

Low-Tech Archive of The Baseline Scenario for March 2009

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Apr 30, 2009 11:21 PM

[Bankruptcy Cramdowns Defeated in Senate](#)

by James Kwak

President Obama, he of the [68% approval rating](#), asked Congress to allow bankruptcy judges to reduce the principal amounts of mortgages on primary residences (they can already modify almost all other loans in bankruptcy). The goal was to pressure mortgage lenders, or the investors who now own those mortgages, to modify the mortgages themselves to give homeowners a better option than foreclosure. Because, you know, we have a housing foreclosure crisis going on. But after passing the House, the measure got only 45 votes in the Senate, with zero Republican support and twelve Democrats defecting.

Banks campaigned against the measure by – get this – threatening that it would destabilize financial markets. The [New York Times](#) reported:

A letter signed by 12 industry organizations this week to senators warned that the legislation would “have the unintended consequence of further destabilizing the markets.”

Translation: banks are weak; weak banks are dangerous; therefore Congress should not do things that might be bad for banks.

According to the [Washington Post](#):

[Senator Richard] Durbin negotiated with Bank of America, J.P. Morgan Chase and Wells Fargo for weeks, hoping their support would bridge the gap. Even after the proposal was weakened significantly, the financial services industry refused to sign on.

I know the main legitimate argument against bankruptcy cramdowns: it increases the riskiness of mortgages, and therefore mortgage rates would have to go up a little for everyone. (Which sounds fine with me.) But the way this issue played out had nothing to

do with what would be best for the country as a whole; it had everything to do with what the banks wanted.

Instead of bankruptcy cramdowns, the Times reports that the banks got a reduction in the insurance premiums they will pay the FDIC for deposit insurance - which is like a group of car owners voting themselves lower premiums on their auto insurance. But because there is zero chance the government will let insured depositors lose money, any shortfall in the premiums paid by banks to the FDIC will be made up by the taxpayer.

Not that this should surprise anyone.

By James Kwak

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Apr 30, 2009 3:56 PM

[GDP Growth Rates for Beginners](#)

James Kwak

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

My post about [French sociology](#) got a wide range of comments, ranging from “Without a doubt, your best post yet” to “Reading this post made me think, for the first time, of ignoring Baseline Scenario from now on,” which I guess indicates we have a wide range of readers. In any case, for today I’m returning to something much more mundane: GDP growth rates. Like many Beginners articles, this one starts out with some basics, and then gets (a little) more interesting, but its main goal is to help you decipher the news that you already read.

To a casual reader, yesterday’s GDP announcement was that Gross Domestic Product (an aggregate measure of economic activity) fell by 6.1% or, more precisely, at an annual rate of 6.1%. What does this mean?

For those of you who have never visited the [BEA website](#), this is what the raw numbers look like. (They give you columns B and E, I calculated the rest.) Note that this is all in 2000 dollars, so inflation has been taken out.

	A	B	C	D	E	F	G	H
1	"Real" Gross Domestic Product							
2	Data from BEA (http://www.bea.gov/national/index.htm), 4/30/09							
3	All figures in 2000 dollars							
4								
5		Quarterly GDP, seasonally adjusted annual rates	Q/Q change	Q/Q change, annualized	Calendar year GDP	Y/Y change	Q4/Q4 change	Peak to current
6	2005q1	10,875.8						
7	2005q2	10,946.1	0.6%	2.6%				
8	2005q3	11,050.0	0.9%	3.9%				
9	2005q4	11,086.1	0.3%	1.3%	10,989.5			
10	2006q1	11,217.3	1.2%	4.8%				
11	2006q2	11,291.7	0.7%	2.7%				
12	2006q3	11,314.1	0.2%	0.8%				
13	2006q4	11,356.4	0.4%	1.5%	11,294.9	2.8%	2.4%	
14	2007q1	11,357.8	0.0%	0.0%				
15	2007q2	11,491.4	1.2%	4.8%				
16	2007q3	11,625.7	1.2%	4.8%				
17	2007q4	11,620.7	0.0%	-0.2%	11,523.9	2.0%	2.3%	
18	2008q1	11,646.0	0.2%	0.9%				
19	2008q2	11,727.4	0.7%	2.8%				
20	2008q3	11,712.4	-0.1%	-0.5%				-0.1%
21	2008q4	11,522.1	-1.6%	-6.3%	11,652.0	1.1%	-0.8%	-1.8%
22	2009q1	11,340.9	-1.6%	-6.1%				-3.3%

The columns are as follows:

- B: Quarterly GDP, or economic activity in that quarter. However, these numbers are expressed as seasonally adjusted annual rates. That is, GDP in 2009Q1 was not \$11.3 trillion, but closer to 1/4 of that number, or about \$2.8 trillion. The BEA multiplies by four, and also applies seasonal adjustments, like correcting for the fact that different quarters have different numbers of days.
- C: The change from the last quarter. So GDP in 2009Q1 was 1.6% less than in 2008Q4.
- D: The change from the last quarter, annualized; put another way, the total change you would get if that rate held constant for a full year; or, roughly column C times 4. This is the headline number you see in the newspapers. But the economy has not actually contracted by 6.1%. Skip ahead to column . . .
- H: This is the total change in economic activity since the most recent peak. In our case, the last peak was 2008Q2, when annualized GDP reached \$11.727 trillion. So far, the economy has contracted by 3.3% - which is already a large amount. Head back to column . . .

- E: This is GDP for the full calendar year. Since column B was already annualized, you don't add up the four quarters for each year; instead, you average them. The confusing thing is that there are two different ways of measuring changes in GDP from year to year, shown in columns F and G.
- F: This is the simple percentage change in column E. So total economic activity in 2008 was 1.1% greater than in 2007.
- G: This is the change from Q4 of one year to Q4 of the next year. This shows you how much GDP grew or contracted *during* the second year. So the economy in Q42008 was 0.8% *smaller* than in Q42007, meaning it contracted in 2008 - even though overall there was 1.1% more economic activity in 2008 than in 2007.

GDP also, by definition, has four components: personal consumption expenditures; private domestic investment (investment by companies and households in big things, like factories or houses); net exports (exports minus imports); and government spending. You will also see growth rates (like above) for each of these components, and for their sub-components. You can see all the tables in the BEA's nice [news release](#). For example, in Q1 personal consumption *grew* at an annual rate of 2.2%, which was the "good" news, but private domestic investment fell at an annual rate of 51.8%, which was the "bad" news. (That 51.8% includes a preliminary wild guess at inventory changes - adding stuff to inventory counts as GDP, taking stuff out of inventory counts as negative GDP - but even excluding inventories, fixed investment fell at a 37.9% rate.) The aggregate GDP growth rates are just the weighted averages of the growth rates of the components.

Yesterday's announcement was at the low (bad) end of most forecasts. The first thing to bear in mind, though, is that this is just the advance estimate. While advance estimates under ordinary circumstances are not that bad, the advance estimate for Q4 was way off. All of these numbers are estimates, and when the world changes, the estimating models become less accurate.

In some cases, a steep fall might mean that the recovery will just come that much sooner - if the floor is somehow independently determined. This could be the case with housing prices, for example, where there are reasons to believe that fundamentals will put a floor under prices, at least expressed as a percentage of average income. But the economy as a whole is a much more complex system, so I doubt you can take the level of the floor as given.

The principles above apply generally to the rates of change you see in the newspaper: you'll see period-to-period changes, which may or may not be annualized, and year-to-year changes, which may compare entire years or a single period with the period one year before. But there are differences in presentation that can be confusing.

For example, the [Consumer Price Index](#) (technically, the CPI-U, which is the headline index) is reported on a monthly basis, and changes in the CPI are reported over three different periods:

1. Change from the previous month, seasonally adjusted (to take into account the fact that people's consumption mix changes over the year) but *not annualized*. This is the current short-term monthly inflation rate.
2. Change from three months before, seasonally adjusted and *annualized*. This is the average annualized inflation rate over the last three months.
3. Change from the same month the previous year; this figure is already annualized by construction.

If you look at the most recent [CPI news release](#), you'll see that these three numbers are -0.1% (change from February to March, not annualized), 2.2% (change from December to March, annualized), and -0.4% (change from March 2008 to March 2009). The 2.2% and -0.4% are comparable, because they are both annual rates, but they are not comparable to -0.1%, which is a monthly rate. And is inflation positive or negative? It depends on which number you look at.

(Of course, the figure that the Fed and many economists focus on is CPI with food and energy stripped out. For that measure, the three numbers are 0.2%, 2.2%, and 1.8%, which are much more in line with each other; remember, the first one is monthly and the others are annual.)

When you see housing price changes, like changes in the Case-Shiller index, you usually see changes from the previous month or changes from the same month a year before; which one you focus on can have a major impact on how you interpret the numbers.

You need to be especially careful when interpreting economic indicator indexes. These do not show the absolute level of some economic phenomenon, but they are constructed to reflect the degree of *change* in some economic phenomenon. As a result, the index is already the "first derivative" of the economic phenomenon, so changes in the index are the "second derivative."

For example, [Calculated Risk](#) today reported that the Restaurant Performance Index increased by 0.2% to 97.7 from February to March. However, as CR points out, "Any reading below 100 shows contraction. So the improvement in the index to 97.7 means the business is still contracting, but contracting at a slower pace." In other words, activity was *lower* in March than in February. Is the increase in the index good news? Well, it's better than a decline, and it's better than staying the same. But indexes like this *should* have some degree of built-in reversion to the mean (around 100); things just can't keep falling at a linear rate forever.

Finally, the [Consumer Confidence Index](#) of the Conference Board can be especially confusing. The index as a whole increased from 26.9 to 39.2 in April (the median over the last 20 years has been around 100, or a little below), driven largely by a jump in the Expectations Index (expectations about how the economy will be in six months) from 30.2 to 49.5. But the reading of 49.5, and the poll questions behind it, still indicate that many more people think the economy will get worse than think it will get better. So what we

have is the economy getting worse, and even as it gets worse, most people think it will continue getting worse - but as time passes, a growing minority think that we are within six months of the bottom.

Hopefully that will help people interpret the numbers that make up so much of the economic news these days. As always, if you find mistakes, please let me know.

By James Kwak

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Apr 30, 2009 6:22 AM

[The People v. The Flu](#)

by Simon Johnson

In [Plagues and Peoples](#), published in 1976, [William McNeill](#) argued that human history can be thought of as the co-evolution of our societies and the “microparasites” to which we are prone. The emergence of settled agriculture, major historical movements of people, and industrialization all brought with them new or more intense diseases. Eventually, most societies figured out how to survive - but of course some didn’t (see [Jared Diamond](#)’s work for details) and many people died young along the way.

You don’t need to buy McNeill’s full view in order to take away the following point. We have to invest and innovate to stay ahead of disease - there is no sense in which these are likely to be completely “conquered” - because they change as we do. Investments are needed not just in the relevant science, but also in how it is used to combat potential epidemics - as well as more general endemic disease.

As I argue [this morning on the NYT’s Economix](#), regarding the current ~~swine~~ H1N1 flu outbreak, global public health officials are doing much better than our friends who watch over financial systems. In terms of reaction speed, communications, and the legitimacy of response agencies, economics has much to learn from the people who fight against epidemics.

But more broadly, in terms of reducing vulnerability in the system, both public health and economics need to do better. We let endemic conditions fester and global risks build up. We haven’t found ways to think clearly enough about what causes major crises - particularly, how do apparently stable systems suddenly face the prospect of collapse? (OK, the biologists are ahead on that one also.)

And, of course, if we continue to run up massive amounts of public debt - through various forms of financial sector misadventure - it becomes harder to fund sensible investments in and around the medical sector (note to Larry Summers: how are we going to afford the big push on public investment [you are advocating?](#)) On top of everything else, unrestrained Big Finance is bad for your health.

By Simon Johnson

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Apr 29, 2009 11:21 PM

[The Importance of Battlefield Nuclear Weapons](#)

by James Kwak

I've been writing a lot about [the game](#) of [chicken recently](#), most often in connection with the GM and Chrysler bailouts. On the Chrysler front, the game is in its last hours. Even after a consortium of large banks agreed to the proposed debt-for-equity swap, some smaller hedge funds are holding out for more money, and even the [extra \\$250 million](#) that Treasury agreed to kick in seems unlikely to keep Chrysler out of bankruptcy.

The problem is that bankruptcy is the only weapon Chrysler and Treasury have in this fight, and it's a strategic nuclear weapon. Bankruptcy is the only threat that can get the bondholders to agree to a swap; but because a bankruptcy carries some risk of destroying Chrysler (because control will lie in the hands of a bankruptcy judge - not Chrysler, Treasury, the UAW, or Fiat), and taking hundreds of thousands of jobs with it, everyone knows that Treasury would prefer not to use it. The bondholders are betting that they can use Treasury's fear of a bankruptcy to extract better terms at the last minute. (And it's even possible that the large banks agreed to the swap knowing they could count on the smaller, less politically exposed hedge funds to veto it.) But Treasury may still press the button, because it needs to make a statement in advance of the bigger GM confrontation scheduled for a month from now.

But there's a much bigger, slower game going on at the same time, and the administration's basic problem is the same: all it has is strategic nuclear weapons that it absolutely does not want to use. The [New York Times](#) had an article today about how "a growing number of banks are resisting the Obama administration's proposals for fixing the financial system." It didn't have a lot of new information, but it summarized the outlines of the game.

The administration has created three main tools to help the banks - and it really, genuinely wants to help them:

1. The [Capital Assistance Program](#) (CAP) to give new capital to banks that need it (based on the stress tests).
2. The [Public-Private Investment Program](#) (PPIP) to encourage the private sector to buy troubled assets from banks.
3. The Term Asset-Backed Securities Loan Facility (TALF) to provide funding to the asset-backed securities market, which is being expanded to mortgage-backed securities.

According to the Times article, the banks want none of it - even though, as many people (including us) have argued, the terms of these programs are clearly favorable to the banks.

Instead, banks such as Bank of America and Citigroup are arguing that they are more sound than the stress tests indicate. This claim is almost not worth debunking, but I'll give it a few words anyway. First, the "more adverse" macroeconomic scenario used in the stress tests is already more optimistic than the forecasts of respected bodies, such as the [OECD](#). Second, the IMF recently estimated total losses on financial institution balance sheets at \$4.1 trillion, future writedowns by U.S. banks at \$550 billion, and U.S. bank capital needs at \$275-500 billion. If B of A and Citi don't need the capital, who does?

In addition, according to the Times, "Several big banks have declared they have no intention of participating in the [PPIP]. . . . Many banks are reluctant to sell their nonperforming loans because they could suffer big losses, forcing them to raise more capital." Finally, only \$6.4 billion in loans have been given out under the TALF - a program currently sized at \$200 billion, and projected to grow to \$1 trillion.

Why are the banks turning their backs on this government largesse? I think there are two reasons.

First, taking capital under the CAP or selling assets into the PPIP involves some hardship, despite the taxpayer subsidies involved. Raising capital dilutes existing shareholders, and selling assets (at prices where someone will buy them) will require writedowns from their current, unrealistic book values. Treasury really wants the banks to participate, because it will increase confidence in the banks, and that's why Treasury is offering to share the pain, via underpriced capital and low-risk loans.

But even though Treasury is so generously offering to share the pain, what's the incentive for the banks to suffer any pain at all? We know the government won't use the strategic nuclear weapon and let them go bankrupt or pull their banking licenses (which amount to the same thing). And Tim Geithner's request for a battlefield nuclear weapon - resolution authority for systemically important financial institutions, including bank holding companies - seems to be going nowhere in Congress. This is not surprising, since the banks [have already demonstrated](#) that they can count on most or all Republicans and at

least a few Democrats in the Senate. With the administration's hands tied and the banks' political power intact, the banks are in the same position they always were: if things go well, they will make money; if things go badly, the government will always bail them out later, on terms they are willing to accept.

On the one hand, the banks are complaining about unprecedented government interference and pressure, and to some extent that is happening. But on the other hand, the banks are ultimately calling the shots, because they know Tim Geithner can't use his only real weapon.

Second, the incentives of managers and shareholders are not aligned. A major factor in the banks' reluctance to participate in their own rescue seems to be fear of government interference, which is code for executive compensation restrictions.

Executives worry that whatever assurances the White House gives them, an angry Congress might impose new rules on banks that participate, particularly on pay. . . . "We're certainly not going to borrow from the federal government, because we've learned our lesson about that," [Jamie Dimon] said earlier this month in a conference about earnings.

Now, while I think some of the compensation caps discussed in Congress (but not passed by the Senate, as far as I know) were silly, I haven't heard a lot of shareholders complaining about them; it's the managers who don't want them. So the situation is very simple. Participating in PPIP, for example, might be a net positive for shareholders, because even though it forces short-term writedowns, it also reduces the risk of larger writedowns in the future. But if managers think that it will lead to compensation limits, then it is a net negative for managers. I think our readers can fill in the rest of this thought.

By James Kwak

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Apr 29, 2009 10:05 AM

[Five Questions for Christy Romer](#)

by Simon Johnson

Christy Romer, chair of the President's Council of Economic Advisers, will appear before the Joint Economic Committee tomorrow. (Details, background, and links to Christy's relevant recent work will appear on [The Hearing](#) shortly; [update, now posted](#)).

I suggest Committee members consider pursuing the following lines of questioning.

1. Please explain precisely how the U.S. will avoid the type of [“balance sheet” recession](#) seen in Japan during the 1990s? Building on that, kindly elaborate on why this kind of recession is not an issue at the global level. Related to this, what is your view of the [IMF’s latest global forecast](#), for example for Western Europe?
2. [Larry Summers argues](#) that growth in the recent past was overly based on the financial sector and there is now a need to rebalance the economy, led by public investment. Do you agree with this view and which public investments - and related private sector activities - exactly would you have in mind? How /why will resources move out of the financial sector, given the level of bailouts (i.e., [insurance for bankers’ bonuses](#)) today and promised for the future?
3. The Administration indicates that it wants to reform the way finance is regulated. Regarding the past two decades, would you agree that the financial sector has [proved able to “capture” regulators and to resist rules](#) (e.g., on derivatives) that would restrict potential profitability? If yes, how exactly do you think future regulators (e.g., the system regulator now under discussion) will resist similar capture?
4. Do you support the idea of [applying and updating antitrust principles](#) to banks that are “too big to fail”?
5. What other approaches make sense for dealing with big banks in the future? Do you agree that controlled financial system risk creates serious potential for huge unpleasant fiscal surprises? Could [Pecora-type hearings](#) be one way to examine how best to bring down these risks?

Feel free to add more questions here or at [The Hearing](#) at WashingtonPost.com. The JEC is definitely interested in what you have to say.

By Simon Johnson

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Apr 27, 2009 11:11 PM

[Pierre Bourdieu, Tim Geithner, and Cultural Capital](#)

by James Kwak

France in the 1960s and 1970s was the source of a tremendous amount of new philosophical, literary, and critical thinking - Foucault, Derrida, Livi-Strauss, Baudrillard, Barthes, etc. But in my opinion, the most important member of that intellectual generation

was the sociologist Pierre Bourdieu. In *Distinction*, Bourdieu's best-known work, he described how economic class is reinforced by cultural capital: economic elites create cultural distinctions, and pass on to their children the ability to make those distinctions, in order to use cultural sophistication as a means of perpetuating class dominance. This may sound abstract, but think about the example that is the subject of Bourdieu's *The Love of Art*: museums. Upper-class parents take their children to fine art museums and teach them how to talk about Rembrandt, Monet, and Picasso; later in college, job interviews, and cocktail parties, the ability to talk about Rembrandt, Monet, and Picasso is one of the markers that people use, consciously or unconsciously, to identify people as being from their own tribe. (Note that democratizing museums - making them open to anyone - doesn't undermine cultural capital, because the key is not looking at paintings, but learning how to talk about them.)

We used the term "cultural capital" in our [Atlantic article](#) as a way of describing the influence of Wall Street over Washington. By this, we meant that one of the primary means by which Wall Street got its way in Washington was by creating and propagating the understanding - among sophisticated, educated, cultured people, as opposed to "populists" or the "rabble" that showed up at anti-globalization protests - that what was good for Wall Street was good for the country as a whole. We didn't mean to say that old-fashioned campaign contributions and lobbying did not play an important role. (We did, however, say that we thought out-and-out corruption of the Jack Abramoff variety was probably a minor factor - not because we have any insider knowledge one way or the other, but simply because such criminal behavior was simply unnecessary given the other levers available.) But I don't think that implicit quid pro quo bargaining is a sufficient explanation, because I believe it entirely possible that there are honest politicians and civil servants who really, truly believe that they are acting in the public interest when they come to the aid of the largest banks.

Tim Geithner may very well be such a man.

The [New York Times](#) ran a long article today about Geithner's close connections to the New York financial elite during his years as president of the Federal Reserve Bank of New York, a curious public-private entity that plays a crucial role in the operation of the Federal Reserve, yet is governed by a board a majority of which is elected by the private sector banks themselves. The general thrust of the article is that Geithner had close relationships with many of the people whose banks it was his job to supervise, and that many of his proposals and policies have been generally friendly to those banks. But it should be noted that even after reviewing [Geithner's calendar](#) for all of 2007 and 2008, with all its tantalizing mentions of posh meals and get-togethers (the Four Seasons is mentioned seven times), the *Times* did not find a smoking gun. Geithner was approached as a candidate to be CEO of Citigroup (an offer he quickly rejected), but nowhere is there any evidence that he traded favors for any kind of personal gain.

Instead, what the article portrays is a continuing series of close contacts - breakfast, lunch, dinner, coffee, charity board meetings, etc. - with a set of very rich, very powerful, very impressive people who all believed in the importance of Wall Street, and the importance of lighter regulation of Wall Street, and the importance of making sure that Tim Geithner believed in it too. It's doubtful that there was anything close to a countervailing influence from people who thought that Wall Street was taking excessive risks and needed to be reined in; the first meeting with Nouriel Roubini was on August 28, 2008. I don't mean to imply that Geithner was an impressionable youngster when he arrived at the New York Fed. He was 42 (older than I am now), and he had grown up in the Treasury Department in the Clinton administration. But that was a Treasury Department headed by Robert Rubin (former head of Goldman Sachs, later head of the executive committee at Citigroup) and his disciple Larry Summers, both of whom were strong believers - at the time, at least - in the importance of Wall Street and free financial markets.

The Geithner presidency seems to have represented the high point of a long tradition of cozy relationships between the head of the New York Fed and the banks it supervised. The *Times* article points out that Geithner's two predecessors ended up as executives at investment banks, and his successor came from Goldman Sachs. But under Geithner, the relationships may have been their coziest:

Other chief financial regulators at the Federal Deposit Insurance Company and the Securities and Exchange Commission say they keep officials from institutions they supervise at arm's length, to avoid even the appearance of a conflict. While the New York Fed's rules do not prevent its president from holding such one-on-one meetings, that was not the general practice of Mr. Geithner's recent predecessors, said Ernest T. Patrikis, a former general counsel and chief operating officer at the New York Fed.

"Typically, there would be senior staff there to protect against disputes in the future as to the nature of the conversations," he said.

And at the same time, Geithner seems to have been an especially able advocate for Wall Street, both while at the New York Fed and as Secretary of the Treasury. The *Times* focuses on a few incidents where he took the banks' side against other regulators, such as the debate over adopting Basel II, which essentially allowed banks to use their own risk models to determine how much capital they needed. And it should be undisputed that since taking over Treasury Geithner has taken positions that are generally friendly to the large banks (Public-Private Investment Program) or reflect a Wall Street-centered worldview that misreads public and political sentiment (AIG bonus fiasco). He has also continued to surround himself with people from Wall Street, including his chief of staff, the law firm that drafted the proposed legislation giving Treasury resolution authority for non-bank institutions, and the asset management firm handling Treasury's troubled assets. None of this is new, of course; Treasury has been hiring people from Wall Street for years. And that's precisely the point.

I don't know Tim Geithner. But I have no reason to believe he is corrupt. Instead, the simplest explanation of the *Times* article is that he has internalized a worldview in which Wall Street is the central pillar of the American economy, the health of the economy depends on the health of a few major Wall Street banks, the importance of those banks justifies virtually any measures to protect them in their current form, large taxpayer subsidies to banks (and to bankers) are a necessary cost of those measures - and anyone who doesn't understand these principles is a simple populist who just doesn't understand the way the world really works.

Returning to my initial theme, he got the cultural education that rich people get, except instead of just going to the Metropolitan Museum of Art and the Museum of Modern Art, he was educated in the culture of Wall Street. Just like an education in art history is a marker of class distinction that is used to perpetuate class distinction, an education in modern finance is a marker of distinction that sets off those who understand the true importance of Wall Street for the American economy. As long the powerful people in Washington, including the regulators who oversee the financial industry, share that worldview, Wall Street's power and ability to make money will be secure.

That is the importance of cultural capital.

Update: I'd like to recommend [this comment](#) by **former young Fed-er**, which inexplicably got caught in the spam filter for the last eighteen hours. Here are some excerpts:

I don't know Tim Geithner either, but I did used to work at the Fed at a very low level, but a level sufficient to grant access to those weekly briefings you see on his calendar, during which he would be briefed by the Fed's research economists. His thinking was definitely steeped in Wall Street kool-aid. He would often pose opinions generated by Wall Street economists and executives to the Fed's economists as a way of challenging their thinking and getting them to explain themselves. One got the sense that he spent an awful lot of time talking to Wall Street executives, but that was, after all, a big part of his job.

What is so shocking is that now, when the mess that is the current system has been exposed to him and everyone else, that his thinking doesn't seem to have changed at all. We were all surprised to varying degrees by the financial crisis (Roubini least, I guess) and many are now trying to rethink the system; Geithner still seems wedded to Wall Street's way, which is to say, "innovation", lending determined by the vagaries of the trading floor, big bonuses, and the whole misbegotten quantitative finance approach (i.e. everything, from incentives to risk and all the complexity of human relations, can be written on a napkin using greek letters and equals signs). . . .

The other thing I got from witnessing these meetings is that, in support of the cognitive capture theory (as opposed to the corruption theory), given that he was such a careful and deliberative thinker, he seemed to have a good deal of integrity.

He respected people's opinions and considered them carefully, and he gave credit where it was due. He seemed to follow a Gandhian leadership philosophy: lead by walking behind.

By James Kwak

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Apr 27, 2009 7:06 AM

[Larry Summers' New Model](#)

by Simon Johnson

Larry Summers [spoke on Friday afternoon](#) at the InterAmerican Development Bank in Washington DC. As he was addressing a group with much experience living through and dealing professionally as economists with major crises, he spoke the “language of economics” (as he called it) and largely cut to the analytical chase.

Summers made five points that reveal a great deal about his personal thinking - and the structure of thought that lies behind most of what the Administration is doing vis-a-vis the crisis. Some of this we knew or guessed at before, but it was still the clearest articulation I have seen.

1. All crises must end. The “self-equilibrating” nature of the economy will ultimately prevail, although that may take massive one-off government actions. Such a crisis happens only “three or four times” per century, so taking on huge amounts of government debt is fine; implicitly, we will grow out of that debt burden.
2. We will get out of the crisis by encouraging exactly the kind of behaviors that “previously we wanted to discourage” two years ago. It is “this insight, this view” particularly with regard to leverage (overborrowing, to you and me) that “undergirds the policy program in the United States.”
3. There is a critical need to support financial intermediation and to ensure it is adequately capitalized, with a view to the risks inherent in the current situation. He then said, with a straight face, that the current bank stress tests are designed with this in mind.
4. Growth in the 1990s and more recently was based too much on finance (this appears to be a relatively new thought for Summers). The high and rising share of finance in corporate profits “should have been a warning”. The next expansion should be based less on asset bubbles and more on investment in key public services.

5. The financial regulatory system “in fundamental respects has been a failure”. There have been too many serious crises in the past 20 years (yes, this statement was somewhat at odds with the low frequency of major crises statement in point 1).

Crises definitely end. But do they end with rapid recovery or with stagnation? There was nothing in Summers speech that addressed how we avoid - at the US or global level - becoming more like Japan in the 1990s, given the state of consumers' and firms' balance sheets around the world. There is no issue with debt levels; apparently, we can turn everything around with fiscal expansion and support for banks.

The essence of the government's short-term strategy is obviously to prop up the financial sector, in order to sustain something close to the current levels of debt in the economy. But there was no hint in his remarks that this creates tension with point #4 - growth needs to be less finance-oriented in the future, i.e., talent has to be allocated elsewhere. If the rents are now government-generated but still in the financial sector, why would people or capital move?

And if enormous effort goes into sustaining the prosperity (and apparently the bonuses, according to first quarter set-asides) of Big Finance, how will that help with serious regulatory reform - which presumably will be opposed by the banks that are now regaining their fortunes? This thinking, put next to the [NYT article this morning](#) on Tim Geithner's work at the NY Fed, is not encouraging.

More generally, there was not even an indirect mention of political economy. Summers' public narrative for the crisis is essentially that there was an accident: stuff happens. This narrative matters. Irrespective of what he thinks privately, unless he and other senior Administration officials can start to use the language (even of economics) regarding regulatory capture, political connections, and the way in which economic booms can create disproportionate political influence for the finance sector, we are unlikely to change the structure of power and the risk of crisis in our economy.

You may not care too much about this - “let's first turn the corner and then worry about other things”, is a standard refrain. And for a recovery, obviously, much depends on actions that Summers and the White House can only indirectly influence - including the [Federal Reserve's push towards inflation](#) and the actions of European governments.

But deferring to big banks and preferring fiscal expansion is very much a decision in the hands of Treasury and the White House. They may feel this is essential to restoring confidence, but that is not the general experience of countries facing major crises. The usual advice - given by the [IMF, often at the behest of the US Treasury](#) - is: manage an insolvency process for failed banks, precisely to reduce fiscal costs now and in the future, and to help restore confidence in the economy. Come to think of it, wasn't this exact point made - forcefully and publicly - by Summers to the Japanese government during the 1990s?

Forbearance on banks may work, but at great cost to the taxpayer. And how is that helpful to either to Summers' stated strategy of growth led by further public investment, or - given the existing state of our public finances - to a more plausible strategy of (nonfinancial) technological innovation?

By Simon Johnson

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Apr 26, 2009 3:56 PM

[Guest Post: Too-Big-To-Fail and Three Other Narratives](#)

by James Kwak

This guest post is contributed by StatsGuy, one of our regular commenters. I invited him to write the post in response to [this comment](#), but regular readers are sure to have read many of his other contributions. There is a lot here, so I recommend making a cup of tea or coffee before starting to read.

In September, the first [Baseline Scenario](#) entered the scene with a frightening portrait of the world economy that focused on systemic risk, self-fulfilling speculative credit runs, and a massive liquidity shock that could rapidly travel globally and cause contagion even in places where economic fundamentals were strong.

Baseline identified the Fed's response to Lehman as a "dramatic and damaging reversal of policy", and offered major recommendations that focused on four basic efforts: FDIC insurance, a credible US backstop to major institutions, stimulus (combined with recapitalizing banks), and a housing stabilization plan.

Moral hazard was acknowledged, but not given center stage, with the following conclusion: "In a short-term crisis of this nature, moral hazard is not the preeminent concern. But we also agree that, in designing the financial system that emerges from the current situation, we should work from the premise that moral hazard will be important in regulated financial institutions."

Over time, and as the crisis has passed from an acute to a chronic phase, the focus of Baseline has increasingly shifted toward the problem of "Too Big To Fail". The arguments behind this narrative are laid out in several places: [Big and Small](#); [What Next for Banks](#); [Atlantic Article](#).

This argument has two components:

Moral hazard: Institutions that are too big to fail create systemic risk; thus the government *must* rescue them if they make bad bets. This creates asymmetric incentives (one-sided payoffs), which encourage them to make excessively risky bets, thereby encouraging the very systemic risk that regulators are trying to avoid. Governments cannot credibly threaten to let such banks fail because the results (e.g. Lehman) are catastrophic.

The Oligarchs: This argument is best laid out in the Atlantic piece, in a discussion of previous IMF efforts to restore countries to monetary balance:

Typically, these countries are in a desperate economic situation for one simple reason-the powerful elites within them overreached in good times and took too many risks. Emerging-market governments and their private-sector allies commonly form a tight-knit-and, most of the time, genteel-oligarchy, running the country rather like a profit-seeking company in which they are the controlling shareholders.

Although theoretically compelling, most of the evidence for this version of TBTF is indirect:

- Higher [concentration and profits in the banking industry](#): (note that the primary source of concentration is clearly M&A activity over 20 years).
- [Increasing share of the financial sector in world GDPs](#) and as a [percentage of US corporate profits and average wage](#) through 2006.
- The [Goldman Sachs mafia](#) (courtesy markets.aurelius).
- Various stories of insiders and whistleblowers who recount specific instances of perverse incentives that encouraged risky behavior.

Along with the explanations underlying Too-Big-To-Fail (TBTF) come certain policy prescriptions that have proven to be very controversial:

- a) Take over large insolvent banks (through temporary nationalization or FDIC receivership), sell off performing assets to smaller banks or investors, and break the bank into smaller pieces.
- b) If needed, employ anti-trust legislation to break apart healthy mega-banks
- c) Build an enduring system that prevents big banks from recreating themselves through M&A (mergers and acquisitions).

Challenges to Too-Big-To-Fail

Timing and Expedience

Is it really imperative to address TBTF first? Attacking banks in the middle of a crisis has high costs (remember Lehman). Would it not be better to wait until the credit/equity markets have fully stabilized and confidence has recovered, and then attack the problem in a quiet orderly manner when banks are not wielding a poison pill over the global economy?

This response to TBTF is rooted in the observation that what began as a financial crisis turned into a global panic, and then morphed into the most intense *global* recession in 70 years, which almost certainly would have become a depression without aggressive govt. response (capital injections, stimulus, base money expansion). TBTF may have been the *trigger*, but is not necessarily the most critical step to solving the current global crisis - and solving the financial crisis is critical to addressing multiple other crises (food, water, energy, environment) that were ignored for the past 15 years (and which were recently designated by the [National Intelligence Council](#) as threats to national security).

Some TBTF advocates answer that TBTF must be addressed immediately because the window of opportunity may soon shut as the political mood shifts (assuming the economy stabilizes) - see [here](#) and [here](#).

In response, the window does not seem that narrow. In a [March 26-29 poll](#), respondents primarily blamed banks and large corporations for the crisis, followed by President Bush (scroll down to see poll). This allocation of blame has been relatively consistent since last October. [Obama's poll numbers](#) seem to have dipped during the February thru March debacle (after Geithner's disastrous first speech), then recovered as the stock markets staged a rally. Recent in-depth polls showed that the public [continued to disapprove of Obama's handling of bank bailouts even as his overall ratings recovered](#). The public hates bank bailouts, but not as much as economic decline.

I would therefore argue that the primary order of business is stabilizing the economy. Everyone agrees that attacking TBTF will not be pretty, however - it will take many months to dismantle organizations with trillions of dollars in assets, and the costs of doing this quickly are enormous. (Consider the massive losses suffered in the accelerated AIG unwinds.) In the S&L crisis, the FSLIC and Resolution Trust Corp. did not fully dispose of S&L assets until 1995. The current crisis is worse, and the FDIC and Fed are facing limited organizational capacity. In the meantime, the big banks will not stand idly by.

Rather than attacking TBTF immediately, we may be better served by building a plan that can be implemented after stabilization is achieved. For instance, we might pass anti-lobbying legislation now (something that isn't likely to cause a collapse in the Dow Jones). Ideally, Team Obama is already building a plan, but if they were, the last thing they would do is announce it. For those who still hope the administration has resisted co-optation and corruption in spite of [recent revisions of Obama's anti-lobbying pledge](#), the Obama Team's strategy for GM & Chrysler suggests a road forward. The markets may be seeing this as well - as suggested by the recent divergence between bank stocks and CDS prices for bank debt (as SJ and JK note [here](#)).

Some TBTF advocates have raised a second justification for attacking TBTF immediately. They worry that the oligarchic bank lobby may sabotage or pervert other reforms, unless the oligarchs are first weakened, and they cite [intense lobbying efforts by banks](#). Reforms such as credit card billing rules seem to be passing at the moment, yet we have no assurance that the Obama Administration will remain able to push such reform through Congress in the future. The rejoinder to these worries is that the Obama Administration's ability to make future changes will depend on the status of the economy when those changes are sought, which begs the question: how critical is TBTF to securing a recovery?

In its strongest form, the case for attacking TBTF *right now* states that the economic crisis will not end unless we first deal with TBTF. In other words, TBTF is a root cause of the crisis (though not necessarily the only cause), and any short-term relief we might gain by temporarily accommodating big banks will only backfire in a few years. Although the balance of Baseline's posts suggests there are many causes, the Atlantic piece does identify the overreaching of elites as the "one simple reason" underlying the economic desperation of developing countries in crisis (which are then compared to the US).

The argument for fixing TBTF immediately to resolve the current crisis thus hinges on the importance of TBTF in causing the crisis. If TBTF is to become one of the dominant narratives behind this crisis, it must contest against other narratives. There are (at least) three groups of narratives that seem to be competing with TBTF.

Competing Narratives

Narrative 1: Systemic Risk

A massively leveraged and unregulated financial system is inherently vulnerable to shocks that rapidly get magnified. Perceived (or imagined) risks can create self-fulfilling outcomes, and such risks can be manufactured by large unregulated actors (e.g. hedge funds, which have been [immensely profitable](#) for investors over the last 15 years even counting the recent hit).

Moreover, tight coupling of global financial systems and economies causes shocks to transmit rapidly throughout the system, with limited fire-breaks. Contagion, once considered a low risk, can spread rapidly throughout sectors and then throughout the world. IMF report, [Figures 1.2 and 1.11 \(heat maps\)](#)

All of this is worsened by extreme leverage, which has been noted by many scholars (and [challenged by some](#)).

Systemic risk was further magnified by the utter elimination of sensible regulation at the behest of free-market ideologues, and indeed the active encouragement of policymakers to engage in risky behavior. Here is a [timeline](#).

In addition, systemic risk is intensified by pro-cyclical policy responses (easing of money in good times, and pro-cyclical factors like mark-to-market in combination with the capital-asset ratio constraints embodied in the Basel Accords).

And finally, systemic risk is massively intensified by the complexity of financial instruments (CDOs, CDSs) which allegedly increase liquidity and volatility (evidence for this is mixed; the [VIX volatility index declined through 2006](#) even as CDO usage intensified), exacerbate systemic linkages (IMF report, [Figures 2.1 and 2.6](#)), and decouple the financing/servicing aspects of loans that are usually married together in vertically integrated banks (both creating information barriers, and [making loan restructuring more difficult](#)).

In the Systemic Risk narrative, fixing TBTF plays an important role in solving the problem, but not the primary role. The systemic risk narrative suggests that stabilization can be achieved through other mechanisms (reinstating lapsed regulation, lowering overall leverage, reflate the non-debt money supply, better oversight of banks, etc.) Preserving these reforms against political challenges over time is difficult, however, and that is where TBTF becomes important.

Narrative 2: **Destruction of the Middle Class**

This narrative ascribes the root cause of the crisis to a long-term decline in middle class spending power; the recent financial crisis was merely the straw that broke the camel's back. The various causes are debated widely, but the [end result is clear](#).

Some versions of this narrative focus on [regressive shifts in tax policy](#) since the 1930s, or structural economic shifts that [reward higher education](#), or [CEO pay](#), or the [decline in union membership](#).

Perhaps the most popular version, however, focuses on massive trade imbalances due to unfair trade practices and/or trade with repressive foreign regimes. Unfairly cheap imports have resulted in the hollowing-out of the US economy, loss of real jobs making real things, decrease in labor bargaining power, declines in real median income, increases in US household debt in order to finance stable consumption levels, and a long-term decrease in spending power. The trade deficit data is indisputable: US current account deficit data is [here](#); China specific data is [here](#).

However, the link between international trade and “middle class decline” is heavily disputed (especially by neoliberal economists). Nonetheless, this narrative has begun to win some backing even among free trade elites. For example, Hank Paulson made it part of his mission to convince China to allow the Yuan to appreciate (to address the trade balance) when he became Treasury Secretary, but the world still remained dangerously addicted to US consumption which was largely financed by foreign debt. (45% of world net capital inflows went to the US in 2006)

The “Free-Trade” version of this narrative sometimes focuses on NAFTA, sometimes on China or other countries. It is generally inseparable from a similar narrative that focuses on Greedy (selfish, lazy) US Consumers who spent instead of saved, with the exception that the Free-Trade version blames foreign trade policy and the Greedy US Consumers version blames US consumers who [spend more than they earn](#). Yet the remedy to both is similar - decrease foreign imports, either through dollar devaluation (if you believe foreign economies are manipulating exchange rates and/or the dollar’s reserve currency status caused the dollar to be overvalued) or through trade barriers (if you believe repressive foreign regimes or foreign trade barriers caused the imbalance). Both methods force the US to supply its own consumption. Critics will point to the disastrous results of such policies in the Great Depression (Smoot-Hawley, etc.), particularly when implemented rapidly, globally, and during an economic downturn - so even if trade caused the problem, now might not be the best time to radically reduce imports.

TBTF plays only a limited role in the Middle Class Decline narrative (although the “oligarch” version of TBTF may argue that financial elites engineered the downfall of the middle class to suit their interests). Fixing the problems requires deep structural changes, which may require the eventual political expulsion of special interests (like the oligarchs). But again, this implies that the timing to attack TBTF is a key tactical question.

Narrative 3: **Irrational Exuberance** (Soft Money, Normal Business Cycle)

The Irrational Exuberance narrative was recently re-popularized by [Shiller’s book](#).

The essence of this narrative suggests that our brains are fundamentally wired to behave irrationally. Behavioral economists are rapidly assembling data to support this assertion. ([For example.](#))

When irrational exuberance takes hold, money becomes cheap as investors expect growth to persist. Consumers and businesses optimistically avail themselves of the cheap credit and increase leverage, until a shock crashes the system and everything reverses. Investors tighten credit, consumers and businesses turn pessimistic, and leverage causes bankruptcies that magnify the problem (just as soft money magnified the boom).

Bank managers have incentives to ride along with the cycle. When everyone else is earning more, bank managers who are “underperforming” are often punished. When the crash comes, managers are often forgiven since everyone else made the same mistakes. Both mass psychology and the competitive environment reinforce this dynamic.

In this narrative, it is hard to argue that bank size matters. Notably, many past financial crisis involved massive numbers of smaller banks, such as the [1930s Great Depression](#) and the [1980s S&L Crisis](#). Even in the current crisis, many [regional banks are also approaching insolvency](#).

Indeed, we can even cite circumstances in previous history where collusion by large banks has *prevented* financial crises from become depressions, such as [JP Morgan in 1907](#).

Importantly, there are two distinctive flavors of the Irrational Exuberance narrative - the Austrian version and the Keynesian version. They dramatically differ in their interpretation of government's role in causing, and solving, economic downturns.

The [Austrian School](#) (e.g. Hayek, Schumpeter, Von Mises) contend that bubbles are exacerbated by government activity (and especially by central banks and soft money policies, but also by government spending). According to advocates of this version of the narrative, deregulation did not cause the crisis, it merely happened at the same time. Irrational exuberance can't be stopped. Bubbles are the problem (made worse, or even caused, by government action), and the "fix" is depression and deflation.

The [Keynesians](#) identify the business cycle as a natural outcome of developed economies and capitalist "animal spirits" (alternatively, "spontaneous optimism"), but contend that the system is not self-stabilizing. Notably, business cycles can create credit collapses that cause deflation, and individually virtuous behavior (excess saving) can perpetuate deflation. The system requires an exogenous demand/credit source (like government) to restore equilibrium.

(At this point, I will abuse my role by noting a few interesting data points:

- Contrary to Austrian predictions, the [intensity of economic cycles in the US decreased substantially after WWII](#), when the govt. actively managed the business cycle.
- As Brad DeLong notes, the end of the gold standard marked the beginning of recovery for every major industrial power during the Great Depression ([chart on page 4](#)).
- As Paul Samuelson argues, every major US economic expansion died prematurely at the hands of the Fed ... This was before Alan Greenspan - a noted fan of Hayek - [facilitated and defended the greatest bubble in recent history](#).)

The Irrational Exuberance narrative is perhaps the least friendly to TBTF. Even the Austrian version identifies TBTF as a problem only because governments have powers they should not have. Remove those powers, and the world-wide depression will hastily fix TBTF. (Notably, this did not happen in the [Long Depression of 1873-1879](#), which was followed by an anemic recovery and the massive inequalities of the Gilded Age). In the Keynesian version of Irrational Exuberance, TBTF is only a problem if the [Lords of Finance](#) oppose the aggressive government action that is needed to restore growth.

So Where Does That Leave Us Now?

Your own favored response to the current economic downturn probably depends on which of the narratives above you find most convincing - Systemic Risk, Middle Class Decline, Irrational Exuberance, or Too-Big-To-Fail.

But of course, more than one narrative may be true, and some of these narratives reinforce each other. Combining Systemic Risk and Irrational Exuberance is particularly nasty, for example.

Interestingly, Too-Big-To-Fail synergizes well with the Systemic Risk narrative, and the Oligarchy version of TBTF plays well in the Middle Class Decline narrative. TBTF has a more diminished role in the various Irrational Exuberance narratives.

In the broader context, the Too-Big-To-Fail narrative seems like an upstart next to the other narratives, but it has a few things working in its favor. For one thing, it points the blame at a specific group of people, and Americans really want someone to blame for this crisis. TBTF also taps a populist/anti-elitist sentiment that harkens back to Teddy Roosevelt's battles against the Robber Barons.

My own objections to TBTF are primarily that TBTF is probably not the dominant cause of the crisis, that attacking TBTF right now could exacerbate the downturn, and that dismantling big banks will require additional measures to address unforeseen complexities (e.g. competing international big banks with lower cost of capital, reduced tools to implement US foreign policy). TBTF is undoubtedly a problem, but is it our most serious and immediate problem?

We are fortunate to have champions like Johnson, Hoenig, and others carrying the banner of Too-Big-To-Fail. Yet while I agree with Baseline Scenario that many other problems in this global crisis require quick action and overwhelming firepower, addressing TBTF requires deliberate and patient action.

I am confident this action can succeed over the long term (should the Obama Administration pursue it) for one primary reason - recent events have widely discredited the dominant paradigm of neoclassical economics. This paradigm, which arguably began with Milton Friedman and was propagated in the public sphere by well-funded think tanks, served as the intellectual artillery that allowed the Oligarchs to shred the laws and regulations that prevented excessive concentration and abuse of financial power. The willingness of respected economic scholars to step forth with new and pragmatic economic ideas is more encouraging than any single change in policy that I could imagine.

By StatsGuy

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Apr 26, 2009 9:55 AM

More Convergence of Views

by James Kwak

Yesterday I highlighted an op-ed written by [Desmond Lachman](#), a veteran of the IMF and Salomon Smith Barney (and currently at the American Enterprise Institute), comparing the United States and the current crisis to an emerging market crisis.

Saturday evening, Nicholas Brady, Secretary of the Treasury from the end of the Reagan administration through the entire Bush I administration, gave a [speech at the Institute of International Finance](#) - comparing the current crisis in the United States to an emerging market crisis, only in that case the banks were in the U.S. and the bad assets were in the emerging markets.

There are uncanny parallels between the situation we find ourselves in today and the one the Bush administration confronted a generation ago. . . . First of all there was a serious LDC [Least Developed Country] debt crisis. It's easy to forget that in 1988 our banking system was in dire straits because the commercial banks held billions of dollars of loans in countries whose economic prospects had ground to a halt.

The solution, according to Brady, was identifying the fundamental problems and forcing all parties to recognize them.

Among the indisputable points we laid out were that new money commitments had dried up in the past 12 months and that many banks were negotiating private sales of LDC paper at steep discounts while maintaining their claim on the countries that the loans were still worth 100 cents on the dollar. There were more, and they were equally sobering. We used these irrefutable facts as a starting point in all subsequent meetings. Our rule was that no suggestions were permitted to be discussed if they didn't accept the Truth Serum. They were off the table. Goodbye. Don't waste time. . . . [W]e persuaded the international commercial banks—at first with great difficulty—to write down the stated value of the loans on their books to something close to market value in exchange for that lesser amount of host-country bonds backed by U.S. zero-coupon Treasuries.

Although Brady does not subscribe to the capture thesis that we outline in the [Atlantic article](#), and is generally gentler on bankers than we are, his assessment of the financial industry is similar.

In broad strokes I would say that when I came to Wall Street in 1954, it was a profession, one that financed the building of this country's industrial capacity and infrastructure. Year by year, however, the industry's emphasis has moved away from that purpose and toward financial innovation for financial profit's sake. . . . [T]he U.S. Department of Commerce figures show that from 1980 to 1982, the financial sector accounted for an average of 9.1 percent of U.S. total corporate profits. By 2005 to 2007 that three-year average had more than tripled, to 28.6 percent. . . .

First we should just come out and say it: the financial system that led us to the brink of disaster is broken.

And despite spending his career on Wall Street, and doing a stint as Treasury Secretary, he ultimately argues that banking should be more boring than it is today.

I believe that we need a simpler system centered on deposit-based banks. Under this approach, individual accounts in the depository banks would continue to be protected up to \$250,000 and these banks would have access to the country's central bank. These institutions would not be allowed to participate in markets involving inordinate leverage or equity transactions that would risk their deposit-protecting charter. In contrast to the current mode, when asked what their primary purpose is, the banks' chief executives wouldn't talk first about shareholder return. Instead they would stand up and say: "Our institution's primary purpose is to repay the depositors' money." . . .

The highly innovative shadow banking system with its mantra of lower transaction costs, which would continue to introduce new concepts, would fund itself from the money markets and other sources but without federal guarantees and access to America's central bank. Institutions that currently straddle the two funding markets would have to choose which type of business to pursue.

This reinforces a theme that Simon has been sounding recently: the divide is not between left and right, but between people who want to preserve the current financial system in its basic outlines (a little more regulation, a little more disclosure, exchanges for derivatives, etc.) and people who think it must be dramatically reshaped.

By James Kwak

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Apr 25, 2009 7:24 PM

Guest Post: Too Many Cooks Spoil the Broth

by James Kwak

This post was written by my friend Ilya Podolyako, an occasional contributor here and a third-year student (though not for much longer!) at the Yale Law School.

In the last couple of days, a few disparate news pieces attracted my interest. First, as I mentioned in my last post on industrial policy, an accelerating, worldwide decrease in consumer disposable incomes is beginning to percolate through the manufacturing sector. As a result, [Caterpillar](#), DuPont, and United Technologies posted double-digit declines in sales. Second, reports surfaced that Fiat, Obama's designated buyer for Chrysler LLC, was looking instead to purchase GM's [Opel division](#). Third, Sen. Diane Feinstein (D-CA) introduced a "[cash-for-clunkers](#)" bill that would provide a credit of up to \$4500 toward the price of a fuel-efficient car for individuals or government-owned fleet operators who turn in a low-mpg "clunker."

What do all these data points have to do with each other? In my mind, they highlight the need for a structured approach to the U.S. industrial sector. The current policies are completely random and occasionally conflicting, which is not surprising, considering that they are coming from different branches of government who seem reluctant to talk to each other. For example, the purpose of the Feinstein bill seems to be to support the auto industry by lowering the effective price of a new car while also boosting aggregate fuel efficiency. Presumably, these measures would help the ailing American automakers transition from making money on SUVs to making money on hybrids. Yet in this context, a government-financed sale of Chrysler to Fiat doesn't make very much sense. If we are concerned about rescuing the American auto industry from the bottom up, why are we selling bits and pieces of this industry to foreign companies? Imagine if GM, Chrysler, and Ford did not exist – in this world, the government could surely find a [better way](#) of spending money to combat climate change than paying Toyota and Honda to chop 20% off the sale price of a new car. Just because other countries [do it](#), doesn't mean we should too.

Similarly, I am skeptical of the wisdom of helping Fiat buy Chrysler when it is also looking to buy Opel. Sergio Marchionne, Fiat's CEO, has openly stated that the company is looking to increase production volume and break into the US market. In fact, given Chrysler's persistent inability [to make cars profitably](#) (it has failed to do so as a standalone public company, a unit of DaimlerChrysler, and a privately owned entity), the company's main value lies in its U.S. dealer network. At the same time, Opel has designed several automobiles that had potential with the American public, such as the Sky roadster and Aura sedan. According to GM's 10K, Opel (which accounts for the bulk of the company's European operations) actually had an increase in both total sales and revenue from 2006 to 2007. Basically, the unit seems to be quite capable of functioning as a stand-alone,

profitable car company. There is thus a real possibility that if Fiat goes through with both the Chrysler and Opel acquisitions, it will end up selling Opels at Chrysler dealerships across America, where they would compete with whatever remains of the GM portfolio.

I don't support protectionist trade policies, but having US government pay for the above outcome seems like an unambiguously bad idea for everyone on this side of the Atlantic. To avoid the wealth transfer, Treasury could condition the promised \$6 billion loan on Fiat's promise to avoid certain follow-on acquisitions, but then the Chrysler sale may fall through altogether, exposing the fundamental instability of the Obama auto rescue plan.

Finally, an L-shaped recovery likely means more trouble ahead for industrial manufacturers outside of the automotive sector like GE or Caterpillar. If either of these companies nears insolvency, I doubt that the Obama administration would jump on the opportunity to help sell off their operations piecemeal to foreign buyers. In the optimal case, the government would just let the companies go through bankruptcy using private sector financing and scrutinize the purchasers of any sensitive assets for national security risk using [an existing apparatus](#). Considering that the auto bailout plan hasn't required GM or Chrysler to preserve any particular number of jobs, I just don't see why the Two-Out-of-the-Ex-Big-Three should be treated any differently.

The Administration's current approach to the industrial sector appears even more haphazard than its efforts to right the financial markets. The government is spending non-negligible amounts of money on dubious short-term goals that conflict with both the acute needs of certain demographics (auto workers, residents of Michigan) and the long-term interests of the American taxpayers. Federal agencies timidly pick up the tab for corporate liabilities like [pensions](#) without proportional claims to their profits. This behavior is the exact opposite of the type of directed industrial policy I suggested [could be worth trying](#).

By Ilya Podolyako

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Apr 24, 2009 10:19 PM

[Why Pay Tuition?](#)

by James Kwak

One of our goals here at The Baseline Scenario is to explain basic [economics, finance, and business concepts](#) and how they apply to the things you read about in the newspaper. I

think I'm pretty good at this. But if you prefer video and diagrams, I may have found something much better (thanks to a reader suggestion).

Salman Khan has created dozens of [YouTube videos](#) covering the basics of banking, finance, and the credit crisis. (There is also a [series on the Geithner Plan](#) that doesn't seem to be on the main index page yet.) I've only watched a few, but they are very clear and from what I can see everything looks accurate.

But what's really exciting is that he also has many, many more videos on math - from pre-algebra through linear algebra and differential equations - and physics. My wife and I watched the one on the chain rule and implicit differentiation and she gave it two thumbs up. (My wife is an economics and statistics professor.) So the next time you - or your child - needs to derive the quadratic formula, just head on over to his web site. Hours and hours of fun.

By James Kwak

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Apr 24, 2009 11:14 AM

[IMF Emerging Markets Veteran on the U.S.](#)

by James Kwak

One of the central themes of our [Atlantic article](#) was that the current crisis in the U.S. is very similar to the crises typically seen in emerging markets, and that resolving the crisis will require (some of) the measures often prescribed for emerging markets. This, Simon said, would be the assessment of IMF veterans who had worked on emerging markets crises.

At the exact same time that we were writing that article, [Desmond Lachman](#) - who worked at the IMF for 24 years, and then worked on emerging markets for Salomon Smith Barney for another seven years - was writing an article for the [Washington Post](#) saying many of the same things.* Here are the first three paragraphs:

Back in the spring of 1998, when Boris Yeltsin was still at Russia's helm, I led a group of global investors to Moscow to find out firsthand where the Russian economy was headed. My long career with the International Monetary Fund and on Wall Street had taken me to "emerging markets" throughout Asia, Eastern Europe and Latin America, and I thought I'd seen it all. Yet I still recall the shock

I felt at a meeting in Russia's dingy Ministry of Finance, where I finally realized how a handful of young oligarchs were bringing Russia's economy to ruin in the pursuit of their own selfish interests, despite the supposed brilliance of Anatoly Chubais, Russia's economic czar at the time.

At the time, I could not imagine that anything remotely similar could happen in the United States. Indeed, I shared the American conceit that most emerging-market nations had poorly developed institutions and would do well to emulate Washington and Wall Street. These days, though, I'm hardly so confident. Many economists and analysts are worrying that the United States might go the way of Japan, which suffered a "lost decade" after its own real estate market fell apart in the early 1990s. But I'm more concerned that the United States is coming to resemble Argentina, Russia and other so-called emerging markets, both in what led us to the crisis, and in how we're trying to fix it.

Over the past year, I've been getting Russia flashbacks as I witness the AIG debacle as well as the collapse of Bear Sterns and a host of other financial institutions. Much like the oligarchs did in Russia, a small group of traders and executives at onetime venerable institutions have brought the U.S. and global financial systems to their knees with their reckless risk-taking — with other people's money — for their personal gain.

And here's the conclusion:

In the twilight of my career, when I am hopefully wiser than before, I have come to regret how the IMF and the U.S. Treasury all too often lectured leaders in emerging markets on how to "get their house in order" — without the slightest thought that the United States might fare no better when facing a major economic crisis. Now, I fear time is running out for our own policymakers to mend their ways and offer real leadership to extricate the United States from its worst economic calamity since the 1930s. If we insist on improvising and not facing our real problems, we might soon lose our status as a country to be emulated and join the ranks of those nations we have patronized for so long.

Enjoy.

* For the record, the Atlantic article was finalized on March 17 and went up on the web on March 26; judging from the URL, it looks like Lachman's article went up on March 25.

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Apr 24, 2009 6:09 AM

[The Next Big Hearing? \(Bill Moyers Tonight\)](#)

by Simon Johnson

Bill Moyers asked me to join [his conversation](#) this week with [Michael Perino](#) - a law professor and expert on securities law - who is working on a detailed history of the 1932-33 "Pecora Hearings," which uncovered wrongdoing on Wall Street and laid the foundation for major legislation that reformed banking and the stock market.

My role was to talk about potential parallels between the situation in the early 1930s and today, and together we argued out whether the Pecora Hearings could or should be considered a model for today.

Bill has a great sense of timing. On Wednesday night [the Senate passed](#), by a vote of 92-4, a measure that would create an independent commission to investigate the causes of our current economic crisis; we taped our discussion on Thursday morning. In the usual format of Bill's show, a segment of this kind would be 20+ minutes, but I believe that tonight our conversation will occupy the full hour (airs at 9pm in most markets; available on the web from about 10pm).

Speaker Pelosi has also come out in favor of some sort of commission, so there is momentum ([and detailed negotiations](#)). But many big questions are still on the table, including: what should be the scope of an enquiry, will it have subpoena powers, and who will run it? And how exactly should we consider benchmarking this against the Pecora Hearings?

Popular anger during a major crisis is completely standard - I can't think of a country that has avoided this. Not many countries can control that emotion and channel it into a productive conversation. Even fewer can figure out how to turn that into meaningful legislation - let alone enforcement of new rules that make sense.

The US has the kind of democracy that could do this. But, as Michael Perino emphasized effectively, given the power of the big finance lobby (now and in the early 1930s), even we need to get lucky.

Perhaps we can tilt the odds slightly in our favor using one edge that was not available in 1932. Write up your suggestions for how to organize the hearings, questions to ask, witnesses to call, and more. Even better, provide the details - substantiated - of what went wrong, and make specific suggestions about the lines of enquiry to pursue. Put these in a comment here or, if you prefer, [The Hearing](#) on WashingtonPost.com - this is already starting to get the right kind of attention on Capitol Hill.

This is not a call to populism. This is a call for ideas that can constructively rebuild financial services in this country and, much more broadly, restructure our economy in sensible and sustainable ways. Ultimately, the Pecora Hearings had impact because they affected the country's debate - and because top leaders paid attention. Surely, we should aim for the same.

By Simon Johnson

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Apr 23, 2009 4:48 PM

[Fun Interview with Simon](#)

by James Kwak

I know Simon very well, so I'm not particularly impressed very often, but I think his [interview with Andrew Leonard](#) of Salon is a fun read, even if you're already familiar with his positions.

My favorite line?

What do we get out of the meta-financial crap? It's not so clear that we got useful things. Did our ATM fees come down? No.

By James Kwak

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Apr 23, 2009 7:29 AM

[Irreversible Errors](#)

by Simon Johnson

The Administration's top thinkers on banking regard themselves as [avoiding "irreversible errors"](#) - meaning precipitate moves on banking. They argue that "wait and see" may work

out and, if it doesn't, they can always take more dramatic action later (e.g., of [the Hoenig variety](#)).

Writing in the [NYT.com's Economix today](#), Peter Boone and I argue that this line of reasoning makes sense, but needs to be taken to its logical conclusion. Specifically, we should recognize that delay in banking crises almost always and pretty much everywhere leads to lower growth and higher fiscal costs - the price of eventual bailouts increases and the amount of fiscal stimulus required goes up. The jobs lost, the longer recovery, and the higher national debt are all costs that must be weighed in the balance. And that balance, in our view, indicates moving faster and in a more comprehensive manner in the direction [suggested by Thomas Hoenig](#) - a senior Federal Reserve official who has a great deal of experience dealing with insolvent banks.

We support much of what the Administration is doing. But their errors with regard to banking are creating irreversible damage.

In addition, we didn't have room in the NYT column to make an additional point. If you think the big banks are strong today, as they [increasingly defy the government](#), how easy do you think it will be to take actions against their interests down the road?

By Simon Johnson

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Apr 22, 2009 11:48 AM

[The Missed Opportunity](#)

by James Kwak

For a snapshot of what's wrong with our banking policy, look at the front page of the business section of today's New York Times. On the left side: "[U.S. in Standoff with Banks over Chrysler](#)." On the right side: "[Banks Show Clout on Legislation to Help Consumers](#)."

On the left side, a consortium of banks holding Chrysler debt is refusing to agree to the current restructuring plan, which involves bondholders holding \$6.9 billion in secured debt getting about 15 cents on the dollar - roughly where the bonds are currently trading, according to the Times.* The banks are playing the ongoing [game of chicken](#) with the government, betting that the government will cave and give them a better deal rather than take a risk on a bankruptcy.

On the right side, the banks are using their lobbying clout to block the administration's proposals to help consumers and households, including the mortgage cram-down provision (which would allow bankruptcy courts to modify mortgages on first homes) and added consumer protections for credit card customers. They currently have all 41 Republican votes in the Senate tied up, which means nothing can pass.

The banks leading the charge over Chrysler: JPMorgan Chase and Citigroup. The banks opposed to cram-downs: Bank of America, JPMorgan Chase and Wells Fargo. The banks blocking credit card protections: American Express, Bank of America, Capital One Financial, Citigroup, Discover Financial Services, and JPMorgan Chase. All or almost all are bailout beneficiaries. But don't blame them: they're just doing what they can to maximize their profits at the expense of the taxpayer, which is perfectly legal (and even ethical, depending on your conception of shareholder rights). Instead, you should be wondering why they are in a position to be maximizing profits at the taxpayer's expense.

If you're Tim Geithner or Barack Obama, you're probably thinking that now would be a nice time to have a controlling interest in these banks so they would stop blocking your efforts to help the rest of the economy. But the government has consistently bent over backward to avoid gaining control over the banks. It began with Henry Paulson (Bush administration) taking non-convertible, non-voting preferred shares last October; it continued with the [Citigroup](#) and [Bank of America](#) bailouts in November and January (during the transition period), in which the banks got underpriced asset insurance in exchange for more non-voting shares; and it peaked in the [third Citigroup bailout](#) in February, when the Obama administration insisted on forcing other investors to convert preferred shares into common, precisely to avoid getting a majority stake.

If the government had simply accepted the ordinary consequences of its actions - majority ownership - it would at least not have to plead for favors from Citigroup and Bank of America, who desperately needed help on any terms the government chose to dictate. Arguably JPMorgan and Wells are in a different situation, since the government was never in a position to buy a majority stake, and they are claiming they only took TARP money as an act of patriotic solidarity. But leaving aside TARP capital, the government has gone to extraordinary lengths to protect the financial system - guarantees on money market funds, increased guarantees on deposits, guarantees on bank debt, massive programs to lend against or purchase securities, not to mention the AIG bailout conduit - without which none of these banks would be in a position to make a profit. Yet it has left the banks in a position to capture the entire surplus from its actions, without getting the kind of concessions that would come in handy now.

Now, there is an ideological position that says that the government should stay out of the private sector, even to the point of making it more difficult for that very same government to achieve its legitimate policy objectives. This is a coherent position, though not one I agree with; it's basically the "keep government weak" philosophy. I would just be surprised to hear that Geithner and Obama are in that camp.

By James Kwak

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Apr 22, 2009 6:18 AM

[The Missing Witness](#)

by Simon Johnson

Yesterday's [JEC Hearing on Too Big To Fail](#) did not include any financial industry representatives. This surprised me - surely they want to go public with their views on the future structure of the financial system? Obviously, they have great behind-the-doors access on Capitol Hill, but surely it is not in their interest to have right, left, and center piling on with regard to breaking up Big Finance? Yesterday, Thomas Hoenig, Joseph Stiglitz, and I were [in complete agreement](#) on this point, and my idea of using antitrust measures against major banks seemed to gain traction during and after the hearing.

Apparently, the committee invited a number of leading people from the industry (i.e., individuals who generally articulate the case for big banks) and they were all too busy to attend (**Update: this statement is incorrect; the potential witnesses who were unable to attend are academics**). This is a curious coincidence, because someone else - in an unrelated initiative - has been trying to set up a discussion involving me and people from the Financial Services Roundtable and/or the American Bankers Association, to be held at the National Press Club, but their calendars are completely full (i.e., there is literally no day that works for them, ever).

There has been some counterargument - e.g., against our Atlantic article on American oligarchs - from people who wish to defend the way that big finance currently works, but so far this has been quite limited in the public domain. The most pushback so far probably came from [Carlos Gutierrez](#) (Commerce Secretary, 2005-09), who argued Monday on CNBC that our argument is "somewhat sensationalist" and that it would lead to a wholesale and unproductive assault by government on the finance industry (i.e., an application of the [Economics of Vilification](#)).

But of course our argument, both in the Atlantic and more broadly, is not against finance per se. In fact, we've received some strong expressions of support from within the financial sector - just not particularly from firms that are Too Big To Fail - as well as from many in the risk-taking entrepreneurial sector. And here Thomas Hoenig - President of the Kansas City Fed, with long experience regulating, winding down, and generally overseeing banks; and very far from being a sensationalist - absolutely nailed it towards the

end of yesterday's hearing. My recollection of his exact wording is: whenever you have banks that are too big to fail, you will get oligarchs (yes, he said oligarchs).

Perhaps Mr Gutierrez and Mr Hoenig can be brought together in some form of public discussion?

Update (4/22, 8pm): No finance industry representatives were invited to the JEC hearing.

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Apr 21, 2009 5:17 PM

[A View from the Inside](#)

by James Kwak

If you haven't picked up on one of the dozens of recommendations from other blogs, I recommend reading Phillip Swagel's [long and detailed account](#) of the view of the financial crisis from his seat as assistant secretary for economic policy at the Treasury Department. It's particularly useful for people like me who make a habit of criticizing government officials.

The writing is dry, but much of the subject matter is fascinating. It often explains or defends Treasury's actions during the crisis, but Swagel certainly owns up to plenty of mistakes or shortcomings. For example, discussing the emergency guarantee program for money market funds, he writes, "Nearly every Treasury action there was some side effect or consequence that we had not expected or foreseen only imperfectly."

The main impressions I get from the paper, good and bad, are:

- Treasury had a fair number smart, skilled people who used a lot of detailed economic analysis in coming up with and vetting ideas. For example, it turns out they actually analyzed Feldstein's proposal to offer government loans at low interest rates but with the ability for the government to use tax liens to get its money back. (They decided it was politically infeasible.)
- They were more aware about the impending crisis, earlier, than most people would think. When he arrived in 2006, Paulson apparently expected a financial system shock because market conditions had been too easy for too long.
- However, they consistently and seriously underestimated the magnitude of the crisis at just about every step along the way. For example:

The prediction we made at an interagency meeting in May 2007 was that we were nearing the worst of it in terms of foreclosure starts— these would remain elevated as the slowing economy played a role and the inventory of foreclosed homes would build throughout 2007, but that the foreclosure problem would subside after a peak in 2008.

What we missed was that the regressions did not use information on the quality of the underwriting of subprime mortgages in 2005, 2006, and 2007. This was something pointed out by staff from the Federal Deposit Insurance Corporation (FDIC), who had already (correctly) pointed out that the situation in housing was bad and getting worse and would have important implications for the banking system and the broader economy.

- Bureaucratic and political constraints matter a lot, and can either prevent solutions from happening, or can produce suboptimal solutions. This is probably Swagel's main point. He has a long discussion of competing proposals for mortgage modification, and how the parties in the debate - and the media - got confused about whether the proposals were benefiting homeowners or banks. Politics can also intervene much more bluntly:

the use of the TARP to support the automobile companies was straightforwardly political: Congress did not appear to want to take on the burden of writing these checks, and President Bush did not want his administration to end with the firms' bankruptcies.

Swagel provides insight into how and why things happened the way they did inside Treasury, but at times he doesn't seem much happier about the outcomes than those of us on the outside. For example, his assessment of the second Citigroup bailout in November 2008 is similar to mine:

The transaction, it turned out, did not appear to stabilize Citigroup. This could have reflected a number of reasons including that the pool of covered assets was still modest compare to a balance sheet of nearly \$2 trillion, that Treasury did not provide details of the assets within the ring fence, and perhaps because many market participants saw the firm as deeply insolvent.

A key insight, however, is that under pricing insurance coverage is economically similar to overpaying for assets—but it turns out to be far less transparent. This insight underpins both the TALF and the bank rescue programs announced by the Obama administration in March 2009.

Ultimately Swagel almost reads like a critic of administration policy (under both administrations). In his playbook for dealing with a banking crisis, the first point is: "Winnow the banking system by putting out of business insolvent institutions (including through nationalization where a buyer is not at hand). The key is to avoid supporting

zombie firms that squander resources and clog credit channels.” However, he says, this has not happened: “the furor [over PNC's acquisition of National City] revealed that there was no prospect for putting out of business a large number of banks.” Instead:

TARP support for unsustainable firms is akin to burning public money while industry stakeholders arrive at a sustainable long-term arrangement. This appears to be the American approach to systemically significant “zombie” firms—to use public resources to cushion their dissolution and restructuring.

Swagel, I’m sure, would say that I don’t appreciate the importance of political constraints on policy. Fair enough. But it’s not clear that he would disagree with me on what policy should be.

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Apr 21, 2009 6:43 AM

[Two Hearings On Banks Today](#)

by Simon Johnson

This morning, by coincidence, there are parallel hearings on Capitol Hill dealing with the nature of our banking system and attempts to stabilize it. In the Cannon House Office Building, starting at 9:30am, the Joint Economic Committee will hear from Thomas Hoenig, Joseph Stiglitz, and me, on whether Big Finance is too big to save (see yesterday’s [preview](#) for details).

At 10am over on the Senate side ([Dirksen Senate Office Building](#)), Secretary Geithner will appear before the TARP Congressional Oversight Panel. We preview that event [this morning on The Hearing](#), with a discussion of the context, the latest numbers, and our forecast of the ideas that will be expressed; it’s a viewer’s guide - but one that you can talk to by sending in comments (and, most important, your questions for the Secretary).

My questions for Secretary Geithner remain [about the same as they were on February 7th](#). As reflected in those questions, I continue to worry that the Administration’s “wait-and-see” strategy is just increasing the ultimate costs - in terms of financial losses and unemployment. No government ever likes to tackle a severe banking crisis head on (mostly because that would greatly upset the financial elite), but it’s almost always the right thing to do.

[I remain unconvinced](#) by the Treasury's line that "there is no alternative" to their approach. Or perhaps they are shifting towards the line that: "based on information that only the government has (and can have), it is our assessment that all other approaches would be more damaging."

If that is now their position, we have built a financial system that is immune to democracy - today's complexity and lack of transparency mean that it is easier than even to become too big to fail. The major banks now know this and will behave accordingly.

By Simon Johnson

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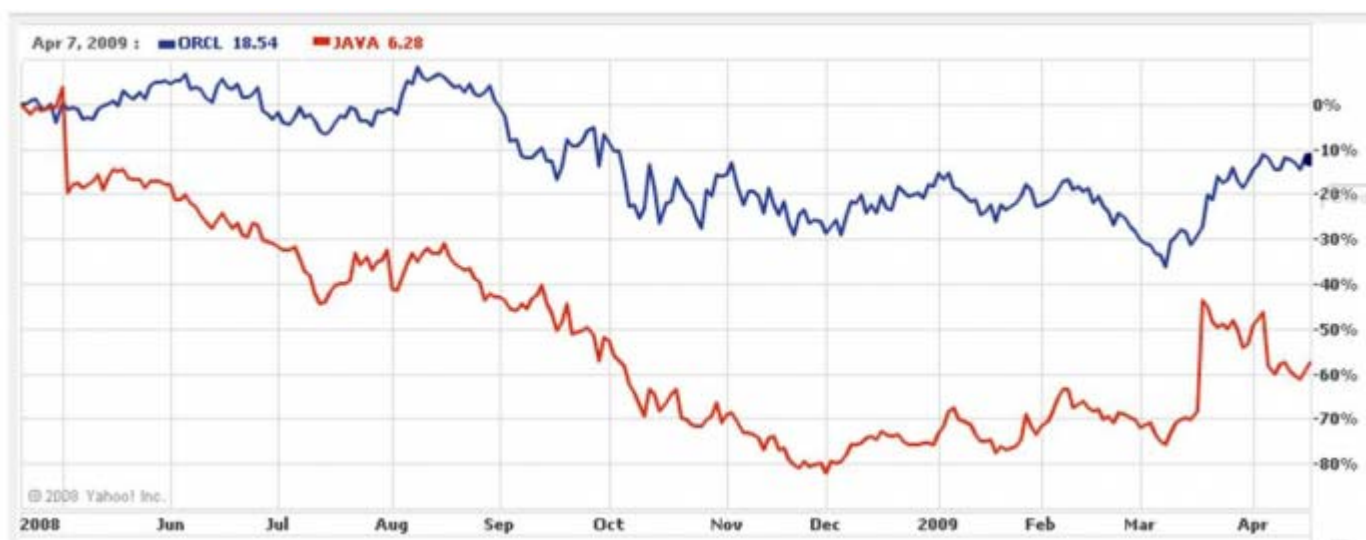
Apr 20, 2009 7:52 PM

[70% Off Sale!](#)

by James Kwak

There has been a fair amount of hand-wringing along Sand Hill Road in Menlo Park over the lack of "exits" - IPOs and acquisitions - for venture-backed technology companies. Given the way the stock market has behaved recently, it's pretty near impossible for a young technology company to go public. And the large technology companies that do most of the acquiring have been unusually quiet, presumably because they are watching their cash and avoiding risks given the global economic downturn.

However, there's one major reason why large technology companies should be buying:



Blue is the share price of Oracle; red is the price of Sun (the spike in March is Sun's merger negotiations with IBM). At some point, prices fall to the point where people start buying again. While the recession has hurt almost every company, it disproportionately hurts companies that do not have fat profit margins, hordes of repeat customers, and deep cash reserves that they can rely on in hard times. The result is huge changes in the relative values of companies, creating some once-in-a-generation bargains.

I don't think the [Oracle-Sun acquisition](#) is a sign of a bottom or anything dramatic like that. But it shows that at least some companies are doing what they should be doing.

By James Kwak

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Apr 20, 2009 9:35 AM

[Your Hearing: New Blog at WashingtonPost.com](#)

by Simon Johnson

Some readers have emphasized how the current economic and financial situation leaves them feeling powerless. Others complain that it's hard for outsiders even to understand the process through which ideas are debated and become policies - how Capitol Hill really works is a fascinating mystery at many levels.

This morning we're extending our efforts to address these issues with the launch of *The Hearing*, [a new blog at the Washington Post](#). James and I are the moderators and we'll focus the discussion around Congressional hearings - including the broader debates in which these are situated.

The Post has great impact in Washington and it's our hope that *The Hearing* will allow you to express ideas in ways and at a time that can have real effects on policies. For this reason, we'll preview public events and provide ways for you to suggest questions that need to be heard. At the very least, we can all learn more about what is happening and exactly why.

We're open to suggestion regarding the exact format, guest contributors, and generally how to make *The Hearing* more effective. We will, of course, keep BaselineScenario as our primary outlet for opinions and analysis - *The Hearing* is intended to be complementary, by bringing your voices into the specifics of idea flow through Congress. We'll tell you here when you should consider going to look there.

My first post deals with tomorrow's JEC hearing on "Is Big Finance Too Big To Save"? I preview what Joe Stiglitz and Thomas Hoenig are likely to say (based on their racing form), and I anticipate where the discussion will go - or at least where I will try to push it, as I'm on the panel also.

If you have points or questions you want raised, please post them here or on the Post's site. There's no guarantee your issues will be taken up, of course, but my guess is that this new forum will help sensible requests - of the kind often seen here - gain broader traction.

By Simon Johnson

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Apr 19, 2009 10:35 PM

[More Accounting Games](#)

by James Kwak

The [New York Times](#) is reporting that the administration is thinking of stretching its TARP funds further by converting its preferred shareholdings to common stock.

The change to common stock would not require the government to contribute any additional cash, but it could increase the capital of big banks by more than \$100 billion.

I hope this is one of those trial balloons they float and later think better of. Most importantly, it makes no sense. That is, there's nothing fundamentally wrong with converting preferred for common, but it doesn't create anything of value out of thin air. I wrote a long article about [preferred and common stock](#) a while back, but here are some of the highlights.

- If you don't give a bank any more money, it doesn't have any more money. By converting preferred into common, you haven't changed the chances of the bank going bankrupt, because its assets haven't changed, and its liabilities haven't changed. If it had enough money to cover its liabilities, but it couldn't buy back its preferred shares from Treasury, it's not like the government would have forced it into bankruptcy anyway.
- If you accept the idea that converting preferred into common creates new capital, then you are implying that those preferred shares weren't capital in the first place. From a capital perspective, then, the initial TARP "recapitalizations" did nothing, and nothing happens until the conversion. You can't say that JPMorgan got \$25 billion of capital last fall and it's going to get another \$25 billion now just by virtue of the conversion.
- Tangible common equity and Tier 1 capital are just two ways of *measuring* the health of a bank. Taking money that wasn't TCE and calling it TCE doesn't serve any economic purpose. There is a minor benefit to the bank because now it doesn't have to pay dividends on the preferred. But otherwise you've just shuffled together the claims of the last two groups of claimants - the preferred and the common shareholders. You've made things look better from the perspective of the common shareholders as a group, because they no longer have preferred shareholders standing in front of them, but the total amount available to all shareholders hasn't changed.

Is there another way to explain this even more simply?

Update: I made a mistake in interpretation last night. They aren't floating a possible strategy here; this is already what is going to happen. I forgot that the [Capital Assistance Program](#) already announced by Treasury - the mechanism for giving more capital to banks that need it after the stress tests - specifies the use of convertible preferred shares. So imagine you are a bank with \$5 billion in TARP capital already. You issue \$5 billion of convertible preferred under the CAP, use the proceeds to redeem the initial TARP, and then - if and when you choose - convert the convertible preferred into common. So the mechanism to do it is there already. I guess they are floating the spin to see if anyone believes this would actually make healthier banks.

Update 2: In case it wasn't clear from the above, I don't have any problem with converting preferred for common. I am probably mildly in favor of it, even, for roughly the same reasons as [Matt Yglesias](#): as a taxpayer, I'd rather have the upside and control that come with common shares.

By James Kwak

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Apr 19, 2009 7:01 PM

[Our Fate Is in Their Hands?](#)

by James Kwak

Last month, Representative John Shimkus spoke out against regulating carbon dioxide emissions on the grounds that [carbon dioxide is plant food](#). "So if we decrease the use of carbon dioxide, are we not taking away plant food from the atmosphere?" Shimkus is on the House Subcommittee on Energy and Environment, which means he has a vote on these issues.

In the wake of a financial and economic crisis of at least generational magnitude, our government will be rewriting the rules of the financial industry. And "our government" includes not just the pedigreed scholars in the executive branch (Larry Summers, Christina Romer, Austan Goolsbee, etc.), but Congressional representatives like John Shimkus - "like" in the sense that they were selected for their jobs, and for their committee seats, in exactly the same way that Shimkus ended up discussing the crucial role of fossil fuels in sustaining plant life on this planet. And when it comes to legislation, Summers, Romer, and Goolsbee have exactly zero votes between them; Shimkus has one.

Planet Money had an interesting interview a while back with [John Campbell](#), one of those people on the House Financial Services Committee. Campbell reminded me of a college student who's about to take a really hard math class, and knows he isn't a math whiz, but is fairly confident that if he studies hard he can probably figure out enough to do a decent job.

I'm not sure even in my own mind - if I were king - I'm not sure what I would do at this point and I don't think I'm alone in that viewpoint. This stuff is not easy; there are a number of different alternatives, a number of different thoughts on how to do it. . . .

One of the debates . . . is if it's too big to fail, can it be regulated enough that it won't fail. Maybe. I'm not sure. . . .

To me, it's an intellectual exercise, too, which I find very fascinating, and it's a problem-solving exercise, which I've always liked to do . . . I was in business. I was essentially a startup and turnaround guy. I went into businesses that were in trouble and tried to figure out how to turn them around. And so right now we now have an economy in trouble, and this is a little bit the same sort of thing on a much bigger scale. [Laughter.]

The first time I heard that interview, I was terrified.

Now I don't mean to be hard on Campbell. Few people sound as smart on a microphone as they do with the benefit of reflection and the backspace key (the writer's best friend), and to some extent he's just saying he has an open mind, which is a good thing. I didn't find Campbell particularly insightful, or particularly dumb. He just seemed like a normal, well-meaning, earnest guy.

But on reflection, maybe that's the way it should be. When it comes to our representatives, the point of our particular kind of democratic system isn't to select for expertise, or intelligence, or ability to understand policy issues. If it were, we should all be profoundly depressed, because it has obviously failed. The point is to ensure accountability, which means that the people making decisions have to answer to someone.

What alternative is there for redesigning our financial system? Imagine you instead entrusted the job to some committee of professional economists from Harvard, MIT, and all those other fancy places. How would you decide who would be on the committee? And do you really want a bunch of economists? Some people would want to include people from Wall Street; others would want to include people from other disciplines, like psychology and political science and history; others would want to include people from Main Street. Any group you managed to convene would be assaulted with charges of bias. And anyone who didn't like the outcome would claim he wasn't bound by its ultimate decisions.

Expert commissions have to have their work approved by Congress before it becomes law, because Congress, for all its imperfections, is the tool we've got for ensuring accountability and thereby creating political legitimacy. Which brings us back to John Campbell.

First, Congressmen do have staffers, many of whom are very knowledgeable about their areas of expertise, particularly when you get to the committee chairmen. They are getting all sorts of intellectually reputable input - from the executive department, from hearings, from think tanks, from the newspapers, and maybe even from the Internet. They are also getting input from their constituents, who presumably are representing their own legitimate interests. (Let's pretend we don't have problems of false consciousness for a moment so I can avoid a huge tangent.) At the same time, however, they are also getting

input from lobbyists and major campaign contributors. Ideally, we want them to make decisions that are in the best interests of their constituents and the country as a whole (probably in that order).

Ultimately, I think this means two things. First, the policy discourse - even when it deals with something complex like systemic financial regulation - has to be conducted in terms that a non-specialist Congressman can understand. Second, the process by which Congressmen gather information and make decisions has to be as transparent as possible. A policy debate conducted in the open, where the public understands the issues at stake and understands who is voting for which position and why, should be one where it is harder to reward major donors and special interests.

For the opposite, we need look no further than the Commodity Futures Modernization Act of 2000 - passed, unread by anyone except the lobbyists who drafted it, in the dying moments of the Clinton administration. And that bill was even sponsored by Phil Gramm, a onetime economics professor.

This is how I learned to live with John Campbell. This isn't particularly insightful to anyone who's thought about representative democracy, and I'm sure some of our readers will find it painfully naive. But I like to think that maybe there are people on the House Financial Services Committee who are secretly not so sure about the difference between preferred and common stock, and maybe they will read [Financial Services for Beginners](#), and maybe that will help them understand what's at stake so they can make an informed decision rather than just voting the way the lobbyists want them to vote.

By James Kwak

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Apr 19, 2009 3:33 PM

[New Day, New Bank, Worse Story](#)

by James Kwak

It's a beautiful day today, and after [Goldman](#) and [JPMorgan](#), I don't feel like diving deep into Citigroup's earnings release. But judging from the [Bloomberg article](#), it's a similar story, just not as good.

1. All the good news was in fixed income trading: \$4.7 billion in fixed income trading revenues; falling revenues in credit cards, consumer banking, and private client.

2. Assets continue to deteriorate: \$5.6 billion in new writedowns in trading accounts; \$3.1 billion in charge-offs and reserves for bad credit card debt.

3. Accounting fictions save the day (the new bit): \$0.6 billion in losses that don't have to be classified as other-than-temporary (and therefore affect the income statement) thanks to [FASB](#); \$2.5 billion in "profits" because of the fall in the value of Citigroup's own debt. The theory behind the latter is that Citi could go into the market and buy back all of its distressed debt, which would be cheaper than paying it off at 100 cents on the dollar. Also: \$0.4 billion in litigation expenses avoided (previously reserved) and tax benefits from an IRS audit.

Point 3 adds up to \$3.5 billion, which dwarfs Citi's \$1.6 billion profit. Why is everyone so optimistic about banks these days?

By James Kwak

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Apr 18, 2009 8:24 PM

[Financial Innovation for Beginners](#)

by James Kwak

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

[Kevin Drum](#) pointed me to [Ryan Avent's insightful review](#) of [Ben Bernanke's recent speech](#) on financial innovation. (How's that for the Internets in action?) Bernanke's brief was simple: to defend financial innovation in general while acknowledging that at the margin it can be counterproductive and may need to be more closely regulated. "I don't think anyone wants to go back to the 1970s," he said in a line that was clearly supposed to make his point. Unfortunately for Bernanke, Avent was listening closely. His rejoinder:

neither could Bernanke point to a truly helpful piece of financial innovation developed after that decade. His examples of successful financial products? Credit cards, for one, which date from the 1950s. Policies facilitating the flow of credit to lower income borrowers was another, for which he credited the Community Reinvestment Act of 1977. And, of course, securitization and the secondary mortgage markets developed by Fannie Mae and Freddie Mac in...the 1970s.

With one exception:

Tasked with defending deregulation as a source of financial innovation, Bernanke reached for subprime lending.

This helped at least partially crystallize some thoughts I have had floating around about financial innovation for a while.

Where I come from (career-wise at least), innovation meant that you invented something that people wanted, or you figured out a cheaper way to make something that people wanted, or you figured out a way to improve something that people wanted. Think of the iPod, or floss with a thin coating that makes it slide between your teeth more easily, or those little plastic things that keep the tips of your shoelaces together. These are things that make our lives, in aggregate, unequivocally better.

Financial innovation, however, comes in two forms. There are financial innovations that make our lives easier. One is the automated teller machine (ATM). ATMs are great. They mean that you don't have to wait in line at bank teller windows or rearrange your schedule to go to the bank when it is open, and most importantly you can get cash at any hour if you need it . . . almost anywhere in the world. I would pay real cash money to use ATMs if I had to (and occasionally I do, if it's not at my bank). Another example is the debit card, which saves me the trouble of dealing with cash altogether. There are corporate versions of these innovations, like corporate purchasing cards, which help automate the process by which employees buy stuff for their companies and get reimbursed for it. These types of innovations increase the quality of service and reduce costs - it's hard to argue with that.

The other kind of financial innovation has to do with extending access to credit. Here I think it's less clear that innovation is unequivocally good.

It is certainly possible for a society to be below the optimal level of access to credit. Consider the idyllic banking paradise that gets mentioned a lot these days, in which people deposited their savings with local banks which, in turn, lent money out to trustworthy local homebuyers and held onto those mortgages to maturity. The good thing about this model is it encouraged responsible underwriting. The bad thing is that it isn't very good at moving capital (money) from one part of the country to the other. Imagine in Iowa no one needs a mortgage, so the banks have no place to lend and can only pay their depositors 0.1% interest. In Florida lots of people need mortgages, so the banks offer 4% on savings accounts, but they still can't attract enough cash and people who would buy houses can't. (Or, alternatively, people who would take out loans to expand their businesses can't.)

Securitization is one innovation that helped overcome this problem and increased access to credit, and I think securitization on balance is a good thing. But it's not in the same category as the iPod, or better floss, or better shoelaces, which are things that make people's lives better directly. Securitization is something that increases access to credit, which may or may not be good, depending on the context.

The effect of securitization should be to moderate differences in interest rates - mortgage rates can come down as money moves into Florida, but they may go up as money leaves Iowa - and perhaps to lower them overall by making more money available to the market as a whole. If we were in a situation where too few people were getting mortgages, this is a good thing. But it is also possible for too many people to be getting mortgages, as we now know. Something similar happened with venture capital and startups over the last fifteen years. After the IPO rush of the late 1990s, billions of dollars of new money piled into the VC industry; that money flowed to thousands of companies that should never have gotten funded, resulting in lost money for investors and lost time and effort for thousands of generally bright and well-meaning entrepreneurs. Even credit cards - which I think most people would say are on balance a good thing, and which I personally use multiple times almost every day - can sometimes be a bad thing: they can prompt people to make unwise purchases they might otherwise not have made, with negative consequences for themselves.

In short, financial innovations whose sole function is to increase access to credit do not in and of themselves make the world a better place. They can help by providing the credit that people need to make the world a better place, but they can also make it possible for people to do irrational and economically destructive things. So when people say that innovation is the source of all progress, that may be true - but not all types of innovation are equal.

You can stop reading here if you want; I've made my main point.

The story I've told so far is a little simplistic: real innovation is good, some financial innovation is good, but some financial innovation just pushes money around, which could be good or bad. What's simplistic is the clear line between "unequivocally good" and "double-edged" types of innovation; many innovations are double-edged to some degree.

Imagine we invented a new way to make a whole new class of light, strong, flexible, and cheap materials that made it possible to manufacture millions of different products more cheaply, vastly increasing the material wealth of middle-class households. Wait a second - we did that. They're called plastics. In the process, we accelerated the depletion of our natural resources including fossil fuels; we created an enormous amount of garbage that is now collecting in giant pools in the middle of our oceans; we poisoned our waterways; and we may be poisoning ourselves as toxins leach from our containers into our food.

The point of this caveat is that many innovations, even "real" innovations, can have negative aspects. (And if those negative aspects are externalities, they will not get incorporated into the aggregate societal decision to produce and consume the resulting products.) So it is never appropriate to say that innovation is always unequivocally good. Still, however, there is a difference between better shoelaces and option ARM mortgages - or between ATMs and option ARM mortgages. The former is a product or service that provides utility directly; the latter is a financial product that enables people to use their

money in ways they could not use it previously, with consequences that can be good or bad.

Update: That thing on the end of your shoelaces is called an “aglet.” Thanks to [Teotac](#). See also K Ackermann’s comment right before Teotac arguing from first principles why that thing must have a name. Now, the reason I thought of that example is I vaguely recall hearing in a TV show about someone who made a fortune by inventing those things. But I can’t remember if it was a fiction or nonfiction show.

Update 2: [Nemo](#) pointed out to me this brilliant Michael Kinsley [article on Avis](#). It’s only tangentially related, but still a fun read.

By James Kwak

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Apr 18, 2009 6:23 AM

[Who Had This Good Idea First? \(A Weekend Comment Competition\)](#)

by Simon Johnson

In early February, [James proposed](#) that bankers’ bonuses be paid out in “toxic assets” - after all, the industry was arguing that these would definitely rebound (“it’s just a liquidity problem”) and that their “true” value was substantially above current market value. The idea was well received by our readers but not so much by the banking or insurance industry.

Someone quickly pointed out that - back in December - Bloomberg reported [Credit Suisse would actually use a version](#) of the same idea. And, in the whirlwind of the fall, I now vaguely remember this same point coming up even earlier in some bigger discussion.

So in the spirit of proper attribution (also because a reader asked and I’d like to know the answer), here is our first ever weekend “comment competition”.

Who really originated this (very good) idea, either in private discourse or - easier to document - in a public comment, blog post, corporate document, or the like? We’d also welcome updates on where any form of this idea is being used in practice.

By Simon Johnson

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Apr 17, 2009 7:07 AM

[The Department Of Justice Is On Line Two](#)

by Simon Johnson

I don't generally overreact to news (from the [NYT this morning](#), on the AIG-Goldman connection that runs through Edward Liddy's stock ownership), but this has gone far enough.

Have we completely lost of sense of what is and is not a conflict of interest? Have we really built a system in which greed fully overshadows responsibility? Is it not time for a complete rethink of what constitutes acceptable executive behavior?

One of our country's leading corporate attorneys made a telling point to me on Wednesday night, "the only way to control executive behavior is to criminalize it," i.e., civil penalties do not change behavior - the prospect of jail time has to be on the table. His broader point was that [antitrust action can make a difference](#) in today's world, but only if this includes potential criminal charges.

The same NYT article reports the following official statement from AIG.

"A.I.G. is a large institution that engages in standard commercial activity with companies all over the world," Ms. Pretto said. "These activities are handled in the normal, day-to-day course of business and rarely, if ever, rise to the level of the C.E.O."

I have three specific comments on this.

1) Do not insult our intelligence. Either Mr Liddy is running the company or he is not. Of course a CEO doesn't handle every detail, but he/she sets the tone, the compensation, and - have we forgotten? - is responsible for what happens.

2) According to the NYT report, Mr Liddy has an apparent conflict of interest. Please answer these questions as simply and directly as possible, because otherwise they will be repeated indefinitely. When did Mr Liddy disclose this and to whom at the Federal Reserve Bank of New York (or to which other responsible government officials)? What did Hank Paulson, then Secretary of the Treasury and former CEO of Goldman Sachs, know and when did he know it?

3) If the Obama Administration thinks this is a storm in a tea cup, think again (I'm sure [Valerie Jarrett](#) gets this, but someone please check). Straws may or may not break camel's backs, but simple symbolic issues - that millions of people can understand and relate to - can bring major political damage in the midst of a broader, more complex economic fiasco.

Let me be very clear on my position vis-a-vis AIG-Goldman and the [broader Washington-Wall Street Corridor](#). I'm not saying that anyone has broken any laws, but rather that laws need to be changed. I'm not even saying that there have been transgressions against the prevailing code of ethics for executives and politicians - although surely we agree that this code needs to be dragged, kicking and screaming, into the 21st century.

I'm just saying that we have a problem - ultimately, with [the belief system that underpins how big finance behaves](#) - and we need to fix it.

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Apr 16, 2009 7:42 PM

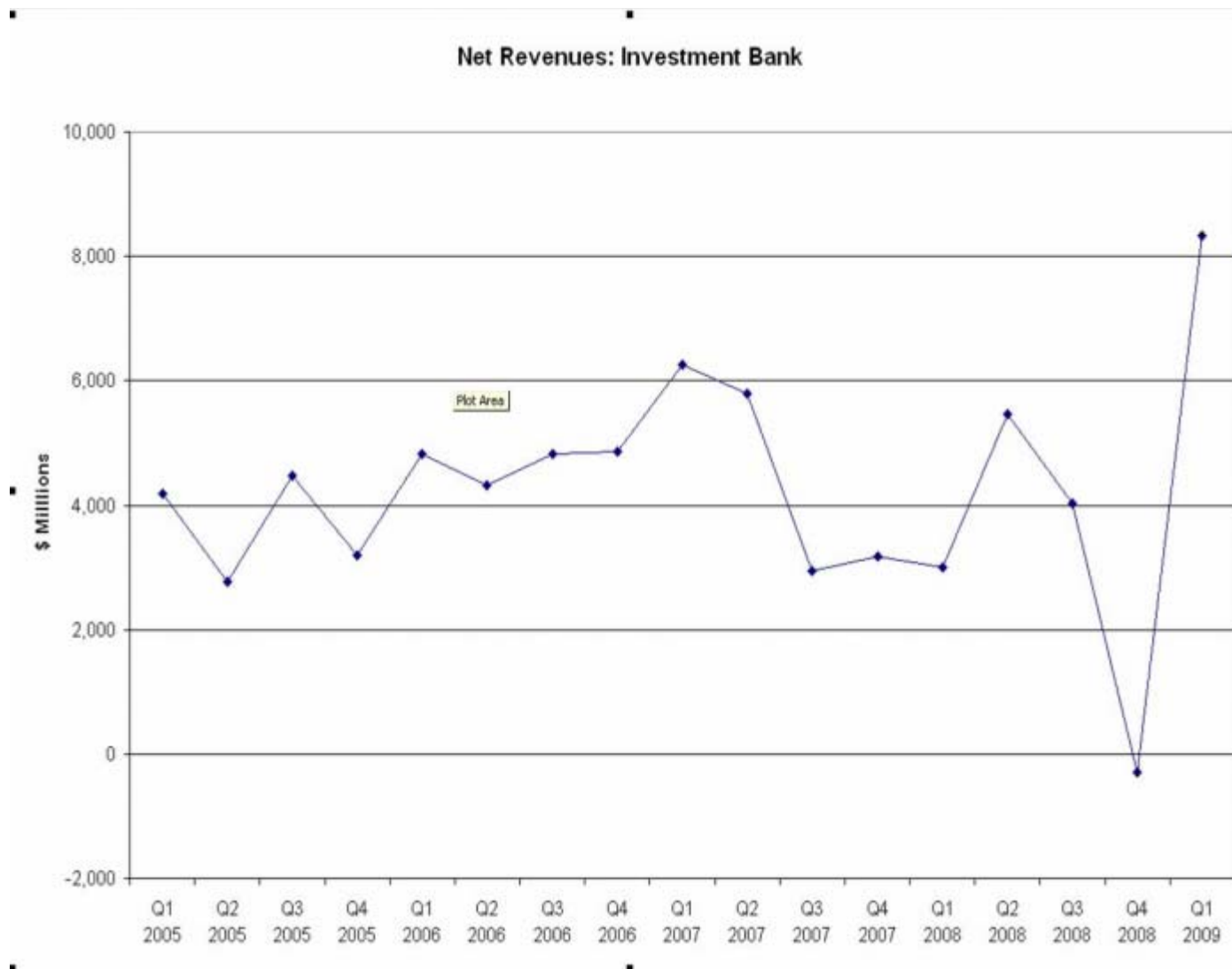
[New Day, New Bank, Same Story](#)

by James Kwak

JPMorgan Chase reported its quarterly earnings today. The [headline](#) was \$2.1 billion in net income, beating analysts' estimates. Behind the headlines, it was similar to the story that [Goldman](#) told earlier this week: a huge jump in fixed-income trading, status quo everywhere else, and continuing writedowns. For example, if you look at the breakdown of revenue by type of activity (not line of business) on page 4 of the [supplement](#), you'll see that revenue was flat or down in every category except one: principal transactions, where it jumped from a loss of \$7.9 billion to a gain of \$2.0 billion. That \$9.9 billion improvement more than explains the entire increase in pretax profit from negative \$1.3 billion to positive \$3.1 billion.

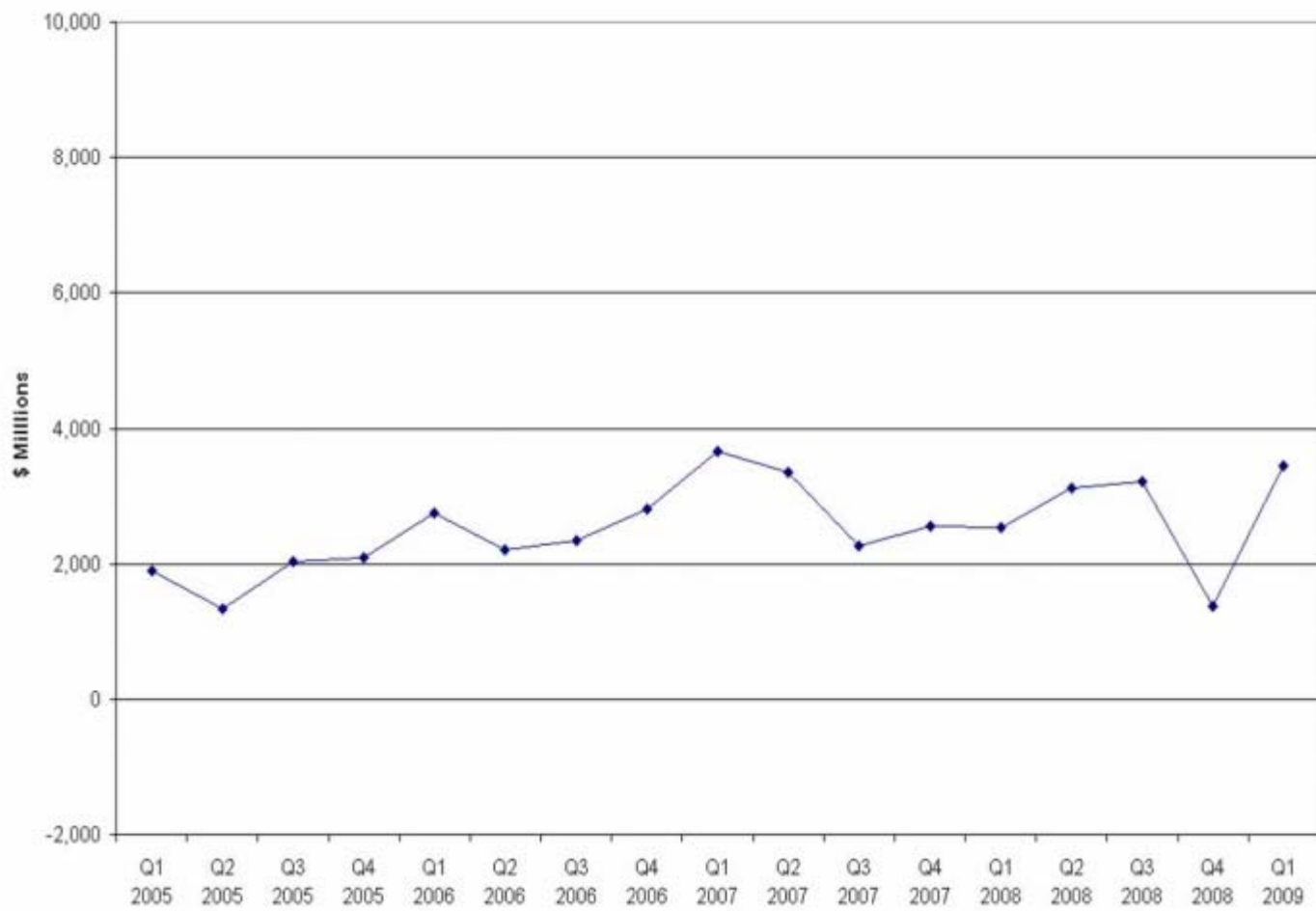
As with Goldman, it was clearly a good quarter for JPMorgan; making money beats losing money any day. But the question to ask is whether it is sustainable, either for JPMorgan or for the banking industry as a whole. To answer that question, here are some pictures.

First, if you look at the net revenues on a line-of-business basis (page 8), you see that virtually all the improvement came from investment banking, which improved from negative \$0.3 billion to positive \$8.3 billion. Here's that \$8.3 billion in historical perspective. (All the charts below are on the same scale.)

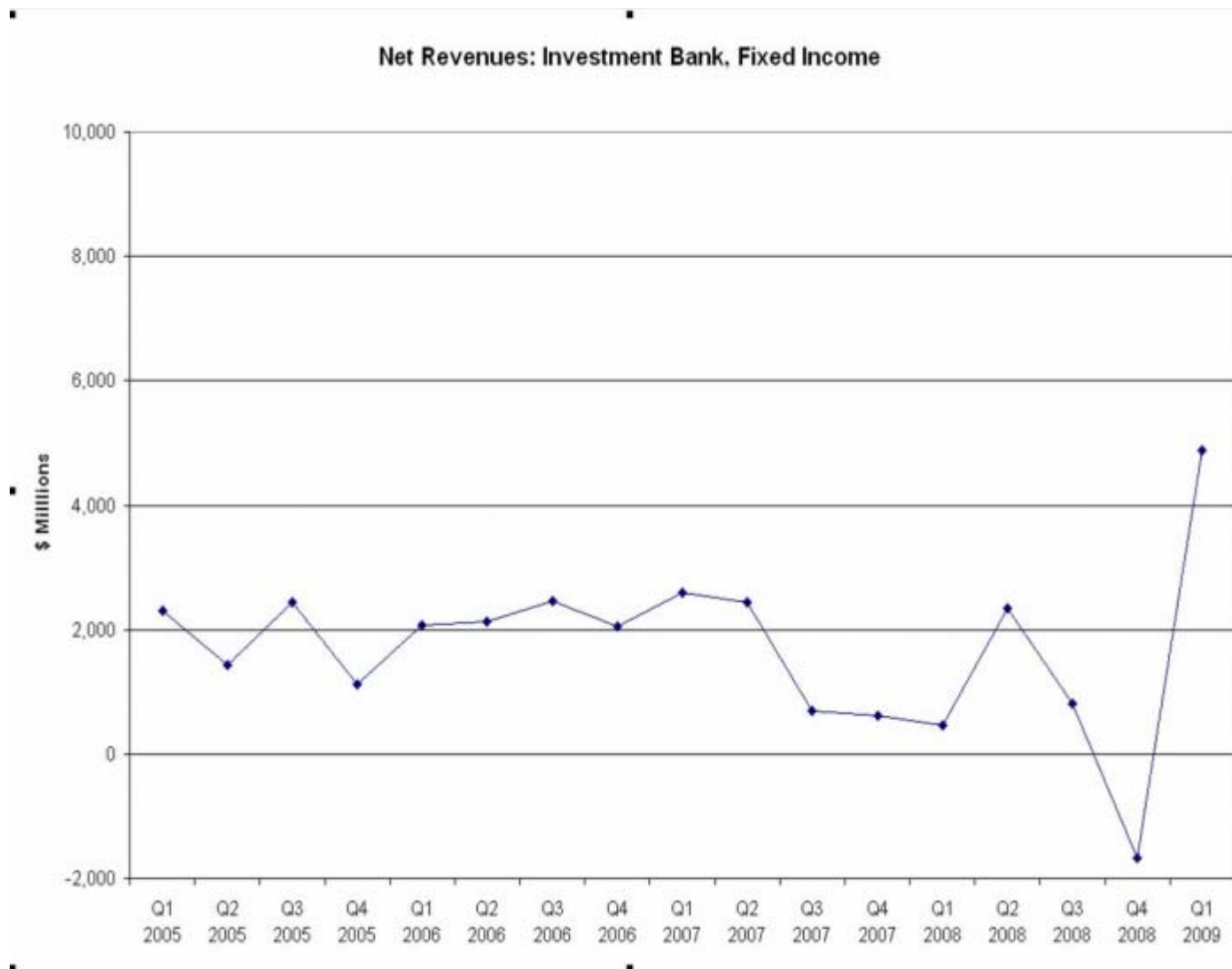


Now what was behind that super quarter? Here is the historical performance of all the investment banking business except fixed income trading:

Net Revenues: Investment Bank, Non-Fixed Income

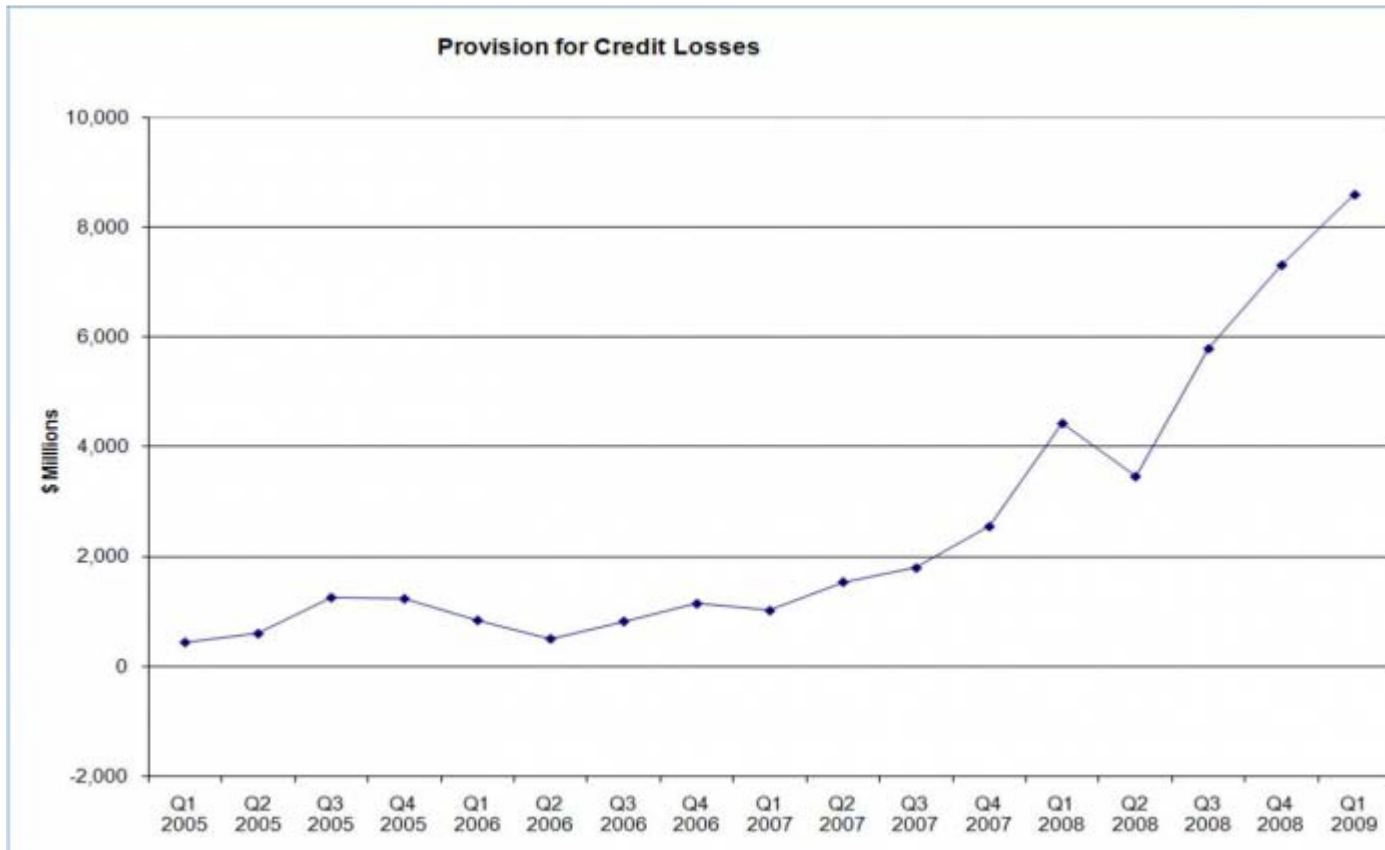


And here's fixed income trading:



So for JPMorgan to reproduce these results quarter after quarter, it would have to have unprecedented, exceptional, super-duper fixed income trading revenues quarter after quarter. Now, JPMorgan's prospects may be better than they were before the bust, since two major investment banks are gone, one of them absorbed into JPMorgan itself, meaning less competition and higher fees all around. But we also know that last quarter was a bit unusual because of the [massive unwind at AIG](#), which hopefully will not be repeated.

And here's the dark side of the story: quarterly provisions for credit losses.



Note that these are income statement figures, so they are *not* cumulative: these are the provisions set aside each quarter, which should reflect the quarterly *change* in expectations about credit losses (defaults). The question is whether these big investment banks can make enough money from trading and fees to make up for the money they are still losing on credit exposures.

Note: I got my data from the financial supplements on [this page](#). There's a small discrepancy in the Q1 2006 numbers, depending on whether you look at the Q1 2006 release or the Q1 2007 release. But it's only about \$100 million, so I didn't bother looking into it.

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Apr 16, 2009 4:44 PM

[Forecasting The Official Forecasts, Spring 2009 Edition](#)

by Simon Johnson

Our forecast of official growth [forecasts back in the fall](#) turned out to be fairly accurate. My update of this assessment - for the new IMF numbers due out next week - is [now online at NYT.com](#).

Many officials seem to have bought into some version of the “it’s a V!” take on the global recession. To me, this looks like [wishful thinking](#). Whether or not you support the “V” view fully, officials should surely be spending more time preparing for worse scenarios.

Just in case - why not prepare properly for the cross-border resolution issues that would arise from the failure of a major global bank? Why did the G20 decline to take on this issue properly? Even the IMF’s baseline, I expect, will suggest potentially serious problems ahead.

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Apr 16, 2009 6:40 AM

[Bring In The Antitrust Division \(On Banking\)](#)

by Simon Johnson

In early February I suggested [there was a showdown underway](#) between the US Treasury and the country’s largest banks. Treasury (with the Fed and other regulators) is responsible for the safety and soundness of the financial system, the banks are mostly looking out for their own executives, and the tension between these goals is - by now - quite evident.

As [we’ve been arguing](#) since the beginning of the year, saving the banking system - at reasonable cost to the taxpayer - implies standing up to the bankers. You can do this in various ways, through recapitalization if you are willing to commit more taxpayer money or pre-packaged bankruptcy if you want to try it with less, but any sensible way forward involves Treasury being tough on the biggest banks.

The Administration seems to prefer “forbearance”, meaning you just ignore the problem, hope the economy recovers anyway, and wait for time or global economic events to wash away banking insolvency concerns. But this strategy is increasingly being undermined by the banks themselves - their actions threaten financial system stability, will likely force even greater costs on the taxpayer, and demonstrate fundamentally anticompetitive practices that inflict massive financial damage on ordinary citizens.

As the [NYT reported yesterday](#), the Federal Reserve - on behalf of all bank supervisors - recently requested banks in no uncertain terms (1) not to reveal stress test results, (2) not to give other indications of their financial health, and (3) most of all, not to announce capital raising plans immediately. The point, of course, is to manage the flow of information so that plans can be made to help the weaker banks at the same time that the market realizes exactly who needs what kind of help.

Amazingly, the biggest banks are defying the federal authorities on this point, insisting on signalling their soundness and - in the case of Goldman Sachs - rushing to raise capital. In the case of Goldman, the explicit intention is to pay back TARP funds and to escape all government-imposed limitations on compensation. This would obviously be good for Goldman and the people who run it. Anything that strengthens their advantage over competitors and increases market share will presumably raise their profits and compensation, making it easier to attract even more good people. (See [my discussion with Terry Gross](#) yesterday for more on these dynamics.)

Such developments would worsen the business prospects of other large banks and potentially threaten their financial situation. The government's forbearance strategy is fragile unless big banks do as the supervisors tell them. But Goldman and other major players apparently think they have so much political power - and this may be more about connections on Capitol Hill than links with the Administration - that they can ignore the supervisors.

Treasury can try to refuse repayment of TARP funds, but Goldman would hardly have made its move unless repayment (particularly after announcing the intention) is essentially a done deal. Supervisors can send more assertive emails, but these are hardly likely to have any effect. The President himself can call on leading bankers to behave better, but [didn't he just do that](#) (and isn't that what [Valerie Jarrett is working hard on](#))?

My practical friends in the Administration like to emphasize that "we are where we are" and that we need to understand the limitations of the policy tools in hand and the realities of our political constraints. I completely agree.

The Department of Justice's Antitrust Division should be called in to investigate the increasing market share of major banks (remember that Bear Stearns and Lehman are gone), the anti-competitive practices of some market leaders (there's more than one predatory way to force your rivals into bankruptcy and to move closer to monopoly power), and the [broader increase in economic and political power](#) of the biggest financial services players over the past 20 years and the last 6 months - this is potentially damaging to all consumers and, obviously, to all taxpayers.

Think of the costs arising from the market power of major banks - and it is financial market power that makes them "too big to fail"; the FDIC has no trouble handling the failure and liquidation of small banks. We started this crisis with privately held government debt at around 40% of GDP. My baseline view is that we will end up closer to

80% of GDP. This means higher taxes for all of us, and this is absolutely not a “left vs. center” or “left vs. right” issue. This is left, right, and center against those parts of the center who insist that we should go back to having the same organizations, essentially unchanged compensation schemes (and all they imply about “Wall Street owns the upside and taxpayers own the downside”), and even more concentrated market power in our financial system.

Probably we need to modernize our thinking about the exact nature of threats arising from financial trusts. Perhaps we need, at some point, new legislation that reflects this thinking. But we can make a great deal of progress, here and right now, with appropriate enforcement of our existing antitrust laws.

The pushback, of course, will be: you can’t do this in the middle of a recession - it will slow the recovery. Honestly, as my colleague Mike Mussa [emphasized last week](#), banking is more likely to follow than lead the recovery; in fact, this is the exact logic that underpins the Administration’s forbearance strategy.

The goal of this antitrust action is to prevent some big banks from further destabilizing the system, hence reducing a serious downside risk. It’s also to limit the taxpayer costs arising from this crisis; for all major bank rescues, the cost is not just the bailout, it’s also the higher fiscal deficit, increased debt, taxes down the road and - given today’s predicament - the very real inflation risks arising from [even more monetary expansion](#). The overarching goal, of course, is to (re)build a more sustainable, sound, and - in all senses - competitive financial system.

By Simon Johnson

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Apr 15, 2009 1:15 PM

[Guest Post: A Closer Look at Industrial Policy](#)

by James Kwak

This guest post is by occasional contributor Ilya Podolyako, a third-year student at the Yale Law School and an executive editor of the Yale Journal on Regulation.

In my [last post](#), I compared Obama’s plan for the automakers to that of the Chinese government. I concluded that the two shared goals, but that these goals fit poorly into the traditional American ethos of free enterprise. For better or worse, the administration will

have to remedy this mismatch sometime soon, either by letting the automakers fail or by openly stating that jobs, national pride, and a green fleet justify a government-backed industry.

Some of the comments to that piece strongly favored the latter course of action. Accordingly, I think it is worthwhile to take a normative look at directed industrial policy generally. In the abstract sense, this system is the opposite of laissez-faire capitalism - the government owns enterprises and dictates both the nature and quantity of their output. This description naturally evokes images of the USSR, Cuba, or the People's Republic of China (before 1992), all countries with "command" economies. The distinctive characteristic of these nations, however, was not the presence of state-owned enterprises (SOEs) per se, but the absence of a legal, noticeable private sector.

Countries like Sweden, South Korea (before 1988), and, indeed, the modern China have demonstrated that directed industrial policy is not an all-or-nothing game.

The state can own some firms while the private sector owns others; these groups can compete in the same industry or service different sectors of the economy. Examples of the middle-ground approach also abound in developed economies: in Norway, the government owns over 60% percent of Statoil, the country's largest employer (now part of Statoil Hydro); in France, the government owns over 80% of the giant power company EDF; Germany, France, and Spain effectively control the management of the defense contractor EADS, despite the fact that 41% of the company's stock is publicly held; until 2006, the Republic of Ireland held 85% of the shares in Aer Lingus, the country's largest airline, a share that has since fallen to 25%; and Canada's government owns dozens of so-called [Crown Corporations](#). Of course, these statistics have lost much of their panache now that the US Treasury owns 80% of AIG, but the figures still show that (intentionally) state-owned industry is not altogether unusual.

That is not to say that SOEs are entirely benevolent. Over the years, economists have identified several key flaws. First, the absence of the profit motive, which often runs along with the guarantee of lifetime employment, removes incentives for employees to work hard. Second, the people involved in managing these conglomerates may retain their profit motive and act on it, even if the companies officially do not, leading to widespread corruption. Third, a company that decides what to produce based on official decree, not market demand information, will have an extremely difficult time determining the "right" amount of output. If said firm makes widgets, it will make either too many or too few widgets, creating waste in the first instance and shortages (assuming that the government regulates price) in the second.

A government committed to firing lazy workers, who could then fend for themselves in the remaining, robust private sector, would seem to be able to solve the first problem with SOEs. A robust criminal code that punishes corruption, when coupled with politically ambitious prosecutors, would probably mitigate the second. The third flaw, however, appears immutable, not merely because of societal momentum or even the laws of human

nature, but because mathematically, pricing information appears to be the only way to measure efficient output.

Where do the above observations leave us? Conventional wisdom argues strongly against government control of industry if this control leads to an outcome different than what the market would otherwise dictate (passive taxpayer ownership poses a somewhat different set of problems). Yet the last 24 months have forced everyone, including [old-guard](#), [free-market purists](#) in charge of the Fed to reexamine conventional wisdom. If the central bank can selectively lend to industries that appear to be failing in the open market, one would think that Treasury or the Department of Commerce could also selectively push certain industries to generate products that they believe would improve the national economy.

Such intervention could come in one of two forms. The government could try to dictate business strategy to firms that receive a substantial amount of bailout money, but as I explained before, this would amount to stacking an inefficient bureaucracy on top of a underperforming business. Alternatively, the President and Congress could fund brand-new entities that would lay high-speed rail, construct nuclear power plants, and build a modern national electric grid. These companies would be staffed with regular employees and managers who would have to answer directly to someone high up in the executive branch. They would also compete alongside their private sector peers, who could choose to provide variations on the basic product (like UPS or FedEx) or attempt to displace the basic product altogether (like private charter school operators).

Normally, this setup would raise concerns about “[crowding out](#)” private-sector capital or innovation, but this theory applies equally to indirect government spending, not just direct industrial participation. True, private firms may be reluctant to compete with organizations backed by “infinite” treasury pockets willing to absorb a loss, but this fear cant get much worse than it is now. Moreover, Congress could fix this problem by specifying early on that these new enterprises will have to shut down after posting 3 years’ worth of consecutive losses.

Here’s the crux: current strategies for economic recovery focus on stabilizing financial institutions and melting credit markets, but they fail to provide an internal engine of growth for the American economy. Theoretically, this growth should continue to come from private-sector innovation, but the private sector is in deep and worsening trouble.

According to the latest Fed report, consumers continue to be saddled with roughly as much revolving (non-mortgage, non-auto) debt as they were in Q2 of 2008. This debt load would have to decrease by 17% to get us back to 2004 levels, when an average household owed around \$6500 on their credit cards. At the current rate of revolving debt change, the adjustment would take at least two years, but this calculation does not account for the decrease in individuals’ personal income, which is falling at around 1.5-3% a year. A sharp decline in [domestic production](#) means that the US will also continue to be a net importer. These characteristics are part of the reason why the country got to where it is in the first place. Without a new strategy, it is unlikely that the ingenuity of a few individual entrepreneurs will be sufficient to pull us out of this depression.

Of course, the government shouldn't pick its areas of economic involvement arbitrarily. A smart policy would be to attack problems that the private sector has traditionally been unable to address (producing cars doesn't fall into this category). The new enterprises should first engage projects that suffer from free-rider and coordination issues which only a central authority can overcome - public works and infrastructure. No one wants to build the first mile of a road to a store if the guy at the other end can get its benefits for free. Next, the government should invest heavily in pharmaceutical, engineering, and biotech research, both at universities and newly invigorated national labs. Since anyone can build on fresh advances, basic science carries many of the same unpleasant investment characteristics as physical public goods.

The above programs aren't that far from the status quo. Congress already chartered Fannie and Freddie; the Pentagon already subsidizes an enormous defense sector. It is time, however, to try and change federal involvement in industry from covert efforts to promote opaque policy goals to thought-out measures designed to help firms and workers prosper. In the worst-case scenario, we privatize our way back to the present.

By Ilya Podolyako

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Apr 14, 2009 12:24 PM

[Is Goldman Really That Good?](#)

by James Kwak

Goldman Sachs released its [quarterly earnings](#) yesterday, and the headline was net income of \$1.8 billion, doubling analysts' estimates. I would say this is definitely good news for Goldman; whether it's good news for the banking sector as a whole is more uncertain.

First, as Bruce Wayne, one of our readers, pointed out, the quarter-over-quarter comparisons left out December. Because Goldman just changed its fiscal year end, its previous quarter ended in November and its latest quarter ended in March. December was reported separately and - surprise, surprise - Goldman took a net loss of \$0.8 billion. So if they had mashed December into Q1, they would have had a four-month "quarter" with \$1.0 billion in profits.

Second, the positive results probably reflect a better mix of businesses than other banks enjoy. Although Goldman has made big one-sided bets, its trading operation traditionally

hedged many of its positions and made a lot of its money on volume. Its positive Q1 results were largely due to strong performance in fixed income, currencies, and commodities (FICC) trading, which reflects the fact that Q1 was a busy quarter - in part because of the [massive unwind at AIG](#) - and, as [Goldman's CFO politely said](#), "Many of our traditional competitors have retreated from the marketplace." With fewer players in town, the oligopoly profits go up - another reason why the big banks are even more powerful than they were before the crisis.

When it comes to the value of its own investments, Goldman seems to have done less well. Its net revenues for principal investments, mainly "Other corporate and real estate gains and losses," were negative \$1.4 billion in Q1 and negative \$0.8 billion in December. While Goldman was able to more than offset this with trading gains, I wonder what the implication is for commercial banks that are not dominant players in trading.

(The [FT](#) also raised an eyebrow at the fact that per-employee compensation in Q1 was much higher than in the year-earlier period. That actually doesn't worry me, because I'm guessing those compensation expenses are bonus accruals - the better the quarter you have, the more money you have to set aside for year-end bonuses.)

By James Kwak

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Apr 14, 2009 10:41 AM

[Unions and Business](#)

by James Kwak

One of the themes of the GM debate goes like this. On the one hand, the UAW is the problem, because it's the high cost of union labor (and in particular, union retiree health benefits) that is crippling U.S. automakers. On the other hand, the UAW negotiated for those benefits fair and square, giving up higher current wages as part of the bargain, so it's the fault of management for making promises they couldn't keep. On the third hand, the UAW should have realized that when you negotiate for retirement benefits from a private corporation, one of the risks you take is that that corporation might go bankrupt. (For one example of these arguments, see [Room for Debate](#) at the NYT.)

Instead of touching that question any more than I already have, I wanted to raise the larger issue of whether unions are bad for business - which is what you would assume, given the lengths many companies go to in order to prevent unions from gaining collective

bargaining rights. In general, this is a hard question to answer empirically. While you can observe differences between companies with unions and companies without unions, there is a huge problem of selection bias: since companies with unions are unlike companies without unions in many ways, you can't say whether any differences in outcomes are due to the effect of the unions themselves, or due to the effect of other factors that would be there regardless of the unions.

John DiNardo and David Lee have an elegant way of getting around this problem in a 2004 paper, "[Economic Impacts of New Unionization on Private Sector Employers: 1984-2001](#)." (The real economists out there probably know this paper already.) Instead of comparing all companies with unions to all companies without unions, they focus on companies where the union certification vote either barely won or barely lost, since these two companies are very similar to each other except for the treatment effect (having collective bargaining rights). This isolates the effect of unionization from other characteristics of the companies in question. They find that unions that barely win an election are successful in obtaining a collective bargaining agreement. Otherwise, however, the effect of successful unionization is insignificant on the company: differences in wages, employment, productivity, and output are all insignificant.

The UAW, historically, is a special case which people can debate for as long as they want. But the evidence is that in recent decades unions are not dangerous to firm survival.

Update: I forgot to add a link to a [shorter summary](#) of the work.

By James Kwak

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Apr 13, 2009 11:08 AM

[The Bank Run Next Time \(Frankenstein's Monster\)](#)

by Simon Johnson

Think about the current and potential future pressure on our largest banks like this. The underlying problems are deep, but the "run" comes from the credit default swap market, and presumably from experienced professional investors - many of whom used to work in the largest banks.

The big banks helped set up these markets. They trained many of the people who are now engaged in speculative attacks on these banks. And the excessive bonuses of yesterday form the capital base for many hedge funds that now lead the attack.

In my [Economix column](#) at NYT.com this morning, I explore the ironies and emphasize the dangers. The system may have a tendency to self-destruct, but don't think that the costs to the rest of us will be anything less than huge.

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Apr 13, 2009 5:57 AM

[Calling All Shareholders](#)

by Simon Johnson

If you cast your mind back to when executive compensation and bonus limits [first reached the mainstream debate](#), you may recall people saying these would be ineffective and the issue is a red herring.

These points do not now seem compelling. People who work at the big banks are quite irked by what they see as unjustified limits on their bonuses. Some of the "talent" [is jumping ship](#). Big bank leadership is lobbying hard to remove the restrictions or, failing that, for the right to pay back government TARP funds in order to escape the bonus cap - leading firms, such as Goldman Sachs, seem poised to raise new capital to that end.

This is a remarkable moment. Excessive risk taking in large firms [was based on](#) inappropriate bonus structures (take risk and get compensated now; face the consequences of that risk down the road), facilitated by a deep failure to understand/control risk inside these organizations and probably made possible by the implicit put option from being too big or too complex to fail (i.e., Wall Street insiders own the upside; taxpayer owns the downside). We have all focused of late on the costs for taxpayers, which of course are horrible, and going forward - with the implicit option now explicit - who can believe this will lead to anything other than further massive bailouts?

But think about this arrangement from the perspective of shareholders. Are we looking at the greatest [tunneling scheme](#) in the history of organized finance?

How can the large banks persuade potential shareholders to put large amounts of new capital with them, given that their systems just failed massively, these systems have not

been substantially changed, and - while there has been a bailout for insiders and creditors - shareholders were largely wiped out from mid 2007-end 2008?

It could, of course, be the case that shareholders see great upside. Anything that has fallen greatly may see some rebound. The large banks have demonstrated their political muscle, so that should help with other forms of government protection and “rents” (economics jargon for easy money from business that others aren’t allowed into). In the early stages of a recovery, perhaps the banks will be more generous to their shareholders; it could be that the excessive tunneling is a feature of a mad boom, and we seem some distance from having another of those.

But probably we are looking at a deeper market failure. Big money managers - including mutual funds, pension funds and insurance companies - have [arguably failed in their fiduciary duty](#) to ensure that major financial companies are run properly and in the interest of shareholders. These money managers have great resources, many years of experience, and real power vis-a-vis the companies. Why didn’t they push for stronger risk management? Why are they so eager to hand over our money again? Where exactly was or is their due diligence?

Instead of shareholder activism being limited primarily to scrutiny of companies (where it often seems to bounce off, particularly if it comes solely from small investors), it should probably be focused more intensely on money managers, including why they are not more effective at limiting the bonus culture of big finance. Is this about their own bonus culture or their connections with the firms in which they are investing or something else? In particular, allowing large banks to also be major money managers creates serious potential conflicts of interest at many levels.

There is discussion of encouraging people to move deposits away from big banks with a pattern of bad behavior. But some of the most powerful banks rely relatively little on retail funding. More effective could be reassessing the practices of debt and equity investment funds, and placing money only with those that are beyond reproach.

It may be that the behavior of these money managers cannot be corrected through the actions of their small investors acting directly or through their employers (after all, our employers should have bargaining power over the funds that manage pension money). If we can’t sort this out through pressure, negotiation, and the market, perhaps money managers themselves should be subject to [more specific legislation](#), implying greater regulation and sensible controls on their fee structure and strict caps on their own bonuses?

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Apr 11, 2009 9:45 PM

\$3.5 Million or \$5 Million?

by James Kwak

In the midst of a severe economic crisis that is, among other things, depressing federal tax revenues and adding to the national debt, the [debate over the estate tax](#) has flared up again. The basic question is whether the exemption will be raised from \$1 million - where it was in 2002-03 and where it is scheduled to return after the Bush tax cuts expire - to \$3.5 million (Obama) or \$5 million (Lincoln-Kyl) per person; there is also disagreement over whether the marginal rate should be 35% or 45%. (Note that even with Obama's proposed 45% tax rate, the [average effective tax](#) rate on estate would be 19%, because of the \$3.5 million exemption.)

There is plenty of debate over this already, so I will confine myself to three points.

1. It's not a question of whether the estate tax is good or bad; it's a question of whether it's better than the alternative. If you take away \$100 billion of tax revenue (that's the Times's figure - not sure how many years that is over), you have to add it to the debt or raise it some other way. Compared to raising marginal tax rates on income, the estate tax almost certainly has less impact on incentives to work, for a few reasons: (a) most people with that much wealth make most of their money from investments, not working; (b) most people - even high earners who pay the top marginal income tax rates - are unlikely to ever pay the estate tax, and even if they do, it will be decades after the current period; and (c) to the extent that that people plan to consume or donate their marginal income (like Bill Gates), the estate tax doesn't affect incentives to work at all. The estate tax has more impact on what people do with their money once they've made it: it encourages contributions to charity, but arguably it encourages consumption instead of saving.

2. The estate tax has the unusual property that even though it only affects the super-rich (and thereby benefits everyone else), many people who are completely unaffected by it are against it. Part of this is undoubtedly due to the fact that far more Americans believe they will someday become rich than actually will become rich. (There was a famous poll cited in *The Economist* a long time ago according to which some large proportion of Americans believed that they were already or would someday be in the top 1% of the population by wealth.) If this economic crisis has any salutary effects, perhaps one of them will be to convince many people that they are not rich enough to pay the estate tax and that, even in this land of opportunity, they are statistically unlikely ever to be rich enough to pay the estate tax - and therefore they should start voting in their own interests and not the interests of celebrities. (And even if you think you will be rich someday, shouldn't you hedge against that not happening, rather than the opposite?) Put another way, the movement to repeal the estate tax should have crested along with the stock market.

3. Like most Silicon Valley entrepreneurs, when I started my company, one of the motivations was the small chance of someday making a lot of money. Back in 2001, none of us looked around the table and said, "You know, I would work really hard at this startup, but since I'm going to have to pay the estate tax if we're successful, I'm just going to phone it in."

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Apr 11, 2009 12:44 PM

[Why Bail Out Life Insurers?](#)

by James Kwak

That's the question I woke up with this morning. Sad, isn't it.

The [Wall Street Journal](#) reported this week that Treasury will soon announce that it will use TARP funds to invest in life insurers, or at least those who snuck under the federal regulatory umbrella by buying a bank of some sort. The argument for the bailout is a version of the "No more Lehmans" theory: the failure of a large financial institution could have ripple effects on other financial markets and institutions that could cause systemic damage. For a bank, the ripple effect is primarily caused by two things: (a) defaulting on liabilities hurts bank creditors, and (b) defaulting on trades (primarily derivatives) hurts bank counterparties, if they aren't sufficiently collateralized (think AIG).

My thought this morning was that life insurance policies are long-term liabilities that are already guaranteed by state guarantee funds, so we don't have to worry about (a), and hopefully most life insurers were not doing (b) - large, one-sided bets on credit risk like AIG. So why not just let them fail and let the states take over their subsidiaries? But then I checked the facts, and it turns out that the limits on state guarantee fund payouts are [pretty low](#). So the scenario is this: you hear bad things about your life insurer, you decide to redeem your policy (usually at a significant loss to yourself), turning it into a short-term liability, and then the insurer has to start dumping assets into a lousy market, pushing the prices of everything further down and hurting everyone holding those assets. Would this really cause a systemic crisis worse than we've already got? I don't know, but no one in Washington wants to take that risk.

Ultimately, though, this goes back to the question of whether this is a liquidity crisis or a solvency crisis. If it's a liquidity crisis - in which case you would expect to see lots of people redeeming their policies already - then there are better ways to prevent a run on the life insurers. For one thing, if the insurers really do have good assets to cover their

expected payouts, the government could just boost the limits on the state guarantees, charge the insurers a premium for the guarantee (insurers already pay a premium for the backstop they get from the states), and pocket the money. Alternatively, the government could act as a reinsurer, taking on some of the payout risk in exchange for a corresponding proportion of the assets and premiums. Using TARP money might work, but since it just adds a few billion dollars to the insurer's capital (without guaranteeing anything), it's not a surefire solution.

If it's a solvency crisis, though, we have to ask whether a few billion dollars of TARP money is enough. The Hartford estimates it is eligible for \$1-3 billion of money. (I picked them because they are discussed in the WSJ story, not because I know anything else about them.) It also has \$288 billion of assets. How do their assets compare with the assets of, say, a bank? In principle, insurance companies are more closely regulated, and their investment mix (in terms of bond ratings) is constrained. But it's also true that insurers - especially the large ones - were investing in more sophisticated products in an attempt to earn higher yields. (For details, see pp. 156-76 of the Hartford's [latest 10-K](#).) And we know that you could lose a lot of money [investing in AAA-rated assets](#). If this does turn out to be a solvency crisis, then this could be the first page of a long story.

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Apr 10, 2009 4:52 PM

[The Economy and Popular Democracy](#)

by James Kwak

One of the central themes of the current economic crisis has been the cozy relationship between "Wall Street" and Washington that resulted from both ideological convergence and old-fashioned campaign contributions. Another theme, as Simon discussed [yesterday](#), has been the absence of a simple left-right axis for opinions to coalesce around. If you think that fixing the banking sector requires a government conservatorship and forcible balance sheet cleanup - rather than periodically dribbling large amounts of cash into institutions and management teams that have already failed by any free-market measure - it's not clear who your advocates in government are.

Tomorrow, however, you can stand up and be counted. A New Way Forward is organizing [demonstrations](#) all around the country, most at 2 PM Eastern Time. The basic message is simple: "If it's too big to fail, it's too big to exist. Dismantle the power of the financial elite and make policies that keep a new crop from springing up. We want our economy and politics restored for the public."

And don't forget your pitchfork. (Just kidding.)

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Apr 10, 2009 12:05 PM

[Stock Market Rally: NYT.com Discussion](#)

by Simon Johnson

How should we interpret the stock market rally? Can we call the bottom, in terms of financial distress and economic crisis (as Goldman Sachs is apparently doing - so it must be true...)? Or are there still potentially serious problems that are masked or exposed by the rally? NYT.com is [running a discussion right now](#); you can post reactions/comments either on that site or here.

By Simon Johnson

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Apr 10, 2009 8:08 AM

[Does The US Still Face An Emerging Market-Type Crisis?](#)

by Simon Johnson

The US has developed some [features more typically seen in an emerging market](#), including disproportionate power and system-threatening activities in the finance sector. In fall 2007, the US (and the world) experienced the kind of precipitous fall in credit, output, and employment that was, in modern times, seen only in “emerging market crises”. Our [first Baseline Scenario](#) was controversial and largely dismissed when it first appeared on September 29, 2008, but many of its arguments and policy recommendations have now been absorbed into official thinking (at least in the US).

Is the US out of the emerging market-type woods? Can we now rule out the possibility of a great depression? Such a severe economic outcome is not currently our baseline view (e.g., as discussed in this [NBR interview](#)), but it is still a downside scenario that needs to

be taken seriously - and, at least in our interpretation - this is also the view of Bernanke's Fed (see [our piece on Sunday](#) and the [profile in yesterday's Washington Post](#).)

Why is a depression scenario still on the table?

The problem is not the potential degree of insolvency of banking per se. And it's not only about the way financial markets operate. Nor is it just about how the market for credit default swaps (created by and for big finance) is proving - [once again](#) - to be a powerful, potentially self-fulfilling mechanism for betting on financial institution failure.

Rather, the danger in this situation arises primarily from the attitude and approach of the US Treasury. We are supportive of this Administration on many issues, and I applauded the ideas and actions of Treasury [around the G20 last week](#). But I don't think Treasury understands the potential speed with which the crisis can again become more severe - moving back into another phase of chaotic jumps in financial distress around the world.

The most compelling evidence for lack of readiness comes from those who are now most articulate in Treasury's defense. "Congress will not provide any more money" and "you must recognize the political constraints" are sensible points. But think about what they also imply. Treasury is not making the case, full-time and flat-out, for more funding - on a contingency basis - from Congress. At least from my conversations on Capitol Hill, I see no signs that this is Treasury's top priority. In fact, I would go further and be blunter: no one is ready.

I recognize that this would be a hard sell. And I understand that the mood is shifting away from bailouts and towards attempting to manage some sort of debt-for-equity swap; which seems to be what the WSJ is [heavily hinting at this morning](#). But if you've taken nationalization off the table and you have very little cash remaining for anything bailout/rescue-related, you are vulnerable to runs.

The only way to stop speculators is with massive financial firepower (you must be able to scare them; no one way bets on bank defaults) and a credible set of policies that show things are going to turn around ([act at the system level; don't try to handle the banks piecemeal](#)). Don't let bankers' past misdeeds (or current power) and market panics ruin the economy and so many people's lives. Go get the money from Congress - Capitol Hill is full of responsible and responsive people, but the Administration has to make the case, at the highest levels and in the most persuasive manner that saving the financial system from collapse is our top priority.

Don't make the mistake of Hank Paulson who, until September 17th, always assumed he had more time to prepare (or just prevaricate). When the crisis is upon you, there is no time.

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Apr 9, 2009 9:16 AM

[What Next For Banks?](#)

by Simon Johnson

The case for keeping banks in something close to their current structure begins to take shape. It's not about traditional claims that big banks are more efficient, or [Lloyd Blankfein's argument](#) that this is the only way to encourage risk-taking, or even the House Financial Services Committee view that immediate resumption of credit flows is essential for preserving jobs.

Rather, the argument is: those opposed to banks and bankers are angry populists who, if unchecked, would do great damage. Bankers should therefore agree to some mild reforms and more socially acceptable behavior in the short-run; in return, the centrists who control economic policymaking will protect them against the building backlash. This is a version of [Jamie Dimon's line](#): "if you let them vilify us too much, the economic recovery will be greatly delayed."

There are three problems with this argument: it is wrong, it won't work, and it doesn't move the reform process at all in the right direction.

The "center vs. the pitchforks" idea fundamentally misconstrues the current debate. This is not about angry left or right against the center. It's about centrist technocrat (close to current big finance) vs. centrist technocrat (suspicious of big finance; economists, lawyers, nonfinancial business, and - most interestingly - current/former finance, other than the biggest of the big, particularly people with experience in emerging markets.)

Just as an example, a broad range of entirely centrist people (including in and around the IMF; former Treasury; you'd be amazed) are expressing support for the ideas in our Atlantic article. People on the left are, not surprisingly, also in line with this view; but we're also hearing convergent thoughts from some on the right - many who emphasize improving the environment for entrepreneurship don't see big finance as their friend. So far, the only person who called to complain works for an "oligarch."

You might think the "anti-pitchfork" strategy might work, particularly as it has in the past (e.g., in the early Clinton years). The problem for this strategy now is not just the fragile state of banks - by itself this can be ignored for a long while through forbearance, behind a smokescreen of complicated schemes with confusing acronyms - but the ways in which the markets they created now operate.

Just as global financial liberalization created the potential for capital to move violently across countries and greatly facilitated speculative attacks on currencies, so financial deregulation within the United States has made it possible for capital markets to attack - or, in less colorful terms, go short or place massive negative bets on - the credit of big banks and, in the latest developments, the ability of the government to bailout/rescue banks.

The [latest credit default spreads data](#) for the largest banks show a speculative run underway. As the system stabilizes, it becomes more plausible that a single big bank will fail or be rescued in a way that involves large losses for creditors. This would like trigger further speculative attacks on other banks, much as the shorting of countries' obligations [spread from Thailand to Indonesia/Malaysia and then to Korea in fall 1997](#).

The government's own policies are facilitating these attacks, because as the Fed and Treasury make progress towards easing credit conditions, this makes it easier and cheaper for large hedge funds and others to take large short positions. And keep in mind the underlying loss of confidence is self-fulfilling: as you lose confidence, you want to go short, and selling the credit causes further loss of confidence - and banks are forced out of business.

The government's entirely reasonable and long overdue request for a resolution authority will set up runs on that authority. If the authority is not granted, the runs will be on the government's low and failing ability to save banks - given that the trust of Congress has been lost and no more cash for bailouts is likely forthcoming (presumably until there are large further shock waves or until Goldman Sachs itself is on the line.)

The continuing pressure on banks has nothing to do with populism and everything to do with the internal contradictions of the house of cards they built. Now they will scramble to limit short selling or find other emergency measures that will protect their credit. Such partial fixes would do nothing to stop the underlying deterioration of their credit; think about how countries facing currency attacks [throw up futile defenses, try to change the rules, and squander their reserves on the way down](#).

You can see where this is going, but do not cheer. The likely result will be misery for many and further financial chaos around the world.

The big issue is of course the financial sector reform process. Some of my colleagues expressed great satisfaction with the progress made by the G20. But progressing down a blind alley is not something to be pleased about. I have yet to hear a single responsible official in any industrial country state what is obvious to most technocrats who are not currently officials: anything too big to fail is too big to exist.

If the bankers were just stupid, as [suggested by David Brooks](#), then regulatory fixes might make some sense. But we know that bankers are smart, so it is their organizations that became stupid. What is the economic and political power structure that made it possible

for such stupid organizations to become so large relative to the economy? Answer this and you address what we need to do going forward.

At a high profile conference in the run-up to this crisis, someone destined to become a leading official in the Obama Administration responded to a sensible technocratic critique of the financial system's incentive structure (from the IMF, no less) by [calling it "Luddite"](#). By all accounts, this is the prevailing attitude in today's White House.

But the right metaphor is not breaking productive machines, or peasants with pitchforks, or even the poor vs. the rich. It's as if the organizations running the nuclear power industry had shown themselves to be stupid and profoundly dangerous. You might wish to abolish nuclear power, but that is not a realistic option; storming power plants makes no sense; and the industry has captured all regulators ever sent after them.

The technocratic options are simple, (1) assume a better regulator, of a kind that has never existed on this face of this earth, (2) make banks smaller, less powerful, and much more boring.

By Simon Johnson

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Apr 8, 2009 12:03 PM

[Inflation Expectations for Beginners](#)

by James Kwak

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

Only a few years ago, the accepted remedy for a recession was for the Federal Reserve to lower interest rates - namely, the [Federal funds rate](#). Now, however, the economy has been stuck in recession for over fifteen months and the Federal funds rate has spent the last several months at zero. (The Fed funds rate cannot ordinarily be negative, because one bank won't lend \$100 to another bank and accept less than \$100 in return; it always has the option of just holding onto its \$100.) As a result, the Fed has resorted to other policy tools, most notably large-scale purchases of agency and Treasury securities, funded by creating money. (Here's [James Hamilton's analysis](#).)

As the Fed's monetary policy plays a more prominent role in the response to the economic crisis, there will be more talk of inflation or, more accurately, inflation

expectations. While inflation is what affects the purchasing power of the money in your wallet, inflation expectations are what affect people's behavior in ways that have a long-term economic impact. Take the case of wage negotiations, for example: a union that believes inflation will average 5% over the life of a contract will demand higher wage increases than a union that believes inflation will average only 1%. Once those higher wages are built into the contract, the employer is forced to raise prices in order to cover those wage increases, and inflation begins to ripple through the economy.

One of the major objectives of modern monetary policy is to control inflation expectations, because controlling inflation expectations is the first step to controlling inflation. If there is a short-term burst of inflation - as we had a year ago, if you look at headline inflation numbers that include the prices of food and energy - the macroeconomic consequences can be limited if people believe that the Fed can and will bring inflation under control.

Unfortunately, it is impossible to know exactly what people's inflation expectations are; in fact, it may not even be a sensible question, since different people have different understandings of what inflation is. However, there are three main approaches to estimating inflation expectations.

1. Inflation-indexed government bonds. (If you need a refresher on how a bond works, read the first part of [this article](#).) A traditional bond is a stream of payments that is fixed in nominal terms: for example, \$100 in 10 years, and 6% interest, paid semi-annually (\$3 every 6 months). Such a bond is not inflation-indexed; if inflation goes up, the purchasing power of that \$100 goes down, and it's too bad for the bondholder.

An inflation-indexed bond, by contrast, pays an amount that is indexed to some measure of inflation. In the U.S., where these bonds are called Treasury Inflation Protected Securities (TIPS), we use the Consumer Price Index. A TIPS bond may have a \$100 face value and pay a 2% interest rate. However, every 6 months, that \$100 face value is adjusted to reflect the change in the CPI, and the interest payment is calculated as a percentage of the adjusted value of the bond. Then, after 10 years, the bondholder gets back not \$100, but \$100 times the ratio between the CPI at the end of the period and the CPI at the beginning of the period. This way the bondholder is guaranteed a 2% real return (assuming he paid \$100 for the bond), no matter what the rate of inflation is in the interim.

The implied inflation expectation, then, is the difference between the yield on an ordinary bond and the yield on an inflation-indexed bond with the same maturity. If the 5-year Treasury has a yield of 4% and the 5-year TIPS has a yield of 2%, then inflation expectations for the next five years are (about) 2% per year. The reasoning is that in order to buy the regular bond as opposed to the inflation-indexed bond, an investor has to be paid a higher yield to compensate him for the level of inflation that he expects.

Actually, in addition to expected inflation, the Treasury investor also has to be paid an inflation risk premium because, all things being equal, it is better not to have inflation risk

than to have it. So the implied inflation expectation is actually slightly less than the spread between the regular and the inflation-indexed bonds. If you didn't follow that, don't worry, just remember that, roughly speaking, Treasury yield = TIPS yield + expected inflation.

2. Inflation swaps. These are a type of derivative contract, where the payments under the contract depend on the value of an inflation index, such as the CPI. The swap has a nominal value of, say, \$100, but \$100 never changes hands. Instead, at the end of some period of time, party A pays party B a fixed rate of interest on \$100 - say 2.5% per year. At the end of the period, B pays A the cumulative percentage change in the inflation index over the period. Assuming A has \$100 in his pocket, he has now hedged the inflation risk on that \$100, because no matter what happens, at the end of the period he will get an amount that compensates him for the impact of inflation on his \$100. The price of this hedge is \$2.50 per year. (Because these are over-the-counter contracts, there are many variations on this, including swaps with periodic coupon payments.)

For the same reasons described above, the implied inflation expectation is roughly 2.5% per year: party B thinks inflation will be less than 2.5% per year, and therefore is willing to take 2.5% and pay the amount of inflation; party A thinks inflation will be more than 2.5% per year, and therefore is willing to pay 2.5% per year to get the amount of inflation back. So the market clears at 2.5%. (Actually, for the exact same reasons as with bonds - party B has to be paid an inflation risk premium for absorbing the risk in this trade - the inflation expectation is slightly less than 2.5% per year. There are also some complications having to do with the lag in the publication of inflation indices, but let's ignore that for now.)

One curiosity is that the inflation-indexed bond method and the inflation swap method can produce different estimates. Theoretically this should not happen, because if two products that will have the same price in the long term (since they are based on the same index) have different prices today, there should be an arbitrage opportunity. Why this happens in practice is discussed on pp. 5-6 of this [Bank of England paper](#). (Thanks to [Bond Girl](#) for pointing out the paper.)

3. Surveys. You can also just ask people what they think inflation will be. Economists ordinarily prefer markets, under the principle that when people are paying money they are signaling what they really believe. But if you think there are sufficient problems with the markets you may want to go with surveys. [Tim Duy](#) has a post with a number of charts, including one of an inflation expectations survey.

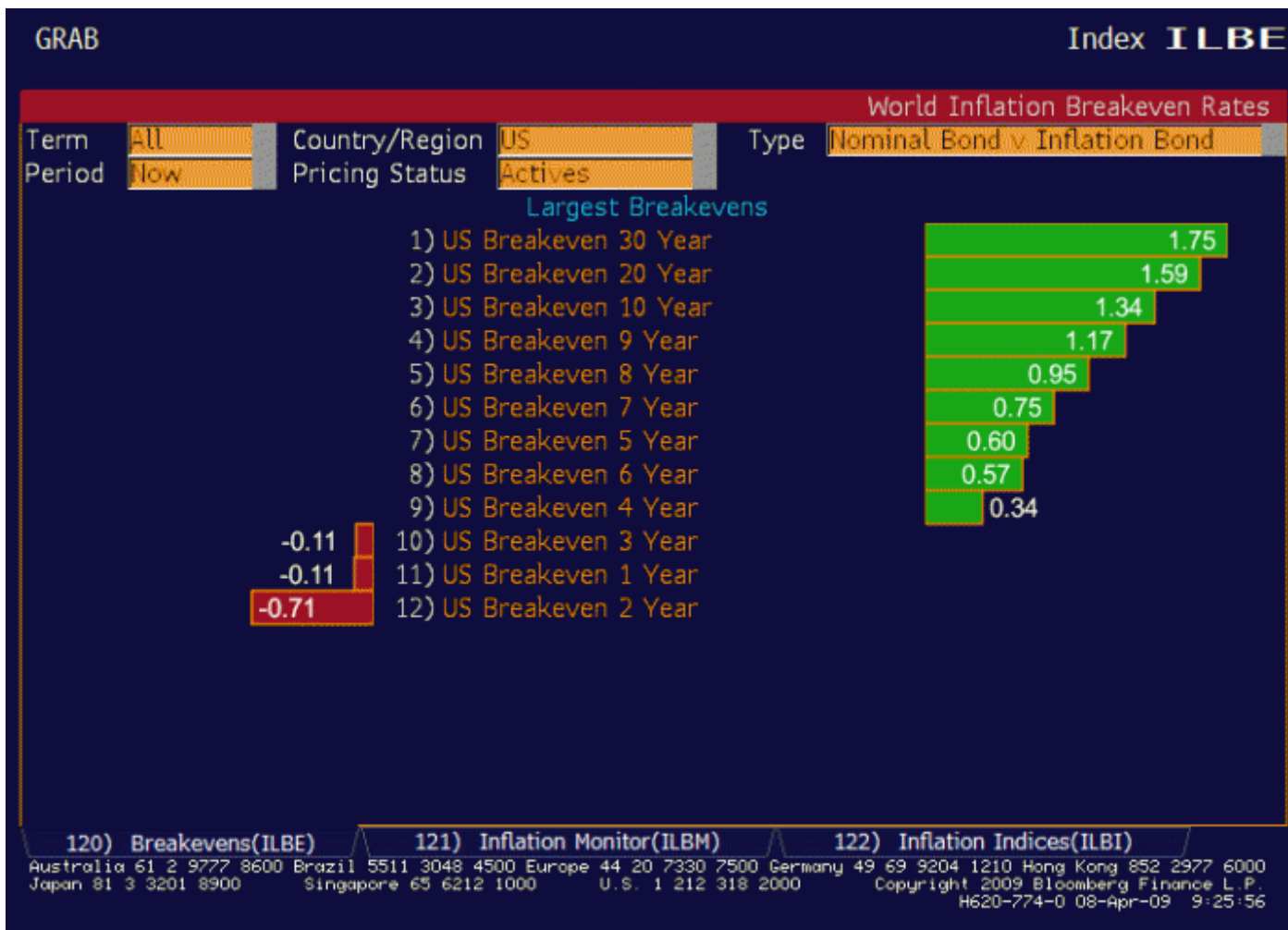
So what do things look like today?

This is the historical graph for implied U.S. inflation over the next 5 years, based on TIPS. Remember, you are looking at 5-year inflation expectations as they changed over the last year.



In the dark days of October-December, inflation expectations were clearly negative: that is, the market was expecting deflation over a 5-year period. Things have picked up, but inflation expectations are still around 0.6% - far less than the 1.7-2.0% targeted by the Fed. And that 0.6% is before adjusting for the inflation risk premium, so inflation expectations are actually lower than the chart shows.

And these are current inflation expectations over various time horizons, again derived from inflation-indexed bonds. Note that they are sorted by value, not by time.



TIPS are not very liquid compared to regular Treasury bonds, and the implied inflation expectation numbers are sensitive to aberrations in both the Treasury and the TIPS markets (which have both been pretty aberrant recently). For example, if there is a shortage of TIPS of a given maturity, then the TIPS yields will be artificially low and the implied inflation expectation will be artificially high. Still, it seems like inflation expectations are on the low side, even when it comes to the 10- and 20-year time horizons. (I don't know what's going on with the 2-year number: when I look at the underlying bonds, it seems like it should be about -0.1%.)

For more on measuring inflation expectations, there is a short primer from the [San Francisco Fed](#), as well as the [Bank of England paper](#) mentioned above.

By James Kwak

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Apr 8, 2009 5:37 AM

Is It a V?

by Simon Johnson

Yesterday, at the Peterson Institute for International Economics, Mike Mussa and I [discussed - and debated](#) - the likely shape of the US and global economic recovery. Mike has great experience and an outstanding track record as an economic forecaster. [His view](#) is that the entire post-war experience of the US indicates there will be a sharp rebound. [Victor Zarnowitz](#) apparently stressed to Mike, a long time ago, “deep recessions are almost always followed by steep recoveries.”

I completely accept the idea that a slow or L-shaped recovery for the US and at the global level would be something outside the realm of experience over the past 50 years. I would also suggest that the financial crisis in fall 2008, the speed of decline in the US, and the synchronicity of the slowdown around the world over the past 6 months has also surprised everyone (including most officials) who think that we are always destined to re-run some version of the post-1945 data.

[I argued](#) that the nature of our economy has changed profoundly over the past 30 years, and we are only now beginning to understand the consequences. There has been [some pushback](#) against the main argument of our Atlantic piece, which is that a (very modern) financial oligarchy has taken disproportionate economic and political power in the US (aside: “we’re just stupid” is not much of a defense; the people involved are very smart, so how exactly did they get to create stupid organizations with the power to blow up the entire economy?) But no one is seriously disputing (1) the financial sector has become very large, (2) it was able to take on risks that were massive relative to the system, (3) these risks were not well managed, to say the least. We have experienced the financial equivalent of [Three Mile Island](#); you will never look at finance again in the same way.

What does this imply for shorter-run macroeconomic dynamics? Do conventional US-based macro models still apply in the same way? Can finance drive growth in the same way as it has over the past 20+ years? How easy is it to switch people and capital into new sectors, for example so growth can be more driven by non-financial technology development? To the extent that banking survives the waves of contagion that are apparently still with us (look at the [CDS spreads for major US banks](#) over the past few weeks; during the rally!), won’t bankers hunker down for a while and refuse to take risk - until the next bubble, of course?

I agree with Mike that fixing the financial system is often not necessary (or actually sufficient) for a rapid economic recovery, although in today’s situation I worry about the

disruptive effects of current bank bailout plans in many countries. A fast recovery, particularly if combined with moderate inflation, would probably improve the banks' balance sheets considerably. To me, fixing the banks - i.e., greatly reducing their economic and political power - is essential for all our futures, irrespective of when and how the economy recovers. We cannot allow the same kind of potentially system-breaking risks to be taken again, and we cannot assume that the solutions that failed in the past (e.g., tweaking regulatory powers) will work in the future. Next time, the banks won't just be Too Big To Fail, they'll be Too Big To Rescue - the fiscal costs if we let this happen again would likely be huge; where is it written that the U.S. will for all time have fiscal credibility and provide the world's leading reserve currency?

The main short-term issue for the shape of our recovery is surely that balance sheets are perceived as damaged all around the world. Plenty of creditworthy consumers think they need to be more careful. Firms with sensible investment projects are worried about the future availability of credit. Governments have only a limited ability to engage in fiscal stimulus; almost no one ran a sufficiently counter-cyclical surplus during the boom. And policy responses in most of the G20 remain inadequate.

If we have created a more unstable financial structure, perhaps we have stepped back in time to the US in the 19th century, when downswings could take considerably longer (or recoveries were more likely to be L-shaped; [look at the NBER's data](#)) than in the post-1945 period? Or have we become more like an emerging market not just in terms of the excessive power of finance and the ability of one overexpanded sector to bring us down, but also in terms of our [broader macroeconomic dynamics](#)?

Emerging markets do, it is true, often recover quickly from steep declines. But they usually achieve this through managing a large real exchange rate depreciation (i.e., the nominal exchange rate falls by more than prices increase), which produces an export boom. At the level of world economy, we cannot export our way out of this recession.

By Simon Johnson

The PIIE event audio is [available already](#). It was also recorded by C-SPAN; when I learn the broadcast details, I'll add them here and also put on Twitter.

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Apr 7, 2009 9:05 AM

[Baseline Scenario, April 7, 2009](#)

by James Kwak

Baseline Scenario for 4/7/2009 (9am): Post-G20 Edition

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

This long-overdue (and hopefully widely-awaited) version of our Baseline Scenario focuses largely on the United States, both because of the volume of activity in the U.S. in the last two months, and also because the U.S. will almost certainly have to be at the forefront of any global economic recovery, especially given the wait-and-see attitude prevalent in Europe.

Global Economic Outlook

The global economy remains weak across the board, with no significant signs of improvement since our last baseline. The one positive sign is that some forecasters are beginning to recognize that growth in 2010 is not a foregone conclusion. The [OECD](#), for example, now forecasts contraction of 4.3% in 2009 for the OECD area as a whole - and 0.1% contraction in 2010. This is broadly with [our previous "L-shaped"](#) recovery view.

Even that forecast, however, expects quarter-over-quarter growth rates to be positive beginning in Q1 2010. (This is not a contradiction: if growth is sharply negative in early 2009, then quarterly rates can be positive throughout 2010, without total output for 2010 reaching average 2009 levels.) While most forecasters expect positive growth in most parts of the world in 2010, those forecasts seem to reflect expected reversion to the mean rather than any identified mechanism for economic recovery. The underlying assumption is that at some point economic weakness becomes its own cure, as falling prices finally prompt consumers to consume and businesses to invest. But given the unprecedented nature of the current situation, it seems by no means certain that that assumption will hold. In particular, with demand low around the globe, the typical mechanism by which an isolated country in recession can recover - exports - cannot work for everyone.

U.S. Outlook

Like the global economy, the U.S. economy only looks worse than it did two months ago, with unemployment up to 8.5% and no real indicators of an incipient recovery. (See Calculated Risk's [March summary](#) for all the dismal details.) The causes of economic weakness are largely unchanged and widely known:

- De-leveraging by consumers (paying down debt, voluntarily or involuntarily), leading to reduced consumption and increased saving
- De-leveraging by companies, leading to reduced investment
- Reduced supply as well as demand for credit, constraining even those who want to borrow and spend
- Continuing falls in real estate prices

This combination of reduced spending and reduced credit has sharply depressed aggregate demand, creating a classic vicious cycle where reduced demand leads to reduced economic activity which leads to reduced spending power via increased unemployment and reduced corporate profits. In addition, concerns about financial system solvency are constraining the ability of financial institutions to supply the credit needed by the economy. There will likely be a rolling wave of defaults and debt restructurings in the US and around the world over the next couple of years; this is hard to avoid and constitutes a major reason why the recovery will be slow compared with previous recessions.

The Obama administration's responses to date can be grouped into three broad areas: the financial sector, the real economy, and monetary policy. In each case, the administration has made great efforts that either are yet to pay off or will not pay off.

Financial Sector

The core problem is that large segments of the financial sector are insolvent, or that many market participants believe that large segments of the financial sector are insolvent. In either case, the problems are situated on the asset side of financial institutions' balance sheets. Although banks have taken hundreds of billions of dollars of writedowns on toxic assets, the fear is that they will need to write down hundreds of billions or over a trillion dollars more as those assets continue to deteriorate in value.

In the early phases of the crisis, concerns focused on structured securities (CDOs, CDOs-squared, etc.) that experienced [disproportionate losses](#) as default percentages on underlying assets increased. However, as the crisis has spread from the financial sector into the real economy, increasing default rates are taking their toll even on plain-vanilla assets, such as whole mortgages. (Along the way, the financial sector has moved from a [liquidity crisis to a solvency crisis](#).) Because banks' assets are sensitive to macroeconomic conditions, it is difficult if not impossible to put a bound on their expected losses as long as there is uncertainty about how long and deep the current recession will be.

The core problem today is that there is a gap between the current book value of assets and the real value of those assets, at least as perceived by many market participants. That gap is large enough to threaten the capital cushions of at least some banks. Many people have suggested solutions to this problem, ranging from outright government takeover (followed by balance sheet cleanup and privatization) to cheap government credit insurance.

However, the Obama administration's proposals so far have been relatively modest, perhaps due to unavoidable political constraints. The overall strategy has been to:

- Insist that the banks are fundamentally healthy, and that the market prices of their assets are artificially depressed due to a lack of liquidity in the market
- Continue providing just-enough capital on an as-needed basis to keep banks afloat, while avoiding any more aggressive measures, as was done in [Citigroup's third bailout](#)

Note that this strategy is not internally illogical: if you believe that asset prices will recover by themselves (or by providing sufficient liquidity), then it makes sense to continue propping up weak banks with injections of capital. However, our main concern is that it underestimates the magnitude of the problem and could lead to years of partial measures, none of which creates a healthy banking system.

The main components of the administration's bank rescue plan include:

- Stress tests, conducted by regulators, to determine whether major banks can withstand a severe recession, followed by recapitalization (if necessary) in the form of [convertible preferred shares](#)
- The Public-Private Investment Program (PPIP) to stimulate purchases of toxic assets, thereby removing them from bank balance sheets

The stress tests have two main problems. First, they are [no longer credible](#), because the worst-case scenarios announced for the stress tests are no worse than many economic forecasters expect in their baseline scenarios. Second, the administration has as much as said that the major banks will all pass the stress tests, making it appear that the results are foreordained. It is possible that the stress tests will be used to force banks to sell assets as part of the PPIP, which would be a good but unexpected consequence.

We also do not expect the PPIP to meet its stated objective of starting a market for toxic assets (both whole loans and mortgage-backed securities) and thereby moving them off of bank balance sheets. In essence, the PPIP attempts to achieve this goal by subsidizing private sector buyers (via non-recourse loans or loan guarantees) to increase their bid prices for toxic assets. Besides the subsidy from the public to the private sector that this involves, we are [skeptical](#) that the plan as outlined will raise buyers' bid prices high enough to induce banks to sell their assets. From the banks' perspective, selling assets at prices below their current book values will force them to take writedowns, hurting profitability and reducing their capital cushion.

As long as the government's strategy is to prevent banks from failing at all costs, banks have an incentive to sit the PPIP out (or even participate as *buyers*) and wait for a more generous plan. Again, the key question is how the loss currently built into banks' toxic assets will be distributed between bank shareholders, bank creditors, and taxpayers. By leaving banks in their current form and relying on market-type incentives to encourage them to clean themselves up, the administration has given the banks an effective veto over financial sector policy. There is a chance that the PPIP will have its desired effect, but otherwise several months will pass and we will be right where we started.

Ultimately, the stalemate in the financial sector is the product of political constraints. On the one hand, the administration has consistently foresworn dictating a solution to the financial sector, either out of deep-rooted antipathy to nationalization, or out of fear of being accused of nationalization. On the other hand, bailout fatigue among the public and in Congress, aggravated by the clumsy handling of the [AIG bonus scandal](#), has made it

impossible for the administration to propose a solution that is too generous to banks, or that requires new money from Congress. As a result, the administration is forced to work with a small amount of remaining TARP money, leverage from the Fed and the FDIC, and the private sector.

The Real Economy

With each month, the outlook for the real economy gets worse. It is particularly disturbing that economic forecasts are being [revised downward](#) every month as well. However, the administration has at least partially delivered on two major policy measures necessary to help restart the real economy.

The fiscal stimulus package signed in February should help, but it is simply too small given the size of the problem. After deducting the fix to the Alternative Minimum Tax (alternative for stimulus purposes), the package was only about \$700 billion, of which a large part was in tax cuts of questionable impact. This will partially compensate for falling private sector demand and improve the economy from where it would have been otherwise, but it cannot be expected to turn around the economy on its own. In an ideal world, the administration would be planning a second stimulus package as a contingency measure for later this year. However, given that the bill passed with zero Republican votes in the House and only three votes in the Senate (those votes bought with major concessions), it seems unlikely that the administration will be able to get Congress to commit another half-trillion dollars anytime soon.

The housing plan announced in early March is also a positive step, albeit one that should have been implemented months before, by the previous administration. The housing plan relies heavily on cash incentives to loan servicers and second-lien holders who are willing to modify mortgages. However, only time will tell whether those incentives are sufficient to actually change servicers' behavior on a large scale. Again, this is far better than nothing, but whether it is enough to counteract the ongoing free-fall in housing prices remains to be seen.

In addition, the Obama administration took a harder line on GM and Chrysler, rejecting their restructuring plans and giving them new, tight deadlines to work out deals with their workers and creditors (GM) or with Fiat (Chrysler). In order to pressure bondholders to make concessions, the administration is trying to signal that it is willing to let the auto companies go into bankruptcy. But from a political perspective, they seem to be in a no-win situation. A Democratic administration that lets GM go bankrupt could face a revolt from one of its core constituencies; but bailing out the auto industry will only increase bailout fatigue from an increasingly resentful Non-Bailed-Out Majority that no longer identifies with autoworkers.

Monetary Policy

With the economy still stalled and the executive branch struggling with political constraints, the Federal Reserve has seemed increasingly willing to step into the breach. As an independent agency within the government, armed with emergency powers under Section 13(3) of the Federal Reserve Act, the Fed is the one actor that can, to some extent, simply take matters into its own hands. And although everything the Fed does is wrapped in gradualist language to cushion its impact on the markets, the Fed does seem to have embarked on a new, more aggressive phase of monetary policy.

Until late in 2008, the Fed's primary role was to provide liquidity, in the form of short-term lending to financial institutions. Since then, however, it has expanded its role in at least two directions. The Term Asset-Backed Securities Loan Facility (TALF) puts the Fed in the position of deciding where to allocate credit across the economy. And the recent decision to start buying long-term Treasury securities means that the Fed is using new approaches to create money. While there is a debate over whether this constitutes "quantitative easing" or just "credit easing," this represents a major expansion of the Fed's role, which we discussed in our recent [Washington Post Outlook article](#). These actions may help create moderate inflation and prevent the onset of sustained deflation; there is also a danger that inflation will be [substantially higher than expected](#).

Regulation

Since virtually no one is happy with the current situation, there has unsurprisingly been discussion of how the financial sector should be changed in the future. Treasury Secretary Geithner outlined his proposals in Congressional testimony, with an emphasis on the need for centralized monitoring of systemic risk, and for the power to take over any financial institution that could bring down the system as a whole.

One of the root causes of the crisis, and of the difficulty in resolving it, has been the political power and ideological influence of the financial sector, which we discuss at length in our [Atlantic article](#). Our preferred solution is to have [smaller banks](#). Early indications, however, are that the Geithner plan will go a different direction - allowing large banks, but giving regulators new powers over them. The resolution authority currently being sought by the Administration - and which we support - [may have unintended consequences](#), some of which could ultimately prove positive if handled in the right way.

On a worrying note, the Financial Accounting Standards Board recently caved in to banking industry pressure (transmitted by the House Financial Services Committee) and [relaxed the rules](#) implementing fair value accounting. In some circumstances, financial institutions will find it easier to ignore market transactions and use internal models in order to value assets on their balance sheets. We think that fair value ("mark-to-market") accounting has played a small role, if any, in the crisis. However, the full impact of this rule change will not be known until we see how it is applied by batteries of lawyers on Wall Street and in Washington; for one thing, it could change banks' incentives to participate in the PPIP. And the fact that the financial industry, at this moment in history, still has the power to get its way in Washington is disturbing.

U.S. Summary

On balance, we believe that the Obama administration, and Fed Chairman Bernanke, are making every effort to combat the financial and economic crisis. However, some aspects of the response, most notably the fiscal stimulus, have been underpowered. And a combination of ideological and political constraints has hampered the administration's efforts to rescue the banking system. For these reasons, we still do not see the mechanism that will cause the economy to turn around.

In this context, we interpret the recent stock market rally as indicating that the economic decline is slowing; it does not necessarily denote that rapid recovery is just around the corner. We would also emphasize that credit markets are pricing in a substantial risk of default for some leading brand names, both in financial services and manufacturing - as the system stabilizes and bailouts become harder to justify, the probability of default for large companies may continue to rise.

International Issues

The lead-up to the recent G20 summit exposed some of the tensions between the U.S. (and the U.K.) and Europe when it comes to economic policy. To generalize for a moment, Europe (led by Germany and France) favors less fiscal stimulus spending, more fiscal discipline, and lower inflation risk; the U.S. favors more stimulus and more expansionary monetary policy, at the risk of higher inflation.

We favor the U.S. position, for a simple reason. Not only is the current global recession very severe, but it is unlike any we have seen before, and therefore we cannot rely on historical patterns to tell us when and how the recession will end. In that context, and with unemployment climbing virtually everywhere, it makes sense to do more rather than less to turn the economy around. The European position is that their more advanced social welfare systems will both limit human misery and provide an automatic fiscal stimulus, both of which are true. However, European economies are just as vulnerable as ours to a prolonged period of deflationary stagnation - a risk that, unlike Ben Bernanke, they seem willing to take.

Given this divide in opinion, there was no chance for a meaningful resolution at the G20 summit. However, the G20 did have some notable achievements. First, increasing funding for the IMF to \$1 trillion gave it the capacity to actually bail out multiple mid-size economies, which may become necessary as the recession progresses. Second, by [eliminating Europe's de facto control over the IMF](#) (and the U.S.'s de facto control over the World Bank), the summit gave other members of the G20 more of a stake in helping develop and support concerted international solutions to the economic crisis. While this could take months or years to pay off, it is an important first step.

Further coverage of the crisis and policy proposals (a partial index)

Background material

Financial Crisis for Beginners primer, includes 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/>

Previous editions of Baseline Scenario:

- September, 2008 (first edition): <http://baselinescenario.com/2008/09/29/the-baseline-scenario-first-edition/>
- October 2008, 2nd edition: <http://baselinescenario.com/2008/10/06/the-baseline-scenario-2nd-edition/>
- Mid-October: <http://baselinescenario.com/2008/10/13/baseline-scenario-101308-analysis/> and <http://baselinescenario.com/2008/10/13/baseline-scenario-101308-policy/>
- Late October: <http://baselinescenario.com/2008/10/19/baseline-scenario-102008/>
- November: <http://baselinescenario.com/2008/11/10/baseline-scenario-111008/>
- December: <http://baselinescenario.com/2008/12/15/baseline-scenario-121508/>
- February: <http://baselinescenario.com/2009/02/08/baseline-scenario-2909/>

More on Europe

The European crisis, why the Europeans are not coping, and what to do about it

<http://baselinescenario.com/2009/02/22/the-choice-save-europe-now-or-later/>

<http://baselinescenario.com/2009/01/05/eurozone-hard-pressed-2-fiscal-solution-deferred/>

Our original European stabilization fund proposal:

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

More on current US and global 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/>

Policy recommendations from October/November 2008

“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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Apr 6, 2009 6:16 AM

[Inflation Prospects In An Emerging Market, Like The U.S.](#)

by Simon Johnson

There are two ways to think about inflation in today's economy. The first, suggested by conventional macroeconomic frameworks for the US, is that, with rising unemployment and actual output sinking further below “potential” output, inflation will stay low - and we could actually experience the dangers of falling wages and prices (think what happens to mortgage defaults in that scenario). This is the view, for example, expressed by [Fed Vice Chair Don Kohn last week](#), and the Obama Administration seems to be on exactly the same page - talking already about a further very large fiscal stimulus.

Some people in this camp do see a danger of inflation, down the road, as the economy recovers - and resumes its potential level (or growth rate). As a result, many of them stress that the Fed will need to start “withdrawing” its support for credit and raising interest rates as soon as the economy turns the corner. One informed insider’s reaction to our piece [on Ben Bernanke in the Washington Post](#) on Sunday was that we were too easy on Bernanke for failing to tighten monetary conditions as the economy began to recover after the last big easing earlier this decade (specifically, our correspondent argues that Bernanke provided the intellectual underpinnings for what Greenspan wanted to do.)

In today’s post-G20 summit situation, some of my former IMF colleagues are worried that further monetary easing around the world will create inflationary pressure in middle-income emerging markets, where inflation is often harder to control than in richer “industrial countries.” But if you think the broader political and economic dynamics of the United States have become [more like those of emerging markets](#), e.g., the concentrated power of the financial elite and their ability to access corporate welfare, doesn’t that also have potential implications for inflation?

In discussions of emerging markets, you rarely hear discussion of “potential output.” This is a slippery concept even for the United States, with origins in the idea of running factories at “full capacity” but also reflecting the traditional bargaining power of labor - macroeconomists argue about the exact reasoning but most agree it’s a magical place where inflation is stable. If output (or growth) is too high relative to potential, inflation rises and, depending on where you are relative to some sort of inflation goal, the central bank needs to tighten monetary policy in order to bring it down.

Emerging markets traditionally experience big movements in relative prices (e.g., entire sectors collapse), big ups and downs in credit (i.e., regular banking crises and recoveries), and waves of government bad behavior (think [expropriation of people’s pensions](#) or other assets). Potential output simply isn’t stable, or perhaps even measurable, in situations with a lot of investment (in good times) and much disinvestment or scrapping of capital (when times turn sour).

So what determines inflation in emerging markets? This is simple, but also very hard to manage: the balance of supply and demand for money. The government issues money through its financing of budget deficits and various credit-support operations; this obviously tends to push up inflation (i.e., more money tends to reduce the value of money outstanding). People’s demand for money depends on what they expect in terms of inflation, and this is often affected by what the exchange rate is doing - a depreciating currency both raises the prices of imports directly and moves people’s inflation expectations upwards. In the background, of course, a growing economy has an increasing demand for money, so the economy can handle - and perhaps even needs - money issue. In practice, policymakers watch the inflation rate like a hawk and move rates up or down accordingly - but subject to the political pressures coming from higher or lower growth, perhaps relative to their perception of “trend” but without reference to any kind of “potential” concept.

What kind of economy is the US today? The financial sector has taken a huge hit and is almost certainly going to contract. The credit system remains disrupted and levels of investment are almost certainly down across the board. Many firms, nonprofits, and consumers overexpanded relative to what they now see as their more permanent prospects, so there is a big move to “repair balance sheets” (pay down debt; invest less). Potential output, if that is still a meaningful concept for the US, must be falling; and potential growth (based on some idea of where productivity can go) must also be down.

Even more important in the short-run, inflation expectations are on the move. There are different ways to think about this (naturally elusive) concept, but take a look at the [latest data from the inflation swap market](#) (we’ll do an explainer on this; for now, just look at how expectations have rebounded already from their low at the end of last year; if you want technicalities on this market, [try the beginning of this](#) document). If you prefer to focus on the implied inflation expectation in indexed 10 year US Treasury bonds this stood at 1.4 percent on Friday and shows a similar rebound over the past few months.

(For some reason, my official colleagues prefer bonds; my financial market friends prefer swaps.)

As we explained in [our Washington Post article yesterday](#), we strongly support what Ben Bernanke is doing - there is a lot of uncertainty and the alternatives are much worse. But we don’t accept the premise that the Fed’s actions today cannot cause inflation quite soon. Arguing more about this, here and elsewhere, should help us think about how to manage the consequences and minimize the costs.

Excessive inflation is a typical outcome in oligarchic situations when a weak (or pliant) government is unable to force the most powerful to take their losses - high inflation is, in many ways, an inefficient and regressive tax but it’s also often a transfer from poor to rich.

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Apr 6, 2009 12:16 AM

[Kindle and Facebook](#)

by James Kwak

1. I submitted the blog to Amazon for publication on the Kindle. Their form says they have a backlog, so we’ll see if it ever happens. If you have any pull at Amazon, put in a word for us.

2. We now have a [Facebook page](#) called The Baseline Scenario. If that link doesn't work for you you should be able to search for it and then become a fan. The page imports the RSS feed from the blog, so you can read the blog without leaving Facebook, if that's your cup of tea. There is also a Wall that you can post things to as usual. In the future, we may figure out more things to do on Facebook, but that's it for now.*

We do these things ([Twitter](#), too) because we want to make things easier for our readers. It's a generally correct rule in business that it is a good thing to make life easier for your customers. I believe that if you want people to read your stuff, you have to go where they are - and if that's Twitter, or Facebook, or Kindle, then that's where you should be.

* Incidentally, I don't understand the Facebook model. They seem to be trying to get people to use and enjoy the Internet within the tight confines of Facebook. This reminds me of the old days of CompuServe and AOL. Ordinarily when I work I have about 10-12 tabs open on my browser, and at most one of them is Facebook. There is so much stuff on the Internet, why would you limit yourself to the stuff your friends posted? Besides, I find their user interface non-intuitive, and with each iteration they make it less powerful - and I used to work at a software company.

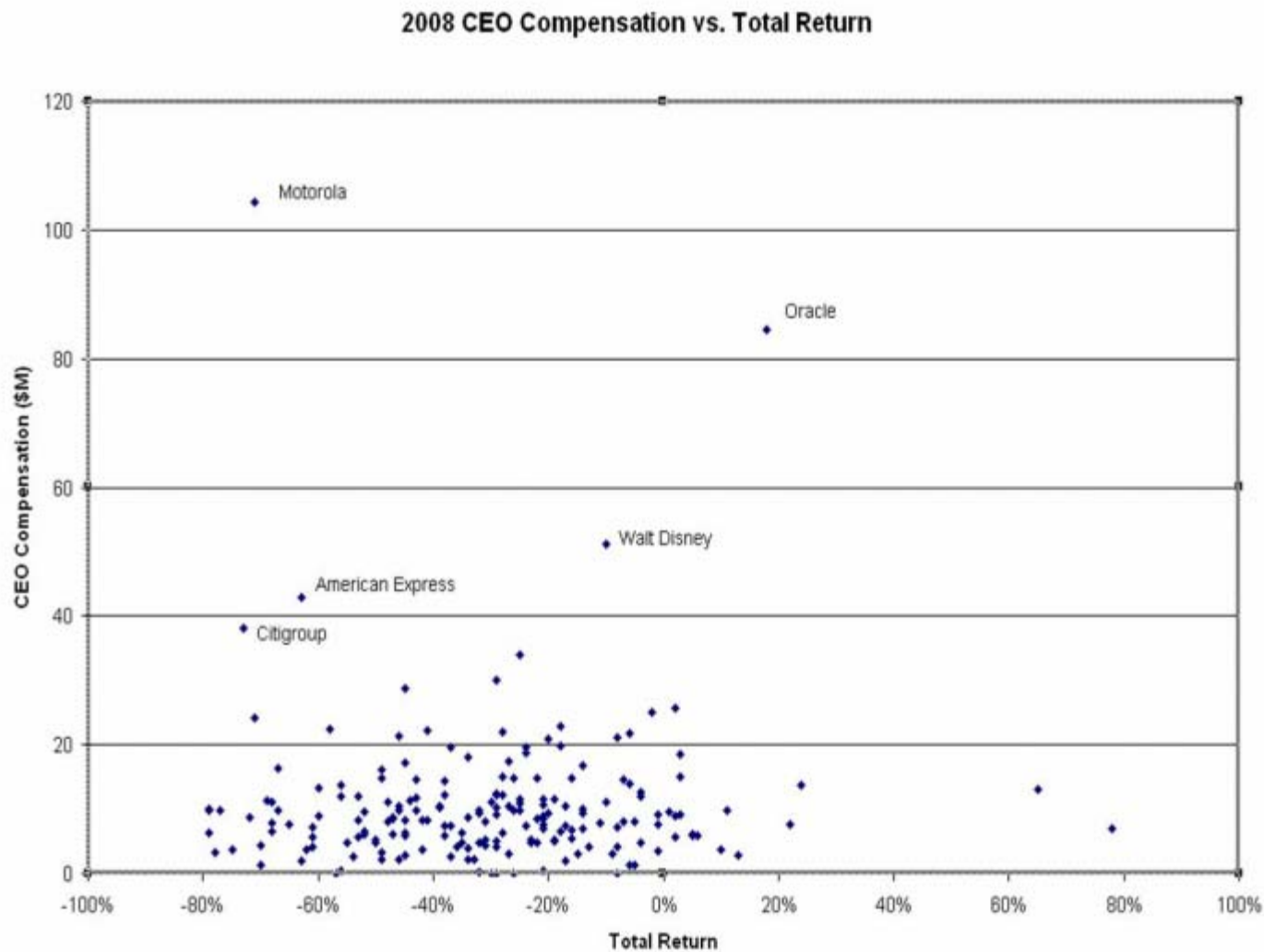
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Apr 5, 2009 4:29 PM

[Two Things That Have Nothing To Do with Each Other](#)

by James Kwak

Data from Equilar ([methodology](#)), published by [The New York Times](#):



I know this is simplistic, but I just couldn't resist.

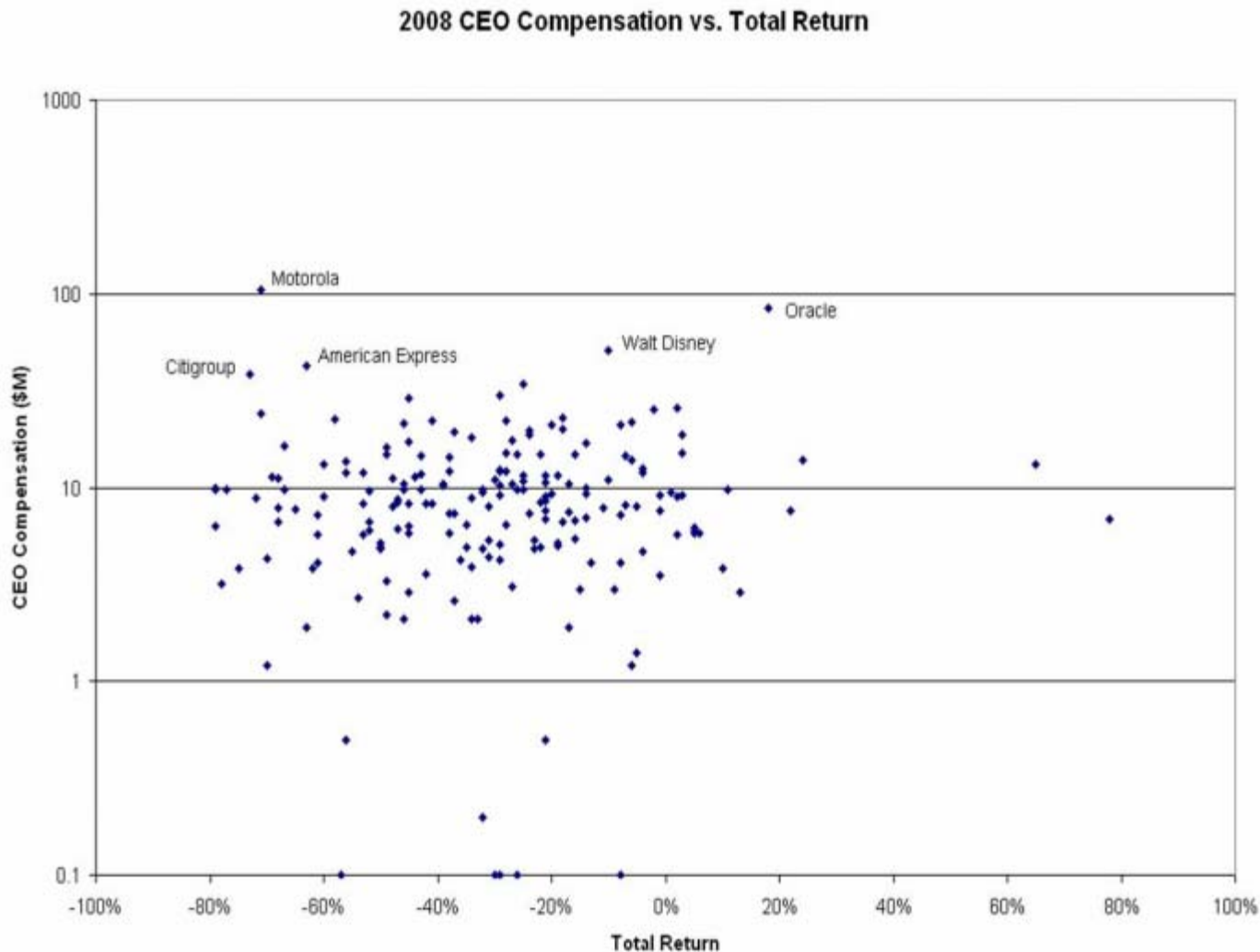
Some caveats:

- Stock total return is a poor way to measure CEO performance - yet it's the one that CEOs and boards commonly point to to justify compensation.
- A CEO may have been granted a large stock award in 2008 as a reward for "good performance" in 2007. This could explain the combination of high compensation and poor 2008 performance. However, just think about what that means for a second.
- Most of the large compensation awards are largely restricted stock or stock options. These were valued as of the data of the grant, so if the company's stock price later fell, the CEO is unlikely to realize the calculated value of the award. But imagine if the stock price had gone up instead: the CEO and the board would be

insisting that the award should be valued as of the grant date, not the later exercise date (when it would be worth much more).

Also, I excluded a company called Mosaic, because it's total return was 257%, so it packed all the other companies into one side of the chart. Mosaic's CEO earned \$6 million.

Update by request: With a log scale.



I had actually already done this chart, so it was an easy request. I'm not sure a log scale is inherently better given the spread of the compensation data; as you can see, now the outliers are on the low end, even when you code people like Steve Jobs (compensation = \$1) as \$0.1 million. But the story is still the same.

By James Kwak

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Apr 5, 2009 7:55 AM

[Mandelson Moment](#)

by Simon Johnson

If you want an unusual insight into our potential future, take a look at Channel 4's interview on Thursday with Peter Mandelson (UK's Business Secretary, very close to Gordon Brown and a key person around the G20 summit).

[In this clip](#), Mandelson comes on around the 12:48 mark (after Peer Steinbrück, the German finance minister, provides some complacent sound bites.)

But the surprising statement comes after the short interview with me (I start at 17:40 approx; Mandelson comes back around 21:38). I have no idea if Mandelson knew this could happen, but Jon Snow (the anchor) goes back to him and asks if he agrees with me that the UK could borrow from the IMF.

The conventional answer, of course, would be something like "under no circumstances." Instead, Mandelson says the UK won't be "at the top of the queue" for going to the IMF. Even when pressed, he laughs but refuses to categorically rule out that the UK might need to borrow from the Fund.

And he also clearly articulates the broader G20 strategy vis-a-vis the IMF: destigmatize borrowing. And what could be more helpful, in that regard, than countries such as the UK borrowing when they need assistance (think banking, budget deficit, current account deficit) but before they approach a traditional full-blown crisis situation?

By Simon Johnson

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Apr 4, 2009 11:09 PM

[Making Creditors Suffer](#)

by James Kwak

Tyler Cowen, co-author of a prominent [independent economics blog](#), has an article in The New York Times explaining “[Why Creditors Should Suffer, Too](#).”

What the banking system needs is creditors who monitor risk and cut their exposure when that risk is too high. Unlike regulators, creditors and counterparties know the details of a deal and have their own money on the line.

But in both the bailouts and in the new proposals [for financial regulation], the government is effectively neutralizing creditors as a force for financial safety.

I couldn’t agree more (except for the bit about the regulatory proposals, and that’s just because I haven’t read them closely). We need creditors who will pull their money or demand tougher terms from financial institutions that are doing things that are either too risky or just plain stupid; that’s theoretically a more efficient and cheaper enforcement mechanism than regulatory bodies.

Cowen also has an accurate read of the current situation:

This poses a very difficult public relations problem for the government, because the Federal Reserve and the Treasury do not want to discuss the importance of the creditors too publicly right now.

Why not? It would be bad precedent, and mind-bogglingly expensive, to promise to pick up all future obligations to major creditors. At the same time, any remarks that threaten to leave creditors hanging could panic the markets. So silence reigns.

Or, there’s an implicit expectation that creditors of large financial institutions will be protected, but that expectation periodically wears off and has to be bolstered by some confidence-boosting measure, but that measure can never be an explicit guarantee . . . and so on.

Cowen has some suggestions for how to fix this problem in future regulation. But what should we do right now? As long as the ongoing, ever-changing bank bailout leaves existing entities (a) under current ownership and (b) out of bankruptcy court, no force on earth can make the creditors suffer without their consent. So either we need to accept that creditors get a free pass this time, or we need to relax one of those constraints.

By James Kwak

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Apr 4, 2009 10:54 PM

Be Nice

by James Kwak

Comments are an important part of this blog, and I'm sure that many of you read the blog as much for the comments as for the posts. I'm also very proud of the knowledge, intelligence, and writing ability of our commenters. Simon and I write about a wide range of topics, and so it is never a surprise to me to find comments from people who know any particular topic far better than I do. Looking at other economics blogs, I think we have one of the best discussion communities around, with both a large number and a high average quality of comments.

However, there has been a recent increase in the number of comments that can be construed as offensive in one way or another. While most hardened Internet commenters can probably take a personal attack now and then, I'm afraid this will intimidate some people and deter them from joining the discussion. So we are creating some [guidelines for comments](#), which are really nothing more than what you should have learned in kindergarten.

1. No profanity.
2. No attacks or insults aimed at other commenters. Calling a public official an idiot is one thing; calling someone who just wrote a comment an idiot is another.
3. No attacks or insults aimed at entire categories of people based on race, gender, religion, national origin or identity, or something similar.

If I see comments falling into these categories, I will delete them. I am also adding filters on a few words to flag comments for moderation. I expect most of those comments will be approved. For example, if you use the word "moronic," I just want to check that you are referring to, say, the Commodity Futures Modernization Act, not a previous comment.

Thank you for all of your comments. For those of you who do not comment, thank you for reading the blog. It's no exaggeration to say that Simon and I would not be doing this if it were not for all of you.

By James Kwak

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Apr 4, 2009 6:54 PM

[Guest Post: Obama's Plan for the Auto Industry](#)

by James Kwak

My Yale Law School colleague Ilya Podolyako comments on the Obama administration's plan for the auto industry and the tension between public goals - preserving jobs, increasing fuel efficiency, etc. - and private goals - profitability.

By now, the dust seems to have settled around [Obama's rescue plan](#) for two-thirds of the long-ago "Big 3" (in 2007, Chrysler ranked 12th in the world in total auto sales; GM has ranked 2nd; Ford, which is not receiving government assistance, was 4th). The policy itself seems prudent enough. The President's Task Force on the Auto Industry recognized that due to its small scale, reliance on light trucks, and objectively low product quality, Chrysler is not viable as a stand-alone company. On the other hand, General Motors has large economies of scale and makes certain well-received products (the [report](#) mentions the Chevy Malibu and Cadillac CTS by name, though one could add the Cavalier, Corvette, and Escalade to those lists), but faces exorbitant legacy costs for its nearly one million retirees and low margins on its fuel-efficient vehicles. Given this fact pattern, the plan does as good of a job as anyone could in offering a helping hand to iconic American manufacturers while preserving some incentives for efficient private-sector operation.

My problem with the restructuring proposal comes not from any one of its details, nor even its general spirit. At this point, I feel fairly neutral about heavy-handed government involvement in US industrial policy. Admittedly, I am from Michigan and really like cars (despite consistent problems, I keep driving Fords, though I am not sure why), so I have some emotional connection to the industry to balance against the gross, obvious inefficiency of pouring money into enterprises that, by their own admission, will at best break even by 2014. I also do believe that a GM bankruptcy would lead to the net loss of a significant number of jobs that would permanently cripple Michigan's already desperate economy.

I am concerned, however, with the absence of any apparent long-term vision for the "American" automobile industry within Obama's proposal. A [New York Times](#) story provides a nice contrast to our own state of affairs when it explains that "Chinese leaders have adopted a plan aimed at turning the country into one of the leading producers of hybrid and all-electric vehicles within three years, and making it the world leader in electric cars and buses after that."

Mechanically, the Chinese policy does not seem to be that different than that of the United States. If anything, it is facially less intrusive into the affairs of the automakers, though the fact that the government continues to own a controlling stake in most such

entities makes this difference illusory. The national government will provide research funds for the development of alternative-fuel vehicles, coupled with direct subsidies for consumer purchases of such products. The PRC's policy motivations look similar to those present on our shores too: cut down on pollution, preserve national stability in the face of shrinking foreign oil supplies, and foster industrial excellence.

The issue is that whereas the Chinese government is content with spending public money for an indefinite period to promote these well-defined (and fairly reasonable goals), the U.S. executive branch cannot be. American leaders are directly accountable to voters, who generally dislike state-directed industry. Yet this feature of our political system runs counter to the motivations for the automaker bailout. These seem to be, in order of importance:

1. National pride: The United States of America became a superpower while leading the world in car manufacturing; people in and out of government associate the two phenomena with each other. Accordingly, they want to retain the symbolic value of GM or Chrysler.
2. Job preservation: No explanation necessary, though the jobs in question are localized. No one has made the argument that the collapse of GM or Chrysler would pose a systemic risk to the national economy as whole.
3. Environmental considerations: The President appears to believe that U.S. automakers can play an important role in the larger effort to reduce greenhouse gas emissions by manufacturing fuel-efficient cars.

The above considerations are fundamentally political; they are not the ingredients of a profit-making business. With these goals, inquiry into the potential viability of GM or Chrysler as a private enterprise matters only as a way to distract voters frustrated with selective government handouts.

But this strategy is both unsustainable and unwise. First, if Obama intends to keep the auto-companies as a federal jobs program, he shouldn't pay large, institutional investors in the process. That's what TARP II, EESA, and PPIP are for. Second, one would think that for both the employment and the environmental goals, there is no need to combine the bureaucracy of the Department of Treasury with that of General Motors. I am willing to accept that, given the track record of private sector management at the Big 3, the government may have at least as good of an idea of what consumers want as the people who designed the Pontiac Aztec. Of course, if that is the case, members of the Auto Task Force should be managing the R&D and Manufacturing divisions directly instead of making a slightly reshuffled deck of top executives drive back to Washington every two months for progress reports. Third, selling off GM's relatively well-performing European operations, along with its prized partnership with China's SAIC, would diminish the company's stature as an American powerhouse while undercutting the very economies of scale that give it remaining strength.

So, where do we go from here? If Obama's goals for the intervention are actually those that I identified, he should be frank with the population, if only because the current plan is so clearly incompatible with business logic. The proposal should function for now and buy the Administration some time to recoup political capital, but in these tumultuous times, the notion of a gently nationalized car industry may not do too poorly. On the other hand, if Obama wants to see GM and Chrysler survive as smaller, profit-making companies, he should write off the \$20 billion in aid that, under the current plan, would stick with the "good" GM, let the bondholders go through bankruptcy, and use his stature to negotiate some sort of a politically favorable but economically sustainable agreement with UAW.

By Ilya Podolyako

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Apr 4, 2009 7:22 AM

[Ben Bernanke: More Important Than The G20 Summit](#)

by Simon Johnson

It may strike you as extraordinary that the G20 summit barely touched on what is, arguably, the key policy issue going forward - what will central banks do, including the detailed when and how of avoiding falling wages and prices (deflation). Fiscal stimulus is already almost fully in play around the world, regulatory reform will at best be slow and not relevant to the recovery, and "we promise to avoid an irresponsible protectionist trade war" is nice but more about not making things worse rather than getting our economies going again. Funding and leadership model change for the IMF can help prevent emerging markets from cratering, but in terms of impact on global growth or unemployment, it's second order relative to the macro policies of the world's largest countries.

The real issue is monetary policy, including interest rate cuts where there is still room for these - to me the biggest news of the week was actually that the European Central Bank cut rates by less than expected (its main interest rate [stands at 1.25 percent](#)). This confirms the ECB still does not see deflation as a clear and present danger. Look at all the downward pressures in the European economy, from East European collapses (and associated West European banking problems) to property market declines in the UK, Ireland and Spain (and what that means for banking) and export industry stress (and they have bankers too). The ECB is taking an extraordinary and - to my mind - incorrect position. If they truly wait until deflation is "fully in the data" (central bank jargon), it will be too late.

The dramatic trans-Atlantic, or at least eurozone-dollar, contrast is in terms of monetary policy, not fiscal stimulus or attitudes towards future regulation. In our piece in the Washinton Post Outlook section on Sunday ([already online](#)), we provide an updated back story on how exactly the Fed and its chair got to the point of taking bold and unprecedented moves towards expansionary monetary and credit policy.

In our view, the Fed's current "print the money" strategy (and, yes, I know the Fed doesn't like this term or even "quantitative easing") is make-or-break for turning the economic corner any time soon. It's incredibly risky in terms of potential inflation - more than the Fed would ever concede - but preferable to all the available alternatives.

The power of our big banks presents [a profound economic and political problem](#). Whatever happens - miraculous recovery or prolonged depression - this needs to be fixed. But we also can't wait around for attempts to break up the banks; the prospects for unemployment and poverty are too dire to tolerate delay. First and foremost, we need to prevent global deflation and begin the difficult process of sustaining a recovery.

Remember this. If you run an expansionary fiscal policy (building bridges), I have an incentive to free ride (selling you BMWs) and not engage in a similar fiscal stimulus. But if you run an expansionary monetary policy, your exchange rate will tend to depreciate, putting pressure on my exporters and I'll be pushed - by BMW-type producers - towards providing a parallel monetary stimulus.

There is only one person who can talk the ECB out of its current, ruinous policy: Ben Bernanke.

By Simon Johnson

Update (by James): This article has gotten a fair amount of commentary already.

- [Mark Thoma](#) says it depends on whether inflation expectations remain anchored (at 2%, where the Fed wants to peg them).
- [Tim Duy](#) says that we are making the mistake of confusing "credit easing" with "quantitative easing." Duy points out (correctly) that Bernanke has repeatedly insisted that the Fed will mop up the excess money when necessary in order to dampen inflation; this means that the Fed is trying to keep inflation expectations where they are, despite the influx of money now. This could be Bernanke's intention, but I think there's still a question of whether the Fed will be able to follow through when necessary, and the resulting uncertainty could itself feed inflation expectations.

One thing I want to clarify, which Simon says above but is perhaps not clear in the article, is that we do not think that Bernanke is making a mistake. We think that despite the inflation risk, this is still the right strategy, because of the risk that the other tools used to restart the economy may not have sufficient oomph.

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Apr 3, 2009 11:39 AM

[Obama Wins At G20: Europeans Lose Control of IMF](#)

by Simon Johnson

The big news at the G20 was obviously about the IMF, with the Americans pulling out an impressive deal on funding ([compare with our predictions...](#)). But the money is not the biggest achievement. The big move was in terms of who will run the IMF in the near future - as I explain [my NYT.com column this morning](#), there is an implicit and almost immediate shift towards emerging markets.

President Obama had just the right tone yesterday. Admittedly, he was helped by the fact that we no longer have anything to be arrogant about, but still the way he reached out to other countries - while also pointing out that they made big mistakes and are currently in trouble - conveyed exactly the right message. The US will do much better if it lets emerging markets and developing countries have a serious and permanent place at the big table.

Among other things, this will fundamentally change the way the IMF operates. As a symbol and for its potential impact on the international economy moving forward, yesterday's final loss of European control over the IMF really matters.

By Simon Johnson

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Apr 2, 2009 4:57 PM

[The Mark-to-Market Myth](#)

by James Kwak

Today the Financial Accounting Standards Board voted - by one vote - to [relax accounting standards](#) for certain types of securities, giving banks greater discretion in determining what price to carry them at on their balance sheets. The new rules were sought by the

American Bankers Association, and not surprisingly will allow banks to increase their reported profits and strengthen their balance sheets by allowing them to increase the reported values of their toxic assets.

This makes no sense, for three reasons.

1. Investors and regulators are not idiots. They know what the accounting rules are. If banks claim they were forced to mark their assets down to “fire-sale” prices, investors can look at the facts themselves and apply any upward corrections they want. Now that banks will be able to mark their assets up to prices based solely on their own models, investors will the downward corrections they want. It’s a little like what happened when companies were forced to account for stock option compensation as expenses; nothing happened to stock prices, because anyone who wanted to could already read the footnotes and do the calculations himself.

However, the situation is not symmetrical, and the change is bad for two reasons. First, fair market value (“mark to market”) has the benefit of being a clear rule that everyone has to conform to. So from the investor’s perspective, you have one fact to go on. The new rule makes asset prices dependent on banks’ internal judgment, and each bank may apply different criteria. So from the investor’s perspective, now you have zero facts to go on. It’s as if auto companies were allowed to replace EPA fuel efficiency estimates with their own estimates using their own tests. We all know the EPA estimates are not realistic, but we can find out exactly how they were obtained and make whatever adjustments we want. If each auto company can use its own criteria, then we have no information at all.

Second, this takes away the bank’s incentive to disclose information. Under the old rule, if a bank had to show market prices but thought they were unfairly low, it would have to show some evidence in order to convince investors of its position. Under the new rule, a bank can simply report the results of its internal models and has no incentive to provide any more information.

So what we get is less information and more uncertainty. That was all reason number one.

2. Between the two options, this is the unsafe choice. Accounting in general is supposed to embody a principle of conservatism. Given plausible optimistic and pessimistic rules, you are supposed to choose the pessimistic one. But think about what happens here. Let’s say the bank has to mark to market, but it turns out the economy recovers and the asset increases in value. In this scenario, the writedown reduced the bank’s capital, so it had to get more. When the asset recovers, the bank is profitable and can buy back the shares it sold.

In the opposite scenario, the bank marks to its own imagination, but in reality the market price was the long-term price. At some point in the future, the bank will have to write down that asset, but it may not have the capital to absorb that writedown, in which case it will fail.

The choice is between the risk of raising too much capital and the risk of not raising enough capital. FASB chose the latter.

3. Mark-to-market is a red herring to begin with. Accounting rules are much more complex than “all assets must be marked to market” and “all assets can be marked to model.” There are different types of assets (Level 1, 2, and 3); different types of impairments to asset values (temporary and other-than-temporary); different accounting impacts (some writedowns on the balance sheet affect income statement profitability, some don’t); and, most importantly, different ways of holding assets. How a bank accounts for an asset depends in part on whether it *says* that asset is held for trading purposes, is available for sale, or will be held to maturity. Wharton has a high-level discussion of some of these issues, but if you really want to understand them you should read Sections 1.B-D of the SEC’s [study of mark-to-market accounting](#), which I helpfully [summarized](#) for you in an earlier post.

The SEC’s conclusions were, in short:

- Most bank assets are not marked to market to begin with, and half of the ones that are marked to market are the type that don’t affect the income statement.
- Marking assets to market had only a very small impact on bank capital through September 2008.
- The bank failures of 2008, including Washington Mutual, were not caused by marking assets to market (increasing loan loss provisions were a bigger culprit). In each case, stock prices started falling before the banks took writedowns, implying that investors already knew something was fishy before the accountants did anything.

I don’t know any of the back-room dealing, but it seems like the banking industry is taking advantage of the confusion to push through a change it wants, because it will make it easier for banks to massage their balance sheets and harder for investors to see what is really going on.

Update: Here’s a thought. What if the function of these rule changes is to make it easier for banks to ignore the results of the PPIP auctions? For example, Bank A puts up a pool of loans for auction, but doesn’t like the winning bid and rejects it; Bank A doesn’t want to be forced to write down its loans to the amount of the winning bid. Or, alternatively, Bank B sells a security to a buyer, and Bank A holds the same security; Bank A doesn’t want to be forced to write down the security to the price of Bank B’s transaction.

The [change to fair value accounting](#) (Rule 157) may make it easier to claim that the sale by Bank B was a “distressed sale,” meaning it can ignore it for valuation purposes. Even if it can’t ignore the sale, the [change to other-than-temporary impairment](#) may make it easier for Bank A to classify any impairment as temporary and therefore avoid an income statement hit. You’d have to be a specialist to know the answers for sure, but in any case these rule changes don’t make it any harder.

By James Kwak

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Apr 2, 2009 3:56 PM

[Taking Care of Our Grandchildren](#)

by James Kwak

There is a lot of rhetoric these days about making our grandchildren pay for our spending today. Like any “deficits are always bad” argument, this one doesn’t even meet the plausible metaphor test. That is, grandparents routinely spend money (thereby reducing their grandchildren’s eventual inheritances) on things that will make their grandchildren’s lives better.

As Nancy Folbre puts it in [Economix](#) (the New York Times blog):

Think of the United States economy as a family farm in need of modernization. Energy prices are going up, but all the tractors are gas guzzlers. Some of our fields have accumulated toxic levels of pesticide, and we need to develop new and better technologies of sustainable production. Our grandchildren want to run the farm, but will need good health and a college education to do it well.

Spending money on increased energy efficiency, research and development, health, and education could increase the value of their assets, helping them repay debt.

That’s just her closing metaphor; I recommend the entire article (it’s pretty short). There is a legitimate debate about *what* government spending actually benefits our grandchildren and what doesn’t, but it doesn’t make sense to say that every incremental dollar of current spending is hurting our grandchildren.

I tried to make this point on [Planet Money](#), but I like Folbre’s story more.

By James Kwak

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Apr 1, 2009 11:43 PM

Comments and the Spam Filter

by James Kwak

If your comments are not showing up: We use WordPress.com, and its optional spam filter, Akismet. I have no control over what Akismet flags as spam. Ordinarily it is very good, but I just looked in the spam folder and noticed that an unusually high number of legitimate comments got accidentally flagged as spam. I freed those I found from spam-land (which should help those of you who are serial commenters), but this problem may recur. I don't have time to check the spam filter very often, but I will try to glance at it now and then.

By James Kwak

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Apr 1, 2009 1:12 PM

The New Masters of the Universe

by James Kwak

Back in the early days of the Clinton administration, James Carville was credited with saying [something like this](#):

I used to think that if there was reincarnation, I wanted to come back as the President or the Pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody.

The story back then was that bond investors, by buying or selling Treasury bonds, could lower or raise the government's cost of borrowing and interest rates across the economy, depending on how they felt about government policy.

Today bond investors have discovered a much more direct lever over government policy. I've already written about the importance of bondholders in dealing with the [financial sector](#). This week we are seeing their power over the auto industry.

GM faces roughly the same problem as the banks we have been talking about so much. Its assets, broadly speaking - not only factories, designs, and patents, but its general ability to make money by selling cars - don't cover its liabilities. Those [liabilities](#) are largely bonds

(\$28 billion - I believe that excludes the recent bridge loans from the government) and union contracts (\$20 billion owed to a health care fund, along with ongoing payroll). In order for GM to avoid bankruptcy, the creditors (bondholders and the union) need to voluntarily give up some of their claims. This is what is known as restructuring.

Now why would a bondholder do this? Right now you are holding a piece of paper that says GM will pay you \$100 million plus interest. Why would you give that up for \$8 million in cash, a new piece of paper saying GM will pay you \$16 million plus interest, plus about 0.3% of the equity (stock) in GM, which is apparently the [deal on the table](#)?

You would only do this if you think the alternative is worse. The alternative, in such a situation, is bankruptcy, where a judge will decide how much you get. And clearly at least some bondholders are afraid of this alternative, since bonds were trading around 16 cents on the dollar on Monday. But this is a special case, since we know that for both political and economic reasons the Obama administration does not want the American auto industry to disappear, and many commentators ([Yves Smith](#), for one) think that a bankruptcy would have that outcome.

The result is a high-stakes game of chicken. Bondholders are betting that President Obama will not take the risk of forcing GM into bankruptcy. If that is true, the government's only option will be to sweeten their offer to bondholders, or to give up on restructuring and bail out GM the old-fashioned way (large low-interest loan, equity injection, etc.). Either way the value of GM's bonds would go up.

Obama, by contrast, has to show that he is serious about the bankruptcy option, if he is to have any hope of scaring the bondholders into agreeing to a restructuring. I think this is the most likely explanation of his [statement](#) that bankruptcy might be the best medicine for GM and Chrysler - which drove one series of bonds down from 19 cents to 10 cents in trading today.

The problem he faces is that the government's credibility in a situation like this is weak, both because of the political and economic risk of a GM bankruptcy, and because of its [flinching](#) in a similar situation involving GMAC in December.

And who is on the other side of the table? Why, it's PIMCO, the fund manager that has patriotically volunteered to be one of the participants in the Treasury Department's public-private investment funds to buy toxic securities.

Correction: Nemo points out in a comment below that there was no statement by Obama, just a leak.

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Apr 1, 2009 12:11 AM

Obama Takes The Lead: G20 Viewer's Guide

by Simon Johnson

With our myriad banking problems, rapidly rising unemployment, looming political battles over the budget and much more on the pressing domestic agenda, is the G20 summit in London (dinner Wednesday and meeting Thursday) really worth all the time and effort that the President and his team have devoted to it? And, granted that President Obama has to attend this heads of government meeting for protocol reasons, is there much that this summit can realistically achieve - i.e., are there actions that will be taken as a result of the summit that would not otherwise have happened and that can really make a difference to the parlous state of our economy?

These are all reasonable questions. And the answer is simple: in terms of the obvious major issues of the day, [this summit is unlikely to achieve much](#).

But every global economic recovery has to start somewhere and it probably has to begin small. And there are some slight glimmers of hope because (a) President Obama is taking a global leadership role, (b) he is doing this in a creative way that might seem surprising, but which should reduce the chance of a further global meltdown.

To be clear, President Obama's team tried to turn this into a constructive meeting that would contribute in a major fashion to a global recovery. They pushed hard for further fiscal stimulus around the world, but were rebuffed by the Europeans (for some of whom - e.g., those who speak German - fear of inflation trumps all other sensible considerations). There is no real summit-related progress on that front - just the usual kind of official window dressing. But it was worth a try and the topic can be reopened in future discussions.

Obama's team didn't push quite as hard for expansionary monetary policy elsewhere in the world, to match what Ben Bernanke and the Fed are now doing in the US, partly because there is an unfortunate anachronistic notion that central banks are "independent" and should not be discussed by heads of government. This leaves the European Central Bank with a deflationary policy stance (in large part, again because it is dominated by the Germanic anti-inflation obsession); this is dangerous for that whole continent and - given they comprise around a quarter of the world economy - for all of us.

No one made much progress with financial regulation. None of the G20 governments really seem to have got to grips yet with the implications of having created large financial institutions that are too big to fail - and which derive great economic benefit and, in some cases, political power from this status. At least the US is beginning to think harder about

how to regulate the system, but the positive signs along this dimension are quite limited and nothing to do with the G20.

If the summit will make essentially no progress on the big three topics of fiscal, monetary and regulatory policy, how exactly is President Obama showing leadership and making a difference? Here's the creative surprise - it's by raising a great deal of money for the IMF and proposing fundamental changes in the way that organization operates.

The IMF currently has about \$250bn to lend; this is not enough to really make a difference in a world of trillion dollar problems. The Europeans proposed to raise this to \$500bn, which seems still low - particularly as it's mostly European countries that have a pressing need to borrow; you guessed it, the Germans don't want to put up more. The Obama Administration is pushing for closer to \$1trn in total IMF funding and, after a lot of hard work, seem likely to get close to this target.

In essence, this is a clever way to force the Europeans to help themselves. The Europeans won't do it with fiscal or monetary policy, and their regulatory changes - even if meaningful - won't help the recovery. So the US has persuaded other countries to stuff the IMF full of cash and line it up as the lender of last resort to European economies that now find their property markets collapsing, their currencies under pressure, and their budget deficits increasingly hard to fund.

But that's not all. The masterstroke is simple and also brilliant. The US is pushing for - and likely to get - the Managing Director (known as the MD) of the IMF to be selected through an open, competitive and merit-based selection process.

Why is this a big deal? Governance of the IMF has been for too long dominated by Europeans - by convention, every MD has been European since the founding of the organization; the results have been questionable. The MD has enormous power and great discretion on almost all questions - the IMF is subject only to its own rules and its executive board is dominated by... Europeans. This combination wore thin with much of the rest of the world a long time ago.

Deeper governance reform and de-Europeanization of the Fund (e.g., Europe is massively overrepresented in terms of board seats) is long overdue, but the Europeans have been strong enough to slow down the process in the past. As a result, middle income and poorer countries rightly question if the IMF really works for them or just for the Europeans (and, it must be said, for the United States.)

By forcing open the leadership selection process of all International Financial Institutions (e.g., so this means no more guaranteed job for an American as President of the World Bank), the Obama team has jumped over major roadblocks around IMF governance. It has also formed a natural alliance with large emerging markets (Mexico, Brazil, India, China, South Korea, South Africa, etc), who are also members of the G20; the natural next step would be to support a new MD from one of these countries. Emerging markets

lending to struggling Europe, through the IMF, is something we should all get used to thinking about.

Arising directly from the G20 process and this summit therefore, the IMF gets a large amount of cash and the real opportunity to establish broader legitimacy - this should help convince countries that loans from the IMF will come on reasonable terms in the future, and this in turn should serve as a buffer against further downturn.

How much difference will this make? We don't know, but it's a sensible step. Global leadership pushing hard in the right direction is surely much better than what the world experienced before Barack Obama became President.