financial crisis on greed is like blaming an airplane crash on gravity. Sure, there may be some correlation between greediness and working in certain parts of the financial services industry. But take people randomly off of Main Street and put them in that position - where most of your compensation is in a year-end bonus, and your bonus depends on the volume of business you do that year, not on the long-term profitability of that business, or on the success and satisfaction of your customers, and no one can take that bonus away from you in the future - and I wouldn't bet that they would behave any differently.

Henry Blodget - yes, [that Henry Blodget](#) - has a variant of this argument in an article also in [The Atlantic](#) (yes, I'm a subscriber, and I finally found a few minutes to look at the latest issue). After the usual explanation of bubbles, he looks at things from the Wall Street perspective.

Professional fund managers are paid to manage money for their clients. Most managers succeed or fail based not on how much money they make or lose but on how much they make or lose *relative to the market and other fund managers*. . . .

In the money-management business, therefore, investment risk is the risk that your bets will cost *your clients* money. Career or business risk, meanwhile, is the risk that your bets will cost *you or your firm* money or clients.

The tension between investment risk and business risk often leads fund managers to make decisions that, to outsiders, seem bizarre. From the fund managers' perspective, however, they're perfectly rational.

This is similar to my earlier theory about [why banks won't lend](#). It's also similar to [Andrew Lo's explanation](#) of why chief risk officers didn't clamp down during the bubble. Basically, the incentives are such that it is more valuable to you or your company to be doing roughly what everyone else is doing than to do what you think is right (not in the moral sense, but in the profit-maximizing sense). We think the capitalist system is wonderful because all firms act to maximize their profits (and I do think that capitalism is the best economic system around, if that phrase even means anything), but the fact is that firms are made up of people, and the connection between the interests of those people and the interests of their firms is indirect at best. OK, I'll cut off the tangent there; the rest of that thought will have to wait for another post.

In any case, the question isn't how to make bankers less greedy, but how to create incentives that better align their personal greed with the interests of their firms and their clients. And how to do it without doing things that are possibly unconstitutional - like simply banning certain forms of compensation - or that have all sorts of unanticipated consequences. Maybe strict limits on executive compensation would do the trick. I know the argument that this will deter talented people from entering the industry, but - and the business world is one place where I do have a lot of experience - the difference in "talent" between CEOs and people one or two levels down is minimal if not negative. ([Rakesh Khurana](#) has a book on the distorted market for CEOs, and either he or [Jim](#)

Collins - can't remember which - has evidence that companies would be better off promoting people (who have never been CEOs) from within than shopping on the CEO market.) Put another way, I think there are plenty of hardworking, bright, experienced people in banks today who would be happy to be senior executives for a mere \$1 million per year.

In the end, this is all probably pretty obvious: don't blame people for being the way they are, and instead try to create structures and incentives that will protect them (in general) from themselves (in particular). More on that another time.

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Dec 7, 2008 12:57 PM

Is This A Crisis Or Just A Recession?

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

The world seems quiet. Sure, we have record job losses in the US, a likely decline in global trade for 2009, and what seems like to be a Great Leap Downwards for Chinese growth. But no one is quite as worried as they were a month ago, let alone two months ago. It feels, perhaps, like a "regular" global recession (albeit not something we have seen in 20+ years), in which growth decelerates markedly, but then we start to rebound in a timely manner.

Now, I'm happy to accept that as part of my current baseline view (and we will revise our forecast accordingly). But there are serious downside risks to this forecast, i.e., we could move again into crisis mode. The three places I look at on a daily basis for crisis-promoting potential are:

1. The US financial sector. There is still pressure around the insurance industry and some parts of the banking system will surely need more capital before too long. But the rather generous terms of the Citigroup bailout have reassured shareholders and the Fed is providing massive lifelines, we think, to the needy of any kind. And while the auto industry could still have an accident, most likely there is enough cash just around the corner to get them into February. Plans for a big fiscal stimulus have also probably reassured people to some (vague) extent, at least for the time being.
2. Emerging markets. Here the news is pretty bad and not as widely known as all that is wrong with US financials. In particular, I'm struck that many of the most perceptive analysts of China have clearly realized that growth has hit a serious wall, yet they feel

unable to mark down their forecasts dramatically. I don't know if this is more about not wanting to upset clients or the Chinese authorities (or the Chinese authorities who are your clients), but there is definitely cognitive dissonance afoot. Still, with the oil market taking a long hard look at \$40 oil and thinking about the lack of likely technical resistance at that level, I rather suspect that the broader commodity sector has seen through the Chinese Veil. Still, crisis is about discontinuity and default, and there is real potential for some oil producing and commodity exporting countries to run into serious payments problems. No one has yet thought enough about some of these far-flung places (no names please) and their interconnections with the rest of the global system.

3. The eurozone. This is where the crisis potential really lies ([no change from last week](#)). The credit default swap spreads say there is danger ahead for Greece, Ireland, Italy, and - if that is true - for others also. This is a classic fiscal problem pure and simple, although it is the macro hedge funds who are sounding the horn - saying it is time to go hunting (remember: as liquidity returns to the core financial markets, it becomes easier to take big negative bets). These eurozone sovereigns have a great deal of debt and this debt is not in a currency they control - ironically, through joining a currency union they created a potential emerging market situation, in which a national strategy of moderate inflation and depreciation is no longer an option and debt burdens must be dealt with through painful fiscal adjustment. The real crisis, however, arises from the fact that almost no one in Europe - and definitely no officials - either see this coming or are willing to take any action to head it off. Note that while the ECB has begun to cut interest rates, as we recommended in October, no one in Europe feels it is their job to take on the broader systemic issues that [we emphasized need to be dealt with at the same time](#) - in complete contrast to the situation in the United States (at least as the Obama team becomes seriously involved).

As we have seen time and again since mid-September, what really leads to serious crisis is denial. There is not much denial left in the US (although watch this space for any update to that) and there is no much I could tell you about, for example, Russia that would really shock at this point. But suggesting the idea that a serious sovereign credit problem looms in Europe is enough to make me quite unpopular with some of my current and former colleagues.

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Dec 6, 2008 10:15 PM

[**Causes: Where Did All That Money Come From?**](#)

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

We've gotten some comments to the effect that, for all the discussion of the financial crisis and the various bailouts, we haven't looked hard at the underlying causes of the financial crisis and accompanying recession. The problem, as I think I've hinted at various times, is that any macroeconomic event of this magnitude is overdetermined, on two dimensions. First, there are just too many factors at play to identify which are the most important: in this case, we have lax underwriting, lax bond rating, skewed incentives in the financial sector, under-saving in the U.S., over-saving in other parts of the world, insufficient regulation, and so on. How many of these did it take to create the crisis? There is no good way of knowing, because the sample size (one, maybe two if you add the Great Depression) is just not big enough. Second, there is still the conceptual problem of identifying the proximate cause(s). To simplify for a moment, we had high leverage which made a liquidity crisis possible, and then we had the downturn in subprime that made it plausible, and then we had the Lehman bankruptcy that made it a reality. Which of these is the cause? Leverage, subprime, or Lehman?

In any case, we're not going to resolve these issues. But I want to start an occasional series of posts looking at one of the root causes at a time.

Today's topic was inspired by this week's meetings between U.S.-China meeting in Beijing, where, according to [the FT](#), "the US was lectured about its economic fragilities."

Zhou Xiaochuan, governor of the Chinese central bank, urged the US to rebalance its economy. "Over-consumption and a high reliance on credit is the cause of the US financial crisis," he said. "As the largest and most important economy in the world, the US should take the initiative to adjust its policies, raise its savings ratio appropriately and reduce its trade and fiscal deficits."

There has been a lot of tut-tutting, here and especially abroad, about over-consumption and over-indebtedness in the U.S. According to this story, the problem is that U.S. consumers grew addicted to spending, and financed their spending through ever-increasing amounts of debt. Over-consumption fed itself, because it drove up asset prices, which enabled consumers to take on even more debt, which enabled them to spend more, and so on. But, according to this story, the assets were not actually getting more valuable - a house in the suburbs of Las Vegas is the same house it was ten years ago - and the asset price bubble and the debt mountain both had to collapse. (Note that, if you blame the U.S. consumer, then mortgage brokers, investment banks, and bond rating agencies all become mere enablers; if they hadn't existed, the consumer would have figured out another way to rack up the debt.) The counterfactual "solution" (the historical path that would have avoided this outcome) was for the U.S. consumer to live a more sober life, consume less, and take on less debt.

I am unsatisfied with this story for two reasons. First, I don't think it's much of an explanation to say that people were insufficiently virtuous. People are the way they are, and you can only change them slowly, if at all. (The radical stage of the French Revolution, and the Chinese Cultural Revolution, both tried this, and failed miserably.) So maybe Americans are more like grasshoppers than ants. Maybe it's our popular

culture, or our mediocre public education system, or our irrational optimism, or something else. And maybe, at the margins, our leaders could have taken a few steps to talk people down from their belief that assets only appreciate in value. But it wouldn't have changed much.

Second - and this was supposed to be the topic of this post - it takes two to tango. If the U.S., seen as a single unit, borrowed a big pile of money, that's because someone else lent it to us - and lent it to us cheaply. And while China isn't the only country that lent us money, it was the major new lender of the last decade.

The U.S., as we all know, has been running a large trade deficit. The flip side of a trade deficit, leaving aside a few details, is foreign capital inflows. Again, looking at the U.S. as one big household, if we consume more than we produce, we have to pay for it somehow; we pay for it by selling assets (foreign direct investment in the U.S., foreign purchases of U.S. stocks, etc.) or borrowing money from overseas (foreign purchases of U.S. bonds). If we are not saving enough to invest in our economy, then the investment is coming from some other country that is saving more than it needs for its economy.

So far, this may sound like ants and grasshoppers, one being more virtuous than the other. (Although, in the current situation, both are equally responsible for the degree of economic imbalance in the world.) But it's a little more complicated. Because while Americans were over-consuming, the Chinese government was consciously and explicitly suppressing domestic consumption. It did this by intervening on foreign currency markets to keep its currency, the renminbi, artificially low. Having a cheap currency made Chinese goods cheaper in the U.S., increasing our imports. It also reduced the purchasing power of people in China, making it harder for them to buy imported goods and reducing their standard of living. So to the extent that the U.S. over-consumed, it was aided and abetted by other countries under-consuming, China most prominently.

I don't know the specific mechanism used to control the exchange rate, but in general the most direct means would be some combination of printing more renminbi and using it to buy U.S. dollars. In order to be able to control its currency, and as a result of keeping it low against the dollar, the Chinese government has amassed roughly \$2 trillion in foreign currency reserves, which are believed to be largely in U.S. dollar-denominated assets, such as Treasury bonds and the bonds of government agencies such as Fannie Mae and Freddie Mac.

Now, China wasn't the only country building up foreign exchange reserves, largely in dollars. Since the emerging markets crisis of 1997-98, the conventional wisdom has been that large currency reserves are necessary to protect yourself against an attack on your own currency, and as a result countries like Russia, South Korea, and Brazil (all victims in 1997-98) amassed hundreds of billions of dollars' worth of reserves on their own.

All of the U.S. dollar reserves held by all of these countries were effectively loans to the U.S. Treasury bonds were loans to our government; agency bonds were loans to our housing sector. This large appetite for U.S. bonds pushed up prices and pushed down

yields, lowering interest rates and thereby fueling the U.S. bubble. Even though the money didn't go directly into subprime lending, it lowered the costs for all the investors who were investing in subprime. so at the same time that irrational beliefs about asset prices were driving those prices up, the increased availability of money looking for things to buy also drove prices up. Looking at it counterfactually, if there had not been so much global demand for U.S. assets, it's unlikely that even the once-divine Alan Greenspan could have kept 30-year mortgage rates as low as they were, since the only lever he had control over, the Fed funds target rate, is an overnight rate. And if mortgage rates hadn't been so low, the bubble couldn't have been as big.

Which brings us back to the present. Does China really want us to mend our ways, "raise [our] savings ratio appropriately and reduce [our] trade and fiscal deficits," or do they just enjoy hearing themselves say it? If the U.S. does start saving and reduces its trade deficit, the impact on China's export-led economy could be devastating. On paper, China could switch toward promoting domestic consumption, thereby reducing its reliance on exports, but at a minimum this is likely to cause significant internal dislocation for a period of years. In any case, they are likely to get what the wish for: the U.S. savings rate is likely to increase significantly simply due to the rush of panic that many Americans have felt for the last two months, and the trade deficit is likely to improve both due to a reduction in consumption and due to the fall in commodity prices. Countries that want someone else to do their consumption for them may have to start looking elsewhere.

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Dec 5, 2008 12:18 PM

[How Can GM Avoid Bankruptcy?](#)

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

With the Big 3 back in Washington, it seems like time to resuscitate the debate over the auto industry bailout. Luckily, Felix Salmon took the time to look through GM's [bankruptcy plan](#), which is being advertised on GM's new, also gag-inducing [GM Facts and Fiction](#) website. Here's one particularly gag-worthy claim from the plan:

GM has never failed to meet a Congressional mandate in the important areas of fuel efficiency and vehicle emissions, and sets the industry standard for "green" manufacturing methods.

Let's not mention that GM has fought increased fuel efficiency standards with every dollar it could spend on lobbyists for decades.

Anyway, [Salmon's post](#) focuses on one issue that has troubled me as well. One of GM's biggest problems, along with plummeting demand for cars, is \$62 billion in debt. In order to become a financially viable company, they have to reduce this debt, presumably by converting some of it into equity. But that debt is held by private entities, and no amount of pleading from the Big 3, the UAW, Jennifer Granholm, Congress, or Barack Obama HIMSELF can force them to restructure the debt. My worry is that in negotiations of this sort, where each side is holding a gun to the head of the other, debtholders could very well say: "Go ahead, go bankrupt, we'll take our chances that we can get a better deal from a bankruptcy court or, worst case, we can recover more in cash than the value of the equity you're offering today." One of the points of a bankruptcy is to get a court that can force bondholders to accept a settlement rather than relying on their good graces.

On a related subject, a lot of people are throwing around the 80% number: supposedly, 80% of people will not buy a car from a company in bankruptcy. A GM spokesman said (to Felix Salmon) that GM's sales were already falling because of fears about bankruptcy. Maybe. But I strongly suspect that 80% is just a poorly worded and interpreted poll question. If you ask people in the abstract if they would buy cars from a bankrupt car company, of course they will say no. But in the real world, if the car they want is made by a bankrupt company, and they get a good deal, they will buy it. Just look at the [November auto sales](#). GM was down 41%; Toyota, Honda, and Nissan were down 34%, 32%, and 42%, respectively. And everyone buying a car in November must have been aware that bankruptcy for GM was a serious possibility. (Besides, haven't we been talking about a GM bankruptcy on and off for years?) Sure, bankruptcy will hurt sales a little. But 80% is just not credible.

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Dec 5, 2008 12:18 PM

[We Are All in This Together](#)

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

Dani Rodrik has a [short, clear post](#) on (a) why countries are tempted to engage in protectionism during recessions and (b) why they shouldn't. It only uses 1st-semester macroeconomics. The bottom line is that the preferred outcome is for all countries to engage in fiscal stimulus at the same time. The hitch is that most of the developing world can't afford to. The implication is that it is in the interests of the wealthy countries to find a way to support the developing world.

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Dec 4, 2008 12:15 AM

How the SEC Could Have Regulated Subprime Mortgages

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

From a new paper (link below):

Kafka would have loved this story: According to our current understanding of U.S. law there is far better consumer protection for people who play the stock market than for people who are duped into buying a house with an exotically structured subprime mortgage, even when the mortgage instrument is immediately packaged and sold as part of a security.

The crux of the matter is that securities transactions - notably, the sale of a security to a customer by a broker - are governed by SEC regulations, which impose a fiduciary relationship on the broker, meaning, among other things, that the broker can only sell financial products that are suitable for that customer. However, no such rule governs the relationship of a homebuyer to a mortgage broker or company, meaning that behavior by the latter must be actually fraudulent before it can be sanctioned.

Jonathan Macey, Maureen O'Hara, and Gabe Rosenberg (two of whom are at my very own Yale Law School) have a [new paper](#) (abstract and download available) arguing not only that mortgage brokers should have a fiduciary responsibility to their customers, but that they *already do* under two reasonable interpretations of existing SEC regulations. (It has to do with whether a complex subprime mortgage is already a security or, failing that, whether it is related to a security transaction.) This means that the SEC could have been regulating these things all along.

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Dec 3, 2008 6:06 PM

Recorded Webcast of Yesterday's MIT Class

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

The Flash recording is [right here](#).

Unfortunately, this is the last webcast for now; the final class on December 9 will not be recorded. For previous classes and class-related materials, use the [Classroom category](#).

Thanks to all of the participants on the Internet.

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Dec 3, 2008 9:37 AM

More Danger for the Eurozone?

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

Back in the exciting days of October, Peter, Simon, and I wrote an op-ed in [The Guardian](#) about the potential for cracks to appear in the Eurozone, even possibly leading to one or more countries withdrawing from the euro. With so many other things to worry about, this scenario didn't get a lot of attention. Since then, pressures have been slowly building. For example, the spread between the 10-year bonds of Greece and Germany has grown from around 30 basis points during most of the decade to over 1.5% now. (The picture below is from last week.)



According to an FT chart (sorry, can't find the link), Greece also has to raise 20.3% of its GDP in debt next year (the equivalent figure for the U.S. is 10.3%), so the spread should only get bigger.

The Eurozone is based on the idea that a single monetary policy can serve the interests of all of the member countries. The problem is that when macroeconomic conditions vary widely between countries, they will have different interests. In a severe crisis, some countries may be tempted to (a) engage in quantitative easing (of the sort the Fed is beginning to do) or (b) implement a large fiscal stimulus (of the sort that Pelosi, Reid, and Obama are about to do). (a) is impossible for a Eurozone member, and (b) is constrained by limits on deficit spending, although I believe those limits are honored more in the breach than in practice.

In any case, the potential problems are getting big enough that [Martin Feldstein](#) has weighed in as well. Hopefully this will draw more attention to the issue. It may still be a low probability, but the economic and political consequences of undoing the greatest step toward European integration in, oh, the last thousand years would be huge.

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Dec 2, 2008 10:33 PM

Kenneth Rogoff Embraces Inflation

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

[Right here](#). I wouldn't ordinarily just pass along a link you can find elsewhere, but I can't help remarking that that makes two former chief economists of the IMF to take this position. That was Simon's old job; his article on the topic is [here](#). Of course, you are free to keep whatever opinion you may have about the IMF and its chief economists.

(Thanks to [Mark Thoma](#) for flagging this.)

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Dec 2, 2008 10:33 PM

Yes, But WE'RE Above Average

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

My former employer has published a survey of business people around the world conducted in early November. It's not particularly surprising, but I especially liked [this chart](#) (free registration required), according to which a plurality (39% to 38%) of North American companies think that their profits this fiscal year will be *better* than last fiscal year. (The "current" fiscal year ends sometime between November 2008 and October 2009, so in most cases it includes the steep part of the downturn.) The global numbers are 38% up and 43% down.

Maybe being an executive at a large company selects for unnaturally optimistic people. I've always suspected that there is a significant, quantifiable optimism bias to the statements of business people, even their private ones. (Their public ones, of course, are colored by the desire to positively influence their stock price, which can lead to some

interesting results.) It's something I've thought of studying but never had the time for. If anyone knows of any research, let me know.

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Dec 2, 2008 4:58 PM

The Importance of China

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

So, the global economy is falling apart, but not in the way people expected. Under the de facto arrangement sometimes known as “Bretton Woods II,” emerging market countries pegged (officially or unofficially) their currencies to developed world currencies at artificially low rates, having the effect of promoting exports and discouraging consumption by emerging market countries and promoting consumption and discouraging exports in developed countries. Of course, the classic example of this was China and the U.S. The U.S. trade deficit and Chinese trade surplus created a surplus of dollars in China, which were invested in U.S. Treasuries and agency bonds, keeping interest rates low and indirectly financing the U.S. housing bubble and consumption binge of the last decade (and, therefore, growth in Chinese exports).

The general fear was that U.S. indebtedness would lead China to diversify away from U.S. assets, causing the dollar to fall and U.S. interest rates to rise, hurting the U.S. economy and making it harder to finance the national debt. This may yet happen someday. But instead of demand for Treasuries collapsing, it's been demand for every other type of asset that has fallen. Treasury yields have collapsed and the dollar has appreciated about 20%. Still, despite this increased purchasing power, the fall in U.S. (and global) consumption is having a severe impact on growth of the Chinese economy. Even though the Chinese government has signaled that it will do [everything in its power](#) to keep growth above 8% per year (down from 11-12% in the past few years), the slowdown has severely constrained the ability of the urban manufacturing sector to absorb internal migration from the countryside, and there are signs of a [reverse migration](#) that is aggravating the problem of rural poverty in China. Although China may seem to have all the cards - high economic growth, large foreign currency reserves - it could yet turn out to be a major loser of the global economic crisis.

This is of course just a brief introduction. For more I recommend Brad Setser, among others: some of his posts are [here](#), [here](#), and [here](#).

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Dec 2, 2008 3:18 PM

MIT Global Crisis Class, Today at 4:30pm

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

December 2, 2008

The Global Crisis, class #4

Relevant links, including background material and tracking of all relevant developments available through <http://BaselineScenario.com>.

Update: [Webcast for today's class](#) (RealMedia).

Summary of class content and structure:

1. Update on the global crisis

1. The latest news from around the world
2. What may be next? Looking to Europe...

2. The case for and against bailing out Citigroup

1. Comparison with General Motors
2. Assessment of the bailout terms
3. Who was to blame? And for what exactly?

3. The situation in Europe

1. Signs of pressure: financial sector and real economy
2. Policy responses: European Central Bank interest rate cuts, a more unified fiscal stimulus?
3. Specific country issues: Italy, UK, Spain and others

4. Prospects for global financial system reform.

- a. Recap on likely strategy of President-Elect Obama's team with regard to fiscal and monetary policy. What is their likely global strategy, with or without the IMF?

b. How does this fit with what the rest of the G7 or emerging markets or any other influential players want?

c. Can we see a full overhaul of the global system coming soon? If not, why not?

Final class is on Tuesday, December 9. ***Discussion in the December 9 class will be off-the-record; it will not be broadcast or recorded.***

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[Original audio source](#)

Dec 1, 2008 11:51 PM

The Lawsuits Begin ...

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

OK, there are probably other lawsuits already. But now a [hedge fund is suing](#) Countrywide (Bank of America), claiming that its loan modification program violates contract law and that if Countrywide wants to modify any mortgages it must buy out the existing investors at face value.

This is one aspect of the “securitization problem” that got [a lot](#) of [air time](#) on this blog a few weeks ago.

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Dec 1, 2008 11:51 PM

More Signs of Monetary Expansion

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

With the Federal Reserve's main policy tool, the Fed funds rate, past the point of diminishing returns (although the target rate is 1%, the actual rate has been well below that for weeks), there are more signs that the Fed is willing to use new tools to stimulate the economy. Fed Chairman Bernanke's [speech today](#) spelled out quite clearly (no more Greenspan-speak here) what the plan is (emphasis added):

Although conventional interest rate policy is constrained by the fact that nominal interest rates cannot fall below zero, the second arrow in the Federal Reserve's quiver—the provision of liquidity—remains effective. Indeed, there are several means by which the Fed could influence financial conditions through the use of its balance sheet, beyond expanding our lending to financial institutions. First, the Fed could purchase longer-term Treasury or agency securities on the open market in substantial quantities. This approach might influence the yields on these securities, thus helping to spur aggregate demand. Indeed, last week the Fed announced plans to purchase up to \$100 billion in GSE debt and up to \$500 billion in GSE mortgage-backed securities over the next few quarters. . . .

Second, the Federal Reserve can provide backstop liquidity not only to financial institutions but also directly to certain financial markets, as we have recently done for the commercial paper market. Such programs are promising because they sidestep banks and primary dealers to provide liquidity directly to borrowers or investors in key credit markets. In this spirit, the Federal Reserve and the Treasury jointly announced last week a facility that will lend against asset-backed securities collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration.

...

Expanding the provision of liquidity leads also to further expansion of the balance sheet of the Federal Reserve. **To avoid inflation in the long run and to allow short-term interest rates ultimately to return to normal levels, the Fed's balance sheet will eventually have to be brought back to a more sustainable level.** The FOMC will ensure that that is done in a timely way. **However, that is an issue for the future; for now, the goal of policy must be to support financial markets and the economy.**

There have been a number of articles in the last week on the shift toward quantitative easing, and in particular the fact that the Fed is no longer sterilizing all of its liquidity injections (compensating for them by selling Treasuries to suck up cash). Here's one from [FT Alphaville](#) with some nice graphs.

In their [Real Time Economics post](#) a week ago, Simon and Peter argued that this is precisely what we need. However, opinions differ - some fear that the increased long-term risk of inflation outweighs the benefits of monetary stimulus now.

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Dec 1, 2008 2:20 PM

Next MIT Class on Global Crisis: Tuesday, December 2nd

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

Tomorrow, Tuesday December 2, at 4:30pm (please note special start time for this week), we will webcast our next MIT class on the global crisis. The session will run until 7pm, as usual, with a break around 5:30pm.

This is the last class on the crisis that we will broadcast & record, at least for now. (There will also be a class on Tuesday, December 9, which will review the crisis to date; I'll post summary materials but that session will not be recorded.)

On December 2nd, I plan for us to cover the following topics:

1. The Citigroup Bailout, including whether this is or is not good value for the taxpayer (search this website for Citigroup to see readings). Robert Rubin's [interview with the Wall Street Journal](#) on Saturday is also essential reading (the WSJ article requires a subscription; the blog [naked capitalism provides a free summary and some reactions worth discussing](#)).
2. The situation in Europe, which continues to worsen. We'll review the latest developments in the real economy and indications of various kinds of pressures (think: Italy, but the UK, Spain and other countries may well come up).
3. Prospects for global financial system reform. We can see fairly clearly the strategy of President-Elect Obama's team with regard to fiscal policy, and we can infer some implications for monetary policy. But what is their likely global strategy, with or without the IMF? How does this fit with what the rest of the G7 or emerging markets or any other influential players want? Can we see a full overhaul of the global system coming soon? If not, why not? (Search for Global Reform on this website for readings.)

Feel free to post questions here or email to us, through this website. We'll cover as many as possible in the classroom discussion.

Details on the webcast and some potentially useful background follow:

The RealMedia stream for Tuesday afternoon will be:

http://web.mit.edu/webcast/sloan/2008/simon_johnson/sloan-financial_crises-simon_johnson-E51345-02dec2008-1630-350k.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.

And, in case it is helpful, here is a summary of our MIT Global Crisis class materials on the web so far:

#1, October 29: The slides I used are available on the web. This session was not recorded.

<http://baselinescenario.com/2008/10/29/mit-class-1-on-global-crisis/>

#2, November 4: Video available, with summary of discussion:

<http://baselinescenario.com/2008/11/06/downloadable-mit-class-on-the-global-crisis/>

#3, November 18: Class outline is in the first link; video is in the second link

<http://baselinescenario.com/2008/11/18/session-outline-mit-global-crisis-class-at-4pm-today/> <http://baselinescenario.com/2008/11/21/video-of-tuesdays-mit-class/>

#4, December 2: see materials above and postings to follow

Note: original course plan was posted at the end of October, but more than a few things changed in the world since then:

<http://baselinescenario.com/2008/10/28/mit-global-crisis-class-outline/>

If you read this far, hopefully you know that the readings for the class are the postings on this website in general: <http://BaselineScenario.com>. Structuring and opening up a MIT course in this way is an experiment. Based on your feedback (e.g., posted here or emailed to us or otherwise sent to MIT Sloan), we'll either do something like this again or not.

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