

Low-Tech Archive of The Baseline Scenario for January 2009

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Jan 31, 2009 10:49 AM

[Transparency And Power](#)

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

Put this morning's articles on Bank Rescue Plans in the [Financial Times](#) and the [Washington Post](#) next to each other, and you can see where we are heading. (Remember: policy announcements need to be bigger than what is leaked, so expect headline numbers larger than floated here - the FT suggests "total buying power" of the initiative will be \$1trn; I expect closer to \$2trn.)

The foreclosure mitigation steps seem reasonable, although on the small side - with perhaps \$80bn of the available \$320bn from TARP II being committed here. The heart of the matter is the banks' balance sheets, including their toxic assets and presumably deficient capital. The principles at work seem to be:

1. Do not compel the banks to do anything. There seems to be a great deal of concern about bank manager sensitivities. Sounds like we will be overpaying for bad assets. I can't believe there will really be no effective constraints on executive compensation; that would be political dynamite - and I'm sure Capitol Hill is expressing itself forcefully on this point as I write.
2. Buy some of the worst assets. Relatively little capital will be committed to this, as it is a nonessential and small part of the scheme - there is no way to sort out the valuation issue unless you are prepared to be tough with the banking system. Let's say \$50bn here, with credit from the Fed to scale up to \$500bn or so.
3. Use a ring fencing/government insurance scheme for most of the bad assets; this is the [Citi II/BoA-type deal](#) but now available to all banks. The mark on assets used for the insurance payout is generous to the banks, the premium is low and any claims on the banks received by the government do not constitute a meaningful share of voting stock (which makes me think we're going to more preferred or deferred stock and fewer warrants.) The deal will be quite untransparent, but a reasonable presumption should be that if it is more complex and harder to value, it is sweeter for the banks. The

government will commit about \$200bn in capital to this venture; based on the funding structure and ratios we saw in Citi II, this could allow the total amount insured to exceed \$2trn (hence my headline expectation).

One problem, of course, is that this exhausts TARP II without substantially addressing bank capital (although there must be some window dressing in this regard). The Administration might like to see if their approach brings in new private capital, and come back to Congress for further recapitalization funds only if necessary. They may also still be open to negotiation on this issue over the next couple of days - remember the fiscal stimulus still needs to pass the Senate.

The bigger issue is much simpler. The banks made many bad decisions and now have assets worth much less than their liabilities. We have guaranteed their liabilities, because we had a look at the alternative and it was ghastly. So who pays for the losses and on what basis?

I would prefer something [much simpler and more transparent](#): new capital in exchange for a change in control at the major banks - presumably leading to new private owners, wholesale managerial change, and the breakup of the big banks. Instead, we are looking at the mother of all Credit Default Swaps - if things go well, we get a small premium; if things go badly, we are on the hook for a huge and hard-to-quantify amount ([ask AIG](#)). Either way, the bankers get the greatest deal of this or any century, and they emerge more powerful than ever.

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Jan 30, 2009 10:20 PM

[Trial Balloons: Insuring The Bad Assets](#)

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

The Administration is obviously floating ideas to assess potential reactions, particularly from Congress. Today's [front page WSJ article](#) on banking should be seen in this light. It's obviously not a fully-fledged proposal, but the concepts are there to elicit opinions and I don't think it's particularly helpful if we hang back.

The article raises the possibility that bad assets from banks will be divided into two parts, (a) bought by an aggregator bank, and (b) insured against further losses by the government.

We've covered the general principles of an [aggregator bank](#) and good/[bad bank](#) splits elsewhere. Let me focus here on the specific (and credible) permutations in the WSJ article.

The bad bank would only be for assets that have already been marked down heavily by banks. These the aggregator would buy at this (low) book price. Hopefully, there would be less overpaying than in the [original Paulson concept](#), but the pricing is still murky.

The heart of this proposal is the insurance idea. This would be (much) larger than, but along the same lines as the [Citigroup II](#) deal in November and the [Bank of America](#) deal in January. The problems with this approach are threefold.

1. There is not enough potential upside for taxpayers. Throwing in relatively few warrants, as with Citi and BoA, does not make much of a difference - even if the strike price is [more favorable than in TARP I](#).
2. There is not enough explicit recapitalization. Proponents hope that cleaning up the balance sheets in this way will bring in coinvestment from the private sector. But this seems likely to come slowly and in small amounts in the foreseeable future.
3. There will be nowhere near enough transparency in this structure. The insurance provided by the government will almost certainly be too cheap relative to the risks, but evaluating this properly will be impossible for outsiders. (To see what I mean, look at the [details of the Bank of America](#) deal.)

Putting limits on bank executive pay make us all feel better, but it will not address the fundamental issues. The government will ride in to save the banking system. Shouldn't the taxpayer get a fair return on his/her investment in this venture - particularly as the whole banking system clean-up is likely to cost us over 10 percent of GDP, so "potential upside" really means "limiting our total losses" and "making sure not all the ensuing profits fall into the hands of already-rich private parties"?

And wouldn't we like to feel confident that many incompetent bank executives will lose their jobs, while someone breaks up the "too big to exist" banks? (Our [current proposal](#) is along these lines is here, but of course there are [other reasonable options](#).)

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Jan 30, 2009 3:38 PM

[Random Observations on the GDP Announcement](#)

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

By now I imagine you know that GDP contracted at an annual rate of 3.8% in Q4, beating economists' ["consensus" prediction](#) of a 5.4% decrease. (Why do people insist on calling an average of forecasts a "consensus?") A few thoughts:

- You can waste a lot of time looking over GDP statistics. Go to the [news release page](#) and download the Excel tables in the right-hand sidebar.
- The ["consensus"](#) is that the reason for the positive surprise was an unexpected increase in inventories. (Goods added to inventory count as production, even if they aren't bought off the shelves.) But . . .
- With any set of numbers that add up to their totals, you can't really find true causality. All you can do is point out numbers you think are particularly interesting. Another way to look at it is that the numbers were helped out a lot by short-term deflation, particularly due to falling gasoline prices. Personal consumption expenditures (PCE) , the biggest component of GDP by far, fell at an 8.9% annual rate in nominal terms. But the price deflator for PCE fell by so much - an annual rate of 5.5% - that in real terms PCE only fell at a 3.5% annual rate. That fall in prices was almost entirely due to the fall energy prices, which is highly unlikely to be repeated. But do people consciously reduce their spending in nominal or real terms? Nominal, I would think. So, as I "predicted" in December (I always have so many caveats that it's not really fair to say that I ever predict anything), Q4 was better than expected, but Q1 is likely to be worse than predicted (before today, that is, since everyone is revising their Q1 forecasts down right now), since people will keep ratcheting down spending in nominal terms, but we won't be bailed out by such a steep fall in prices.
- The savings rate climbed from 1.2% to 2.9% - but it still has a long way to go (it was over 10% in the 1980s).
- Real expenditures on food were down 4% (that's not an annual rate, that means people spent 4% less on food in Q4 than in Q3). Ouch. I hope that was mainly a shift from restaurants to eating at home.

Back to more useful things.

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Jan 29, 2009 2:03 PM

[Global Economic Outlook \(Senate Testimony\)](#)

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

My written testimony, submitted to the Senate Budget Committee for today's hearing is here ([in pdf](#)) and after the jump as a post. This is essentially our new Baseline Scenario, although we'll likely make a few small changes before putting it out as that.

You can watch the [hearing here](#). I was struck by how many questions were about what can be done for US housing. The Senators expressed frustration that substantial further amounts are likely needed to shore up the banking system, yet little has been done for the underlying issues in housing. They are also quite dubious of any bank recapitalization/clean-up scheme that leaves existing management in place.

Several expressed a preference for tackling the fiscal stimulus, bank restructuring, and housing refinance together, to get a better handle on what we can and cannot afford. Personally, I think that's a sensible approach - as long as we move forward quickly on all three fronts.

Testimony to the Senate Budget Committee hearing on *The Global Economy: Outlook, Risks, and the Implications for Policy*, January 29, 2009.

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of <http://BaselineScenario.com>

Summary

- 1) The world is heading into a severe slump, with declining output in the near term and no clear turnaround in sight. We forecast a contraction of minus 1 percent in the world economy in 2009 (on a Q4-to-Q4 basis), making this by far the worst year for the global economy since the Great Depression. We further project no recovery on the horizon, so worldwide 2010 will be "flat" relative to 2009.
- 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 and spend less.
- 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 during the boom and now face balance sheet constraints.
- 4) Compounding these problems is a serious test for the Eurozone: financial market pressure on Greece, Ireland and Italy is mounting; Portugal and Spain are also likely to be affected. The global financial sector weakness has become a potential fiscal issue of the first order in these countries. 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 is moving sharply towards near-crisis, particularly as global trade contracts and there are immediate effects on both corporates and the financial system. Currency collapse and debt default will be averted only by fiscal austerity. The current IMF strategy - most clearly evident in East-Central Europe - is to protect creditors fully with programs that do not allow for nominal exchange rate depreciation. This approach increases the degree of contraction and social costs faced by domestic residents, while also making economic recovery more difficult. These programs will likely prove more unpopular and less successful than were similar programs in Latin America in the 1980s and in Asia in the 1990s. As East-Central Europe slips into deeper recession, there are severe negative consequences for West European banks with a high exposure to the region (including Austria, Sweden and Greece).

6) The global situation is analogous to the problem of Japan in the 1990s, in which corporates attempted to repair their balance sheets while consumers continued to save as before and fiscal stimulus repeatedly proved insufficient. The difference, of course, is that exports were 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. The European Central Bank still fails to recognize the seriousness of the economic situation. The Bank of England is embarked on a full-fledged anti-deflation policy, but economic prospects in the UK still remain dire.

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. The Obama Administration will have a hard time bringing its G20 partners to a more pro-recovery policy stance.

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. A “lost decade” for the world economy is quite possible. There will be some episodes of incipient recovery, as there were in Japan during the 1990s, but this will prove very hard to sustain.

Background

The current official consensus view (e.g., as seen in the World Bank's Global Economic Prospects, the OECD's [leading indicators](#), or the latest IMF [World Economic Outlook](#)) is that we are having a serious downturn, with annualized growth for the fourth quarter in the US at around minus 5%. But the consensus is that a recovery will be underway by late-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 [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.

Understanding the Crisis

The precipitating cause of today's global recession was a severe "credit crisis," but one that is frequently misunderstood in several 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. In particular, while the US boom was at the epicenter of the crisis, regulated European financial institutions played a critical role in facilitating the boom and spreading the adverse consequences worldwide. And, like the US, some European governments ran relatively irresponsible fiscal policies during the boom, making them now unable to bail out their financial systems without creating concerns about sovereign solvency.

3. 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.

4. The initial problem, from mid-September 2008, was a fall in the supply of credit. But this does not mean that the current and likely pending 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.

5. 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.

6. As a result, while attempts to clean up the US and European financial systems make sense - and are needed to support any eventual recovery - this will not immediately stop the process of financial contraction and economic decline.

7. Fiscal stimulus, similarly, can soften the blow of the recession, but will not directly address the underlying problems. And many countries already face binding constraints on what their governments can do in this regard.

8. A dramatic shift in the stance of monetary policy is required in almost all industrialized countries and emerging markets. Unfortunately, the need for this shift is not currently recognized by official orthodoxy and it is not yet clear when this will change.

The Global Situation Today

Western Europe

Major Western European countries, beginning with the UK, have been severely affected by the global recession. The composite of forecasts tracked by Bloomberg predicts a contraction of 3% in GDP not only for the UK, whose housing bubble and degree of dependence on the financial sector were arguably greater than in the US, but even in Germany, whose exports are under severe pressure; their cars, machinery, and similar durables have a great reputation, but how many of them do customers really need to buy this quarter? The Eurozone as a whole is expected to contract by over 2%.

In the UK, the prospect of further bank nationalization now looms. The UK is a AAA-rated sovereign with its housing market in a nose dive, overextended (and apparently mismanaged) major banks, and a government on its way to guaranteeing all financial liabilities and directing the flow of credit moving forward. The emerging strategy is

based more on depreciating the pound - which is contributing to tensions with other European countries - and surprising people with inflation than on fully-funded bank recapitalization. Additional fiscal stimulus increasingly looks irrelevant and perhaps even destabilizing. The yield on 10-year government bonds is, of course rising - now over 3.5%.

Pressures on individual governments are even greater in some parts of the Eurozone, where individual countries do not have control over monetary policy. 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. Recognizing that credit ratings are a lagging but not meaningless indicator, Greece's downgrade was not unexpected, but Spain's downgrade from AAA is a significant milestone. Further European downgrades are in the air.

What do all these situations have in common? Markets are repricing the risk (or coming to their senses) on the dangers of lending to a wide range of governments. And this is not just about emerging markets (East-Central Europe) or industrialized countries that sustained a boom based on euro convergence (Portugal, Ireland, Italy, Greece and Spain are now known collectively in the financial markets as the PIIGS). The markets are potentially rethinking the risk of any government's obligations.

The reaction that one hears from senior European officials and richer Eurozone countries is that Greece (and Spain and Italy and others) should deal with their fiscal problems themselves. There is very little sympathy. However, we expect that in the end Greece will receive a 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.

What are the implications for German debt? There is no question that Germany will do whatever it takes to maintain a reputation for fiscal prudence. Despite the severe downturn, the German government recently struggled to pass a stimulus package of only 2.5% of GDP over two years, and the pressure now is to balance the budget. But problems in the Eurozone are putting pressure on the European Central Bank (ECB) to loosen its policies (and there are murmurs already about easing repo-rules as credit ratings fall - basically, supporting euro sovereigns during their downward spiral), and this has implications for currency risk. Despite the pressure to relax monetary policy, the ECB will continue to be slow to respond. The ECB's decision-making process seeks

consensus and some key members are still more worried about inflation down the road than deflation today. The ECB's benchmark rate is still at 2%. Eventually the ECB will catch up, but not before there has been considerable further slowing in the Eurozone.

The current consensus forecast 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.

Japan

The yen has appreciated as carry trades have unwound, so people no longer borrow in yen to invest elsewhere. This, in addition to the global recession, has had a crippling effect on exports, which fell by 35% from December 2007 to December 2008. Corporates are likely to want to strengthen their balance sheets further and households with already-high savings rates are unlikely to go on a spending spree. As a result of these factors, the Bank of Japan recently predicted that the country will suffer two years of economic contraction and deflation.

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. This difficulty in creating positive inflation expectations will make it harder for any fiscal stimulus to be successful in restarting the economy.

China

The current crisis has shown that China's economy is far from invulnerable. The 6.8% year-over-year growth rate in Q4 may have implied that the quarter-over-quarter growth rate was around zero, and forecasts for 2009 are in the 6-8% range - below the level commonly understood as the minimum to avoid growth in unemployment.

The major increase in savings by China over the past 10 years was primarily due to high profits in the corporate sector. Chinese growth now seems likely to slow sharply, and this will likely reduce savings and the current account. China still does have long-standing scope for a fiscal stimulus. But the Chinese economy is only about 6% of world GDP and their effective additional stimulus per year is likely to be around 3% of GDP. 3% of 6% is essentially a rounding error in the world's economy, and will have little noticeable effect globally - although it might just keep oil prices higher than they would be otherwise.

India

There are striking similarities between the current policy debate in India and in the Eurozone. In both places, there is little or no concern that inflation will rebound any time soon. At least for people based in Delhi, there is as a result confidence that aggressive monetary policy can cushion the blows coming from the global economy. As in the Eurozone, all eyes are on monetary policy because of fears that fiscal policy cannot do much more than it is already doing, given that government debt levels are already on the high side.

The discordant note comes from the business community. They feel that Delhi does not fully understand that the real economy is already in bad shape. Sectors such as real estate and autos are hurting badly. Small businesses, in particular, are bearing the brunt of the blow. The banking picture seems more murky, but is surely not good. And of course the [Satyam accounting scandal](#) could not come at a worse time.

Overall, official growth forecasts need to be marked down for India, although the monsoon was good and the agricultural sector is not highly leveraged. India will likely cut interest rates further quite soon (and has space for additional cuts), but we should not expect much more from the fiscal side.

East-Central Europe

Pressure on other emerging markets continues to intensify. East-Central Europe (including Turkey), which spent the last several years borrowing heavily from Western European banks, has been especially hard hit by the contraction of credit as those banks turn to hoarding cash. The IMF is projecting contraction for both East-Central Europe and Russia; in the latter case, this is a Corporates and governments have major debt rollover problems, and most of the region is a severe turnaround from estimated growth of 6.2% in 2008.

The European Union's strategy for East-Central Europe is coming apart at the seams. Supporting exchange rates at overvalued levels does not make sense and actually adds to adjustment costs. Consequently, social tension is mounting in [Latvia](#) and elsewhere. The Latvian government is struggling to reduce nominal wages; this is an almost impossible task anywhere. The government in Iceland has fallen. Fresh waves of financial market pressure are likely to move throughout the region, probably triggered by the timing of external debt rollover needs.

Worldwide, many emerging market countries will need to borrow from the IMF. Some countries will be willing to go early to the IMF, but for most the fear of a potential stigma (and desire to do well in upcoming elections) will lead them to prefer fiscal austerity (and perhaps even contractionary monetary policy) without IMF involvement. The IMF will be more engaged in smaller emerging markets, such as in East-Central Europe. But it doesn't have 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. We should expect the IMF to lend another \$100bn over the next

six months (worldwide), and the G20 needs to keep talking about providing the Fund with more resources.

Larger emerging markets will not suffer collapse, but will increase (attempted) savings and, as a result, will experience slowdowns. The temptation for competitive devaluation will grow over time. 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. While some commodity prices may have reached their floors, a return to the levels of early 2008 will not happen until significant global growth has resumed, which could take years.

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.

United States

Perhaps the most fundamental barrier to economic recovery in the US is the weakness of balance sheets in the private sector. 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. This desire to save is causing major reductions in both consumption and private investment, creating the economic contraction we see all around us.

There are three major categories of potential policy responses: fiscal, financial, and monetary. However, each of them faces real constraints.

First, a substantial fiscal stimulus is already in train. The constraint on further action along this dimension, 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 around 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.

One view is that US government debt remains the ultimate safe haven, and this is surely true in general terms - particularly in moments of high stress. But this [excellent recent presentation](#) by John Campbell should give us pause (technical [paper here](#)). His point is

that while US long bonds go through episodes when they are good hedges against prevalent risks (e.g., now and in the recent past), this is not always true. In particular, if inflation becomes an issue - think 1970s - then long bonds are really quite risky, in both popular and technical meanings of risk. You may think your bond holdings are a great hedge, but in fact they are a fairly substantial gamble that inflation will not jump upwards.

I'm supportive of the fiscal stimulus, at the currently proposed level, and I also strongly support the view that cleaning up the banking system properly will add further to our national debt - probably in the region of 10-20% of GDP, when all is said and done. (While this seems like a lot, Linda Bilmes and Nobel Laureate Joseph Stiglitz have estimated the long-term cost of the Iraq War at \$3 trillion which, although this may be on the high end, is over 20% of GDP.) And I further agree that some form of housing refinance program will help slow foreclosures, and this should further increase the chances that the financial system stabilizes.

But all of this adds up. US government debt held by the private sector will probably rise, as a percent of GDP, from around 41% to somewhere above 70%. This is still manageable, but it should concentrate our minds. The net effect of our financial fiasco is to push us towards European-style government debt levels, and this obviously presses us further to reform (i.e., spend less on) Social Security and Medicare. And we really need to make sure we don't have another fiasco of similar magnitude any time in the near future.

Second, financial sector policy has not been encouraging. Despite a series of efforts that were both heroic and chaotic, the banking sector today is roughly in the same state it was in after the collapse of Lehman in September: investors do not trust bank balance sheets, further writedowns are expected, and stock prices are above zero mainly because of the option value of a successful government rescue.

Looking at the banks more directly, there are no easy answers. Dramatic bank recapitalization are controversial because this would imply effective nationalization, which is not appealing to Wall Street (and to many on Main Street). The original TARP terms from mid-October are no longer available, as they were very generous to banks and there is widespread backlash against bailouts. Also, the latest Citigroup bailout (from mid-November), recently repeated for Bank of America, is not appealing as an approach for the entire financial system as this was an even worse deal for the taxpayer. A clever financial engineering-type approach of ring-fencing bad assets, with some sort of government guarantee, is unlikely to provide a decisive breakthrough.

Let's say the government launches a comprehensive bank recapitalization and balance sheet clean-up scheme, with broad support on Capitol Hill. This bolsters confidence in the US banking system, causing a rise in equity prices and - most important - a strengthening of debt, both for banks and perhaps for leading nonbank corporates. Three international consequences seem likely.

1) This move forces the rest of the G7/G10 and the Eurozone to do the same, or something very similar. If we have very strong (and government-backed) banks in the US and somewhat more dubious banks anywhere in other industrialized countries, money will flow into the stronger US banks. Think back to the consequences of the original infectious [blanket guarantees in Ireland](#) in October; the effects now would be similar. You can think of the UK's upcoming moves either as a smart way to get ahead of this, or as something that will further a destabilizing wave of competitive recapitalizations - the policy is good, but doing it without coordination across countries can trigger Iceland-type situations.

2) If all major economies need to back the balance sheets of their banks, then we have converted our myriad banking sector problems into a single (per country) fiscal issue. Who has sufficient resources to fully back their banks? This obviously depends on (a) initial government debt, (b) size of banks (and their problem loans, global and local), and (c) underlying budget deficit. [Ireland](#) and [Greece](#) will be in the line of fire, but other weaker Eurozone countries will also face renewed pressure. Officials are currently trying to work through this predictive analysis, and there is some thinking about preemptive preparations, but events are moving too fast - and the international policy community again can't keep up.

3) In some countries - particularly emerging markets but also perhaps some richer countries - the foreign exchange exposure of banks will matter. Here the issue will be whether the government has enough reserves to back (or buy out) these liabilities; the [problems of Russia](#) since September foreshadow this for a wide range of countries. The absolute scale of reserves does not matter as much as whether they fully cover bank debt in foreign currency. Most emerging markets face significant difficulties and need some form of external support in this scenario, particularly as both commodity and manufactured exports from these countries will continue to fall.

If, by good fortune, the US and global recession is already at its deepest - as some in the private sector now hold - then we face a tough situation but the difficulties are manageable. However, our baseline view remains that the real economy is not yet stabilized, and hence we will see worse outcomes in Q1 and Q2 of 2009 than currently expected by the consensus. Such outcomes are not yet reflected in asset prices, and the problems for banks - and the implications for fiscal sustainability - around the world will mount.

Third, monetary policy can still make a difference. In particular, we risk entering a deflationary spiral with falling prices and downward pressure on nominal wages. In mid-December, the inflation swap market implied minus 0.5% average annual inflation for the next five years (although this expectation has increased somewhat since then). Deflation is not yet completely entrenched, so it is still possible to turn the situation around.

However, the Fed has not yet settled on the view that deflation is 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.

Global Policy Implications

One leading anti-recession idea for the moment is a [global fiscal stimulus](#) amounting to 2% of the planet’s GDP. The precise math behind this calculation is still forthcoming, but it obviously assumes a big stimulus in the US and also needs to include a pretty big fiscal expansion in Europe. (Emerging markets will barely be able to make a contribution that registers on the global scale.)

This global policy strategy is already running out of steam.

- Very few countries now find room for a fiscal stimulus; debt levels are too high and fiscal capacity is hard pressed by contingent liabilities in the banking system - particularly with an increasing probability of quasi-nationalization. As a result, the idea of a 2% of GDP global fiscal stimulus seems quite far-fetched at this point.
- Further monetary easing is therefore in the cards, especially as fears of deflation take hold, both for developed countries and emerging markets. There may now be some catching up by central banks - in that regard, see the latest [Turkish move](#) as a foreshadowing.
- Commodity prices will likely decline further as the global economic situation turns out to be worst than current consensus forecasts. As a result, official growth forecasts for most low income countries seem far too high.
- The worldwide reduction in credit continues, largely driven by lower demand for credit as households and firms try to strengthen their balance sheets by saving rather than spending.

The crisis and associated slowdown started in the US, but the recession is now global. The US economy is no more than 1/4 of the world economy, so even the largest US fiscal stimulus (say 3% of U.S. GDP per annum) cannot be not large enough to move the world at this stage. If we stabilize our financial system fully and restore consumer credit, this will help. But remember that we are subject to shocks from outside and the outlook there is worse than in the US in many ways. Outside the US the tasks look much harder.

One key principle, stated repeatedly by both the G20 and the IMF, is that policy responses need to be coordinated. This is a basic lesson of the Great Depression, when protectionist trade policies reduced exports across the board without benefiting any nation. The current crisis has not seen a widespread outbreak of higher trade barriers -

although some of the bailout programs national governments have offered to domestic industries could amount to protectionist subsidies. Instead, however, we are seeing friction over currency valuations, as countries (who can afford to) try to boost their exports. In terms of recent developments, [Switzerland](#) threatened to intervene on foreign exchange markets to suppress the value of the Swiss franc. And the [French finance minister](#) criticized the U.K. for letting the pound depreciate.

In addition, fiscal constraints give national governments an incentive to reduce the size of their stimulus packages and attempt to free-ride off of other countries instead. Many countries are probably looking to the United States and hoping that our reasonably large stimulus - 6% of GDP, spread roughly over two years - will help turn around the global economy as a whole.

Looking Forward

The first order of business is clearly to revive the US and global economies. However, it is also imperative that we understand the nature of the global economic order that we live in, with the goal of minimizing the chances of a similar economic crisis in the future and the severity of such a crisis should it occur. As mentioned above, while the government balance sheet can absorb the cost of restoring the economy this time, it is not clear how many times we can add 20% of GDP to the national debt.

We also need to recognize that financial crises, just like bubbles, will recur. Government regulators, no matter how motivated and skilled, are no match for the collective ingenuity of billions of human beings doing things that no regulator envisioned. 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 alternatively the need to put in place measures that will compensate for the stimulus once the economy has recovered.

In order to create the conditions for long-term economic health, we need to identify the real structural problem that created the current situation. 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. 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. Ordinarily, by delivering capital to the places where it is most useful, global capital flows 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 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.

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 [this 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. The only solution is to invest in the basic ingredients of productivity growth - education, infrastructure, research and development, sound regulatory policy, and so on - so that our economy can develop new engines of growth.

Further coverage of the crisis and policy proposals

Background material

Previous editions of Baseline Scenario:

- November: <http://baselinescenario.com/2008/11/10/baseline-scenario-111008/>
- December: <http://baselinescenario.com/2008/12/15/baseline-scenario-121508/>

Financial Crisis for Beginners primer, includes recent material on “bad banks” and the Swedish approach to cleaning up the banking system:

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

Deeper causes of the crisis, an ongoing series:

<http://baselinescenario.com/category/causes/>

More details on current topics

Strategies for bank recapitalization

- Economic ideas: <http://baselinescenario.com/2009/01/27/to-save-the-banks-we-must-stand-up-to-the-bankers/>
- Political developments: <http://baselinescenario.com/2009/01/25/the-emerging-political-strategy-for-bank-recapitalization/>

Global fiscal stimulus: <http://baselinescenario.com/2009/01/21/global-fiscal-stimulus-should-it-be-an-obama-priority/>

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/>

“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/>

Testimony to Joint Economic Committee (October 30, 2008):
<http://baselinescenario.com/2008/10/30/testimony-before-joint-economic-committee-today/>

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

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Jan 29, 2009 11:02 AM

What Does “Private” Mean?

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

Yesterday, [Tim Geithner](#) told reporters, “We have a financial system that is run by private shareholders, managed by private institutions, and we’d like to do our best to preserve that system.” On its face, I think most Americans would agree that a private

banking sector is better than just having one big government bank. But “private” can still mean a lot of different things. For starters, here are three: (a) day-to-day operations are managed by ordinary corporate managers who are paid to maximize profits, rather than by government bureaucrats; (b) those profits flow to private shareholders, rather than the government; (c) the overall flow of credit in the economy is determined by private market forces, rather than the government.

When people debate “nationalization,” it’s not always clear whether they are talking about ending (a) and (b) or just (b). The recapitalizations to date under the TARP Capital Purchase Program have bent over backwards to avoid either one. Because the government purchased nonconvertible preferred shares, it has no ability (that I know of, although [Robert Reich](#) thinks otherwise in an article I’ll come back to) to turn them into common stock with voting rights that lead to management control; and because the shares pay a fixed 5% dividend, they are a lot like a loan, where any profits after paying off the loan flow to existing shareholders.

However, the two could theoretically be separated. If we want taxpayers to benefit from any recovery by the banks, but we are worried about government bureaucrats making lending decisions, the government could theoretically buy a new class of common stock that earns dividends and trades on the market like ordinary stock, but has diminished voting rights - say, enough for the government to appoint a minority of the board of directors. In other words, letting the taxpayer benefit from banks’ future recovery does not necessarily imply government bureaucrats.

(As an aside, [Sweden](#) plunged wholeheartedly into (a) as well as (b), although it did later reprivatize the banks it took over.)

More broadly, though, what about (c)? In the financial sector, the flow of credit is not determined solely by banks’ lending decisions - or, rather, those lending decisions are heavily influenced by the secondary market for their assets. As the story has been told many times, mortgage lenders were pushing subprime loans because investment banks wanted them to fill their securitizations, and they wanted to fill those securitizations because hedge funds and other investors on the other end wanted those CDOs. In this model, the banks are the intermediaries, and the investors with the money in the first place are the ones determining where credit goes, on the large scale.

The government has always been in this game. One of the best-known examples is Fannie Mae and Freddie Mac (although, whenever I bring up those names, I feel bound to mention that they actually provided a declining proportion of housing money during the boom, precisely because everyone else was piling in), who influence the mortgage market by buying mortgages on the secondary market. But the government has become a much bigger player in the last few months. In the latest move, the Treasury Department is setting up a [conduit](#) to buy new and existing student loans from lenders. The goal is to give those lenders a market where they can resell student loans, which will hopefully encourage them to make those loans (because now they don’t have to worry about the loans going bad - although I believe many of these loans were already guaranteed). Like

the already-announced program to buy asset-backed securities, this is an attempt to restart (influence) the flow of credit by intervening in the secondary market. Conceptually, the government is trying to lend its own money, using the banks solely as originators, since the banks are nervous about lending their money. Although I am probably misusing the term, it's an attempt to get around the liquidity trap: if banks prefer cash to any non-cash assets, then give them a way to immediately turn loans into cash.

(Still, I'm confused about why you would open the program to existing as well as new loans. If banks can sell existing loans to the conduit, then they will do that, and it won't necessarily stimulate new lending.)

(Also, I tend to think that a program like this one has positive externalities, in that [education is a good thing](#). Although, as a [commenter](#) on my earlier post whom I greatly respect argues, subsidies for education just end up pushing up the price of education.)

As Robert Reich points out in his article, even the "bad bank" idea doesn't necessarily keep the banking system in private hands. He has a good description of the current situation, though I'm not sure I agree with him over the degree:

But as the Mini Depression worsens, "toxic assets" are no longer all that distinct from a vast and growing sea of non-performing or endangered loans on the banks' balance sheets. Toxicity has spread to loans made to people and companies that were good credit risks as recently as early last year but are now bad risks. You don't have to be an honest financier (no oxymoron intended) to figure this out: Ten percent of Americans are behind on paying their mortgages. Millions more are behind on paying their credit-card bills. Hundreds of thousands of small businesses are behind on paying their own bills. Auto suppliers are can't pay their bills. And so it goes.

As a result, he says, a government "bad bank" might end up buying most of the assets in the banking system (that seems like an exaggeration, but I get the point), and suddenly the government is the biggest bank around. That is, if it isn't already.

If you are worried about government influence over credit, it's always been here, and it's increasing, because without the government there might not be any flow of credit in certain markets. It does make sense to debate the forms that influence should take, but there's no getting rid of it.

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Jan 28, 2009 9:04 PM

[The Scariest Blog Post Ever](#)

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

Seeking Alpha is perhaps the largest financial blog/blog aggregator around. And for at least a week now, one of their “most popular” posts has been [The Scariest Chart Ever](#). Take a look. Then come back here.

The chart itself isn’t very scary. It shows that the amount borrowed by banks from the Federal Reserve - “Borrowings of Depository Institutions from the Federal Reserve” - has spiked from a trivial level (a few billion dollars) to several hundred billion. It sat at a trivial level because, in ordinary times, there is no reason for a bank to borrow at the discount window when it can borrow instead from another bank at a lower rate (since the Fed funds rate is usually lower than the discount rate). It has spiked up recently as a symptom of the credit crisis; basically, what the chart shows is that the Fed is doing its job of providing liquidity in a crisis.

What’s scary is that the author of the post claims that the chart shows “federal borrowing,” called it “the scariest chart ever,” and concluded, “Anyone still think there are not some rough patches down the road?” . . . and then this became the most popular post on the most popular financial blog in the world. And even though a few people (including me) tried to point out the basic error, the vast majority of the comments pile on to the idea that this chart shows a huge spike in government borrowing.

This is scary (actually, depressing might be a better word) for those of us who think that blogs (and the Internet in general) can serve a valuable purpose in disseminating useful information and allowing constructive discussion. It also points to the importance of [financial education](#), although maybe this example is more about basic verbal education (read the title of the chart) and numerical education (read the numbers on the Y axis: if the chart says that government borrowing was a few billion dollars as recently as 2007, then there’s something wrong).

Update: I should point out that in general I think Seeking Alpha provides a useful service by aggregating information from a wide variety of blogs and using community techniques to filter through them. Among other things, they republish some articles that Simon and I write here. This example just shows that sometimes the community filtering technique produces weird results.

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Jan 28, 2009 4:28 PM

[Senate Testimony Tomorrow](#)

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

From 10am until about noon on Thursday (January 29th), I'll be testifying to the Senate Budget Committee on a panel discussing [The Global Economy: Outlook, Risks, and Implications for Policy](#). I'll post my testimony here after the session, and - potentially with some edits - this will also serve as the revised version of our Baseline Scenario.

Now would be a good time to tell me if you think there are important developments around the world, big or small, that we have overlooked recently. And if you have other policy-related points that you think I should consider making, please post those as comments here also.

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Jan 28, 2009 3:49 PM

[Long-Term Returns to Stimulus: Education](#)

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

The fiscal stimulus debate is currently hampered by confusion over its objectives. On the one hand, one purpose of the stimulus is to generate economic activity quickly in order to boost aggregate demand and break the recessionary spiral we seem to be in. On the other hand, people rightly worry about the capacity of the government to spend large amounts of money quickly without wasting it, and argue that the money should be put to productive use, rather than paying people to dig holes and then fill them in again. (This is why you see (at least) two versions of criticism of the stimulus plan: on the one hand, the criticism is that the government is incapable of putting money to productive use; on the other hand, the criticism is that money for things like electronic health records will not be spent in time to have a short-term effect.)

My opinion is that both are valid purposes. There probably is a limit to the number of tens of billions of dollars the government can spend next month without wasting some of it. But given the projected [duration of the output gap](#) (the difference between potential and actual GDP, meaning that the economy is performing below its full-employment capacity), I think there is also value in programs that take several quarters to disburse their money - as long as those programs are also good investments.

One major area of spending is [education](#), where the plan includes more than \$150 billion in new spending over two years. While politicians (and economists) reflexively cite

education as an area where investments can have positive long-term returns (through increases in productivity which increase GDP and our average standard of living), I wanted to see what empirical research there has been on this topic. There has been a lot of research on the impact on individuals' earnings of additional education (this is a common example used in first-year statistics classes), but somewhat less on the impact on national economic growth.

Two leading researchers in the economics of education are Claudia Goldin and Lawrence Katz. I looked through their papers, and the simplest one I found that covers this topic directly is "[The Legacy of U.S. Educational Leadership: Notes on Distribution and Economic Growth in the Twentieth Century](#)." This paper discusses the United States' educational lead over other countries in the 20th century and the impact it had on the U.S. economic growth. The main difference between the U.S. and Europe was not elite education, but the development of mass secondary education between World Wars I and II: as the economy became more technologically sophisticated, there was greater need for an educated workforce, including in production jobs.

Many studies have found that countries with more educated labor forces experience higher rates of economic growth. More difficult to determine is the extent to which the positive relationship between education and growth results from the causal impact of education on growth and not from reverse causation or from confounding factors correlated with both education and growth. Educational advance can contribute directly to economic growth by increasing the human capital and thus the productivity of the work force, and indirectly by increasing the rate of innovation and adoption of new technologies.

They addressed only the first effect: the impact of higher productivity. The results:

The direct impact on economic growth of the expanding education of the work force was about 0.37 percent per year . . . since 1915, and the educational factor accounts for 23 percent of the 1.62 percent per year increase in U.S. labor productivity (non-farm, non-housing business GDP per worker for 1913 to 1996 . . .).

In other words, 23% of productivity growth in the last century was due to increased education. In other studies, they discuss the decline in the rate of educational growth (the average educational level of the workforce) that has set in since 1980. If increased spending on education can reverse that decline (a big if, I know), then it could have a significant impact on productivity for decades to come.

I know this is a very controversial topic. For an opposing viewpoint, [Arnold Kling](#) says (referring to Goldin and Kaz's [new book](#)) that what's really at work there is that the average educational level can't keep growing at its earlier pace, since the current level is higher than the former level, and it just isn't possible to dramatically increase college attendance and graduation rates."

If readers know of other more recent, or contradictory, studies on the relationship between education and economic growth, please share.

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Jan 27, 2009 11:41 PM

[Meanwhile, Elsewhere . . .](#)

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

All the hubbub about the new Obama Administration and the probably-impending bank rescue plan has diverted my attention a bit from goings-on in the rest of the world. I decided to spend a little time checking in, thanks to the magic of the Internet. And things do not look so good.

- Japan, in what looks like sign of desperation, announced a plan to [buy shares directly](#) in companies (not just banks) that are having trouble raising capital. The idea seems to be that, since companies are having trouble borrowing money from banks, they should get it from the government instead. This looks like a much broader and more direct intervention - deciding who gets capital and who doesn't - than anything that has been contemplated in the U.S.
- Germany, the largest economy in the EU and one once thought to be relatively safe in the current crisis (as compared to the U.S. or the U.K., with our overgrown financial sectors), is now projected to see a contraction in GDP of over 3% (composite Bloomberg forecast) - but still struggled to pass a [stimulus package](#) of \$65 billion - or 2.5% of GDP - over 2 years. And despite an annual government deficit under 3% of GDP (ours is over 8% by comparison), the political pressure is to reduce the deficit and return to a balanced budget out of fear of inflation. This only highlights the tensions within the Eurozone between countries with different economic situations and priorities.
- The [Institute for International Finance](#) projects that net private sector capital flows (investments, whether direct investment, equity, or debt) to emerging markets will be \$165 billion in 2009, a staggering 65% drop from 2008. Commercial banks are expected on balance to withdraw \$61 billion from the region. As a result, regions such as Eastern Europe whose recent growth was dependent on foreign lending are likely to contract for some time to come, as companies are unable to refinance their debt.
- Robert Zoellick, head of the World Bank, estimates that the economic crisis has pushed [100 million people](#) around the world into poverty.

One of the themes of this crisis has been that whatever problems we have here in the U.S., countries with weaker borrowing power, currencies, social safety nets, and financial sectors face much bigger problems. That isn't changing.

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Jan 27, 2009 12:52 AM

[To Save The Banks We Must Stand Up To The Bankers](#)

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

The Financial Times has just published an [op ed](#) by Peter Boone and me, arguing that aggressive bank recapitalization and toxic debt clean-up is essential in the U.S. - and that this can be done with strong protections for taxpayers and without nationalization. The FT did a great job cutting our draft down to fit their print edition (of Tuesday, January 27th); I don't think they took out anything crucial. But, just in case, after the jump is the full article as submitted.

(Note: newspapers usually like to choose their own titles for op eds, and the FT is no exception. But I like their choice and I've used it as the heading for this post.)

If you hid the name of the country and just showed them the numbers, there is no doubt what old IMF hands would say when confronted by the current situation of the United States: nationalize the banking system. The government has already essentially guaranteed the liabilities of the banking system (and no one can risk a Lehman re-run), bank assets at market value must be massively lower than liabilities, and a severe global recession may yet turn into the Greatest Depression.

Nationalization would simplify enormously the job of cleaning up the balance sheets of the banking system, without which no amount of recapitalization can make sense. An asset management company would be constructed for each nationalized bank, and loans and securities could be clearly divided into "definitely good" and "everything else". The arbitrariness of this procedure is not a worry when it all belongs to the government in any case.

The good loans would go into a newly recapitalized bank, where the taxpayer not only holds all the risk (as now) but also gets all the upside. Careful disposal of the bad assets would yield lower losses than feared, although the final net addition to government debt

would no doubt be in the standard range for major banking fiascos: between 10% and 20% of GDP.

As soon as you reveal that the country in question is the United States, the advice has to change for three reasons. First, nationalization is an anathema in the U.S. Second, there is good reason for this - the government here really has no track record of running successful business enterprises. Third, most important, think about what would happen if the American political system gets the bit of directed credit between its teeth, with all the lobbying that entails. If you want to end up with the economy of Pakistan, the politics of Ukraine, and the inflation rate of Zimbabwe, bank nationalization is the way to go.

Yet no one other than the government is available to recapitalize the banking system, and without sufficient capital, lending cannot be stabilized and any incipient recovery - based on the fiscal stimulus and the pending large mortgage refinancing program - will be strangled at birth.

The problem is not just pervasive financial and macroeconomic instability, it's the scale of the recapitalization needed to cover the real losses faced by banks - remember Citi and Bank of America required "survival bailouts" and today are valued merely as options. Additional capital is also needed to support the banks' (and everyone else's) desire for higher capitalization in the future. And, with the world economy still deteriorating, we need even more capital as a cushion against the worst case recession scenario.

And these are just the direct recapitalization components. The asset management companies must pay cash for the distressed assets. Buying at current market prices should protect most of the taxpayer investment and is the only approach that will find political support.

Adding these together suggests that the government will need to come up with "working capital" in the region of \$3trn-4trn. If things go well, at the end of the day the losses to the taxpayer should be quite limited, with the final cost closer to \$1trn. But this requires that the taxpayer gets enough upside participation. How is this possible without receiving common equity which, at today's prices, would imply controlling stakes in the banks (i.e., nationalization)?

We could receive a large amount of nonvoting stock, but a majority silent shareholder is an oxymoron who distorts the incentives of managers towards more bad behavior. And the last thing we need is further political backlash.

The most politically robust solution is to have the government acquire not voting stock but warrants - the option to buy such stock. These warrants would convert to common stock when sold, and a Resolution Trust Corporation-type structure can manage the disposal of these controlling stakes into the hands of private equity investors. New owners would restructure bank operations, fire executives, and break up the banks (particularly if some anti-trust provisions are added).

The sticking point will be banks refusing to sell assets at market value. The regulators need to apply without forbearance their existing rules and principles for proper loan provisioning and for the marking to market of all illiquid assets. We know they can do this in individual cases - NCC, for example, was forced out of business despite seeming well-capitalized by any publicly available measure. It's the big, politically powerful banks that have caught way too many breaks.

The law must be used against both accountants and bank executives who deviate from the rules on capital requirements. This will concentrate the minds of our financial elite. Either they will raise capital privately or the government will provide, but this time on terms favorable to the taxpayer. The banker's lobby, of course, will protest loudly. Good thing we now have a U.S. President who can stand up to them, otherwise we would eventually collapse into nationalization.

By [Peter Boone and Simon Johnson](#)

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Jan 26, 2009 9:31 PM

[Sweden for Beginners](#)

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

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

With the regularity of a pendulum, the focus of discussion has swung back to the banking system (September: Lehman and AIG; November: Citigroup; January: Bank of America, and everyone else). And as everyone waits in anticipation for the Obama team's first big swing, there has been increased discussion of . . . Sweden, including a recent [New York Times](#) article and a fair amount of blog activity, with a broad overview by [Steve Waldman](#). (For other accounts, see this [Cleveland Fed paper](#) and a review of the crisis published by the [Swedish central bank](#) (which, according to Wikipedia, is also the world's oldest central bank).)

Why Sweden? Because Sweden had its own financial crisis in the early 1990s, and by many accounts did a reasonably good job of pulling out of it. A housing bubble, fueled by cheap credit, collapsed in 1990, with residential real estate prices falling by 25% in real terms by 1995 and nonperforming loans reaching 11% by 1993, while the Swedish krona fell in value by 30%, hurting a banking sector largely financed by foreign funds. As Urban Backstrom said in a [1997 paper](#), "[the] aggregate loan losses [of the seven largest

banks] amounted to the equivalent of 12 percent of Sweden's annual GDP. The stock of nonperforming loans was much larger than the banking sector's total equity capital." In other words, the banking sector as a whole was broke.

So what did Sweden do? If the options on the table in the U.S. right now are (a) additional recapitalization, (b) an aggregator bank to buy up bad assets, and (c) nationalization, the Swedish solution included all three. First, in late 1992, the government guaranteed all bank creditors (but not shareholders), with no upper limit. Because investors did not at the time question the solvency of the government, this meant that they would continue to lend money to the banks, and the central bank provided unlimited liquidity just in case. Although the U.S. has guaranteed new debt issued by banks, and there is virtually an implicit blanket guarantee for at least the largest banks, there is still uncertainty among bank creditors, as witnessed by credit default swap spreads.

However, even if an insolvent bank has access to credit, it is still an insolvent bank, hoping somehow to become solvent, so it's unlikely to lend or, even worse, it may be tempted to make extremely risky loans as the only possible path to solvency. As a condition of government support, government auditors reviewed the balance sheets of all the banks involved, with the goal of taking writedowns immediately and showing the true state of affairs. When it turned out that two major banks, Nordbanken and Gota, were insolvent, they were nationalized (Nordbanken was already largely state-owned), giving the state control of over 20% of the banking system (by assets). Gota was merged into Nordbanken, which only held onto "good" assets, and the "bad" assets were moved to two new entities, Securum and Retriva. These entities were capitalized by the government, and bought 21% of Nordbanken's assets and 45% of Gota's assets. This is an example of the good bank/bad bank plan that has gotten so much attention lately. Nordbanken itself (the good bank) was recapitalized by the government, to the tune of 3% of GDP, and became a healthy bank, while Securum and Retriva were told to get whatever value they could out of the bad assets.

Securum and Retriva were run like a cross between private equity firms and asset management companies, both managing and improving assets and also finding buyers for the assets. According to the Cleveland Fed, they managed to return \$1.8 billion out of their \$4.5 billion in initial capital to the government, for a net taxpayer loss of \$2.7 billion. (I can't figure out if the government also lost money on the loan guarantee, although the sources I read implied that it didn't.) And Nordbanken, after being run by the government, was eventually privatized (the government's ownership share is now 19.9%), and the taxpayer recovered the capital put into it in the rescue. As I said above, this is generally seen as a success story, although the Cleveland Fed does have a sobering conclusion:

the cost of the crisis to Sweden was not limited to the capital spent by the [asset management companies]. There have been significant income and output losses associated with the crisis. In the early 1970s, Sweden had one of the highest income levels in Europe; today, its lead has all but disappeared. Cerra and Saxena (2005) found

that the crisis caused a permanent decline in output that can explain the entire fall in Sweden's relative income. So, even well-managed financial crises don't really have happy endings.

The Swedish story is usually used as an argument in favor of nationalization, and that's not an implausible inference to draw. But another lesson you can draw is that it's not the nationalization per se that matters, but the pricing of the bad assets. The key was that the banks were forced to write down their assets in one shot and then to sell them to the bad banks at realistic prices. That cleaned up their balance sheets and, once they were recapitalized, allowed them to operate as healthy banks. As we said a long time ago, TARP was a fine idea as long as it paid fair value for assets and was combined with recapitalization to fill the resulting hole in bank balance sheets. The same holds for an aggregator bank. The problem would be letting the banks decide which assets they want to sell, and then letting them unload them on the aggregator bank at inflated prices. That solves nothing.

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Jan 25, 2009 4:05 PM

[The Emerging Political Strategy For Bank Recapitalization](#)

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

Here's a tough problem.

1. The nation's leading banks are short of capital, and only the government can provide the scale of resources needed to recapitalize, clean up balance sheets, and really get the credit system back into shape. Any sensible approach will put some trillions of taxpayer money at risk. We should get most of it back but - as we've learned - things can go wrong.
2. Everyone hates bankers right now, and these feelings only deepen as we learn more about how the first part of the TARP was spent and mis-spent. No one wants to hear about anything that sounds like a bailout to bankers and their careers.

How does the Administration and Congress sort this one out? This weekend we seeing an approach take shape which, most likely, will work. There are five closely related moving pieces.

First, there will be an immediate [clamp down](#) on regulated banks and hedge funds. This will be popular. By itself, of course, it brings some dangers as pro-cyclical regulatory action is a good way to deepen a recession. But the goal here will be to flush out everyone and anyone who does not have enough capital to stay in business. This makes good economic sense and it will build support for the idea that this Administration can be tough on the financial sector while also turning it around.

Second, the fiscal stimulus will pass soon. This will be widely popular, particularly as there is [something for almost everyone](#) in the short run.

Third, some of the TARP II money will go into a program for refinancing housing. I expect this will run to \$100bn+ (likely leveraged to a higher headline number) and will get broad support; who can really resist trying to break the death spiral of house prices, foreclosures and forced sales? Tim Geithner will probaby announce the broad contours within a day or two of being confirmed - in part because it also makes the point that the remaining \$200bn or so in TARP II will not be enough to recapitalize and clean up the banking system properly.

Fourth, we will begin to understand that our intervention in the banking system is not nationalization but rather taxpayer participation in the upside gains from the impending recovery. Here is the right way to begin selling this,

“If we are going to put money into the banks, we certainly want equity for the American people,” said Pelosi, a California Democrat. “If we are strengthening them, then the American people should get some of the upside of that strengthening. Some people call that nationalization; I’m not talking about total ownership, but we’re just saying.” (From [Bloomberg](#)’s coverage of the House Speaker on television today.)

Of course, we also need a technical solution for how the government gets in and then gets out of the banks, without becoming ensnared in a political and lobbyist quagmire. (We have [proposals](#) for this; so do [others](#).)

Fifth, we need to have what Senator Kent Conrad emphasized today on CNN: “sufficient resources.” This is where the discussion only just begun (e.g., [listen to some of Diane Rehm’s](#) Thursday show) and where we will need to make rapid progress - probably just as soon as the fiscal stimulus is a done deal.

Did I miss anything?

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Jan 24, 2009 8:20 AM

Davos World Economic Forum: A Viewer's Guide

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

The big annual economic meeting at [Davos](#) opens next week (Jan 28-Feb 1 are the official dates), and the discussion there - in both formal and informal interactions - is worth scouring for indications of the current situation around the world and where we all may be heading.

Given the likely composition of the main players this year - world corporate leaders and the non-US policy elite (with the new US policymakers stuck at home, doing real work; **update: this is now [confirmed by Bloomberg](#) for Summers and Bair**) - I would suggest viewers at home and on the ground keep watch for answers to the following.

1. Are we on the same planet? It is not unheard of for Davos participants to appear as if they are living in their own bubble. Watch for opulent parties and excessive consumption, particularly if the people involved have nominated themselves for any kind of government handout. If you meet someone from Merrill, ask if their attendance fees came out of 4th quarter earnings - or if there is still more bad news to come.
2. Who doesn't have their hand out? It would be nice to see a corporate leader or, ideally, more than one, stand up and make a categorical statement along the lines of, "we don't need a bailout of any kind, nor will we seek any kind of additional government assistance however clandestine, and the idea of pseudo-protectionism to goose profits and jack up my bonus is quite repellent." Remember that the slippery slope to global trade wars is not the product of irresponsible politicians alone - they get a lot of assistance from business and lobbyists of many stripes.
3. Are they really in trouble or do they just want to fire us because it's in fashion? More than a sneaking suspicion is arising that many of the firings, layoffs, and pay reductions around the world are not actually necessary. Somehow corporate leaders have formed the idea that this is what they must do, rather the investing more in their people, looking for ways to innovate our way out of the crisis, or generally doing things that are hard work for executives and pay off only over time. No doubt someone will do very well by bucking this trend. But who?
4. Who didn't overspend in the good times? Some self-appointed intellectual and financial leaders - including universities, venture capital, and private equity - previously prided themselves on having deep pockets, a long-time horizon, and recession-proof strategies. Now we find that they overcommitted to things they couldn't really afford, just as if they were No Income No Documentation borrowers. And if you actually hear someone admit personal responsibility for anything at all - however small - in the boom or the crash, write me at once.
5. Is the [G20 at all relevant](#)? The G20 grouping of leading industrialized and emerging market countries has a great opportunity to establish itself as the

preeminent forum for addressing the world's problems, pushing aside the G7, IMF, etc, and rising to the top of the global alphabet soup. The current chair is Gordon Brown and he will be in full voice. But what exactly is the agenda? Some of his re-regulation points make sense and will help preempt problems in the future, but we need more. Where is the recovery strategy, how are really poor people going to be helped, and what - if anything - does global cooperation offer that you can't do with a smart unilateral approach?

You may have thought that denial, arrogance of power, and profound irresponsibility left the world stage around noon on Tuesday. If so, Davos will likely prove you wrong.

Update: [WSJ's preview](#) of Davos gives details of fee structure, attendees, and attitudes. Only Valerie Jarrett will attend on behalf of the Obama Administration.

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Jan 23, 2009 4:02 PM

[Protectionism by Another Name?](#)

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

One thing you can probably get 99% of economists to agree on is that a global trade war in the middle of a global recession is a bad idea. If every country increases import tariffs, hoping to protect its domestic industry from foreign competition, global trade will fall in all directions, hurting everybody. Put another way, increased tariffs are a negative-sum game.

To date, we haven't seen much in the way of higher trade barriers during this crisis, although you could argue that some bailouts constitute subsidies favoring local over foreign companies. Instead, however, we are seeing friction over currency valuations. If you want to boost your net exports but don't want to do the obviously unfriendly thing and increase tariffs, the other option is to devalue your currency: a weaker currency increases the price of imported goods and reduces the price of exported goods, hence reducing imports and increasing exports.

Yesterday, Tim Geithner accused China of "[manipulating its currency](#)," something we've heard periodically over the last several years but not in much in the last few months. (Of course, [Geithner then said](#) that "a strong dollar is in America's national interest," whatever that means.) [Switzerland](#) threatened to intervene on foreign exchange markets

to suppress the value of the Swiss franc. And the [French finance minister](#) criticized the U.K. for letting the pound depreciate. (Hat tip [Macro Man](#) for the last two.)

Theoretically, devaluing your currency is not as bad as import tariffs. If every country tries to devalue its currency at the same time, exchange rates will remain the same; this is a zero-sum game in that sense. It's a little more complicated, because there are at least two ways of devaluing your currency. One is for the central government to sell its own currency and buy everyone else's currency on the foreign exchange market. The other, however, is to run an expansionary monetary policy (lower interest rates, more money creation, etc.), which is inflationary. So one possible outcome is that every country runs an expansionary monetary policy, exchange rates remain the same, but commodity prices go up because there is more money floating around. In today's environment of low or negative inflation expectations, however, that might not be such a terrible thing.

But the other side of competitive currency devaluations is that not all countries are equally well armed. In particular, countries that use the euro cannot devalue their currencies, because they don't control their monetary policy and they don't have the scale to intervene significantly on the market for euros. In short, other countries can devalue their currencies at the expense of Eurozone members. This is one of the reasons why, as [we](#) (and [Martin Feldstein](#)) have warned, the economic crisis will increase tensions within the Eurozone. The [New York Times](#) just ran an article on this exact topic:

Germany, France and the Scandinavian countries are mounting billion-dollar stimulus plans and erecting fences to protect their banks. But the peripheral economies are being left to twist in the market winds.

This is a good indicator that fears about the Eurozone are going mainstream.

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Jan 23, 2009 9:26 AM

[**The Long Bond Yield Also Rises**](#)

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

The spread between Greek government 10-year bonds and the equivalent German government securities rose sharply this week - Greek debt at this maturity now yields 6.0% vs. German debt at 3.1%. Other weaker eurozone countries appear to be on a similar trajectory (e.g., Irish 10 year government debt is yielding 5.8%) and if you don't know who the PIIGS are, and why they are in trouble, [you should find out](#).

We also know East-Central Europe (including Turkey) has major debt rollover problems and most of that region is in transit to the IMF, with exact arrival times determined by precise funding needs relative to the usual political desire to keep the party going through at least one more local election. Put the IMF down for another \$100bn in loans over the next six months, and keep the G20 talking about providing the Fund with more resources.

But the big news of the week, with first-order implications for the US and the world, was from the UK where the prospect of further bank nationalization now looms.

This is a AAA-rated sovereign with its housing market in a nose dive, overextended (and apparently mismanaged) major banks, and a government on its way to guaranteeing all financial liabilities and directing the flow of credit moving forward. A strategy emerges, but it's based more on depreciating the pound and surprising people with inflation than on fully-funded bank recapitalization. Additional fiscal stimulus, increasingly, looks at best irrelevant and - worryingly - perhaps even destabilizing. The yield on 10-year government bonds is, of course rising - now over 3.5%.

In this context and recognizing that credit ratings are a lagging but not meaningless indicator, Spain's downgrade from AAA is a significant milestone. Further European downgrades are in the air.

What do all these situations have in common? We are repricing the risk (or coming to our senses) on the dangers of lending to a wide range of governments. And this is not just about emerging markets (East-Central Europe) or industrialized countries that sustained a boom based on euro convergence (the PIIGS), it is potentially about rethinking any government's obligations.

What about German debt? There is no question that Germany will do whatever it takes to maintain a reputation for fiscal prudence. But problems in the eurozone put pressure on the European Central Bank to loosen its policies (and there are murmurs already about easing repo-rules as credit ratings fall; basically, supporting euro sovereigns during their downward spiral), and this has implications for currency risk. Also, German exports are under severe pressure - their cars, machinery, and similar durables, of course, have a great reputation, but how many of them do you really need to buy this quarter?

And what about the US? One view is that US government debt remains the ultimate safe haven, and this is surely true in general terms - particularly in moments of high stress. But I was struck recently by an [excellent presentation](#) by John Campbell (technical [paper here](#)). His point is that while US long bonds go through episodes when they are good hedges against prevalent risks (e.g., now and in the recent past), this is not always true. In particular, if inflation becomes an issue - think 1970s - then long bonds are really quite risky, in both popular and technical meanings of risk. You may think your bond holdings are a great hedge, but in fact they are a fairly substantial gamble that inflation will not jump upwards.

I also hear people increasingly talking about the limits on sustainable debt in the US (and we will shortly publish a Beginners' Guide on this). I'm supportive of the fiscal stimulus, at around the currently proposed level, and I also strongly support the view that cleaning up the banking system properly will add further to our national debt (probably in the region of 10-20% of GDP, when all is said and done). And I further agree that some form of housing refinance program will help slow foreclosures, and this should further increase the chances that the financial system stabilizes.

But all of this adds up. US government debt held by the private sector will probably rise, as a percent of GDP, from around 41% to somewhere above 70%. This is still manageable, but it should concentrate our minds. The net effect of our financial fiasco is to push us towards European-style government debt levels, and this obviously presses us further to reform (i.e., spend less on) Social Security and Medicare. And we really need to make sure we don't have another fiasco (of any kind) of similar magnitude any time in the near future.

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Jan 22, 2009 9:49 AM

[Constraints On The Comprehensive Obama Plan](#)

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

Yesterday, Tim Geithner stated clearly - and reassuringly - that the Obama Administration will present a comprehensive and detailed economic recovery plan within a few weeks.

We know this plan involves a large fiscal stimulus, and it is reasonably clear there will be around \$100bn for housing refinance/mortgage mitigation (out of TARP II funding), and probably some other symbolically important pieces intended to help consumers directly.

The big question is: what will be done about the total mess that our banking system has become? On this key dimension, we know little about the Administration's specific thinking, but we can already see with considerable clarity the constraints that will bind as their thinking becomes concrete policy proposals.

There are three major political constraints.

First, the Plan must be different in substance and perception from the Bush/Paulson efforts. This may seem obvious and easy, but if you think that toxic asset disposal is

needed, then this has to be packaged and presented quite differently from any of the previous iterations.

Second, there has to be much more buy-in from Congress. Arguably, Mr Paulson's greatest mistake was creating the impression in September that he was trying to steamroll through the original TARP. "Do this or the financial system will die on Monday," is not a message that conveys the impression you actually know what is going on and how to deal with the situation.

Third, whatever happens, transparency and accountability will be not just watchwords, but also a key part of any reality that Congress will be willing to support.

Of course, there are also economic constraints that imply some fairly essential principles.

- Let no bank fail in a way that causes significant losses to creditors. You might think that the massive Fed support for the financial system, put in place since September, makes it safe to let a bank default on its obligations, and you might be right. But I strongly suggest that we not find out - the risks are far too great. Also, this would violate the first political constraint above - you don't want to do anything that could become like the post-Lehman/AIG moment all over again.
- Get it right the first time. The flip-flop policies of the fall were quite damaging. This is not a time for [incrementalism](#) or figuring things out in small steps. Even if the markets are very difficult this week and next, the Administration needs time to work out all the details and build political support - this will take at least a few weeks, perhaps even a month.
- The scale needs to be massive. A key principle of any macro stabilizing program is that it needs to be larger than the consensus suggests at the moment of announcement. Right now, people are talking in terms of \$1trn-\$2trn, but the numbers are rising by the day. The headline scale will depend on how long it takes to put the program in place and what happens in the meantime, but my sense is that we will be talking about sums in the \$5trn range, or perhaps even close to 50 percent of GDP. (Note: this is not the expected final losses or how the Congressional Budget Office will score the program; that should be significantly lower, but of course it's unknowable as it depends on the full set of US and global macroeconomic outcomes).
- Large parts of the banking system need capital. Private equity is available and interested, but it will hang back until it sees greater clarity on (a) the bank program and (b) the macroeconomy. The trick is to convince the leadership of this industry that the turnaround is just about to happen, and then they will pile in.
- We need a banking system, moving forward, that is free of the uncertainty overhang caused by bad assets. So the program needs to include a large degree of balance sheet clean up. There is a [menu of established choices](#) here, and any of these would work if scaled up sufficiently - this will probably be the biggest financial sanitation project the world has ever seen. But the political

constraints will bind here - the central question is simply: what will Congress support?

- In the clean up, the valuation of bad assets taken or purchased from banks will be key. The essential principle here is: we will not overpay. But, of course, there are many devils in the details of how to establish that you are not overpaying. If you have good ideas on this, post them here; [we've posted our suggestions](#), but no one yet has an ideal scheme.

President Obama obviously has to do more than a great sales job to get popular and congressional support; it requires persuasion of historic proportions. There is no doubt that he can do this, but it will be easier if he can propose:

1. A new structure, run by unimpeachable characters, with more transparency than you have ever seen in a public or private body. Let CSPAN cover every deliberation of this aggregator bank/RTC-type organization/control board in mind-numbing detail. Let everyone in on the complexity.
2. Not to nationalize the banking system. There would be a backlash against the idea that the US government can or should run the banking system. Also, can you imagine the explosion in lobbying activity and politically directed credit? The government needs to take the leadership role and commit capital (there is no one else available), but it also needs to get out. ([One proposal is here](#); you can do this other ways).
3. Taxpayer value is of the essence. If you try to make sustaining jobs - either in banking or among borrowers - the key priority of the bank restructuring, things will go badly wrong. We need a cleaner, restructured banking system with new (private) owners and a complete change of management. A stronger banking system will support the change and growth in the US economy. The government, on behalf of the people who ultimately pay the nation's debt, is willing to take on risk. But it must and will get a big chunk of the upside. Imagine the backlash if the banking system recovers through great government exertions and consequently we all have to pay the interest on additional government debt in the region of 20-30% of GDP, while a few relatively well-heeled individuals pocket massive fortunes.

And I would manage expectations very carefully. Cleaning up the banks, stimulating the economy through fiscal means, and reducing foreclosures are necessary but not sufficient for a return to sustained growth. They will likely give us a temporary boost, but we are in the midst of a big adjustment in the pattern of global savings - with almost everyone who is creditworthy around the world wanting to borrow less and strengthen their balance sheets. We need to ride through the ensuing storm, cushioning the blow for the weakest members of our society and the world.

We will get through this and, when we do, we'll have stronger growth, with more opportunities for more people, if the credit system is healthier. But please do not form the impression that even the most comprehensive, carefully thought through, and brilliantly implemented plan will constitute any kind of magic bullet.

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Jan 22, 2009 8:49 AM

[More on Financial Education](#)

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

My earlier post on [basic financial education](#) got a fair amount of attention, so I wanted to point out one source for more information on the topic. Zvi Bodie, Dennis McLeavey, and Laurence B. Siegel hosted a conference in 2006 on “The Future of Life-Cycle Saving and Investing,” and the most of the presentations and comments can be downloaded as a PDF from [this site](#). Some of the general themes of the conference were: people don’t save enough for retirement; people have to make important financial decisions on their own; but people tend to make suboptimal financial decisions (like not rolling over retirement accounts), so giving them more “choice” leads to bad results; and the financial advice they are getting is not necessarily helpful.

Bodie, in his concluding remarks on investor education (pp. 169-71), provides this diagnosis:

We need institutional innovation to address the problem of investor education. Most people have honorable intentions, but we all want to make a living. In that respect, we are all salesmen to some extent. The trick, therefore, is getting people to serve the public interest while they are serving their own interests. . . .

[T]he U.S. Securities and Exchange Commission (SEC) is part of the problem. The educational materials distributed by financial services firms and by the SEC are often misleading and biased in favor of products that may not be suitable for large numbers of consumers. . . .

Therefore, universities and professional associations should cooperate in designing, producing, and disseminating objective financial education that is genuinely trustworthy. In doing so, we have to distinguish between marketing materials and *bona fide* education.

But there is lots more interesting stuff throughout the book. Laurence Kotlikoff (pp. 55-71) analyzes the problems with the conventional method of estimating target retirement savings, and shows that small mistakes can lead to unhappy outcomes. And the sessions are full of frightening information, especially Alicia Munnell’s session; for example, in 2004 the average 401(k)/IRA balance for a head of household age 55-64 was only

\$60,000. The outlook for retirement security looks pretty grim. And all of this was written at the peak of the boom.

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Jan 21, 2009 9:41 PM

[“Bad Banks” for Beginners](#)

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

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

What is a bad bank? . . . No, I don't mean *that* kind of bad bank, with which we are all much too familiar. I mean the kind of “bad bank” that is being discussed as a possible solution to the problems in our banking sector.

In this sense, a bad bank is a bank that holds bad, or “toxic” assets, allowing some other bank to get rid of these assets and thereby become a “good bank.”

To understand this, you need to understand what a bank balance sheet looks like. I've covered this [elsewhere](#), but for now a simple example should do. Let's say that the Bank of Middle-Earth has \$105 in assets (mortgages, commercial loans, cash, etc.), \$95 in liabilities (deposit accounts, bonds issued, other financing), and therefore \$10 in capital. The assets are things that have value and theoretically could be sold to raise cash; the liabilities are promises to pay money to other people; and the capital, or the difference between the two, is therefore the net amount of value that is “owned” by the common shareholders. Next assume that the assets fall into two categories: there are \$60 of “good” assets, such as loans that are still worth what they were when they were made (no defaults and no increased probability of default) and \$45 of “bad” assets, such as loans that are delinquent, or mortgage-backed securities where the underlying loans are delinquent, etc. Say the bank takes a \$5 writedown on these bad assets, so it now counts them as \$40 of assets, but if it actually had to sell them right now they would only sell for \$20 because no one wants to buy them. (When a bank has to take a writedown and for how much is a [complicated subject](#); suffice it to say that in many cases banks have assets on their balance sheet at values that everyone knows could not be realized in the current market, and this is completely legal.)

Right now the bank balance sheet has \$100 in assets, \$95 in liabilities, and \$5 in capital, so it is still solvent. However, everyone looking at the bank thinks that those \$40 in bad assets are really only worth \$20, and is afraid that the bank may need to take another \$20

written down in the future. So no one wants to buy the stock and, more importantly, no one wants to lend it money, because a \$20 write-down would make the bank insolvent, it could go bankrupt, stockholders would get nothing, and creditors (lenders to the bank) would not get all their money back. Because no one wants to lend it money, the bank itself hoards cash and doesn't lend to people who need money.

Although not necessarily to scale, this is roughly what the banking systems of the U.S. and several other major economies look like right now.

How does a bad bank solve this problem? There are two basic models: one in which each sick bank splits into a good bank and a bad bank, the other in which the government creates one big bad bank and multiple sick banks unload their toxic assets onto it.

Bank mitosis

In the first model, the Bank of Middle-Earth splits into two: a Bank of Gandalf and a Bank of Sauron. The Bank of Gandalf gets the \$60 in good assets, and the Bank of Sauron gets the \$40 in bad assets (that may only be worth \$20). The Bank of Sauron will probably fail. But the Bank of Gandalf no longer has any bad assets, so people will invest in it and lend money to it, and it will start lending again.

This model has one tricky problem, though: How do you allocate the liabilities of the old bank between the two new banks? [Luigi Zingales](#) says the simplest solution is to do it on a proportional basis. Because the Bank of Gandalf gets 60% of the assets, it gets 60% of the liabilities. So if the Bank of Middle-Earth owed someone \$1, now the Bank of Gandalf owes him 60 cents and the Bank of Sauron owes him 40 cents. Now the Bank of Gandalf has \$60 in assets, \$57 in liabilities (60% of \$95), and \$3 in capital; the Bank of Sauron has \$40 in bad assets (that are really only worth \$20) and \$38 in liabilities. Instead of one sick bank with \$100 in assets that isn't doing any lending, you have a healthy bank with \$60 of assets that is lending, and what Zingales calls a "closed-end fund holding the toxic assets" whose creditors will probably get some but not all of their money back. The tricky part is that this is a good deal for shareholders in the Bank of Middle-Earth and a bad deal for creditors to the Bank of Middle-Earth, and so it's illegal for banks to divide up the liabilities like this. Zingales recommends legislation to make it possible, but I suspect that even were Congress to pass such a bill, there would still be lots of lawsuits challenging its constitutionality.

I started with Zingales's version of bank mitosis because it illustrates the principle neatly, but the legal complication makes it difficult to implement in practice. Another way to divide one bank into two is to find separate funding for the Bank of Sauron. This is what [UBS did in November](#), with the support of the Swiss government. UBS had \$60 billion in bad assets that it unloaded onto the new bad bank. To pay for those bad assets, however, the bad bank needed \$60 billion. How did it get it? First UBS raised \$6 billion in new capital by selling shares to the Swiss government. Then it invested those \$6 billion in the bad bank - that became the bad bank's capital. Then the Swiss central bank loaned the bad bank \$54 billion. (There is little chance that any private-sector entity would lend a

self-confessed bad bank money, but this was in the public interest.) Because shareholders get wiped out first, that effectively means that UBS was taking the first \$6 billion in losses, and any losses after that would be borne by the Swiss government. This constitutes a subsidy by the Swiss government to UBS, but one that was justified by the need to stabilize the financial system. At the end of the transaction, UBS had diluted its shareholders by 9% (because of the new shares sold to the government) and had a \$6 billion investment in the bad bank it was likely to lose, but it had cleaned its balance sheet of \$60 billion in toxic assets.

One issue in this version is how to value the assets that are being sold to the bad bank. If they are sold at market value (\$20 in the Middle-Earth example), then the parent bank has to take a writedown immediately, which arguably defeats the purpose of the whole transaction (because that could render the parent bank immediately insolvent). In that case, the parent bank would need to be recapitalized (presumably by the government) immediately, and the “bad bank” would actually be not that bad, since it is holding assets it bought on the cheap. If they are sold at the value at which they are carried on the parent bank’s balance sheet, then the bad bank is essentially making a stupid purchase (overpaying for securities it expects to decline in value) for the public good. In the UBS case, forcing UBS to provide the \$6 billion in capital was a way of forcing UBS to suffer at least some of the loss that the bad bank was expected to incur.

Big Bad Bank

The second model, which has been proposed by Sheila Bair, Ben Bernanke, and others, is the [“aggregator” bank](#). Instead of splitting every sick bank into a good bank and a bad bank, in this model the government creates one Big Bad Bank, which then takes bad assets off the balance sheets of many banks. (This doesn’t necessarily have to be created by the government; the [Master Liquidity Enhancement Conduit](#) - bonus points for anyone who remembers what it was for - was supposed to be funded by private-sector banks. But in today’s market conditions, the government is the only plausible solution.) In this plan, the capital for the Big Bad Bank is provided by the Treasury Department (perhaps out of TARP), and the loan comes from the Federal Reserve, which has virtually unlimited powers to lend money in a financial emergency. Once this Big Bad Bank is set up and funded, it will buy toxic assets from regular banks, which will hopefully remove the uncertainty that has hampered their operations.

Yes, the Big Bad Bank is similar in concept to the original TARP proposal, and it faces the same central question: what price will it pay for the assets (the issue discussed two paragraphs above)? If it pays market value, it could force the banks into immediate insolvency, so recapitalization would have to be part of the same transaction. If it pays current book value (the value on the banks’ balance sheets), it will be making a huge gift to the banks’ shareholders. There has been talk of forcing participating banks to take equity in the Big Bad Bank (as in the UBS deal), presumably to make them shoulder some of the overpayment. In any case, the money the government puts in, up to the market value of the assets purchased, is a reasonable investment for the taxpayer; but there will need to be additional money, either to recapitalize the remaining banks (which,

if done at market prices, would lead to government majority ownership), or to overpay for their assets. Pick one.

One last issue: Creating a bad bank works nicely if you can draw a clear line between the good assets and the bad assets. My theoretical Bank of Gandalf above only has good assets, so there are no doubts about its health. But what if you can't? This crisis started in subprime mortgage-backed securities, and it's pretty clear that things like second-order CDOs based on subprime debt are deeply troubled. But as the recession deepens, all sorts of asset-backed securities - such as those backed by credit card debt or auto loans - start losing value, and then even simple loan portfolios lose value as ordinary households and businesses that were creditworthy just a few years ago go into default. Put another way, if it were possible to neatly separate off the bad assets, then the second Citigroup bailout would have worked, since that provided a government guarantee for \$300 billion in assets. Yet Citigroup's stock price, even after Wednesday's huge rally (up 31%) is still below the price on November 21, the last trading day before that bailout was announced. Clearly no one believes that Citigroup had only \$300 billion in bad assets.

The goal of a bad bank is to restore confidence in the good bank, and it's not clear how much of the parent bank's assets have to be jettisoned before anyone will have confidence that only good assets are left. One potential problem with the Big Bad Bank is that banks could be tempted to underplay their problems, sell only some of their bad assets, hope the rest are all good, take the bump in their stock price . . . and then show up two quarters later with more bad assets. If investors suspect that is going on, and that the banks are still holding onto bad assets, then the scheme will fail. The solution to that problem is to overpay for the assets, which gives banks the incentive to dump all of them onto the Big Bad Bank . . . and then we are back where we started.

Update: Citigroup's division into a good bank (Citicorp) and a bad bank (Citi Holdings, which includes the \$300 billion in assets guaranteed by you and me) is more symbolic than anything else at this point, because they are still just divisions of one company. So if Citi Holdings goes broke, the creditors can demand money from Citicorp, which defeats the purpose of a good/bad separation. The goal here was more to communicate what the bank's long-term strategy is (the hope is to either sell off or run off everything in Citi Holdings) in hopes of convincing shareholders that the management knows what they are doing.

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Jan 21, 2009 9:31 AM

[Global Fiscal Stimulus: Should It Be An Obama Administration Priority?](#)

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

The US has the opportunity - and perhaps the responsibility - to immediately retake a leadership role in global economic policy thinking, with the pressing priority of preventing the world's recession from becoming something more serious. But what should be Mr Obama's priorities in this regard, for example in the run-up to the G20 summit in early April - which, given the timetable for these things, will have an unofficial dry run of sorts at the [Davos meetings](#) next week?

The obvious message could be: a large US fiscal stimulus is coming, but the rest of the world needs to do more. In this option, Mr Obama could devote considerable effort to encouraging others to expand their government spending and/or cut taxes.

While worldwide cooperation of this form may have been a constructive thought last year at Davos, when the idea was [first broached publicly](#) by the IMF, a joint global fiscal stimulus is a glorious idea whose time has for now passed.

Much of Europe is facing impending fiscal pressures that mount by the day. The issue there is not fiscal stimulus but "fiscal capacity," meaning the ability of governments to take banks' (bad) assets onto the public balance sheet, and the danger is that not all European governments will feel able to even let their "automatic stabilizers" work fully (i.e., government spending goes up and tax revenue goes down in recession, without any discretionary change in fiscal policy.) There is currently hot debate on and around this issue at the European Commission.

Most emerging markets are similarly facing the prospect of difficulties in rolling over their sovereign debt - at least that part which is not placed directly with the domestic banking system. And the global social safety net that wants to give them some general reassurance and specific fiscal encouragement in this situation - the IMF - looks sorely frayed. Governments in middle income countries sensibly feel it is wiser to keep their fiscal powder dry. If you think they are overly worried, look at the latest data from Singapore today - [16.9% decline in GDP](#) (a subscription link, but the summary data are in the free part) at an annualized rate in the 4th quarter of 2008 compared with the 3rd quarter; think of Singapore as a bellweather for international trade in goods and services at this time.

The exception of course is China, where there is long-standing scope for a stimulus. But the Chinese economy is only about 6% of world GDP and their effective additional stimulus per year is likely to be around 3% of GDP. 3% of 6% is essentially the rounding error in measuring the world's economy, and you are unlikely to notice the effects of China's stimulus globally - although it might just keep oil prices higher than they would be otherwise.

So what should Mr Obama emphasize? Given the latest economic and financial developments, three potential priorities stand out:

First, a world system-wide plan for recapitalizing banks and removing any toxic assets. This has to be implemented country-by-country and of course plans should vary according to circumstances, but the cross-border nature of banking calls out for a more coordinated approach. The US has always been a taste-setter in terms of what constitutes responsible economic policy, and Mr Obama should help persuade other leaders to adopt plans that [broadly mirror his](#). And if they don't follow suit, their domestic financial situations [may well become more complicated](#).

Second, in the global bank clean up, some countries will find themselves short of cash, particularly foreign currency. Rather than risking more Iceland-type situations, the US should help arrange financial assistance where appropriate. This could be through the IMF but if there are historical objections (e.g., from Asia), alternatives can be arranged. The use of regional arrangements - including in Asia - should be encouraged, rather than discouraged; this would be a major departure for US policy.

Third, the world needs to avoid deflation. Moving the US to an explicit inflation target would help, particularly if the announcement is strongly supported (and explained) by the White House at the same time as there is dramatic further monetary easing among leading central banks. The point would be to demonstrate that the US can and will keep its inflation rate above zero without depreciating the dollar - and thus without exacerbating the difficulties of our trading partners. Remember that if countries do not want to cooperate with this approach, they risk appreciation of their currencies - this fear should concentrate minds in the eurozone.

This constitutes a major agenda with many difficult tasks. President Obama not only can do it, but he should. The alternative is a much deeper global recession with greater risks of further sovereign collapse - and many more American job losses.

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Jan 20, 2009 7:02 PM

[Pick Ourselves Up, Dust Ourselves Off . . .](#)

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

Starting today, we must pick ourselves up, dust ourselves off, and begin again the work of remaking America. For everywhere we look, there is work to be done. The state of our economy calls for action: bold and swift. And we will act not only to create new jobs but to lay a new foundation for growth.

When my daughter falls down, I usually say, “pick yourself up and brush yourself off.”

Not surprisingly, Barack Obama’s speech today was long on ambitions and short on specifics, as is customary for the occasion. We’ve been writing at length about the economic challenges that the Obama administration faces and some of its policy options, so there’s no need to rehash that in detail today. Suffice it to say that deep crisis creates a rare opportunity, and Obama has the opportunity to leave a greater mark on the economy than any president since Reagan or perhaps FDR.

On another note: Although this blog is generally about economics, I am particularly curious to hear what the new president will say about torture. I drafted a speech that I would like to hear him give over on [Talking Points Memo Cafe](#).

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Jan 20, 2009 4:12 PM

Nationalization Is Not Inevitable

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

This week’s moves by the British government have created the impression that bank nationalization is inevitable. It is certainly the case that small-scale bank recapitalization, partial balance sheet clean-up, and various forms of financial engineering (e.g., insurance schemes for bad debt) are not only no longer enough, but may even be destabilizing. The problem is that once the market thinks you are on the move to a decisive solution but have not quite mustered the political will needed for complete resolution, it will assume that the final destination involves zero value for equity holders (and perhaps some bumps in the road for bank creditors).

The same logic is now being applied in Ireland and, to varying degrees, in other weaker eurozone countries. And the knock-on effect from assumed nationalization of bank losses to fiscal sustainability is immediate. Quoted Credit Default Swap spreads for some European sovereigns were wider than for investment grade corporates today, which of course makes no sense - but it does indicate extreme pressure in markets and deep confusion (or perhaps great clarity) regarding the impact on government balance sheets.

Nationalization is not the answer in the United States.

The state is not good at running banks anywhere and we really do not want to add politically directed credit as a cause of massive financial losses - the pressure already

evident from some quarters to increase loans to consumers and small business, regardless of credit quality, should be taken as an early warning.

Banks need capital, without a doubt. Banks also have troubled assets and there is great uncertainty about their value. But, at least in the US, it would be reasonable for the government to help clean balance sheets and provide new capital at a price - which can be paid in terms of warrants, i.e., options to buy shares, on terms favorable to the taxpayer. This price should be considerably higher than charged in the TARP I funding provided by Mr Paulson, and banks will certainly want to hang back and let others go first - there is a great incentive to free ride here.

But a mixture of carrots and sticks can still bring banks into a full-scale recapitalization and clean-up program ([technical design suggestions are here](#)). This could be run directly by Treasury, but it would make sense - and also have political appeal - to create a Resolution Trust Corporation (RTC)-type structure to manage the government's portfolio with a great deal of transparency and accountability. The goal of this RTC would be to dispose of government warrants quickly and in such a way as to maximize taxpayer value; it can also manage the toxic assets that are taken up, aiming to minimize fiscal losses. There is plenty of private equity money, currently waiting on the sidelines, that would be keen to buy the government's warrants, exercise the option to take controlling stakes in banks, and break them up - although antitrust safeguards should be strengthened to make sure banks are not sold for their monopoly rents. And it seems likely that many of the banks' current top executives would be replaced in this process.

From the second half of the TARP you could use \$250bn (i.e., TARP II minus funding promised for housing and money already committed), plus another budget appropriation of around \$250bn, to provide \$0.5trn for capital. The RTC could then leverage itself by borrowing from the Fed, aiming for a total balance sheet in the \$1trn to \$1.5trn range.

Bank nationalization in the US is not inevitable. At least, not if a credible, very large recapitalization/balance sheet clean-up program is put in place quickly, to complement both the coming fiscal stimulus and the promised housing refinance package.

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Jan 19, 2009 10:48 PM

[Obama Can; The Rest Of The World, Not So Much](#)

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

The US will shortly have a new President. Congratulations to all concerned, particularly those who kept their cool during the intense moments of crisis during the fall and who surmised - early and correctly - that the current situation requires decisive and comprehensive action. We already have a large fiscal stimulus in the works, a significant housing refinance program was surely being signalled last week, and we are waiting to hear through exactly what kind of new structure the bulk of TARP II funding will be deployed.

If banking stabilizes of its own accord over the next week or so, the new Administration will lean towards a New Bank focused primarily on restarting consumer lending (or they can expand the mandate of a relatively clean existing structure such as Fannie or Freddie). If banking continues to deteriorate, then more of an [RTC-type structure](#) is likely to prevail, i.e., at least partially cleaning up banks' balance sheets - presumably in return for lending requirements.

There is definite potential for inflation in this strategy, but this would not be the worst thing - the gap between [the consensus](#) and [our view](#) is narrowing on this. And in any case President Obama can, quite reasonably, blame his predecessor for almost everything that goes wrong. And Obama can also argue, plausibly, that things would be even worse without his bold actions.

Unfortunately, in most of the rest of the world the economics and politics are not so favorable. Let me remind you of the main points, illustrated with some of the latest developments.

First, the European Union's "don't worry, be happy" strategy for East-Central Europe is coming apart at the seams. Social tension is mounting in [Latvia](#) and elsewhere. The Latvian government is struggling to reduce nominal wages; this is an almost impossible task anywhere. Fresh waves of financial market pressure are likely to move throughout the region, probably triggered by the timing of external debt rollover needs.

Second, Spain's sovereign debt was [downgraded today](#) - a further demonstration that the weaker eurozone countries continue to be reappraised. The spreads on their debts, relative to German government debt, continue to widen. The UK's banking moves today may or may not bring local stability; they definitely seem likely to destabilize regionally - fears of bank nationalization are spreading.

Third, the recently released OECD [leading indicators](#) suggest that while almost everyone is decelerating sharply (aside: and this is at a time when all official forecasts err on the side of overoptimism!), there are some interesting bedfellows in sharp slowdown: Germany, Russia, and China. In fact, almost all of Europe, Asia, and Latin America is caught up with the rapid decline in international trade in one form or another. We have surely only begun to see the social impact.

What are the macroeconomic implications in the immediate future?

- Very few countries now find room for a fiscal stimulus; debt levels are too high and fiscal capacity is hard pressed by contingent liabilities in the banking system - particularly with an increasing probability of quasi-nationalization.
- The idea of a 2% of GDP global fiscal stimulus seems quite far-fetched at this point.
- Further monetary easing is therefore in the cards, both for developed countries and emerging markets, and there may now be some catching up by central banks - in that regard, see the latest [Turkish move](#) as a foreshadowing.
- Fear of deflation will take hold almost everywhere, further pushing central banks towards interest rate cuts.
- Commodity prices will likely decline further.
- The worldwide reduction in credit continues, largely driven by lower demand for credit as households and firms try to strengthen their balance sheets by saving rather than spending.

The crisis and associated slowdown started in the US, but the recession is now global. The US economy is no more than 1/4 of the world economy, so even the largest US fiscal stimulus (say 3% of US GDP per annum) cannot be not large enough to move the world at this stage. If we stabilize our financial system fully and restore consumer credit, this will help. But remember that we are subject to shocks from outside and, right now, a major problem appears to be developing in Europe. President Obama's leadership is just as much needed internationally as in the United States. But outside the US the tasks look much harder.

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Jan 19, 2009 7:56 AM

[The Importance of Education](#)

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

Robert Shiller, he of the Case-Shiller Index (and therefore a reasonable symbolic candidate for 2008 Man of the Year, were it not for a certain presidential election), has an op-ed in [The New York Times](#) advocating a government program to subsidize financial advice for anyone, particularly low-income people. There is a lot to like about this idea. In Shiller's proposal, the subsidy would only apply to advisors who charge by the hour and do not take commissions or fund management fees, so they would have no incentive to steer clients into particular investments or into unnecessary transactions. It seems reasonable that, if they had access to impartial advice, some people might not have taken

on mortgages they had no hope of paying back or, more prosaically, some people might do a better job of budgeting and take on less credit card debt.

But I have one major reservation, which is that I'm not sure how good the financial advice would be. In my opinion, most financial advice floating around is worth less than nothing. To take the most obvious example: by sheer volume, the largest proportion of financial advice that exists (counting all advice that anyone gives to anyone else via any means of communication) is almost certainly advice on buying individual stocks, and the second largest is probably advice on choosing mutual funds. I am firmly in the camp that believes that whether or not stocks obey the efficient market hypothesis, it is not within the capabilities of any individual investor to identify stock trades that will have an expected risk-adjusted return higher than the market as a whole, net of transaction costs. I also believe it is not within the capabilities of any stock mutual fund manager, and that all of the variation in risk-adjusted mutual fund performance can be explained by pure statistical variation. And even if I'm wrong about that, and there are a few exceptional fund managers out there, I don't believe that any individual could distinguish the exceptional managers from the simply lucky ones; and even if he could, by the time he did he would be buying into a fund that had grown so big it was no longer capable of above-market returns.

If this is so, why doesn't the market for financial advice take care of this problem?

Because that market has two major problems. First, you are unlikely to get rich advising people to buy a set of index funds and rebalance their portfolios every six months - not a lot of recurring business there. Most of the advice, as Shiller points out, comes from people who are biased - primarily people who are trying to sell you financial products that, in my opinion, are probably not good for you,* but also people trying to sell you books and magazines about which financial products you should buy.

Second, people want to believe there is a way to get rich. The idea that, given a sufficiently liquid market, anything you happen to know about a company (say, because you read it in *The Wall Street Journal*) is already priced into the stock price is deeply unintuitive to the human brain. And the idea that you can only *rely on* a very low real rate of return - basically, the yield on Treasury Inflation-Protected Securities - is something many people simply do not want to accept.

When you get away from investing in securities, perhaps there is more value that financial advisors can provide. For example, they could help explain the detailed terms of various financial products, or help people understand their spending patterns and come up with budgets. So on balance perhaps Shiller's proposal would do more good than harm. But the risk is it would expose even more people to the sales pitches of financial services companies, which would no doubt multiply their marketing to independent financial advisors several times over. I agree that lack of financial understanding is a significant societal problem, but given the powerful interests involved, I find it hard to come up with a good solution.

* When I was an executive at my company, and “wealth management” specialists made the mistaken assumption that I and my co-founders had a lot of money, I saw a proposal from a major investment bank to buy a product that was guaranteed to return more than a major index of international stocks. The catch was that the return was based on the value of the index alone, and did not include reinvested dividends, and therefore in every historical period I could find for reference this product would have lost me money (relative to just buying an index fund tracking the same index). When pressed, the advisor said his bank didn’t have a position on whether or not this was a good investment. The other side of the trade was being taken by another party who was paying the bank a 3% underwriting fee; in other words, in aggregate the parties doing the trade were bound to lose money, and the bank was going to pocket its fee.

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Jan 18, 2009 7:31 AM

[Global Consequences of a US “Bad Bank” Aggregator: It’s Mostly Fiscal](#)

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

It looks like a bank aggregator for bad assets is pretty much a done deal. [David Axelrod](#) said yesterday we should expect a new approach within a few days, and leading reporters ([NYT](#), [Washington Post](#)) have discerned that this is likely to include a “bad bank” into which troubled/toxic assets can be disposed.

We don’t yet know the details, and these [matter a great deal](#) (for the taxpayer and for the gradient of the road to recovery) but it’s not too early to think about the global implications, at least in qualitative terms.

The backdrop, of course, is that the international banking environment is very unsettled at present, probably worse than any time since mid-October. Ireland just [had to nationalize](#) its previously most aggressive mortgage lender (i.e., in Irish mortgages) and the UK seems poised to announce a [further scheme](#) for helping banks (and probably forcing them to lend, although the British property sector looks highly dubious). “Bad banks” are in the air, in all senses of the term.

Let’s say the US launches a comprehensive bank recapitalization and balance sheet clean-up scheme, with broad support on Capitol Hill. This bolsters confidence in the US banking system, causing a rise in equity prices and - most important - a strengthening of debt, both for banks and perhaps for leading nonbank corporates. Three international consequences seem likely.

First, this move forces the rest of the G7/G10 and the eurozone to do the same, or something very similar. If we have very strong (and government backed) banks in the US and somewhat more dubious banks anywhere in other industrialized countries, money will flow into the stronger US banks. Think back to the consequences of the original infectious [blanket guarantees in Ireland](#) in October; the effects now would be similar. You can think of the UK's upcoming moves either as a smart way to get ahead of this, or as something that will further a destabilizing wave of competitive recapitalizations - the policy is good, but doing it without coordination across countries can trigger Iceland-type situations.

Second, if all major economies need to back the balance sheets of their banks, then we have converted our myriad banking sector problems into a single (per country) fiscal issue. Who has sufficient resources to fully back their banks? This obviously depends on (a) initial government debt, (b) size of banks (and their problem loans, global and local), and (c) underlying budget deficit. [Ireland](#) and [Greece](#) will be in the line of fire, but other weaker eurozone countries will also face renewed pressure. Officials are currently (slowly) trying to work through this predictive analysis, and there is some sketchy thinking about preemptive preparations, but events are moving too fast - and the international policy community again can't keep up.

Third, in some countries - particularly emerging markets but also perhaps some richer countries - the foreign exchange exposure of banks will matter. Here the issue will be whether the government has enough reserves to back (or buy out) these liabilities; the [problems of Russia](#) since September foreshadow this for a wide range of countries. The absolute scale of reserves does not matter as much as whether they fully cover bank debt in foreign currency. Most emerging markets face significant difficulties and need some form of external support in this scenario, particularly as both commodity and manufactured exports from these countries will continue to fall.

If, by great and fortuitous coincidence, the US and global recession is already at its deepest - as some in the private sector now hold - then we face a tough situation but the difficulties are manageable. However, our [baseline view remains](#) that the real economy is not yet stabilized, and hence we will see worse outcomes in Q1 and Q2 of 2009 than currently expected by the consensus. Such outcomes are not yet reflected in asset prices, and the problems for banks - and the implications for fiscal sustainability - around the world will mount.

Financial support for distressed countries within the eurozone, from the G7, and across the G20 will help; the scale may be beyond what the IMF can readily handle by itself. But this is a very big global fiscal problem, and the appetite for large-scale official rescue financing in the face of these problems remains uneven.

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Jan 17, 2009 10:31 AM

Designer Talk: Bank Recapitalization (and Bair's Aggregator)

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

Sheila Bair is delivering a [sensible general message](#): we need dramatic action to clean up banks' balance sheets and, presumably, to recapitalize them. This initiative apparently has support from influential senators, such as [Kent Conrad](#) and [Charles Schumer](#). Many Republicans also seem inclined to come on board.

I like an aggregator-type approach; this is quite consistent with the RTC-inspired structure that [we have been advocating](#) (see the WSJ.com article linked through that post for details; such ideas are consistent with and an update of our proposals from [September](#), [November](#), and [December](#)). But some of the details currently being floated seem less than ideal. Given that the design work on this program is still ongoing and the new Administration will, without doubt, seek broad support on Capitol Hill, I would suggest that the following points be considered or even stressed in the upcoming deliberations.

1. The idea that banks should take equity in the aggregator really doesn't make sense. We are trying to increase available capital in the banking system, not find new ways to commit it. (Historical aside: back in the early spring of 2008, when I was still with the IMF, our proposals contained something equivalent to such a structure; but that train has now left the station.)
2. There is really no reason for the aggregator bank/RTC to overpay for the toxic waste. We should pay market prices - this is the only fair and reasonable thing to do, and anything else will surely lead to a nasty political backlash. Market prices are sometimes hard to determine, but this is a matter where outside evaluation and transparent procedures can deal with the issues. (Note: no need for a complicated auction of the kind proposed this fall.) If these market prices are below the banks' marks, then they will need more capital. The RTC should be set up to provide this capital, for example on the terms that we have suggested. In any case, it is essential to have full reporting to Congress on all details (Open Door or Closed Door, as appropriate).
3. Banks need capital and the taxpayer needs to see value from this unprecedented and regrettably necessary intervention. There may be a temptation to conduct the entire banking program just through waste disposal, and this is what powerful people on Wall Street want. But at the very least, the RTC should receive a considerable amount of warrants (options to buy stock) at a low strike price; these should convert to common stock (with full voting rights) when the RTC sells them. This will enable the RTC to recover value, while selling stakes (and perhaps even control) to new owners. Given that large banks have repeatedly demonstrated their inability to measure risk, let alone control

it, we should have some confidence that this process will lead to the break up of behemoths and a more competitive financial landscape (and let's back this up with supportive anti-trust legislation, just to be sure.)

The leadership of the US banking system failed completely. It's time to clean up the mess that they made, and Sheila Bair's proposals are along exactly the right lines. But let's make them operational in a way that is fair to the taxpayer. This would be appealing change for President Obama to present to the country in his first 10 days (I don't think we can wait 100 days).

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Jan 16, 2009 10:36 PM

[Time for a Weekend](#)

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

We don't try to be a news site - it's too much work to keep up with everything that happens on an hour-to-hour basis - and generally we try to provide analysis and commentary instead. But right now I just want to note the major turn events have taken in the last few days.

After a few weeks of relative calm - the economy was doing badly, but we knew that already, and there were no major controversies or scandals since the auto bailout and Bernie Madoff - the pace has picked up again. To summarize, in case you were on vacation this week:

- Bank of America started falling into the abyss, but got a [lifeline](#), just like Citigroup 2.
- Speaking of which, Citigroup announced that its strategy for the last ten years has been a failure and that it is splitting itself into two banks, a "good bank" and a "bad bank" - but unfortunately it still owns both of them. It also [announced](#) \$6.0 billion in increased loan loss reserves, \$7.8 billion in writedowns on securities, and a \$5.3 billion writedown on derivatives (I wonder how much of that affects the \$300 billion in assets guaranteed by the government), but nevertheless made an Orwellian assertion of "Continued Capital and Structural Liquidity Strength."
- The Bank of America bailout undoubtedly made Congressmen even more mad about TARP, but at the same time all these shaky banks (and personal lobbying by Barack Obama) convinced the Senate to release the second \$350 billion (both houses would have had to block it). The vote was 52-42, with 46 Democrats and 6

- Republicans voting in favor. From one perspective this is not surprising: the Democrats are supposedly the party of activist government, and it was mainly Democrats who passed the bill in the first place. But seen from a long-term perspective . . . the Democrats are the party in favor of saving big banks? and the Republicans are willing to let them fail? How things have changed.
- In a story that hasn't gotten the attention it deserves (no doubt due to general bailout fatigue), Treasury is lending \$5 billion in TARP money to [Chrysler Financial](#). Now, is Chrysler Financial a healthy financial institution that just needs a little more capital to resume lending, or is it a systemically significant financial institution whose failure must be prevented? Right, I don't know the answer either. But I guess after the GMAC bailout it was a foregone conclusion. Chrysler, of course, announced that it was relaxing credit standards and offering zero-percent financing on pickup trucks and minivans. (Full disclosure: I own a minivan.)
 - The [CPI declined](#) 0.7% in December (excluding food and energy, unchanged), meaning that in Q4 the CPI fell by about 3.4% (excluding food and energy, it fell 0.1%)., further stoking deflation fears. But again, most of the fall in prices is just the reversal of the run-up in energy prices in 2007-08. Now that oil prices seem to have flattened out (gasoline and heating oil are up slightly), we should be able to see what is going on. I am still in the camp that the Fed will be able to prevent deflation. It's basically a question of how hard they want to try, and they are afraid if they try too hard they will overshoot and create too much inflation.
 - And Ben Bernanke gave a [speech](#) in which he floated the idea of creating a government-sponsored "bad bank" that would buy troubled assets from troubled banks: "Yet another approach would be to set up and capitalize so-called bad banks, which would purchase assets from financial institutions in exchange for cash and equity in the bad bank." This idea got further support from [Henry Paulson and Sheila Bair](#), and could be the big story of the next week (except for something else happening in Washington on Tuesday). Isn't this original TARP all over again? Yes, it's similar, but there are good ways and bad ways to do it. The [biggest problem](#) I had with original TARP was that it necessarily involved overpaying for assets; [Simon and Peter](#) have outlined one way of avoiding that problem.

Overall, this pace of news, primarily from the financial sector, has not been a good sign over the past several months. It's usually a sign that things are going to get worse, although there is always some chance that this time we will solve these problems once and for all. And there is a new crew moving into town on Tuesday.

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Jan 16, 2009 1:35 AM

[Bank of America Gets Quite a Deal](#)

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

We have a deal. You, the US taxpayer, have [generously provided](#) to Bank of America the following: one Treasury-FDIC guarantee “against the possibility of unusually large losses” on a pool of assets taken over from Merrill Lynch to the tune of \$118bn, and a further Fed back stop if the Treasury-FDIC piece is not enough. In return we receive \$4bn of preferred shares and a small amount of warrants “as a fee”. There is a \$10bn “deductible,” i.e., BoA pays the first \$10bn in losses, then remaining losses are paid 90% by the government and 10% by BoA.

We are also investing \$20bn in preferred equity, with a 8 percent dividend. There will be constraints on executive compensation and BoA will implement a mortgage loan modification program. Essentially, this is the same deal that Citigroup received just before Thanksgiving, known as [Citigroup II](#), which was generous to bank shareholders but not good value for the taxpayer.

This is more of the same incoherent [Policy By Deal](#) that has failed to stabilize the financial system, while also greatly annoying pretty much everyone on Capitol Hill. Hopefully, it is the last gasp of the Paulson strategy and the Obama team will shortly unveil a more systematic approach to bank recapitalization; it would be a major mistake to continue in the Citi II/BoA II vein.

In addition, you might ponder the following issues raised by [the term sheet](#).

1. The \$118bn contains assets with a current book value of up to \$37bn plus derivatives with a maximum future loss of up to \$81bn. This is more detail than we got in the Citi deal, so there is evidently greater sensitivity to calls for transparency. But the maximum future loss is based on “valuations agreed between institution and USG.” What is the exact basis for these valuations? From the term sheet, it sounds like we are talking mostly about derivatives that reference underlying residential mortgages. Absent any other information, my guess is that they can easily lose more than \$81bn - depending on how the macroeconomy and housing market turn out.
2. What is the strike price of the warrants? This was controversial in the Citigroup II deal (because it was unreasonably high), but at least it was quite explicit up front. The announcement is suspiciously quiet on this point, perhaps due to the [recent spotlight](#) on warrant pricing terms.
3. What kind of reporting will there be by BoA to Treasury, and what will be disclosed to Congress, in terms of the exact securities covered by this guarantee and how they perform? The lack of information is a big reason why TARP became discredited and Capitol Hill is so concerned to see more transparency going forward. There is nothing in the term sheet that reveals the true governance mechanisms that will be put in place, or

how information will be shared with the people whose money is at stake (you and me, or our elected representatives). I understand there is market-sensitive information present, but there are obviously well-established ways to share confidential information with members of Congress.

Overall, it feels like the latest (and hopefully the last) in a long line of ad hoc deals, which have done very little to help the economy turn the corner. The new fiscal stimulus needs to be supported by a [proper bank recapitalization program](#), as well as by a large scale initiative on housing.

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Jan 15, 2009 5:23 PM

[The Funding for Recapitalization](#)

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

Congress is now debating how to use the second half of the TARP. I suggest that all \$350bn should be used for bank (and other regulated financial institution) recapitalization, providing this is done in a comprehensive manner (the details of this argument are [now on WSJ.com](#)). And I suspect that an additional budget authorization, beyond TARP, in the region of \$250bn will be needed for the same purpose. If Congress sets up a Resolution Trust Corporation (RTC)-type structure, then this RTC can borrow additional money from the Fed as needed.

The important point is to keep this funding for bank recapitalization separate from the fiscal stimulus. We can continue to debate the size and nature of the stimulus, of course, but roughly \$800bn seems right and the mix of spending and tax cuts currently proposed also makes sense. (On the point of whether the tax cuts would be “wasted” in any sense, remember that consumers have damaged balance sheets and that tax cuts should help on that dimension.)

Bank recapitalization should therefore be seen as complementary to the fiscal stimulus, rather than as any kind of substitute. We need both to be big and bold (and of course we also need a serious housing refinance program that would directly reduce foreclosures).

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Jan 15, 2009 12:20 PM

[Betting on a “Depression”](#)

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

A friend of mine who bets on Intrade (he made money correctly betting that Rod Blagojevich would survive into this year) alerted me to the fact that Intrade now has a [market](#) for whether the U.S. will go into “depression” in 2009 (warning: that link will resize your browser window). Their definition of “depression” is “a cumulative decline in GDP of more than 10.0% over four consecutive quarters,” but they don’t really mean that. What triggers the payout is if the sum of the quarterly *annualized* GDP growth rates for four consecutive quarters is less (more negative) than -10.0%. (To see the difference: GDP in Q3 2008 was 0.13% smaller than in Q2 2008, but this was reported as an annualized rate of -0.5%.) This would mean that the total economic contraction over those four quarters would be more than (about) 2.5%. This would make the current recession the worst since at least 1981-82 (which had a total peak-to-trough decline of 2.6%), but not necessarily anything that anyone would call a depression.

On to the interesting bit: the last price for this market was 56.3, meaning that the market assigns a 56% probability to the occurrence of a “depression” as defined by Intrade. The average forecast collected by the [Wall Street Journal](#) shows a “cumulative decline” of 7.8% (from Q3 2008 to Q2 2009 the forecasts are for contractions at annual rates of 0.5%, 4.3%, 2.5%, and 0.5%), or a peak-to-trough contraction of about 1.9%. Of the 54 individual forecasts collected by the Journal (you can download the data to a spreadsheet), 22, or 41%, are predicting a depression by Intrade’s definition.

So Intrade is more pessimistic than the experts. There has been a lot of talk about the accuracy of prediction markets like Intrade, but a lot depends on the liquidity of the individual market, and this one doesn’t have much (you can see all the outstanding bids and asks). We’ll just have to wait and see who wins this contest.

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Jan 14, 2009 9:58 PM

[Here We Go Again . . .](#)

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

The [Wall Street Journal](#) (subscription required; shorter Bloomberg article [here](#)) is reporting that Bank of America will receive billions of dollars more in government aid, probably in a deal that looks something like the second Citigroup bailout, ostensibly to help absorb losses incurred by Merrill Lynch since the acquisition was negotiated in September but more generally to shore up B of A's increasingly shaky balance sheet. At least someone involved knows how this looks: the reports say the deal will be announced on January 20 - yes, the day of Barack Obama's inauguration - thereby keeping it from being the main story of the day.

It looks bad for all sorts of reasons:

- Wasn't B of A supposed to be a healthy bank? Isn't Ken Lewis (CEO) the person who told Henry Paulson he didn't need the first round of TARP money, but he would take it to show solidarity and for the public good?
- The money is going to finance an acquisition? Isn't that the thing that (according to most people) banks aren't supposed to be doing with their bailout money?
- The B of A-Merrill deal closed on January 1. So it looks like - as the WSJ is reporting - the deal only closed because Treasury gave B of A a verbal commitment to supply the needed bailout money later.
- Isn't this more [policy by deal](#)?

That said, I think some sort of deal has to be done. Even Yves Smith at [naked capitalism](#) (one of the most consistent and sharp critics of the way TARP has been implemented), who says this deal "stinks to high heaven," says that "Merrill is a systemically important player" and "letting the deal with BofA 'fail' is a non-starter." But I predict that when the terms are announced I will think they are too generous - especially since B of A now has all the negotiating power, since they closed the acquisition based on a promise from Treasury.

To recap - because I have this pathological fear of not being understood - I think that TARP's primary purpose is to protect the financial system against the collapse of any systemically critical financial institutions (I leave it to others to define what those are, but Bank of America definitely is one, GMAC I'm skeptical about), and it has suffered from three main problems:

1. The initial round was too small, with banks only getting 3% of assets or \$25 billion, whichever was smaller - which is why Citi and now B of A have had to come back.
2. The terms were too generous; I can make an exception for the first round, but I don't understand why Citigroup 2 and GMAC were so favorable to shareholders.
3. Except for the very generous initial round, it's just a pile of money to be used in ad hoc deals, not a comprehensive program with a coherent strategy, so no one is quite sure how or if it will be able to protect the financial system.

The B of A bailout will only sour public and Congressional opinion further against TARP, making it less likely that the second \$350 billion will ever be released, and more likely that if it is released it will be packaged with all sorts of conditions (not necessarily bad) or allocated to community banks (beside the point).

It is true that one price we are paying in these bailouts is the creation of a new tier of mega-banks that, because they are Too Big To Fail, have the competitive advantage of being essentially government-guaranteed. What we really need as a condition on TARP money is a new regulatory structure to make sure that these mega-banks do not abuse the oligopolistic position we have just handed them, and perhaps a commitment to break them up when economic circumstances allow. That would be considerably more valuable than a cap on executive salaries and corporate jets. But it will also be a lot more difficult to define and to agree on.

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Jan 14, 2009 9:46 AM

[Ireland And An Unstable Europe, Again](#)

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

According to [Bloomberg](#) (citing the RTE website), the Irish Prime Minister said in Tokyo today that Ireland may need to call in the IMF if economic conditions continue to deteriorate. According to RTE (Ireland's public broadcaster), correcting their earlier story, he [said no such thing](#), at least in public.

The broader issue, of course, is that Ireland is not alone in facing economic difficulties - the risk of default, potential debt rollover issues, and credit ratings are [likely to move together](#) for a range of [weaker countries in Europe's eurozone](#). But the presumption has been that the IMF would not get involved in eurozone countries. Any change in this view would throw us back to thinking in terms of the 1970s (when the IMF lent to the UK and to Italy) or the 1930s (when IMF loans could have helped, but of course were not available). Unless you really intend to bring in the IMF for loan discussions, I would suggest it is a bad idea to use those three letters in any conversation, public or private.

Remember that in early October Ireland [destabilized the eurozone](#) by suddenly offering blanket bank deposit guarantees. The apparent lack of policy coordination within the eurozone continues to be worrying. These countries really need to start working together more closely.

Relatedly and consistent with [my presentation last week](#), Greece's sovereign [credit rating](#) from S&P was lowered today.

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Jan 13, 2009 5:55 PM

[Why Fiscal Stimulus Is Not Enough](#)

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

Ben Bernanke gave a [speech](#) today that will be discussed for, well, at least a few days, outlining the Federal Reserve's response to the financial crisis. We will probably devote a couple of posts to it (Simon already mentioned it [below](#).)

Although the Obama team and Congress have been focusing on the politically popular fiscal stimulus plan, replete with hundreds of billions of dollars in tax cuts, Bernanke emphasized that stimulus will not be enough (something that Larry Summers seems to agree with, as Simon noted). Here's the relevant passage:

with the worsening of the economy's growth prospects, continued credit losses and asset markdowns may maintain for a time the pressure on the capital and balance sheet capacities of financial institutions. Consequently, more capital injections and guarantees may become necessary to ensure stability and the normalization of credit markets. A continuing barrier to private investment in financial institutions is the large quantity of troubled, hard-to-value assets that remain on institutions' balance sheets. The presence of these assets significantly increases uncertainty about the underlying value of these institutions and may inhibit both new private investment and new lending. . . . In addition, efforts to reduce preventable foreclosures, among other benefits, could strengthen the housing market and reduce mortgage losses, thereby increasing financial stability.

In a nutshell: as the economy gets worse, more and more loans default, eating into banks' capital cushions; investors are still nervous about all those toxic assets; and the continuing collapse of the housing market hurts all of those mortgages and mortgage-backed securities banks are holding. And as banks teeter toward insolvency, people stop lending them money, and they stop lending people money.

On the plus side, the famous TED spread [dipped below 1](#) today, a sign that credit markets are doing much better than back in September. (The Calculated Risk article behind that link shows improvements in other parts of the credit markets, not just interbank lending.)

On the minus side, [CDS spreads](#) have shot up on Citigroup and Bank of America in the last week - here's Bank of America:



The main peaks you see are the Lehman bankruptcy, the buildup to the bank recapitalization announcement, and the Citigroup crisis. So while there seems to be general improvement in the credit markets, the underlying problems have not been solved.

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Jan 13, 2009 1:12 PM

[Policy Parallels: Eurozone and India](#)

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

I've had a chance, over the past 10 days, to debate the details of what's next for the macroeconomy with leading policymakers in both the eurozone/EU and India. I'm struck by some similarities. In both places, there is little or no concern that inflation will rebound any time soon. At least for people based in Delhi, there is as a result confidence that conventional policy can now act aggressively to cushion the blows coming from the global economy. In the eurozone, all eyes are on monetary policy and the same is true for India - both places have almost the exact debate about whether fiscal policy can do much more than it is already doing, given that government debt levels are already on the high side.

The discordant note comes from people based in Mumbai. They feel that Delhi does not fully understand that the real economy is already in bad shape. Sectors such as real estate and autos are hurting badly. Small businesses, in particular, seems to be bearing the brunt of the blow. The banking picture seems more murky, but is surely not good. And of course the [Satyam accounting scandal](#) could not come at a worse time.

Overall, my strong impression is that growth forecasts will need to be marked down for India and the eurozone. Both will likely cut interest rates further quite soon (and have space for additional cuts), but we should not expect much more from the fiscal side in either place. They will both start to look beyond standard macro policies - although India may make progress on this front sooner.

I also heard strong and reassuring opposition to protectionism - although, I must say the case against any kind of trade restriction comes through more clearly in India than in the eurozone.

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Jan 13, 2009 8:28 AM

[What If You Only Had \\$350bn To Spend?](#)

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

Larry Summers [made a convincing case](#) yesterday that Congress should release the remaining \$350bn of the TARP. It's good to see the Obama team emphasizing [themes beyond the fiscal stimulus](#), including banks and housing. Stronger governance and greater transparency are timely commitments for this program, and who can object to

limits on executive compensation in today's environment? Some Congressional debate makes sense and could be productive, but it's hard to see this request being turned down.

Still, what exactly should the money be spent on? I'm tempted to say: housing, because this continues to be a major unresolved problem that looms over both consumers and their balance sheets. Unfortunately, however, the banks remain a greater priority. The latest developments for both [Citigroup](#) and [Bank of America](#) suggest the banking situation is (again) seen by insiders as more desperate than we outsiders wished to believe.

The next round of bank recapitalization (again) needs to be big and bold, for example along the [lines we have been suggesting](#) for some time (but I'll take another comprehensive plan, if you have one, with strong expected taxpayer value). The problem today is that we just don't know if any major bank is well capitalized; there are too many black boxes that may contain toxic assets. At best, this is a brake on the positive effects that should come from the fiscal stimulus. At worst, we still have a major system issue on our hands.

And there is no reason to think that \$350bn is enough to handle this problem. The original \$700bn was obviously an arbitrarily chosen number, and the money has been spent so far in a rather unplanned manner. What we do next should not be constrained by the fact that there is a check for \$350bn waiting to be picked up. We should design a systematic recapitalization program, figure out what it will cost, and get on with it. My working assumption, based on the published analysis of the IMF regarding losses relative to private capital raising, is that \$1trn - properly deployed - should do the trick.

Then we should get to work on housing (yes, this needs more money).

Update: Ben Bernanke seems to be [thinking aloud](#) along similar lines.

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Jan 12, 2009 7:49 PM

[Not Quite the Marketing You Want](#)

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

Robert Siegel gave GM a priceless gift today: a feature segment on [All Things Considered](#), with a bunch of softball questions and a paean to the Chevy Malibu (which

was, to give credit where credit is due, the 2008 North American Car of the Year, which includes foreign imports). Then Bob Lutz, GM's vice chairman, fumbled the gift and dropped it on the floor, where it smashed into a thousand pieces. When asked what it was like to operate using money borrowed from the federal government, he said:

I've never quite been in this situation before of getting a massive pay cut, no bonus, no longer allowed to stay in decent hotels, no corporate airplane. I have to stand in line at the Northwest counter. I've never quite experienced this before. I'll let you know a year from now what it's like.

At my old company, it was a point of pride to search on price-comparison sites for the cheapest hotels you could find. (I know the argument that it saves money for expensive execs to fly corporate jets rather than flying commercial, because at their hourly rates it's not worth the time spent waiting in line. I think those arguments are bunk, because they assume that the ten minutes you spend waiting in line are ten minutes of work you will not do that day, while my experience is that in high-level positions the amount of work you do is a function of the amount of work you have to do, not the amount of time you have.)

It may be true, as Bob Lutz claims, that GM makes good cars again. (I happen to own and drive a GM car that I am very satisfied with, but it's a Chevy Prizm, which may not count.) But GM's brand reputation today is that it is out of touch, and stories like this don't help.

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Jan 12, 2009 3:21 PM

[More TARP Programs, More Policy by Deal](#)

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

Back on January 2, the Treasury Department announced something called the [Targeted Investment Program](#). I missed this at the time, along with (according to a quick search - thank you Google Reader!) all of the economics blogs that I read. The press release admitted that this was a program announced after the fact to cover the second Citigroup bailout (the first was under the Capital Purchase Program, the main bank recapitalization plan). In essence, the program says that if Treasury thinks a financial institution is at risk of a loss of confidence, Treasury can invest in it under any terms they want. This is very similar to the [Systemically Significant Failing Institutions Program](#), also announced after the fact (in November) to cover the second AIG bailout, which reads almost identically,

except instead of talking about a “loss of confidence” it takes about the “disorderly failure” of a systemically important institution.

This isn't a power grab by Treasury - they already had this power under the EESA (the main bailout bill passed in October, commonly known as TARP). And I happen to agree that if a systemically significant institution - the kind that whose failure would have a major impact on countless other institutions - is going to fail, it should be bailed out. However, I think these programs have two major failings.

First, they do only the vaguest job of specifying what types of institutions will be bailed out, making it difficult to predict when the government will step in. Shouldn't the government be able to figure out at this point which institutions are systemically significant, and say what they are instead of periodically relaxing the criteria to let in, say, GMAC? Second, and more importantly, they are completely vague on the terms of such a bailout (as opposed to the Capital Purchase Program, which has predefined terms that happen to be quite generous to participants). This is a problem because of the incentives it creates. If you are a shareholder in a bank that may be in trouble, you cannot be sure whether or not it will qualify for a bailout. And if you happen to run a bank that may be in trouble, you know that if push comes to shove, you can negotiate a deal with Treasury at the last minute by threatening to blow your brains out on their nice carpet.

This is a case where it would be good for Treasury to tie its hands in advance by predefining the terms of a rescue operation (say, type of asset invested in, warrant amount, strike price, governance, executive compensation restrictions, etc.). First of all, it would enable public debate over the terms, instead of the usual second-guessing on Monday morning when Treasury announces the deal it struck on Sunday evening “before the Asian markets open.” Second, it allows Treasury to say, “This is the only deal on the table. Take it or leave it.” It is a commonplace in negotiations that you are better off if you can credibly claim that your hands are tied, because this gives you a valid reason why you simply cannot concede to your counterparty's requests.

The counterargument will be that each failing institution is different and the rescue has to be tailored to its situation. But I don't really buy this. The predefined plan could be, to take a simple example, that Treasury will buy as much common stock as is needed to inject the required capital, at a 10% discount to the price on at the previous market close. No matter how much capital a bank needs in a pinch, it can get it under those terms - but the more capital, the more the existing shareholders get diluted, which is exactly as it should be. This plan should have relatively harsh terms; the Capital Purchase Program is the one with easy terms that banks turn to first. Even these terms are better for shareholders than bankruptcy, which means that the bank's board of directors has a fiduciary obligation to take them if they can't find private capital and the only alternative is bankruptcy. This is obviously just a simplistic example (maybe convertible preferred stock would be better than common), but I don't see why certain ground rules like this can't be defined in advance.

Update: Actually, I missed one: the [Asset Guarantee Program](#), another vague program intended to be defined on a case-by-case basis, this time to provide guarantees on assets held by systemically significant financial institutions. Apparently, as of December 31, Treasury was still deciding whether the Citigroup guarantee (on \$306 billion of assets) would be handled under the Asset Guarantee Program . . . or under some other program that hasn't been named yet?

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Jan 11, 2009 8:09 AM

[Accountability Time](#)

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

With Congress back in session, accountability is the theme of the week. Barney Frank announced the “[TARP Reform and Accountability Act of 2009](#),” which I hope to get to in a day or two. But for now I want to talk about Elizabeth Warren and the Congressional Oversight Panel for TARP, which issued their [second report](#) on Friday. Of course, beating the accountability drum at Henry Paulson's expense is politically easy, and a lot less controversial than, say, designing a stimulus package or a foreclosure reduction plan. But that doesn't mean it isn't important.

Back in September, Simon and I wrote an [op-ed](#) in the Washington Post that focused on the incentive problems in the initial TARP proposal and cynically predicted:

It is most likely that “governance” over the fund will be provided by periodic hearings of the relevant Senate and House committees during which the Treasury secretary and the fund managers will be asked why they overpaid for banks' securities and will answer that there was no choice if the financial system was to be saved.

(Recall that the proposal at that point was for Treasury to buy toxic assets from financial institutions, most likely overpaying the process.) However, the governance measures were strengthened in the eventual legislation, and it does seem that Elizabeth Warren and most of her committee (Jeb Hensarling, R-Texas, did not endorse the report) are committed to keeping Treasury under tight scrutiny, which is all good.

I'd like to differentiate between two different types of oversight. Simon and I were immediately concerned with the most basic oversight function: making sure there was no fraud, corruption, or pure waste in TARP. This was especially important when Treasury was talking about buying illiquid assets at necessarily higher-than-market prices, which

seemed like a recipe for giving taxpayer money to Wall Street. However, it's still important to ask whether the programs established under TARP, such as the Capital Purchase Program (the main one used to recapitalize banks) represent appropriate uses of taxpayer money or sweetheart deals for recipients. On this issue, the Warren Panel is rightly asking about the investment terms under their fifth question, "Is the Public Receiving a Fair Deal?" Under this heading, it's also appropriate to ask, "What Is Treasury's Strategy?" (the first question).

The second, broader type of oversight is figuring out if TARP is working and what all that TARP money is doing. I think it's good to ask these questions, but the ground we are on is considerably more slippery. The key problem is that Treasury and the Warren Panel don't seem to agree on what the goals of TARP were in the first place - which, of course, is largely Treasury's fault for failing to communicate those goals. According to Treasury, the goals of TARP are:

- Stabilize financial markets and reduce systemic risk
- Support the housing market by avoiding preventable foreclosures and supporting mortgage finance; and
- Protect taxpayers.

I actually agree with those goals, and I think the first one is the most important. However, the Warren Panel (and the Democratic majorities of both houses of Congress, and the large majority of the American public who pay attention to this issue) think that the goal of TARP should be to increase lending and revive the economy. That's why question 4 is "What Have Financial Institutions Done With the Taxpayers' Money Received So Far?" and question 6 is "What Is Treasury Doing to Help the American Family?" ("The Panel asked whether Treasury's actions preserved access to consumer credit, including student loans and auto loans at reasonable rates." But remember, you can't get everything for only \$350 billion when you're dealing with a \$14 trillion economy.)

I know I sound like a Paulson apologist (although here are my [anti-Paulson credentials](#)), but here goes. When the EESA was approved and the first round of bank recapitalizations were announced in October, the widespread fear was that the banking sector would simply collapse altogether, causing catastrophic damage to the real economy. The problem was that no one trusted that the banks had enough money to keep operating, which can quickly become self-fulfilling. The solution was to give them cash. The terms were pretty generous, and there wasn't enough cash, as I [wrote at the time](#), but that was the first step in stopping the bleeding. And if a bank is facing a liquidity crisis, and it gets a capital injection, the last thing it should do is immediately lend the money out again, because that will just put it back into a liquidity crisis.

Since then, however, it's become generally accepted that the purpose of bank recapitalization was to get credit flowing, to the point where even the Federal Reserve is [confused](#). I agree that the point of having a financial sector is to get credit flowing; I just think that preserving confidence in the financial sector's ability to continue existing is prior to increasing lending by the financial sector.

The Warren Panel thinks it's not enough for banks just to have capital, and so they are pressing the question:

The Panel still does not know what the banks are doing with taxpayer money. . . . So long as investors and customers are uncertain about how taxpayer funds are being used, they question both the health and the sound management of all financial institutions.

I have mixed feelings about this. On the one hand, the charge doesn't really make sense: the way to assess the health of a bank is to look at its financial statements, not to find out what it did with a particular bundle of money it got from Treasury. The goal of the investment (and the contemporaneous loan guarantee program) was, as Treasury says, to increase confidence in banks, so that other institutions would lend to them, and the immediate way to increase confidence is to put the money in your vault. And last I checked, money was fungible. After my company raised our second round of funding several years ago, we put it in the same big cardboard box as the rest of our money, and there's no way I could have told you what happened to those \$100 bills as opposed to the \$100 bills we already had. (OK, in reality we had a bank account.)

On the other hand, I would have been able to tell you, at a high level, what the company was doing that we could not have done without that second round of funding. So that seems like a reasonable question that any intelligent CEO should be able to answer in about five minutes.

On the third hand, my main frustration is this: If you want to control what the banks are doing, just nationalize them already! I mean, the consensus among Democratic as well as Republican economists seems to be that government majority control of banks is something to be avoided, and therefore TARP was designed to avoid it; a few people criticized it at the time for not nationalizing banks, but they were pretty rare. However, the consensus (shared by Congress and most of the public that cares) is that banks should be left in private hands, *and* that they should do what the public wants (lend more). If we really aren't happy with how the banks are behaving, we should get majority control in exchange for our investments and control them the old-fashioned way: through the board of directors.

OK, now that I've gotten that off my chest, I can say that I think the Warren Panel is asking a lot of good questions. They called out Treasury for not explaining its actions well ("The question is how the infusion of billions of dollars to an insurance conglomerate or a credit card company advances both the goal of financial stability and the well-being of taxpayers"), not doing anything about foreclosures (which was a requirement of EESA), and performing sleight of hand with the "healthy bank" designation (Citigroup was a healthy bank?). If only everyone could agree on what the goals are, then maybe we could figure out whether TARP is working or not.

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Jan 10, 2009 2:01 AM

[A Sliver of Optimism](#)

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

One of the scary things about this fall's descent into economic chaos was the failure of economic forecasters to keep pace. Every week economists would predict what they said were terrible things, and then the data would come in much worse, reinforcing the overall impression that no one knew what was going on.

Buried in all the negative reports about the December jobs data was one fact that was a tiny bit encouraging: the December job losses were almost [exactly what forecasters expected](#), on average. This indicates that it's possible that the macroeconomic community has come to grips with the magnitude of the downturn; if you're feeling particularly giddy, you might even infer that this means that their GDP forecasts are in the right ballpark, which means (according to the WSJ) that the economy should start growing in Q3.

I wouldn't go that far, though, and I think that Q3 forecast is too optimistic. It takes time to plan and execute a layoff (I've been there), so December layoffs are based on revenue projections based on data from October and maybe November. Because sales continued to fall faster than expected in November, companies will find they have to lay off more people than they initially expected, and that will drag into the new year. Furthermore, no one really knows how much the American household will shift from consumption to saving, and my sneaking suspicion is that it will be more than most people expect.

So all I can offer is a tiny sliver of optimism, that the people in the forecasting business are at least on the same planet as the rest of us. But still no one is sure what planet we're on.

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Jan 10, 2009 12:36 AM

[The Cost of Reputation](#)

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

Or, more accurately, the cost of caring about your reputation.

My recent article on [Risk Management for Beginners](#) closed with some unrigorous speculation about the peculiar incentives of fund managers, who are consistently well compensated in decent and good years and, in bad years, lose their clients' money and move on to start a new fund. Steven Malliaris and Hongjun Yan have a paper on this topic entitled "[Nickels Versus Black Swans](#):" "nickels" being the typical hedge fund strategy of making a small but consistent return with a small risk of a huge loss, and "black swans" being Taleb's preferred strategy that makes a small but consistent loss with a small risk of a huge gain.

Simplifying the model, the problem with a black swan strategy is that by the time the huge gain rolls around, you the manager have already been fired (your clients have withdrawn their money) because of your consistent losses. The result is overinvestment in nickel strategies and underinvestment in black swan strategies - even when the latter have a higher expected return. This result holds even when you assume that the investors are sophisticated, because the key factor is the reputational concerns of the fund managers themselves.

Malliaris and Yan also show that the system can reach multiple equilibrium points: the system can be in one equilibrium where most hedge funds are pursuing suboptimal strategies, and then suddenly shift to another quickly, meaning that the hedge fund industry does not allocate capital as efficiently as one might imagine. This might help explain why (a) everyone is saying that AAA-rated mortgage-backed securities are underpriced yet (b) no one is buying them.

This paper might be seen as simply translating common sense into mathematics. Seen another way, though, it helps explain why individually rational behavior (by fund managers) does not produce the efficient outcomes you learn in first-year economics.

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Jan 9, 2009 1:10 AM

[Paulson v. Buffett](#)

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

Bloomberg has a [new story](#) out comparing the investment terms achieved by TARP with those achieved by Warren Buffett when he invested \$5 billion in Goldman back in [September](#). The results aren't pretty for the U.S. taxpayer: the government received warrants worth \$13.8 billion in connection with its 25 largest equity injections; under the terms Buffett got from Goldman, those warrants would be worth \$130.8 billion. (The calculations were done using the Black-Scholes option pricing formula, which has its critics, but which I think is still a good way of estimating the relative difference between similar options.) That's on top of the fact that TARP is getting a lower interest rate (5%) on its preferred stock investments than is Buffett (10%), which costs taxpayers \$48 billion in aggregate over 5 years, according to Bloomberg. The difference in the value of the warrants themselves is due to two factors: (1) Treasury got warrants for a much smaller percentage of the initial investment amount; and (2) those warrants are at a higher strike price - the average price over the 20 days prior to investment, while Buffett got a discount to market price on the date of investment.

The comparison isn't a new one - we recommended that [TARP emulate Buffett](#) back in October - but Bloomberg's analysis has put the performance gap in striking perspective. Simon has a quote in the article, using the word "egregious," but the really harsh words came from Nobel prize-winner economist Joseph Stiglitz, who said, "Paulson said he had to make it attractive to banks, which is code for 'I'm going to give money away,'" and "If Paulson was still an employee of Goldman Sachs and he'd done this deal, he would have been fired."

Now, to be fair, there are some plausible defenses of TARP. One is that on that fateful October day when Henry Paulson summoned the CEOs of nine major banks to Washington, he needed all of them to accept the deal on the spot, so the terms could not be too punitive. While that may be the case, it doesn't explain why bailouts since then have to be equally generous (since the program is optional, after all) - culminating in the [GMAC bailout](#), where the "warrant" is just the option for the government to lend \$250 million more at a slightly higher interest rate. Another defense I have heard is that the plan needed to leave the banks in a situation where they could attract private capital. I have only limited sympathy for this defense, because it's not as if private equity funds are lining up to invest in Citigroup (or any other major bank), even after two rounds of generous bailouts. Finally, there is the oft-repeated mantra that the country doesn't want the government to nationalize banks, and larger warrants would lead to effective government ownership. Here, I think that the clever minds in Washington could come up with a trust-like structure to shield day-to-day operations from too much government meddling (some oversight is arguably a good thing anyway), and a concrete plan for divesting those ownership stakes would go a long way to defusing any worries about creeping socialism.

On balance, I think it's hard to argue that TARP needed to be as generous to banks and their shareholders as it has been. Broadly speaking, TARP recipients have fallen into two categories: those who didn't need the capital but took it because the terms were good, and those who really needed it (like GMAC). If the terms were tougher, the former might not

have taken them, but that would be fine; the latter still would have taken the money, because the government was the only place they could get it.

So the question remains: why did Henry Paulson, former CEO of the most respected investment bank on the planet, strike such bad deals for the American taxpayer? I don't know the man, but I strongly doubt that it was because of any conscious desire to enrich his colleagues. More likely, I suspect it was an unconscious product of the conventional wisdom, so strongly rooted these last twenty years, that government involvement is bad and should be minimized at all costs - even to the point of avoiding any possibility that the taxpayer might make money in dealings with private-company shareholders.

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Jan 8, 2009 8:02 PM

[Who's Afraid of Deflation?](#)

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

According to the [Federal Open Market Committee's \(FOMC\)](#) minutes, [released on Tuesday](#), some members think inflation targetting would be a useful way to persuade people that prices will not fall, i.e., forestall deflationary expectations. WSJ.com seems to have [the interpretation about right](#),

"The added clarity in that regard might help forestall the development of expectations that inflation would decline below desired levels, and hence keep real interest rates low and support aggregate demand," according to the minutes.

In other words, a commitment to an inflation target, say annual growth of 1.5% to 2%, would help keep prices from falling outright and prevent the kind of economic chaos that plagued Japan in the 1990s and the U.S. during the Great Depression.

The Congressional Budget Office thinks there is still time to prevent deflation (or perhaps it is the new measures already in the works that will keep inflation positive). Their forecast for 2009 (see [Table 1 in today's testimony](#)) predicts low inflation, e.g., the PCE price index is expected to be 0.6 percent for 2009 - but note that the CPI is seen as barely positive, at 0.1 percent, over the same period.

Meanwhile, the financial markets (e.g., inflation swaps) predict minus 4 percent inflation in 2009 (part of which is likely due to lower commodity prices) and then a small degree

of deflation over the next few years. According to this view, we should next see today's price level again in about 5 or 6 years.

Of course, the financial markets could well be wrong. It may be that the markets haven't fully digested or understood the size of the fiscal stimulus, and it may be that further news about other parts of the Obama approach (including the [directly on housing and banking](#)) will significantly change inflation expectations.

But it is striking that financial market inflation expectations - e.g., over a five year horizon - have barely moved from their low/near deflation level since it became clear that Mr Obama would win the election or since we first realized that a massive fiscal stimulus would soon arrive (see slide 2 in [my presentation from Sunday](#); the scale is hard to read, but the decline is from around 2% through the summer to around 0% currently). At least for now, whether or not we are heading for deflation remains the key open question.

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Jan 8, 2009 1:57 PM

[China and the U.S. Debt](#)

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

I'm warming up for a longish Beginners-style article on government debt, which will come out next week or so. In the meantime, the New York Times has an article today about China's [diminishing demand](#) for U.S. dollar-denominated debt. Theoretically this could make it harder for the U.S. to borrow money and thereby push up the interest rates on our debt (now at extremely low levels).

China's voracious demand for American bonds has helped keep interest rates low for borrowers ranging from the federal government to home buyers. Reduced Chinese enthusiasm for buying American bonds will reduce this dampening effect.

However, the article doesn't mention one compensating factor. The fall in China's buildup of its foreign currency reserves is linked to the rise in the U.S. savings rate, which is projected to rise to as much as [6-10%](#) (it was over 10% in the 1980s). Some of that new savings will go to pay down debt, but a lot will go into savings accounts, CDs, money market funds, and mutual funds - which means that depresses interest rates across the board. On the back of the envelope, 6% of personal income is about \$600 billion a year in new domestic savings to compensate for reduced overseas investment. Whether

this will be enough to compensate entirely I don't know. But if we were all one global economy in the boom, we're still one global economy in the bust.

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Jan 8, 2009 6:44 AM

[Causes: Economics](#)

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

We are not short of causes for our current economic crisis. The basic machinery of capitalism, including the [process of making loans](#), did not work as it was supposed to. [Capital flows around the world](#) proved much more destabilizing than even before (and we've seen some damaging capital flows over the past 200 years.) And there are plenty of [distinguished individuals](#) with something to answer for, including anyone who thought they [understood risk and how to manage it](#).

But perhaps the real problem lies even deeper, for example, either with a natural human [tendency towards bubbles](#) or with how we think about the world. All of our thinking about the economy - a vast abstract concept - has to be in some form of model, with or without mathematics. And we should listen when a leading expert on a large set of influential models says (1) they are broken, and (2) this helped cause the crisis and - unless fixed - will lead to further instability down the road.

This is an important part of what my colleague, [Daron Acemoglu](#), is saying in a new essay, "[The Crisis of 2008: Structural Lessons for and from Economics](#)." (If you like to check intellectual credentials, [start here](#) and if you don't understand what I mean about models, [look at his new book](#).) To me there are three major points in his essay.

1. The seeds of the crisis were sown in the Great Moderation (the low inflation, relatively stable last 20 years or so). Everyone who patted themselves or others on the back during that time was really missing the point (p.3). The same interconnections that reduced the effects of small shocks created vulnerability to massive system-wide domino effects. No one saw this clearly.

2. The predominant view was that the US and other relatively rich countries had pretty good institutions (i.e., rules, laws and practices underpinning economic transactions) and that these institutions would prevent powerful people from the kind of abuse that endanger social systems in many parts of the world (pp.4-5). That view was incorrect. (Speaking personally, I had no illusions about the power of the strongest on Wall Street -

particularly after my experience on the SEC's [Advisory Committee on Market Information](#) in 2000-2001. But I didn't have the right mental model of how this power aggregated up, i.e., the way in which these people, and the firms they controlled, had created or recreated a deeply unstable system.)

3. The way we think about reputation, including how it is acquired and maintained, is way off base (pp.6-7). This is fundamental for both formal economics and how you go shopping. You walk into a grocery store with a mental model that is based on the premise that the individuals all through the production chain operate in a control structure designed to build brands and make you think their products are healthy and tasty. Such reputations are costly to build and not readily squandered. But, Daron points out, this is too simple. In particular, we should no longer make the mistake of saying "the company" wants this or that. There are no companies in any kind of behavioral sense. There are people, struggling to get ahead, and it is their interactions that can lead - particularly in finance - to products that are really terrible for you and your neighbors (and even quite bad for themselves).

Daron also urges that we not lose track of longer term economic growth issues in the current policy debate. If the bailout process - including the evergreening of credit by the Federal Reserve - slows down or even freezes the reallocation of resources out of the financial sector, we have a problem. We need to move, at least somewhat, [out of a bloated financial sector and back into the kind of nonfinancial technology](#)-developing sectors that have primarily driven growth in the US since the 1840s.

This is not an argument against a comprehensive stimulus package. But it recognizes the legitimacy of any backlash both against the models that brought us here and many of the sweet deals for leading financial figures (received so far and no doubt currently pencilled in). Beginning with designing, arguing about, and implementing the stimulus, we need to think more clearly about the economics and politics of how we rebuild the financial system. If we recreate something fundamentally unfair and unstable, that will also undermine growth.

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Jan 7, 2009 3:32 PM

[Obama Doubles Down](#)

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

Barack Obama did not actually predict trillion-dollar deficits indefinitely; more precisely, [he said](#), “unless we take decisive action, *even after our economy pulls out of its slide*, trillion-dollar deficits will be a reality for years to come” (emphasis added). At the same time, the highly competent Congressional Budget Office projected a \$1.2 trillion deficit for fiscal 2009 (year ending 9/30/09).

I was initially surprised by Obama’s forthrightness on the deficit question, but on reflection there are three good reasons for him to do it:

1. He wants to lower expectations by making the case that we have a serious deficit problem before taking office.
2. He wants to signal that he is aware of the deficit issue, to try to defuse the attacks he is going to get from fiscal conservatives regarding his stimulus plan.
3. He wants to use the current crisis - and the political opportunity it gives him, as a new and generally popular president with significant majorities in both houses - to tackle the long-term [retirement savings problem](#).

If you parse the sentence, in saying “even after our economy pulls out of our slide,” Obama is saying that the long-term deficit problem would exist with or without the current crisis - and he is right. A \$1.2 trillion deficit, caused by a steep fall in tax revenues, partially by the costs of various bailouts, and a little bit by two ongoing wars, is small compared to the Social Security and Medicare [funding gaps](#) ahead. In signaling that he will announce some kind of approach to entitlement spending by next month, Obama is implying that he wants to take on not just the short-term recession, but also the long-term deficit problem.

This is good for two reasons. First, someone has to face the problem. President Bush “tried” (not very hard) to do something about Social Security in 2005, although the general direction of his proposal, in shifting from a defined-benefit to a defined-contribution model, would have shifted risk from the government onto individuals.

Second, there are economic reasons why long-term sustainability should be addressed at the same time as short-term stimulus. Virtually everyone (even [Martin Feldstein](#)) favors a large, debt-financed government stimulus package. However, the more the government borrows, the more risk there is that lenders will worry about our ability to pay off the debt. While few people expect the U.S. to default, the more widespread fear is that we will print money (in a more sophisticated form, of course) to inflate away the debt. Because of those fears, large amounts of borrowing will drive up interest rates, especially as the economy recovers, both for the government (increasing our interest payments) and for the economy as a whole (undermining growth). The solution, if there is one, is to put forward a credible plan for dealing with the long-term retirement problem.

The risk, of course, is that Social Security and Medicare can be politically lethal, which is one reason President Bush backed off so fast. But I still think this is the right bet for Obama to make. Insofar as any solution is going to involve some pain (lower benefits, increased benefit age, higher taxes, increased control over health care), it is going to be

easier to pass in a time of perceived collective crisis. And being willing to tackle the problem could also help gain support from fiscal conservatives for the stimulus that we need now.

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Jan 7, 2009 7:19 AM

[Overweight Fiscal? \(The Obama Economic Plan\)](#)

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

Most of the current discussion regarding the Obama Economic Plan focuses on whether the fiscal stimulus should be somewhat larger or smaller (\$650-800bn seems the current range) and the composition between spending and tax cuts. President [Obama stressed on Tuesday](#) that trillion dollar deficits are here to stay for several years, and it looks like part of the arguing in the Senate will be about whether this is a good idea.

There is at least one key question currently missing from this debate. Is this Plan too much about a fiscal stimulus and too little about the other pieces that would help - and might even be essential - for a sustained recovery? The fiscal stimulus may be roughly the right size (and \$100bn more or less is unlikely to make a critical difference), but perhaps we should also be looking for more detail on the following:

1. [Recapitalizing banks](#). Their losses to date have not been replaced by new capital and it is currently not possible to issue new equity in the private markets. If you think we can get back to growth without fixing banks, check [Japan's record in the 1990s](#).
2. Directly addressing housing problems, including moving to limit foreclosures and [reduce the forced sales](#) that follow foreclosures. There is apparently some form of the [Hubbard-Mayer proposal](#) waiting in the wings, but we don't know exactly what - and this matters, among other things, for thinking about the debt sustainability implications of the overall Plan.
3. Finding ways to push up inflation, presumably by being more aggressive with monetary policy. Deflation is looming - according to the financial markets, despite all of the Fed's moves and recent statements, prices will fall or be flat over the next 3 to 5 years. This fall in inflation, from its previous expected level around 2 percent per year, constitutes a big transfer from borrowers/spenders to net lenders/savers. The contractionary effect is likely to outweigh any fiscal stimulus that is politically feasible or

economically sound. (We have more detail on this point on WSJ.com today, [linked here.](#))

So perhaps the issue is not the absolute size or composition of the fiscal stimulus, but rather the role of the fiscal stimulus relative to other parts of the Plan. Hopefully, it's a more evenly weighted package, and just we haven't yet seen the details. Still, it's odd that the presence and general contours of these other important elements have not yet been clearly flagged.

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Jan 6, 2009 10:38 AM

[The Economic Crisis and the Crisis in Economics](#)

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

The Economic Crisis

The global financial crisis of fall 2008 was unexpected. A few people had been predicting that serious problems were looming, and even fewer had placed bets accordingly, but even they were astounded by what happened in mid-September.

What did happen? There are many layers to unpeel, but let me begin with the three main events that triggered the severe global phase of the crisis. (See <http://BaselineScenario.com> for more on what came before, how events unfolded during fall 2008, and where matters now stand).

- 1. On the weekend of September 13-14, 2008, the U.S. government declined to bailout Lehman. The firm subsequently failed, i.e., did not open for business on Monday, September 15. Creditors suffered major losses, and these had a particularly negative effect on the markets given that through the end of the previous week the Federal Reserve had been encouraging people to continue to do business with Lehman.
- 2. On Tuesday, September 16, the government agreed to provide an emergency loan to the major insurance company, AIG. This loan was structured so as to become the company's most senior debt and, in this fashion, implied losses for AIG's previously senior creditors; the value of their investments in this AAA bastion of capitalism dropped 40% overnight.
- 3. By Wednesday, September 17, it was clear that the world's financial markets - not just the US markets, but particularly US money market funds - were in cardiac

arrest. The Secretary of the Treasury immediately approached Congress for an emergency budgetary appropriation of \$700bn (about 5% of GDP), to be used to buy up distressed assets and thus relieve pressure on the financial system. A rancorous political debate ensued, culminating in the passing of the so-called Troubled Asset Relief Program (TARP), but the financial and economic situation continued to deteriorate both in the US and around the world.

Thus began a financial and economic crisis of the first order, on a magnitude not seen at least since the 1930s and - arguably - with the potential to become bigger than anything seen in the 200 years of modern capitalism. We do not yet know if the economic consequences are “merely” a severe recession or if there will be a prolonged global slump or worse.

The Crisis in Economics

Does this economic crisis constitute or imply a crisis for economics? There are obviously two answers to this question: no, and yes.

Let me discuss the “no crisis” view first. There are actually several variants on this view. The first is that the post-Keynesian consensus comes through the crisis just fine. In fact, the current emphasis on fiscal stimulus in the US (and the debate about fiscal stimulus elsewhere) supports the position that we are back to Keynesian fundamentals. There is a decline in private spending underway, and governments around the world are seeking to replace that with public spending (or, if you prefer, the private sector suddenly wants to save more, so the public sector better rush to save less.)

A more nuanced version of this view adds some financial accelerators, or perhaps we should now call them decelerators. We obviously had a series of bank runs in mid-September, but not just by small depositors and not just on banks. We also had a situation where falling values for collateral triggered more asset sales (either for accounting reasons or due to market pressure of various kinds), and this led to further lowering of collateral.

More broadly, there was also some kind bad expectations trap, in which everyone expected everyone else to default and that kind of fear of counterparty risk is obviously self-fulfilling.

In other words, this view is that we can retrofit our favorite mainstream models to accommodate what happened, at least at a fairly high level of abstraction. There is no crisis for macroeconomic thinking, let alone for economics.

An alternative interpretation is that mainstream macroeconomics is in big trouble. You can think about this in terms of whether standard thinking provides plausible answers to four current policy issues. (Daron Acemoglu of MIT has an important essay in preparation, arguing that there are deeper problems for economics, including for the most

fundamental microeconomics - such as how we think about firms and reputations - in the light of the crisis.)

First, let's begin with whether macroeconomics can answer definitively or even informatively the most important question of the day. Are we in danger of falling into another Great Depression, with a prolonged, worldwide fall in output and employment?

The mainstream answer to this question is: no, because we've learned a lot about economics since the Great Depression and because we also learned a great deal about policy both during and after the 1930s.

I'm not so convinced. For example we know that a key policy mistake in the early 1930s was to allow banks to fail. This will not happen again, at least not for "systemic institutions" - as the G7 made clear in October. But bank failure was a problem because it contributed to a big contraction in credit - this has been well established in the work of Ben Bernanke and others. Unfortunately, we know relatively little about how to stop today's process of falling credit around the world, known as "global deleveraging."

Second, consider the current consensus on saving the day in the US and around the world through a large US fiscal stimulus - probably \$800bn over several years, which would constitute the largest peacetime boost ever for the US economy. Is this really the right approach?

We know that allowing the price level to decline was an essential error of the early 1930s, as this increased the real debt burden for everyone with fixed nominal obligations. We think we know how central banks can prevent this kind of deflation, and Mr. Bernanke's now famous November 2002 speech laid out a clear road map for appropriate policies - even to the extent of "quantitative easing," i.e., extending more credit without sterilization through selling Treasuries, thus increasing the monetary base.

Still, I am struck by the fact that while the opinion leaders among US-based macroeconomists eventually called for some version of "credible irresponsibility" (to counter deflation or even produce inflation) in Japan during the 1990s, we have still not reached the point where such terms have joined the acceptable lexicon for most of the mainstream on the US economy today. (Some leading economists, I find, are willing to talk in these terms in private, but not yet in public.)

I would stress that nothing in the Fed policy or the Obama Plan has yet turned the corner on this issue. In fact, inflation expectations have not risen significantly since it became clear Mr. Obama would win the election and introduce a major fiscal stimulus.

Think about that in terms of monthly payments on your (or my) house. Let's say the interest rate on your mortgage is 6%, which is roughly the average for the U.S. When inflation runs around 2% (as is typical), the real, inflation-adjusted rate you pay is lower - actually only 4%. But the price level is now expected by the financial market to be flat on average for each of the next 5 years. So in this case the real interest rate will be 6%.

In other words, the advent of deflation implies a massive unexpected transfer of income from borrowers to lenders. With the face value of outstanding mortgages over \$10trn, this will likely depress spending by more than can be compensated for by any reasonable fiscal stimulus.

The appeal of recreating positive inflation expectations is that it would put downward pressure on the dollar and thus push our major trading partners to cut interest rates and engage in their own forms of monetary expansion - or face appreciation of their currencies and a fall in exports. The result will be higher global inflation, to be sure, but this is the only realistic way to persuade European Union members to take the measures necessary to stimulate their stronger economies or even save their own weaker economies from default.

President Obama can ask our allies to provide stimulus until he is blue in the face, but the fact of the matter is that the very size of our own fiscal expansion gives the Germans and others the incentive to free ride - they are hoping to recover on the back of exports to our infrastructure projects. It is only more expansionary monetary policy in the US that will force their hands in the right direction, for us and for them.

Third, what is the deeper cause of this crisis? A supersized financial system - the obesity of banks and shadow banks - helped create the vulnerabilities that made the September crisis possible. This financial system captured its regulators and took on far more risk than it could manage (or even understand). And this is a statement not just about US banks, but also about most parts of the global financial system.

The answer lies with the political economy of the US financial system, including the power politics of large financial firms. These grew large relative to the institutions that support and constrain them. In effect, we created an emerging market-type of structure. There is nothing in the mainstream textbooks or working papers about this - the general working assumption has been that institutions in the US were significantly better than in emerging markets. The time has obviously come to question in what sense this is really true.

The US banks have received generous bailouts, at least after the Lehman-AIG events, with no change in management. Have they become stronger or weaker? After the crisis we will have probably no more than 6 major banks in the US, with little threat from new entrants and small hope of controlling their actions indefinitely through effective regulation.

The problems are even more pressing if it is the case that these banks need to be recapitalized fully. They oppose this policy, for obvious reasons. The fiscal stimulus may well prove ineffective in the face of this political opposition, which is still well represented at the heart of the new administration's economic strategy. Again, however, I find leading economists to be surprisingly quiet on this key issue.

The fourth question is: what are the implications for the eurozone? Again, there is a huge divergence of opinions among economists on this point. Personally, I'm struck by the 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 - over the past few weeks - 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 over 90 percent, and the perceived risk of default is significant. 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 - in my opinion - 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. But the global mainstream economics approach still seems to be emphasis on fiscal policy coordination.

In any case, monetary policy in Europe 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.

Probably existing macroeconomic thinking can accommodate this kind of analysis. It's a blend of financial market analysis with political economy. But I don't know any models, let alone much empirical work, that bears directly on - or comes close to testing - any dimensions of this issue. Economics is in thin air.

My guess is that, among other things, we need to change dramatically our ways of thinking about fiscal policy. This needs to prepare for irregular but large crises, which implies being more countercyclical - and that implies less growth in boom times. Monetary policy will not stop bubbles and regulators will always fall behind; responsibility for making sure we can handle major financial crises rests with fiscal policy.

Rethinking the Structure of the Global Economy

If economics is in so much trouble, what does this imply for thinking about economic policy - both in terms of sensible crisis management and more medium-term attempts to rebuild a reasonable global system?

In order to create the conditions for long-term economic health, we need to identify the real structural problem that created the current situation and likely means the global economy has entered a new phase of instability. 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).

Let me suggest a way to think about these economic issues, although I know this will not sit well with many macroeconomists (although it may go down better with those who focus on longer run growth issues). 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. (None of these points would have sat well with mainstream finance or economics two years ago, but perhaps the consensus around some of these points has shifted recently.)

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, <http://baselinescenario.com/2008/12/07/financial-crisis-bubbles-causes-psychology/>). 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 opinion piece on this topic, available through [<http://baselinescenario.com/2008/11/11/obama-economic-strateg/>]). 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.

Understanding how to prevent stability from creating future vulnerability will require us to rethink a great deal about economics and how economies operate. Political economy is probably the place to begin, but a lot more needs to be done on fundamentals. Whether or not our economies manage to avoid a major global depression, economics is in crisis.

Revised version of text prepared for delivery as Presidential Address to the Association for Comparative Economics, San Francisco, January 4, 2009; [pdf version here](#). Comments from members of the Association are gratefully acknowledged. Conversations with Daron Acemoglu and Adam Davidson helped to shape these remarks and this essay draws freely on joint work with Peter Boone and James Kwak (see <http://BaselineScenario.com> for details), but the views expressed here are solely those of the author, Simon Johnson, copyright 2009.

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Jan 5, 2009 1:21 PM

[Causes: Hank Paulson](#)

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

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

I generally prefer systemic explanations for events, but it is obviously worthwhile to complement this with a careful study of key individuals. And in the current crisis, no individual is as interesting or as puzzling as Hank Paulson.

The big question must be: How could a person with so much market experience be repeatedly at the center of such major misunderstandings regarding the markets, and how could his team - stuffed full of people like him - struggle so much to communicate what they were doing and why?

Hank Paulson's [exit interview](#) with the Financial Times contains some potential answers but also generates some new puzzles.

Paulson [argues](#) that he lacked the legal powers and resources necessary to intervene decisively and early on in the crisis, and this may account for some of his actions through mid-September. Still, the Fed has plenty of powers and essentially unlimited resources in a crisis, and it's not clear why Paulson and Bernanke, acting together, couldn't have done more - for example, after Bear Stearns revealed (to most observers, private and official, and presumably to them) the depth of the systemic problems. It's odd that Paulson feels the severity of the crisis was only apparent after the intervention in Fannie Mae and Freddie Mac.

The greatest puzzle, of course, is why Lehman was not saved. Paulson essentially says that letting Lehman fail was not his idea, and the well-informed FT article implies it was definitely not due to Geithner. Yet it's not plausible that Bernanke would have taken such a stand. So who did it?

(The excellent recent WSJ article on that critical weekend - link [here](#), but subscription required - also jumps that key moment; it's as if there is a cone of silence on this point. Perhaps Geithner's upcoming confirmation hearing will reveal more.)

But there is also a more analytical puzzle. In his interview, Paulson stresses the role of capital flows and the so-called "global savings glut" in driving down risk premia and encouraging a system full of bad decisions (and the FT rightly regarded this as an important statement, and put it on the front page). Paulson also implies that more urgent multilateral action on this dimension would have helped.

Yet Paulson himself was instrumental in blocking, or not taking forward (and that's close to the same thing), the deal brokered in the [Multilateral Consultation](#) between the world's major trading areas. This was a major opportunity to advance policies both in the US and elsewhere that would have exactly addressed what Paulson now says was an evident first-order system problem.

Of course, the idea of de-emphasizing any kind of multilateral approach might have come from the Bush White House, but this level of detail is almost always delegated to the Treasury. And there is every indication that Mr. Bush trusted completely and listened carefully to Paulson at every stage, including throughout this fall's downward spiral.

Corroborating evidence for the idea that Paulson did not want to work in a multilateral fashion comes from the fact that in fall 2007 he called for sharp spending cuts at the IMF (see [his IMFC statement](#), near the top of the last page). The US Treasury continued to push for these cuts in the ensuing months, despite the obvious onset of a serious worldwide financial crisis - about which they, of all people, surely had the most inside knowledge. In fact, despite the current series of urgent crises, the IMF still finds itself constrained by the roughly 20% budget cut that the US insisted upon. Quite why these limits on spending were not immediately relaxed after September - which would have been easy to do under G7 or G20 leadership - is yet another mystery that can presumably be traced back to the attitude of the US authorities, although the crisis-deniers in Europe probably also played a supportive role.

In any case, Paulson was entitled to choose a strategy to address global imbalances other than that of the Multilateral Consultation. But what was his global strategy.? No one has yet been able to explain that to me, but please do make suggestions in comments on this post.

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Jan 5, 2009 10:03 AM

[Eurozone Hard Pressed: 2% Fiscal Solution Deferred](#)

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

One leading anti-recession idea for the moment is a [global fiscal stimulus](#) amounting to 2% of the planet's GDP. The precise math behind this calculation is still forthcoming, but it obviously assumes a big stimulus in the US and also needs to include a pretty big fiscal expansion in Europe. (Emerging markets will barely be able to make a contribution that registers on the global scale.)

What are the likely prospects for a major eurozone fiscal stimulus? My [presentation yesterday](#) on this question is here. The main points are:

The pressure is really on euro sovereigns with relatively weak fiscal positions. This may not seem fair, in the sense that the crisis started far away (in some sense), but that is how crises work.

Whether or not the global recession is bad, countries like Greece and Italy (and a set of countries now known in the markets by the unfortunate acronym of PIIGS) are being pushed towards urgent fiscal austerity, i.e., the opposite of expansion.

They could, of course, get some sort of help from stronger eurozone members, for example in the form of much lower interest rates. But this does not seem to be immediately in the cards.

The reaction that one hears from senior European officials and richer eurozone countries is that Greece (and Italy and others) should deal with their fiscal problems. There is very little sympathy and even less bailout money. This is in striking contrast with the attitude - and willingness to open pocket books - shown towards East-Central Europe, which is currently being treated more as a set of innocent bystanders.

It is hard to see how to pull a large global fiscal stimulus out of the hat. Pursuing expansionary monetary policy in the US and elsewhere is much more likely to have first order effects on industrial countries and, through them, on the world's economy.

Asking for a major push on fiscal policy is not a bad thing in most contexts. But it does encourage free riding, i.e., you go build a lot of roads and bridges and I'll recover through exporting vehicles and machinery to you - which appears to be the current German strategy.

Getting the G7 or G20 to really coordinate on fiscal stimulus is rather like OPEC trying to coordinate oil production cuts. Both are really hard to do in a severe downturn, particularly as budget pressures mount.

Aside: my presentation was part of a panel discussion on the euro at the American Economic Association conference in San Francisco. ECB Vice President Lucas Papademos was also on the panel, and told the press afterwards: (I'm taking the quotes as reported by Citigroup this morning, to illustrate what the market is focussing on)...

"inflation will not be allowed to fall significantly below 2% for a protracted period of time, over the medium term, which we do not expect on the basis of our present analysis". He added, that the ECB "will do what is necessary, in terms of the timing and the size (of interest policy action) to ensure price stability". However, he added that "cutting interest rates to very low levels must be judged with special care because of the long-term implications for price stability"

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Jan 4, 2009 11:01 AM

[Risk Management for Beginners](#)

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

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

Joe Nocera has an article in today's [New York Times Magazine](#) about Value at Risk (VaR), a risk management technique used by financial institutions to measure the risk of individual trading desks or aggregate portfolios. Like many Magazine articles, it is long on personalities (in this case Nassim Nicholas Taleb, one of the foremost critics of VaR) and history, and somewhat light on substance, so I thought it would be worth a lay explanation in my hopefully by-now-familiar Beginners style.

VaR is a way of measuring the likelihood that a portfolio will suffer a large loss in some period of time, or the maximum amount that you are likely to lose with some probability (say, 99%). It does this by: (1) looking at historical data about asset price changes and correlations; (2) using that data to estimate the probability distributions of those asset prices and correlations; and (3) using those estimated distributions to calculate the maximum amount you will lose 99% of the time. At a high level, Nocera's conclusion is that VaR is a useful tool even though it doesn't tell you what happens the other 1% of the time.

naked capitalism already has one [withering critique](#) of the article out. There, Yves Smith focuses on the assumption, mentioned but not explored by Nocera, that the events in question (changes in asset prices) are normally distributed. To summarize, for decades people have known that financial events are not normally distributed - they are characterized by both skew and kurtosis (see her post for charts). Kurtosis, or "fat tails," means that extreme events are more likely than would be predicted by a normal distribution. Yet, Smith continues, VaR modelers continue to assume normal distributions (presumably because they have certain mathematical properties that make them easier to work with), which leads to results that are simply incorrect. It's a good article, and you'll probably learn something.

While Smith focuses on the problem of using the wrong mathematical tools, and Nocera mentions the problem of not using enough historical data - "All the triple-A-rated mortgage-backed securities churned out by Wall Street firms and that turned out to be little more than junk? VaR didn't see the risk because it generally relied on a two-year data history" - I want to focus on another weakness of VaR: the fact that the real world changes.

Even leaving aside the question of which distribution (normal or otherwise) to use, VaR assumes the likelihood of future events is dictated by some distribution, and that that distribution can be estimated using past data. A simple example is a weighted coin that you find on the street. You flip it 1,000 times and it comes up heads 600 times, tails 400 times. You infer that it has a 60% likelihood of coming up heads; from that, you can calculate the probability distribution for how many heads will come up if you flip it 10 more times, and if you want to bet on those coin flips you can calculate your VaR. Your 60% is just an estimate - you don't know that the true probability is 60% - but you can

safely assume that the physical properties of the coin are not going to change, and you can use statistics to estimate how accurate your estimate is. But another way, your sample (the 1,000 test flips) is drawn from the same population as the thing you are trying to predict (the next 10 flips).

By contrast, imagine you have two basketball teams, the Bulls and the Knicks, who have played 1,000 games, and the Knicks have won 600. You follow the same methodology, bet a lot of money that the Knicks will win at least 5 of the next 10 games - and then the Bulls draft Michael Jordan. See the problem?

Now, are asset prices more like coin flips or like basketball times? On an empirical level, they may be more like coin flips; their probability distributions aren't likely to change as dramatically as when the Bulls draft Jordan, or the Celtics trade for Kevin Garnett and Ray Allen. But on a fundamental level, they are more like basketball teams. The outcome of a coin flip is dictated by physical processes, governed by the laws of mechanics, that we know are going to operate the same way time after time. Asset prices, by contrast, are the product of individual decisions by thousands, millions, or even billions of people (when it comes to, say, wheat futures), and are affected as well by random shocks such as the weather. We have little idea what underlying mechanisms produce those prices, and all the simplifying assumptions we make (like rational profit-maximizing agents) are pure fiction. Whatever the underlying function for price changes is, if it winds up distributed in a manner similar to some mathematical function, it's by accident; and more importantly, no one tells us when the function changes.

Going back to asset prices: To estimate the probability distribution of price changes, you need a sample that reflects your population of interest as closely as possible. Unfortunately, your sample can only be drawn from the past, and your population of interest is the future. So you really face two different risks. You face the risk that, in the current state of the world (assuming you can estimate that perfectly), an unlikely event will occur. You also face the risk that the state of the world will change. VaR, at best (assuming solutions to Smith's criticisms), can quantify the first risk, not the second.

Let's say you are just interested in your VaR for tomorrow. The chances that the real world will change significantly from today to tomorrow are small, but you still have the question of deciding how far back to draw your sample from. Is tomorrow's behavior going to be most similar to the behavior over the last 30 days, the last 30 months, or the last 30 years? It depends on when the real world last changed - and you have no good way of knowing that (although there are statistical ways to guess). And when you try to look at your VaR for the next quarter, or year, you have the additional risk of the world changing under your feet.

To put it another way, what happened in the last two years? One explanation is that the models were intrinsically faulty (wrongly specified). One explanation is that the models didn't go back far enough to incorporate data about steep falls in housing prices. And one explanation is that no amount of data would have helped, because the world changed.

I want to apply this thinking to a question that has annoyed me for years. You often hear personal finance types saying, “over every 30-year period, no matter what year you start in, stocks always outperform bonds.” Their data usually go back about 100 years. So this sounds like you have 70 data points (you don’t have the results for the last 30 starting years), right? Nope. If that were the case, you could start your 30-year period on every single trading day in those first 70 years, which would give you about 17,500 data points. Maybe you have 3 data points, because you have 3 non-overlapping (and hence arguably independent) 30-year periods. But this all assumes that during the 30 years starting right now, the stocks basketball team and the bonds basketball team have the same relative strengths that they did over the last 100 years, which is a big assumption. There are other reasons to believe stocks will have higher returns than bonds, but the fact that for ten years everyone has been assuming stocks must do better than bonds leads me to believe it may not happen this time - at least if you take, say, 2000 as your starting point. (I suppose I should mention that about 63% of my non-cash financial assets are in stocks, more if you include REITs.)

There was one part of Nocera’s article that I liked a lot:

At the height of the bubble, there was so much money to be made that any firm that pulled back because it was nervous about risk would forsake huge short-term gains and lose out to less cautious rivals. The fact that VaR didn’t measure the possibility of an extreme event was a blessing to the executives. It made black swans [unlikely events] all the easier to ignore. All the incentives — profits, compensation, glory, even job security — went in the direction of taking on more and more risk, even if you half suspected it would end badly. After all, it would end badly for everyone else too. As the former Citigroup chief executive Charles Prince famously put it, “As long as the music is playing, you’ve got to get up and dance.” Or, as [John Maynard Keynes](#) once wrote, a “sound banker” is one who, “when he is ruined, is ruined in a conventional and orthodox way.”

This, I think, is an accurate picture of what was going on. If you were a senior executive at an investment bank, even if you knew you were in a bubble that was going to collapse, it was still in your interests to play along, for at least two reasons: the enormity of the short-term compensation to be made outweighed the relatively paltry financial risk of being fired in a bust (given severance packages, and the fact that in a downturn all CEO compensation would plummet); and bucking the trend incurs resume risk in a way that playing along doesn’t.

If you were an individual trader, the incentives might have been the opposite: shorting the market was an opportunity to make a name for yourself and open your own hedge fund, while buying more mortgage-backed securities would just keep you in the same bonus tier as everyone else. But it’s the CEOs who called the shots, and their personal risk aversion was what mattered. Or, in the brilliant words of [John Dizard](#) (cited in the [naked capitalism article](#)):

A once-in-10-years-comet-wiping-out-the-dinosaurs disaster is a problem for the investor, not the manager-mammal who collects his compensation annually, in cash, thank you. He has what they call a “résumé put”, not a term you will find in offering memoranda, and nine years of bonuses.

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Jan 3, 2009 1:38 PM

[The Importance of Accounting](#)

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

Or, as I thought of titling this post, SEC does something useful!

Accounting can seem a dreadfully boring subject to some, but it gets its moment in the sun whenever there is a financial crisis . . . remember Enron? This time around is no exception. During the panic of September, some people were calling for a suspension of mark-to-market accounting, and while they did not get what they wanted, they succeeded in inserting a provision in the first big bailout bill to study the relationship between mark-to-market accounting and the financial crisis.

A brief, high-level explanation of the dispute: Under mark-to-market accounting, assets on your balance sheet have to be valued at their current market values. So if you have \$10 million worth of stock in Microsoft, but that stock falls to \$5 million, you have to write it down on your balance sheet and take a \$5 million loss on your income statement. The criticism was that mark-to-market was forcing financial institutions to take severe writedowns on assets whose market values had fallen precipitously, not because of their inherent value, but because nobody was buying these assets - think CDOs - and that banks were becoming insolvent because of an accounting technicality. Under this view, banks should be able to keep these assets at their “true” long-term values, instead of having to take writedowns due to short-term market fluctuations.

I am instinctively skeptical of this view, and in favor of mark-to-market accounting, because I believe that while market valuations may not be perfect, they are generally better than the alternative, which is allowing companies to estimate the values themselves, subject only to their auditors and regulators. But the issue is considerably more complicated than either the simple criticism or my simple defense would imply.

Earlier this week, the SEC released its [study of mark-to-market accounting](#) as required by the bailout bill. Their conclusions are simple:

fair value [mark-to-market, as will be explained] accounting did not appear to play a meaningful role in bank failures occurring during 2008. Rather, bank failures in the U.S. appeared to be the result of growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence.

This should not be surprising. At a high level, accounting conventions are artificial constructs designed to ensure some measure of uniformity in financial reporting. Whatever the rules are for calculating certain numbers, savvy investors know those rules, and can make adjustments as they feel appropriate. (A good example of this is accounting for stock options as expenses - even before this became a mandatory part of the income statement, it was in the footnotes, so analysts knew what was going on; as a result, when it did become mandatory, it had little or no impact on stock prices.) In this case, even if banks did not have account for certain assets at market values, the investors still knew exactly what was going on in the markets for those assets, and could draw their own conclusions.

At 259 pages, I doubt many of you will read it, so I will provide a bit of a summary and commentary. Still, many parts of it are both educational and interesting. The executive summary is only 10 pages long. If you aren't familiar with the basics of financial accounting, sections I.B-D make a good introduction.

What Is Mark-to-Market Accounting?

The first thing to understand is that the world is not neatly divided into “mark-to-market” accounting and some single other form. The broad concept is “fair value” accounting; assets subject to this treatment must be valued at the price they would receive in an arms-length market transaction. Fair value accounting may apply to assets that are not traded on visible, liquid markets (like exchange-traded stocks), so in itself it can involve estimates. And there are a number of alternatives to fair value accounting, of which the most familiar is probably historical cost accounting (assets are carried on the balance sheet at whatever you paid for them).

Companies have a fair amount of latitude in deciding how they account for different assets. In some cases, the accounting treatment depends not on the nature of the asset itself, but on what the institution plans to do with it. For example, the same security can be designated as part of a trading account, available for sale (AFS), or to be held to maturity (HTM). Trading assets are accounted for at fair value, and changes in their value affect the income statement (profits and losses) directly; AFS assets are accounted for at fair value, but changes in value do not show up on the income statement (only in a line of adjustments to equity, and these adjustments to equity do not affect regulatory capital requirements); and HTM assets are not accounted for at fair value. In addition, there are also assets that only become subject to fair value accounting if they are subject to other-than-temporary impairment (OTTI); the idea here is precisely to ignore short-term fluctuations, but only write them down if they lose long-term value.

In short, the system is already designed to protect financial institutions from having to take writedowns in their asset portfolios due to short-term market movements, which is what fair value accounting stands accused of.

What Impact Did Fair Value Accounting Have During the Crisis?

Not much.

The first thing to note is that a majority of financial institution assets (55%) are not accounted for at fair value, and only half of those that are at fair value are of the type that affect the income statement (and therefore regulatory capital).

The second thing to note is that changes in fair-value assets during the first three quarters of 2008 were relatively small as a percentage of overall equity. Across a broad sample of the financial industry:

Items reported at fair value on a recurring basis, . . . resulted in . . . [a] 3% and 4% increase (on a comparable nine-month basis) for the first quarter and the first three quarters of 2008, respectively. . . .

impairment charges . . . represented 3% and 8% of equity (on a comparable nine-month basis) for the first quarter of 2008 and the first three quarters of 2008, respectively.

OTTI on securities comprised the largest component of total impairment charges, at \$62 billion or 5.1% of equity.

In English: Changes in fair-value assets that affect the income statement actually increased equity by 4%; changes that do not affect the income statement reduced equity by 8% (remember, that's a percentage of equity, not assets); and most of that was other-than-temporary impairment, meaning that the institutions themselves thought these were permanent changes, not short-term fluctuations. Instead of fair-value assets, it was good old-fashioned loan losses that hurt the financial industry's income statement:

net income for banking, credit institutions, and GSEs was most significantly impacted by the increase in the charge for provision for loan losses, which is a historical cost concept, as the provision for loan losses is primarily based on "incurred" losses.

The SEC also specifically studied those banks that failed during the crisis:

For most of the failed banks studied, fair value accounting was applied in limited circumstances, and fair value losses recognized did not have a significant impact on the bank's capital. For the failed banks that did recognize sizable fair value losses, it does not appear that the reporting of these losses was the reason the bank failed. Market concerns about these companies, as evidenced by their share price, appear to indicate that the marketplace factored in losses for these banks that had not been recognized in U.S. GAAP reported income.

For small banks (<\$30 billion in assets), declines in capital were overwhelmingly (~90%) due to increased loan loss provisions for the loans they held on their books. The same was true of Washington Mutual. The only exception was IndyMac, for which increased loan loss provisions only accounted for about 50% of capital declines. Even for IndyMac, though writedowns on fair-value assets were not made at fire-sale prices:

While IndyMac stated that it believed that a portion of the fair value losses it recognized during 2008 would recover over time, IndyMac also stated that it used its judgment to arrive at a fair value estimate for these securities that it believed did not represent a fire-sale valuation.

For the three largest banks, the SEC compared bank stock prices to book values (which reflect writedowns), and found that “market concerns regarding these companies predated any significant fair value losses that these companies recognized.” In other words, investors were concerned because they knew that the banks had large mortgage portfolios, and they could see what was happening to the values of houses, mortgages, and mortgage-backed securities, and they drew their own conclusions independent of writedowns in quarterly statements. And the deathblow to Washington Mutual was caused not by a new accounting statement: “Instead of reduced capital, the proximate cause for the failure of WaMu appears to have been dramatic increase in deposit outflows sparked by concerns about the quality of the bank’s mortgage loan assets.”

The report draws a similar conclusion regarding non-banks, such as Bear Stearns:

Instead of accounting and reporting being the crisis’ primary driver, the observations indicate that the liquidity positions of some financial institutions, concerns about asset quality, lending practices, risk management practice, and a failure of other financial institutions to extend credit appear to be the primary drivers. . . .

liquidity pressures brought on by risk management practices, and concerns about asset quality precipitated by a rapid decline in confidence in these financial institutions, appears to be the primary cause of their financial distress and in some cases bankruptcy.

This goes back to the basic point that whether or not a financial institution is solvent - and I have heard it said by people who should know that Bear Stearns was solvent at the time of its collapse - it can still suffer a liquidity run.

Why Is Fair Value Accounting Good?

Ultimately, the point of fair value accounting is to provide accurate information to investors. The basic principle is that where possible, companies should account for their assets at their real values, not at some other value that they can make up. The SEC study cites one example of where not using fair value accounting caused a problem:

...in the Savings and Loan Crisis in the U.S., historic cost accounting masked the [extent of the] problem by allowing losses to show up gradually through negative net interest

income. It can be argued that a mark-to-market approach would have helped to reveal to regulators and investors that these institutions had problems.

(Citing Franklin Allen & Elena Carletti, Mark-to-Market Accounting and Liquidity Pricing, 45 Journal of Accounting and Economics, at 358-378.) In the S&L crisis, thrifts did not have to account for the fact that their loan portfolios had plummeted in value because the interest rates they were receiving were lower than the interest rates they were paying depositors (due to a surge in inflation).

There is no chance that one report from a largely discredited agency will settle this question once and for all. But hopefully it will at least teach people that the issue is a lot more complicated than you would think from reading newspaper opinion pages.

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Jan 3, 2009 1:38 AM

[The G20: Gordon Brown's Opportunity](#)

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

Prime Minister Gordon Brown has been trying to drum up support for some form of Bretton Woods Two, i.e., a big rethink regarding how the global economy is governed. So far, little support has materialized for [any kind of sweeping approach](#) to these issues.

Still, the chairmanship of the G20 affords him a great opportunity to make progress in other ways. (The [G20 website](#) still [needs updating](#), as does the group's [Wikipedia entry](#); the key point is that this is now a forum for heads of government, rather than for ministers of finance/central bank governors. The chair was due to rotate to the UK in any case; the fact that it falls to Mr Brown in person is an amazing stroke of luck for him.)

The [G20 focus in November](#), as you may recall, was largely on re-regulation and it remains to be seen how much of that agenda will be implemented by the next meeting on April 2nd. But that meeting was substantially under French auspices, despite taking place in Washington. Mr Sarkozy's staff were jubilant by the meeting's end: "we have put the bell on the American cat" was the most memorable quote. The next meeting will take place in Britain, with a new US President at the table, and looks likely to be a much more serious affair.

In particular, protectionism is without a doubt on the rise. The [G20 communique](#) had some boilerplate language against trade restrictions, but these are now sneaking to the

forefront, currently [disguised](#) as various forms of urgent bailout support (and with strong hints of capital controls in the air for emerging markets). So the G20 should really come to grips with this, for example with a much clearer statement of what is and is not allowed in the current context. You might hope also for a “name and shame” approach, but I think you would be disappointed.

While grappling with protectionism, Mr Brown can also engage with the thorny issue of China’s exchange rate. The continuing Chinese current account surplus and creeping depreciation of the renminbi will be the focal point of protectionist resentment on Capitol Hill and elsewhere in 2009. Dealing with this issue was delegated to the IMF, but the latest indications are that the Fund would prefer to move on. This creates a gap into which Mr Brown could sensibly step, with some well-timed bilateral and multilateral diplomacy.

In fact, I would not be surprised if Mr Brown moves towards tying anti-protectionism with measures that limit exchange rate misalignment (i.e., if you don’t let your currency become massively undervalued, we’ll keep protectionist pressures at bay). For a real coup, he could also propose more teeth for actions against exchange rate undervaluation, perhaps along the lines suggested by [Arvind Subramanian and Aaditya Mattoo](#).

Any progress in this direction would be a major achievement, and it could lay a genuinely cooperative foundation for a serious - and long overdue - discussion of what a Bretton Woods Two system could look like.

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Jan 2, 2009 5:37 PM

[Reliving the Fun Times](#)

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

With the holidays coming to an end, my little burst of reading books (as opposed to newspapers and blogs) is coming to an end with the recent collection [Panic](#), edited by Michael Lewis, which I got for Christmas. (I also got *Snowball*, the new biography of Warren Buffett, but that’s 900 pages long, so it may be a while.) The book contains several as-it-happened articles on each of four recent financial panics: the 1987 stock market crash, the 1997-98 emerging markets crisis, the collapse of the Internet bubble, and the thing we’re going through now. It’s long on entertainment - both the entertainment of hearing people say things like, “The more time that goes by, the less concerned I am about a housing bubble,” and the entertainment of reading legitimately

good writing, some of it by Lewis himself. But given the format, it's necessarily short on analysis, and its main point, if any, seems to be that all panics are alike: people underestimate risk, they think they are different, they do silly things, Wall Street people make a killing, and then bad things happen.

I believe the book was released in November, but it seems like the final touches were put on sometime in late spring or early summer - Bear Stearns had fallen, but Freddie and Fannie were still independent, and Lehman was just another investment bank. So the book provides this past summer's perspective on the crisis: a collapsing housing bubble taking down isolated hedge funds that had invested in mortgage-backed CDOs, and one investment bank (Bear Stearns) for no clearly explained reason: Lewis's own essay on the topic focuses on the inherent complexity of Wall Street firms and how even their CEOs don't understand them. Reading the articles from 2007 and early 2008 reminds you how few people if any foresaw the impact the collapsing bubble would have on the financial sector as a whole.

There were a few especially thought-provoking bits, however.

An April article by Matthew Lynn in [Bloomberg](#) cites a study by Veronika Krepely Pool and Nicolas Bollen, two finance professors, of monthly returns reported by hedge funds. Analyzing those returns, they estimated that 10% of the returns were distorted; for example, gains of 1% were reported much more often than losses of 1%, implying that at the very least hedge funds were fudging their 1% losses upward and making up for it (or not) by fudging their larger gains downward in later months - in order to minimize the number of losing months. I think today everyone will get the reference.

In a July 2007 essay on the Asian crisis, [Joseph Stiglitz](#) seems to foreshadow the emerging markets troubles of the past few months:

Before the crisis, some thought risk premiums for developing countries were irrationally low. These observers proved right: The crisis was marked by soaring risk premiums. Today, the global surfeit of liquidity has once again resulted in comparably low risk premiums and a resurgence of capital flows, despite a broad consensus that the world faces enormous risks (including the risks posed by a return of risk premiums to more normal levels.)

Stiglitz points out that because developing countries spent the past decade amassing war chests of foreign currency reserves, they were less vulnerable to the type of panic that struck in 1997: "the fact that so many countries hold large reserves means that the likelihood of the problem spreading into a global financial crisis is greatly reduced." Unfortunately, however, this time the problem spread in reverse - from the wealthy countries to the emerging markets - with similar consequences for the latter.

You'll probably experience the warm feeling of nostalgia reading this book (especially when coming across articles you read at the time they were written). For me, I actually experienced the most nostalgia reading about the Internet bubble, which I spent at Ariba.

(In September 2000, Ariba was worth about \$40 billion, on sales of about \$350 million and negligible profits. Explaining this to people, I used to say, “at our peak, we were worth more than General Motors.” That line doesn’t work anymore.) My favorite bit was hearing Jim Cramer (yes, [that Jim Cramer](#)) saying, in October 2000, that the Internet was over: “The idea that you can develop something for the Net today and have it be commercially viable is crazy. . . . It was fun for about three or four years. Oh, it was fun. It was cool. It was a really cool thing. Now it’s just something I wish weren’t in front of me.” Which reminded me of one of the best things about bubbles collapsing: all the people who just jumped on for the ride go away.

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Jan 1, 2009 9:22 PM

[Causes: Econbrowser Speaks](#)

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

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

As you might imagine, I read (or skim) a lot of economics blogs. One of my favorites is [Econbrowser](#), written by James Hamilton and Menzie Chinn. Whereas many blogs tell me good ideas that I didn’t think of but that theoretically I might have come up with (given infinite time and mental alertness), Econbrowser almost invariably teaches me something I absolutely couldn’t have known beforehand.

In the last week, both [Hamilton](#) and [Chinn](#) have written about the causes of the current economic crisis.

[Menzie Chinn](#)

For Chinn, the current situation was created by a “toxic mixture” of:

- Monetary policy
- Deregulation
- Criminal activity and regulatory disarmament
- Tax cuts and fiscal profligacy
- Tax policy

He thinks that lax monetary policy was not particularly significant (or, more specifically, the policy was not lax given the information available at the time). He says that some

examples of deregulation were more significant than others (repealing Glass-Steagall OK, the Commodity Futures Modernization Act not so much, which is the distinction I also made in an [earlier post](#)). Deregulation bleeds into the third point - the abandonment of regulatory agencies of their policing functions, along with examples where regulators committed actual fraud to aid the companies they were supposedly regulating (IndyMac being the prime example).

But the last two points are the ones you don't hear a lot about. The Bush tax cuts fueled the asset price bubble, especially the second one (in 2003), which came long after the recession had ended and when housing prices were on the steep part of their climb. Under tax policy, Chinn takes aim at the tax deductibility of second homes; combined with tax cuts that largely favored the rich, this increased demand for second homes, and therefore the prices of homes. Right now many people are calling for tax cuts as a way to stimulate the economy, and while you can debate whether tax cuts are more effective than increased spending, that is a reasonable debate to have. In retrospect, the error Chinn is pointing to is cutting taxes - providing a fiscal stimulus, in other words - when it wasn't needed, at the same time that interest rates were low. Since the Reagan administration, the argument for tax cuts has been to shrink the size of government, increase the incentive to work, and return money to people who know how to spend it better than the government. Only this time, we've reached a point where (almost) everyone agrees we need a fiscal stimulus, and the need is so pressing we're going to ignore the fiscal handcuffs created by the Bush tax cuts, which makes no one happy.

[James Hamilton](#)

In a November 2008 lecture, current IMF chief economist Olivier Blanchard discusses the boom in oil prices in a footnote:

How could the very large increase in oil prices from the early 2000s to mid-2008 have such a small apparent impact on economic activity? After all, similar increases are typically blamed for the very deep recessions of the 1970s and early 1980s.

Hamilton takes almost the opposite approach: maybe it was high oil prices that tipped the global economy into recession. While this may sound preposterous (everyone knows it was housing, right?), remember that the U.S. housing bubble has been front-page news since at least early 2007, yet the peak of financial panic didn't occur until September-October 2008. Was there really a lot of new information about the subprime mortgage market that appeared during that time? Christopher Dodd was already holding hearings on the subprime meltdown in March 2007 (thanks to Michael Lewis's book *Panic!* for reminding me of that.) Or was it something else?

Hamilton takes a 2007 model created by Lutz Kilian and Paul Edelstein of how changes in energy prices affect personal consumption. (Summary: an increase in energy prices that would require a 1% reduction in other purchases to buy the same amount of energy actually leads to a 2.2% decrease in consumption over 15 months.) He then applies the

model to actual energy prices since the middle of 2007 and (according to my eyeballing the chart) shows that about half of the falloff in consumption over the period is due to increased energy prices.

The (possible) implication is that if oil had remained at its early 2007 prices, the decline in housing prices that was already clearly visible would not have been enough to cripple the financial system and bring the global economy to its knees. In the process, of course, we ended up with oil in the \$30s, but the damage has clearly been done. Hamilton promises to continue this topic in a future post, and I'll be watching out for it.