Low-Tech Archive of The Baseline Scenario for February 2009

Known problems:

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

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Feb 27, 2009 12:58 PM

Bad Banks on This American Life This Weekend

from The Baseline Scenario by James Kwak

For public radio fans, Simon is on this weekend's episode of This American Life, "Bad Bank," with Adam Davidson and Alex Blumberg of Planet Money, explaining what happened to our banking system. Regular readers of this blog will already know most of what they cover, and some of it comes from episodes of Planet Money you may already have heard (including the "ransom note" conversation). But if your friends and relatives are not quite as up to speed as you are, feel free to recommend this episode. (It's the third TAL episode to focus entirely on the economic crisis; the others are listed on our Beginners page.)

TAL plays at different times on public radio affiliates this weekend. Starting Sunday night or Monday, the free online stream will be available from the TAL page. And if you subscribe to their podcast, you'll get the episode Sunday night or Monday.

In my opinion, TAL is the best show available in any medium anywhere, so I recommend listening to them even when they're not talking about the economy.

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Feb 28, 2009 3:40 PM

Citigroup Arithmetic Explained

from The Baseline Scenario by James Kwak

Since I've been writing about preferred and common stock so much this week, I thought I would just try to explain the arithmetic of the Citigroup deal announced today. (By the way, it isn't a done deal: all it says is that Citi is offering a preferred-for-common conversion to its outside investors, and the government will match them dollar-for-dollar, although the WSJ says that several investors have agreed to participate.)

Right now, according to Google Finance, Citi has 5.45 billion common shares outstanding. It is offering to convert up to $27.5 billion of preferred shares held by "private" investors other than the U.S. government (like the government of Singapore and Prince Alwaleed) into common shares, at a conversion price of $3.25. That would create another 8.46 billion shares. For every dollar that is converted, the U.S. government will also convert one dollar of its preferred stock, up to $25 billion; that is the $25 billion from the first round of recapitalization back in October, which is paying a 5% dividend. (Fortunately someone realized we should convert that before converting the second chunk, which pays 8%.) That would create another 7.69 billion shares. So if everyone converts as much as possible, there will be 21.60 billion shares outstanding, of which the U.S. government will own 7.69, for an ownership stake of 36%, the number you read in the papers. (Actually, if the private investors convert exactly $25 billion and not $27.5 billion, the government would own 37%, but that's a detail.) The other private investors would own 39%, and current shareholders would own 25%.

The government got some warrants on common shares in connection with the earlier recapitalizations. I assume the warrants it got for the first investment will no longer exist (because that first investment is being "paid back"), but the warrants on the second investment, if exercised, would presumably push the government up a couple percentage points.

Where did the $3.25 price come from? Who knows. Yesterday's closing price was $2.46. If that price had been used, the government's target ownership percentage would have been 38% instead of 36%, which seems immaterial. Presumably it was the product of a negotiation, since it's hard to see how the investors involved - especially the ones that are not the U.S. government - would have wanted to pay more than the current stock price for a company that is clearly in trouble. At least they didn't use $3.46, which is the price that any future Citigroup convertible preferred stock can be converted at.

And why did the stock plummet (now $1.57), despite the fact that the preferred shareholders are "paying" $3.25 per share? Probably because the common shareholders realize this is largely an accounting game, and the preferred stock wasn't worth its face value to begin with. The current shareholders' ownership stake could fall from 100% to 25%, but the stock is only down 36%. This implies that the market thinks that the total common shareholders' stake will more than double in value, but won't quadruple in value (the amount required to offset the dilution). Their stake increased in value because (a) Citigroup can avoid paying dividends on all the preferred stock that gets converted and (b) that much less money will have to get paid back to preferred shareholders in case of liquidation. But there's still a large cloud hanging over Citi, and it's on the asset side of the balance sheet.

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Feb 27, 2009 7:28 AM

The Smell Of Coffee

from The Baseline Scenario by Simon Johnson

The late Rudi Dornbsuch of MIT had a way of cutting to the chase, preferably in public and with a minister of finance present. He knew a huge amount about financial crisis, and could distill a lifetime of study and involvement in collapses succinctly: "it always takes longer than you think; but when it happens, it always happens faster than you can imagine."

The latest credit default swap data for European banks bring Rudi's perspective to mind - for the United States. We've debated this week what to do about U.S. banks, arguing about which unappealing options are less bad. In my view, the choice is not "nationalize vs. don't nationalize," but rather "keep our current partial nationalization/bottomless pit subsidy system vs. start down the road to reprivatization."

But, honestly, this entire debate may be overtaken by events.

Economic developments in East-Central Europe are very bad. Almost everyone will get IMF loans but, be that as it may, there is a big contraction underway. Nonperforming loans will increase for the West European banks lending to East-Central Europe or lending to firms that are (or were) exporting. Prominent European governments will struggle to afford the implied bailouts - remember, back in October these governments made it quite clear they are on the hook if their banks come under pressure. At the same time, of course, we have a nose dive in property in Ireland, Spain, and the UK.

My point is not that Europe is in big trouble, with no plausible regional rescue mechanisms in place. This is completely obvious - the debate among prominent Europeans is now whether or not to send distressed eurozone members to the IMF, and on what basis.

Focus on this instead: the European banking and fiscal fiasco is a dagger pointed at the heart of major US banks, which have a great deal of exposure - one way or another - to much of Europe. Ask any U.S.-based "global bank".

Treasury is constructing an elaborate transfer mechanism through which big banks can be kept in business, thanks to the public purse, without the taxpayer acquiring a majority of the common stock. The contortions required are striking. But this entire approach is predicated on a rosy stress scenario, which assumes the global economy cannot get much worse, at least in the short run.

It may soon be time to wake up.

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Feb 26, 2009 11:55 AM

No, Wait! You Got It Backwards!

from The Baseline Scenario by James Kwak

AKA, Convertible Preferred Stock for Beginners.

There is nothing inherently wrong with convertible preferred stock. In Silicon Valley, for example, venture capitalists almost always invest by buying convertible preferred. The idea is that in the case of a bad outcome, the VCs are protected, because their shares have priority over the common shares held by the founders and employees. Say the VCs put in $10 million for 1 million shares, and the founders and employees also have 1 million shares, so the company immediately after the investment is worth $20 million. If the company liquidates for $15 million, the preferred shares have a “preference,” which means they get their $10 million back (often with a mandatory cumuluative dividend as well) first, and the common shareholders take the loss. However, in a good outcome, the VCs can exchange their preferred shares one-for-one for common. So if the company gets sold for $100 million, the VCs convert, and they now own 50% of the common stock, so they get $50 million.

When I heard that the government was going to give future capital as convertible preferred stock, and perhaps change some of the previous capital injections to convertible preferred, I thought this was a good thing. It would give the taxpayer more upside potential, and it would also give the government the option to take over the banks simply by converting its preferred stock to common whenever it wanted.

But the key in the Silicon Valley example is that the VCs have the option to convert or not. The Treasury Department’s new Capital Assistance Program has this precisely backwards.

Under the new Capital Assistance Program (CAP), the government will invest in banks by buying preferred shares with a 9% dividend. This is like the old Capital Purchase

Program (used last fall for the first round of recapitalizations), but with one huge twist. Now the bank, **AT ITS OPTION**, can choose to convert the preferred shares into common, at 90% of the average closing share price during the 20 days ending on February 9 (the day before the new Financial Stability Plan was "announced").

An example would probably help here. Let's say that Bank of America (BAC) needs another $25 billion in capital. The government will give BAC $25 billion in cash, which BAC has to pay back in 7 years (that's the mandatory conversion date). In the meantime, BAC has to pay 9% interest, or $2.25 billion, per year. But, at any time, BAC can convert any amount of that to common shares, at $5.49 per share. (The average closing price over the 20 days was $6.10.) If it converted $5 billion into common, the government would get about 910 million (5 billion divided by 5.49) common shares, but now BAC only owes the government $20 billion and is paying 9% interest on only $20 billion.

In short, BAC has just sold the government 910 million shares for $5.49 each.

This is called a put option. At any time, BAC can sell ("put") shares to the government for $5.49, but it never has to. (The convertible shares the Silicon Valley VCs get are like call options; at any time, they can buy common shares by trading in preferred shares, but they never have to.) Having an option is always good.

What will BAC do with this option? If its stock price is above $5.49, it can either do nothing, or it can issue new common shares and sell them to private investors, say at $8. Then it can use that $8 to buy back preferred shares from the government, or just hold onto it. If its stock price falls below $5.49, things get interesting. Then BAC can buy up its shares on the market for, say, $3, and then immediately sell them to the government for $5.49. It won't get $5.49 in new cash, but it will reduce its debt to the government - because preferred shares that have to be bought back and pay interest are basically debt - by $5.49, which is almost as good.

(This would have the side effect of supporting BAC's stock price, because it means there is a buyer (BAC) who is theoretically always willing to pay $5.48 for the stock. Ricardo Caballero must be smiling)

In practice, it's not quite this simple, because the bank will require Treasury's permission to buy back common shares from other investors. But even if BAC doesn't buy back any shares, it still has the option - whenever its stock price is below $5.49 - of reducing its debt to the government by $5.49 simply by giving the government a share worth less than $5.49.

What's wrong with this? Well, nothing, if your goal is to give banks money. What you've just done is stick the government with the downside risk - we could get paid back in worthless stock - while the bank shareholders get all the upside potential. You've done this by giving the bank, for free, an option that has value. Back of the envelope, Peter thinks this option is worth about 65 cents per dollar of money invested. (It's worth so much because bank stocks are so volatile these days.) Put another way, for every $10 billion of capital we invest this way, we are giving away another $6.5 billion. I think it's probably a little less, because the option is not as flexible as the holder would like it to be, but you get the point.

As I've said many times before, if you think the banks need money, and you want to give it to them (instead of, say, nationalizing them), just give it to them already. Don't come up with these ridiculously fancy schemes to hide it. Yesterday Krugman gave Simon and me credit for writing this sentence:

This is another sign of the serious brainpower that has been expended on finding ways to avoid or minimise government ownership of banks, and to avoid the slightest possibility of offending shareholders – shareholders whose shares have positive value primarily because of the expectation of a further government bail-out.

But to tell you the truth, at the time we wrote that I didn't realize just how much brainpower went into this one.

There are some other worrying things in the term sheet I'll just touch on here:

- *Any* qualifying financial institution can get anywhere from 1 to 2% of the value of its assets under this program, simply by asking - even if it doesn't need it. I guess if you're going to be giving gifts (free put options) to the banks that need to be saved, you need to be fair and give the same gifts to banks that don't need to be saved. Banks will need regulatory permission to get more than 2% - a clear sign that getting money under this program is a good thing for banks.
- On top of that 2%, any qualifying financial institution can get additional money under this program in order to retire the preferred stock it sold last fall under the Capital Purchase Program. This means they can take back non-convertible preferred stock and give the government convertible preferred stock instead, with no cash changing hands.The dividend rate on the new stuff is higher (9% vs. 5%), so a bank wouldn't necessarily do this. But if its stock price is lower than its conversion price (the average price on the 20 days ending on February 9), then it should do the swap, and then immediately convert the preferred into common (so the dividend goes away). That way, instead of owing the government, say, $10 billion and paying interest on it, it can give the government $5 billion worth of common stock instead. (For those asking the obvious question: Citigroup's conversion price is $3.46. Yesterday it closed at $2.52. You might call this one the "Citigroup clause," not to be confused with Santa Claus.)
- The convertible preferred stock will have no voting rights. This is hardly surprising, given that the whole point of the exercise is to avoid government control. But it's by no means necessary. For example, VC firms always get voting rights for their convertible preferred shares.

There are some very clever people in Treasury these days.

Update: Oh, I forgot the most important point. This still does nothing for the asset side of the balance sheet, which is where the big monsters are hiding.

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Feb 26, 2009 12:31 AM

Listening To The Secretary

from The Baseline Scenario by Simon Johnson

Secretary Geithner spoke with NPR's Adam Davidson today and the result, on the Planet Money podcast, is a helpful guide to official thinking.

The Secretary's best line, at around the 18 minute mark is, "If you underestimate the problem; if you do too little, too late; if you don't move aggressively enough; if you are not open and honest in trying to assess the true cost of this; then you will face a deeper long (sic) lasting crisis."

The contrast he draws is with those who favor a more gradual approach to banking system problems that would "stretch it out." After about 17 minutes (and again around 20 minutes), Secretary Geithner contrasts what he is doing with "letting the market sort it out by itself".

He does not even hint at the possbility that there is a government-led strategy that could faster than what he has in mind. So could it be that he really has in mind something that will actually be bold and move fast?

I don't think so. He says we will "make capital available where it is necessary". But he also stresses, in response to Adam's last question (after around 25 minutes), "[Nationalization] is not the right strategy for the country." And Secretary Geithner says clearly "that broad strategy" would do more damage than his policies.

The bottom line is that the government will support the credit system a great deal and in many innovative ways, but Treasury will try really hard to avoid FDIC-type takeovers/reprivatizations of large banks. This is quite striking, and presumably the hope is that a big "no nationalization" rally in the price of banks' common equity will turn the tide more generally.

But the government's stress scenario is quite optimistic, the real economy continues to weaken, and global problems mount. How much government capital can you put into the banking system until the lack of taxpayer upside becomes quite awkward? And if that taxpayer upside takes the form of common stock, how do you prevent the state from effectively acquiring a controlling stake in large troubled banks? Numerous smart people are at work on this problem, but it is probably intractable.

The underlying question is in any case much simpler. How long can you say, "we are being bold" when in fact [you are not]?

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Feb 25, 2009 12:54 PM

But What About the Slump?

from The Baseline Scenario by James Kwak

Simon's reaction to Obama's speech last night is up at The New Republic.

I think Simon and I agree that the speech was strong on long-term issues, but did not shed much-needed light on how we can emerge from our short-term challenges. One way to position this is to say that if we really are facing a potential "lost decade," then talking about the long term is a bit premature. Imagine ten years of zero real GDP growth as opposed to 2.5% real GDP growth (with population continue to grow at 1-1.5% or something like that). That would take decades to make up (if it is even possible) and could outweigh any well-meaning efforts to bolster our long-term government finances.

On the other hand, I'm a bit more positive than Simon, because I wasn't expecting the details of the banking rescue plan in a major speech to the whole country, for both practical reasons (I don't think they are ready yet) and political ones (Obama wants to keep some measure of distance from whatever Geithner does). If I have time later today I'll say something about the long-term issues.

Update: Now it's later. The main thing I liked about the Obama speech is that it reflected what I believe to be the true long-term economic priorities of the country. The day after Obama was elected, I listed what I think are our top four long-term challenges (economic and non-economic): global warming, terrorism and nuclear proliferation, retirement savings (both the insufficiency of retirement savings, and the fact that retiree benefits threaten to break the federal government's balance sheet), and health care.

Obama's speech yesterday was mainly about four things: energy, health care, education, and fiscal sustainability. That maps pretty closely to what I think our priorities should be.

He was willing to say that these are urgent, serious problems. And when it comes to the government deficit and the national debt, he has chosen to forgo the gimmicks used in the past: not only keeping the Iraq War out of the budget, but also pretending that the AMT will not be fixed every year in the future.

Admitting you have a problem, and recognizing its magnitude, is a necessary, though not sufficient, step on the way to solving it.

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Feb 25, 2009 12:54 PM

Wait And See

from The Baseline Scenario by Simon Johnson

Here's the economic strategy update. Yesterday, Ben Bernanke apparently convinced the market that no major banks will need to be taken over due to lack of capital. If he knows this, I'm not sure exactly why we need the stress tests. But we now know the outcome of those tests.

At the same time, Chairman Bernanke has made (or reiterated) a clear call on the economic recovery. Look at p.A2 in your morning WSJ; in the third panel of the chart, the heading tells you all: "Real GDP contracts… Bounces, then moderates."

There is no sign of a potential lost decade here. The central range of the forecast for 2010 is entirely above 2 percent, leaning towards 3 percent (Q4 on Q4).

So the banks have - by assumption - sufficient capital. The stress test will be relative to this baseline; you can see that the "maximum stress" will be pretty mild and, very important, short-lived.

President Obama therefore can present and emphasize his (admirable) long-term goals, as he did last night.

I just have one question. How exactly do we get growth over 2 percent in 2010 (and after)? The global economy is getting worse, consumer and business confidence is weak everywhere (tell me if you know different). There is no sign of housing turning around, consumers are cutting back, and large organizations are all planning to trim costs for the next financial year. Our policy response so far: moderate fiscal stimulus, underfunded housing policy, and small potatoes for the banking system. Monetary policy sounded bold a month ago; now less so (again, if your central forecast is so rosy, why embark on risky or controversial further monetary expansion?)

The answer is: wait and see. If we get a recovery, then we are fine. If there is no recovery, we'll deal with it at that time and we can bolder at that time.

I remember hearing the exact same thing from the Paulson Treasury after the failure of Bear Stearns.

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Feb 24, 2009 5:52 PM

Noisy Silence

from The Baseline Scenario by Simon Johnson

Ben Bernanke spoke at length today on Capitol Hill. But did he say anything?

Over in The Guardian's on-line comment page, James and I suggest an answer. There was nothing new on the big macroeconomic issues of the age. And on banking, we remain disappointed…

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Feb 24, 2009 10:53 AM

Tangible Common Equity for Beginners

from The Baseline Scenario by James Kwak

For a complete list of Beginners articles, see Financial Crisis for Beginners.

You may have seen in the news that the government is thinking about exchanging its "preferred stock" in Citigroup for "common stock." Here's one of many articles. Which, if you are at all sensible and have any sense of proportion in your life, should be complete gobbledygook. The first part of this article will try to explain the gobbledygood; advanced readers can skim it. The second part will offer some of the usual commentary.

Banks, like all companies, have balance sheets. On one side they have assets - stuff they own. On the other side they have liabilities - money they owe other people - and equity. Equity can be thought of in two ways. First, it is the money that the initial owners put in to start the business; before you can borrow money from someone else, you usually have to have some money or other assets of your own that you put in. Added to that money are retained earnings - all the profits the company has made but has not paid out to the owners as dividends. Second, equity is what is left over after you pay off all your creditors. If you sold the assets and paid off the liabilities, the rest would go to the company's owners.

That equity "belongs" to the owners of the company; if it's a publicly-owned company, those are the shareholders. The market value of the equity is the total amount that people would pay today to own all of that balance sheet equity: it's the total number of shares times the share price. The market value of equity is generally different from the "book value" (balance sheet value) of equity, because if you own a company, you own not only today's equity, but also all the profits the company will make in the future. Under certain circumstances the market value of equity can be less than the book value of equity - that's the case if investors think that the company's management is destroying value, or that the book value of equity on the balance sheet inflates its true worth.

The complication is that there are different kinds of equity. The way to think about this is to think about the various ways that companies can raise cash from investors. At one extreme there is secured debt: the company goes to a bank, takes out a loan, and pledges some of its assets as collateral. If it doesn't repay the loan, the bank gets the collateral. Then there is unsecured debt: the company issues a bond, which is just a promise to pay in the future, and the investor pays money for this bond, hoping to be repaid with interest. At the other extreme there are common shares. These give you no rights in particular, except the right to control the company, through the board of directors. Conceptually, the common shareholders own the equity, and benefit from the future profits, but the company has no obligation to give them any of the equity, or to pay out any of the profits as dividends. Then in between debt and common shares there are these things called preferred shares, which come in many flavors. Preferred shares are like debt: they may pay a required dividend, which is like interest on a debt; there may be rules on when they have to be bought back by the company, such as in case of a major transaction. They are also like equity: in case of bankruptcy, preferred shareholders only get paid back only after all the debt holders have been paid back; in some cases, preferred shares can be converted for common shares at a predetermined price, which allows preferred shareholders to benefit if the common stock goes up in value.

In summary, there is a spectrum of instruments through which companies raise money, and these instruments have differing priority in making claims on the company. They also differ in how likely the investor is to be paid back. Secured debt comes first, common shares come last, and everything else comes in between.

Trust me, we're getting closer to the question I started with.

Ordinarily, you don't need to debate whether preferred shares should count as debt or equity. However, for banks in particular, there is a concept called capital adequacy. A capital adequacy ratio is the ratio between some measure of capital to total assets. Imagine for a moment that there was only one kind of debt - say, deposits - and one kind of capital - ordinary shares. Say my bank has $100 in assets. As we all know, assets can go up or down in value. If I have $90 in debt, then I have $10 in capital, and my ratio is 10%. This means that my assets could fall in value by up to 10% and I would still be able to pay back my depositors. If, instead, I have $99 in debt, then my ratio is only 1%. If my assets fall by more than 1% in value, I won't be able to pay back my depositors, I'll be insolvent, and the FDIC will take me over so it can pay off the deposit guarantees at minimum risk to itself. This is why the capital adequacy ratio matters, especially to bank regulators. What minimum capital ratios should be is a complex topic, most of which I will avoid, but you can see why they matter.

The part I can't avoid is how the capital - the numerator of the ratio - is calculated. As I said above, there are many different types of capital. Besides common shares and preferred shares, believe it or not, you can count deferred tax assets (credits you gain by losing money in one year, which you can apply against taxes in future years where you make money) as capital. One commonly used measure of capital is called Tier 1 Capital, which includes common shares, preferred shares, and deferred tax assets. A less commonly used measure is Tangible Common Equity (TCE), which includes only common shares. Obviously, TCE will yield a lower percentage than Tier 1.

Which of these measures is better? That's sort of an arbitrary question. The fact that you change the numbers you type into your spreadsheet doesn't change the actual health of the bank any. They just measure different things. Each one measures the ability of the bank to withstand losses before its ability to pay off its liabilities starts getting compromised. One difference between the two is whether you count preferred shares as liabilities, which depends on how bad you think it is that preferred shareholders don't get their money back. Another difference depends on what you think the deferred tax credits are worth in a worst-case scenario. In any case, the skeptics, like Friedman Billings Ramsey, have been insisting since the beginning of the crisis that TCE is the proper measure of bank solvency. And most immediately, Tim Geithner has said that the new bank stress tests will focus on TCE. So if your bank doesn't have enough TCE, it will fail the stress test, and then . . . who knows what the administration has the stomach to do.

Getting back to the current situation . . . The initial government investments in Citigroup, back in October and November, were in the form of preferred shares. Between the two bailouts, the government put in $45 billion in cash and got $52 billion in preferred stock (the $7 billion difference was the fee for the guarantee on $300 billion of Citi assets). That preferred stock was designed to be much closer to debt than to equity: it pays a dividend (5% or 8%), it cannot be converted into common stock (so it cannot dilute the existing shareholders), it has no voting rights, and it carries a penalty if it isn't bought back within five years. In fact, it is hard to distinguish from debt, except perhaps for the fact that, if Citi defaults on it (cannot buy the shares back) we don't need to worry about systemic instability, because the government can absorb the loss. As preferred stock, these bailouts boosted Citi's Tier 1 capital, but not its TCE.

Because of the newly perceived need for TCE, the bailout plan under discussion is to convert some of the preferred stock into common stock. Citi wouldn't actually get any new cash from the government, but it would be relieved some of the dividend payments (currently close to $3 billion per year), and of the obligation to buy back the shares in five years. (For the impact on Citi's capital ratios, see FT Alphaville.) This is a real benefit to the bank's bottom line, and hence to the common shareholders. At the same time, though, Citi would issue new common shares to the government, diluting the existing common shareholders (meaning that they now own a smaller percentage of the bank than before). In theory, the amount by which the shareholders in aggregate are better off should balance the amount of dilution to the existing shareholders.

The trick is deciding what price to convert the shares at. All of Citi's common shares today are worth around $12 billion, so if you converted $52 billion of preferred shares into common, the government would suddenly own over 80% of Citi. (In the conversion, you divide the value of the preferred stock you are converting by the price of the common stock, and that yields the number of common shares the government now owns.) The Geithner team is still continuing the Paulson policy of avoiding anything that looks like nationalization, so the talk is that the government ownership will be capped at 40%; that means the government could only convert about $8 billion of its preferred stock. There will probably be some clever manipulation of the numbers to say that the preferred stock is actually worth less than $52 billion, or that it should be converted at a higher price than the current market price of the stock. (This seems like a blatant subsidy to me, since new investors buying large blocks of stock in a public company typically pay *less* than the current market price.) There is also talk of trying to get some of Citi's other preferred stock holders to convert as well, because the more they convert, the more common shares, and hence the more the government can have without going over the 40% limit.

I still don't understand why people care so much about whether the government owns more or less than 50% of the common shares. This just seems like a fig leaf. The more important issue which people can argue about is whether government is controlling Citigroup's day-to-day operations. (Some say that's good, some say it's bad.) According to The New York Times, this is already happening. Alternatively, if you want to minimize government control, the government could tie its own hands; for example, no matter what its percentage ownership, the government's stock purchase agreement could say that it has the right to appoint a minority of the board of directors but no more than that.

I think the situation we want to avoid is what is going on at AIG, where the government owns 80% of the company but still seems to be negotiating at arm's length with the company. This is the worst of all worlds, because even though it already bears the vast majority of the losses, and has the power to clean up AIG (by writing down all its assets to their worst-case scenario values and then recapitalizing the firm sufficiently), the government is treating AIG like an independent entity. For example, if the government did a radical cleanup, it's hard to see how AIG would still be in danager of ratings downgrades - which are the immediate problem it faces. But that story may have to wait for another post.

Update: Changed "private company" to "publicly-owned company" in the 1st line of the 3rd paragraph. Someday I'll learn to proof-read before posting. Thanks to Manu for catching that.

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Feb 24, 2009 7:01 AM

Was It The Hedge Funds? (Diane Rehm Show at 11am)

from The Baseline Scenario by Simon Johnson

Hedge funds have been nominated as a prime culprit in the current financial disaster. European governments, in particular, seem keen to impose greater regulation on hedge funds, including more transparency and compliance requirements. In fact, this is will be one of the main deliverables they seek at the G20 summit on April 2nd.

I'm not opposed to stronger regulation, and hedge funds have obviously disappointed investors - especially with their illiquidity under pressure. But are hedge funds really responsible for the depth of the crisis? They were present at the scene of the crime, in terms of buying and trading what we now call "toxic assets," but surely their role was minor relative to supposedly "regulated" US and European banks.

Of course, many hedge funds have closed down in the past six months, but have any actually failed to repay loans to banks? I'm searching for examples.

And in terms of political power, during the fall or today, how many hedge funds add up to the influence of Goldman Sachs?

If the debate on Diane Rehm's show at 11am this morning (current link) is about hedge funds (and private equity) vs. regulated banks as causes of the crisis, I'm taking the banks.

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Feb 23, 2009 10:49 PM

Privatize The Banks Already

from The Baseline Scenario by Simon Johnson

The debate on bank nationalization in the United States is off to an inauspicious start. Most of the arguing so far is framed in terms of: yes/no, or what kind of in-between strategy can be tried and for how long. This misses the point.

In some important and not good ways, we have already nationalized the financial system.

There's the direct ownership that the government received through TARP and the reupping with Citi, BoA and some others. These stakes are obviously not (yet) voting stock, but the taxpayer certainly has capital at considerable risk.

Then we have the lines of credit provided by the Federal Reserve which, without a doubt, were instrumental to the survival of almost all major banks during the fall - and arguably remain critical today. The taxpayer has further downside risk here.

And, most importantly perhaps, we have the expansion of the Fed's balance sheet as it seeks to step in to replace the weakening banks and the drying up of credit markets. In effect, the Fed is becoming a commercial bank as well as a central bank.

The government is essentially taking over the role of intermediation - take funds in and lend them out - for the US economy. This is a form of nationalization, and it will lead to all the lobbying and politically directed credits we have seen in other nationalized financial systems; taking away this credit once the economy starts to recover will not be easy. We have state control of finance without, well, much control over banks or anything else - we can limit executive compensation (maybe) but we don't get to appoint directors (or replace entire boards) and we have no say in who really runs anything. Responsibility without power sounds accurate.

Why have we de facto nationalized? Because the private credit system - particularly large banks - is weakened and not getting any better. Attempts to deal with the problem banks are apparently blocked by the political power of influential bankers.

How then do we really privatize? By exercising leadership: take over insolvent banks and immediately reprivatize them. The new controlling owners can replace the boards of directors (tell me: why haven't they resigned already?), and these boards can decide who to keep and who to let go from existing management. The taxpayer retains a significant number of shares (or the option to buy common stock) as a way to ensure upside participation - the economy will one day recover, and that will be a very good day for owners of the remaining banks.

Above all, we need to encourage or, most likely, force the large insolvent banks to break up. Their political power needs to be broken, and the only way to do that is to pull apart their economic empires. It doesn't have to be done immediately, but it needs to be a clearly stated goal and metric for the entire reprivatization process.

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Feb 23, 2009 2:53 PM

Defending A Peg: Lessons for the US Banking Authorities

from The Baseline Scenario by Simon Johnson

You've seen it a thousand times. A country's exchange rate used to make sense, but now it is hopelessly overvalued. And, consequently, your pegged exchange rate now looks like a one way bet. Every Financial Times subscriber starts to think about how to either get out of your currency or, if they are feeling aggressive, how to more actively speculate that the exchange rate will soon depreciate.

And the beauty of this situation - from a speculator's point of view - is that the relevant authorities will never move quickly or decisively to the inevitable end point. Sooner or later, the currency will be devalued and, if the country's citizens are lucky, sensible economic policies (and perhaps external financial support) will be put in place to support the new exchange rate. But, for a surprisingly long time, the government will make statements along the lines of, "we will defend our exchange rate," "we have plenty of reserves," "we will never devalue," or - my favorite - "the fundamentals are fine."

This analogy sprang to mind when I read this morning's joint statement by Treasury, the FDIC, OCC, OTS, and the Fed.

The U.S. government stands firmly behind the banking system during this period of financial strain to ensure it will be able to perform its key function of providing credit to households and businesses. The government will ensure that banks have the capital and liquidity they need to provide the credit necessary to restore economic growth…

Any government capital will be in the form of mandatory convertible preferred shares, which would be converted into common equity shares only as needed over time to keep banks in a well-capitalized position and can be retired under improved financial conditions before the conversion becomes mandatory. Previous capital injections under the Troubled Asset Relief Program will also be eligible to be exchanged for the mandatory convertible preferred shares…

Because our economy functions better when financial institutions are well managed in the private sector, the strong presumption of the Capital Assistance Program is that banks should remain in private hands.

This would be a fine statement in many contexts. But there is now an obvious endpoint, which is very much on everyone's mind - there is no point in pretending otherwise. Either banks will be taken over by the government - and then reprivatized (and I insist on immediate reprivatization) - or they will not. And "not" is fine with me, but this option is only persuasive if you can really explain how it is going to happen and provide a decent deal for taxpayers (given that this will effectively insure bankers' bonuses).

I'm not saying there are any easy or attractive alternatives. In particular, the lack of prior stress tests mean the government does not yet have full information on banks' balance sheets (aside: what exactly have bank regulators been doing for the past two years?)

But this morning's statement feels like another partial, vague, and underfunded commitment. This does nothing to reduce uncertainty. And, just like fears about fixed exchange rates in other contexts, this will undermine confidence in the economy more generally. Whether it will speed or slow our movement towards the endpoint remains to be seen.

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Feb 22, 2009 4:22 PM

The Choice: Save Europe Now Or Later?

from The Baseline Scenario by Simon Johnson

In major every crisis you have a choice. You cannot choose between inaction and action, because ultimately you will be forced to act. You do not really choose between bailout and no bailout, because very soon you find that all the reasonable options involve some sort of bailout for some people (and not for others). And, try as you might, there is no way to choose to let your neighbors fail completely - because that failure has such awful consequences for their citizens and, in all likelihood, for your banks, that you finally come across with the money.

But you do have a choice on when to come to help your neighbors and your friends, and you can definitely choose the form of this assistance. if you come in earlier and in a more systematic fashion, the cost for everyone is lower and the chances of a fast recovery are stronger.

The sensible decision might seems obvious from a distance or in retrospect, but it's this exact choice that the richer and more stable countries in Western Europe are now struggling with.

Back in October, we argued for a eurozone stabilization fund, as a means of mutual support and - most importantly - as a way to provide liquidity and buy time for euro sovereigns who need to make fiscal adjustments. Circumstances have changed, of course, but I would like to reiterate the following proposal,

Create a European Stability Fund with at least €2tn of credit lines guaranteed by all Eurozone member nations and potentially other European countries with large financial systems such as Switzerland, Sweden and the UK. This fund should provide alternative financing to member countries in case market rates on their government debt become too high. This will prevent a self-fulfilling cycle of rising interest rates. The fund should be large enough to have credibility; countries could access the fund automatically, but should then adopt a 5-year program for ensuring financial stability, subject to peer review within the Eurozone.

I should also clarify that we are not suggesting that countries leave the eurozone (this would be bad for everyone) or that this is likely (the adverse consequences are sufficiently obvious on all sides). In fact, my presentation in early January - which has circulated to some effect - very much emphasizes that eurozone fiscal austerity is our baseline expectation.

The German Minister of Finance this week suggested that financial support within Western Europe is on the cards for the first - presumably, his mind is being concentrated by potential developments for Austrian banks. At the same time, there are strong voices opposed to any kind of bailout, e.g., represented by Charles Wyplosz writing yesterday on VoxEU.org. Europe should really have had the full moral hazard theology debate back in the fall; better than late than never, but it's awfully late.

Remember this. Eventually, you will go to help your neighbors (again, see Iceland for details). And the longer you delay, the more it will cost, in both monetary and human terms. And, for those of you still hung up on moral hazard, I can assure you that support provided today will not prevent middle class and poorer people from being hammered hard by the crisis - and I would suggest that they will sort out their rulers at a time and place of their choosing.

Provide generous support, come in early, and insist on a sensible macroeconomic framework - some fiscal adjustment is almost always needed. Do not require eurozone countries to go to the IMF.

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Feb 21, 2009 10:07 PM

Bank Nationalization: A Viewer's Guide

from The Baseline Scenario by Simon Johnson

At the end of last week, Senators Dodd and Schumer signalled that financial elite solidarity has broken; "nationalization" is no longer taboo. The consensus is dead (check with Barney Frank), crazy ideas abound, and long live what new policy approach? Here's five sets of issues to guide your viewing this week as we slip and slide sideways into our future.

1. The White House and Treasury have fallen behind events. When and how do they try to regain control of the situation? Is there a relatively early and decisive move up their sleeves? This seems difficult, as they have committed to doing stress tests first and foremost, and presumably any meaningful tests take at least a week (probably they were intended, when announced, to buy more than a month). But these are resourceful and imaginative people, with lots of connections and some big friends to save, and they fully understand the importance of retaking the initiative. Watch for a major announcement Sunday - always good to act before the Tokyo market opens - or early in the week.

2. The strategy alluded by the Senators is: the devil take the hindmost. This implies two big banks are in the line of fire; both, of course, are strenuously denyingthat anything of the kind is true (we could call this the Irish Ministry of Finance line; it also worked for Northern Rock and Iceland, at least for a while). But the banking system problems are likely to be much deeper, and any attempt to deal with just two banks is likely to founder fairly quickly. Probably our financial leadership will for now dig in around "two and only two," but when the consensus is so fragmented, anything can happen. Follow the public statements of Lloyd Blankfein closely; use the hubris in his February 8th, 2009, Financial Times op edas a benchmark (remember: this was timed to appear upstage on the morning Secretary Geithner was supposed to present his financial system plan).

3. How does the designated government leadership communicate that credit probably needs to contract for all banks, including anything taken over by the government, given the declining willingness to borrow by creditworthy individuals and firms? Some of the language used in and around the House Financial Services Committee hearing with bankers demonstrated a worrying misperception - just because banks are taken over does not mean they should, could, or would increase lending. If we get a substantial increase in government directed credit, our problems will get much worse before, if ever, they get

better. This is definitely a media blitz assignment for senior political nominees at Treasury. Will we learn more of their names this week?

4. There is no panacea, and that includes taking over banks. We face a pervasive global confidence problem for consumers, firms and - in some countries - governments.   The government takeover of failed banks with systemic importance is the worst of all possible strategies, apart from all the alternatives. Decisive action on the banking system is necessary but not sufficient for the economic recovery. Will this message be communicated clearly by the architects of the bank strategy, to keep expectations at reasonable levels? Could someone, please, have a word with the official forecasters (yes, I'm looking at the Federal Reserve). It is hard to focus the world (and Congress) on forestalling Financial Armageddon when your crack modellers publicly predict something close to a V-shaped recovery near the end of the forecast horizon.

5. Will there be a clear, upfront commitment to reprivatization, with a promise that large banks will be broken up in the process? Changing the industrial structure of banking is essential for altering the political economy of the sector. Community bankers - influential in the Senate - need to be brought onside with aggressive FDIC-type interventions, and this is more likely to happen if they sense that that the era of megabanks is drawing to a close (the dinosaurs are finished; someone notify the mammals). Watch also for supportive body language among private equity investors. If the banking lobby breaks into small pieces, politics could become a lot more interesting.

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Feb 21, 2009 1:31 PM

Springtime for Banks

from The Baseline Scenario by James Kwak

Less than a week after pulling off the media coup of publishing his universal credit insurance proposal in both the FT and the WSJ on the same day, Ricardo Caballero has a new proposal for solving the banking crisis, this one in tomorrow's Washington Post.

He should go back to the last one.

Here's the new proposal: "The government pledges to buy up to twice the number of bank shares currently available, at twice some recent average price, in five years." According to Caballero, this will have the following effects:

1. Because bank stocks immediately become more valuable, it has a wealth effect that pushes up the value of all assets.
2. Banks will be able to raise private capital, because they can issue additional shares equal to all of their outstanding shares, and these shares will have a price floor.
3. Because this will have a stimulative effect and will solve the bank capital problem, the economy and the banking sector will go back to normal, and five years from now the government won't actually have to buy any shares, because they will be trading above the government-guaranteed price floor.

Let's start with the most important issue: fixing the banking sector. Caballero's credit insurance plan would solve this goal, because it involves cheap government insurance for all bank assets. This proposal, by contrast, is a private sector recapitalization plan. Essentially, each bank would be able to raise new capital (by selling shares) equal in value to twice its current market capitalization, because those shares are guaranteed. For Citigroup, that would be about $20 billion. Does anyone think that would be enough to lift the clouds hanging over Citi? JPMorgan, by contrast, could raise about $150 billion. But there's nothing saying that they have to, and bank managers who think that twice their current share price is still undervalued will have no new incentive to raise capital.

This is especially true because of the perverse incentives this plan creates, which make it especially hard to understand. This plan creates a government guarantee on the stock price. In other words, it says, "No matter how stupid you are, what ridiculous risks you take, and how bad your bank is, we will buy your stock at an artificially inflated level." Is this really the way to create a healthy banking system? I understand why people are afraid of government control over banks, but this seems at least as bad to me, since it creates an obvious incentive to take excessive risks. In addition, this takes away the usual incentive for raising capital: the need to maintain capital adequacy levels. Now that the government has guaranteed that shareholders will not lose their capital, no matter what, why raise more and split the upside with new investors?

What about the stimulative effect on the economy? Basically bank stocks would double in value overnight. Now, the S&P 500 Financial Sector Index is down about 80% from the summer of 2007; banking stocks are probably down a little more, say 85%, and insurance stocks down a little less. So the day after this plan is announced, your bank stocks - by now a small part of most portfolios - are down only 70% instead of 85%. While this might have some wealth effect, I think it would be relatively small; among other reasons, stock holdings and retirement accounts have a relatively small impact on consumption, compared to wages, dividend and interest income, or even home values (because they can be used for home equity lines). And I don't see how it could turn around the economy.

Besides, if the idea is to stimulate the economy by making people feel wealthier, the simplest and fairest way to do this is through a tax cut. But the problem with tax cuts right now is that most of the tax cuts will simply be saved. This should be even more true of the Caballero plan, which just makes your banking stocks double in value. And if we are looking for creative ways to make people feel wealthier, what about a government guarantee to buy your house, in five years, for whatever you paid for it? (That was a rhetorical question.)

But, Caballero says, the great thing about his plan is that it is free. Because the plan will turn around the economy and return the banks to normal, the government will never actually have to buy the shares. This is [wishful thinking] in its most pure form. Yes, it is possible that if we fix the banking system, the economy will turn around, and most of these troubled assets will return to something like their current book values. But in that case, every proposal anyone has offered will turn out to be free. Caballero's credit insurance plan will cost nothing, because the government will never have to cover any losses. Paulson's plan to buy toxic assets will cost nothing, because those assets can then be sold for more than the government paid. The nationalize-reprivatize plan will cost nothing, again because the the government can sell the bad assets at a profit. Buiter's and Romer's "good bank" plan will cost nothing, because the good banks will be worth more than the capital it takes to set them up. A government recapitalization plan - say, for example, the government buys, at twice the current price, a number of shares equal to the current shares outstanding, will cost nothing, because the government's new shares will be worth more than it paid for them. (This is similar to Caballero's plan, except we know that the banks will actually raise capital, and the taxpayer gets the upside as well as the downside.)

But as Martin Wolf put it in a post I've recommended before and recommend again, "the heart of the matter . . . is whether, in the presence of such uncertainty, it can be right to base policy on hoping for the best." That question answers itself.

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Feb 21, 2009 8:19 AM

From Here To A Lost Decade

from The Baseline Scenario by Simon Johnson

Why don't all recessions seem to teeter on the brink of turning into a "lost decade" as President Obama described, accurately, our current predicament?

In a standard recession, some people (or firms or governments) cut back on their spending. But others either maintain their spending or actually buy more. A recession is typically a good time to invest in relationships and buy longer-lasting assets; for example, it's a good time for private universities (with endowments) to hire faculty, build labs, and acquire the land for new buildings. Anyone with a long time horizon, deep pockets, and access to cash ordinarily thinks in these terms.

But instead of this kind of countercyclical private sector investment behavior, Drew Faust, the President of Harvard this week sent a downbeat message to her stakeholders,

[W]hat has become clear is that we are living through much more than a bump in the road. Our economic landscape has fundamentally changed.

President Faust goes on to say that the endowment has lost value and cuts need to be made. I'm not questioning the judgment of President Faust or the idea that some parts of the university sector overexpanded during the boom - in fact, similiar messages are being communicated, one way or another, at many other schools.

On the contrary, there are few organizations that cannot take at least 3-5% out of their nonpersonnel costs after a long boom - we all get sloppy about our spending when times are good for a long while. This, of course, is part of why we face a recession.

What worries me much more is when organizations with long horizons and a strong balance sheet (e.g., anyone with an endowment, venture capital, private equity, people who own property without an onerous mortgage, etc) decide that the only prudent thing to do is cut spending dramatically. And universities are likely relatively sheltered, e.g., people still go to college even in a prolonged downturn, and applications to some professional schools typically go up. I mention them here only as example that shows the depth of our problem.

The rest of the world economy looks bad and likely to get worse. If you know of any bright spots (i.e., anyone, other than the US government, buying more than last year), post the details here or otherwise spread the word. I talk to a lot of people with information and ideas from many places; good news is scarce and official forecasts (which still contain an imminent recovery) seem greatly exaggerated.

If the global situation is really as gloomy as this suggests, surely the G20 leadership will finally get serious with recovery measures in time for the London Summit on April 2nd? If the global economy loses a decade, they are responsible. Tell them this, early and often.

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Feb 20, 2009 6:50 AM

Dublin (and Vienna) Calling

from The Baseline Scenario by Simon Johnson

If you think credit default swap (CDS) spreads are informative with regard to developing pressure points and issues that policymakers should focus on (or will likely spend hectic weekends dealing with), you should look at the latest CDS spreads for European banks. The Irish story we have already flagged. I'm also concerned that developments in East-Central Europe are starting to affect the prospects for West European banks, most notably in Austria.

My point is not that collapse is imminent. Rather, I would suggest that now is the time for preemptive policy action - presumably at the European Union level - to head off these problems. As we have been arguing since last October, there needs to be an integrated European-wide approach to these problems, including agreement on who receives what kind of financial support and under what circumstances. The roles of the European Central Bank and the IMF (if any) in this context are in particular need of further explicit elaboration.

It is simply astonishing that, after all we have seen, senior European policymakers remain in substantial denial about the depth of global problems, the way in which these have direct impact on Europe, and value of thinking ahead.

Even if you are convinced that the CDS market represents pure speculative pressure, i.e., unrelated to "fundamentals", spreads at this level are still a call for action. In fact, in that case there is no excuse for not putting in place transparent and well-communicated fiscal policies with massive external financial support. That should scare any speculators away.

Of course, if you believe that the CDS market is completely uninformative, there is nothing to worry about. And there was, in retrospect, nothing to worry about when the same market pointed to growing dangers for UK mortgage lenders in fall 2007, US banks in 2007-2008, Iceland in fall 2008, and emerging markets right before the IMF started handing out big loans.

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Feb 19, 2009 5:54 PM

Everyone Get in Line

from The Baseline Scenario by James Kwak

For months now, Ricardo Caballero has been proposing yet another solution to the toxic-asset problem: universal, government-provided insurance for the assets. He recently let loose a double-barrelled volley in both the FT's Economists' Forum and the WSJ's Real-Time Economics blogs. I believe he is correct that this would solve the problem: if the government is insuring any bank assets that the banks want them to insure, then the banks are protected from any further write-downs, and they are healthy by construction. However, there are other ways of getting to the same outcome. One would be for the government to pay face value (or current book value) for any assets that the banks would want to sell. Another would be to take over every single bank that fails Mr Geithner's stress test, pull out all of their bad assets, and reprivatize them. All of these solutions will result in banks that are not encumbered by the fear of further writedowns on toxic assets.

In judging between these options, we need to look at the details. For Caballero's asset insurance proposal, this means looking at the price of the insurance. Remember, banks could buy this insurance right now on the free market if they wanted to. The problem is that the insurance is too expensive. Caballero's proposal is only a solution if the government offers insurance at a lower price than the market (a subsidy, in other words). And this is precisely what he is suggesting:

The price of the insurance should be set at pre-crisis levels for the corresponding asset class. If there is a sense that these assets were over-rated to begin with, then we should adjust the prices accordingly (for example, use AA pre-crisis insurance prices for overly-rated AAA assets).

This arrangement should be coupled with tight monitoring of the insured institutions and with retroactive fines a few years down the road to those institutions (and their management) whose assets underperform relative to their asset class.

Essentially, this relies on the assumption that the assets will turn out better than we currently think. ("[T]here is no need to resolve the thorny issue of the insurance price and the quality of the assets right now. We can wait for the passage of time and a return to normality to determine whether their assets were worse than the representative asset in the corresponding asset class.") If they do, then everything will turn out OK. If they don't, then we will charge the banks fines to reflect the difference. It seems to me that those fines represent an uncertain liability that will still be hanging over the banks; or, alternatively, the fines will be so small that they won't affect the banks materially.

In the end, this looks the same to me as the plans in which the government simply buys the bad assets. In Caballero's plan, the government doesn't lay out cash, but provides underpriced insurance that creates large potential liabilities. In the asset-buying plans (including Geithner's public-private partnership), the government does lay out cash, but gets assets that have some value, and could have more value in the future. In either case, the ultimate size of the bill depends on whether or not the assets recover in price; once the risk has been transferred to the government, the rest is just details.

Now, that doesn't make this option necessarily any worse than the others. I believe the goal is to have healthy banks, and the taxpayer will pay one way or another. So the asset insurance proposal deserves consideration.

But what I really don't understand is Caballero's framing of the discussion. In the FT:

In all likelihood, political constraints severely limited the ambition and effectiveness of the US financial stability package. Economists need to unite behind relaxing these constraints. Talking lightly about nationalisation, as is increasingly taking place, does exactly the opposite.

There are two types of arguments for nationalisation. One argument is a gut reaction that enough-is-enough and we must stop transferring resources to Wall Street's "crooks and oligarchs." This reaction only adds fuel to the fire and exacerbates self-destructive mob-mentality behaviour.

We need to stop this.

And on Real-Time Economics:

It is true that the recent announcements are lacking specific details, and perhaps revealed that the Treasury's economic team overestimated people's ability to distill the good news in an abstract message of principles when in panic mode. But there is good news in them, as they reflect a much deeper understanding of the fundamental uncertainty problem ravaging insurance and credit markets than commentators and politicians have. It is time for all of us to focus on facilitating their difficult task and to try to fill some of the gaps.

It seems to me that Caballero is saying that the proponents of nationalization - recently joined by Alan Greenspan - are irresponsible, and that the correct path is to support Tim Geithner and his plan - which, according to Caballero, is basically the same as his plan. ("US Treasury Secretary Tim Geithner's proposal . . . is probably as much as he could get in a heavily-politicised environment. Coupled with the bad bank arrangement and guarantees for private asset buyers, it resembles the insurance solution described above.") This claim is confusing to me, since Geithner's plan is for private capital, backed by government loans, to buy up toxic assets. But there's no need to debate that here.

The important point is that Caballero's proposal is one that would probably be welcomed by most banks, since it allows them to continue in their current form while transferring their risks to the government. This enables Caballero to write off political considerations as unwelcome intrusions into the sphere of economic reason. However, if you support a solution - like nationalization (or, as Simon prefers to call it, "reprivatization") - that would not be welcomed by the banks, then political considerations become part of the story. In any case, I find it surprising that an MIT professor would call on his academic colleagues to stop criticizing the Treasury Department because they are "exacerbat[ing] self-destructive mob-mentality behaviour."

Insert your own historical analogy here.

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Feb 19, 2009 9:31 AM

A Step in the Right Direction

from The Baseline Scenario by James Kwak

I don't have a lot to add to Simon's article about the housing plan in The New Republic - as you might imagine, we did talk about it - but I do want to take issue with the title, "Insufficient Boldness." One quirk about writing for other publications is that you usually (not always) have complete control over the body of the article, but no control of the title (and often you don't know what the title will be until you see it printed).

I agree that the main concern is that the plan does not go far enough. This is because the main proposal for struggling homeowners is to provide cash incentives to lenders. It is impossible for the policy wonks in Washington to predict just how many mortgages will be modified with the bonuses offered. If they are acting rationally (I know, a big if), the lenders have already done a calculation on every delinquent mortgage they hold, and they have already decided not to modify the vast majority of them. So the question is, will a few thousand more dollars (note that this is more than was initially proposed by Sheila Bair) tip the equation toward modification? And in how many cases? (There is one scenario under which this could unblock the modification process: perhaps the lenders have been holding out on modifications so as not to lose out on the government bonuses, and now that they know what the bonuses are they will start making modifications. But there's no good way to predict the size of this effect.)

So I think that the Obama team has to be ready to sweeten the pot later - or take other, more aggressive measures - if this plan does not have the desired effect. Of course, if they were going to do that, they wouldn't announce it now (because you don't want lenders just to hold out for the next round of larger bonuses). So maybe that is the plan.

But on balance I think most of what is in the plan is helpful. If only it had come, say, twelve months ago.

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Feb 19, 2009 7:34 AM

President Obama's Housing Plan

from The Baseline Scenario by Simon Johnson

There is an old saying among experienced economic policymakers, "in a major crisis, do not err on the side of being insufficiently bold." And we know that President Obama's economic team are avowed proponents of this approach.

The housing plan unveiled yesterday is impressively comprehensive - I go through some of the details in a post this morning on The New Republic's Site. But is it bold enough?

The parts dealing with conforming mortgages, thus involving Fannie and Freddie, are very much in line with what we have been advocating - these organizations now work for the government, so put them to work. The scale of this piece seems roughly appropriate.

The Administration feels it cannot currently approach Congress for more funding, and this is presumably why there is so little funding in the remainder of the housing plan - and, remember, we know that many modified mortgages will later default again. If this assessment on the lack of funding is correct - and I'm not convinced - at the very least it suggests the Fiscal First strategy was not such a great idea.

And this has implications for next steps. If you think there is even a moderate chance of needing more funding down the road, wouldn't it be better to start a serious conversation now with Congress? In particular, a more holistic approach - with banking and housing included - is surely the right way to frame that interaction.

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Feb 18, 2009 11:10 AM

Kidnapping Chrysler

from The Baseline Scenario by James Kwak

In this brief interval before the new housing plan is announced, I'll try to sneak in a comment on the auto bailout, and the plans submitted by GM and Chrysler yesterday.

This may be an obvious question that many people have thought about, and got some discussion in December, but: Why does Cerberus (the private equity firm that owns Chrysler) need money from the government?

Let's take this step by step. Assume GM has a viable restructing plan, but it needs $30 billion to execute the plan, after which it will be a viable standalone business. Even on that assumption, given market conditions, they would be unlikely to be able to sell $30 billion in newly-issued stock or raise $30 billion through bonds or loans, because of information asymmetry: put simply, no one would believe them. Therefore, they can only get the money from the government, because the government is the one institution that will provide a below-market loan because of the public interest (saving the auto industry and either hundreds of thousands or millions of jobs, depending on whom you believe).

Now, with Chrysler, which is asking for $5.3 billion in new loans (on top of the $4.3 billion already committed, and in addition to another $6.0 billion from the Department of Energy's alternative energy funding program - see page 16), there is a difference: The people writing the plan and the people who could provide the money *are the same people*, since Chrysler is majority-owned by Cerberus, so there is no information asymmetry. Let's provide a comparison. If Chrysler were a Silicon Valley, venture capital-funded startup that needed cash, and had a viable plan, the VCs would simply invest more money, effectively diluting themselves (and the founders). If the Cerberus overlords really believe the plan that their underlings mailed in yesterday, why not put in the money themselves? And even if they don't want to put in additional equity like a VC would, why not loan the money to Chrysler and keep the interest payments themselves instead of sending them to Washington - and avoid the oversight that comes with government money? (In the proposal, Cerberus does offer to exchange their $2 billion loan to Chrysler for equity; but this just shows that they don't expect to get the full $2 billion back. More tellingly, they are not offering to send good money after bad; they are not even offering to contribute some new cash, leveraged with a loan, which is the classical private equity model.)

Cerberus's stated reason in December for not putting in more money was that this would violate their fiduciary duty to their limited partners. This looks to me like an admission that putting more money into Chrysler is a bad investment, but if someone knows more about this argument, let me know.

There are two other plausible reasons why Cerberus would prefer to go to the government. The first is if they can get cheaper capital (a lower-interest loan) from the government than from their limited partners or from the capital markets. But then the question becomes why the government should be in the business of giving cheap capital to a private equity firm that has other sources of capital.

The other possibility is that Cerberus/Chrysler doesn't actually believe the plan, and that's why Cerberus doesn't want to put in the money. The plan is a Hail Mary strategy that might work, but the chances of it working aren't good enough to put in their own money; but if they can get free money from the government (free in the sense that if

Chrysler collapses, Cerberus won't have to repay the government), they might as well give it a shot. This is the implication of page 13 of the Chrysler proposal:

If Chrysler is unable to restructure its liabilities and if further government funding is not forthcoming, the "Orderly Wind Down" alternative would be pursued, however it may have severe social and economic consequences for both Chrysler and the broader U.S. economy

This sounds like an admission that they are willing to attempt the plan with government money, but not their own money.

However, we can't reliably infer what Cerberus really believes from their behavior, because even if they were willing to put in their own money, they wouldn't say so until after the government turned them down. You've probably heard this bank bailout analogy: The banker walks into the Oval Office, puts a gun to his head, and threatens to blow his brains out unless he gets a bailout; the government bails him out because they don't want to have to clean the carpet. The difference here is that no one cares about Cerberus (the three-headed dog that guards the entrance to the underworld), so instead he dragged a hostage named Chrysler into the Oval Office and put the gun to her head. In the end, this feels like a kidnapping, where Cerberus is betting that the Obama Administration won't be willing to take any risks with the hostage's life.

(Of course, American oligarchs don't use guns; they use lobbying. Which is why John Snow is still chairman of Cerberus despite overseeing this catastrophic bet on the auto industry.)

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Feb 17, 2009 9:41 PM

YLS Conference on the Financial Crisis

from The Baseline Scenario by James Kwak

If you are a true crisis junkie (or you are having trouble falling asleep tonight and need more to read), my own Yale Law School held a conference on the financial crisis, its causes, and potential solutions (including better regulation) on Friday. There were a number of famous names present, including Lucian Bebchuk, Christopher Mayer (of the Hubbard-Mayer proposal), Anil Kashyap, and others. You can look at the agenda or check out the readings for sessions one, two, three, and four (each includes links to PDFs of the papers).

And where was I during all of this? I was home with my daughter.

(Let me know if you find something particularly important that I should read - I'm finding it impossible to keep up.)

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Feb 17, 2009 4:11 PM

The "Good Bank" Proposal

from The Baseline Scenario by James Kwak

There has been a small but increasing amount of attention being given to the "good bank" idea: instead of creating a government entity to buy toxic assets from existin banks - or nationalizing existing banks, removing their toxic assets, and then reprivatize them - why not create brand new, good banks with the same government money, enabling them to lend money unencumbered by previous bad decisions, and then privatize them? (Willem Buiter floated this idea on January 29, and Paul Romer has a similar proposal in the WSJ, although I'm proud to say that Nemo, who has his or her own blog, raised it in a comment on this blog two weeks earlier.)

Romer suggests using government capital to create new, healthy banks that can essentially compete with the existing banks, which can then be treated under existing rules and regulations - if they become insolvent, they get taken over; some of their liabilities (like FDIC-insured deposits) are guaranteed, and some aren't - and that's that. Buiter goes a step further and recommends taking away banking licenses from the legacy bad banks and making them institutions that just run off their existing assets, in part by selling their good assets to the new good banks.

These are elegant solutions because they get to where we want to be - healthy banks - yet avoid the problem of overpaying for toxic assets (which can happen in many forms, including non-recourse loans and asset guarantees), and the alternate problem of having to take over legacy banks (which will be politically difficult, given the antipathy that "nationalization" generates in the U.S.).

This approach faces some serious complications, however. First, there is the question of what happens to the legacy banks. Once such a program is announced, their stock prices should go to zero, since those prices are now predicated on friendly government intervention. That may not be so bad. More significantly, no one will want to lend them money, at least not without an explicit government guarantee. So either there will be a bank run - in which case we'll have to figure out if they are still Too Big To Fail - or the government will have to guarantee all the liabilities that aren't guaranteed already, which creates a big taxpayer liability. Of course, maybe this is just the same taxpayer liability we run into down any path we look, so this isn't necessarily a fatal flaw with the plan.

Another complication is this: How do you get a few sufficiently large banks off the ground and running quickly? Romer proposes creating wholesale banks (the kind that only have businesses as customers) because they can be created more quickly (they don't need huge branch networks), which would then buy good assets from legacy banks. Buiter also says that the new good banks will buy assets, such as deposit accounts and presumably branch networks, from the legacy banks. The legacy banks certainly won't want to sell their good assets - have you noticed they've only been talking about selling the bad ones? - but Romer thinks that faced with being shut down by regulators they'll have no choice. As a risk-averse person who found starting a small software company a huge endeavor, the idea of trying to create multiple large banks at once out of an office in the Treasury Department seems daunting, but arguably we couldn't do much worse than the banks we've got now.

And who will be running them? Both Buiter and Romer bring up the problem of having the government owning the few healthy banks in the economy and thereby making lending decisions. But both correctly note that we are already committed to significant government involvement in the banking sector. And one of the problems to date has been the contortions the Paulson Treasury Department went through to try to minimize government involvement. Given the current state of the economy and the banking sector, we might do worse than having some lending decisions made by bureaucrats, influenced by political considerations. We also run a similar risk under the nationalize-clean up-privatize scenario. In any case, there are structural mechanisms that could be taken to try to limit government influence, such as creating independent boards of directors (presumably staffed with upstanding citizens from the financial sector, though where you'd find them I'm not sure - I would nominate John Bogle if he still wants to work) with sufficiently long terms to insulate them from Washington.

I may not have done the proposals justice, so read them yourself and see what you think. But before you get too excited, remember that there is nothing like this in Geithner's Financial Stability Plan, so it is unlikely to happen.

Update (2/18/09): Since Paul Romer is one of the people whose work I discuss here, I want to point out a comment he left below. You can read it here.

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Feb 17, 2009 2:06 PM

Germany Shows Leadership (?)

from The Baseline Scenario by Simon Johnson

In the discussion over whether or not Ireland and other eurozone countries face serious economic issues (e.g., as suggested by the credit default swap, CDS, market), we have been joined by an unlikely ally: the German Finance Minister, Peer Steinbrueck. To avoid any misunderstanding, here is the exact wording from Bloomberg this morning:

German Finance Minister Peer Steinbrueck said late yesterday that euro region countries may be forced to bail out members of the 16-nation bloc that face problems refinancing their debt.

While he didn't name countries facing problems, Ireland is in a "very difficult situation," Steinbrueck said.

It is true that the CDS market has its problems and may not always provide a reliable indication of trouble. This is the line being taken by Irish officials, reported in the same Bloomberg story:

Ireland's Finance Ministry said it's incorrect to draw conclusions about the "soundness of Ireland's public finances" from credit-default swaps on Irish government bonds.

"The credit default market is small and opaque," the Dublin-based Ministry said in an e-mail today. "Also it is generally used as a speculative tool by a small number of market participants to gamble on movements in the CDS market itself rather than to insure against default."

But time and again, over the past two years, this same CDS market has given us an accurate read on the dangers ahead (my article on this question, written while I was at the IMF, is here). Ignoring warning signs on the grounds that they are "bad data" is dangerous.

A much better approach would be to address the underlying fundamental questions, and show everyone - clearly and persuasively - that Ireland is fiscally sound even with the contingent liabilities it has take on through guaranteeing bank liabilities.

If you are not in a position to so persuade people, then it is time to talk with your allies and close friends about the circumstances under which financial support may be available. Mr Steinbrueck's words will not be appreciated in all quarters, but they are timely (and hopefully will not be retracted). In particular, he is right to address not only Ireland but all of the weaker eurozone countries, just as we have been doing.

Above all, do not get into the situation of Iceland, which had too much denial for too long, and abruptly approached its relatives for money late and in a manner that did not engender strong support.

Remember this cautionary tale. In early October 2008, after the Icelandic Prime Minister had been turned down for loans that would have prevented calamity, he remarked accurately and depressingly, “we are all going back to fishing.”

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Feb 16, 2009 11:55 PM

Reprivatization After Paulson

from The Baseline Scenario by Simon Johnson

The worst possible way to nationalize would be to assume responsibility for the liabilities of banks, at the same time as not putting in place adequate oversight and failing to ensure that the taxpayer gets any upside. Even worse, we could install managers with a proven track record of incompetence. Anyone who proposed such a scheme today - as we collectively kick the tires of plausible alternative approaches - would be dismissed as an ridiculous crank.

Yet it is exactly this kind of nationalization that we - or, more specifically, Hank Paulson - already did.

It is true that there has been no change of control and bank shareholders have done remarkably well under the circumstances. And it is also true that the amount of new capital, from the original TARP funds, is relatively small for most banks (Citi and Bank of America are exceptions). But, make no mistake about it, the Federal Reserve and the Treasury - acting on behalf of taxapayers - saved the banking system in late September/early October 2008 through making available large and extraordinary lines of credit, as well as key injections of capital.

Of course, this was not formal nationalization - but it placed us on the hook for most, if not all, of these banks’ liabilities. In effect, we provided a massive cheap insurance policy to the banks, the people who run them, and their boards of directors. Focus on these boards for a moment; they are very much part of the problem.

Corporate boards are supposed to represent shareholders, but to a large degree they do not. Most board members are appointed by the CEO or hold their position due to the

CEO's tacit support. The idea that these board members effectively oversee the activities of these large banks seems almost quaint. While I am sure they are all fine, upstanding citizens, many of them seem considerably out of their depth. Others seem too deeply intertwined with the company executives, with other boards, and with the corporate elite more broadly. Strikingly few of them have stepped forward to take any kind of responsibility.

Fannie Mae and Freddie Mac were "taken over" by the government - placed into conservatorship - in summer 2008 because the Treasury determined that they did not have enough capital, so there was a risk they might need to draw on the government. Both boards of directors were removed at the direct instigation of Secretary Paulson. He had the legal right to do so precisely because these institutions had special access to the public purse. Note, however, that Fannie and Freddie had not actually drawn on the Treasury at the time they were taken over. It was the view that there was a prospect of drawing that entitled the Secretary to act.

Since then, of course, all banks have received similar access - through TARP and the Federal Reserve, to be topped up by further such support announced last week by Secretary Geithner. Some might still argue that accessing liquidity from the Federal Reserve is not the same thing as the Fannie/Freddie arrangement, as the Fed supposedly never takes credit risk. But this is not a widely held position, particularly after the second round bailouts of Citi and BoA. And Secretary Geithner, following in the footsteps of Secretary Paulson, clearly indicated that the Treasury would provide risk capital in all the schemes involving the Fed, i.e., the bookkeepers may quibble about the details, but you and I will be providing extraordinary financial support to the banking system for the foreseeable future.

Why did Secretary Paulson therefore not seek the legal authority to remove or change boards of directors when a bank drew - or potentially could draw - on the government? Presumably, he did not want to upset the banks' executives. Perhaps there were other reasons.

In any case, the issue today is not whether we should nationalize. Mr Paulson effectively nationalized the liabilities of major banks without putting in place any effective supervision of banks' operations. This is not a winning combination.

What we really need is to reprivatize - to return the banks to real private owners, preferably with strong voices on boards, and perhaps with controlling ownership stakes. And we must, above all, make sure those owners have the incentive to break the banks into smaller, more manageable pieces, none of which are "too big to fail." As part of this process, some boards of directors will either have to go or be reshaped dramatically. And new boards can decide who should or should not run these greatly restructured banks.

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Feb 16, 2009 5:48 PM

Can the Public-Private Plan Work?

from The Baseline Scenario by James Kwak

Back in September, Simon and I wrote two op-eds on the governance and pricing challenges of buying toxic assets. As many people have noted, those problems have not gone away. The latter, in particular, represents a formidable barrier to Tim Geithner's latest proposal to create a public-private partnership to relieve banks of their toxic assets. (In summary, the problem is that banks do not want to sell at the price the free market will offer, because (a) they think the assets will be worth more later and (b) doing so would force them to take writedowns that might make them insolvent.)

Lucian Bebchuk also wrote an op-ed on this topic in September, and to his credit he is still trying to turn "TARP II" into something feasible in his new paper, "How to Make Tarp II Work." The paper has some good ideas but I'm not sure it solves the basic problem, which unfortunately has to do with the laws of arithmetic.

One of Bebchuk's key points is that there should be multiple funds buying toxic assets rather than one super-aggregator fund, for the basic reason of price competition:

The existence of such a significant number of private buyers armed with substantial capital will produce a well-functioning market for troubled assets. This will be a market in which many potential sellers (banks) face a significant number of potential buyers (the funds). The profit share captured by the funds' private managers will provide these managers with powerful incentive to avoid overpaying for troubled assets. At the same time, the profit motive of the selling banks, coupled with the presence of competition among the private funds, will make it difficult for funds to underpay for troubled assets. As a result, we can expect the market for troubled assets to function well, with prices set around the fundamental economic value of purchased troubled assets.

More on that last sentence later.

He also has a clever idea for how to create that competition: Have private-sector fund managers bid for government money (capital or loans - more on that in a second) by bidding the maximum percentage of capital they are willing to provide (the rest of the funding coming from the government). The fund managers willing to put up the most of their own money will get the government funding. This will use the market to minimize the amount of government money that has to be contributed.

Bebchuk also recommends lock-up provisions that ensure that investors - whether private or public - cannot withdraw money from the funds for at least three years. This will help fund managers focus on long-term value without having to worry about having to sell assets into an illiquid market in order to meet demands for redemptions.

These are good ideas. But I'm not sure they are enough to make the market work, and this is where the laws of arithmetic come in. In fact, here's Bebchuk's statement of the problem:

A well-functioning market will convert some of the troubled assets held by banks into cash and, perhaps more importantly, provide more reliable valuations for the troubled assets that banks will retain. While this might confirm the claims made by some banks about the value of their assets, it might lead to realization that some other banks are insolvent or inadequately capitalized, which would require infusions of additional capital. Thus, restarting the market for troubled assets might well be insufficient by itself to solve banks' problems.

Even if you have multiple buyers willing to pay "economic value" for the assets, and multiple banks who want to sell them, you could still have a market failure; those banks could refuse to sell because it would force them to recognize losses that might make them insolvent (and no CEO wants to be CEO of an insolvent bank). In fact, this is what many people think is the case right now. All the people who might invest in a public-private partnership could buy those toxic assets right now, but they can't agree on prices with the banks who hold those assets.

So if we want TARP II to work, it has to make it easier for buyers and sellers to agree on prices. Lock-up provisions could help, but presumably if there are private investors willing to agree to three-year lock-ups, then private fund managers could raise money from them right now. What is Geither's public-private partnership going to change? In order to get to a price that buyers and sellers can agree on, buyers have to be willing to pay more than they are currently willing to pay (because the banks aren't selling at their current willingness-to-pay). There's only one way the government can do that: by sweetening the deal.

Here is Bebchuk's example of how this might work:

Consider a $1 billion fund established with a $50 million equity investment contributed by the private manager and $950 million in debt financing from the government's Investment Fund. In this case, while the private manager will be the first to bear any losses of the portfolio, the private manager's potential loss from the fund's $1 billion portfolio will be capped at $50 million. On the upside, however, the private manager will fully capture any profits that the government's capital of $950 billion generates above the loan's low interest.

Let's say that I'm a fund manager, and without government money I'm willing to pay 30 cents for some asset. That means that when I run my valuation models, there is some chance I will be able to sell it for more than 30 cents, and some chance that I will have to sell it for less, and those distributions balance each other. Government money doesn't change that distribution of outcomes; it just changes the share of the gains or losses that I incur. In Bebchuk's example, out of those 30 cents, only 1.5 cents (5%) are mine, so I don't have to worry about the risk of the price falling below 28.5 cents. But I still get all of the upside. You can see how that shifts *my* expected outcome in my favor. Because my losses are capped at 5% of my purchase price, I might be willing to pay 40 cents intsead of 30 cents: even though my chances of making money are small (the distribution of eventual sale prices hasn't changed), my losses are capped at 2 cents (5% of 40 cents), so I don't need a lot of upside to compensate for my limited downside.

In short, the larger the proportion of government funding, the higher my willingness-to-pay. The purpose of Bebchuk's auction is to find the fund managers willing to do the job with the least government funding.

This all makes sense, but here are the issues. First, the government financing in this example is a government subsidy. If the taxpayer is taking on the downside (after the first 5%), but none of the upside, and charging the fund manager a low interest rate, then that's a losing proposition. Looked at from another perspective, if the fund manager's expected take has gone up, then someone else's expected take has gone down. Maybe it's a subsidy we have to grant for the public interest, but there's still no free lunch. (The government could contribute some capital instead of debt, but then the government's capital has the same characteristics as the private capital, and the same amount of debt will be required to sweeten the deal sufficiently.)

Second, it still might not work. We don't really know what the gap right now is between buyers' willingness-to-pay and sellers' reservation prices. A government sweetener will increase buyers' willingness-to-pay, but there is a limit: if buyers think that an asset is worth 30 cents, and the chances of it ever being worth more than 50 cents are infinitesimal, then they will never pay more than 50 cents - and we don't know if that's enough to get the banks to sell. So it's possible that we could set up the most efficient possible mechanism for distributing government financing to the most well-incented fund managers, and the market could still fail.

In the end, if Treasury is going to go down the public-private toxic-asset-purchasing path, then I think Bebchuk has some good suggestions. But there's still no magic bullet here.

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Feb 16, 2009 9:46 AM

Every Consensus Must End

from The Baseline Scenario by Simon Johnson

The prevailing consensus on any economic policy is a fascinating beast. For years it can stay put, seemingly immovable, and even - in some cases - becoming enshrined in legislation or central bank statute. One day it begins to shake, ever so slightly; under the pressure of events, a wider range of serious opinion develops. And then, all of a sudden, the consensus breaks and you are running hard to keep up.

We saw this last year with regard to discretionary fiscal policy - fiscal stimulus - in the US. Eighteen months ago, very few mainstream economists or other policy analysts would have suggested that the US respond to the threat of recession with a large spending increase/tax cut. The consensus - based on long years of experience and research - was that discretionary fiscal policy generates as many problems as it solves. To argue against this consensus was to bang your head against a brick wall, while also being regarded as not completely serious.

At some point in November/December 2007, this consensus began to shake. The history may prove controversial but my perspective at the time and in retrospect is that Marty Feldstein was the first heavyweight economist to question the consensus (including in interactions on Capitol Hill), and he was followed closely by Larry Summers' influential writings in the Financial Times. Within a month or so, the consensus broke. Not only did we get a fiscal stimulus in early 2008 for the US, but the IMF quickly adopted the same pro-stimulus line globally and the terms of the debate changed everywhere. This fed into a process out of which came at least a temporary new quasi-consensus: a large US fiscal stimulus is part of the sensible policy mix today.

The consensus on banking just broke cover. For some weeks it has been under intense pressure. At least since the fall, serious people have been informally floating various new ideas on how to deal with the technical problems surrounding toxic assets and presumed deficient bank capital. But since mid-January, the mainstream consensus - that we should protect existing large banks and keep them in business essentially "as is" - seems to have cracked.

Paul Romer and Willem Buiter favor an approach that emphasizes the creation of new banks. Roger Farmer wants to go in a completely different direction. These are just a few examples of the great (and completely constructive) new dispersion of ideas around banking - post links to your favorite new ideas in comments below.

Advocates for the previous consensus - and the status quo - seem to be located mostly in the financial sector itself (e.g., Lloyd Blankfein). The Administration's view, as I discussed with Bill Moyers last week, is apparently still up for grabs. And I understand "what next" for banks will be a central theme for debate among staffers on Capitol Hill this week.

On the technical details, I could support any number of schemes. My main concern is limiting taxpayer downside and making sure the taxpayer gets as much upside participation as possible. We have a proposal on the table, but other ideas have merit and the US debate in this regard seems likely to be productive - in striking contrast with Europe, where denial is still the name of the game.

There is only one point on which I would insist. The banking lobby has become too powerful, in large part because big banks have balance sheets that are too big relative to the size of the economy. If a bank has total assets of over 10% of GDP, it is obviously too big to fail. Of course, the smart people who run these banks know this and act - politically and economically - accordingly.

We need a strong system of financial intermediation, and this must feature people willing to take risks with their own capital. In that context, there may be efficiency arguments in favor of relatively large deposit-taking/lending banks (although I'm far from convinced), but it is the political economy considerations that are overwhelming. When all is said and done, if we still have large banks with great political power, we will eventually find ourselves in even bigger trouble.

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Feb 15, 2009 10:44 PM

The Irish Question

from The Baseline Scenario by Simon Johnson

My Friday post on Irish credit default swap (CDS) spreads seems to have fed into a productive debate among experts on the Irish economy. Still, there is something of a puzzle here.

I was reporting public information from the CDS market, previously covered by Bloomberg, to motivate a call for action by the G7. The potential parallel between Ireland and Iceland is also an idea that has been around for quite a while.

The Irish Economy blog features contributions by some very smart people with a great deal of global experience. The tone in some comments on my postings is therefore a suprise. I was particularly struck by this,

"While the Irish fiscal and economic situation is severe, Ireland does not require any external assistance. It has a low public debt, an asset-rich sovereign wealth fund and plenty of capacity to raise taxes and cut public spending after a decade of rapid fiscal expansion.

Moreover, it is quite unhelpful for outsiders to call for intervention, since it adds fuel to ill-founded concerns about sustainability.

The CDS dynamics are similar to those of a speculative attack on a currency. While speculative attacks can be self-fulfilling if the fundamentals are weak enough, plenty of speculative attacks peter out and this is the most likely scenario in the Irish case also"

The first and third paragraphs make sense, and hopefully are correct. The middle paragraph is striking. If the fundamentals are strong, there should be no trouble fending off a speculative attack. Such attacks only have serious impact when they uncover deeper problems, or when the problems are already obvious to everyone, or when there is tactical mismanagement (very unlikely in this case, surely).

"Don't make reference to our difficulties, if you are from the outside and speaking in public," reminds me of Malaysia in 1997-98, where I did some (not well received by powerful people) work. I know why Malaysia was so defensive, but Ireland has always been open to all kinds of ideas and arguments.

If your country's economic situation is strong, you can laugh off any suggestion that outside assistance is needed. If your situation is weak, discussing the pros and cons of approaching others for help makes sense. It is seldom a good idea to limit debate.

Markets are not moved by comments on someone's website. They are moved by policy actions or inaction. Do you want policymakers to listen to a wide-ranging debate or not? If not, why not?

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Feb 15, 2009 6:44 PM

Tracking the Household Balance Sheet

from The Baseline Scenario by James Kwak

One concept that has gotten a lot of attention the last few months is the household balance sheet: the relationship between household assets and liabilities, and what that means for household behavior (consumption versus saving). Though not the precipitating factor in the current crisis, the weakening of household balance sheets (fewer assets, same liabilities, less net worth, more anxiety) has likely had a significant effect in depressing consumption, which has been the single largest factor in our recent decline in GDP. The Federal Reserve recently released a snapshot of the household balance sheet in its triennial Survey of Consumer Finances, so we can see what the situation looks like in some detail. The survey was actually taking in 2007, but with a few adjustments we can see what the current balance sheet looks like.

On the headline level, median income fell from $47,500 to $47,300 (all figures are in constant 2007 dollars), while median net worth (assets minus liabilities) grew from $102,200 to $120,300. No surprise there: we already knew wages stagnated, while real estate and stocks appreciated. However, since the survey was conducted in 2007, median net worth fell by 17.8% according to the Fed estimate, to $99,300, and that's just to October 2008. Given that the cumulative returns of the stock market have been about -15% since October 31, and that housing prices have fallen as well (and the Fed used a housing index that has fallen less than the Case-Shiller index*), that net worth is probably between $90,000 and $95,000 - significantly less than in 2004, and back around 1998 levels ($91,300).

I wanted to come up with a composite picture of the median family, to see how they are doing. This is actually impossible to do precisely, because of the way the survey data are presented in the report: for each category of assets (or liabilities), they say what percentage of families (in each income quintile) have that asset, and then the median value owned *among families that have that asset*.** So I came up with the following compromise: for each asset or liability, I include it if more than 50% of the families in the middle income quintile have it; in that case, I record the median amount held by families who hold that asset. This isn't the median family, but we might call it a "typical" family. (If you didn't follow this, don't worry about it.)

The picture I get, with some basic assumptions,*** looks like this:

	2004	**2007**	**2009**
Income	47,500	47,300	47,300
Assets			
Bank accounts	3,300	2,700	2,700
Retirement savings	19,000	23,900	17,900
Vehicles	14,400	14,600	14,600
Primary residence	148,300	150,000	125,400
Total assets	185,000	191,200	160,600
Liabilities			
Mortgage on primary residence	84,800	88,700	88,700

Installment loans	11,800	12,800	12,800
Credit cards	2,400	2,400	2,400
Total liabilities	99,000	103,900	103,900
Net worth	86,000	87,300	56,700

The picture you get is surprising. From 2004 to 2007, the typical family only took on $4,900 more debt - mainly in mortgages, but some for installment loans (primarily for cars and education) - but its assets grew by slightly more, a little bit because of home values but more because of increased retirement savings, presumably due to the rise in the stock market. (For those wondering at that small increase in home values: the median value of all homes increased from $175,000 to $200,000, but the median homeowner is not in the 50th percentile in income; he or she is somewhere in the 60-80th percentile range, so he has a more expensive house than the typical family.) In this picture, the typical family looks reasonably prudent, although taking on 4% more debt with no increase in income is not necessarily recommended.

When the crisis hit, though, the typical family took large hits in retirement savings and in home equity that cost over one-third of its net worth. So even though the typical household still has the jobs it had before the crisis (unemployment is still "only" 7.6%), it is much more worried about saving for whatever it has to save for - college tuition, retirement, etc. - and hence much less willing to spring for the proverbial flat-screen TV.

(Bear in mind that this picture tells us nothing about the foreclosure crisis, since the typical mortgage holder is not delinquent at this point. The foreclosure crisis and its impact on mortgage-backed securities is about the ability of problems at the margins to have severe impacts on certain kinds of securities and the institutions that hold them.)

At the end of the day, I think we knew all this already. But seeing it in numbers does help illustrate the crisis from the household perspective.

Notes:

* The Fed used the state-level purchase-only Loan-Performance Home Price Index, from which they derive a decline in value of 9.2% from the survey date (sometime in 2007) until 10/31/08. By contrast, the Case-Shiller Composite 20 fell by 14.5% from December 2007 to October 2008, and 16.4% from December 2007 to November 2008. Since inflation was positive during this period, the real fall in the Case-Shiller index was even greater.

** For example, of families in the middle income quintile (40th to 60th percentile), 71.6% own their primary residence, and of those the median house value in 2007 was $148,300 - but that's just the median value for the 71.6%, not for all 100%.

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For 2009, retirement savings reduced by 25% (stock market is down ~45%), housing by 16.4% (from Case-Shiller), other values the same as in 2007.

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Feb 14, 2009 6:14 PM

The G7 Are Asleep At The Wheel. Why?

from The Baseline Scenario by Simon Johnson

The global crisis approaches another major twist in its downward spiral. A key barometer of financial and fiscal pressure - the credit default swap (CDS) spread - has widened sharply for Irish government debt over the past few days; the markets think that the risk of a sovereign default is rising sharply. Immediate action is needed to forestall a dramatic deterioration of growth prospects across Europe and around the world.

The G7 ministers of finance and central bank governors met today in Rome. It was a great opportunity for this group of leading industrial countries to reassert its leadership in the global economy, taking strong preemptive action to prevent a recurrence of the calamitous days and near total financial collapse of September/October 2008.

Instead, all we received officially is a communique that blandly restates what these documents always say: we are opposed to instability and we are working on it, honestly. When an official has nothing to say, he or she talks about "principles" - and this was a pure principles communique (e.g., see their 3rd and 6th paragraphs). Nothing new or even vaguely reassuring.

Unofficially, it appears the situation is even worse. The G7 is signalling a lack of support for various key countries that are in the line of financial market fire. This is irresponsible, short-sighted, and bound to lead us all into great danger.

G7 effectiveness is at a low point. Why? The Europeans are in denial, particularly regarding the way their banks and their broader economic and political elite contributed to the global financial fiasco. The Americans are distracted, to put it mildly, while they search for a policies that make sense. There is a great deal of unproductive finger pointing within the G7.

But the real issue is that no one is yet ready to take on the deeper underlying problem - the political power structure of modern finance. While this structure is a particular problem - and particularly obvious right now - in the US, all industrialized countries today share some version of the same problem. We supersized our banking systems, allowed them to load up on risk that could threaten the macroeconomy, and gave them a mindboggling put option - in other words, the taxpayer is on the hook for a vast amount of downside. Across the industrialized (and coming soon to the industrializing world), the message from bankers is the same: give us the bailout money, or your economy will suffer.

Coming to terms with this reality and doing something about it will take leadership - the skills, popularity, and vision needed to really take on bankers (and preferably, win). That leadership is unlikely to come from Europe, Japan, or Canada. It's also unlikely to come from the G20 (which is basically the G7 plus large emerging markets), whose next heads of government meeting is on April 2nd.

Everyone and everything, in some sense, waits for the US and for President Obama. How long will it be before he is able to fully and personally take charge of sorting out banking at home - and help those trying to do the same abroad?

If you see any other - even slight - glimmer of hope in this situation, post it as a comment here.

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Feb 14, 2009 2:14 PM

Welcome to New Readers

from The Baseline Scenario by James Kwak

We've had a big surge of first-time visitors since Simon's interview with Bill Moyers started broadcasting last night. We hope you enjoy the site and return often. You can also get free updates using an RSS reader or via email.

On the chance that some of you are new to the economics blogs, I wanted to suggest a few other sites you might also want to check out (in addition to our Financial Crisis for Beginners section). We are nowhere close to the be-all and end-all of information about the global economy, and in any case the more perspectives you get, the better.

- Planet Money is an excellent, excellent podcast for people who are relatively new to the world of economics and the financial crisis, and for people who commute and can listen to it in their cars. I listen to it for fun.

- Calculated Risk and naked capitalism are good sources for near-real-time news about the crisis and the economy in general. Calculated Risk has a particular focus on housing and mortgages; naked capitalism has incisive commentary from one side of the political spectrum.
- Econbrowser is more technical and data-oriented; more advanced readers will like this one.
- Economist's View and Marginal Revolution provide in-depth articles applying economics to broad range of phenomena.
- RGE Monitor is the home of Nouriel Roubini and also aggregates articles from all over the Internet.

Of course, we would love to see you again here.

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

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Feb 13, 2009 6:09 PM

The Stress Test: Time for Transparency

from The Baseline Scenario by James Kwak

Like many people, I was disappointed by the Financial Stability Plan announced on Tuesday. But I think there is one glimmer of hope: the "stress test."

A key component of the Capital Assistance Program is a forward looking comprehensive "stress test" that requires an assessment of whether major financial institutions have the capital necessary to continue lending and to absorb the potential losses that could result from *a more severe decline in the economy than projected*. (Emphasis added.)

The stress test is supposed to indicate which banks are healthy and which aren't (so they can be fixed or closed). We need this for the reason most of you already know: nobody thinks the banks (meaning, mainly, the big ones) are healthy. The New York Times has a good summary of the situation. Nouriel Roubini thinks U.S. banks are facing another $1 trillion in write-downs. The IMF thinks it's more like $500 billion. The only people who think the banks are healthy are the bankers themselves:

"Our analysis shows that the banks have varying degrees of solvency and does not reveal that any institution is insolvent," said Scott Talbott, senior vice president of government affairs at the Financial Services Roundtable, a trade group whose members include the largest banks.

Edward L. Yingling, president of the American Bankers Association, called claims of technical insolvency "speculation by people who have no specific knowledge of bank assets."

The first reason to ignore Talbott and Yingling is that whenever someone says something, but he would say the exact same thing *even if it weren't true*, you should ignore what he says. (When Stan O'Neal said Merrill Lynch was great at risk management, what did you expect him to say? That they sucked?) The second reason is that even if they are right, it doesn't matter, because no one believes them. The banks don't face an immediate liquidity crunch because so many of their liabilities are guaranteed by the government: expanded FDIC insurance, guarantees on newly issued debt, the Fed accepting their junk assets as collateral. But even so, as long as people think the banking sector is sick, the economy will continue to stagnate, and the deepening recession will make banking assets worth less and less, until finally the banking sector really is sick. If Talbott and Yingling have some secret knowledge that their banks really are healthy, it won't help them.

The stress test theoretically will prove once and for all who is right, and whether the banks can withstand a worst-case scenario (remember, every month the forecasts for the recession are always worse than the previous month). This is a core regulatory function, for two reasons. First, as long as the government is backing up bank liabilities, it has the right to monitor them in order to protect itself; this is what the FDIC does, and why it closes banks when they become insolvent. Second, insofar as the health of the economy as a whole depends on the banking system, all of us, in the form of our government, have the right to know if the banking system is working properly.

When the stress test is applied to Some Big Bank (SBB), it will have one of two outcomes. If the regulators determine that SBB is insolvent and has to be taken over, that would be a good outcome, first because the outcome will be credible to everyone (except maybe Talbott and Yingling), and second because then the government can clean SBB up (that is, transfer the bad assets off its balance sheet) without having to negotiate with anyone. If, however, they determine that SBB is healthy (or can be made healthy with a little extra capital), that could be good or bad. If they just assert it ("believe us, we've looked"), then we are right back where we started, because that outcome will have no credibility. Fairly or unfairly, there are already too many people who think that Tim Geithner is in Wall Street's pocket. The only way to gain credibility in the event that SBB passes would be to publish all the details of the test: details about all of SBB's assets (including all of the assets that underlie those assets) and all of the assumptions and models that were used in the test. That way independent researchers could come to their own conclusions. Of course, I'm not sure how feasible a stress test on this magnitude itself is, let alone such a massive exercise in transparency, and SBB's traders would all scream. But I don't see any other way out.

Calculated Risk seems slightly optimistic about this exercise.

Yves Smith, not so much.

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Feb 13, 2009 3:29 PM

Bill Moyers Journal Tonight: American Banking Oligarchs

from The Baseline Scenario by Simon Johnson

A lot of people seem to be worrying about American bank oligarchs and how to break their political power. Bill Moyers has obviously been thinking about these issues for a long time, and he invited me to come by yesterday to talk more about how we got into this situation and how we might - if we are very lucky - get out with our economy more or less intact.

The interview is scheduled to run Friday evening (tonight) at the beginning of his PBS show; the segment should also be on his website after 10pm - and a preview/summary is already posted on Bill's site. Comments welcome, as always.

Hopefully, there will be more such discussions, so tell me what ideas need additional explanation or substantiation to convince people on the depth of our predicament and to further the debate regarding a real exit strategy.

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Feb 13, 2009 10:18 AM

The G7 Needs To Act, This Weekend, On Ireland

from The Baseline Scenario by Simon Johnson

Look at the latest Credit Default Swap spreads for European sovereigns (these are the data from yesterday's close). As we've discussed here before, CDS are not a perfect measure of default probability but they tell you where things are going - and changes within an asset class (like European sovereigns) are often informative.

European CDS have been relatively stable - albeit at dangerously high levels - for the past month or so. But now Ireland has moved up sharply (the green line in the chart). We've covered Ireland's problems here before (banking, fiscal and - big time - real estate); type "Ireland" into our Search box for more.

My point today is simple: a key warning sign just moved from orange to red.

The G7 ministers of finance and central bank governors need to focus on this problem during their discussions today and tomorrow. What is the strategy for Ireland? Does the European Union come in to help? Is this a job for the IMF?

Just don't, please, tell me more about the "basic principles" of financial reform (and similar nostrums in the draft communique) unless and until you have addressed the Irish Problem. And don't tell me, "the Irish have to sort this out for themselves." Eventually, the world always comes to help; check your notes on Iceland. It's much better and much cheaper to come in early and decisively - of course, the Irish will have to do some painful things, but we really can help (or, if we can't, this will be a long dark winter for the eurozone).

We need a plan of action for Ireland, and we need it now. What we don't need is another Iceland-type situation.

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Feb 13, 2009 1:11 AM

Ransom Note Interview

from The Baseline Scenario by Simon Johnson

Following my post Thursday morning regarding a potential massive financial/macroeconomic heist - let's call it the ransom note ("give us all your money, and you can have your economy back") - Adam Davidson had the great idea of interviewing the author.

We did so Thursday afternoon as part of a NPR Planet Money podcast that we co-hosted and, if all goes well, you can hear the results Friday afternoon. I tried to convey the tone (and in one case, the precise content) of your comments in the discussion. And the author … well, listen for yourselves and tell me what you think - you can post comments here or at Planet Money.

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Feb 12, 2009 4:00 PM

Europe Is in Bigger Trouble than the U.S.

from The Baseline Scenario by James Kwak

This is a theme that Simon in particularly has been sounding. Now, according to the Telegraph, a confidential European Commission memo confirms this. To review, the basic problems, relative to the U.S., are:

- Disproportionately large banking sectors (the Iceland problem) in some countries, such as the U.K.
- High exposure to U.S.-originated toxic assets (up to 50% of those assets, I have heard estimated).
- Major exposure to emerging markets, primarily Eastern Europe and secondarily Latin America, which have been harder hit by this crisis than anyone else.
- Higher pre-crisis national debt levels (for many but not all countries).
- For countries that use the euro, no control over monetary policy.

On top of these structural problems, there is denial:

The IMF says European and British banks have 75pc as much exposure to US toxic debt as American banks themselves, yet they have been much slower to take their punishment. Write-downs have been $738bn in the US: just $294bn in Europe.

Finally, whatever you want to say about the inevitability of the decline of American hegemony, the U.S. dollar and U.S. Treasury bonds still play a unique role in the global economy, which probably allows us to take on more debt than other countries without crippling our economy through currency depreciation and high interest rates. Or, as Yves Smith puts it, “The nice thing about having the reserve currency is the US isn’t worried about that sort of thing…..yet.”

Update: Arnold Kling linked here, and added this great comment:

It’s been years since I read Steve Roach describe the United States as the “tallest pygmy” in world currency markets, and it’s a metaphor that just seems to always apply.

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Feb 12, 2009 8:49 AM

Robbery Note - From The Banking Oligarchs This Morning

from The Baseline Scenario by Simon Johnson

The modern bank robber calmly hands a note to the teller, asking for money and making a moderately specific scary threat. The robber, of course, expects the teller to hand over unmarked bills without a fuss.

This morning's "research" note from a major international bank is entitled, "Falling Short: The government needs to buy toxic assets," and the heart of their one page argument is, with the emphasis as in the original,

One main stumbling block to the purchasing of troubled assets has been pricing, specifically how does the government price a diverse set of assets in a way that does not put the taxpayer on the hook. However, this should not be the standard by which we judge the efficacy of the plan, because a more prolonged deterioration in the economy will result in a higher terminal unemployment rate and a greater deterioration of the tax base. As such, the decline in tax revenues will crimp many of the essential services provided by the government. **Ultimately, the taxpayer will pay one way or another, either through greatly diminished job prospects and/or significantly higher taxes down the line to pay for the massive debt issuance required to fund current and prospective fiscal spending initiatives.** We think the government should do the following: estimate the highest price it can pay for the various toxic assets residing on financial institution balance sheets which would still return the principal to taxpayers.

Tell me if you think I am overreacting - it has been a difficult week - but I interpret this as saying: "give us as much money as you can, or else." And the "or else" appears to be unemployment up around 20% and debt/GDP in the red-for-danger zone.

Can bankers really trump the American government in this fashion? It's painful to read, but probably helpful that the oligarchs put their cards (and notes) on the table so brazenly. This is, after all, a critical fight to save American democracy, and it's good to know what we are up against.

Update: I talked, on the record, with the author of this note. To hear our conversation - also involving Adam Davidson of NPR - click for the post (it's two above this post) and follow the link (the Podcast should be available from Friday afternoon.)

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Feb 12, 2009 12:48 AM

Rahm Emanuel’s and David Axelrod’s New Dilemma

from The Baseline Scenario by Simon Johnson

The President’s top political counselors face the following dilemma. They want to be tough on banks because that makes sense politically and, presumably, because it fits how they - with considerable relevant experience - would like to address the deeper underlying problems in the financial system.

But at least some prominent economic counselors to the President strongly disagree. The Treasury Secretary, in particular, articulates the view that being tough on the banks and top bankers would further worsen credit markets and thus deepen/prolong the recession. Mr Geithner wants to try other routes, and while he does not rule out imposing policies that banks would not like, it is not in his Plan A or likely a feature of his Plan B.

The President has evidently sided with Treasury, either because he decided they have superior technical competence, or because Emanuel and Axelrod themselves gave way when the experts stared them down.

The dilemma is this.

Should Emanuel and Axelrod continue to push hard for being tough on big banks, or should they throw in the towel for now and let Treasury run through its various schemes? To oppose Tim Geithner would divide the Administration and also seem strange - after all, presumably they were closely involved in his selection. But standing quietly by, say for two years, is not appealing if a critical part of our economic policies heads down a long blind alley. And as a midterm election strategy this would be questionable.

The presumption in this dilemma is that Treasury officials are the experts. But is that really the case?

As the President stressed Monday night, we face an impending financial system collapse of a kind not seen in the US in over 70 years. The situation, both technically and politically, is akin to what - over the past 25 years - we have seen frequently in emerging markets but seldom in more developed countries (with Sweden and Japan as notable exceptions.)

The world's leading experts on such problems are for the most part not at the US Treasury, which is staffed primarily with people who have spent their careers working in (until now) relatively tranquil markets. Most of the relevant crisis resolution experience is to be found at the International Monetary Fund (IMF). The IMF is not comfortable giving advice to the Administration - the US is its largest shareholder and the Fund's HQ is a few blocks from the White House for a reason - and IMF officials also cannot be called to testify before Congress. But the views of leading IMF banking crisis experts are freely available - off the record.

What they say is this. The right thing to do is reboot the financial system. Find out immediately which banks are insolvent, using market prices. Allow private owners to fully recapitalize, if they can. Have the FDIC take over all banks that cannot raise enough private capital. Try to re-privatize those banks quickly, while making sure the taxpayer has strong partcipation in the upside. The difficulty with this approach is not, in the US or elsewhere, anything technical - it is really quite straightforward. The problem here and everywhere else that has faced a serious financial crisis is: the power of the banking lobby.

If the IMF experts are right and Treasury is wrong, does that help resolve the dilemma?

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Feb 11, 2009 2:24 PM

No Wishful Thinking

from The Baseline Scenario by James Kwak

At management team meetings at my old company, there was a slogan I was known for: "No wishful thinking." I would trot it out whenever I felt like our expectations for the future (say, our sales projections, or our product delivery dates) were being influenced by our desires for the future. Let's say, for example, that you have to hit your sales target, raise more money, or lay people off. It is very easy to plan around hitting your sales target, because the other options are unpleasant. But that would clearly be folly.

I thought of this when listening to an interview Adam Posen did for Monday's Planet Money (beginning around the 6-minute mark). The Geithner Plan had not yet been announced, but Posen already had the right diagnosis: wishful thinking. The administration, on his analysis, is hoping that it will be able to turn the economy around without having to take tough measures with the banks.

Martin Wolf puts it this way:

[H]oping for the best is what one sees in . . . the new plans for fixing the banking system. . . .

The banking programme seems to be yet another child of the failed interventions of the past one and a half years: optimistic and indecisive.

I also thought this was particularly insightful:

Why then is the administration making what appears to be a blunder? It may be that it is hoping for the best. But it also seems it has set itself the wrong question. It has not asked what needs to be done to be sure of a solution. It has asked itself, instead, what is the best it can do given three arbitrary, self-imposed constraints: no nationalisation; no losses for bondholders; and no more money from Congress.

It does seem like Geithner's proposals are a kind of effort to piece together a solution given those three constraints, ultimately founded on the hope that the underlying problems are not all that serious. But I'll stop there. Sometimes we bloggers compete to come up with marginally more interesting ways of telling the same story. For today I'll just recommend reading all of Wolf's post.

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Feb 10, 2009 11:38 PM

Axelrod And Emanuel Were Right (On The American Bank Oligarchs)

from The Baseline Scenario by Simon Johnson

When you cut through the technical details and the marketing distractions, sorting out the US banking fiasco comes down to one, and only one, question. How tough are you willing to be on the people who control the country's large banks?

One option is to be gentle with them and adopt only ideas that they pre-approve. This route involves complicated schemes to purchase, lend against, or otherwise "wash" toxic assets out of the banks using taxpayer subsidies. This will be expensive (for the taxpayer), messy politically, and - most likely - will not work, in the sense of restoring the banking system to something close to its normal mode of functioning; check with Hank Paulson for details.

Alternatively, you can be tough and take steps towards really assessing which banks are insolvent when you use market prices to value their assets. These banks can be taken over in a scaled-up FDIC-type procedure (no golden parachutes!), and controlling stakes in fully recapitalized banks can be sold off immediately to new private owners. The new private owners can handle, under proper anti-trust supervision, the break up the banks. This approach will be cheaper for the taxpayer (but nothing is free at this stage), easier to explain to the electorate and their representatives, and it will work - this is in fact the standard prescription because it always works. But it will not make powerful bankers happy.

So which way is the Obama Administration heading? We honestly don't yet know; the signals are mixed.

Indications that we are rolling over for the banker lobby are: (1) weak executive compensation caps, announced last week, and (2) insufficient money available or yet sought to back up the recapitalization that should follow the "once and for all" stress test of the banking system. The math on point (2) is: there is only $320bn left from TARP, of which - we learned today - $100bn is to go in further support for the securitized credit market, $50bn for housing support (and this could end up higher), and at least $50bn for private-public toxic asset purchase/loan scheme (thi is my inference from the statement that this bank should be $500bn going on $1trn total). The $120bn or so left over is probably not enough to recapitalize one major troubled bank, let alone the entire system.

But there are also more positive signs. Secretary Geithner was much more critical of bankers and their compensation schemes than officials have been to date. And President Obama is clearly angered by bankers' arrogant bonuses. The Administration's messages of transparency and accountability are refreshing and exactly on the mark. And I liked this line from Geithner (from CNNMoney),

"These banks need to understand that access to government resources is a privilege, not a right. It's not for the banks. It's for the people, and companies depend on that."

Do the banks understand this? Read Lloyd Bankfein's article in Monday's Financial Times, and tell me if you see any such indication from the CEO of Goldman Sachs.

So how do you get the message across? Obviously, we need the comprehensive stress test immediately and it has to be transparent and very tough. And this is where David Axelrod and Rahm Emanuel have apparently been exactly right in the past 10 days. According to press reports (NYT yesterday and WSJ last week), both have pushed for tougher symbolic and substantive actions that would hurt bankers' pocketbooks and weaken the largest banks.

Remember, weakening the big banks and their bosses should not be seen as an unfortunate side effect of beneficial medicine. It is exactly what we need to do under these circumstances. Unless and until these banks' economic and political influence declines, we are stuck with too many people who know exactly what they can get away with because their organizations are "too big to fail."

And weakening these banks (or actually having some of them go out of business and be broken up) as part of a comprehensive system reboot - with asset revaluations at market prices and a complete recapitalization program - will help return the credit system to normal.

For reasons that are not obvious, Axelrod and Emanuel have not prevailed on the degree of toughness towards the American Banking Oligarchy. But this may change. Let us hope it is soon.

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Feb 10, 2009 10:37 PM

Now, About That Stimulus Bill

from The Baseline Scenario by James Kwak

As I understand them, the Republicans' main reasons for opposing the stimulus bill (0 votes in the House, 3 in the Senate) were: (a) the bill contains too much evil government spending, (b) it doesn't spend money fast enough to affect the economy, and (c) it's too big. There are really no grounds for bipartisan agreement on (c), especially since many Democratic economists believe the stimulus is too small given the yawning output gap. But even conceding for a moment that (a) and (b) are valid concerns, I'm still baffled by the reduction of state aid from $79 billion to $40 billion. (See the New York Times comparison here.)

According to the Center on Budget and Policy Priorities, states are facing new budget shortfalls of $51 billion this fiscal year (ends June 30) and at least $94 billion for next fiscal year. Direct federal government aid to states will do no more than partially fill those budget gaps and enable state and local governments to keep people employed instead of firing them - teachers, firefighters, etc. While one might have concerns about whether the government can spend money on new programs efficiently, in this case the money will go to basic services that the government is already providing. This is only wasteful if you take the extreme view that all government spending in general is wasteful and any excuse to reduce it is a good one (the old "starve the beast" argument). The money can be spent quickly, because all the mechanisms needed to spend it already exist. Even if it is spent over several months (because people earn their salaries over the year), it will still have an immediate stimulative effect, because people who have jobs spend a lot more than people who don't have jobs. It will have a high multiplier, because every dollar of government payrolls counts as one dollar of GDP, so the multiplier on government salaries is roughly the multiplier on tax cuts plus one. And it will even save a little money in unemployment benefits.

There are a lot of things one can argue about in the Senate version of the stimulus, but this I just don't understand at all.

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Feb 10, 2009 10:01 AM

So Now We Know . . .

from The Baseline Scenario by James Kwak

Counting down to the announcement of the Geithner plan, the New York Times has this account of how it came into being (and why it should be called the "Geithner plan," although maybe Larry Summers is hiding behind him):

In the end, Mr. Geithner largely prevailed in opposing tougher conditions on financial institutions that were sought by presidential aides, including David Axelrod, a senior adviser to the president, according to administration and Congressional officials.

Mr. Geithner, who will announce the broad outlines of the plan on Tuesday morning, successfully fought against more severe limits on executive pay for companies receiving government aid.

He resisted those who wanted to dictate how banks would spend their rescue money. And he prevailed over top administration aides who wanted to replace bank executives and wipe out shareholders at institutions receiving aid.

I'm not a huge fan of executive compensation caps, as I think they are something of a sideshow. But I think the general approach of playing nice with banks and their shareholders is a mistake, because it leads to intransparent subsidies like the privately-financed bad bank is sure to be. (If the government is guaranteeing assets bought by private investors, as is widely rumored, it's still a subsidy; it's just not as obvious as writing a check.)

The most important thing in the bank rescue plan should be cleaning up their balance sheets to the point where even in a worst-case scenario we don't need to worry about bank solvency (at least for those banks that are left standing by the rescue). If the government announced, “we will buy any assets you want to sell, at their current book values,” this would be a massive subsidy worth hundreds of billions of dollars (and requiring trillions of dollars in initial outlays), but it would at least restore confidence in the banks. If the government announced, “we are taking over Citigroup, Bank of America, and JPMorgan because they are insolvent, and we will write down their questionable assets to nothing, recapitalize them, and later reprivatize them,” this would also restore confidence, although it would unleash a flood of litigation and political attacks against the government for engaging in “socialism.” But if instead you try to split the difference, avoid too much government involvement, and pretend you are not subsidizing the banks, you end up coming up with these too-clever-by-half subsidies that you are trying to hide from Congress and the public, and no one can be confident that they will work.

It’s possible that the “uniform stress test” will be rigorous enough to weed out and either close or recapitalize all those banks that may become insolvent in a severe recession. And it’s possible that the government guarantees will be generous enough to bring in enough private capital to buy up enough toxic assets to make bank balance sheets trustworthy enough. So it will take a few months to learn if the plan will work.

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Feb 10, 2009 7:10 AM

Secretary Geithner’s Speech: A Viewer’s Guide

from The Baseline Scenario by Simon Johnson

At 11am this morning, from the Cash Room at the Treasury, Secretary Geithner will lay out his vision (and hopefully some convincing details) regarding how to get the US financial system back on its feet. What should we listen for as indications that this is heading in the right direction?

1) If there is a “once and for all” audit of the banking system, as President Obama seemed to say yesterday, what do we learn about the toughness of the rules under which this will be conducted? Annoucing an thorough assessment is potentially a positive step, but vagueness spells trouble (for us, not the banks) down the road. We need this audit to force major banks to use market prices to mark down fully their portfolios; anything else is evasion and procrastination.

2) Are there any indications that the Treasury will pursue other policies that are tough on the bankers? We already know that in terms of executive compensation, Mr Geithner argued for - and won - very weak limitations (or, you might say, a generous insurance scheme for their future bonuses). And the NY Times is reporting that he also prevailed on whether bank executives should lose their jobs or bank shareholders suffer further losses. Is there anything at all in the speech that would at least make the CEO of a major bank frown? Writing in the Financial Times yesterday, Lloyd Blankfein (head of Goldman Sachs) essentially said that it is "business as usual" - is there any sign Secretary Geithner will call his bluff?

3) Is the Secretary using private equity to reform or to shore up the banking system? Any hint that Treasury will send private equity in to clean up banks and clean out their managers would be most welcome. But if today's proposals bring private equity's interests into line with the bankers, e.g., because they both gain from hidden government subsidies in a private-public toxic assets acquisition, that is not helpful. The financial lobby is powerful and our only hope is to split it and use, for the time being, some of the Finance Oligarchs against the others.

4) Then, of course, we have to figure out how to contain the power of the Oligarchs who win big. It would be would be a major breakthrough for the Secretary recognize, in any fashion, that the largest banks are "too big to exist." Is there even a hint that he thinks the size and concentration of our banking system is a problem, and that our new regulations and supervisory structures should take this on? Does he make any move that would create incentives or pressure for large banks to break up (or to be broken up by new owners)?

5) What is the market reaction? If the stock prices of the largest, most troubled US banks are up after his announcements, that means the market is expecting further generous handouts for these compananies and the people who run them. This is a rare instance when a Treasury Secretary's words should aim to push down at least some prominent stock prices.

I've talked over the past few days with people with extensive financial market experience, with journalists who've covered every angle of this story, and with academics who think about these issues all day and night. And I've had remarkably similar conversations with each. After a short warm up on the depth of our predicament and the excess of our bankers, the person looks at me and says: "of course, we should just nationalize."

Personally, I don't favor nationalization in the sense of the government trying to run the banking system. But I increasingly feel that, ultimately, the government will have to (a) properly recapitalize the banks, (b) as a result, acquire the right to determine who are the next private owners of these banks, and (c) bring in private equity and other financial interests to clean up the banks (yes, oligarch v. oligarch). I don't know how long it will take to get there, but I'm afraid most of the time between now and then will be wasted.

Unless Secretary Geithner can lay out an alternative path with convincing detail today, my expectation remains: the banks will not be fixed with the current approach, and the true reckoning still lies before us.

(Along these lines, our detailed proposed questions for Secretary Geithner's Senate hearings, this afternoon and tomorrow morning, are here.)

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Feb 9, 2009 11:01 AM

Is Saving Good?

from The Baseline Scenario by James Kwak

For a complete list of Beginners articles, see Financial Crisis for Beginners.

Way back in October, one of our readers sent in a question which can be paraphrased roughly as: "During the boom everyone said we should be saving more. Now people are saying we should be spending more. What gives?" This question has been sitting in my inbox unanswered. Until now.

Two of the leading economics blogs in the world (OK, the English-speaking world) published posts entitled "The Paradox of Thrift" yesterday, solving my problem for me. Tyler Cowen started off with a link to Matthew Yglesias, who wrote a non-technical explanation of the sort I usually do in my Beginners posts. Read that first. (Cowen adds some semi-technical notes that you may or may not understand.) James Hamilton then gives a technical explanation, but by "technical" here I'm only referring to first-year undergraduate macroeconomics, so most people should be able to follow. Read that second, at least through the second paragraph after the second graph.

Yglesias basically says that if you save instead of spending, your bank can lend the money out to someone else to spend instead of you. It might go to your neighbor's home equity line to buy a new flat-screen TV, in which case the economic impact is the same as if you had bought a flat-screen TV. Or it might go to some entrepreneur who is building a new factory, in which case the short-term GDP impact is the same (the money gets spent), but the long-term economic benefits are arguably higher (because in the long term we need new capital investment for the economy to continue growing). Hamilton shows the same thing with a simple equation. In the immediate term, S (personal savings) and I (private investment) both contribute to GDP, so one is just as good as the other; but in the long term, we need I, so savings are good.

However, it does not necessarily follow that every dollar saved necessarily and magically becomes another dollar invested. There are many reasons why increased savings may result not in increased investment, but simply in the same level of investment, which means total output (GDP) will be lower. Yglesias, Hamilton, and Cowen all point out various examples of why this can happen. In a dismal economic climate like the current one, entrepreneurs may not want to build new factories (put another way, demand for credit may not exist, so the banks have no place to lend the money). Or the savings may be going into zombie banks that are hoarding cash instead of lending it out. Or the economy may simply not be able to adjust fast enough: in order to shift out of cars and into anti-gravity hovercraft, it may just not be possible to retrain the workers fast enough to put all the available capital to use.

So in the long term, there are good things about a higher savings rate, not least that it will reduce the number of people facing poverty in their retirement years. But if we get there too quickly, it could exacerbate the recession we are going through.

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Feb 8, 2009 11:00 PM

Baseline Scenario, 2/9/09

from The Baseline Scenario by Simon Johnson

Baseline Scenario for 2/9/2009 (11pm edition, February 8): link to pdf version

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

Summary

1) The world is heading into a severe slump, with declining output in the near term and no clear turnaround in sight. 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. The U.S. will provide a moderate fiscal stimulus in 2009 and 2010, amounting to about 2 percent of GDP in each year.

4) The forthcoming (due this week) attempt to deal with banking system problems in the US will be insufficiently forceful. The structure of executive compensation caps introduced last week suggests the Obama Administration currently is unwilling to take on the large banks politically. The degree of recapitalization will be too small and the measures will help existing management stay in place. Large banks will remain “too big to fail” and shareholders will still be unable to constrain executive compensation. Lending will remain anemic.

5) 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.

6) 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).

7) 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.

8) 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.

9) 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.

10) 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 4%. 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, 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 and recapitalize 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

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 constraints on this dimension are, first, the ability of the Republican opposition to block legislation in the Senate and, second, 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. Campbell’s worries fit with the recent creeping upwards of the yield on 10-year US government bonds, from near 2% towards 3% over the past 2 months.

We're supportive of the fiscal stimulus, at the currently proposed level, and we 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 we 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 percentage of GDP, from around 41% to somewhere above 70%. This is still manageable, but it should concentrate our minds - we do not agree that the impact of the fiscal stimulus will be adverse, but we agree the US government fiscal position could become more precarious down the road. 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 remains 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.

And a long laundry list of measures ("try everything"), each of which is insufficient, does not add up to a comprehensive approach unless and until it fully recapitalizes the banking system. In fact, a relatively complex and opaque approach to what is really a simple problem - the chronic lack of capital in the banking system - could well generate the (accurate) impression that the bankers are availing themselves of a nontransparent approach and in effect stealing resources from the state. This is the kind of behavior more commonly seen at such scale in a troubled developing economy, and while it does not preclude episodes of growth, it is usually associated with repeated crises, widening inequality and - eventually - social/political instability.

Our baseline view is that the government launches a medium-scale bank recapitalization and balance sheet clean-up scheme. This will not be enough to really turn around the situation in US banking. But it could temporarily bolster confidence in the US banking system, causing a rise in equity prices for banks (as the market expects more government subsidies) 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 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 cantrigger 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 thisfor awide 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. We will need to readdress the need to fully recapitalize the banks, but really making progress with this depends on a political willingness to take on the powerful banking lobby.

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. The inflation swap market currently implies minus 0.3% average annual inflation for the next two years (although the five-year expectation is for inflation at 1.5% per year). 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; a more explicit form of inflation targeting is also likely to be introduced. 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. The net effect on the dollar, of course, depends on how bad the situation is in other regions, particularly the Eurozone.

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 an 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 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 recently over five years is around 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. Overall, it is difficult to see Japan being a major contributor to global growth.

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.

Other emerging markets

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 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 even if the IMF doubles its loanable resources to $500bn (as recently announced), 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.

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 significantly raise the world's growth rate 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 reducing 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.

But this change in the allocation of resources is greatly complicated by the increased political power of the financial lobby. During the boom years, large banks and their fellow travelers accumulated ever greater political power. This power is now being used to channel government subsidies into the now outmoded (and actually dangerous) financial structure, and in essence to prevent resources from moving out of finance into technology and manufacturing across the industrialized world.

We have done considerable damage to our economies through a debt-fueled bubble. But it could get worse. If the financial sector can use its political power to generate a higher level of subsidies from the government, we will convert even more of our banking industry into pure rent-seeking activities (i.e., all the bankers will do is lobby, successfully, for more support in various forms). If public policy is captured by banks in the US, Europe and elsewhere, then we face much slower productivity and overall growth rates for the next 20 years.

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/
- Guide to evaluating official announcements: http://baselinescenario.com/2009/02/07/ten-questions-for-secretary-geithner/

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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Feb 8, 2009 8:44 PM

High Noon: Geithner v. The American Oligarchs

from The Baseline Scenario by Simon Johnson

There comes a time in every economic crisis or, more specifically, in every struggle to recover from a crisis, when someone steps up to the podium to promise the policies that - they say - will deliver you back to growth. The person has political support, a strong track record, and every incentive to enter the history books. But one nagging question remains.

Can this person, your new economic strategist, really break with the vested elites that got you into this much trouble? The form of these vested interests, of course, varies substantially across situations, but they are always still strong, despite the downward spiral which they did so much to bring about. And fully escaping the grip of crisis really means breaking their power.

Not only is this a standard way of thinking about crisis resolution in many developing and post-communist countries, it also turns out to be a good guide to thinking about the US today. We have a powerful banking industry that has mismanaged its way into deep trouble. Yet these banks obtained an initial bailout - the Troubled Asset Relief Program, or TARP - on generous terms, and have consistently failed to use the opportunity provided by this government support to turn their operations around. Not only that, but they have flaunted their power - and their arrogance - through paying themselves large and largely inappropriate bonuses.

We come now, this week, to the podium. And Treasury Secretary Tim Geithner takes the stand (on Tuesday), to tell us how he proposes to use the remainder of the TARP funds, support from the Federal Reserve, and other policies to turn around the financial system and pull us out of recession. We previously posed relevant technical questions for this week; answers (or lack of answers) to these should determine if Geithner's approach is likely to succeed. Think of that as a framework for reasonable technocratic assessment. But there is also the key political dimension to emphasize.

The elites who run the US banking industry have had a great run of economic good fortune. They used this wealth to further strengthen their political power, both through donations to politicians of almost all stripes and more broadly through taking positions of formal and informal influence throughout the executive and legislative branches.

Our unsustainable debt-fuelled boom, in other words, produced both the conditions for a major global financial disaster, and a political strengthening of the people who benefited most from the risk-taking and associated compensation packages that made this disaster possible. Ending the financial crisis is relatively straightforward - a forced recapitalization and change of ownership/management in the banking system - although this will not immediately lead to an economic recovery (more on that here). But seen in deeper political terms, decisive action to restructure large banks is almost impossible. Such action would require overcoming perhaps the single strongest interest group in the United States today.

How can you do it? The answer must be by splitting this powerful interest group into competing factions, and taking them on one by one. Can this be done? Definitely, yes. In particular, bank recapitalization - if implemented right - can use private equity interests against the powerful large bank insiders. Then you need to force the new private equity owners of banks to break them up so they are no longer too big to fail. And then… there is always more to do to contain the power of a lobby that is boosted by any boom and which, the more it succeeds, the more likely it is to ruin us all.

(Note: this is also a guest post at http://www.growthcommissionblog.org/; if you'd like the World Bank potentially to take note of your comments, please post there as well as here.)

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Feb 8, 2009 3:42 PM

Here's an Idea . . .

from The Baseline Scenario by James Kwak

. . . since the Geithner-Summers team seems to be looking for them.

Why not say that all bank compensation above a baseline amount - say, $150,000 in annual salary - has to be paid in toxic assets off the bank's balance sheet? Instead of getting a check for $10,000, the employee would get $10,000 in toxic assets, at their current book value. A federal regulator can decide which assets to pay compensation in; if they were all fairly valued, then it wouldn't matter which ones the regulator chose. That would get the assets off the bank's balance sheet, and into the hands of the people responsible for putting them there - at the value that they insist they are worth. Of course, the average employee does not get to set the balance sheet value of the assets, and may not have been involved in creating or buying those particular assets. But think about the incentives: talented people will flow to the companies that are valuing their assets the most realistically (since inflated valuations translate directly into lower compensation), which will give companies the incentive to be realistic in their valuations. (Banks could inflate their nominal compensation amounts to compensate for their overvalued assets, but then they would have to take larger losses on their income statements.)

We can dream, can't we?

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Feb 7, 2009 9:02 AM

How Do You Like Them Free Markets?

from The Baseline Scenario by James Kwak

By now everyone knows about this past year's Wall Street bonuses: $18.4 billion total, the fifth-highest total ever; the $4 billion in bonuses rushed through by Merrill Lynch before its acquisition by Bank of America; and John Thain's demand for a personal $10 million bonus (which was initially a demand for $30-40 million, according to Felix Salmon). This has, not surprisingly, unleashed a torrent of rage against Wall Street, up to and including Barack Obama, who called the bonuses "shameful."

The usual defense of this sort of behavior is that you have to pay the market price for talent, the bonuses for top people are only a small fraction of the value they contribute (not a particularly good argument this year), and so on. And this is, not surprisingly, what John Thain was able to muster up in his defense on CNBC:

If you don't pay your best people, you will destroy your franchise. Those best people can get jobs other places, they will leave. . . . you have to– pay market prices at the time.

Yes, there is a market for labor, and compensation is the price set by that market. And maybe it's even a free market. But it's certainly not a well-functioning market (one where price = marginal cost, for example, or where the surplus is divided between the parties, or where the right incentives are created).

Lucian Bebchuk and Jesse Fried have a basic overview of some of the problems with the market for executives (in which the price is executive compensation) in "Executive Compensation as an Agency Problem," which deals primarily with CEO compensation. The basic problem is the old principal-agent problem: how do you get an agent to act on behalf of his principals, instead of looting them for his own gain? Bebchuk and Fried spend most of the paper criticizing an "optimal contracting" model, in which "boards [of directors] are assumed to design compensation schemes to provide managers with efficient incentives to maximize shareholder value," arguing instead for their preferred "managerial power" model, in which managers use their power over the board to maximize their own compensation while simultaneously weakening its links to their performance and making it as hard to understand as possible, in order to minimize shareholder outrage. Having observed the way CEOs get selected and compensated, and having read Rakesh Khurana's book on CEO searches, and most importantly having a pulse, I'm surprised there is even a debate about this, but the paper is from 2003, so maybe the debate is over by now.

According to Bebchuk and Fried, the basic dynamic at work is that directors like being on boards (it's a lot of money for not much work, and it's prestigious), CEOs control who is on the board of directors, CEOs control the information that goes to boards, and board members have weak incentives to act on behalf of the shareholders (they generally don't own much stock). The only real checks on CEO pay are public outrage (hence the usage of hard-to-understand things like deferred compensation and pension benefits) and large and powerful shareholders. This leads to certain outcomes that are hard to justify on the theory that boards are negotiating in the interests of the shareholders, most strikingly the tendency to give large, gratuitous "goodbye payments" on top of already-generous negotiated severance packages. Note that John Thain's demand for a bonus was only withdrawn after it was leaked to the Wall Street Journal (cue the public outrage).

Now, this paper primarily applies to compensation of CEOs (and their close friends, whom the CEO can take care of). But a similar problem applies to all Wall Street compensation. Just like CEO compensation depends on the myth that there is a small group of people with the ability to be CEOs, Wall Street compensation depends on the myth that there is a small group of people with the ability to work on Wall Street. (A myth that is pretty well belied by the fact that every year a flood of college and business-school graduates whose only common trait is that they all want to make money comes to Wall Street, and during the boom they all made lots of money.) That compensation is set by top executives and approved by the board, all of whom are bought into the myth of their own uniqueness; the shareholder, be he a teacher on Main Street or a mutual fund manager in Greenwich, doesn't have a seat at that table. Put another way, compensation should theoretically be determined by the owner of the company - the person who gets the profits after salaries and bonuses are paid - but that person has been cut out of the negotiation by the weakness of our corpoorate governance practices.

Theoretically the market for labor could be what forces prices up; if one company paid below-market bonuses, the story goes, its top people would defect for competitors. But there are problems with this argument. First, all that means is that you have a market failure: when you have a small number of players, it's easier and cozier for everyone to continue paying the same large bonuses (at the shareholders' expense) than to pay the level a free market would ordinarily dictate. Second, what would be wrong with top people defecting? Wall Street's most prestigious investment bank, Goldman Sachs, is also the one that was least willing to hire from the outside and most likely to promote from within - which is one way of saying that you think that people are overpriced on the open market. Third, if bonuses are a function of the threat of people leaving, why are bonuses this year (when there are no job opportunities) the same level as in 2004 (when they were plentiful)?

Weak shareholder control over executive compensation is, of course, common to all industries. The big difference is that while the CEO of Tyson Chicken (for example) doesn't devote much energy to enriching the people who work on his chicken farms, the CEO of Merrill Lynch did devote energy to enriching the people on his trading desks. While most companies are run for the benefit of a few senior executives, Wall Street firms are unusual in that they are run for the benefit of a large class of professionals. It's almost a form of sharing the wealth. Except this year there wasn't much wealth, and what little there was arguably wasn't theirs to share in the first place.

Update: Bebchuk has an article in the Wall Street Journal arguing that the executive cap limits announced this week aren't strict enough.

Update: Lloyd Blankfein, CEO of Goldman, has an op-ed in the FT recommending restrictions that go beyond what the Treasury Department proposed, including long-term vesting schedules and addition limits on when shares can be sold. A friend of mine who used to work at Goldman tells me that Goldman already has some of these vesting and delivery restrictions in place.

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Feb 7, 2009 8:45 AM

Ten Questions For Secretary Geithner

from The Baseline Scenario by Simon Johnson

Next week, Tim Geithner will have an opportunity to explain his plans for the financial system (Cash Room of the Treasury, Monday, 12:30pm), and defend these plans in front of the Senate Banking Committee (Tuesday, starting at 10am) and Senate Budget Committee (Wednesday, also from 10am).

Here are the questions (in bold) we would ask him. And, just in case any of you are involved in preparing the Secretary's briefing book, we also suggest some answers.

1. Do you agree that, to restore trust in the financial system, it is essential that the Treasury (working with other relevant US authorities) take rapid steps to "once and for all" completely recapitalize the banking system?

2. Would you also agree it is critical that you and your colleagues tell the unvarnished and unequivocal truth regarding the needs of the financial system and your plans to recapitalize banks, so that clarity regarding the policy framework can be restored and uncertainty diminished?

3. Do you agree that a one-off, transparent assessment - with the methodology and results fully divulged in public - of the solvency and financial condition of all banks is required within three months so that we can precisely define and address the problem?

- The only answer that should give any credibility to questions 1 and 2 is: yes.

4. Many banks value securities, mortgages, and other loans close to the face value of the obligation on their books, while market prices for similar assets are far below book value. Which value should be used when assessing these assets to determine if banks are solvent or not?

- The only fair answer for taxpayers, and the only way to ensure adequate capital comes into the banks subsequently from private investors, is: we will value all assets at market values. If market values are not available, then a highly conservative approach should be taken, i.e., assign a very low value. This will lead to major asset write downs at all banks and a larger need for capital, but it will ensure that this is the last time (in the foreseeable future) the Treasury needs to recapitalize banks.

5. Some sources report the Treasury is considering purchasing assets from banks which have been marked to market, while insuring assets which have not been marked to market. This would enable banks to avoid marking down assets, i.e., so that they don't need to recognize further losses. Why should taxpayers insure any asset at a price significantly different from the market price?

- The concept of "insuring" assets that have been priced above market value is a non-starter. It would be a means to provide taxpayer money to banks by stealth, and is not credible since it will become transparent (and face a major political backlash) as soon as the details face serious scrutiny.

- The Treasury needs to state clearly that most banks need large recapitalizations based on current asset prices, and it would not be fair to taxpayers if we provide cheap insurance (e.g., as if the assets are really AAA) for bad assets that are marked too high on banks' balance sheets.

- If the banks are forced to mark assets to their true prices, there is no need to provide insurance. You may as well recapitalize the banks fully to reflect those losses and then let them also manage all the remaining risk on their balance sheets.

6. How much money is Treasury expecting will be needed in the recapitalization of banks, i.e., what will be the net new injection of capital?

- If the answer is not at least $1trn, in line with the estimates of the IMF, then it's not enough. (Note: the headline number may need to be larger, depending on the approach; focus on the recapitalization/increase in capital of the banking system as the bottom line).

- We can rely on private capital also to inject funds, but only if the principles the authorities use for valuation of banks are very conservative so that there is adequate upside to new investors.

- If the headline amounts are less than $1 trillion, this is surely not enough.

- If the headline amounts are vague or we hear statements such as “it’s too early to know,” then the entire approach is not credible and we will need to reconvene when the Treasury is properly prepared and ready for a serious discussion.

7. Where will Treasury get this amount of money at short notice?

- The best answer would be a mix of private and public funding, but initially at least $1trn of public funding for recapitalization needs to be available.

- If the answer for public funding is: “the remaining TARP funds plus backstop loans from the Federal Reserve”, this is unlikely to be enough.

- Treasury needs to request further funding from Congress in the next month or so, in particular several hundred billion dollars in additional debt limit authorization; this can then be combined with Federal Reserve financing to get to scale quickly.

- There is no substitute for an early and completely frank conversation with Congress regarding why this new funding is needed, how exactly it will be used, and what the impact will be on various stakeholders (including insiders at the large banks, new investors, and the taxpayer).

- If the Treasury requires banks to write down assets to market prices, it will provide the clarity needed for private investors to re-enter the market. The stock prices of the worst banks will fall because it becomes clear the government is not prepared to provide further cheap taxpayer money as a subsidy, but this will finally put the banks at valuations that attract new private owners willing to make substantial investments. The government will then be providing funds alongside the private sector and less government funding will ultimately be needed.

8. How many of the largest 5 banks will likely end up with government as majority owner?

- Any honest market-based valuation of bank assets will show a majority of large banks are presently insolvent but can be righted with substantial new capital.

- If the answer isn’t “at least two,” then either the Treasury does not plan to properly value assets, or someone is not yet prepared to tell the full truth.

9. How does Treasury plan to use its shares when it has a controlling stake?

- If the answer is, “as a passive shareholder,” then we are really in for a rough ride (as seems to be the approach of Gordon Brown in the UK).

- The Treasury needs to have a plan to get shares back to the private sector quickly. We need new, strong private owners. This is the only way to really restructure the banks and force the necessary changes in management personnel and systems.

10. Does Treasury anticipate changes in management at these banks as a consequence of these actions?

- There is a critical need for new management in banks, but this should generally come alongside the infusion of new private capital. New private owners should restructure the banks and greatly improve how they are run.

- It is important that strong anti-trust provisions be attached when the government sells its stakes to new investors. This will ensure they have an incentive to break the largest banks into smaller, more manageable entities, all of which could productively be placed under new management.

- Any bank that is "too big to fail" is also "too big to exist". This should be a fundamental principle applied by both regulators and anti-trust authorities overseeing all dimensions of the financial system.

This Q&A was drafted by Peter Boone and Simon Johnson.

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Feb 6, 2009 3:03 PM

And Now, the Counterargument

from The Baseline Scenario by James Kwak

With mainstream and not-so-mainstream economists (including us) tripping over themselves talking about the need for a stimulus plan (and how the current one may actually be too small), and having just written an article saying the U.S. can probably absorb some more national debt before things go haywire (so did Simon), I thought it was only fair to point to the counterargument.

William Buiter at the FT argues that the U.S. cannot afford a major fiscal stimulus because the government (by which I think he means the entire political system, not just the Obama Administration) has no deficit-fighting credibility. If people do not believe that the government will raise taxes in the future to generate positive balances (I'm sorry to inform Congressional Republicans that cutting spending is not really an option, given the growth of entitlement commitments in the future and our increasing military needs, although cutting the growth rate of spending might be possible), they will conclude that the debt can only be paid off by inflating it away, which will drive interest rates up, the dollar down, and inflation up. Buiter spells this argument here and more recently here where he adds the U.S. is behaving like an emerging market economy in crisis (something with which we would agree).

The argument is plausible - yes, it is true that people could start dumping Treasuries and other dollar-denominated assets because of fear of the U.S. national debt - but not necessarily conclusive - on the other hand, they might not. Buiter recognizes the first objection to his argument: in fact, people's behavior shows that they are not worried.

It is true that . . . recent observations on government bond yields don't indicate any major US Treasury debt aversion, either through an increase in nominal or real longer-term risk-free rates or through increases in default risk premia. . . .

In a world where all securities, private and public, are mistrusted, the US sovereign debt is, for the moment, mistrusted less than almost all other financial instruments (Bunds [German government debt] are a possible exception).

But . . .

But as the recession deepens, and as discretionary fiscal measures in the US produce 12% to 14% of GDP general government financial deficits – figures associated historically not even with most emerging markets, but just with the basket cases among them, and with banana republics – I expect that US sovereign bond yields will begin to reflect expected inflation premia (if the markets believe that the Fed will be forced to inflate the sovereign's way out of an unsustainable debt burden) or default risk premia.

The US is helped by the absence of 'original sin' – its ability to borrow abroad in securities denominated in its own currency – and the closely related status of the US dollar as the world's leading reserve currency. But this elastic cannot be stretched indefinitely.

And as a result . . .

The only element of a classical emerging market crisis that is missing from the US and UK experiences since August 2007 is the 'sudden stop' - the cessation of capital inflows to both the private and public sectors. . . . But that should not be taken for granted, even for the US with its extra protection layer from the status of the US dollar as the world's leading reserve currency. A large fiscal stimulus from a government without fiscal credibility could be the trigger for a 'sudden stop'.

Buiter's argument is essentially a tipping-point argument. Yes, the markets seem unconcerned about U.S. government debt, but pass that stimulus bill and all of a sudden - or shortly thereafter - they will panic. As I said, it's possible. But the markets should already be anticipating that stimulus bill passing. (I find it hard to believe that with unemployment up to 7.6% the Republicans will block it; their better percentage is to go along reluctantly, say they are doing it to support President Obama, and turn on him when the economy does not respond immediately.) So all the information Buiter is basing his analysis on is already out in the market, and the market has shrugged it off.

More generally, though, we just don't know. National debt of 60-70% of GDP in private hands (a rough post-crisis estimate) might be too much for Ecuador or Argentina, but what about for the world's largest and most central economy? There just isn't any data. Arguably debt incurred in World War II finished off the British Empire (I believe Niall Ferguson discusses this at the end of *Empire*), but the U.S. was already the world's economic superpower by a wide margin. The U.S. was able to bring down debt from well over 100% of GDP after World War II. And we had debt (in private hands) of 49% of GDP as late as 1995, with the same tax-averse political culture we have now (this is after the Gingrich Revolution of 1994), yet the Clinton Administration was able to engineer low interest rates.

Maybe there is a tipping point somewhere. But no one knows where, and there isn't much useful evidence. So do we forego the stimulus package because we're afraid of the unproven tipping point? Maybe if, like Buiter, you think we are at the edge of the cliff and most people just don't see it yet (although they have the same information you do), and you think the potential costs are huge.

In any case, I recommend reading at least one of Buiter's posts.

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Feb 6, 2009 12:09 PM

New Report Out, TARP Still a Subsidy

from The Baseline Scenario by James Kwak

Elizabeth Warren's Congressional Oversight Panel has announced that TARP has so far exchanged $254 billion in exchange for $176 billion worth of assets, which amounts to a cash subsidy of $78 billion (full report). The numbers are based on an analysis of ten specific deals - eight of the largest under the original Capital Purchase Program (not the eight largest, however, as Merrill is missing), plus the second bailouts of AIG and Citigroup. In the former, Treasury received $78 of assets for every $100 expended; in the latter, it received only $41. These results were then extrapolated to the full sample.

This is not really news, since the CBO already forecast a subsidy of $64 billion out of the first $247 billion invested, and the OMB came up with a similar estimate even earlier -

and everyone writing back in October realized that the banks were getting a sweetheart deal compared to what was available from private capital, as indicated by Buffett-Goldman and Mitsubishi-Morgan Stanley.

The new report does have some interesting tidbits, however:

- It values the investments by Buffett, Mitsubishi, and Qatar Holding (in Barclays) at $110, $102, and $123 in value per $100 invested.
- It identifies the largest sources of the subsidy as (a) the ability of banks to buy back shares at par on demand and (b) the liquidation costs Treasury would incur if it sought to sell its holdings to other investors.
- It confirms what again everyone already knew, that one reason for the subsidy was the fact that Treasury offered the same terms to all banks (as opposed to getting better terms from weaker banks, which is what the private sector does). However, this doesn't explain the thing that has always baffled me: why the terms for Citigroup 2 (and Bank of America 2) were even more generous than the terms for the Capital Purchase Program, since those deals were individually negotiated with the government holding all the cards.

There is also this passage that I thought was accurate:

Treasury may have determined that granting the subsidies described above to a group of banks, regardless of their condition, on essentially the same terms was necessary, for one or more reasons, to preserve the integrity of the financial system. Whether the subsidy provided by Treasury to financial institutions represents a fair deal for the taxpayers is a subject for policy debate and judgment, not one that can be answered in a purely quantitative way.

In its public statements about its TARP expenditures, Treasury did not describe the program in terms of subsidization, nor did it explain why some banks should be subsidized more than others. Instead, Treasury repeatedly described investments "at or near par." . . . [T]he Panel believes that if TARP is to garner credibility and public support, a clear explanation of the economic transaction and the reasoning behind any such expenditure of funds must be made clear to the public.

If nothing else, I suppose this creates a benchmark that the new Geithner Plan will have to beat. I can imagine the people around the conference room: "Must . . . give away . . . less money . . . than . . . Paulson!"

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Feb 5, 2009 12:19 PM

The G20 Has A New Website: HM Treasury

from The Baseline Scenario by Simon Johnson

I've been calling for the G20 to modernize its communications strategy, including by updating their website from time to time.

I know the British (incoming chairs) are working on this, but there are still glitches. At the time of posting, if you click on www.g20.org, you get http://www.hm-treasury.gov.uk/, which is not exactly the same thing. And the link at the top of that page (next to the signature red phone box) doesn't work…

I suggest you try this instead: http://www.londonsummit.gov.uk/en/, and write up your reviews (on substance, process, or technology in and around the summit) as comments here - I will bring them to the attention of the appropriate authorities.

(Update: they fixed the links within a few hours; now they could edit their FAQ so they make more sense, or just use a spellchecker, e.g., "The G20 is carrying out the parpartory work for the Leaders summit in London on 2nd April")

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Feb 5, 2009 10:16 AM

Insuring Bankers' Bonuses

from The Baseline Scenario by Simon Johnson

Here's what we know so far about the plans for the US banking system that Tim Geithner will unveil next week.

1. The heart of the scheme will, most likely, be an insurance arrangement, in which the government (part Treasury and mostly Fed) insures a big part of large banks' portfolio of toxic assets against further loss. The devil is in the pricing of this insurance and how transparent that is - and we will put out more on this shortly - but the clear signal so far is that this will be a veiled major recapitalization of banks at taxpayer expense.
2. As announced yesterday, the government will set restrictions on the pay of executives in banks that participate. But note that, under these rules, bonuses are not restricted. Instead, they are just deferred and paid in shares. In other words, if

> there is cheap recapitalization through government-provided insurance, these executives are getting an incredibly good deal.

Think about it this way. While the macroeconomy goes badly, the government will pay out on the insurance policy and keep the large banks in business. Once the macroeconomy turns around, as of course it will, the banks can pay off the government and pay out massive bonuses.

We are, in effect, insuring incompetents (i.e., the executives who got us into this mess) against both the delayed consequences of previous bungling by themselves and any future missteps they may make.

But even this won't be enough for the top dogs on Wall Street. We predict that banks will start resetting the strike price of previously deferred bonuses, along the lines of what we have already seen from Google. Watch carefully and track what happens in your comments here.

What we really need is a simple, transparent recapitalization of the banking system. More complicated proposals are opaque and less likely to work. And once people see through the illusions, there will be great disappointment and much resentment.

(This post was written jointly by Peter Boone and Simon Johnson)

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Feb 4, 2009 6:24 PM

New Collaboration with Planet Money

from The Baseline Scenario by James Kwak

We are starting a collaboration with Planet Money, one of my favorite podcasts of any kind, to provide introductory articles on some important topics. The first one, National Debt for Beginners, went up today. Loyal readers of our Beginners series should recognize the format and style; Planet Money should help us reach a larger audience for this type of information.

More to come.

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Feb 4, 2009 9:13 AM

Framing the Geithner Bank Plan

from The Baseline Scenario by Simon Johnson

What are your expectations for the impending Geithner Bank Plan? Listening carefully to the messaging from the top, you are probably hoping for an increase in bank lending. In fact, over the past few weeks, Congressional leaders (e.g., at the Senate Budget Committee hearing last week) and the President (e.g., see the penultimate paragraph of last week's TV address) have repeatedly insisted that, going forward, banks that receive government support should increase their lending.

And you've probably seen matching statements from the banks recently, either (a) explaining why the fall in lending was not their fault, or (b) celebrating the fact that, against all odds, they did manage to increase loans in the last quarter.

So the perception has been created that the new Bank Plan will succeed if it raises bank lending, and that it can be judged by this metric.

But this is the wrong framing of the problem. Or, perhaps it was the right framing for last October, when credit supply was severely disrupted, but it is an out-of-date and perhaps dangerous way to think about what is now needed.

If many creditworthy consumers and firms currently want to borrow less (i.e. increase their savings/strengthen their balance sheets), the amount of outstanding credit in the economy should fall.

Banks have definitely tightened lending standards (subscription link, but the point is in the free part) - there might be some overreaction here, but everyone agrees that overly loose standards were a major cause of the crisis, so what else would you want them to do? Certainly there are some creditworthy borrowers who cannot currently get loans at the prevailing interest rate, but how many?

If you think there was overlending in the boom (and who doesn't?), then you should expect a contraction in total credit now - this is the simple and compelling idea behind the fancy term "deleveraging".

The task is not so much to force lending to increase now, but rather to clean up the banking system so that, when the recovery begins in earnest, credit will be available on reasonable terms and subject to sensible lending standards.

This difference matters because the real danger is that either the executive or legislative branch will see the need to mandate that lending must increase - or that loans must be made to particular categories of borrowers, such as small business or housing. This would be a recipe for more bad loans and further damage to the banking system (and more costs for you, the taxpayer.) It would also lead to corruption, scandal, and reform fatigue.

The Geithner plan may work - let's see the details before we take a more definite view on that. But if the wrong expectations are set, it could even work well and still be judged a failure.

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Feb 3, 2009 4:59 PM

Searching for a Free Lunch

from The Baseline Scenario by James Kwak

I don't envy President Obama's economic team. When it comes to fixing our banking system, there is no easy solution.

I've been sick the past few days, but someone pointed out this article in The New York Times a few days ago that has a concrete illustration of the problem: a bond that an unnamed bank is holding on its books at 97 cents, but that S&P thinks is worth 87 cents (based on current loan-default assumptions), and could fall to 53 cents under a more negative scenario . . . and that is currently trading at 38 cents. Assume for the sake of argument that all of our major banks are insolvent if they have to mark these assets down to market value. The crux of the issue is that any scheme in which the banks receive more than market value is a gift from taxpayers to bank shareholders, and any scheme in which they are forced to take market value is one that the banks will not participate in. Let's look at a few possibilities:

1. The government forces banks to write down their assets to reflect worst-case scenarios (unless they do this, no one will have confidence that the asset values won't fall further), and *then* recapitalizes them to make them solvent. This is a desirable outcome, but bank shareholders won't go for it because they will be mostly wiped out. This is roughly what Sweden did with two banks, but Sweden nationalized them first, so the shareholders didn't matter.
2. The government creates an aggregator bank to buy up toxic assets. If the aggregator pays market value, no bank will sell; if it pays above market value, it's

a gift. The current idea I've heard is that the aggregator will only buy assets that have already been significantly marked down, but that doesn't really help the banks any.

3. Another idea is having the government guarantee toxic assets, as it did for Citigroup and Bank of America so far. But this doesn't solve the problem. There is already a market to insure toxic assets - it's called the credit default swap market. If the government provides insurance at existing market prices, no bank will buy it, because the cost of the insurance would make it insolvent. If the government provides cut-rate insurance, as it almost certainly did for Citi and B of A, then it is a gift. The only "benefits" of an insurance arrangement are: (a) it's much less obvious that the government is giving bank shareholders a gift; and (b) the way Citi and B of A were structured, it wouldn't require a lot of cash from Treasury (and hence from Congress), because most of the guarantee was provided by the Fed.
4. Meredith Whitney thinks that the banks should sell their "crown jewel" assets - presumably, businesses they have that are still in good shape - to private equity firms, and use the cash to repair their balance sheets. This would be a nice solution, but I don't foresee it happening. Given the choice between selling the good operations and being left with barely-solvent portfolios of runoff businesses, or holding onto the good operations and hoping for a government bailout, I think all the Wall Street CEOs are betting on the latter.

I think there are two possible outcomes to all of this: (1) the government makes a gift to bank shareholders and justifies it on the grounds that there was no other choice; or (2) the government forces the banks to sell assets at market value and accept a government recapitalization program - either by exercising its regulatory authority (similar to an FDIC takeover) or by just buying out all the common shareholders at their current low prices. In option (2), the government would then re-privatize the banks at some point. But there's no easy solution.

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Feb 2, 2009 10:15 PM

The IMF Sends A Message

from The Baseline Scenario by Simon Johnson

The IMF communicates its view of the world economy in two ways. The first is quite explicit, in the form of a World Economic Outlook with specific growth forecasts. The latest update to the Outlook, published last week, recognized that world growth is slowing down, but anticipated a V-shaped recovery (there is a reassuring V in their Figure 1, or you can look at the Q4 on Q4 numbers for 2009 in the pdf version - the US does not contract during the coming year, according to this view.)

According to the forecast - which factors in only actual policies in place; no assumed miracles allowed - this is not much of a global crisis, particularly for emerging markets (e.g., emerging market growth dips to 3.3% for 2009 and then pops back up to 5% for 2010 in the annual average data; China's growth will accelerate from now through end of 2010, etc.) Given that, among other things, the IMF is the point organization for emerging market troubles, the message seems to be a soothing one.

But the IMF also communicates with both its lending to countries in difficulties, and with statements on and around this lending. Here the news is in striking contrast to the forecast.

The Fund has plenty of money (or access to the same) - it can currently lend up to $250bn, and has currently disbursed just under $50bn. Most observers have interpreted this as indicating the IMF does not need additional resources. But now the IMF begs to differ. John Lipsky, First Deputy Managing Director (the #2 in the hierachy and #1 carrying a US passport), said at Davos that the Fund would like to double its resources, to $500bn. Of course, he stressed that this is only as a contingency measure - but do not be misled by this terminology. The world economy is in serious trouble, this has first order implications for emerging markets, and there will in all likelihood be crises throughout the developing world and perhaps also among some richer countries (think Iceland, but bigger). The IMF wants you to know this.

The IMF also wants you to know that its major shareholders, including the US, Japan, and large European countries, are in broad agreement with this more negative view. The Fund would not be floating publicly a scheme for raising this amount of money if it did not already have the richest countries on board, at least in terms of broadly supporting the need for more funding. The writing on the eurozone wall probably helped - if the IMF is called upon in Western Europe, it needs to have a considerable amount of cash in hand.

The good news is that with the IMF taking matters so seriously, raising $250bn should not be difficult - in fact, Japan has already pledged $100bn. And the IMF could well move to issue its own bonds - in addition to providing a new source of funding, this would bring the Fund closer to financial markets in ways that will help make the organization more effective.

My reaction is in line with that of Montek Ahluwalia - former senior IMF and World Bank official and now a top economic policymaker in India. At Davos, he called the plan to raise $250bn, "very modest". Other phrases, such as "too small" or "at least a start" also spring to mind. In the fall, I predicted that the IMF would need at least $1 trillion in resources to get us through this global crisis. If anything, I now think that estimate was too low.

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Feb 2, 2009 11:57 AM

Should The U.S. Nationalize Its Banking System? Live Chat At Noon

from The Baseline Scenario by Simon Johnson

Over on NPR.org at noon, Eastern time, the Planet Money team is running a live chat on options for the US banking system. The link is here. I hope you can join us.

Update: you can watch the "replay" of this chat on NPR.org. The comments/questions were very good.

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Feb 1, 2009 10:09 PM

Rahm's Doctrine And Breaking Up The Banks

from The Baseline Scenario by Simon Johnson

According to David Leonhardt, writing in today's New York Times magazine,

TWO WEEKS AFTER THE ELECTION, Rahm Emanuel, Obama's chief of staff, appeared before an audience of business executives and laid out an idea that Lawrence H. Summers, Obama's top economic adviser, later described to me as Rahm's Doctrine. "You never want a serious crisis to go to waste," Emanuel said. "What I mean by that is that it's an opportunity to do things you could not do before." (Links in the quote are from the on-line original.)

Leonhardt explains how this Doctrine can be applied to issues ranging from health care costs to education, and some of this is already apparent in the fiscal stimulus details currently before Congress.

Can the same approach also guide actions regarding our deeply broken and broke financial system? There are three possible answers.

1. No. If you support this view, you presumably think (a) there are no powerful vested interests on Wall Street, (b) these vested interests are not a first order reason why we are in so much trouble, (c) these same interests are doing a good job leading us towards economic recovery. My guess is that this is currently the view of only a small minority; perhaps it is limited just to people who received large TARP-funded bonuses.

2. Yes in principle, but the situation is now so dire that we really don't have the opportunity. In this view, the Wall Street interests are a problem, but we need to get credit flowing again as fast as possible, and this requires being nice to banks and bankers. If you think that maintaining or increasing the amount of nominal credit in the economy is the number one issue (e.g., for February), then this view may have some validity. But if credit is falling in part because creditworthy people don't want to borrow as much as before and because desired savings are increasing almost everywhere in the world, then the case is weaker. Most likely, we have some time to sort out the banking system properly.

3. Yes, but how? Members of the incoming Administration have spent years thinking ahead about controlling health care costs and reforming education; no one really anticipated there would be an opportunity - let alone a potential need - to restructure the financial industry. Perhaps we should leave this to G20 reregulation, meshing with the Dodd-Frank legislative agenda at the national level? This might be part of the answer, but it doesn't seem to match other proactive uses of Rahm's Doctrine or the scale of the financial catastrophe.

Recent prominent actions on Wall Street - excessive risk taking, pervasive mismanagement, failure to take responsibility, mind-boggling bonus behavior - all point to a deeper underlying problem: no real owners. Large banks operate on the fundamental principle that it is all, "other people's money."

So it has been and so it is - except now it is very much taxpayer money, from the Treasury and from the Fed, that keeps large banks alive. In essence, the government is already the primary provider of capital to this part of the banking industry, i.e., we are in some fundamental sense already the owners, and if we provide more capital or insure/purchase more bad assets then we really own the store. (If anyone from a large bank would like to do without taxpayer support at this stage, please step forward.)

What should we do with our ownership rights? We will, no doubt, attempt to exercise greater control over executive compensation and bonuses - and the industry, no doubt, will evade the spirit of these controls quite effectively. We might impose some other symbolic restraints over corporate jets and the like, but none of this will be meaningful.

The only real way to apply Rahm's Doctrine is to break the overly powerful vested interests in this part of the economy, and that means to break up the banks. The government needs to sell its effective control rights over large banks to private investors - providing them with at least temporary permission to become concentrated owners. Antitrust provisions must ensure that the large banks are dismantled in this process. Whether the executives stay or go is a matter for the new owners to decide. (For an example of how to organize the technical details of acquiring and disposing of government ownership, see our previous suggestions; there are other ways to do this that would also be quite straightforward.)

One pushback response to this proposal is: it's too different, too risky, and there's a good reason we've never been able to do this before. Fortunately, we have a serious crisis and Rahm's Doctrine is in effect. And, really, it's just an application to the US context of what other well-run countries have done when faced by a collective breakdown of bank executive competence.

Progress on the healthcare and education fronts will take many years, and the right way to measure success may well prove controversial. Progress on banking can be swift and the relevant metrics are straightforward - are the big banks broken up and placed under new, more effective ownership? And does the taxpayer finally get some upside?

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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.