

Low-Tech Archive of The Baseline Scenario for March 2009

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May 31, 2009 3:44 PM

When Market Incentives Lead to Bad Outcomes

One of our readers recommended a fascinating and important article on health care economics, “[The Cost Conundrum](#),” in The New Yorker. It’s by Atul Gawande, a surgeon and a professor of public health and surgery at Harvard.

Gawande contrasts McAllen, Texas, which has some of the highest health care costs in the country, with El Paso, Texas, a demographically similar city with moderate health care costs, and with low-cost communities such as Rochester, Minnesota (home of the Mayo Clinic) and Grand Junction, Colorado. To simplify greatly, his conclusion is that the medical community in McAllen practices medicine as a business, while the community in Rochester or Grand Junction practices it as a way of improving health. But the aberration isn’t the profit-loving doctors of McAllen; it’s all the doctors who are not out there maximizing profits.

The real puzzle of American health care, I realized on the airplane home, is not why McAllen is different from El Paso. It’s why El Paso isn’t like McAllen. Every incentive in the system is an invitation to go the way McAllen has gone.

And the prognosis is not good:

In the war over the culture of medicine—the war over whether our country’s anchor model will be Mayo or McAllen—the Mayo model is losing. In the sharpest economic downturn that our health system has faced in half a century, many people in medicine don’t see why they should do the hard work of organizing themselves in ways that reduce waste and improve quality if it means sacrificing revenue.

In short, we have a health care system that motivates doctors to behave like businessmen and maximize their revenues from patients. In the long run, those incentives are wearing down whatever ethic of professionalism or feelings of altruism lead doctors to behave differently. But while the pursuit of profit in the free market is supposed to benefit the

public – and probably does in most areas – here it has led to an explosion of costs with no measurable improvement in health care outcomes.

Let's go out on a long excerpt designed to motivate you to read the whole article:

We are witnessing a battle for the soul of American medicine. Somewhere in the United States at this moment, a patient with chest pain, or a tumor, or a cough is seeing a doctor. And the damning question we have to ask is whether the doctor is set up to meet the needs of the patient, first and foremost, or to maximize revenue.

There is no insurance system that will make the two aims match perfectly. But having a system that does so much to misalign them has proved disastrous. As economists have often pointed out, we pay doctors for quantity, not quality. As they point out less often, we also pay them as individuals, rather than as members of a team working together for their patients. Both practices have made for serious problems.

Providing health care is like building a house. The task requires experts, expensive equipment and materials, and a huge amount of coördination. Imagine that, instead of paying a contractor to pull a team together and keep them on track, you paid an electrician for every outlet he recommends, a plumber for every faucet, and a carpenter for every cabinet. Would you be surprised if you got a house with a thousand outlets, faucets, and cabinets, at three times the cost you expected, and the whole thing fell apart a couple of years later? Getting the country's best electrician on the job (he trained at Harvard, somebody tells you) isn't going to solve this problem. Nor will changing the person who writes him the check.

By James Kwak

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May 30, 2009 11:40 PM

Regulatory Capital Arbitrage for Beginners

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

[Arnold Kling](#) helpfully pointed out a [2000 paper](#) on regulatory capital arbitrage by David Jones, an economist at the Fed. In his post, Kling said, "In retrospect, this is a bit like watching a movie in which a jailer becomes sympathetic to a prisoner, when we know that the prisoner is eventually going to escape and go on a crime spree." Having finally

read the paper, I have little to add in the way of analysis. But I thought it provided a useful basis for a discussion of what regulatory capital arbitrage (RCA) is and why it is a helpful way of thinking about the financial crisis.

Regulatory capital refers to the amount of capital a financial institution must hold because of regulatory requirements. Capital is the amount of value in a bank that is attributable to the shareholders – that is, the bank’s assets minus its liabilities. There are different kinds of capital, but we can ignore that here.

One function of capital – the function that regulators care about – is to insulate banks from losses. Assets can fluctuate in value; a borrower can owe you \$100, but if he goes bankrupt and flees the country, that loan is worth zero. The amount of your liabilities does not fluctuate, however. If you have \$100 in assets, \$90 in liabilities, and \$10 in capital, then you can withstand a 10% fall in the value of your assets and still pay off your debts; if you have \$98 in liabilities and \$2 in capital, then a 3% fall will make you insolvent (unable to pay off your debts).

Regulators impose capital requirements in order to help ensure the safety and soundness of banks. There are various reasons why safe and sound banks are good, but the most direct – from the regulator’s perspective – is that the government is insuring the bank’s liabilities; for example, the FDIC now insures deposits up to \$250,000 per person. Since the government is on the hook if the bank becomes insolvent, it wants to reduce the chances of that happening – hence capital requirements.

The question is how much capital should be required, and the key concept is risk-based capital. The idea is that some assets are riskier than others. If you hold very safe assets, like cash or short-term U.S. Treasury bills, then the chances of even a 3% fall in value are minuscule, so you shouldn’t need to hold much capital. However, if you hold risky assets, like loans to build offshore drilling platforms in the Arctic Ocean, then you should have to hold more capital.

The theory is simple. Every asset has a certain amount of risk; a firm that holds that asset should also hold, for that asset, an amount of capital proportional to its risk. Both on the firm level and on the system level, then, capital levels will adequately insure against the risk of losses. The tricky thing is putting this into practice, for two reasons: first, it’s impossible *a priori* to know how risky a given asset is (you can only estimate it); second, the potential complexity of financial transactions far exceeds the ability of regulators to specify rules for every one.

The 1988 Basel Accord (now known as Basel I) introduced international standards for risk-based capital requirements. Under Basel I, banks have to hold capital equivalent to 8% of their *risk-weighted assets*. Each type of asset has a risk weight that reflects its riskiness. For example, OECD government bonds have a zero risk weight – theoretically, they have zero risk, and hence require zero capital; home mortgages have a 50% risk weight; and uncollateralized commercial loans have a 100% risk weight. So if a bank held \$100 in Treasuries, \$100 in home mortgages, and \$100 in commercial loans, it

would have \$300 in assets, but only \$150 in risk-weighted assets ($0\% * \$100 + 50\% * \$100 + 100\% * \$100$); therefore would have to hold \$12 in capital ($8\% * \150). Looked at another way, the capital requirements are 0% on government bonds, 4% on home mortgages, and 8% on commercial loans.

Regulatory capital arbitrage happens because, all other things being equal, banks would like to hold less rather than more capital. The reason is that, in general, bank profits are proportional to the amount of assets that they hold. One main source of banking profits is interest margin: the spread between the interest charged on loans and the interest paid on deposits and other sources of funding. For any given interest margin, profits will be strictly proportional to loan volume (assets). The same logic applies to banks' principal investment and trading businesses; for any given strategy, doubling the size of the position will double the expected profit. So to increase profits, you have to increase assets. If a bank wants to increase its assets, it can do so either by increasing its leverage (lowering its capital as a percentage of assets) or increasing its capital; the former is preferable, because the latter requires issuing new shares, which dilutes current shareholders. (Also, issuing new shares results in lower earnings per share, lowering the stock price.)

How does regulatory capital arbitrage work? There are many strategies, but the most straightforward to describe and to implement is securitization. Recall our bank earlier that had \$100 in mortgages, for which it had to hold \$4 in capital. Let's say it creates a simple collateralized debt obligation out of these mortgages. It sells them to a special-purpose vehicle (SPV) that issues bonds to investors; these bonds are backed by the cash flows from the monthly mortgage payments. The bonds are divided into a set of tranches ordered by seniority (priority), so the incoming cash flows first pay off the most senior tranche, then the next most senior tranche, and so on. If these are high-quality mortgages, all the credit risk (at least according to the rating agencies) can be concentrated in the bottom few tranches (because it's unlikely that more than a few percent of borrowers will default), so you end up with a few risky bonds and a lot of "very safe" ones.

The magic is that by getting sufficiently high credit ratings for the senior tranches, the bank can lower the risk weights on those assets, thereby lowering the amount of capital it has to hold for those tranches. The risky tranches will require more capital, but it is possible to do the math so that the lower capital requirements on the senior tranches more than outweigh the higher requirements on the junior tranches. So you end up with lower total capital requirements – in some cases, 50% lower – simply through securitization. Jones runs through some examples in his appendix.

An extension of this strategy is to selectively sell some tranches and hold onto others. In this way, a bank can end up with assets that have a high degree of economic risk but a low risk weight for capital purposes. This is possible because the rules setting capital requirements are lumpy (e.g., all home mortgages have a 4% capital requirement) while there is an infinite range of actual financial assets. [Structured finance](#) makes it possible to manufacture securities with various combinations of economic risk and regulatory risk weights, which can then be sold to investors with different preferences.

Why would you want assets that have a high degree of risk but require little capital? In general, high risk means a high expected return. So these assets give you a high expected return on a small amount of capital, which is exactly how you maximize your “shareholder value.” This is also how you maximize your true economic leverage – the ratio between the risk you are taking on and the capital buffer you hold – beyond the leverage that shows up in your accounting statements. And, of course, it’s how you maximize the chances that your bank will blow up if something goes wrong.

The shift from fixed-percentage capital requirements (Basel I) to [value-at-risk](#) (VaR) methodologies (Basel II) only increased the potential for regulatory arbitrage. In VaR, the riskiness of any asset is determined by a model based on the historical attributes of the asset. In theory, this is an improvement, because it gets around the problem of lumpy fixed percentages, and tailors the risk weight to the unique characteristics of the asset itself. In practice, however, it made it possible to assess riskiness based on small amounts of historical data from periods during which, for example, subprime loans rarely defaulted because rising housing prices always made it possible to refinance. By underestimating the risk of certain assets, these models underestimated the capital required to support these assets.

As the business developed earlier this decade, many of the lower-rated tranches ended up going not to regulated banks, but to unregulated hedge funds that were trying to maximize their yields. Even though these hedge funds did not have regulatory capital requirements, these custom-manufactured securities had a similar impact there: they enabled investors to take on a large amount of economic risk using a small amount of capital. As a result, they increased the chances that hedge funds would go bust when the economy turned.

In general, a hedge fund failing is not such a terrible thing; that’s the price investors pay for seeking out higher yields. And I don’t buy the argument that hedge funds need to be regulated just because some of their investors happen to be warm and fuzzy, like teachers’ pension funds. However, individual hedge funds could grow large enough that their failure could have systemic effects. And in aggregate, the “shadow banking system” – unregulated institutions that amass capital from investors and direct it to users of capital via various types of investments – is itself a wholesale form of regulatory capital arbitrage, since this part of the financial system can escape regulatory capital requirements altogether, undermining the basic principle that the system should have sufficient capital to support the risks it takes on.

Regulatory capital arbitrage complicates the problem of designing a new regulatory structure for the financial sector. First of all, it implies that capital requirements must apply in some form to the shadow banking system as well as the traditional banking system. Otherwise, as Jones noted back in 2000, certain forms of financial intermediation will simply shift from the traditional to the shadow system. In addition, if the problem we want to manage is systemic risk, then focusing solely on institutions with certain types of charters will not be sufficient, especially as the unregulated ones become bigger and more numerous.

Second, it makes it hard to rely on capital requirements as a safeguard against either individual bank failure or systemic failure. It is probably a fair assumption that whatever rules are written, smart bankers and their lawyers will find ways to unbundle economic risk from regulatory risk weights and thereby take on more risk than they are supposed to. In my opinion, this is another argument for imposing size caps on financial institutions to ensure that they do not become too big to fail.

Third, however, regulatory capital arbitrage also makes it harder to enforce size caps. Let's say no institution is allowed to have more than \$300 billion in risk-weighted assets. What's to stop it from amassing \$300 billion of assets that are disproportionately risky relative to their risk weights? In short, we need a system for risk weighting that is harder to "game" than the current one – and a set of regulators who will enforce it. Given how long Basel II has been going on, and what it has come up with, this is asking for a lot.

By James Kwak

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May 30, 2009 8:18 AM

Mr. Geithner Goes to China

At his confirmation hearing in January, Tim Geithner [nailed the China Question](#). China prevents its exchange rate from appreciating through intervention (buying foreign currency), and this allows it to sustain a large current account surplus. Geithner said, as plainly as you can expect from a senior official: this is not in accordance with international rules and should stop.

Not only is this sensible economics and correct on the rules, it is also good politics. If you want to head off the considerable inclination towards protectionism in Congress, it would help greatly for the Chinese renminbi to rise in value (e.g., review the discussion at [this House hearing](#)).

But almost as soon as Geithner spoke on this issue, there was slippage. By late February, Hillary Clinton was [asking the Chinese nicely](#) to continue holding US Treasury securities and, it now seems, punting the exchange rate issue. Above all else, China [wants to be left alone](#) on the renminbi – variously arguing that any appreciation would jeopardize jobs, derail growth, and plunge the country into chaos.

So what should we expect from Geithner's [upcoming China trip](#)?

Not much.

China refuses to talk politely about its exchange rate and rebuffs all sensible diplomatic initiatives on this front – they have held the IMF at bay for nearly 2 years on this exact issue. The rhetoric is that their fiscal stimulus will bring down their current account surplus without need for significant exchange rate appreciation. This is smokescreen.

The reality is that the administration is afraid that China will shift out of its dollar holdings, pushing up interest rates on Treasury debt and jeopardizing their Fiscal First reflation strategy. The Chinese have played up these fears by speaking obliquely on the desirability of a non-dollar international reserve currency – this is a pipedream, but you get the point.

The administration has essentially blinked in the face of Chinese growling. This is strange for two reasons.

First, where would China move its reserve holdings? The other reserve currencies are generally considered to be the pound, the yen, and of course the euro. Which one would you definitely prefer to the dollar these days?

Second, any shift in the Chinese portfolio would also tend to depreciate the dollar – depending on what else is going on at that time – and this would likely push up inflation. However, the administration might welcome some inflation right around now, reducing real debt burdens, and helping banks' balance sheets and their operating profits. And a depreciated dollar would raise exports, greatly facilitating our economic recovery. It would be awkward for this to be explicit US policy, but any Chinese move would provide the administration with plausible deniability.

The standard view among the very people now running US macroeconomic policy is that the large Chinese current account surplus during the boom – and the consequent build-up of foreign exchange reserves – was destabilizing, because it helped make credit conditions looser in the US. In fact, “don’t blame us, it was the global [Chinese, Japanese, oil producers’] savings glut” is almost a mantra among our policy elite.

Personally, I would not overweight this element of the global credit mania – the financial services metabubble started long before China’s surplus became significant. But I’m seriously worried about the potential protectionist backlash today, given that China is the only major country that does not play by standard international trade and finance rules. The administration thinks it can safely postpone discussing China’s exchange rate for another, sunnier day. I’m not so sure.

Still, not wanting to discuss difficult topics should make for an easy visit to China.

By Simon Johnson

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May 30, 2009 12:08 AM

The Importance of Compensation

In my opinion, one of the biggest contributors to the crisis we know so well was compensation schemes that gave individuals at financial institutions – from junior traders all the way up to CEOs – the incentive to take massive bets. Put people in a situation where the individually rational thing to do is take lots of risk, and they will take lots of risk – especially if they are generally ambitious, money-loving, and predisposed to think that if the market is giving it to them, they must deserve it.

Alan Blinder does a good job explaining the problem in simple terms in the first half of his [WSJ op-ed](#). However, I'm not optimistic about his solution:

It is tempting to conclude that the U.S. (and other) governments should regulate compensation practices to eliminate, or at least greatly reduce, go-for-broke incentives. But the prospects for success in this domain are slim. (I was in the Clinton administration in 1993 when we tried — and failed miserably.) The executives, lawyers and accountants who design compensation systems are imaginative, skilled and definitely not disinterested. Congress and government bureaucrats won't beat them at this game.

Rather, fixing compensation should be the responsibility of corporate boards of directors and, in particular, of their compensation committees. . . . The unhappy (but common) combination of coziness and drowsiness in corporate boardrooms must end. As one concrete manifestation, boards should abolish go-for-broke incentives and change compensation practices to align the interests of shareholders and employees better. For example, top executives could be paid mainly in restricted stock that vests at a later date, and traders could have their winnings deposited into an account from which subsequent losses would be deducted.

Why am I not optimistic? Disney.

In 1995, Disney Chairman and CEO Michael Eisner hired his longtime friend Michael Ovitz to be president of the company. Ovitz was the founder of one of Hollywood's most powerful agencies, but had no experience even working in a company like Disney, let alone managing it. Eisner negotiated his friend's employment contract, which included a \$1 million annual salary and 5 million options, vesting in annual increments beginning in 1998. In addition, if Ovitz were fired within his first five years (but not if he were fired

for “gross negligence,” and not if he resigned voluntarily), he would be given – in addition to his salary for the remainder of the contract – \$10 million, \$7.5 million per year remaining on the contract, and his first 3 million options.

In 1996, one disappointing and controversial year after Ovitz joined, “Eisner and Ovitz agreed to arrange for Ovitz to leave Disney on the non-fault basis provided for in the 1995 Employment Agreement.” *Brehm v. Eisner*, 746 A.2d 244 (Del. Sup. Ct. 2000). As a result, Ovitz got about \$40 million in cash and 3 million options.

Disney shareholders sued the board of directors, both for approving a compensation agreement that gave Ovitz an incentive to try to get fired in the first five years, and for allowing him to leave on a “non-fault basis” rather than firing him for cause (gross negligence). On both counts, the courts, in both *Brehm v. Eisner* and *In re Walt Disney Co. Derivative Litigation* (Del. Ch. 2005), held that the board was not liable because of the “business judgment rule.” The business judgment rule says, in essence, that as long as a board of directors does not have a conflict of interest, informs itself adequately, and makes a decision, it cannot be held liable for that decision, no matter how obviously stupid it is or how catastrophic it turns out to be.

The business judgment rule is not a crazy rule; it is designed to allow directors and managers to take risks that may turn out badly without worrying that they may be held personally liable. But one of its effects is to shield boards of directors from any accountability for executive compensation decisions. It’s nice to say that boards “should” implement compensation practices that align managers’ incentives with those of shareholders, but it’s hard to see why this should happen.

Board behavior is determined by two things: power and incentives. The problem is that even though things have improved a little since Enron and WorldCom, directors are often de facto appointed by the CEO and serve at his pleasure; serving as a director is cushy enough that directors want to keep their jobs; and directors are dependent on the CEO and other managers for information. Although directors nominally represent the interests of shareholders, they can become a kind of insider, captured by the perks of the job and management’s control over the flow of information. From an individual director’s perspective, the high-percentage play is to approve generous compensation packages for the CEO and his lieutenants; that maximizes his chance of holding onto his board seat, and he has no personal accountability for his vote. Blinder describes “executives, lawyers and accountants” running rings around government regulations and regulators; today’s board of directors is an even easier mark for them.

Blinder says regulation of compensation practices is likely to fail. Having lived through it, he would know better than I. But I don’t think that waiting for better corporate governance is the answer. We will still be waiting when the next crisis hits.

If anything, I find myself more sympathetic to the views of Goldman CEO [Lloyd Blankfein](#):

We should apply basic standards to how we compensate people in our industry. The percentage of the discretionary bonus awarded in equity should increase significantly as an employee's total compensation increases. An individual's performance should be evaluated over time so as to avoid excessive risk-taking. To ensure this, all equity awards need to be subject to future delivery and/or deferred exercise. Senior executive officers should be required to retain most of the equity they receive at least until they retire, while equity delivery schedules should continue to apply after the individual has left the firm.

For policymakers and regulators, it should be clear that self-regulation has its limits. We rationalised and justified the downward pricing of risk on the grounds that it was different. We did so because our self-interest in preserving and expanding our market share, as competitors, sometimes blinds us – especially when exuberance is at its peak. At the very least, fixing a system-wide problem, elevating standards or driving the industry to a collective response requires effective central regulation and the convening power of regulators.

Blankfein's comments about regulation were not specifically addressed to executive compensation, but the references to "basic standards" in the first sentence and "elevating standards" in the last imply that he would not see compensation as off limits for regulation.

By James Kwak

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May 29, 2009 11:38 AM

The Risk Of Deflation In The Eurozone

In January, Lucas Papademos, Vice-President of the European Central Bank ECB), strongly suggested that inflation would not fall much below 2% in the eurozone (see the end of [this post](#)). Translated from the language of central bankers, he implied that the risk of deflation in the eurozone was virtually nil.

Now Jean-Claude Trichet, head of the ECB, with reference to the latest [eurozone \(0%\) inflation rate](#), says that we should disregard the data because a recovery is just around the corner.

Alternatively, we are close to the baseline eurozone view laid out in my [January presentation](#) (part of a panel discussion with Mr Papademos). You can break this down into three specifics.

1. Private sector demand is weak; it's hard to see who will lead the recovery within the eurozone. In addition, the demand for European exports has fallen much more than expected, as seen – for example – in the big decline in [German Q1 output](#).
2. The ability of the public sector to offset this decline with discretionary fiscal policy is quite limited, due to balance sheet constraints in some countries (look at the latest credit default swap data [from weaker euro sovereigns](#); [CDS primer](#)) and clear policy preferences in others (i.e., how Germany worries about inflation, even when there is none).
3. Banks look troubled across many eurozone countries, and as the real economy surprises on the downside these problems will increase – with presumed implications for government bailout programs and balance sheets (the [IMF was quite negative](#), see Tables 1.3 and 1.4 on pp.28 and 34 respectively, on European banks before the latest round of bad news). Remember that the European economy depends on banks much more than does the US.

If the world turns around and/or oil prices continue to rebound, the eurozone can presumably avoid deflation. But it's hard to see inflation rising any time soon due to the eurozone's own dynamic.

And if deflation takes root, it is hard to see this proving more tractable or less damaging than deflation in Japan during the 1990s. Which part of [Japan's lost decade](#) now looks easy to avoid in Europe?

By Simon Johnson

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May 28, 2009 10:52 PM

Feel-Good Story of the Day

[Calculated Risk](#) reports that Citigroup is livid that S&P would have the audacity to downgrade the senior tranches of commercial mortgage-backed securities.

Citigroup commented that the changes were “a complete surprise”, “flawed”, lacked “justification” and the “S&P methodology changes do not seem rational or predictable”. Ouch.

It's nice to see that the banks – who spent the last decade shopping for favorable ratings from the rating agencies, and overwhelming them with thousands of complicated offerings backed with sophisticated models – and the rating agencies – who spent the last decade giving AAA ratings to the banks' models and are now claiming that [it was all the banks' fault](#) – are getting along so nicely. Some marriages truly are forever.

By James Kwak

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May 28, 2009 9:54 PM

Sheila Bair Listens to Me

Yesterday I said that Tim Geithner or Sheila Bair should come out and [slap down](#) the idea that banks will be allowed to bid on their own assets. And today she did! Rolfe Winkler, in a guest post at [naked capitalism](#), did the hard work transcribing the audio of the press conference.

Although banks cannot buy their own assets, Bair did say, “I think there have been separate issues about whether banks can be buyers on other bank assets and I think that’s an issue that we continue to look at.” As I said yesterday, and as Winkler also said, I think this is also a bad idea. Even if you successfully deter outright collusion, you can still have outcomes where the industry as a whole is using subsidies to overpay for its own assets and shift the loss onto the government.

And no, I don't actually think that Sheila Bair reads this blog, much less listens to what I have to say.

By James Kwak

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May 28, 2009 4:12 AM

Brazen Tunneling and Inflation

In most societies it is traditional to be somewhat sneaky in squeezing your shareholders or the government. You might set up a complicated [transfer pricing scheme](#) or perhaps you arrange for a family-owned firm to [acquire assets on the cheap](#) from the publicly traded corporation that you control. Or you could always arrange for the Kremlin to provide foreign exchange at a “special” price.

In the New United States, life is much simpler and bank tunneling considerably more brazen.

I’m starting a bank blotter. Here are some early entries, from the WSJ on Wednesday:

1. We’ll pay ourselves very high wages, rather than substantial bonuses ([p.C3 in print edition](#)). This is brilliant. These banks are supposed to be recapitalizing themselves, which means earning profit – and this is usually harder to do if you increase wages. Lower wages would mean the exit of employees at some of the world’s least well run firms – entities consistently plagued also by the world’s most blatant agency problems – but the banks simply assert that would be a bad thing.
2. We’ll use [the PPIP money](#) to buy toxic assets from ourselves and thus “participate in the upside” ([p.C1 in print edition; reviewed here yesterday](#)). In any decent society, this would set the red flags flying, but the banks have apparently lost all sense of moderation. Look carefully at (perhaps) the most fantastic angle here – these assets will be moved “off balance sheet”, as if that does anyone any good; remember many such assets started off there and moved on balance sheet as the crisis developed. Come to think of it, the complexity inherent in the implicit conflicts of interest in this ~~seam~~ scheme would [go over well in Russia](#).

What does any of this have to do with inflation? If you want to the Fed [ever to be able to tighten](#), you need a healthy enough financial sector – i.e., given what we now know about policymakers’ preferences, banks in the “too big to fail” category better not be close to failing.

Big banks that pay higher wages will have less capital for the next round of difficulties. Banks that keep legacy assets close at hand will likely find out (again) why these loans and securities were called toxic. A weaker set of big banks will encourage the Fed to allow the yield curve to steepen, so monetary tightening happens later and perhaps too late to prevent inflation from taking off. Tunneling makes it harder for the Fed to tighten when inflationary pressures appear.

And if you think that inflation is not possible in the US any time soon, please see my column on [NYT’s Economix](#) (usually appears at around 7am Thursday morning, New York time) – post comments there or here.

By Simon Johnson

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May 27, 2009 10:56 AM

Banks Want Government Subsidies to Buy Assets from Themselves

From the headlines of the Wall Street Journal: “[Banks Aiming to Play Both Sides of Coin — Industry Lobbies FDIC to Let Some Buy Toxic Assets With Taxpayer Aid From Own Loan Books](#)” (subscription required, but [Calculated Risk](#) has an excerpt). I thought the headline had to be a mistake until I read the article.

To recap: The Public-Private Investment Program provides subsidies to private investors to encourage them to buy legacy loans from banks. The goal is to encourage buyers to bid more than they are currently willing to pay, and hopefully close the gap with the prices at which the banks are willing to sell.

Allowing banks to buy their own assets under the PPIP is a terrible idea. In short, it allows a bank to sell half of its toxic loans to Treasury – at a price set by the bank. I’ll take this in steps.

Assume that a bank has a portfolio of loans on its books at \$100 and that, when held to maturity, those loans will turn out to be worth \$90. In the absence of any transaction, it will end up losing \$10.

First, imagine the bank is buying these loans from itself with no government support. Let’s say it decides to pay itself \$80. Obviously this does nothing – no cash has changed hands, and the bank still has the toxic loans. It might take a \$20 “loss” today, but it will gain \$10 by holding those loans to maturity, so its net loss is still \$10.

Second, imagine that the bank creates an investment fund where its own money is matched dollar-for-dollar by Treasury money. If the fund buys the loans from the bank at \$100, then the fund will eventually lose \$10. That loss will be split between the bank and Treasury, so now the bank’s net loss is only \$5, because the other \$5 of losses is absorbed by Treasury. Conversely, if the fund pays less than \$90 for the loans, the gains will be split with Treasury, so the bank’s net loss will exceed \$10. If it pays exactly \$90, then the bank is no better or worse off than before the transaction.

In other words, it's exactly the same as if half of the loans were sold to Treasury, with the bank holding onto the other half. From the bank's perspective, it wants the price to be as high as possible.

Third, imagine that the equity in the investment fund is split evenly between the bank and Treasury, but it is leveraged up to six-to-one by a loan that has an FDIC guarantee. This has the effect of capping the bank's downside if the loans do really badly. The guarantee wouldn't kick in if the loans end up being worth \$90, but let's say they end up being worth \$70. Now if the fund pays \$90 for the loans, that is about \$6.50 of bank money, \$6.50 of Treasury money, and \$77 of FDIC-guaranteed loan. So the bank loses \$6.50, Treasury loses \$6.50, and the FDIC loses \$17. With no transaction, the bank would have lost \$30.

The third scenario is the PPIP.

So if banks are allowed to buy their own loans, they will have the incentive to overbid for those loans. As long as the price they pay exceeds the eventual value of the loans, they will come out ahead, even without the loan guarantees. This is bound to close the gap between buyers' bids and sellers' reservation prices – by ensuring that at least one buyer (the bank) will bid more than the reservation price set by the seller (the bank). And the way these investment funds are set up, the private equity partner – the bank – will be the one deciding how much to bid; the whole point of these "partnerships" was to get the government out of the business of valuing assets. In short, since the government doesn't have the expertise necessary to guard the henhouse, we'll let the fox do it.

Do you think this is so crazy it couldn't possibly be what the banking lobby is asking for? Consider this:

[Norman R.] Nelson proposed to the FDIC that banks be allowed to control as much as half the capital in a buyers' group. In some cases, he wrote, "the selling bank should be able to participate as the only private-sector equity investor."

(Nelson is general counsel of the Clearing House Association, a trade group representing ten of the world's largest banks.)

The blather being spouted in support of this self-dealing is so blatantly disingenuous it makes you wonder if this is some sort of joke.

"Banks may be more willing to accept a lower initial price if they and their shareholders have a meaningful opportunity to share in the upside," Norman R. Nelson . . . wrote in a letter to the FDIC last month.

Um, no. Participating as buyers will only ensure that banks will be motivated to overpay. If they think that the price is too low, they would prefer to just hold onto the asset – especially now that the stress tests have made clear that no bank will be forced to liquidate assets under pressure.

“Bankers see it as a win-win,” said Tanya Wheless, chief executive of the Arizona Bankers Association, which has urged the FDIC to let banks buy their own assets through PPIP.

That’s absolutely true – for them, that is.

Towne Bank of Arizona plans to sell some of its soured real-estate loans into PPIP and wants to profit from the program. “We think it would be attractive to our shareholders to be able to share in whatever profits there are from the venture,” said CEO Patrick Patrick.

It seems like this proposal is too extreme for some people in the banking lobby to support; neither Scott Talbott of the Financial Services Roundtable nor Edward Yingling of the American Bankers Association was quoted.

You would think that the government would slap down this idea in a second. But here’s the FDIC spokesman on the issue: ”It’s an issue that’s been raised and an issue we’re aware will need specific guidelines.”

Now, even if banks aren’t allowed to buy assets directly from themselves, there are still reasons to be worried. If you think of the banking sector as one big entity, then it’s obviously in the interests of that entity to buy assets from itself exactly as described above – only with Bank A buying from Bank B and Bank B buying from Bank A (or more complicated permutations as required). In other words, there is a massive incentive to collude. Now, collusion is illegal. So the question is whether the banks can get themselves into an equilibrium where they all overpay for each other’s assets – thereby benefiting everyone – without actually conspiring to do so. This is like when one airline raises prices and immediately every other airline follows suit – there’s nothing illegal about it, even though the end result is the same as if they had colluded.

But let’s not make it easy for them. If this proposal has any chance of going anywhere, then Tim Geithner or Sheila Bair should come out and reject it right now.

By James Kwak

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May 27, 2009 12:51 AM

We’re on Kindle

At the request of a few readers, we're now publishing the blog to [Kindle](#). I have a suspicion that block quotes in some posts may not work properly. (I used to use a simple indent for block quotes; now I use the <blockquote> tag to try to solve this problem.)

I have never seen or touched a Kindle, so I have no way of testing it. Please let me know if you try this out and if you have any problems.

By James Kwak

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May 26, 2009 10:54 PM

“I Have 13 Bankers in My Office”

The [Washington Post](#) (hat tip [Mark Thoma](#)) has a profile of Brooksley Born, who has been credited by dozens of commentators (including us) for unsuccessfully attempting to increase regulation of derivatives in the late 1990s while serving as the head of the Commodity Futures Trading Commission. There's much to admire, including being the first female president of the Stanford Law Review, making partner while working part-time, and, most importantly, this:

Born keeps informed, but she has other concerns, bird-watching jaunts and trips to Antarctica to plan, mystery novels to read, four grandchildren to dote on. “I’m very happily retired,” she says. “I’ve really enjoyed getting older. You don’t have ambition. You know who you are.”

Then there are the frightening flashbacks to the regulatory battles we are sure to relive this fall:

Greenspan had an unusual take on market fraud, Born recounted: “He explained there wasn’t a need for a law against fraud because if a floor broker was committing fraud, the customer would figure it out and stop doing business with him.”

Translation: Imperfections in free markets are logically impossible.

She wanted to release a “concept paper” — essentially a set of questions — that explored whether there should be regulation of over-the-counter derivatives. . . . [Robert Rubin, Larry Summers, and Arthur Levitt] warned that if she did so, the market would implode and predicted tidal waves of lawsuits.

Translation: You cannot say anything that might upset the markets.

In one call, Summers said, “I have 13 bankers in my office and they say if you go forward with this you will cause the worst financial crisis since World War II.”

Translation: The Deputy Treasury Secretary should listen to the thirteen bankers in his office.

[Mark Thoma](#) sums up:

The people in charge of the regulatory agencies were convinced that unregulated markets were self-correcting, and that regulation was not needed and would more likely do harm than good. As this shows, no amount of convincing from people who weren't as smart as the smartest guys in the room was going to change that. The question for me is whether those in charge now, Summers for example, have learned their lesson and the humility to be derived from it, or whether they will be defensive of their own role to the extent that it affects the type of regulation they can support. I'd very much like to believe they have learned their lesson, though humility seems to be lacking, but watching Summers and others argue that the private sector and the market is preferable to temporary government takeover of banks (i.e. his and the administration's opposition to temporary nationalization), – the continued faith that the market always knows best – makes me wonder if they have.

By James Kwak

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May 26, 2009 10:54 PM

[**Feldstein on the Economy**](#)

What does it mean that [Martin Feldstein](#) (hat tip [Mark Thoma](#)) is now one of my favorite economists, when it comes to commenting on the current economic crisis? Feldstein's analysis:

- Evidence of recovery so far is thin.
- The stimulus package will kick in and provide a short period of growth.
- But as the stimulus wears off, growth will fade away again.
- The Obama Administration's policies are pointed in roughly the right direction but not big enough to turn the tide.

Here's his conclusion:

The positive effect of the stimulus package is simply not large enough to offset the negative impact of dramatically lower household wealth, declines in residential construction, a dysfunctional banking system that does not increase credit creation, and the downward spiral of house prices. The Obama administration has developed policies to counter these negative effects, but, in my judgment, they are not adequate to turn the economy around and produce a sustained recovery.

Having said that, these policies are still works in progress. If they are strengthened in the months ahead – to increase demand, fix the banking system, and stop the fall in house prices – we can hope to see a sustained recovery start in 2010. If not, we will just have to keep waiting and hoping.

By James Kwak

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May 26, 2009 9:35 AM

The Crisis Is Over, And We Wasted It

Rahm Emanuel [reportedly](#) has a doctrine: [Never let a serious crisis go to waste](#). His point is a good one - vested interests usually block change across a wide range of important issues in the US, and a major financial/economic crisis provides an opportunity to bypass or breakthrough those interests in order to introduce meaningful and substantial change. [Emanuel listed](#) (from the 1:40 minute mark) five priority areas for change: health care (cost control and expansion of coverage), energy (independence and alternatives), taxes (fairness and simplicity), education (fundamental changes to effectively train the workforce), and financial regulation (transparency and accountability).

The financial crisis is abating - although the economic costs continue to mount and new problems may still appear (ask [California](#) or Ukraine). At least among the people I talk with on Capitol Hill, there is a very real sense that business is returning to usual; certainly, the lobbyists are out in force, they want what they always want, and it's hard to see many of them as seriously weakened. How much progress have we made on any of Emanuel's priority areas or, for that matter, along any other public policy dimension that was previously stuck?

The charitable answer would be: this is still a work in progress and you cannot expect miracles overnight. True, but Rahm's Doctrine (as Larry Summers apparently calls it)

says that you should implement irreversible change while you still have the chance. Tell me if I missed something, but has there been any breakthrough of any kind? Was it wrapped up in the fiscal stimulus? Is the credit card bill a bigger blow to vested interests than we have so far recognized? Has there been some secret progress on healthcare (although than a vague and apparently deniable pledge drive)? Were the bank stress tests more subtle than meets the eye?

We discussed this issue on [Bill Mayer's Overtime segment](#) from about the 2:20 minute mark on Friday. Jon Meacham just [interviewed President Obama](#) and came away with no clear sense of where the President is really pushing to make fundamental change – although Jon and Bill nicely summarize where he is compromising (from about the 4 minute mark of Overtime).

On financial sector issues, the lobbies look stronger than ever. “You can’t recover without us” appears to be a winning slogan for big banks and their appointees. Tough financial regulation may still appear later this year, but it looks like an uphill struggle – and there is no sense that the administration even wants to break vested interests in this sphere.

Perhaps Rahm’s Doctrine was overly optimistic as a broad aspiration, but at least on the financial front some tangible opportunities went to waste.

By Simon Johnson

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May 25, 2009 11:30 PM

What Good Is It, Anyway?

Behind the ephemeral debates over the financial crisis and the bailouts it has spawned, there is a broader debate about the financial sector as a whole: what good is it, how much of it do we need, and how do we know if it is working?

There are many descriptions of what the financial sector does, but most of them have something to do with moving capital (money) from someone who has more than he needs to someone who could use a bit more. And I think most people would agree that is a good thing, as long as the latter person has some productive use for it. Mike at Rortybomb, in [“The Financial Sector We Want,”](#) describes a doctor saving up \$1,000 more than she needs for consumption and lending it to a factory, which returns her \$1,100 after a year. In real life, we need some kind of a financial sector to get the money from the doctor to the factory, even if it’s just a single local bank. Everyone is happy.

When you start asking how big the financial sector should be, and whether or not it is working properly, things get more complicated. One of the Economist's [Free Exchange](#) bloggers took the position that financial innovation is generally good in and of itself, although it has a high risk of creating "negative spillovers" – a higher risk than for non-financial innovation: "Most financial innovations are positive, and we don't know *ex ante* which will be negative, so giving ourselves the power to block certain innovations because they might have negative spillovers is risky." At first blush, this seems like a reasonable extension from real-world innovation to financial innovation.

However, Mike (Rortybomb) has an interesting [counter-argument](#). Financial innovation, he says, is not like real-world innovation; the former only creates value if it solves an existing market imperfection. Figuring out which factories are worth investing in – so the doctor doesn't have to worry about it – solves a market imperfection. But his point is that it's the factory that's creating the value; the financial sector is helping make that possible. So, he argues, if someone figures out a way to get a higher yield out of a risk-free investment (and that was the point of the CDO boom, where you could create a "super-senior, better-than-AAA" bond that paid a higher yield than Treasuries), then you either have to show what market imperfection it is solving, or it isn't actually risk-free. In most cases, he suspects, innovation that generates a higher return does so simply by taking on more risk.

So what are we to make of the last quarter-century, when the financial sector got bigger and bigger and the people in it got richer and richer?

An instinctive free-market reaction might be to assume that the financial sector was doing great things, and that the people getting rich deserved to. But from Mike's perspective, you have to ask: did people suddenly discover how to fix such massive market imperfections that they deserved to make that much money for so long? [Ryan Avent](#) put it this way:

Frankly, I have no idea what most of the recent growth in finance was for. . . . To get back to Mike's original point, when you have a few people taking home billions, that's a sign of either very good luck or some brilliant new strategy. When you have a lot of people in finance taking home billions, then something has gone badly wrong. Either something unsustainable is building, or there are some serious inefficiencies in the market.

And [Felix Salmon](#), I think, pinpointed the crucial issue. If the financial sector was doing such a good job innovating, then it shouldn't have continued making so much money.

[O]ne would hope and expect that between sell-side productivity gains and a rise in the sophistication of the buy side, any increase in America's financing needs would be met without any rise in the percentage of the economy taken up by the financial sector. That it wasn't is an indication, on its face, that the financial sector in aggregate signally failed to improve at doing its job over the post-war

decades — a failure which was then underlined by the excesses of the current decade and the subsequent global economic meltdown.

Ordinarily, if an industry innovates, a few people make a lot of money, and then most of the benefits flow to that industry's customers. Let's take one of the greatest examples of recent history: Microsoft and Intel together probably created a handful of billionaires and a few thousand multi-millionaires out of their employees; but for at least the last ten years, no one going there has gotten anything more than a decent salary and a good resume credential. As computers get smaller, cheaper, and faster, the benefits flow overwhelmingly to their customers — to us. And those are near-monopolies. The general pattern in the technology industry is that a few entrepreneurs make a lot of money, and the vast majority of people make a decent salary; even the highly-educated, highly-trained, hard-working software developers, most of whom could have been "financial" engineers, are making less than a banker one year out of business school.

That's the way innovation is supposed to work. You invent something great, you make a lot of money, then your competitors copy you, prices go down, and the long-term benefits go to the customers. And you and your competitors all get more efficient, meaning that you can do the same amount of stuff at a lower cost than before. If you want to make another killing, you have to invent something new, or at least invent a better way of doing something you already do.

By contrast, the historical pattern of the financial sector — rising revenues, rising profits, and rising average individual compensation — is what you get if there is increasing demand for your services and, instead of competing to lower costs and prices, you limit supply. Sure, prices fell on some financial products, but financial institutions encouraged substitution away from them into new, more expensive products, with the net effect of increasing profitability (and compensation). Why this happened I won't try to get into here, but it would be worth understanding if we want to reduce the chances of living through this crisis again in our lifetimes.

By James Kwak

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May 25, 2009 3:40 PM

Recession and Recovery: How Long?

I've [commented earlier](#) that many economic forecasts seem to assume reversion to the mean — here, meaning average economic growth over the last two decades. For a great example, go to the [Wall Street Journal](#) and admire the GDP growth rates projected for Q3

2009 through Q2 2010, marching happily up and to the right. (The numbers are 0.6%, 1.8%, 2.3%, and 2.8%.) This recession is different, however, and even if there is a mean to revert to after U.S. households decide how much they want to save, there's no telling how long it will take.

For one perspective, the [Carnegie Endowment for International Peace](#) had a session at the end of April featuring a few IMF economists. Marco Terrones (link to PowerPoint at the bottom of the page) looked at the typical duration of a recession and the ensuing recovery. The duration of recovery is measured to the point at which the economy reaches its previous peak output (the output level when the recession began – December 2007 in our case). He looked at 122 recessions since 1960.

Terrones's key point was that recessions last longer, and take longer to recover from, if they are linked to financial crises or if they are globally synchronized, for reasons that are probably evident to our readers: popping credit bubbles lead to an increase in the savings rate, dampening consumption; and globally synchronized recessions mean that no country can export its way back to growth. On average (slide 5), a recession that is both linked to a financial crisis and globally synchronized will last three quarters longer than normal (seven rather than four), and recovery, measured from the beginning of the recession, will take seven quarters longer than normal (fourteen rather than seven). (There is obviously some correlation there, since the longer the recession, the more ground needs to be made up.) Those are just averages, but projecting onto our experience that means recovery would start in Q4 2009, but we would not reach our peak (December 2007) output level until late 2011. Since the workforce will have grown by a few percent in the interim, unemployment would not reach December 2007 levels – if ever – for another year or two.

Seven quarters of contraction and seven of recovery to previous peak don't seem that bad. Of course, this is still just an estimate based on data going back to 1960, and there is nothing in that time period like what the world is going through today.

This analysis is covered in greater detail in Chapter 3 of the IMF's April [World Economic Outlook](#).

By James Kwak

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May 25, 2009 7:37 AM

[Design A Country Rescue Package Here \(Comment Competition\)](#)

Here's your Memorial Day assignment. You have been called to the table for top-level policy discussions in a large monetary union. One of the bigger countries in this union has a serious problem. Their exports are down slightly and there are some longer-run structural issues, but the immediate issue is (1) a housing bubble just burst, resulting in a big fall in tax revenue, (2) the political system seems paralysed, i.e., cannot raise other revenues or cut spending in any sensible fashion, and (3) the market for this government's debt appears likely to turn very sour. Sounds like a classic fiscal crisis.

Here are your possible recommendations:

1. Let them go bust. This is tempting, given the failure of the political class in this country to come to terms with its obvious problems. Also, this would presumably shake the rules of the system enough so they can finally raise revenue or cut spending sensibly. But this would also create dangers for other countries in your currency union, for example by increasing the risk premia on all debts. And a lot of poor people will get hit hard; you know that always happens in a free fall.
2. Give them a big loan. This is, of course, what the political elite in this country would like - they are asking for money on easy terms, arguing that none of these current difficulties are really their fault. If you feel that at least some of their problems are temporary, a loan makes sense. But you'll also want some conditions, meaning steps they should take to ensure you get paid back. If they don't pay back (or can't pay back for a long while), that creates costs for taxpayers in other (more fiscally responsible) parts of your union and what would be fair or politically sustainable about that? So what conditions do you want to **impose** negotiate towards?
 - No conditions. You trust them and they are your friends. Hopefully, they will run things better in the future.
 - Tell them to raise revenue and/or cut spending. They can decide; it is a sovereign country after all.
 - Insist that they raise revenue. If doing so effectively is prevented by their constitution, they need to change the constitution.
 - Tell them to cut spending any which way they can. This will hit the poor just like in the "go bust" scenario, but this way the country's elite can blame you.

Underlying all this, of course, you have to take a view on the politics. What vested interests exactly have got them into this mess? Certainly, there was a big shock from circumstances outside their control, but this country's policies were asking for trouble – any time you run a big housing boom, you are vulnerable to a dramatic slowdown (and loss of revenue). If you are going to lend money, don't you want to feel that the loan will allow or even force the political equilibrium to shift? Otherwise, won't this country repeatedly run into the same kind of fiscal difficulties? This kind of fiscal crisis is always about powerful groups, but are we facing oligarchs or something else in this particular instance?

This missing option above, of course, is to give the country a loan at the same time as they restructure their debts, i.e., a form of debtor-in-possession bankruptcy financing. But the creditors to this country are also powerful at the level of the monetary union and perhaps in the more fiscally-responsible parts of that union – so count on these groups to oppose any debt write-downs. One argument they'll use is that such restructuring will either trigger a panic or lead to higher borrowing costs for other member countries. So what are you going to do about that?

You can answer these questions either for [Spain](#) or [California](#).

By Simon Johnson

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May 23, 2009 8:45 PM

Foreclosures and Modifications for Beginners

On last week's [This American Life](#), Chris Arnold of NPR did a good segment on loan servicers and why they do or do not modify loans for delinquent borrowers (starting around the 10-minute mark). There isn't a lot that avid readers won't know already; the central message is that it would be better for everyone involved – including lenders and investors – if more loans were modified. It also doesn't address the legal issues created by collateralized debt obligations where the tranches have different priorities. But if you're confused about the basics, it's worth listening to.

Still, there were a couple things that were new or interesting to me:

- Scott Simon, a managing director at PIMCO (the world's biggest bond fund manager), said that he thinks loan servicers should be modifying more mortgages; that seems like a pretty clear vote from the investor side.
- The segment brings up the issue of computer systems, which is something I hadn't thought of but should have. Apparently, most if not all of the big, bank-owned servicers don't have computer systems (software) that can estimate the net present value of a foreclosure as opposed to a modification, taking into account zip code-specific repair costs, broker's fees on the sale, closing costs, foreclosure-specific legal costs, and expected sale proceeds. Big-company information technology is something I know well, and I can say with a high degree of confidence that if they started designing these things in 2007, they won't be done until sometime next year at the earliest, and there's a good chance they won't work, and even if they do they will have difficulty handling the load. On the other hand, one good product manager and ten good developers in Silicon Valley could

probably build something better in about 12-18 months. I sure hope the fate of the economy doesn't depend on custom homegrown software.

By James Kwak

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May 23, 2009 12:54 PM

What I Didn't Get To Say On Bill Maher Last Night

We could have talked more (or even the whole show) about the ideas of [Muhammad Yunus](#). His book, [Creating A World Without Poverty](#), argues we should look beyond standard for-profit business and consider expanding the emphasis on “social business.” This – among other things – preserves investors’ capital but doesn’t aim to make it grow, while serving pressing social needs with a business-like delivery model.

Versions of these ideas came up repeatedly in [a course](#) I just finished running at MIT, with [Anjali Sastry](#) and other colleagues, in which more than 50 students put their business skills to work helping health care projects in Africa become more effective. Muhammad is definitely right that more and more business people want to get involved in this kind of social space, and many [social entrepreneurs](#) welcome input/advice/any kind of serious contribution.

Ordinarily, we might dismiss a zero real rate of return as uninteresting to anyone who has other uses for their money – but Muhammad is quite eloquent on how such an investment is complementary to seeing more in your life and in finding ways to really help others.

In addition, presumably this part of your portfolio would be pretty stable and largely uncorrelated with other investments. Perhaps, in the light of recent events, we should all consider having part of our longer-term savings in a “preservation of capital” category of assets. This is not the usual ambition that the finance industry encourages, but it may become part of sensible diversification – particularly if it enables you to help others in measurable, productive ways (and Muhammad is big on measurement and assessment of success, while recognizing it is hard in this sphere). Perhaps it even provides us with a “parachute” of perspectives, network connections, and resources that are available if our regular careers go off-track?

Actually, I didn’t get to say many other things also – in this kind of format, you have to answer the questions (pretty much) as asked and go with the flow of the conversation. Feel free to tell me what points I missed; even better if you have a succinct phrasing I can use for any future interviews.

And thanks for all the [useful input](#) that you provided in the run up to Friday evening.

The Overtime segment of the show – recording immediately after the TV broadcast – is on the web ([currently here](#), but that's not a permalink; [update: permalink](#)). For the show itself you need [HBO](#), which will have it on-demand until July 5th.

By Simon Johnson

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May 23, 2009 12:34 AM

Option Pricing for Beginners

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

I've had [two posts](#) so far on the terms under which Treasury sold back to Old National the warrants on Old National stock that Treasury got in exchange for its TARP investment, so I thought it was time for an introduction to warrant/option pricing.

The warrants received by Treasury give Treasury the right to buy common stock in the issuing bank under predefined terms. Buying the stock is called *exercising* the warrant. The warrant specifies how many shares Treasury can buy; the price that it must pay to buy them (the exercise price); and the term of the warrant, meaning how long Treasury has to decide whether or not it wants to exercise the warrant. If Treasury never exercises the warrant, then it expires and nothing happens. For our purposes, a warrant is the same as a call option; there are some differences I will ignore, which are outlined [here](#).

Warrant terms

These warrants were part of the [terms](#) of the TARP Capital Purchase Program, which is what Treasury used to recapitalize banks last fall, starting in October. The warrants have value for Treasury – how much, I'll get into later. Therefore, they make it possible for Treasury to be more generous with other terms of the transaction. Arguably, the warrants helped compensate for the fact that Treasury was buying preferred stock with a very low dividend yield – only 5%. There is no way that most banks would have been able to issue new preferred stock with only 5% dividends back in October-November. Probably the more important reason the warrants were mixed in was that they made it easier to justify the transaction politically; through the warrants, the taxpayer could "participate in the

upside" if things went well, because if the stock price went up, the warrants would become more valuable.

As part of the Capital Purchase Program, banks had to give Treasury warrants on common stock equal in value to 15% of the amount of money invested. Treasury invested \$100 million in Old National, so it needed warrants on \$15 million worth of common stock. So it got warrants to buy 813,008 shares at an exercise price of \$18.45; $813,008 * 18.45 = 15$ million, or something very close to it. \$18.45 represented the value of the common shares at the time of the investment. The idea is that the warrants were supposed to be "at the money," if the stock went up, Treasury could exercise the warrants and make money; but if it went down, Treasury would get nothing (at least not from exercising the warrants).

Actually, that isn't quite accurate, for two reasons. First, according to the original [term sheet](#), the exercise price was set not at the share price on the investment date itself, but as the average of the closing price for the twenty previous trading days; the idea here, which is common, is to protect both sides against day-to-day swings in stock prices. In Old National's case, that would have been \$16.35. However, in early April the [Wall Street Journal](#) reported that Treasury changed the terms to base the exercise price on the date that the bank's application to participate in the CPP was approved, which was an earlier date. Because November-December was a period of falling bank stock prices, in the large majority of cases the change in dating had the effect of increasing the exercise price of the warrants, thereby reducing the value of the warrants to Treasury (because it would have to pay more for each share). In Old National's case, it produced an exercise price of \$18.45 instead of \$16.35.

(Ilya Podolyako actually drafted a post about this at the time, but I chose not to publish it because I didn't want to be hammering Treasury for every little thing they did that helped the banks. But I think it's an important part of this story. Ilya also pointed out that when private companies do this kind of thing – setting the exercise price based on market prices in the past – it's called backdating, and it's illegal. My apologies to Ilya for not publishing the post then.)

Those warrants have a term of 10 years, meaning that Treasury has until 2018 to decide whether or not to exercise them. They also have an unusual "Reduction" feature, which says that if the bank raises more money than Treasury invested by the end of 2009, through sales of new common or perpetual preferred stock, half of the warrants will instantly evaporate.

Warrant pricing

So how much are these things worth? On the date of the sale, Old National's common shares were trading at \$14.70 – \$3.75 *below* the exercise price of the warrants. So if Treasury had done the crazy thing and exercised the warrants, it would have paid \$18.45 for a share of stock worth \$14.70, for a total loss of about \$3 million.

However, the warrants themselves, like all options, always have some positive value, as long the term has not expired. You never have to exercise the warrants, so in no scenario will you be forced to lose money on them; and there is always some chance that the stock price will go above the exercise price, at which point you could exercise them and make money. The question is how much.

Conceptually speaking, you are trying to figure out the chances that the stock will someday be worth more than \$18.45, times the profit you will make from exercising the warrants at that point. This clearly depends on the following parameters:

- Exercise price: The higher the exercise price, the less likely your warrant is to make you money.
- Current stock price: The higher the current price, the more likely you are to make money.
- Time to maturity: The more time you have, the higher the chances that the stock price will climb above the exercise price.

And it depends on one more parameter: volatility or, roughly speaking, the tendency of the stock price to move up and down. In the case of Old National, the stock price has to go up by \$3.75 (25.5%) before the warrant can be exercised at a profit; the more volatile the stock, the more likely this is.

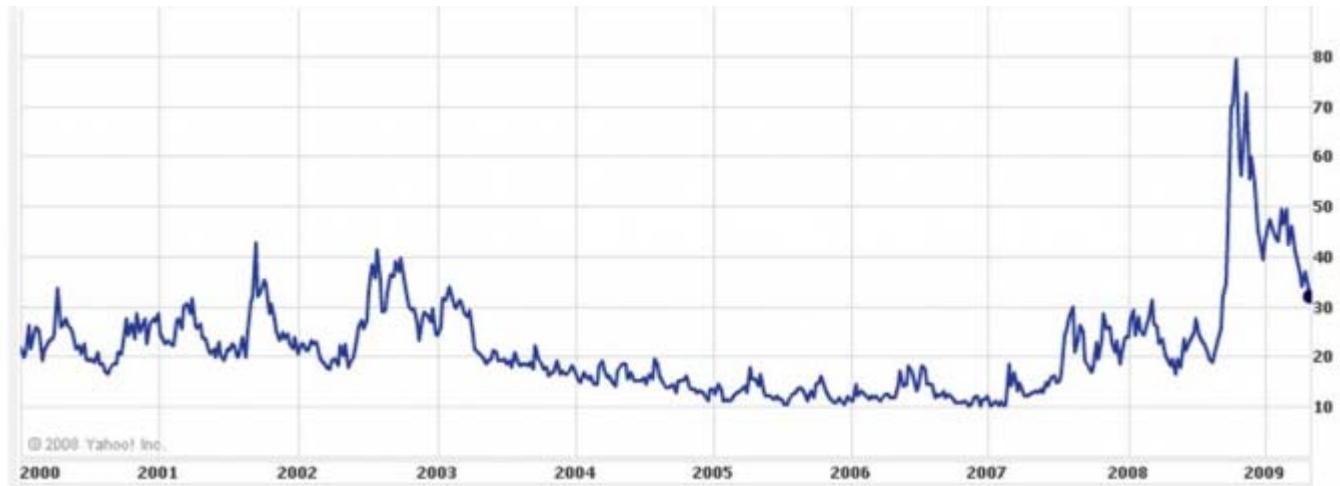
Making some additional assumptions, like zero transaction costs and zero dividends, Fischer Black and Myron Scholes worked out a formula to calculate the value of an option from these parameters (and the risk-free interest rate, since you are looking at the future and money loses value over time), which is now known as the Black-Scholes formula, and has been described as the central pillar, for better or worse, of modern finance. (Nassim Taleb strongly disagrees.) I think I had to derive the formula in a micro class a long time ago, but my memory of that year is a bit fuzzy, perhaps because I met my wife in that class.

In any case, the formula incorporates this useful intuition: To calculate the value of an option, you only need to know the expected value of exercise on the maturity date. This is because, theoretically, that is the only day on which you should ever exercise an option. Even if your option is \$10 “in the money” (market price exceeds exercise price by \$10), there is always a little bit of extra option value, because the potential upside is infinite, and the potential downside is bounded by \$10.

Note that the formula says you can price an option without even having an opinion about the fundamental value of the underlying stock – all you need are its current price and its volatility. This is consistent with a general (though not necessarily correct) principle that stock markets always efficiently price assets, so any opinion you may have about the stock’s fundamental value is foolish.

Also note that the key assumption in the formula is that stock prices will move randomly with constant volatility, and the key parameter in the formula is volatility. The other

inputs are basically observable (though not quite in the case of the risk-free rate), but volatility is not. You need to know the volatility of the stock price between now and the maturity date, but all you can see is its volatility in the past. This makes option pricing especially difficult right now, because stock price volatility has been much higher over the last eight months than over the previous eight years. (The chart is the implied volatility of the S&P 500 since 2000.)



So if you use the volatility over the last eight months, you will get a much higher warrant value than if you use the volatility over the last eight years. More fundamentally, using any volatility assumption based on past data falls into the trap of assuming that the future will be like the past. This is never a foolproof assumption, and the longer the timeframe you are looking at, the worse the assumption becomes. It usually may not matter a lot for typical short-dated options (30 days, 60 days, etc.) – unless the world changes during those 30 days – but it matters a lot for long-dated warrants, like the 10-year warrants that Treasury got.

Real stocks also pay dividends, and the higher the future dividends, the less your warrant will be worth – because those dividends essentially come out of the future stock price. So your formula has to have some estimate of what dividend payouts will be. Again, this is especially hard right now, because many banks – including Old National – have drastically cut their dividends recently, and it's difficult to predict when they will go back to paying higher dividends.

Finally, the “Reduction” feature of the TARP warrants throws another wrench into the works. To value the warrants, you have to take into account the fact that half of them could vanish if Old National raises \$100 million by issuing stock before the end of the year; and as long as the warrants were outstanding, they had an incentive to raise that money. That involves making guesses about the overall funding climate, and the corporate strategy of Old National, neither of which can be statistically estimated.

So now you should know enough to understand the three key assumptions behind the estimates in [Linus Wilson's paper](#). (However, the Bloomberg story does not provide its option pricing assumptions.) You should also be able to follow the discussion over assumptions between q and Sandrew in the comments to my previous post, [beginning here](#).

What should Treasury have done?

q, a regular commenter here, concludes that the price Treasury got is within the range of reasonableness, given his preferred set of assumptions. However, he [also says](#) (agreeing with [Nemo](#)) that Treasury should not have negotiated a sale to Old National, but should have simply held onto them until maturity (remember, you don't want to exercise them early); if the real issue was restrictions placed on TARP money, the government could have rolled them back (for banks that bought back their preferred shares). Or, if Treasury didn't want to hold onto them, they could have auctioned them off.

While these are economically superior to simply negotiating a sale in a market with a single potential buyer (Old National), it gets us into the complicated world of TARP terms and conditions. First, the original term sheet said that Treasury could not sell more than 50% of the warrants before the end of 2009, because, remember, 50% of the warrants would vanish if the bank made a qualifying equity offering. Still, Treasury could have sold half and then held the rest; this would have had the salutary effect of giving Old National an incentive to raise new capital.

Second, assuming Treasury did not sell the warrants, when Old National bought back its preferred shares, it got the right to buy back the warrants at "fair market value" – but there is no market. (You can get a quote on short-dated options, but not long-dated ones – these are typically over-the-counter.) I haven't found the implementation rules, but an article in [Fortune](#) said this:

February's stimulus legislation – which gave TARP recipients the right to repay funds without raising new capital or observing any waiting period – specified that Treasury must liquidate a bank's warrants at the current market price after it repays its TARP preferred stock.

I gather from bits and pieces I remember reading that there is some sort of appraisal process where the bank and Treasury first try to agree on a value, and I believe if that fails then there is supposed to be an auction. Auction participants would know all about option pricing, of course, and would apply a range of assumptions; presumably the sale would go to the buyer with the highest volatility assumption, which would probably (but not certainly) yield a higher price than Treasury got.

Of course, the banks have their opinion about all this (from the same Fortune article):

The American Bankers Association trade group last week sent Treasury Secretary Tim Geithner a letter calling for the government to eliminate the warrant-

repayment provision altogether. The ABA said repurchasing the warrants amounts to an “onerous exit fee” for banks that have already repaid in full the funds they got from Treasury. . . .

Treasury must attempt to liquidate the warrant, the stimulus legislation says. But the ABA decries this as well, saying in its letter that selling the warrant to a third party could unfairly dilute a bank’s shareholders.

In other words, Treasury should just rip up the warrants – even though the warrants were one reason why the banks got investments on such generous terms in the first place. How times have changed since last fall.

By James Kwak

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May 22, 2009 10:44 AM

Warrant Sales Could Cost Government \$10 Billion

Mark Pittman at [Bloomberg](#) estimates the total potential cost to taxpayers of selling warrants back to banks at low prices: \$10 billion. These are the warrants that banks had to issue to Treasury in exchange for preferred stock investments under TARP. Pittman uses the [Old National example](#) as a benchmark: Old National paid \$1.2 million to buy back warrants that he estimates at \$5.8 million. (Linus Wilson, the first person I know of to do the calculations, estimated a [range of values](#) from \$1.5 million to \$6.9 million.) Extrapolating that “discount” to all the other warrants that Treasury currently holds, Pittman finds:

Under the Old National warrants formula, Bank of America Corp. would save \$2.03 billion, followed by Wells Fargo & Co. at \$1.48 billion and JPMorgan Chase & Co. at \$1.46 billion. Morgan Stanley’s benefit would be \$983 million, Citigroup Inc.’s would come in at \$965 million and Goldman Sachs Group Inc. would have \$693 million, according to the data compiled by Bloomberg.

If you are concerned about banks’ capital levels, that’s one way to help them out. The alternative, suggested by Wilson and others, would be for Treasury to auction off the warrants; if the bids were too low, it could create a trust, transfer them from Treasury to the trust, and release the banks of any TARP obligations triggered by those warrants.

It also contrasts sharply with the treatment of private (not publicly-traded) banks such as [Centra](#), as documented by David Kestenbaum of [Planet Money](#).

I'll have more on option pricing later.

By James Kwak

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May 21, 2009 6:40 PM

Geithner Plan vs. Paulson Plan

[Dennis Snower](#) works out the arithmetic behind the Public-Private Investment Program and shows something that [we've suspected](#): if the assets are really toxic (the gap between book value and long-term expected value is big), the subsidy just isn't big enough. He also shows that if the assets are only a little toxic, the government subsidy induces private sector bidders to overbid, making the subsidy bigger than it needs to be.

Snower's hypothetical asset has an expected value of \$50. According to his calculations:

- If the bank has it on its books at \$70, the private sector will bid it up to \$85 because of the government subsidy. The government would have been better off under the original Paulson Plan (just buy it off the bank at book value, in this case \$70).
- If the bank has it on its books above \$85, the private sector will not buy it at all and the plan will do nothing.

Now, his asset has different characteristics than the assets out there in the real world, whose expected values are not knowable, let alone known. That may change the analysis, but I doubt it changes the ultimate result.

Thanks to the reader who recommended this.

By James Kwak

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May 21, 2009 6:05 PM

Many Countries Are Worse Off Than We Are

These are real GDP growth rates for Q1 over Q4, not annualized (like we do here in the U.S.), for the G7 and the Eurozone:

- Japan: -4.0%
- Germany: -3.8%
- Eurozone: -2.5%
- Italy: -2.4%
- U.K.: -1.9%
- U.S.: -1.6%
- France: -1.2%

Figures are from Bloomberg. Canada seems to be doing better, but Bloomberg doesn't have quarter-over-quarter rates.

And here are the year-over-year figures:

- Japan: -9.7%
- Germany: -6.9%
- Italy: -5.9%
- Eurozone: -4.6%
- U.K.: -4.1%
- France: -3.2%
- U.S.: -2.6%
- Canada: -2.3%

Not pretty.

By James Kwak

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May 21, 2009 3:10 PM

CAFE, Part Two

In the [same post](#) I discussed yesterday, Keith Hennessey cites the same NHTSA report – the [Final Rule](#) governing CAFE standards for model years 2011-15, issued in January 2008 – to make this point: “The proposal will have a trivial effect on global climate change.” (It’s point 5 in his post, and was also picked up by [Alex Tabarrok](#) in his

endorsement.) Hennessey cites the NHTSA report accurately, but the report itself is misleading.

What does the report say? Look at Table VII-12 on page 624. There are three scenarios that we are concerned with: No Action (which Hennessey calls, and I will call, "Baseline"); Optimized ("Bush Plan"); and Total Costs Equal Total Benefits ("Obama Plan"). If you want to know why Optimized is Bush and $TC = TB$ is Obama, see my previous post. In the year 2100, the projected carbon dioxide ("CO₂") concentration in the atmosphere, in parts per million, is:

- Baseline: 717.2
- Bush: 716.2
- Obama: 715.6

That's pretty convincing – or is it?

To answer that question, we'll have to look at the report that those numbers are drawn from: the enormous [Final Environmental Impact Statement](#), whose summary is [here](#). You can see that the two documents tie by looking at Table S-9 on page 14 of the FEIS, which matches the table in the report Hennessey cites.

First, U.S. light vehicles account for a disproportionately large, but still absolutely small share of global greenhouse gas (GHG) emissions. From page 5:

Emissions from the United States accounted for approximately 15 to 20 percent of global GHG emissions in the year 2000. With more than one-quarter of these U.S. emissions due to the combustion of petroleum fuels in the transportation sector, CO₂ emissions from the United States transportation sector represent approximately 4 percent of all global GHG emissions. Emissions from passenger cars and light trucks account for about 60 percent of emissions from the U.S. transportation sector.

So the greenhouse gas source targeted by CAFE accounted for 2.4% of global emissions from all sources. If we're going to look at a 2100 projection, though, we have to take into account the fact that that percentage is certain to go down over the century as countries like China and India become more developed under any scenario. I'm going to guess that by 2100, even in the baseline, U.S. cars and light trucks would fall to 1.6% of global GHG emissions; that means that on average, over the century, they would be producing 2% of global emissions.

Obviously, if all we do is reduce emissions from one source that accounts for 2% of the total, we're not going to have a noticeable impact on global warming. If we want to know if we're doing "enough" in this one little area, the right question to ask is: if we were able to reduce emissions from all sources by the proportion that we are able to reduce U.S. car and light truck emissions, would that have an impact? To answer that question, we have to multiply the impact of the CAFE standards by 50. Then the numbers look like this:

- Baseline: 717.2
- Bush (assuming similar reductions of all other sources): 667.2
- Obama (same assumption): 637.2

That's starting to look better, but in the baseline, CO2 ppm in 2030 are 455.5, so we're still really high.

Second, however, the much more misleading part of this report is its assumptions about what happens after 2020.

To begin with, we have to understand what the various scenarios are. It's not clearly spelled out, but the Summary implies that the baseline scenario is one in which the 2010 CAFE standards are extended to cover the 2011-15 period; see for example footnote 13 on page 13. Most of the other scenarios estimate what would happen with different CAFE standards for model years 2011-15. The important point is that *they only measure the impact on model years 2011-15*. Relative to the baseline, they don't even assume that higher standards in 2015 will lead to higher scenarios in later years; they assume that after 2015, CAFE standards *revert* to the baseline. For example, see footnote 10 on page 8:

NHTSA uses 2060 as the end point for the analysis [of fuel consumption] because it is the time at which 98 percent or more of the operating fleet would be made up of MY 2011-2015 or newer vehicles, thus achieving the maximum fuel savings under this rule.

(Footnote 11 on page 11 says essentially the same thing, in the context of toxic air pollutants.) You see? They are assuming that higher standards for MY 2011-15 will have *no effect* on standards in later years.

This is absurd. Even if NHTSA never wrote another CAFE standard for any year after 2015, the fact that, under either the Bush or Obama plan, CAFE would be higher in 2015 than in the baseline implies that fuel efficiency will remain higher than in the baseline for some time to come, if not forever.

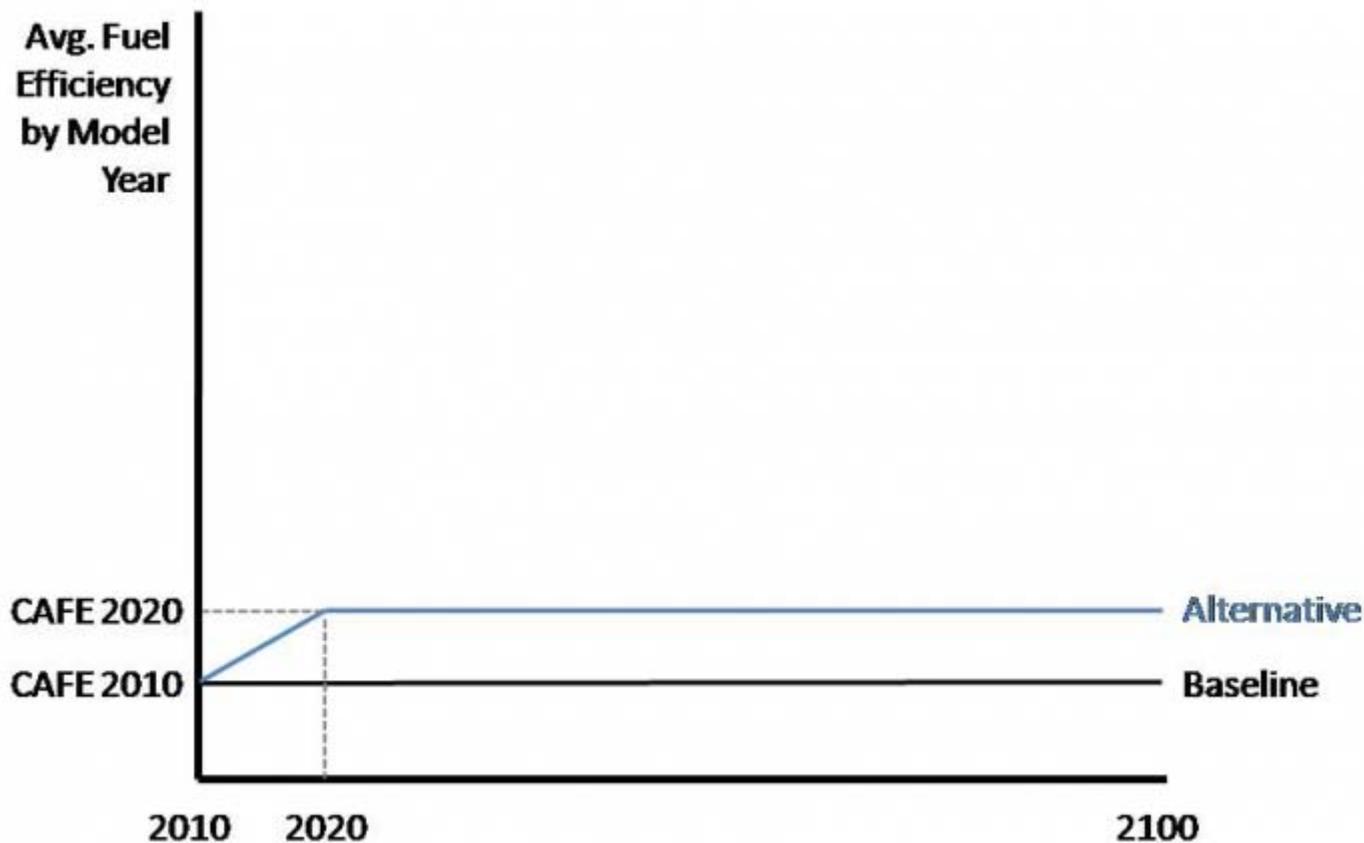
For greenhouse gases, however, the analysis is not quite so ridiculous. To see the assumptions, however, we have to leave the summary and go to the [Cumulative Impacts](#) section. There, at the bottom of page 53, we see this:

For each alternative, NHTSA assumed that passenger car and light-truck CAFE standards would continue to increase over MY 2016-2020 at their average annual rate of increase over MY 2011-2015. . . . NHTSA assumed further that the fuel economy standards for model year 2020 would remain in effect through the end of the analysis period [2100].

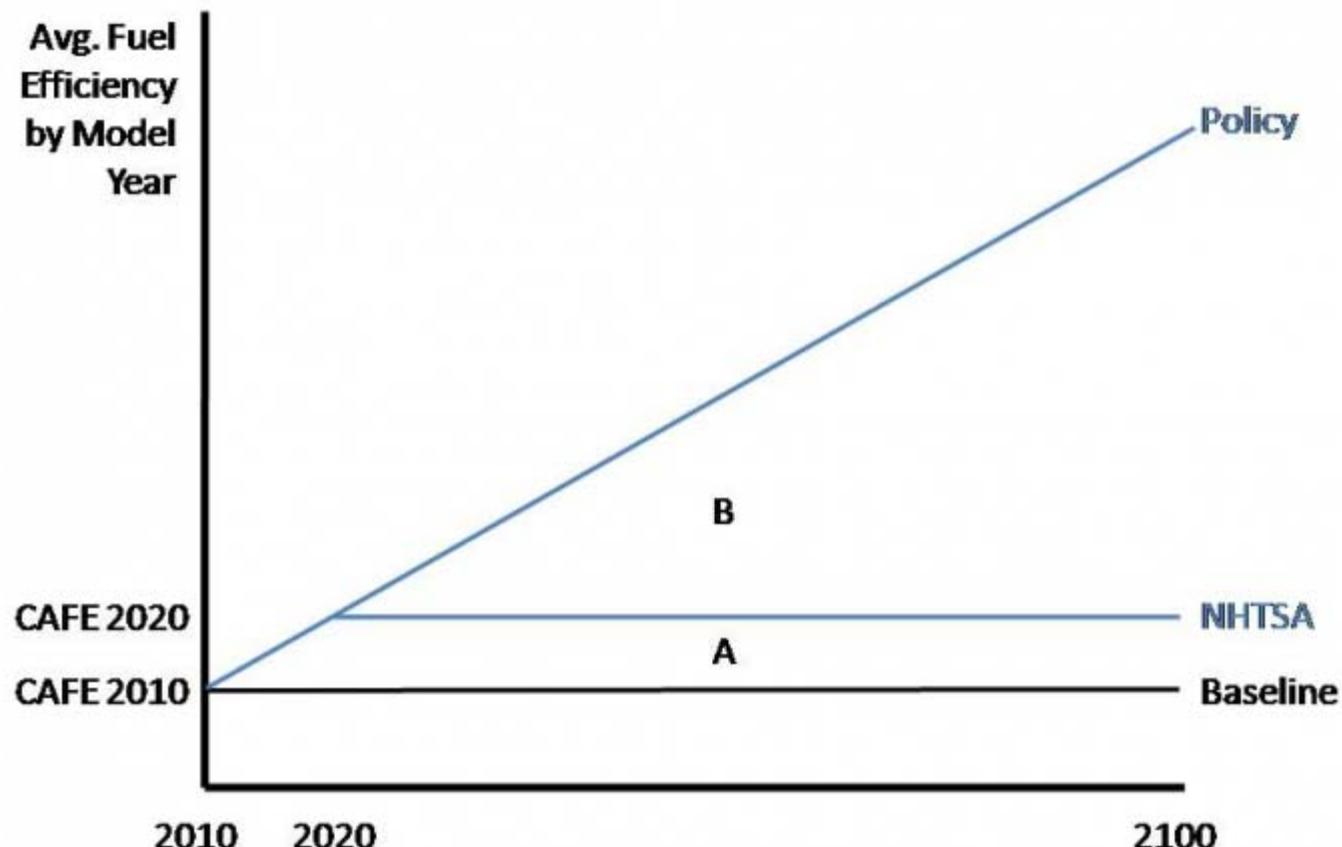
So for greenhouse gases, they are not assuming that fuel efficiency reverts to the 2010 level in 2016. Instead, they assume that fuel efficiency continues to increase in a straight line until 2020 – and then remains flat for the next 80 years.

This is still absurd, though slightly less so than assuming that fuel efficiency gets worse in 2016.

Graphically, the report is estimating the impact of the alternative scenario (Bush or Obama) versus the baseline like this:



Obviously, it's true that if you improve fuel efficiency for 10 years, and THEN YOU STOP, you are not going to have a large impact. The point is to continue improving fuel efficiency. And you cannot simply choose your fuel efficiency independently in each year; the achievable CAFE standards for 2021 depend heavily on what the actual standards are for 2020. Put another way, the policy objective is to get on a long-term improvement trajectory that will get us where we need to be, as in the following picture:



The policy whose impact we are trying to estimate is a policy that targets a certain rate of improvement in fuel efficiency, as drawn above – not a policy of improving fuel efficiency for ten years and then stopping, which is what NHTSA estimated. It is true that neither Bush nor Obama proposed setting CAFE standards for the next 91 years, but the rate of improvement over 2011-15 does determine the potential improvement in 2016-20, and the rate of improvement in 2016-20 determines the potential improvement in 2021-25, and so on. To say, as the NHTSA report does, and Hennessey and Tabarrok echo, that increasing CAFE standards for ten model years will not solve global warming is narrowly true but deeply misleading. It's like telling someone who's about to go for a short jog, "Don't bother – once around the block isn't going to get you ready for a marathon." Sure, you have to train for months – but you have to start with that first run. And if you don't go once around the block today, you won't be able to go twice around the block tomorrow.

This isn't a Bush vs. Obama thing. Both Bush and Obama said we have to go once around the block today, and twice tomorrow, and so on for a week. (Obama said we should go a bit further each day than Bush, but you'll note that the difference between Bush and Baseline is bigger than the difference between Obama and Bush.) The issue is that the NHTSA said one week of training wouldn't be enough to run the marathon. You can't conclude from that that one week of training is pointless.

The immediate question is, how much bigger is A + B than just A? In the picture above, A + B is 4.8 times as big as A. (Think of A as one slice that is 85 years long on average; B is eight slices, ranging from 75 years long to 5 years long; all the slices are the same width.) This is not quite accurate, first because model years phase into the overall fleet over time, and more importantly because we don't know how long fuel efficiency increases can be roughly linear. (At some point, if we have practical fuel cell cars, there could be a huge jump upward.) But it will do as a crude ballpark estimate. If we go back and apply a factor of 4.8 to the improvements we saw above (extrapolated over all GHG sources), we get this:

- Baseline: 717.2
- Bush: 477.2
- Obama: 333.2

Now we're talking.

Of course, these numbers are crude estimates. But this is the order-of-magnitude impact we're talking about – hundreds of parts per million, not 1.0 or 1.6 parts per million. By extrapolating over all GHG sources, and by assuming continued effort past 2020, we add two orders of magnitude to the NHTSA estimates. These things won't happen by themselves; we need to do what we can about those other GHG sources, and maintain the political will for more than a few years. But increasing CAFE standards can have the right order-of-magnitude impact; it's not a waste of effort.

By James Kwak

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May 21, 2009 7:16 AM

Real Time With Bill Maher, Tomorrow

Tomorrow evening I'm on [Bill Maher's HBO show](#), as part of a three person panel with [Muhammad Yunus](#) and [Jon Meacham](#). Bill runs a wide-ranging discussion covering pretty much anything that's been in the news over the past week or so. With Muhammad and Jon there, I'm sure we'll get into issues of ethics and values – including whether we have let "the profit motive" become too central in our society.

In terms of other topics related to economics, my guess is we'll talk about:

1. Whether financial markets and the economy have really bottomed out. Relative financial calm but continued negative economic impact seems to fit what [we are seeing and hearing](#).
2. To what extent we should expect more regulation as a response to this crisis. On this, see my [Economix column this morning](#) – there is definite tension between regulating tightly and hoping that banks will be profitable enough to earn their way back towards standard capital levels.
3. Is there yet a plausible national agenda for [reforming healthcare](#)? In particular, how exactly do we propose to control costs – the trajectory of which looks damaging, particularly as seen in the projections for Medicare down the road?
4. Is President Obama proving effective at pushing change in an incremental manner, or should he be more bold? Is [Rahm's Doctrine](#) real or just rhetoric?

Tell me if you think there are other questions that may come up – it's a live show, so everything can change up until 10pm eastern Friday. And feel free to suggest answers – I'll be able to look at anything you send in until about an hour before the program starts.

By *Simon Johnson*

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May 21, 2009 12:40 AM

[The Economics of CAFE](#)

Note: There are two somewhat significant updates at the bottom, just before the Appendix.

CAFE stands for [Corporate Average Fuel Economy](#) – the average fuel efficiency that is calculated annually for every manufacturer that sells cars or light trucks in the U.S. and compared to standards set by the National Highway Traffic Safety Administration, part of the Department of Transportation. (If you want to know more about how CAFE is measured, see the Appendix to this post.) Yesterday, President Obama proposed new, [higher CAFE standards](#) for models years up through 2016, by which point aggregate efficiency should reach 35.5 miles per gallon.

The typical conservative response to regulations like this is that they impose costs on the economy. In this case the main argument is that mandating higher fuel efficiency standards makes cars more expensive to produce; so car companies have to charge more for them; so fewer people will buy cars, and fewer people will be employed in the auto

industry. I was planning to try to pre-empt this argument, but Keith Hennessey, former head of the National Economic Council under Bush II, [beat me to the punch](#). His post summarizes some findings from a [900-page report](#) produced by NHTSA in January 2008, when the Bush administration released the latest version of the CAFE standards. One of his main points, taken from that report, is that the Obama standards will cost 49,000 jobs. That's relative to some baseline that I haven't been able to identify, but it's 38,000 jobs more than the Bush standards. The table is on page 586 of the long report; the Bush plan is "Optimized" and the Obama plan is "TC = TB." Hennessey's post has been picked up by [Marginal Revolution](#) (where I found it) and by [The New York Times](#), so I decided I should stay up late and write a response.

Hennessey's insight was to notice that the Obama plan looks similar to a plan analyzed under the Bush administration – TC = TB – and rejected in favor of Optimized. If you look at the first chart in his blog post you'll see why he makes this guess, and it seems good to me. Based on that assumption, he can take the NHTSA's analysis of the TC = TB plan and apply it to the Obama plan.

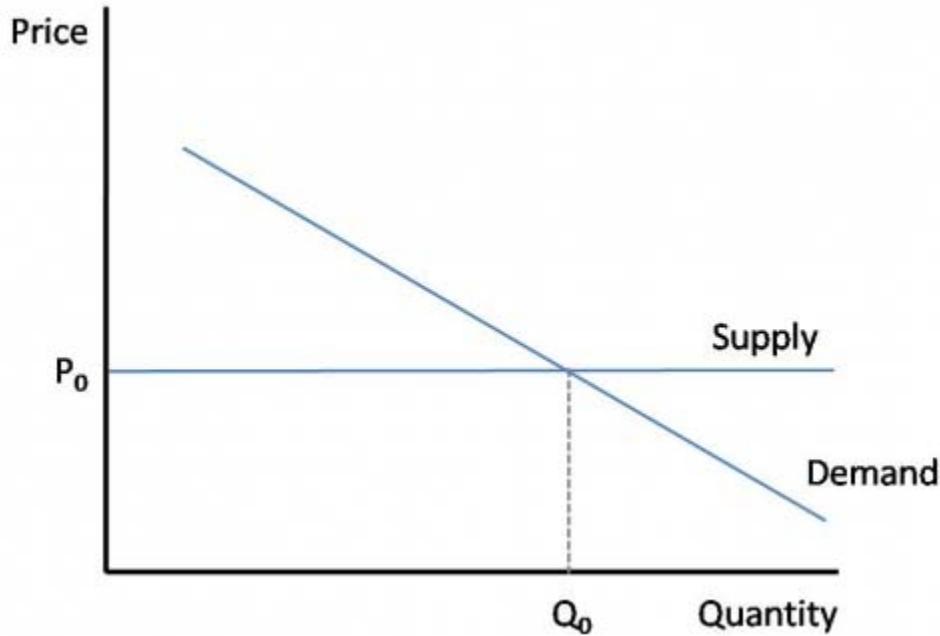
Optional interlude on "Optimized" and "TC = TB"

The Optimized plan is the one that, according to the analysis, maximizes net benefits to society – that is, benefits of the regulation minus costs of the regulation. The TC = TB plan is the one that gets the highest fuel efficiency while ensuring that the net benefits are not negative. The conceptual idea is that there is that there are diminishing marginal net benefits to higher fuel efficiency – you use less fuel and emit less carbon dioxide ("CO₂"), but it gets more and more expensive to squeeze more efficiency out the engines, so the cars cost more and more.

I acknowledge this point, but I don't put a lot of faith in it, because the calculation of benefits is highly dependent on your assumptions, such as the price of oil and the monetary value of reducing carbon emissions. In this study, the NHTSA used a range of \$0 to \$14 per metric ton of CO₂, and used the midpoint (\$7) in its estimates. The higher your estimate of the aggregate cost of CO₂ emissions, the higher your optimal fuel efficiency standards will be.

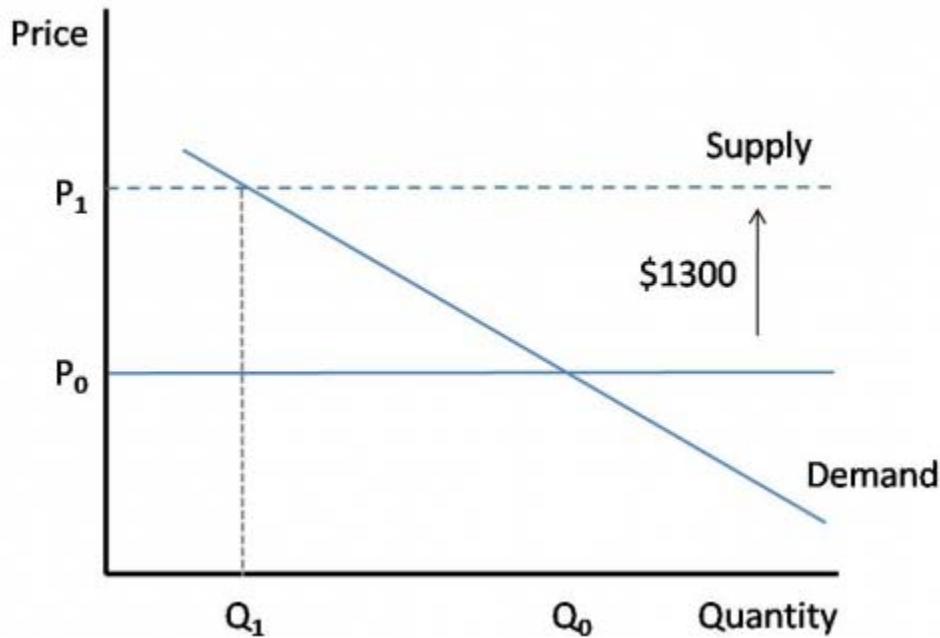
Back to jobs

The argument that higher fuel efficiency standards reduces jobs goes like this. The diagram below shows the market before regulation. Auto companies will supply cars at some price that includes their cost plus the profit margin they need to pay off their debts and provide a return to their shareholders. (You could draw the supply curve with an upward slope and everything that follows would be essentially the same.) The more expensive the car, the fewer people will buy it. At equilibrium, the price is P₀ and Q₀ cars will get produced and sold.

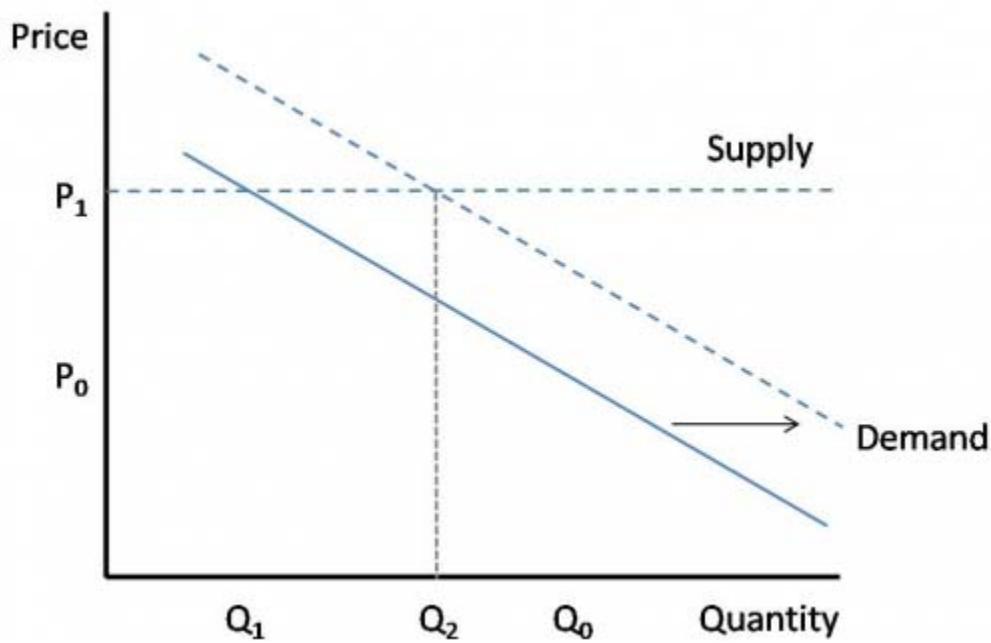


Optional interlude on demand and supply curves: The curves show the quantity offered (supply) and bought (demand) at each price. Where they intersect is where the market should end up. This is incredibly confusing to people who know math but do not know economics, because the axes are backwards from the way they are in every other quantitative field that I know of. I believe this is the fault of some English guy named [Marshall](#).)

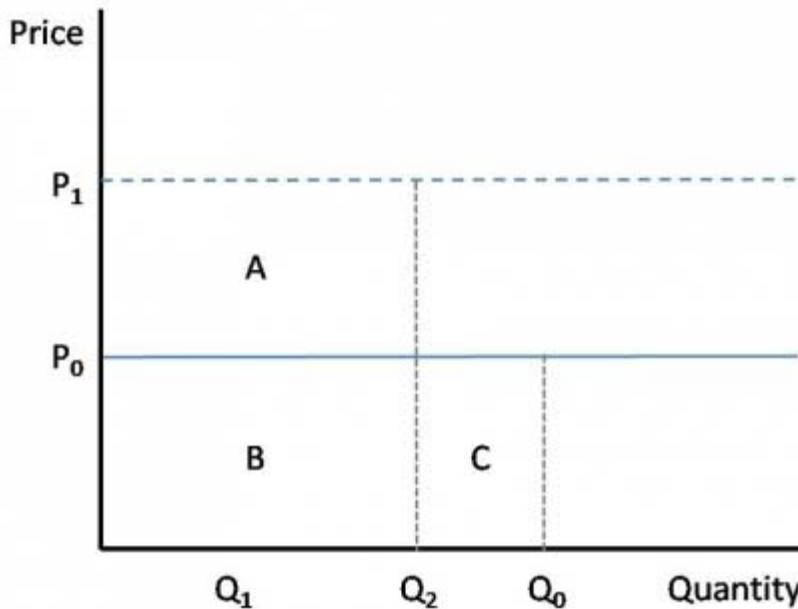
Then regulation comes along, increasing costs for car makers. The Obama people have been using the number \$1300, so let's use that number. This acts something like a tax. The price charged goes from P_0 to P_1 , where $P_1 = P_0 + \$1300$. At the higher price, fewer people will buy the car, so quantity declines to Q_1 . Fewer people get cars (bad) and fewer cars get produced, meaning fewer jobs in the auto industry (bad).



However, there are two problems with this argument in its simple form. The first problem is that it isn't the same car – now it's more fuel efficient. That's good, and it means that people will be willing to pay more for it. In other words, the demand curve shifts outward, so at equilibrium, quantity will be Q_2 , which is somewhere between Q_0 and Q_1 . Q_2 will still be less than Q_0 ; otherwise, the free market would have come to that equilibrium by itself. (If people valued the increased fuel efficiency at \$1300 or more, the industry would already have done it, at least according to a pure free-market argument.) So things are not as bad as in the picture above.



The other thing is that there is actually \$1300 of additional stuff in the car, which someone has to build. So even if fewer vehicles are being made, they are not the same vehicles. If we take manufacturing cost as a proxy for labor inputs throughout the entire supply chain, then these vehicles require more labor than the pre-regulation vehicles. (You could say that you get the increased efficiency from more sophisticated components – but someone has to design and build those components, and if they were as easy to design and build as the less sophisticated components, then they wouldn't cost any more.) So as a crude approximation, in the pre-regulation world the auto industry employs $B + C$ people, while in the regulated world it employs $A + B$ people. And there's no way to tell from a conceptual drawing which is greater.



That's the theory. But how do things work out in the real world? First I'll look at the consumer side, then I'll return to the production and jobs side.

Consumers

The first thing to note is that the manufacturing cost of every vehicle will not go up by \$1300 – that's just an average. It's also not as simple as saying that the manufacturing cost of gas guzzlers will go up more and the cost of fuel-efficient vehicles will go up less, because car companies can meet the standards any way they want, and increases anywhere in the fleet help. (They can't just change their mix, as explained in the Appendix.) All other things being equal, you would expect more investment to go into the gas guzzlers, because the marginal returns to investment should be higher than in the Prius; but other things are not equal, like maybe the marginal bit of engine efficiency gets you more bang in the Prius than in a pickup truck, because it is already lighter and more aerodynamic.

On top of that, car companies have sophisticated pricing strategies that involve all sorts of cross-subsidization. For example, American manufacturers until recently sold small

cars at small profit margins while selling large cars and trucks at huge margins. All other things being equal, you would expect them to discount the more efficient models and increase prices on the less efficient models *with the same footprint* (see Appendix), because that would have the net effect of increasing their CAFE, but again many things are unequal.

But let's assume that prices will go up by some amount. Does that mean that fewer people will be able to afford cars, as implied by the diagrams above? Maybe. The flaw with all those diagrams is that they assume that there is only one car at one price, when in fact there are dozens of models, each with dozens of potential variations, all at different prices. For example, let's say that in an unregulated world you would buy a top-of-the-line Toyota Camry XLE, with an MSRP of \$25,575. Whoops, everything is now \$1300 more expensive (let's assume). Are you going to switch to mass transit? No, but you could switch to the Camry LE V6, which is \$1300 less than the XLE. Or you could give up the navigation system, which has an MSRP of \$1200. Or, if you want all the options, you could switch to a Ford Fusion, which is a little less expensive than a Camry, but which I hear is a very good car.

So would fewer new cars actually get sold? Maybe, at the margin, there are some people who are already buying the very cheapest new car out there (or the cheapest model in the class they need), and will be forced out. However, it is also possible that one or more manufacturers will come out with an even cheaper car to supply them – or simply keep a low-end model or two in their existing form, without additional manufacturing costs. In any case, the net effect should be smaller than in the theoretical one-model world, where there is no ability to switch into a cheaper substitute.

And, to take a normative stance for a minute, it's not as if this is perpetrating some great injustice on the American consumer, like forcing people to take mass transit. There is a big used-car market in the U.S. (where my family has bought two of the three cars we have ever owned), and, believe it or not, there is no Constitutional right to a new car. Theoretically, increased prices for new cars could ripple into the used car market – eventually – but you can still substitute into slightly cheaper models. At the bottom end of the spectrum, people who can barely afford any car are looking at things like my 99 Chevy Prizm – and I doubt that new CAFE standards are going to boost its resale value by more than a few cents.

Producers

So, I think I've outlined a number of reasons why job losses should not be as great as in a crude "\$1300 tax" analogy in a world where only one car model exists: demand for cars will go up because they are better; there is more stuff in the cars that has to be built; and people can substitute into different new cars instead of being forced out of the new car market. The fact remains that the NHTSA report cited by Hennessey estimates 49,000 job losses relative to the baseline scenario which, I assume, is the world prior to the 2008 Bush Administration change to CAFE standards for model years 2011-15. So we need to look at what's behind that number.

In the main report, the entire discussion is on pages 584-86, and this is what we have on methodology:

The calculations assume that compliance costs are passed onto consumers in the form of higher prices. These higher vehicle prices (net of the benefits of added fuel savings and added resale value) lead to reduced demand for vehicles. Estimates of sales losses are made using the price changes and the elasticity of demand for new vehicles (-1.0). Losses in sales are translated into losses in jobs by dividing through by the average number of vehicles produced per full time jobs in the automotive industry (approximately 10.5 vehicles per job).

So it looks like they did take into account the fact that the vehicles are worth more. Another thing to note is that the estimate covers the entire auto industry, so the 49,000 jobs number includes overseas jobs; the number of domestic jobs would be considerably lower. But it's not clear whether there is one model with a single type of car, or a more sophisticated model.

The main report cites Chapter VII of the Final Regulatory Impact Analysis (FRIA), which I cannot find on the [NHTSA web site](#). I am looking for the FRIA for the Final Rule for model years 2011-15, which became effective in January 2008. I can find something called the [Preliminary Regulatory Impact Analysis](#) for those model years, which is actually dated April 2008, and is probably pretty close.

In that report, the relevant section, "The Impact of Higher Prices on Sales," begins on page 259. There is a long explanation of how they estimated the increased value of a more fuel-efficient car, which looks pretty rigorous. But this is a crucial paragraph:

A sample calculation for Ford passenger cars under the Optimized 7% alternative in MY 2011 is an estimated retail price increase of \$782, which is multiplied by 0.911 [to reflect the increased resale value of the car, less some increased costs of ownership] to get a residual price increase of \$712. The estimated fuel savings over the 5 years of \$281 at a 3 percent discount rate results in a net cost to consumers of \$431. Comparing that to the \$21,821 average price is 2.39 percent price increase. Ford sales were estimated to be about 1,300,000 passenger cars for MY 2011. With a price elasticity of -1.0, a 2.39 percent increase in sales could result in an estimated loss in sales of 3,104 passenger cars at a 3 percent discount rate.

So the model assumes a world where every manufacturer makes exactly one passenger car and one light truck and applies a price elasticity of -1.0. Now, it's possible that that price elasticity was estimated using a similarly aggregated model of the world, so perhaps this approach is accurate. But I'm also worried about the \$782 estimate for retail price increases. The methodology for estimating manufacturing cost increases is complicated, to say the least. It is based on estimates of the cost, effectiveness, and availability of specific new technologies (pp. 88-93). Then these are applied to data from the manufacturers about their production plans (see pages 126-28). As far as I can tell (I

admit, I didn't read every word), the algorithm takes these car company plans as a given, meaning that it does not allow them to shift their production plans in response to changing CAFE standards. This seems unrealistic to me.

While I'm skeptical, I don't have any strong evidence that the estimated sales losses are too high. However, there is a bigger problem on page 271:

There are three potential areas of employment that fuel economy standards could impact. The first is the hiring of additional engineers by automobile companies and their suppliers to do research and development and testing on new technologies to determine their capabilities, durability, platform introduction, etc. The agency does not anticipate a huge number of incremental jobs in the engineering field. Often people would be diverted from one area to another and the incremental number of jobs might be a few thousand.

The second area is the impact that new technologies would have on the production line. Again, we don't anticipate a large number of incremental workers, as for the most part you are replacing one engine with another or one transmission with another. In some instances the technology is more complex, requiring more parts and there would be a small increase in the number of production employees, but we don't anticipate a large change.

[The third is lower sales.]

It seems to me that they are ignoring the fact that more complicated, more expensive cars with more stuff in them require more labor to build. Essentially, this study is saying that it will cost more to build more fuel-efficient cars because they require new technologies that must be developed and manufactured at a higher cost than the old technologies – yet those new technologies and components will not employ any more people than the old technologies. If they don't employ any more people – anywhere along the supply chain – why are they more expensive? I doubt that the new technologies use more iron or copper than the old ones; if the increased value doesn't come from raw materials, it must be added by people, somewhere along the line. A little might go to intellectual property licenses, but that can't amount to all of the incremental cost.

Anyway, something seems deeply wrong to me here. In short, this approach denies that box B on my last diagram has any impact on employment.

In the end, I'm willing to acknowledge that higher fuel efficiency standards should mean slightly lower new car sales, which could lower auto employment a little. But the 49,000 number is definitely high for at least two reasons: (a) it ignores the additional jobs required to build more complicated, more expensive cars; and (b) if you're looking at this from a U.S. standpoint, it includes foreign automakers. And it may be high because it doesn't fully reflect substitution between car models, either by manufacturers or by consumers.

I have something to say about the environmental impact as well, but that will have to wait for tomorrow, as this is already my longest blog post ever.

Update: Lying in bed last night, I changed my mind. I'm not willing to concede that higher fuel efficiency standards mean fewer auto industry jobs; they might, but it's not certain.

The elasticity of a product is the amount that purchases of that product will change in relation to changes in its price. We say that gas and cigarettes have low elasticity: double the price of gas, and people will still buy almost as much of it; the same goes for cigarettes. Elasticity is expressed as the ratio of the proportional change in sales to the proportional change in price. So if the elasticity of cars is -1.0, that means for a 3% increase in price, you will get 3% fewer cars sold.

The implication, which I missed last night, is that almost the exact same amount of money gets spent on new cars ($1.03 * 0.97 = 0.999$) – there's just more money per car. If the price goes up because manufacturers are able to raise prices, keeping the cars the same, then more money (per car) goes to their profits, so employment can go down. The same thing is true with a tax, where more money goes to the government. If the price goes up because the cost of steel goes up, then more money goes to steelmakers, so employment in the auto industry can go down.

In this case, though, the price increases are because the cars have more car stuff in them, increasing their manufacturing costs. So the amount of money being paid into the auto industry is the same and the profits are the same, and money going to raw inputs is the same. So auto industry employment can only go down if labor's share of costs goes down, or if per-worker compensation goes up. In the absence of a reason why one of those should be happening, I don't see why employment would go down.

Also, thanks to Oliver, I fixed a typo in the first paragraph – 2006 should be 2016.

Update 2: RJ raised the safety question in [this comment](#). Dominic J, winstongator, odograph, and StatsGuy responded in replies (directly below the original comment), saving me the trouble of doing the research. Thanks.

Appendix: Interesting Facts About CAFE

There are many things I didn't know about CAFE until I did the research for this post. Here are three that may be interesting.

1. CAFE does not fall into the [miles-per-gallon trap](#). If you take two cars, one that gets 10 mpg and one that gets 20 mpg, and drive them the same distance, you will not get an overall average mpg of 15; you will get 13.3. Try it yourself if you don't believe me. You do not have this problem if you use gallons per mile instead; in that case your two cars would use 0.1 and 0.05 gallons per mile, and on average they would use 0.075 gallons per mile, which is exactly what you would expect.

This is the formula that [CAFE uses](#):

$$\text{Actual Fuel Economy Level} = \frac{N}{\sum_i \frac{N_i}{\text{MPG}_i}}$$

where N is the total number of cars, Ni is the number of model i, and MPG_i is the MPG of model i. It says it uses MPG, but if you stare at it long enough you'll work out that the denominator of the fraction is calculating how much gas it would take to drive every car one mile, which is a gallons-per-mile calculation, and everything works out.

2. There is a different standard for each vehicle "footprint," which Hennessey helpfully defines as "the shadow made by the vehicle when the sun is directly overhead." So if you have bigger cars, you are allowed to have lower gas mileage. One implication is that you can't meet higher CAFE standards simply by dropping SUVs and increasing sales of small cars, since your aggregate standard (that you have to meet) is a weighted average of the standards for each of your models – weighted by the number of each model that you sell.
3. CAFE compliance is based on actual vehicle sales, not predicted sales. I was a little suspicious about this.

By James Kwak

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May 20, 2009 5:42 PM

[Why You Should Read the Text, Not Just the Tables](#)

Keith Hennessey, the last head of the National Economic Council before Larry Summers, has a [blog post](#) out (hat tip [Alex Tabarrok](#)) reviewing yesterday's announcement by the Obama administration on their proposed new CAFE (Corporate Average Fuel Economy) standards. It links to a very informative [report](#) that I'm still digesting. (I was planning a post on the economics of CAFE for today, but now I need to read part of that report.)

Update: I found a mistake in the way Hennessey used a table and I posted about it here. Hennessey graciously acknowledged the mistake, fixed it on his post, and left a comment here. So I decided to delete my criticism. I really should have sent him an email first, and I feel bad about that.

By James Kwak

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May 20, 2009 6:15 AM

Consumer Protection When All Else Fails (Written Testimony)

I took three points away from [yesterday's hearing](#) in the House of Representatives.

1. We need layers of protection against financial excess. Think about the financial system as a nuclear power plant, in which you need independent, redundant back-up systems - so if one "super-regulator" fails we don't incur another 20-40 percentage points in government debt through direct and indirect bailouts. A consumer financial products protection agency should definitely be part of the package. **Update: The Washington Post reports that [such an agency is now in the works](#); this is a big win for [Elizabeth Warren, Brad Miller](#) and others (add appropriate names below).**
2. Congress will work on this. The intensity of feeling with regard to the need to regulate is striking, and there is much that resonates across the political spectrum.
3. In the end, much of banking is [likely to become boring again](#). Special interests are convinced that they can fend off the regulatory challenge, but I find this increasingly unlikely. Enough people have seen through what they did, how they did it, and what they keep on doing. No doubt the outcomes will be messy and less than optimal, but at this point "less than optimal" is much preferable to "systemic meltdown".

There is still much to argue about and, no doubt, there will be setbacks. We'll get a better or a worse system, depending on how the debate goes. And if the external scrutiny slips away, so will point #3 above. But this was still by far the most encouraging hearing I've so far attended.

The main points from my written testimony to the subcommittee are below.

- 1) The U.S. economic system has evolved relatively efficient ways of handling the insolvency of nonfinancial firms and small or medium-sized financial institutions. It does not yet have a similarly effective way to deal with the [insolvency of large financial institutions](#). The dire implications of this gap in our system have become much clearer since fall 2008 and there is no immediate prospect that the underlying problems will be

addressed by the regulatory reform proposals currently on the table. In fact, our underlying banking system problems are likely to become much worse.

2) The executives who run large banks are aware that the insolvency of any single big bank, in isolation, could potentially be handled by the government through the same type of FDIC-led receivership process used for regular banks. However, these executives also know that if more than one such bank were to fail (i.e., default on its obligations), this could cause massive economic and social disruption across the U.S. and global economy. The prospect of such disruption, they reason, would induce the government to provide various forms of bailout. They also invest considerable time and energy into impressing this point onto government officials, in a wide range of interactions.

3) As an example of the ensuing bailouts, in its latest iteration the current administration has (a) run [stress tests in which the stress scenario was not severe](#), (b) determined that banks are solvent, but some should raise small amounts of capital, (c) at the same time continued to provide large amounts of government subsidy through FDIC-guarantees on bank debt, large credit lines from the Federal Reserve, and cheap capital from the Troubled Assets Relief Program.

4) [The government strategy today](#) is forbearance, as in the early 1980s, in which you wait for the economy to recover by itself and hope that this brings the banks back to financial health. This is risky because: it may not work (depending on the defaults seen in “toxic” assets); it may lead the banks to engage in undesirable short-term behavior (with either too much or too little credit, depending on how exactly their incentives are distorted); and it rewards banks for previous irresponsible actions (and therefore encourages more of the same in the future).

5) As a consequence of both this general failure to deal with big bank insolvency and the specific problems induced by current government policy, big bank executives have an incentive to reduce the probability that their bank fails for idiosyncratic reasons but they are much less concerned about their bank failing in a manner that is synchronized with other banks. These bank executives [have a strong incentive to copy](#) the actions and policies of other big banks.

6) By not changing incentives for powerful bank insiders, we are lining ourselves up for another big “moral hazard trade” – think of this as a bailout by the Federal Reserve of everyone, but especially banks. Current and future bank executives will take risk again – but next time it will be risk with the public’s money. A housing bubble led to the current difficulties but the meta-bubble is a rise in financial services as a share of the economy, which has been underway since the 1980s. In the latest manifestation of the ensuing shift in economic and political power towards the financial sector, an unsustainable “Fed bubble” is potentially underway. This may lead to outcomes that are considerably worse than what we have seen so far.

7) Everyone agrees that insolvent banks are a bad thing. Since September 2008, we have learned about the additional difficulties that follow when no one knows if banks are

insolvent are not. There are many manifestations of this problem, including: illiquid markets for toxic assets; accounting tricks, like the [FASB rule change](#) and the [preferred-for-common stock conversion](#); and stress tests that turn out to be not very stressful, with outcomes that are apparently negotiable and [mostly about public relations](#).

8) There is a striking contrast between how we deal with small/medium-sized banks (using an FDIC intervention) and large banks – only the latter can obtain never ending bailouts. The solution would be some kind of regulator able to take over any financial institution, but also better ways of measuring asset value, capitalization, etc. In line with that general approach, Thomas Hoenig has [a strong proposal](#) for our current situation, which is to use negotiated conservatorship, as was done with Continental Illinois.

However, even his approach needs to be supplemented with quickly breaking up and selling off troubled banks; this is a daunting administrative task, but [better than the alternatives](#).

9) The critical weakness in our system is that bank executives get to keep their jobs and their money. All key insiders should be fired when their banks become insolvent (as part of the government intervention and support process), irrespective of the reason for that insolvency. They should also be subject to large fines, equal to or in excess of the value of their total compensation while leading the bank that failed. As things currently stand, powerful insiders have learnt that they can gamble heavily and never lose personally or professionally.

10) Our national debt will increase substantially as a result of direct bank bailouts and, more importantly, the discretionary fiscal stimulus needed to keep the economy from declining – as well as the standard deficit due to cyclical slowdown (a feature of the “automatic fiscal stabilizers”). This will constrain our future actions as a nation. For example, it may limit our options in terms of health care reform, with severe adverse social, economic, and budgetary implications.

11) The costs to consumers from our broad and deep banking crisis come in many forms. For example, in a period of financial confusion, it is easier to raise fees on consumers – they will have a harder time switching to other credit companies and many of them need the credit in order to survive. Supporting consumption is a key part of our economic recovery, but we are letting credit card issuers hit consumers hard; this is evidence of prior uncompetitive behavior (i.e., limiting entry, in order to raise prices later).

The remainder of my testimony summarized the argument from “[The Quiet Coup](#)”, as published in *The Atlantic*.

By Simon Johnson

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May 19, 2009 7:11 PM

First Buy High; Then Sell Low

On Monday last week, Old National Bancorp bought back the warrants it had granted Treasury as part of its participation in TARP, after buying back its preferred stock on March 31. Today, the [New York Times](#) ran a story saying that Old National only paid \$1.2 million to buy back the warrants, while the warrants were almost certainly worth more.

The main authority cited by the Times was [Linus Wilson](#), a finance professor at the University of Louisiana, Lafayette and a sometime commenter on this blog, so let's go straight to the source.

Linus's blog post is [here](#) (from May 14, I'm embarrassed to say) and his paper is [here](#). Basically, he runs three different valuation models on the warrants (pages 14-16 in the paper), each with three different sets of assumptions. The assumptions have to do with volatility, dividend yield, and probability that half the warrants would be canceled.

- Volatility matters because the value of an option depends on its volatility, and volatility has increased recently, so you will get a different estimate depending on the length of time you estimate volatility over.
- Dividend yield matters because higher future dividends reduce the value of warrants (since when you exercise the warrant, you only get the share, not the share plus the dividends paid while you were holding the warrant), and again the dividend yield depends on whether you look at historical data or at current dividends.
- Finally, the warrant terms include a provision that half the warrants will be canceled if the bank makes a qualifying stock offering before the end of 2009. So the assumptions include subjective estimates of the likelihood of the bank making such a stock offering.

You can look at the paper to see how Wilson came up with these assumptions. My guesses would be that the most likely assumptions are the volatility assumption of the middle valuation, the divided yield assumption of the high valuation, and the warrant cancellation probability assumption of the low valuation.

Wilson's preferred model (page 14) produces the lowest estimates of warrant values – from \$1.5 million to \$6.9 million. Traditional Black-Scholes (page 16) produces estimates from \$4.1 million to \$8.5 million.

(For those wondering, warrants have a positive value even though the exercise price of the warrant exceeds the market value of the common share you get by exercising the

warrant, because there is a significant chance – given the length of the warrants – that at some point the share price will exceed the exercise price.)

OK, so that's the calculation. The question is, since Treasury undoubtedly has many smart economists who know all about derivative pricing, why did they end up getting only \$1.2 million? That question is left as an exercise for the reader.

Correction: I changed “Treasury” to “Old National” in the second sentence; thanks to Proofreader for catching that.

Update: There are some good comments, starting [here](#), on different assumptions for the warrant pricing and what values you get in that case.

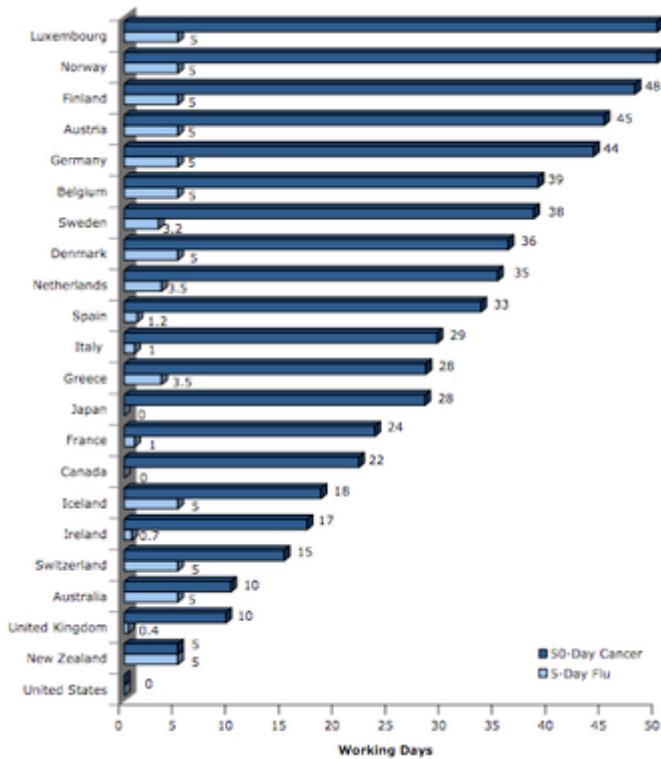
By James Kwak

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May 19, 2009 11:43 AM

Economics of Sick Days

Ezra Klein is one of those bloggers, like [Matt Yglesias](#) or [Andrew Sullivan](#), that sometimes make me want to just give up. Yesterday he started a new blog at the [Washington Post](#), and promptly put up fifteen posts on his first day – and not the one line variety, either. Today, he brings us this chart from the [Center for Economic and Policy Research](#):



This is Klein's explanation:

You're seeing two things here. The light blue line measures paid sick days. This is what you use if you need to take three days off because you have a fever. The dark blue line is paid sick *leave*. This is what you use if you need to take three months off because you have cancer. Every other country on the list offers at least one. Most offer both. The United States is alone in guaranteeing neither.

Why does this matter? Because sick people without paid sick days go to work anyway, infecting others and increasing the virulence of epidemics. Or, when it comes to things like the common cold, they simply get more people sick, which sucks for them.

As a father whose daughter is in her first year of pre-school, I'm more sensitive to this phenomenon than when I was younger. I've gotten sick at least five times this year – which is about five times more than normal – and I try to avoid going to my classes when I'm sick to avoid infecting other people (even though I'm paying about \$100 per hour for those classes).

So why don't we require paid sick days here in the United States? Of course, there's always an ideological argument – that's government intrusion into the private sphere – but the argument you hear more often is that it imposes costs on businesses, particularly small businesses. Well, what's wrong with that? A government mandate would affect all companies equally, so it shouldn't make it any harder to compete in general. For small business owners, it would take away the unpleasant choice between minimizing costs and

treating your employees right; the people hurt would be the ones who are willing to minimize costs on the backs of their employees, and the ones helped would be the ones who are not. (For the record, my company has paid sick days – but we’re in an industry that generally treats its employees well, so I’m not claiming any particular virtue.) Put another way, it takes away the competitive advantage of employers who do not treat their employees well. For anyone worried about American competitiveness overall, look back at that chart.

But then the higher costs of paid sick days would be passed on to consumers, just like a tax, which would reduce consumption and represent a drag on the economy, just like any other tax. Yes – but this is just a question of externalities. We already pay that tax, just in different forms. We pay it in the health care costs of treating the sick; we pay it in shortened lifespans of people who die (in extreme cases) from contagious illnesses; we pay it in reduced quality of life due to being sick; and we pay it in parents staying home from work (paid or unpaid) to take care of children too sick to go to school or day care.

The difference is that in a free market, when you let each company decide not to have paid sick days, that company only internalizes a fraction of these costs: the fraction associated with lower productivity of its own infected employees, and possibly with the premiums of its health care plan – but many of these companies don’t have health care plans anyway. So, like with all externalities, if the firm doesn’t face the full costs of its production, you get too much of the thing it produces – in this case, sickness.

By James Kwak

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May 19, 2009 6:20 AM

[Insolvency And Consumer Protection \(House Testimony Today\)](#)

Congressman Brad Miller has [some interesting ideas](#) about how to respond to the financial crisis; not exactly on the same page as Treasury. He’s called a hearing for this morning to talk about, in the first instance, how to assess insolvency in the banking system – and what to do about it (he chairs the [Investigations and Oversight subcommittee](#) of the House Committee on Science and Technology.) But my guess is that the conversation will cover considerably more ground, including his idea that we establish a Financial Products Safety Commission. (A full preview is [now available at our joint venture](#) with the Washington Post.)

The basic notion behind this commission is that [consumers were taken advantage of by unscrupulous lenders](#). Of course, you could also say that consumers fooled themselves, but if that is pervasive and has systemic implications then we need to take it on. In his [recent testimony](#) before the Joint Economic Committee, Joe Stiglitz emphasized the need for more consumer protection, and this idea is also strongly advocated [by Elizabeth Warren](#) - against the odds, she continues to [make some progress](#).

On the other hand, perhaps we already have enough consumer protection-type agencies? Would it be better to focus our efforts on overseeing and constraining the behavior of lenders and everyone else in the credit production and distribution chain? There's plenty of education and information available about financial products ([or not](#)), but somehow that doesn't get through to people when they need it. How should consumer protection be conceptualized, designed, and implemented in this space?

Over on [The Hearing this morning](#), you can vote for or against the Financial Products Safety Commission – or send it back to Congress, the experts, and the lobbyists for more discussion. Any opinions written up in your comments there (or here) may be taken down and used to construct a more sensible national debate.

By Simon Johnson

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May 18, 2009 10:16 PM

Bankers Will Be Boys

Apparently, Anne Sibert has written an article at [VoxEU](#) describing three types of bad behavior committed by bankers that helped produce the crisis:

They committed cognitive errors involving biases towards their own prior beliefs; too many male bankers high on testosterone took too much risk, and a flawed compensation structure rewarded perceived short-term competency rather than long-run results.

I say “apparently” because I can’t get through to VoxEU despite trying three different browsers and two different computers (can’t ping it, either). But there’s a long summary over at [naked capitalism](#).

Everything she says sounds right, although the classification of three behaviors is a little frustrating, because they fall into three different categories. Confirmation bias is just part of the human condition; I’m not sure what we can do about that, short of inventing

[Cylons](#) (and we know where that leads). Testosterone is part of the male branch of the human condition; so the potential solution is to have more female bankers. And flawed compensation structures are completely human creations, so we can definitely do something about them.

Yves Smith hones in on that last point:

The “bad incentives” turn of phrase, while narrowly correct, does not put blame where blame was due. The industry’s leadership designed the compensation schemes; they were not visited upon them by a mysterious outside force.

I’m familiar with confirmation bias (I suffer from it myself, of course) and with flawed incentive structures, but I found the second point the most interesting. Here’s an interesting excerpt from Sibert:

In a fascinating and innovative study, Coates and Herbert (2008) advance the notion that steroid feedback loops may help explain why male bankers behave irrationally when caught up in bubbles. These authors took samples of testosterone levels of 17 male traders on a typical London trading floor (which had 260 traders, only four of whom were female). They found that testosterone was significantly higher on days when traders made more than their daily one-month average profit and that higher levels of testosterone also led to greater profitability – presumably because of greater confidence and risk taking. The authors hypothesise that if raised testosterone were to persist for several weeks the elevated appetite for risk taking might have important behavioural consequences and that there might be cognitive implications as well; testosterone, they say, has receptors throughout the areas of the brain that neuro-economic research has identified as contributing to irrational financial decisions.

Let’s say you could provide reasonably convincing evidence that you would get better long-term results by using a team that had an even balance of men and women. Could you get away with an affirmative action policy that instituted a quota for female traders? According to the Supreme Court’s extremely mushy and frustrating “intermediate scrutiny” standard for gender discrimination, you would have to show that the policy is “substantially related” to the achievement of “important governmental objectives.” (I assume that there’s enough of a state-action component here, since we’re dealing with major, federally-regulated financial institutions.) Reducing systemic risk sounds like an important objective to me.

Update: The link to VoxEU works now, and I fixed the name of the author of the article.

By James Kwak

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May 18, 2009 9:11 PM

Liquidity Crisis? Check

Remember the days of talking about the TED spread and interbank lending? [So over](#). And apparently Sheila Bair said “the liquidity crisis is over for good.”

One way to look at the decline in interbank lending rates is that interbank lending has become safe again – because governments around the world have made it so abundantly clear that they will not let major banks default on their liabilities, no matter what happens. So what we have is interbank lending rates that are artificially suppressed by implicit government support.

In any case, I guess now we’ll find out if Tim Geithner was right that this is just a liquidity crisis, not a solvency crisis.

By James Kwak

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May 18, 2009 2:27 PM

Rating Agency Self-Defense

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

I’m drafting a post for [The Hearing](#) on credit rating agencies (the ones who gave AAA ratings to all those CDOs). The CEO of Fitch is giving this [prepared testimony](#) tomorrow. Here’s the question: Can anyone find anything in there that constitutes a constructive suggestion for how regulation of rating agencies could be improved? Or is it all just self-serving insistence that there is no problem?

(My favorite part is on pages 6-7 where he says, effectively, “Don’t regulate us – regulate the issuers and underwriters instead!”

By James Kwak

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May 18, 2009 12:05 PM

New Cars, Mortgages, and Race

Like most forms of hardship in our society, the foreclosure crisis is disproportionately affecting minorities. The New York Times conducted a study of [foreclosures in the New York area](#) and found, among other things:

Defaults occur three times as often in mostly minority census tracts as in mostly white ones. Eighty-five percent of the worst-hit neighborhoods — where the default rate is at least double the regional average — have a majority of black and Latino homeowners.

Well, that might simply be a function of poverty: statistically speaking, minorities are more likely to be poor, and therefore more likely to become delinquent on their mortgages. But I don't think it's that simple.

First, whether you are likely to go into default is a function not just of your income, but of both your income and the size of your mortgage. As [Tanta](#) wrote,

The belief that subprime borrowers are “poor people” has taken root so deeply that you need a jackhammer to rip it out. The capacity C of traditional underwriting was, of course, always relative to the proposed transaction. A lower-income person buying a lower-priced property was, you see, not a case of subprime lending; assuming a reasonable credit history, it was a prime loan.

Let's say you start out with a middle-income person who, like most, might be vulnerable to an economic downturn. There are a couple things you can do that will make him more likely to go into default when the downturn (or an illness, or a divorce) hits. You can push him into too big a mortgage. In Tanta's words,

The trouble with the low-income prime loan was that it was a small prime loan. And that there were, in many market areas, more lower-income people than lower-priced properties. Both industry greed—wanting to make the biggest loans possible to make the biggest profits possible—and industry overcapacity, combined with ever less-affordable housing in the employment-rich population centers, brought us to a situation in which we might not have started with poor people, but they were certainly poor by the time we got done putting them into too much loan to buy too much house. There are subprime borrowers you find. There are those you create.

You can also give him a higher-rate mortgage than he could otherwise qualify for. According to the Times article:

Roughly 33 percent of the subprime mortgages given out in New York City in 2007, [Secretary of HUD Shaun] Donovan said, went to borrowers with credit scores that should have qualified them for conventional prevailing-rate loans.

In general, high-rate mortgages account for a larger proportion of mortgages in [minority communities](#), even after taking median income into account. According to sociologist Gregory Squires,

We see these loans heavily concentrated in poor neighborhoods and targeted to minority neighborhoods. There is some evidence that these neighborhoods were actually targeted — that lenders have gone after people whom they think are less sophisticated borrowers, including single women and the elderly. . . .

Credit rating and income would and does explain some of the patterns. But when you control for those, segregation is also a factor. . . . In those metro areas where segregation is highest, the share of loans that are subprime goes up.

If you are disproportionately steering minority borrowers into higher-rate mortgages, then of course they will suffer a higher rate of defaults and foreclosures than you would predict solely from their other characteristics (income, credit rating, etc.).

But why would you do this? I mean, it's obvious why an individual broker would: higher commissions. But why would a competitive industry as a whole do this?

In principle (by which I mean first-year microeconomics textbook principle), the free market should eliminate most forms of commercial racism. If a minority homebuyer is a good risk at 6%, then Good Bank willing to lend at 6% will get his business, and Bad Bank who insists on 9% will lose his business; over time, Good Bank should drive Bad Bank out of business. There are probably some doctrinaire free-market people who would insist that this in itself proves that racism does not occur: if banks are charging higher rates to minorities, then the existence of the free market proves that those minorities are higher risks.

But there is ample evidence of racism in areas where the correlation of race and credit risk is not an issue. Almost fifteen years ago, in "[Race and Gender Discrimination in Bargaining for a New Car](#)," Ian Ayres and Peter Siegelman sent pairs of testers into auto dealerships, armed with identical back stories and identical bargaining scripts, and even wearing similar clothing. (All testers said they would provide their own financing for the car.) Black men were initially offered twice the initial markup (price minus dealer's cost) as white men; after negotiation, black men ended up paying three times the markup of white men.

Ayres and Siegelman discuss two sets of theories why racism might occur. The first set is based on animus: car dealers don't like minorities and therefore treat them worse, even though it is bad for their bottom line. The second set is based on statistical inference: car dealers might think that being a minority is likely to be correlated with higher search costs or lower access to information, either of which might make the buyer more likely to accept a high asking price.

In the case of mortgages, search costs might have been a factor. Perhaps an equilibrium developed where minority neighborhoods were dominated by high-interest lenders, so if you were going to enter that neighborhood, it made more sense to charge the going rate and split the high profits with your competitors than to undercut them and trigger a price war. Or perhaps there are information disparities that correlate with race, even after controlling for income. Taking advantage of people because they are poorly informed, as far as I know, is completely legal.

In retrospect, this seems like an area where better consumer education could have played a role. Back to the Times:

Upper-income black borrowers in the region are more likely to hold subprime mortgages than even blacks with lower incomes, who often benefit from homeownership classes and lending assistance offered by government and nonprofits.

Maybe the economic debacle we are all living through will lead to better personal finance education, both in school and for adults. That's one silver lining to hope for, since an end to racism is almost certainly far off.

By James Kwak

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May 18, 2009 9:35 AM

Remember Chuck Prince!

This week the administration begins a serious behind-the-scenes charm offensive on its regulatory reform plans. The argument seems to be: we are where we are on banks' solvency/recapitalization, so let's not argue about that; it's time to strengthen financial regulation in line with our G20 commitments.

But there is a serious dilemma lurking behind the [foreshadowing](#), the [rhetoric](#), and the [talking points](#). (Aside to Treasury: please find someone other than big financial players to

endorse your next 100 days report; many taxpayers [will find p.5](#) of your first report particularly annoying – if you don't understand this point, you are too close to the big banks.)

Here's the problem.

At this point in most financial crises, you would have a big recapitalization program underway – with or without the trappings of a formal insolvency process. Bank executives would be out, and new teams would be well on their way to figuring out how risk control systems broke down so completely and deciding how much of the business can be sold off vs. restructured vs. closed. Obviously, we are somewhere quite different – in our brave new post-stress test world, the insiders who run these banks feel like they just won the lottery (or perhaps that's the right to run all future lotteries, with most of the winning tickets reserved for themselves and with the government footing the bill for any potential losses?)

The political pressure to regulate tightly in this environment is obvious and, with every further public relations gaffe by the industry and inspector general [investigation into its friends](#), the legislative agenda will get tougher on banks.

There is an obvious economic case for tightening regulation – after all, even the people who ran the Great Deregulation from Treasury during the 1990s now say, “when the facts change, we change our minds”. But the lack of sensible upfront recapitalization for the banks means that they will be tempted to go even further in terms of regulatory tightening. After all, the incentives for executives running banks are now all messed up – irrespective of whether they were really Too Big To Fail in the past, they're all convinced they are Way Too Important To Fail today.

If your bank fails at the same time as all other banks fail or hit serious trouble, there will be a bailout. The implication is that bank executives should copy the behavior of others, as much as possible; above all else, don't do anything different – idiosyncratic risk is the real danger. [Chuck Prince \(former head of Citi\) nailed this](#), as well as a good portion of your retirement savings:

When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing. (July 2007)

The dilemma, of course, is that you don't really want to overtighten regulations on banks during a recession – this will further discourage lending. This was an important rationale for doing an upfront recapitalization and forcing a change of control in big banks. When we missed that opportunity, we essentially set ourselves up for “procyclical regulation”.

And if you think we can punt on regulation and come back to the issue when the economy looks stronger, you need to spend more time on Capitol Hill. The banks are already bouncing back in terms of political clout, and they have a simple regulatory

answer: nothing meaningful. So if you support the end of deregulation, you need to push for it now.

By the way, is [Chuck Prince still rich?](#)

By Simon Johnson

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May 17, 2009 4:23 PM

Be Careful What You Tweet

In Guatemala, at least. Various commenters on this blog have, at one time or another, recommended pulling your money out of those “too big to fail” banks that are getting so much government support. In Guatemala, Jean Anleu Fernandez was [arrested and jailed](#) for sending this out on Twitter:

First concrete action should be remove cash from Banrural and bankrupt the bank of the corrupt.

I guess he also said the bank was corrupt. Well, people have said that around here, too.

More broadly, the government is in crisis, with frequent popular protests, over allegations that [Rodrigo Rosenberg was assassinated](#) on the orders of the president because he uncovered evidence of murder and corruption by the government.

Here's a request from a friend:

One of the things keeping our friends out in the streets safe is that the international community is paying attention to what's going on. If you could take a few minutes and send an email to your country's ambassador in Guatemala – if from the US it's Mr. Stephen G. McFarland at AmCitsGuatemala@state.gov – letting him or her know that you are concerned about what's going on in Guatemala and hope your country is doing its best in assuring people's right to peacefully protest against the violence in Guatemala, and to help investigate the murders, it would really go a long way. If you have another nationality then writing to your Ambassador in Guatemala would also be of great importance.

Gracias de todo corazón!

By James Kwak

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May 17, 2009 4:05 PM

More Bank Balance Sheets for Beginners

If you read [this blog](#) and listen to [Planet Money](#), you may have had enough of this topic, but Calculated Risk pitched in with two posts on [liquidity](#) and [solvency](#) crises, complete with graphical balance sheet illustrations. He does a better job than I have of conceptually illustrating the workings of the various bank bailout plans that have been offered.

This is his assessment of the current strategy:

The Geithner approach is to keep injecting capital into the banks to cover the losses. This is known as the “Zombie” bank approach. . . .

Although the bank is balance sheet insolvent, the bank will never be business insolvent [unable to pay its debts as they come due] because the government will continue to provide money to cover losses.

If only a small percentage of financial assets are held by zombie banks, then this approach will probably work. These banks will be crippled, but the other banks can meet the financing needs of the economy.

I should note that CR does not say the entire banking system is insolvent, or that any banks in particular are insolvent.

The posts are from late April but I missed them, probably because they were on my birthday.

By James Kwak

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May 17, 2009 3:05 PM

Guest Post: Capturing the Regulatory Mothership

This guest post was contributed by Ilya Podolyako, a third-year student (for a few more days) at the Yale Law School and until recently executive editor of the Yale Journal on Regulation and co-chair, with James Kwak, of the Progressive Law and Economics reading group.

Though many economic indicators continue to look grim, the sense of crisis has largely faded from the front pages in the last few weeks. In my opinion, this is shift in demeanor of reporting is due to audience fatigue, not some fundamental change in the underlying dynamics of the economy. As the ever-prescient Onion [points out](#), the American public has only so much tolerance for tragic stories, regardless of their source. For better or worse, however, calls for a drastic restructuring of the regulatory framework have quieted as of late. The Obama Administration has already spent a large amount of political capital on its first round of stimulus, the auto “bailouts,” and the day-to-day management of the financial sector, and will likely have to use up some more for further bank recapitalization and a possible second round of the stimulus. Unsurprisingly, in this environment, blueprints for a brand-new “systemic” financial regulator seem to have been shelved, despite a general consensus that some such entity is necessary to avoid future economic meltdowns.

This development may have some surprising upsides. For one, we have time to scrutinize the wisdom of putting enormous power into the hands of a single agency. The extant regulatory framework is certainly inadequate in many respects. Yet consolidating the exchanges, the SEC, the CFTC, the OCC, the OTS, federal housing agencies, federal consumer protection organs, a macroeconomic policy maker, a new oversight agency for derivatives, and perhaps a dedicated industrial policy manager into one body with wide-ranging authority carries enormous risks that cannot be ameliorated unless we manage to fix certain seemingly intractable underlying problems first. These include the outsize importance of the financial services sector to the U.S. economy, the permeation of government by individuals with a vested interest in preserving this status quo, and basic human fallibility and greed. Of particular concern is the possibility of regulatory capture, which takes place when a regulator begins acting for the benefit of its subjects rather than in accordance with its stated mandate of minimizing systemic risk. While any agency can theoretically be captured by concentrated and powerful individuals, a breach of the “mothership” would carry far more severe repercussions than the loss of one or two “destroyers.” Of course, only the mothership can accomplish certain tasks; in the economic context, it would exist to take on challenges of a scope that smaller bodies simply cannot handle.

The dynamics in play are thus straightforward. First, the capture of a single, large regulator could carry catastrophic consequences, whereas the capture of a smaller regulator that holds only a fraction of the mothership’s powers would be merely disastrous. Second, we want a mothership, because our current fleet doesn’t seem up to task. Third, if getting the mothership actually increases the vulnerability of the economic system over a dispersed set of regulators coordinated by the president, we should resist the temptation to get it and look elsewhere for solutions. The problem is that determining whether the third condition holds is actually quite difficult. I have been working on a

game-theoretic model that could suggest an answer, but in the meantime, a smattering of observations should suffice.

Two archetypal scenarios for regulatory capture exist. The first is an underpowered, understaffed regulator working to control a wealthy, concentrated industry. In these situations, the sheer imbalance in resources means that the regulated parties can reward or punish the agency, but not vice versa. Predictably, rational bureaucrats will choose to cater their policies to the benefit of the subjects instead of suffering their wrath – recall, a regulatory job well done rarely carries any significant benefits to its engineers. The Department of Interior's [Minerals Management Service](#) is a perfect example of a body that appears to have [fallen prey](#) to this pattern. Even a person of upstanding moral character can understand the difficulty of resisting the repeated entreaties of Exxon and the like for the sake of sticking to an unadulterated scheme of allocating oil and gas exploration rights. Someone sitting at the MMS desk may well wonder if anyone would ever notice a shift away from the prescribed approach towards one that favors the companies they deal with on a day-to-day basis. These incentives to cooperate exist even though the relationship between the regulator and the regulated parties is facially adversarial, with MMS holding rights that producers want but cannot get.

The second standard scenario for regulatory capture takes place when the same agency identifies items to source from the private sector and supervises the production of these items. The Department of Defense springs to mind as an example. The Pentagon almost certainly has the best interests of the Armed Forces in mind when it sets out its procurement goals. The combination of public ("free") money and a desire to avoid saying one's coworkers and superiors made a mistake, however, means that projects live on even when they go horribly wrong. Private-sector contractors benefit from bloated budgets for [littoral combat ships](#) that suffer from fundamental structural defects (the program has since been scrapped), military officers occasionally pick up [a kickback](#), and the taxpayer ends up footing the bill. The political prominence of the Pentagon aggravates the effects of regulatory capture, since colonels know they can fight off most allegations of inefficiency by claiming that a critic is unwilling to support the troops.

A financial superregulator would have certain characteristics that distinguish it from the above examples. Unlike the Department of Defense, it will focus on a politically unpopular constituency – bankers – and thus be unable to deflect Congressional oversight as unpatriotic. Similarly, any good-faith attempt to create the systemic risk agency would give it power to punish the regulated parties for offensive behavior, avoiding a repeat of the MMS fiasco. These improvements do not make the would-be regulator immune from capture; they just raise the capture's difficulty and cost.

Problematically, these same measures may increase the willingness of various parts of the financial sector to work together. In the face of reforms that could destroy the hedge fund business, for example, various players could unite in a massive lobbying effort despite the possibility that their competitors could hold out and get the benefits of laxer regulation for free. Even more worrisome is the fact that agency employees will quickly realize both their immense power to dissolve fortunes and the fact that they could benefit

enormously from letting some financiers pay them not to do so. Since regulatory pressure is free and political costs of being too tough are diffuse, the only visible constraint on the regulator's efforts will be the diminution of profits that regulated parties could spend on bribes or lobbying efforts. Currently, various entities battle each other for turf. While a company could buy out a single regulator like the OTS, there is always a threat that a different agency will come in and demand more ransom. This possibility discourages companies from trying to capture individual agencies and encourages them to try to comply with substantive rules. A single, umbrella entity, however, could actually guarantee a positive outcome in exchange for (an admittedly larger) chunk of cash. Indeed, given its ability to make or break businesses, a superregulator could demand payoffs with a previously unseen force. For the first time, industrial investment in corruption could become not just smart, but safe.

Avid readers of this blog will be rightfully skeptical of the above scenario. As the crisis has demonstrated, the current regulatory framework is fraught with issues: it encourages large companies to shop for favorable supervisors, conceals systemic risk, and diverts money from real capital investments towards administrative maneuvering. Yet good intentions alone will not prevent Congress or the Executive Branch from making the situation worse by creating one opaque and powerful agency to take the place of several opaque and powerless ones. Just think of what happened with the CIA.

By Ilya Podolyako

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May 17, 2009 10:33 AM

Guest Post: Interpreting The Indian Election

This guest post was contributed by [Arvind Subramanian](#), a senior fellow at the Peterson Institute for International Economics. He notes two surprises in the outcome of [India's recently concluded election](#) and suggests that India offers an alternative model of development for much of the world.

The results from the Indian elections point to a victory for the incumbent Congress party and its allies. Congress was led de jure by the economist-turned-politician Dr. Manmohan Singh and de facto by the Italian-born Sonia Gandhi, who is part of the Nehru family, which has been a force in Indian politics since the late 1800s and provided three Prime Ministers.

Two casualties of the election have been the Communists who resisted economic policy reform and opposed the nuclear agreement between India and the United States, and the Hindu nationalist party, the BJP.

Going forward, these results augur well for Indian economic policy reform. The Congress will be numerically strong enough not to have to rely on partners for political support and will be able to push through new policy initiatives.

Another likely consequence is that the Nehru family will probably provide India, not immediately but within the next couple of years, with its fourth Prime Minister—Rahul Gandhi, son of Rajiv Gandhi, grandson of Indira Gandhi, and great grandson of India's first Prime Minister Jawaharlal Nehru.

These results are surprising for two reasons. Indian elections have traditionally been characterized by the phenomenon of anti-incumbency: ruling politicians get routinely thrown out of power. This government is the first in over 40 years that has been re-elected after a full term in office.

The second reason for surprise is that anti-incumbency has been defied at a time of global economic crisis. While India was affected by the crisis, it has been less affected than other countries for reasons explained [here](#) and [here](#). Economic growth, while down from the 9 percent annual rate prior to the crisis, will be about 5.5- 6 percent this year. Moreover, rural India – where the bulk of voters live – has done well. Indian agriculture, which has been relatively insulated from the world economy, has been resilient (good monsoons for five years have played their part) and even thriving (sales of cell phones and two-wheelers have been perky). The ruling Congress government benefited enormously from these economic conditions.

Internationally, the Indian election results and the performance of its economy during the crisis raise the question of whether the Indian approach to globalization—not too much foreign finance like the Eastern Europeans and not too export reliant as China—[has some merit](#). Goldilocks globalization and dynastic democracy is the model that India is offering the world.

By Arvind Subramanian

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May 16, 2009 8:34 PM

Microsoft: Just Another Company

Earlier this week, Microsoft issued [long-term debt](#) for the first time in its history, selling \$3.75 billion of 5-, 10-, and 30-year bonds. From a corporate finance perspective, I guess this makes sense, since it got to lock in historically low borrowing rates. Treasuries are low, and Microsoft paid only about one percentage point more than the U.S. government, which makes sense since it does have over \$20 billion in cash, no other long-term debt, and – let's not forget – a virtual monopoly on computer operating systems and basic desktop software. (In some ways, Microsoft looks like a safer place to lend money than the U.S. Treasury, except for the ability of the latter to print its own money.) But it's still a little sad.

First, we have an (optional) *Corporate Finance for Beginners* interlude:

There has been a ton of research on the optimal “capital structure” for companies, meaning the ratio of debt to equity. Conceptually, companies raise money from two sources: debt (selling bonds) and equity (selling common shares). Debt, as we know, has to be paid back; equity doesn't. In the 1950s, Franco Modigliani and Merton Miller proved that, under certain (quite large) assumptions, the capital structure of a firm doesn't matter. In the real world, however, there are a number of reasons why it should.

The simplest question is probably why any company would borrow money that it doesn't need. After all, Microsoft has over \$20 billion in cash, and it continues to make money. Taking on unnecessary debt isn't something that I would do in my personal finances. But the idea is that companies are different: all of their money comes from and eventually belongs to someone else – for convenience, let's call them bondholders and shareholders – so it's just a question of which source is better. For one thing, a company could simply raise money by selling bonds, and then turn around and give the money to its shareholders. So from one perspective, you should ask the shareholders if they would rather have more cash in their pockets, or own a company that had less debt and was therefore worth more.

One major consideration is taxes. (The simple form of the M&M theorem assumes no taxes.) The interest on bonds is tax-deductible for the company, while dividend payments to shareholders are not; they are paid out of after-tax income. So in that sense debt financing is cheaper than equity financing.

But the broader issue has to do with the cost of capital. The cost of debt is pretty simple – it's the interest rate you have to pay on the bonds. But the conceptual point is that equity has a cost as well – it's the rate of return that shareholders expect to get by buying common stock. The higher that required rate of return, the less they will pay for your shares, and the more expensive it is to raise money by selling shares (because you need to sell more shares to get the same cash in return). Even if you (like Microsoft) have enough cash on hand that don't need to sell shares, you could be using your cash to buy back shares on the market; by not doing so, you are implicitly “selling shares” and paying the cost of equity. That's the concept, at least; trying to estimate your own cost of capital can be very

difficult, and trying to estimate the cost of capital for a marginal transaction is pretty close to impossible.

Now, back to Redmond.

A company like Microsoft – with no debt, lots of cash, and a highly profitable business – has an extremely low cost of debt. If Microsoft took on a huge amount of debt, that cost of debt would go up, because investors would see that debt as riskier; the more debt you have, the higher the risk that you will default. But given where they are on the curve, the textbook answer is that they could afford to take on some debt.

But what is Microsoft going to do with that extra cash? There seem to be two main theories: (1) buy back more shares than it is already buying back and (2) buy companies.

I've never fully understood why some people think that buying back shares is always a good thing for shareholders. If your market value is \$100, and you use up \$10 in cash to buy back shares, then it's true that there are 10% fewer shareholders that the value has to be divided between; but it's also true that your company is worth exactly 10% less. In practice, share buybacks can boost share prices because they act as positive signals: if the company thinks its stock is underpriced, then maybe it is. But I don't see how it can work as the long-term strategy that some companies, like IBM, think it is.

As for buying companies, Microsoft already had enough cash to buy any company that could actually have benefited by being bought by Microsoft. Sure, Yahoo! and SAP are out there, but they've already done all the innovation they're ever going to do; from this point these companies are just playing a game of adding their earnings together and trying to minimize the number of shares to divide them by.

In short, issuing debt looks like just the latest step on Microsoft's way to being a company that uses financial engineering to boost its share price rather than inventing new products. Now I know that Microsoft has thousands of very smart and ambitious employees, so the fact that it has become a sinkhole where talent goes in and nothing new comes out is sad. The simplest explanation is probably that Microsoft is not too big to fail (although maybe it is – what would happen to our economy if nobody were around to fix security holes in Windows and IE??!!), but simply too big to manage. In addition, software has a tendency to get more and more unwieldy and difficult to modify as it gets bigger and older, and Windows is one of the biggest and oldest programs around.

So maybe it's a smart move. But it isn't anything for Bill Gates to be proud of.

Update: Microsoft credit default swaps are trading at 37.5 basis points – 2 basis points higher than U.S. Treasuries, and lower than just about every other sovereign government except France, Germany, Finland, and Norway.

By James Kwak

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May 16, 2009 9:00 AM

Peer Steinbrück's Peers (Weekend Comment Competition)

Everyone has their favorite politician. Mine is [Peer Steinbrück](#), Germany's Minister of Finance. In terms of having inappropriate – but revealing – things to say at just the wrong moment, Mr. Steinbrück is world class.

This week he blasted the US bank stress tests as [worthless](#). Back in October 2008 he famously denied there was any problem in the European banking system, shortly before the G7/IMF weekend that culminated in European bank rescues. And in early 2008 he and his subordinates castigated the IMF for suggesting that Germany and the eurozone could experience even a mild slowdown – have you seen [the latest data?](#)

This comment competition is straightforward. Find the politician (or other leading public figure in any country) with the most untimely quote of the past 18 months. We're looking for hubris and denial, preferably 24 hours before an abrupt policy U-turn – so please indicate the precise context that makes the quote appealing. If your choice is Peer Steinbrück, pick his most perfect moment.

By Simon Johnson

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May 15, 2009 2:18 PM

The Green Shoots Debate

Earlier today, Simon [suggested](#) that “we are out of the panic phase of the crisis.” [Bond Girl](#) said [in response](#), “There appears to be some confusion between exiting the panic phase of the crisis and actually recovering.” That is something that I certainly agree with, and I suspect Simon does as well (although he may not agree with her entire comment.)

There has been a lot of discussion of “green shoots” scattered around the Internet recently. Most of it, I think is premature. A lot of economic indicators seem to show that things are getting worse at a slower rate than before. One major source of optimism was last week’s jobs report, which showed a net loss of “only” 539,000 jobs. Here’s an excerpt from the [New York Times](#) coverage:

Yet the deterioration was milder than expected, prompting encouraging talk.

“The most intense spate of weakness is probably behind us,” said Michael T. Darda, chief economist at the research and trading firm MKM Partners. “Less bad is always a prelude to good. It’s going to take some time for this economy to get back on its feet, but we might be closer to the recession ending.”

Investors bought into that message, sending stock prices soaring.

To put this in perspective, I turn to the always-accurate [Menzie Chinn](#) (follow the link for a good picture):

Revisions are downward (but getting smaller over time), the growth rate becomes less negative, but hours continue to decline rapidly.

As I’m sure other people have noted, these are second derivatives that are improving: the direction of change is still negative, but the change in the rate of change is positive. This is not too surprising, because some levels of economic simply cannot fall beyond a certain point in the short term. As Calculated Risk pointed out, the [turnover rate](#) for autos in the U.S. reached 27 years in February, which is clearly unsustainable; cars just don’t last that long. In the long term, maybe we can adapt to a society with fewer cars, but for now many people need them to survive, so someone will have to buy new cars. And, in fact, auto sales improved slightly in [March](#) (though not in April). Given the speed of the descent in Q4 and Q1, the bottom presumably cannot be that far off.

The four-week average of new unemployment claims is another indicator that the end of the recession (meaning the end of economic contraction) might not be too far off; [James Hamilton](#) and [Calculated Risk](#) both think this is plausible.

What happens next, however, is another question. Will the economy return to long-term trend growth of about 2.5-3.0% per year? Or will we muddle along with a “jobless recovery” where economic growth is barely sufficient to keep pace with population growth? The important thing to remember is that trend growth is just a long-term statistical average; there’s no magical mechanism that generates growth all by itself. I’ve said before that a lot of 2010 forecasts look like reversion to the mean, which is a valid way of forecasting, say, the expected height of the offspring of two tall people, but not necessarily economic growth.

For one thing, there’s no going back to the economy of 2002-07: a disproportionate share of economic growth then came from finance and real estate, and that isn’t happening

again for a while. More fundamentally, as Calculated Risk points out, we have reason to believe that the usual engines of recovery – personal consumption and residential real estate – are likely to be [missing in action](#), in part because the crisis is likely to have caused a long-term increase in [household savings](#).

So what's with all the optimism? To some extent, it reflects people's personal predilections: optimists see a recovery in the same data where pessimists see a long, flat line. In addition, though, I suspect there's at least a little marketing at work here. As Peter pointed out, Obama's "buying stocks is a potentially good deal" [remarks](#) on March 3 almost perfectly picked out the bottom of the stock market – a better call than any stock market prognosticator. The man can do anything! Of course, there's some endogeneity there; the most powerful person on the planet should be able to move the stock market, at least a little. And the administration seems to have nudged up its level of public optimism slightly, no doubt hoping to boost confidence and spending at the margin. If they can do it, more power to them. The economic stimulus package and, more likely, the monetary stimulus provided by the Fed will also have an effect. But they are fighting against millions of foreclosures to work through and a newfound desire to save on the part of the American consumer, and it will be a long battle.

By James Kwak

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May 15, 2009 11:50 AM

Self-Defeating Marketing

Today I got a "Welcome Guide" from Bank of America because I was until recently a Countrywide customer. Countrywide, like many institutions that are in trouble, was offering some very high CD rates last year before being acquired by Bank of America, so I put money there – below the FDIC limit, of course – just like I put money at IndyMac and Wachovia shortly before they failed. (For people who like to chase high rates, I recommend [Bank Deals](#).)

Anyway, this nicely designed welcome guide had a page titled "Clarity," with this text:

We're working to take the guesswork out of home lending with ideas such as our Clarity Commitment. This simple one-page loan summary clearly highlights key terms of each new loan. We've made it easy to read and easy to understand. So when you're ready to buy or refinance, you can be confident that you're choosing a loan that's right for you.

Unfortunately, there's a footnote that say, in very fine print:

This summary is provided as a convenience, does not serve as a substitute for a borrower's actual loan documents and is not a commitment to lend. Borrowers should become fully informed by reviewing all of the loan and disclosure documentation provided. Not available on all products and programs.

I understand the value of high-level disclosures and the need for detailed contracts. But as a marketing message, this one seems to shoot itself in the foot.

By James Kwak

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May 15, 2009 6:50 AM

[Is The Crisis Over Yet? The CBO Weighs In](#)

Confidence is returning to most credit markets, consumer spending is likely to rebound for some items (autos and housing repair are leading contenders), and firms in the US are starting to sound more optimistic. On NYT.com's Economix yesterday, [Peter Boone and I suggested](#) that we are out of the panic phase of the crisis - in large part because the US fiscal stimulus has reassured people worldwide, but also because President Obama has had a broader calming effect.

Today, the Congressional Budget Office is pointing out that it would be premature to congratulate ourselves too much (disclosure: I've [joined the CBO's Panel of Economic Advisers](#), but none of the information here comes from them). As you likely know, the [administration is proposing to lend](#) \$100bn to the IMF, as part of that organization's increase in resources following the G20 summit. [Peter Orszag](#), head of OMB, [argued that there was zero probability](#) of this money being lost, so \$100bn should be "scored" for budget purposes as \$0bn – which is how this kind of transaction has been handled in the past. As the IMF likes to say, it is "the lender of last resort, but the first to be repaid."

After considerable back and forth, the scoring issue was referred to the CBO. The CBO has reportedly decided there is a 5 percent probability of default by the IMF. This is an extraordinarily important statement. Most informed people just assume that the risk of IMF default is zero, because that would essentially constitute a complete breakdown of the global economy and payments system. But nothing is zero probability, particularly in a world of massive financial panics, incipient protectionism, and improvised global governance.

We can discuss if 5 percent is too high or too low; the CBO details are not out yet, so it's hard to know exactly the time scale they are thinking about – my guess is 5 years. In any case, this estimate tells you that – even with the increase in IMF resources to close to \$1trn, which will go through if the US approves this \$100bn loan – the CBO thinks (a) the crisis is not over, and (b) there is a nonzero probability that the entire global system breaks down. Take this seriously.

[Our point yesterday](#) was: don't throw another fiscal stimulus into the mix at this point, even the IMF – which has become a strong advocate of discretionary fiscal policy under some circumstances – is saying that it will not speed the recovery much. Save the fiscal space for further stimulus for when you might really need it, i.e., the unlikely, but possible, confluence of circumstances that would constitute another serious panic phase.

By Simon Johnson

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May 14, 2009 7:11 PM

[The Skirmish over Credit Cards](#)

The Senate may be voting this week on a bill to tighten regulation of credit card issuers – or not, since you can never tell with the Senate. Despite an [agreement](#) between the ranking members of the Senate Banking Committee, there is a series of amendments from both sides to go through; [Real Time Economics](#) has a summary of the issues that were open as of earlier this week.

I wrote a post on [The Hearing](#) earlier describing the debate as one between two economic perspectives: classical economics (credit card issuers should be able to offer any terms they want; if people accept them, that by definition means it increases their utility) and behavioral economics (people suffer from cognitive fallacies, like thinking that they will never pay any of those fees threatened in the credit card agreement, so regulations should help people make better decisions and protect them from bad decisions).

Looking back over that post, it was far too balanced. There is a plausible theoretical argument that tighter restrictions have the effect of limiting the supply of credit to marginal customers, but that's not what's going on here. First of all, there isn't much demand for credit these days. Second, it's really about whether credit card issuers will be able to use increased interest rates and fees to partially offset their increased default rates. And of course, this isn't going to be decided by economics, but by power. The more relevant question is the one that [Simon was asked on MSNBC](#): "Do the banks own the Senate?"

As we've written before, there is a complex relationship of co-dependency between the government and the banking sector. The administration has placed its bets on the banking sector in its current form, with its current leaders, and has provided it large amounts of financial support; and many members of Congress have even more direct allegiances to the banking sector via the mechanism of campaign finance. At the same time, banks are largely hated today, and credit card companies perhaps more than any other part of the banking industry. (They are largely the same companies – Bank of America, Citigroup, and JPMorgan Chase all have huge credit card businesses – but people feel differently about their credit cards and their checking accounts.) So this bill, and President Obama's [lobbying](#) for it, is a way to strike a blow for the beleaguered consumer while not doing too much damage to banks' profitmaking ability. As [Felix Salmon](#) pointed out, the Federal Reserve already defined new credit card regulations that go into effect in July 2010.

From the banks' perspective, this may look like a slippery slope to more regulation, and so they are trotting out all the usual arguments that Salmon describes in his post. But when push comes to shove, I doubt they will call in all their favors fighting this battle. The big fight will be over the new regulatory structure in the fall, and in the meantime it doesn't hurt to let the administration have a victory.

By James Kwak

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May 14, 2009 6:35 PM

New Forms of Internet Communication

Arnold Kling has developed a new form of communication across the Internet: he wrote a blog post entitled "[Paging Simon Johnson and James Kwak](#)," pointing to a [2000 paper](#) by a Federal Reserve economist on the usage of securitization and off-balance sheet entities to effectively lower banks' capital requirements for the same level of asset exposure. According to Kling, "the article clearly shows that the Fed was aware of regulatory capital arbitrage (RCA) and it paints a largely sympathetic picture of the phenomenon."

I haven't sprung for the \$31.50 to download the full article yet, but it is going on my reading list.

Kling also said he is "researching the history of capital regulation," which is something I would also look forward to reading.

Update: One of my friends pointed out that my university has online access to lots of journals, including the one this paper was published in, so I now have a copy.

By James Kwak

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May 14, 2009 5:29 AM

Can The US Save The World? (House Testimony)

Yesterday I testified to the House Subcommittee on International Monetary Policy and Trade (part of the House Financial Services Committee). The hearing's title was "Implications of the G-20 Leaders Summit for Low Income Countries and the Global Economy," and the main topic was whether Congress should support [an extra \\$100bn for the IMF](#) that the Obama Administration agreed at the G20 summit in early April ([witness list, webcast, and written testimony](#)).

The committee was mostly in favor of the US continuing to play a leading role in supporting the IMF, but [pressed the witnesses](#) to explain whether the IMF could lose this money (highly unlikely), how this would protect American jobs (definitely, but hard to quantify precisely), and if the broader package of IMF reform should also be supported (e.g., the [proposed gold sales](#) are being reassessed, to see they could generate more resources for aid to developing countries).

[Politico is reporting](#) that US funding for the IMF is likely to be attached to the war supplemental spending bill. The subcommittee's chairman, Gregory Meeks, seemed positive – as did all the Democrats who spoke, along with Gary Miller, the Ranking Member/Senior Republican. But, based on remarks made by at least two Republican members of the subcommittee, there is likely to be a big public fight at some point. My guess is that the Democratic side will press hard for President Obama to more publicly explain why supporting the IMF (and the G20) is very much in the US interest.

The main points from my written testimony are below. While Treasury represents the US vis-a-vis the IMF and traditionally has considerable scope for action, the views of Congress on IMF details are very important as both guidance and constraints. In our advice on the wide range of IMF-related issues below, both I and the other witnesses laid out broadly similar views with varying emphasis – there was actually much more disagreement among committee members than at the witness table.

Main points

Low income countries have been severely affected by the global economic downturn. Many of the worst consequences, including on the poorest people, have yet to be felt.

In that context, by contributing to the stabilization of the world's financial system, the G-20 summit had a positive effect. However, it left open a large number of important issues, some of which call for immediate congressional attention.

First and foremost, low income countries need to receive considerable additional resources in order to weather the crisis. This crisis is not of their making and, prior to this shock, poorer countries were making considerable progress along the lines of implementing exactly the policies advised by richer countries and the International Monetary Fund (IMF).

The IMF has adapted its standard forms of conditionality to current circumstances. The goal of protecting core social spending is commendable and long overdue, and the implementation in recent East European and Pakistan programs is encouraging.

However, the retreat from structural conditionality has probably gone too far and needs to be reappraised; the weaknesses of low income countries arise from and are manifest in disproportionate power of key individuals or sectors, and this needs to be addressed in a transparent manner wherever the IMF is engaged. In situations where such issues have been taken on board – as with transparency for extractive industries – the reception among civil society has been very positive.

The potential US legislative package (including IMF gold sales, its new income model, and \$100 billion for the New Arrangements to Borrow) is worth serious consideration but also needs careful congressional review. The \$250bn issue of Special Drawing Rights is a bold move which, while it involves some risks, is well worth taking – hopefully, this will be regarded as a pilot project for potentially larger increases in resources for troubled countries, on an “as needed” basis.

The G20 called for \$6 billion of additional concessional resources from the Fund over the next 2-3 years for Low Income Countries, including some vague phrasing on money from gold sales. So far, the gold piece of this puzzle remains stalled at the level of the IMF's executive board. More transparency around board discussions on this and other items would reveal who is holding up change and for what reason.

Providing additional resources to low income is a very good idea, and increasing the resource flow from and through the IMF is timely and appropriate. If these resources can come from “extra” proceeds from gold sales, that would be an attractive solution – particularly as the income model needs some adjustment in the light of (a) the increase in Fund lending over the past 12 months, and (b) the introduction of the Flexible Credit Line, which offers the promise of Fund revenue even during quiet times for the global economy. However, it is too early to determine how profoundly the Fund's income model will be affected by this crisis and how the world responds.

As long as the Fund lends at concessional rates to low income countries (and the relevant, Poverty Reduction and Growth Facility interest rate is only 0.5% per year currently), loans may be attractive relative to grants – the key issue is the resource flow that is available, i.e., does lending allow more transfers in a meaningful and sustainable manner. Avoiding unsustainable debt burdens is of course of paramount importance.

Most important, we should take all available actions to shore up low income country defenses against this crisis. We should also guard against any form of complacency.

For that reason, it is most important that the IMF be authorized to restore its budget to its early 2008 level (i.e., before the 15-20% across the board cuts were implemented). Cutting the budget and letting go some of the most experienced IMF staff was the unfortunate result of gross macroeconomic negligence at the level of leading industrialized countries, including the US and its G7 partners. At the same time as the IMF was warning, clearly and firmly, that a global crisis was developing, major shareholders pushed through budget cuts that resulted in some of the IMF's best people leaving the organization.

Undoing the budget cuts would be embarrassing to leading European countries, but it should find support from the Obama Administration – after all, it was their idea to make increasing IMF resources a central issue at the recent G20 summit. The IMF simply does not currently have sufficient skilled staff to undertake all the important tasks it has been asked to handle.

The G20 summit effectively agreed to end the European monopoly on the position of Managing Director at the IMF. Since the summit, there has been some indication of backsliding on this issue, but assuming that European countries can be kept to their commitments, this would be a major step in the right direction. Given that the next leadership change is likely to take place in a little over a year, identifying and supporting sensible candidates from emerging markets would be most constructive. If an Indian or a Brazilian, for example, could be brought in as Managing Director, that has the potential to greatly expedite the rebuilding of the IMF's legitimacy and its engagement throughout the developing world.

Unfortunately, IMF credibility has been somewhat damaged by its inability to follow through on exchange rate surveillance, particularly with regard to China. While there seems to be a movement towards implicit agreement among leading countries, in and around the G20, to take this issue off the table, that would be a serious mistake. Countries must not think that competitive devaluation (or even sustaining accidental undervaluation) is a sensible or attractive policy. This will lead to greater global imbalances and potential instability, as some countries compete to get current account surpluses and other countries – willingly or not – run deficits.

Unless and until countries are assured that there is an effective international lender of last resort, they will be tempted to try to accumulate large amounts of reserves. This creates problems for reserve currency countries (e.g., the United States) as well as for the global

system as a whole. We need an international system that can handle these issues and prevent them from becoming destabilizing. The IMF should be given another chance to show that it can help run the global system in a constructive fashion. This is of paramount importance for the United States and for everyone who wants to participate in an open international trading system – particularly low income countries, which have few other opportunities to grow and which remain highly vulnerable to shocks of all kinds.

By Simon Johnson

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May 13, 2009 1:19 PM

Law, Economics, and Regulation

One of the curious things about coming to law school was discovering the very high regard that “economics” is held in, at least in some areas like torts and contracts, where “law and economics” has become the primary theoretical construct. In essence, this school of thought holds either that the law has developed in such a way as to promote efficient economic outcomes, or that it should promote efficient economic outcomes. There is now an empirical branch of law and economics, but historically the law and economics approach was largely theoretical. For example, in United States v. Carroll Towing Co., 159 F.2d 169 (2d Cir. 1947), Judge Learned Hand wrote that the whether behavior is negligent should be determined by multiplying the probably of an accident by the cost of the accident and comparing that to the cost of taking precautions. Twenty-five years later, Richard Posner argued that this rule would lead to the optimal level of accident prevention, because it doesn’t make economic sense to pay more for accident prevention than the corresponding reduction in the expected costs of accidents; at that point, the firm would be better off just paying damages to accident victims. (There, now you don’t need to take first-year torts – just apply that principle everywhere.)

The Hand-Posner principle has filtered into the world of public policy and regulation as the argument that the benefits of regulation must exceed their costs. This argument is ascribed to Cass Sunstein, who “[cruised through Tuesday’s Senate confirmation hearing](#)” to be the “regulatory czar” in the new administration, which sounds much more powerful than “Administrator of the Office of Information and Regulatory Affairs” in the Office of Management and Budget. Sunstein is a widely respected law professor who specializes in just about everything (constitutional law, administrative law, regulation, and now behavioral economics – he co-authored *Nudge* - with a brief foray into the death penalty on the side). In principle, he would be able to review new regulations being defined throughout the executive branch. So the cost-benefit model of regulation – already

favored by the previous administration – may become more firmly entrenched in the federal government.

While this makes perfect sense in principle, I’m skeptical of how it works in practice. The basic problem is that it’s difficult if not impossible to measure either the probability of an accident or the expected costs of the accident, especially since there is a wide range of potential accidents and a wide range of potential outcomes (among other things, the same injury to different people will have a different compensable value, since damages are based in part on wage loss).

Take seat belts, for example. This should be an easy case: it couldn’t have been that hard, back in the 1960s, to estimate the number of lives and injuries that would be saved by installing seat belts and making their usage mandatory. It shouldn’t be that hard to estimate some of the expenses that would be saved – police and firefighters, vehicle damage, medical expenses, etc. But what about death or long-term disability? Or just simply having recurring back pain for the rest of your life? What is that worth? It is true that our legal system has ways of valuing these things, but they are outgrowths of common law (whenever you hear the term “common law,” think of 16th-century English judges deciding cases about horses and cows, and you won’t be too far off) and they produce results that are at worst perverse – if you’re going to run over someone in a car accident, hit the old person on Social Security, not the young hedge fund manager – and at best incomplete. For the most part, if it can’t be bought and sold in a market (like cars, or labor), it has no value.

This can be a particular problem when it comes to regulations that affect health or the environment. It affects any chronic health condition that simply makes people feel worse, since it’s difficult to quantify the cost of your feeling crummy. (I know there are economists who work on this kind of valuation; they include my wife, which is why I know how difficult this is.) Then imagine trying to do the cost-benefit analysis on reducing emissions of greenhouse gases. It’s easy to estimate the cost of technology to reduce smokestack emissions. But what’s the cost of not doing so? How do you estimate the total cost of the ice caps melting, sea levels rising, violent storms becoming more frequent, huge swaths of agricultural land turning to desert, and so on? How do you estimate the benefits of new shipping lanes opening up? And how do you estimate the likelihood of any of this happening?

Finally, to return to our favorite application, imagine that the government had considered the idea of systemic risk regulation five years ago. It would have cost money; it would have created new disclosure requirements for banks and possibly hedge funds; it would have required countercyclical measures in a boom that would dampen economic growth. Those are the costs of regulation. And how would anyone have estimated the benefits? No one would have estimated the scenario we face today – trillions of dollars of asset writedowns, 3.3% contraction in the U.S. economy and counting, even more severe damage elsewhere in the world economy. And as a result, the regulation would have died.

To be honest, I'm a bit conflicted about this whole issue. I think that conceptually this is the right way to think about government policy, and in many areas we could certainly use more of it. But it's a mistake to think that all policies can be boiled down to cost-benefit calculations when one side of the equation is difficult or impossible to measure accurately, and the last thing we need today is more economics-based overconfidence. Sunstein did say that the approach shouldn't put regulation "in an arithmetic straitjacket," so we'll have to see what he actually does.

By James Kwak

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May 13, 2009 6:40 AM

[Vote For \(Or Against\) The IMF](#)

The Washington Post is widely read on Capitol Hill and the reception among key people to [The Hearing](#) blog (run by us and the Post) has been generally very positive. Members of Congress and their staff want to get you more involved in their discussions around economic policy, and we're experimenting with ways that will help your opinions – whatever they are – get across at a time and in a manner that increases their impact.

To that end, we're developing on-line polls in which you can register your views on questions that are currently being debated – either in general terms or as specific legislation – on the Hill (of course, longer comments are also welcome; it's a blog, after all). [Today's question](#) is about whether the United States should provide an additional \$100bn to the IMF, as was agreed [at and immediately after the recent G20 summit](#); this is for a hearing held by a subcommittee of House Financial Services, which starts at 10am.

We've argued consistently that supporting the IMF can play an important role in stabilizing the global economy, and the Obama Administration handled this aspect of the G20 summit well. But have they made the case for why this is important, how the IMF will change, and what could happen if the recapitalize-the-IMF ball is dropped? Do you really believe the Europeans will follow through on their promise not to press for (yet) another European as the next Managing Director of the IMF (and there are some signs of backsliding on this issue)? Without that, can the IMF fully rebuild its legitimacy?

Does the money for the IMF feel like essential stabilization or a bailout for countries that shouldn't be bailed out? What would it take to persuade you to support the Administration on this point? Post your comments here or at The Hearing, but [the poll is only at The Hearing](#).

By Simon Johnson

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May 12, 2009 9:53 AM

Antitrust For Banks? Ask Carl Shapiro

The Department of Justice seems to thinking, at least in principle, about potential antitrust action in and around banking. Assistant Attorney General [Christine Varney spoke about this yesterday](#), but her exact wording is open to interpretation, “”I have to ask if too big to fail is a failure of antitrust enforcement.” (The [press release was uninformative](#) on this point)

More encouraging was the background briefing given to the New York Times, as seen in [this paragraph](#),

“Ms. Varney is expected to say that the Obama administration will be guided by the view that it was a major mistake during the outset of the Great Depression to relax antitrust enforcement, only to try to catch up and become more vigorous later. She will say the mistake enabled many large companies to engage in pricing, wage and collusive practices that harmed consumers and took years to reverse.”

The thinking among antitrust experts has been that there is not much market power, conventionally defined, in financial services. But this thinking may change, for at least three reasons.

1. There is definitely less competition now in investment banking (no more Lehman or Bear Stearns). Banks are bragging that their fees and trading profits will consequently be higher.
2. Reportedly aggressive action by investment banks, vis-a-vis particular countries/securities, [grab headlines](#). One way to think about these alleged actions is an [exercise of \(socially destructive\) market power](#). Predatory practices are surely easier to get away with in a period of global confusion.
3. Changes in fees for overdrafts are [beginning to attract attention](#). This may be a matter for bank regulators rather than antitrust, or even for a financial products consumer protection agency to be named later (remember [Joe Stiglitz's recent testimony](#)), but it does make you ask: what is the market structure that allows banks to do this?

There is an awkwardness to these concerns, of course, because Phase II of [Larry Summers' Recovery Model](#) calls for banks to earn their way back to reasonable capital levels. Banks know they now have a high level of political cover and are likely to act accordingly. If the Department of Justice moves towards banks, it will presumably be stalled by Treasury and others.

Still, the legal system has a dynamic of its own. And [Carl Shapiro, Deputy Assistant Attorney General for Economic Analysis](#), is completely capable of thinking clearly about our new (?) Too Big To Fail economy – e.g., start on [p.108 of his book](#) for ideas that begin to be more broadly relevant to the debate on finance today. With some help, he and his DoJ colleagues can figure out how best to bring public policy to bear.

Post your suggestions for them here.

By Simon Johnson

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May 11, 2009 1:21 PM

Insurance and Health Insurance

I've been meaning to write a post on health insurance ever since hearing Karen Tumulty on [Fresh Air](#). (She was discussing her [Time article](#) on underinsurance.) I happen to think that a free market for insurance works pretty well in most circumstances (and I did co-found an [insurance software company](#)); for example, if you can afford the house, you can generally afford the insurance for the house. But it doesn't work very well for health care, because many people are simply uninsurable under free market principles (expected health care costs exceed their income, let alone their ability to pay), and hence would be left to die. We think we have a private, for-profit insurance system today, but we can only avoid its disturbing implications by hedging it in with public backstops and regulations.

Since the Senate Finance Committee is taking up health care reform this week, I finally wrote that post today for [The Hearing](#).

By James Kwak

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May 11, 2009 12:53 PM

Stress Tests: The Questions Continue

From [Felix Salmon](#):

Why did Treasury switch from TCE to the even-more-obscure common capital metric? Quite possibly to help Bank of America and Citigroup get the amount of capital they needed to raise down to a number within the realms of possibility. After all, these tests were designed so that they couldn't be flunked. And that might have seemed a real possibility back when Treasury was still using TCE.

By James Kwak

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May 11, 2009 12:21 PM

That Was Fast

The Obama administration is strengthening its [antitrust enforcement policy](#).

That said, this in itself probably wouldn't have done anything about the "too big to fail" problem. It might have increased scrutiny over large bank mergers – like Nations-Bank of America, Bank of America-Fleet, or JPMorgan Chase-Bank One, but frankly those probably would have gone through anyway; the banking industry is just not that concentrated compared to some others. Too big to fail is a combination of size, interconnectedness, and the critical role of finance for the economy. But the signal that the administration will actually enforce antitrust law is a step in the right direction.

By James Kwak

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May 11, 2009 6:13 AM

Is Larry Summers The Next Gordon Brown?

Gordon Brown, the British Prime Minister, is [in big trouble](#). It turns out that a medium-sized industrialized democracy like the UK can be run in pretty much the same way as a traditional emerging market – fiscal irresponsibility (cyclically-adjusted general government deficit [now forecast at 12.2 percent of GDP for 2010](#)) gives you a boom for a while, but the eventual day of reckoning is economically painful and politically disastrous. If you also need to deal with an oversized bubble finance sector, that makes the adjustment even more painful.

It is of course sensible to use fiscal stimulus to offset a fall in private demand, and to some extent this can be effective – with a lag. But if you lose control over public spending and borrow too heavily (helped by the fact people like to hold your currency), it ends badly.

From the beginning, we've expressed concern here that the entire Summers Plan was [overweight fiscal](#), i.e., not enough resources for recapitalizing banks and addressing housing directly (for the context of this assessment, see our [full baseline view](#)). Back in December/January, this was a strategic choice worth arguing about; now it's a done deal and following the (very) limited recapitalization outcome of the bank stress tests, it seems likely that household and firm spending will remain sluggish. If that is the case, the Administration's logic implies throwing another big fiscal stimulus into the mix – and the Summers' team is already preparing the groundwork.

The IMF is now warning against the risks of this approach, albeit using carefully worded language.

In a 20 minute presentation [at the Carnegie Endowment](#) on April 30th, Olivier Blanchard made statements that are striking coming from the IMF's chief economist ([webcast](#); [slides](#); [fan chart for growth forecast](#)).

Remember that the IMF is the custodian of the official consensus on the global macroeconomy and financial system – so if their baseline view is [in the same ballpark as your stress test results](#), the IMF is telling you to be more pessimistic. They can nudge a powerful government, like the US, in a particular direction – but [not too hard in public on a politically sensitive issue](#) such as fiscal sustainability (or lack of capital in the banking system).

Blanchard is clear that the IMF sees the need to “fix the financial system”. He also assumes this will happen slowly, and indicates this slowness is not helpful for the recovery. The implication is that the US will resort to even more fiscal stimulus if the recovery proves sluggish – look at his slide on p.7, dealing with fiscal sustainability (this is discussed at about minute 11 in the webcast). This presentation of country averages is an IMF way of talking about difficult country-specific situations without being indelicate – and the point here is to push you to think about the nonconvergent (red...) debt path with contingent liabilities (i.e., what the government is committing to

the banking system without acknowledging the fact); the yellow path for debt, with slow economic growth, also does not look good.

Blanchard doesn't show the US debt forecast – presumably that would be indelicate. But at the 13:13 mark, he warns that the US may be heading in the same fiscal direction as Ireland (!), "the [US budget] numbers are not great but we hope that something will be done."

The content and timing of that "something" is left vague – add your suggestions below.

By *Simon Johnson*

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May 10, 2009 8:11 AM

James Surowiecki and Me

Back when I had time to read *The New Yorker*, I was a big fan of James Surowiecki. I would always look for his column; if it was there, it was usually the first thing I would read. Unfortunately, he's [no fan of mine](#).

Surowiecki makes three points about our recent [long post on nationalization](#):

1. If the government were to take over a large bank like Citigroup, it would not be able to sell it into the private sector quickly, but would most likely own it for several years, which constitutes nationalization.
2. Recent U.S. history, by which he means the S&L crisis, shows that the right strategy is "exercising regulatory forebearance, cutting interest rates sharply (which raises bank profit margins), and helping the banks deal with their bad assets" – not bank takeovers.
3. We were misleading in citing the IMF's \$4.1 trillion number instead of the lower \$1.1 trillion number for U.S. financial institutions. "I assume they used the \$4.1 trillion number because it's much scarier, and offers a much gloomier picture of the state of the U.S. financial system. Unfortunately, it also offers a much more misleading picture of the system."

Sigh. I guess it's impossible to make everyone like me.

I'll take the points in reverse order.

3. I plead partially guilty to this one (I wrote that section of the post). \$4.1 trillion is the IMF's aggregate estimate of all writedowns by all financial institutions globally. To be honest, I used it because that was the number I remembered, and I was writing fast and late at night. (I do this in my spare time, remember?) The point I really meant to make was that the IMF's estimate was *going up*, because the problem had spread into all sorts of lending. You'll note that I didn't actually compare the \$4.1 trillion to any other number – now that would have been misleading.

When I dealt more specifically with U.S. bank capital levels in [another post](#), I did use the relevant IMF number: \$275-500 billion in capital needs. \$275 billion is a much bigger number than \$75 billion, the bottom-line total of the famous Table 3 of the stress test results. Surowiecki attempts to deal with this in his post called "[The Fed and the I.M.F. Agree](#)," where he reconciles these two numbers. His reconciliation is correct as far as it goes. However, the stress tests were supposed to be for a "more adverse" scenario, meaning more conservative than the expected scenario; the [IMF numbers](#), by contrast, are their *expected* scenario (see mainly PDF pp. 27-28 and 32-34). Who's right? Well, [Calculated Risk](#) has a chart showing clearly that unemployment is already running slightly worse than projected in the "more adverse" scenario (see the second chart in that post), indicating that the "more adverse" stress test scenario/IMF expected scenario (which are similar, as Surowiecki notes) should be thought of as an expectation, not a conservative forecast. So if you believe that the stress tests were supposed to buffer against the possibility of a worse-than-expected outcome, they aren't doing it.

There is another major difference between the stress tests and the IMF that deals not with the forecasting question, but with the capital adequacy question. The stress tests calculate capital requirements as a percentage of risk-weighted assets, while the IMF uses total assets (confusingly defined as "total assets less intangible assets" (PDF p. 34, note 39)), which ordinarily will be significantly higher (risk weights are generally less than or equal to one). So 4% of one does not equal 4% of the other. (The IMF's \$275-500 billion range reflects 4% and 6% thresholds.) Citigroup, for example, had total assets, excluding intangibles, of \$1,897 billion as of [December 31](#) (the snapshot used by both the stress tests and the IMF), while according to the stress tests it had risk-weighted assets of \$996 billion. Who is right I will leave to others to debate, but the stress tests are allowing banks to get by with much less capital than the IMF report implies they should.

2. I am confused by Surowiecki's interpretation of recent U.S. history. The "regulatory forbearance" he mentions happened early in the 1980s when, among other things, thrifts were allowed to invest in a broader set of assets and were allowed to offer higher interest rates to depositors, deposit insurance ceilings were raised, and capital adequacy requirements were relaxed for thrifts facing insolvency. This may have helped banks survive but, according to a [later FDIC report](#), it also postponed and amplified the later crisis: "With respect to commercial mortgage markets, this legislation set the stage for a rapid expansion of lending, an increase in competition between thrifts and banks, overbuilding, and the subsequent commercial real estate market collapse in many regions." The early 1990s saw precisely the opposite; the FDIC Improvement Act of 1991, for example, limited regulatory discretion in dealing with struggling institutions.

Forbearance can work, but it is not a cure-all. The FDIC report later contrasts beneficial and harmful forbearance programs, but it criticizes large-scale forbearance programs in no uncertain terms:

Longer-term, wholesale forbearance as practiced by the FSLIC was a high-risk regulatory policy whose main chances of success were that the economic environment for thrifts would improve before their condition deteriorated beyond repair or that the new, riskier investment powers they had been granted would pay off. The latter type of forbearance, which the FSLIC adopted against the background of a depleted insurance fund, is widely judged to have increased the cost of thrift failures.

In addition, the policies of the 1980s played out in a very different economic environment. The assets in question were primarily loans, rather than the complex securities we are dealing with today. And the global economic climate was considerably better than today, which helped banks earn their way out of their problems.

In any case, the bottom line of the S&L crisis was over 1,600 FDIC interventions between 1980 and 1994. (We've had 33 so far this year.) The Resolution Trust Corporation was charged with managing the assets of banks and thrifts that had become insolvent, not "helping the banks deal with bad assets." One can argue about the lessons of the 1980s – particularly about what they mean for large banks – but it's by no means clear that the policies Surowiecki highlights forestalled the need to take over banks.

1. I think this is one of the more serious criticisms of government takeover of a large bank – namely, that it would take a long time before it could be returned to the private sector. But that doesn't mean prolonged political control over lending decisions. The important thing about a takeover is that you can clean up the balance sheet, for example by transferring the toxic assets to a separate entity, without having to negotiate with anyone. Once you've done that and the bank is recapitalized (no one is saying this will be free), the government's stock can be put into a trust with an independent board of trustees with long terms. This would insulate the bank reasonably well from political pressure, since the trustees' legal obligation will be to run the bank for its own long-term benefit, and to privatize it when possible at the highest possible price for the taxpayer.

There is actually an example of this right now: AIG is majority-owned by the government, but the government's stock is controlled by three trustees who are independent of Treasury and the Fed. This is why the Treasury is forced to negotiate with AIG like any other private party that is looking out for its own interests. On the other hand, Treasury had zero voting shares in Bank of America back in December – yet it felt able to threaten Ken Lewis with replacement if he didn't close the acquisition of Merrill. My point is that you get government influence either way, regardless of the legal structure. With Bank of America, the source of the influence was the likelihood that B of A would need assistance from the government in the future. With AIG, the source of the influence was yelling and screaming through the media, plus the fact that AIG also needed additional assistance.

I'm not saying that the AIG situation is perfect, just that it is possible to insulate a government-owned entity from political meddling – as the government found out, to its frustration. The mistake with AIG, I believe, was giving it that independence without having fixed its fundamental problems – the ones that cause it to keep coming back for more money. Were the government to take over a large bank, it should clean up the balance sheet and recapitalize first – without negotiating – and then turn it over to an independent set of trustees.

This “big banks are different” issue is a serious one and worthy of consideration. But it doesn’t necessarily justify the application of a completely different set of principles than the ones that are routinely applied to smaller banks.

Update: There’s another difference between the stress tests and the IMF: the [type of capital](#) – TCE (IMF) or Tier 1 common capital (stress tests). I was suspicious of this but didn’t have time to look into the impact.

Update: James Surowiecki’s [response below](#).

By James Kwak

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May 9, 2009 7:39 AM

“Nationalization” (A Weekend Comment Competition)

Writing [in the *Financial Times*](#) on January 27th, 2009, Peter Boone and I expressed our opposition to bank nationalization in no uncertain terms,

If you want to end up with the economy of Pakistan, the politics of Ukraine, and the inflation rate of Zimbabwe, bank nationalization is the way to go.

Most others who recently advocated a managed bankruptcy process – or FDIC-type intervention – for big banks (with or without the injection of new government capital) were careful, at least initially, to avoid using the word nationalization. And many took pains to explain in detail why their proposals were quite different from nationalization.

But at some point this became a debate in which informed bystanders perceived the sides as being for or against “nationalization” - a semiotic transition that has obviously helped the big bankers, at least in the short term.

This weekend's comment competition is in two parts. Who first made "nationalization" the central word for the U.S. bank discussion? And who was most influential in establishing that the national debate be defined in these terms?

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May 9, 2009 6:10 AM

Stress Tests: What Was the Point Again?

There has been a lot of drama over the last week, which we have certainly contributed to, about the stress tests. It was all very exciting, finally seeing numbers purporting to show how healthy or unhealthy each bank was. But let's recall what the point of this whole exercise was.

Depending on your perspective, the goal is either to restore confidence in the health of the financial system, or to ensure the health of the financial system, which are obviously closely related. We care about the health of the financial system because the financial system is critical for the health of the economy as a whole: without banks that are willing to lend money for people to buy houses, cars, and consumer goods, or for businesses to invest in real estate, factories, inventory, software, etc., none of these things will happen. So the ultimate goal is to ensure the availability of credit.

There are ways to measure the availability of credit directly. One of them is the Fed's quarterly [survey on bank lending practices](#), which was released earlier this week (hat tip [Calculated Risk](#), as usual). For a quick overview, I recommend the [charts](#). The charts show you, for each quarter, the *change* in supply of or demand for credit in that quarter – in other words, they are showing you the first derivative.

The quick summary is that lending practices tightened for every category of loans for the seventh straight quarter (in some categories, tightening has been going on even longer). In most categories, the rate of tightening – the difference between the number of banks who say they have tightened credit and the number who have loosened it – is lower than the peak in the October survey. But this just tells us that the second derivative is positive, which was to be expected, since the October peak was the highest ever recorded in every category, when virtually every bank was tightening credit. The first derivative is still negative, which means it is still getting harder to get a loan across all major categories.

Note that the latest survey was taken in April, which is after the banks' spectacular first quarter results. So despite the major banks' insistence that they are healthy and they can earn their way out of their troubles – which appears to be the government's strategy as well – it is still getting harder to get a loan. Now, it may actually be true that the banks

can earn their way out, if you look at the second figure, which shows that virtually all banks have been increasing their spreads on commercial and industrial loans every quarter for the past year. As money gets cheaper, competition dies off, and lending standards get tighter, profits go up.

At some point, increasing bank profitability – if it can be sustained – should translate into increased competition, lower spreads, and increased availability of credit. But we are a long way from that point.

The other thing the charts show is that demand for credit has been negative for several quarters in every category, with the exception of prime residential mortgages, which turned positive in the April survey – almost certainly due to refinancing at historically low rates. So even though we saw increased consumer spending in Q1, it was with lower borrowing. This reflects the expected shift in consumer behavior away from debt and toward saving.

By James Kwak

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May 8, 2009 9:46 PM

[Chrysler and Bankruptcy Law in Gory Detail](#)

I was talking to an old friend last night about the Chrysler bankruptcy and, in particular, whether Chrysler (and Treasury, and the UAW) will be able to get around the order of priority of creditors in bankruptcy – which ordinarily would favor the senior secured lenders who are trying to block the proposed plan. I thought I would do a little research, but then (again via [Calculated Risk](#)) I found Steve Jakubowski's [analysis](#) of precisely this issue, which apparently everyone on the Internet has already been linking to. It's actually Part 3 of a series; you may want to start with [Part 1](#).

My summary, for those who don't like reading citations from court opinions: The issue with the "[restructuring initiative](#)" agreed-upon by Chrysler, the government, Fiat, and the UAW, is that it only pays the senior secured creditors \$2 billion in cash for \$6.9 billion in secured debt; since secured creditors' claims should come first, they argue they would get more from a liquidation. In particular, the VEBA created to fund retiree benefits is owed \$8.5 billion; it is getting \$4.6 billion debt and 55% of the equity in New Chrysler.

The government's plan is to get around this by creating a new entity, New Chrysler, and having the existing entity, Old Chrysler, sell its assets to New Chrysler. Technically speaking, Old Chrysler is not being reorganized; it is just selling assets. However, [as](#)

[Jankubowski explains](#), a bankruptcy court can block such an asset sale if it is effectively a reorganization by another name. The Second Circuit (the appeals court that would hear the appeal of the bankruptcy proceeding) has said that such an asset sale may go ahead if there is a “good business reason” for it – a test that is spelled out, not entirely clearly, in other court opinions.

Behind the legal test, the underlying legal principle at issue, discussed in [Part 3](#), is whether the “absolute priority” rule, which determines the order of claims by creditors in bankruptcy, prevails over the general policy consideration that bankruptcy is intended to enable companies to return to healthy operations. To simplify greatly, Chrysler and the government’s argument is that without the “asset sale,” the company will simply disintegrate; the creditors’ argument is, or could be, that that doesn’t matter.

If you want to know what corporate law is like, I recommend reading the posts in full.

Update: It looks like the creditors’ opposition [may fall apart](#), although we can’t be certain. well, at least you learned something about bankruptcy law.

By James Kwak

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May 8, 2009 6:26 AM

The Other Stress Test (For Bankers)

There is nothing you can teach Wall Street titans regarding the timing of news flow. Stephen Friedman, the former head of Goldman Sachs, resigned last night as chair of the New York Fed’s board, after committing essentially a rookie error. In December/January, he traded the stock of a company (Goldman) overseen by the NY Fed, while helping to pick a new head of the Fed (formerly from Goldman), and presumably being aware of other potentially nonpublic information regarding bank rescues (benefiting Goldman both directly and indirectly). The real error, given the Federal Reserve System’s incredibly lax rules on potential conflicts of interest at this level, was failing to disclose this information to the NY Fed – they learned it from WSJ reporters and that cannot have been a good moment.

If you have to resign, pick your time of day carefully, and Friedman is obviously advised by the best people in the business. I’m looking at the hard copies of four newspapers. The news of his departure does not make the front page of the NYT (not even the small stuff at the bottom) or the front page of their Business Day section. There is nothing on the front page of the FT or Washington Post. Even the WSJ only manages three

paragraphs on the front page, before sending you to look for p.A10. (It was [on cnn.com from 5:55pm](#) last night, together with [his resignation letter](#).)

I haven't checked who first broke the news, but Friedman's resignation was of course the major development of yesterday. The bank stress test results were hard-baked a long time ago, and almost all the icing on that cake had already been leaked. But the stress test for bankers is still underway.

The idea of a stress test, of course, is to see what goes wrong under pressure. We do this for banks with hypothetical scenarios, but when you go to see the cardiologist you need to step on a treadmill and actually get your heart rate up. The stress test for bankers is very relevant for thinking about our future financial system in three ways:

1. We are now seeing how they behaved during a boom, both in terms of compensation system and insider-type transactions.
2. We can see what happened during a crash and attempted recovery; part of which is about massive taxpayer provided subsidies (do the bankers even have the manners to say thank you?) and much of which is about tilting the playing field towards pre-provision earnings (for which Jan Hatzius of Goldman has the most eloquent exposition).
3. Most interesting, of course, is how bankers think. They regard themselves as entitled to outsized compensation that encourages excessive risk taking. They think that insider trading rules apply to other people. And they are convinced that only they – and their friends – are capable of running government in boom or bust (or in ways that boom leads to bust, at which time you buy low and then recover through large implicit support from the government.)

Really what we have seen over the past two years (a great Freudian slip from the [Comptroller of the Currency on NPR last night](#)) is a stress test of our bankers. If you think they basically did fine, then we can go about our business with essentially the same financial system that has developed in the last couple of decades.

If you have concerns about how they behaved and the potential consequences of such behavior down the road, then we need to talk further. The banks passed their stress tests, in part because these were designed by bankers and people friendly to bankers (we could also think about how our regulators have done over the past two years). But are the bankers passing their stress tests?

By Simon Johnson

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May 8, 2009 2:00 AM

Grading on a Curve

[Mark Thoma](#) has a great analogy for the stress tests. He picks up on this statement by Tim Geithner:

Some might argue that this testing was overly punitive, while others might claim it could underestimate the potential need for additional capital. The test designed by the Federal Reserve and the supervisors sought to strike the right balance.

Then this is Thoma:

I've given a lot of tests over the years, and I can pretty much make the mean on a test come out how I want through the design of the questions and how I score the answers. If I want a mean of 70, or around there, I can get it, and if a mean of 50 is the target, that's possible too. . . .

If we choose a score of "70" as the dividing point between being solvent and being insolvent, then the percentage of banks passing the test is a function of the difficulty of the stress test: how the items on the balance sheets – the answers to the questions – are interpreted.

The whole thing is a fun read. I don't think it's a crucial point, but I like this part of the analogy:

Why did the government negotiate the outcome with banks and how lenient were they in those negotiations? There are always students who want to argue about the result of a test, to have sections regraded, and how you respond to attempts to "negotiate" a grade can affect the percentage passing the class, particularly when – as with the stress tests – there aren't a lot of students/banks taking the test.

By James Kwak

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May 7, 2009 9:01 PM

Help

Has anyone figured out how to make the numbers in Table 3 (PDF p. 10) in the [stress test results](#) add up? I understand what all the lines mean individually, but the presentation seems incomplete. Looking at Citi for example, I know that they expect 104.7 in losses on existing assets, but they expect Citi to make 49.0, for a net loss of 55.7. Common capital on 12/31/08 was 22.9, and $22.9 - 55.7 = -32.8$, so absent recapitalization that would leave Citi at -32.8 on 12/31/10. The “SCAP buffer” (which seems like the opposite of a buffer, but whatever) is 92.6, so with the buffer Citi would have 59.8 on 12/31/10. But 59.8 is well over 4% of Citi’s risk-weighted assets of 996.2.

Maybe the model has Citi’s assets climbing up to \$1.5 trillion? Or maybe the losses and “resources to absorb losses” do not have a dollar-for-dollar effect on common capital?

Anyway, it seems like at least one number is missing. If you can explain this, or link to someone who can, I will . . . be grateful.

Update: The most common theory is that 59.8 is 6% of 996.2. But I don’t think that is the explanation, for the reasons I cite in this [comment reply](#) and that Nemo also flagged. Also, [Erich Riesenbergs](#) points out that the fact that this works out to 6% for Citi is a pure coincidence, if you look at the same calculation for other banks.

By James Kwak

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May 7, 2009 2:29 PM

[GMAC Arithmetic](#)

[Calculated Risk](#) has a table listing all of the leaked stress test figures so far. As a percentage of assets, the big banks need between 0% and 1.4% in additional capital. But there is one outlier: GMAC, with \$189 billion in assets, needs \$11.5 billion in capital.

This implies that GMAC is not just low on capital, it has negative capital. If you were to give GMAC \$11.5 billion in new cash, it would have \$200 billion in assets. The minimum tangible common equity requirement being used for the stress tests is probably in the [3-4% range](#). If it’s 4%, then the post-recapitalization GMAC would have \$8 billion in tangible common equity – which means that right now it has negative \$3.5 billion in tangible common equity. (The situation is slightly worse if you assume that it will be recapitalized through a preferred-to-common conversion, or if the threshold is 3%.)

The thing that confuses me is that, on paper, you can’t recapitalize a company with a negative net worth. No investor would pay \$11.5 billion to own 100% of the common

shares in a company that is worth \$8 billion. (You can recapitalize a company that is under-capitalized: if it has \$5 billion in capital and needs another \$5 billion, then the new investors get 50% of the company.) This is why it is important (from the government perspective) for the stress tests to show that some banks are low on capital, but not that they have negative capital.

Maybe there's some clever accounting mechanism or financial wizardry I'm missing.

Update: OK, now that I read the stress test document (I must be the last economics blogger to do so), I see there's a mistake above. According to the stress test, GMAC is sufficiently capitalized now; the problem is that under the "more adverse" (realistic) scenario, its 2009-10 losses will be greater than its capital. So its expected capital at the end of 2010, *absent recapitalization in the interim*, would be negative.

It is not arithmetically impossible to recapitalize such a company, because we don't know that this outcome will occur with certainty. I *might* pay \$11.5 billion to own a company that, in the more adverse scenario, will be worth less than \$11.5 billion at the end of two years – *if* I think that the possibility of a better outcome makes the bet worthwhile. Put another way, even if its end-2010 expected value is negative, its current value is still at least a little positive, because of option value. Still, though, it's a pretty dodgy investment, so GMAC will probably have a difficult time raising new capital by selling common stock to the private sector.

The comment Nemo made below about the difference between market value and book value is true, but I also think my response is true: if anything, market values are below book values these days.

Finally, [Felix Salmon](#) also noticed that GMAC is the outlier on the bad end.

By James Kwak

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May 7, 2009 11:01 AM

Stress Test Debate

See [NYT.com's Room For Debate](#). I like what [Yves Smith says](#). Post your reactions there or here.

By Simon Johnson

Update (by James): My last pre-results thoughts are at [Foreign Policy](#).

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May 7, 2009 10:29 AM

Failure Is Good

Regular readers will know that we are fans of Thomas Hoenig, president of the Kansas City Fed (see [here](#)). I was catching up on the week's news via [Calculated Risk](#) and came across Hoenig's recent op-ed in the [Financial Times](#), which I recommend as a follow-up to (or shorter version of) our [previous post](#). Nor surprisingly, Hoenig argues that large bank holding companies should be allowed to fail, meaning:

Non-viable institutions would be allowed to fail and be placed into a negotiated conservatorship or a bridge institution, with the bad assets liquidated while the remainder of the firm is operated under new management and re-privatised as soon as is feasible.

Hoenig provides a list of arguments in support of this position. He starts with moral hazard, which would not have been at the top of my list. But I particularly like these:

So-called “too big to fail” firms have been given a competitive advantage and, rather than being held accountable for their actions, they have actually been subsidised in becoming more economically and politically powerful.

As these institutions are under repair, the Federal Reserve is making loans directly to specific sectors of the economy, causing the Fed to allocate credit and take on a fiscal as well as a monetary policy role.

A systematic approach would reduce the uncertainty that has paralysed financial markets; the cost is more measurable and therefore manageable.

Here's a link to the [whole thing](#) again.

By James Kwak

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May 7, 2009 6:29 AM

Stress Tests and The Nationalization We Got

The post was co-authored by Simon Johnson and James Kwak.

When the stress tests were first announced on [February 10](#), bank stocks went into a slide (the S&P 500 Financial Sector Index fell from 133.13 on February 9 to 96.18 two weeks later), in part on fears that the stress tests would be a prelude to [“nationalization” of the banks](#). This week, it has emerged that several large banks will require tens of billions of dollars of new capital, most notably [Bank of America](#). They could obtain that capital by exchanging common shares for the preferred shares that Treasury now holds, an accounting trick that [boosts tangible common equity](#) without providing the banks any new cash. Such a conversion would greatly increase the government’s stake in certain banks, perhaps even above the 50% level, yet the markets seem relatively [unconcerned](#) this week, with the S&P 500 Financial Sector Index at 168.14 and rising.

What happened?

Back in February, America was mired in a public debate over the word “nationalization” and what it meant for our banking system, with contributions by Nobel Laureates Paul Krugman and Joseph Stiglitz, former and current Fed officials Alan Greenspan, Alan Blinder, and Thomas Hoenig, and administration figures Timothy Geithner, Larry Summers, and even Barack ([“Sweden had like five banks”](#)) Obama, among others. On a substantive level, the debate was over whether large and arguably insolvent banks should be allowed to fail and go into government conservatorship, as happens routinely with small insolvent banks. Opponents of this view who wanted to keep the banks afloat in their current form, including the current administration, beat off this challenge by calling it nationalization (more precisely, by demonizing government control of banks). Perversely, however, what we got instead was increasing co-dependency between the government and the large banks, as well as increasing influence of the government over the banks, and vice-versa. And according to the market, the banks should be quite happy with this outcome.

As a starting point for thinking about this issue, there are good reasons to be skeptical about nationalization, meaning indefinite state ownership of the banking system.

Government ownership of banks or any other company can go badly wrong. Anyone growing up in the United Kingdom during the 1960s and 1970s experienced first-hand the problems that occur when the government runs major industrial and infrastructure companies – particularly when they have powerful unions. Margaret Thatcher came to power in 1979 in part because the state-run parts of the U.K. economy were not doing well, and the wave of deregulation that she started (and the financial boom it triggered) was a reaction to that context.

Similarly, people working in Eastern Europe and the former Soviet Union in the 1990s got a close-up view of wasteful and unproductive state ownership at work. Privatization was not handled well in some situations, particularly when it led to the emergence of powerful oligarchs. But the state had been a dreadful owner in almost every respect – quality of service in stores, productivity in manufacturing companies, resource management in oil and gas companies, and massive pollution by energy and transportation systems.

All of these nationalized industries had something in common. When companies did badly, the losses were borne by the state. As a result, there was little incentive for company managers to improve their performance. Some years they would get lucky and even make a profit – but at those moments, most of the benefits would go to the insiders, in higher wages, bigger perks and the like.

Direct state ownership of industry has proved disappointing almost everywhere. It turns out to be an arrangement in which a small group of people – whoever has power at or around the state enterprise – get the upside, while society as a whole gets all the downside. There is a prominent role for government in the modern economy: setting rules, enforcing contracts, supporting longer-term research and development, and trying hard to continually upgrade education. But managing banks is not part of that package, primarily because politicians should be kept away from credit. Once the allocation of loans becomes politicized, you get all kinds of pathologies and, most likely, more inflation as the central bank loses the ability to cut back on credit.

However, this does not mean that the state has no role to play in the banking system.

In every developed country, the financial industry is closely monitored and regulated – on paper at least – because of its crucial role in the economy. That regulation has two major objectives that almost no one disagrees with. The first is protecting depositors. There is no simpler scam than accepting deposits, paying them out to bank insiders (or “investing” them in insiders’ money-losing projects), and then going bankrupt. Even in the absence of fraud, mismanagement can lead to the same result. If people do not trust banks to hold their money, they will hold onto cash instead – increasing the cost of everyday life, and starving the economy of credit.

The second, related objective is preventing bank failures, when they do occur, from causing major damage to other institutions. At any moment, a reasonably complex bank will own a diverse portfolio of assets, owe money in different forms to many different investors, and have open trading positions with many counterparties. Unwinding these relationships through a traditional bankruptcy process could cut off liquidity to other financial institutions and cause a ripple effect of successive failures.

In the U.S., the solution to this problem was defined in the Great Depression and has never been seriously questioned. Deposits are guaranteed by the Federal Deposit Insurance Corporation (FDIC), which receives insurance premiums from banks. In return, federal and state regulators have the right to monitor banks in order to minimize the

losses that the FDIC could suffer. This is analogous to a workers' compensation insurer auditing its customers' workplaces to make sure they meet prescribed safety guidelines.

Under this system, if a bank is at risk of failure, the regulator can demand that it increase its capital. If it cannot find additional capital, or if it is insolvent, the FDIC will take over the bank. Most often the bank's assets (loans, securities, buildings, customer base, deposit accounts, etc.) are transferred to another bank, insured deposits are protected, losses to uninsured deposits are minimized, and operations continue nearly seamlessly. By most accounts, this process runs very smoothly. And it happens regularly – [25 times in 2008, and 29 times through April](#) this year.

Even when the FDIC has to operate a bank for some time before it can find an acquirer or wind it down, we never talk about the FDIC "nationalizing" a bank. An FDIC intervention is typically called a conservatorship or a receivership, depending on whether the bank will be liquidated or not. Although insured depositors are protected, uninsured creditors such as bondholders are not; how much they get depends on what the FDIC can sell the assets for. And shareholders are almost entirely wiped out.

Although this process includes a period of government control, there's a good reason why no one calls it nationalization: the process preserves the incentives of free market capitalism. Shareholders, who took the most risk for the highest expected returns, lose their money. Bondholders, who took some risk for modest expected returns, lose some of their money. Managers lose their jobs. Healthier, better-run banks claim the assets, grow, and make more money.

The recent nationalization debate has this precisely backwards.

The problems of the banking sector are clear, although reasonable people may disagree about their magnitude. America's biggest banks suffered massive financial losses due to bad loans and worse risk management, while reducing their capital to the legal minimum and then lobbying Washington to reduce that minimum. The crisis began with unexpected losses on complex securities, but has since spread to every type of financial asset, as the deepening recession undermines the ability of all types of borrowers to repay their loans. The IMF has boosted its estimate of aggregate losses by financial institutions to [\\$4.1 trillion](#), only a fraction of which has been written down on balance sheets.

As a result, some of our largest banks are either insolvent – their assets are worth less than their liabilities – or are short on capital, and confidence in them has been preserved solely by the government's willingness to provide capital injections, loans, and debt guarantees as necessary to keep them in operation.

In most countries, the course of action would be clear. The government would take over banks, remove "bad assets" from their balance sheets, inject fresh capital, and put them into the private sector. This is essentially what the FDIC does when it takes over a bank. There is some debate about whether the government currently has the power to do

this for bank holding companies – Tim Geithner says no, Thomas Hoenig says yes – but if not, this is certainly something the Obama administration could press for.

In fact, this is usually the approach suggested by the U.S., both directly and through its influence at the IMF. For example, the U.S. repeatedly and publicly pressed Japan to do exactly this during the 1990s.

If the government were to implement this type of policy, the recent stress tests would be a reasonable first step. The stress tests would determine which banks were failing, and then they would be put into conservatorship. This is what investors were afraid of in February, because when a bank goes into conservatorship, its common shareholders are effectively wiped out – which, again, is what is supposed to happen in a free market system when companies mismanage themselves into the ground.

Since February, however, the government has clearly communicated that it has no such intentions, for example in [Geithner's insistence](#) that “the vast majority of banks have more capital than they need to be considered well capitalized by their regulators.” Even as the capital shortfall numbers have leaked out over the past few days, the government has emphasized that no banks will actually be allowed to fail, or even be allowed to be put into a conservatorship; instead, they will first attempt to raise capital from the private sector, and failing that they can convert their TARP preferred stock into common stock. Even if this results in significant government ownership, there is no evidence that shareholders or creditors will be forced to take losses. As rfreud said in a [comment here](#), “The stress tests results are confidence-building in that they signal the low likelihood of nationalization or seizure. Reform at the moment seems a distant prospect.”

The strategy, in short, is to continue to prop up our existing large banks in place (no such consideration has been granted to small banks) through a lengthening list of bailout measures. Why?

One reason is that taking over banks has somehow been redefined as “nationalization,” with the images it conjures up of forced confiscation of property. Yet there are no guns involved here. Ordinarily, when an investor puts a large amount of new capital into a bank, it gets some measure of control in return. Yet Treasury has bent over backward to minimize its voting shares, beginning with the initial round of recapitalizations and continuing through the latest Citigroup bailout in February.

Perhaps after fighting off charges of “socialism” from the McCain campaign, the Obama administration is wary of any steps that could be described as nationalization. And so instead of insisting on its well-understood duty to shut down failing banks for the public good, it has tied its hands by taking this option off the table.

But what are we getting instead? Increasing government support for the financial system, and increasing government influence over the flow of credit – or nationalization by another name.

Instead of the government taking over and sorting out banks transparently, the big banks are receiving massive government support:

- \$700 billion in Troubled Asset Relief Program (TARP) money is flowing to no fewer than eleven separate programs, as documented by the [TARP Special Inspector General](#), including preferred share purchases, asset guarantees, purchases of asset-backed securities, and subsidized purchases of toxic assets.
- The Federal Reserve has committed trillions of dollars to lend against and purchase securities of all kinds from the banking sector.
- The FDIC is guaranteeing hundreds of billions of dollars of newly issued bank debt, and is set to guarantee loans to private investors to buy loans from banks under the Public-Private Investment Program (PPIP).

In exchange, the government is deciding how credit is allocated in the economy, albeit on the wholesale rather than the retail level. In addition to direct loans to automakers, programs such as the Term Asset-Backed Securities Loan Facility are effectively distributing money to support specific types of lending (credit cards, auto loans, etc.), and the Fed is purchasing over \$1 trillion of mortgage-backed securities in order to push mortgage rates down to historically low levels.

In addition, there is anecdotal evidence that the government, while renouncing official control of any banks, has intervened in management decisions for some of the weaker players. According to Bank of America CEO Ken Lewis, he was threatened with removal if he failed to complete the acquisition of Merrill Lynch. And [unnamed sources](#) recently reported that federal regulators are considering removing Vikram Pandit from Citigroup.

In short, relationships between the government and the large banks have never been closer, with large amounts of money flowing in one direction, and complete co-dependency going in both directions. Those relationships are not entirely friendly, which is not surprising. In any crisis when public resources are called on to bail out the private sector, not all of the oligarchs will survive; Bear Stearns and Lehman have already vanished. But the winners – which should include Jamie Dimon of JPMorgan Chase and Lloyd Blankfein of Goldman – will emerge even more powerful and influential than before.

In rejecting “nationalization” (regulatory takeover and conservatorship), the government has not ensured a private, properly functioning banking system. Instead, it has muddled into a broken-down, undercapitalized system that is nominally in private hands, but is able to tap the state for apparently limitless support. And to date, that support has flowed on one-sided terms, with the taxpayer accepting downside risk but limited upside potential. No wonder bank shareholders are comfortable with this outcome.

As a result, the banks have largely preserved their existing management teams and bonus plans: on Wall Street, [first-quarter accruals for bonuses](#) returned to the levels of the glory years of 2006 and 2007. Creditors and counterparties have been kept whole, most notably through the AIG bailout. And shareholders have seen their share prices supported by the

promise of sustained government support. The incentives we have ended up with are more similar to those of a nationalized system than those of a free market. Instead of state-owned coal mines run for the benefit of miners (the U.K. in the 1970s) or state-owned oil and gas companies run for the benefit of bureaucrats (the Soviet Union in the 1980s), we have state-backed banks in the U.S. run for the benefit of bankers and their creditors.

The smart economists in the Obama administration must know what is going on. But having insisted that large bank takeovers are tantamount to nationalization and therefore off the table, the administration is betting that the financial system will repair itself – or “[earn their way out](#),” as StatsGuy put it.

This is possible. With the competition in both investment banking (Bear Stearns, Lehman) and mortgage lending (most of the specialist mortgage lenders) gone, the survivors all enjoy larger market shares and higher prices, contributing to their somewhat healthy profits in the first quarter. Even the large banks that receive the lowest grades in the stress tests will be given relatively cheap capital by the government; Treasury will use its resulting stakes to apply behind-the-scenes pressure to the banks (more government influence), but without taking decisive steps to clean up bank balance sheets. Instead, it will hope that the PPIP will do the trick, using cheap government financing.

But success is by no means certain. And we cannot know for how long the government will have to continue propping up weaker banks, at growing taxpayer cost, while they absorb funds that could otherwise help the economic recovery.

In the end, when a financial system is dominated by banks that are too big to fail – and they do fail – the only options are an FDIC-style takeover or the kind of public-private co-dependency that we see today. As far as the current crisis is concerned, the die is cast and the big banks won.

For the future, however, the question is how to avoid a situation where banks cannot be made to fail gracefully without creating systemic risk. As a starting point, we believe that banks that are too big to fail are too big to exist. Only then will we be able to maintain the incentives necessary to manage risk, punish failure, and reward success.

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May 6, 2009 9:20 AM

[Is Everyone Confused Yet? \(Bank Stress Tests\)](#)

The public relations campaign packaging the bank stress tests is kicking into high gear and our professional information managers are really hitting their stride. They face, of course, a classic spin problem: you need to get the information out there, but you don't want to be too definitive on the first day or soon after – if you're easy on the banks, that looks bad; if you're tough on the banks, that might be dangerous.

The best way to handle this is by jamming your own signal – which they are starting to do in brilliant fashion. [To the WSJ](#) you leak that BoA needs to raise a great deal of capital (\$35bn); they run this story on the front page, next to a great frown on the face of Ken Lewis. But [you tell the FT](#) that Citi will need “to raise less than \$10bn” (note that the on-line FT version of this story, as of 8:30am Eastern, seems to have been adjusted downwards relative to the print edition that arrived at my house 4 hours ago.) The [NYT yesterday](#) sounded quite upbeat.

Of course, deliberately or inadvertently confusing people is made much easier by the fact that the experts are in sharp disagreement. Goldman's Jan Hatzius says that the worst is now behind us in terms of loss recognition and pre-provision earnings will be much higher in the US than they were in Japan during the 1990s – here he and others are taking on the IMF's [Global Financial Stability Report](#). And he has two good points in this regard,

Although we agree that top-line revenue growth is likely to be relatively weak, this should be offset by cheap and largely government guaranteed funding, a steep yield curve, and ample spreads on bread-and-butter lending. We believe that these spreads will remain relatively wide even as risk appetite returns, because they partly reflect the lack of lending capacity following the demise of the shadow banking system and not just the cyclical increase in risk aversion.

In plainer economic terms - the big banks that survived have more market power and access to large government subsidies. [Larry Summers is quite clear](#): “supporting financial intermediation” is a “critical node” in the President’s economic strategy.

Still, Dick Berner of Morgan Stanley pushes back, arguing that the cumulative losses will continue to increase, “Upward revisions to our loss estimates reflect higher loss severities, primarily in securities.” And other well-informed parties continue to warn about forthcoming problems in commercial real estate, consumer balance sheets, and of course the European economy – I’ll review the latest European developments in [my Economix column](#) tomorrow, but let me preview it this way: not good.

What will be the overall impact of tomorrow’s stress tests announcements on understanding of our overall economic and financial situation? To paraphrase slightly Larry Summers’ smiling response to a question (actually on the future of Fannie and Freddie) after his [recent speech at the Inter-American Development Bank](#), “if you think that was a clear answer, you weren’t paying close enough attention.”

By Simon Johnson

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May 5, 2009 11:16 PM

Pollution, Race, and Poverty

Under a common conception of free-market capitalism, firms should do whatever they can – legally – to maximize value for shareholders, which often means maximizing profits. As long as firms do not bear the costs of the externalities they create – like air pollution – they will continue to create them. That's all taken as a given.

What is a little more sinister, yet still completely legal, is *where* they will create them. Even in the absence of cash costs per ton of pollution, the effective costs to polluters will vary from place to place; those costs show up in the political difficulty of getting permits to build and operate facilities, the degree of environmental regulation, the likelihood of local muckraking journalists writing unpleasant exposés, the ability of the local populace to bring political pressure to bear, and so on. The net effect is that the low-cost places to put pollution tend to be communities with relatively less political power – in this country, communities of minorities and the poor.

A team of researchers from the University of Massachusetts-Amherst and USC recently released a new report, “[Justice in the Air](#),” that quantifies the disparate environmental impact of toxic air pollution on minorities and the poor, by firm and by facility. Michael Ash and Jim Boyce also have a [working paper](#) that describes the data sources and the methodology.

For the study, they merged three data sets: the EPA’s RSEI-GM database, which measures toxic emissions by all industrial facilities, tracks them to 1-square-kilometer cells, and weights them by their impact on human health; census data showing the proportion of minorities and the poor by census block (mapped into the RSEI-GM’s individual cells); and a U-Mass database that tracks the corporate owner of each facility included in the RSEI. From there, for each firm, they calculated the proportion of its toxicity-weighted pollution that affected minorities or the poor.

The results are not surprising. For example, 18.1% of the health impact of air pollution falls on African-Americans, while they make up only 11.8% of the population; 15.3% of impact falls on the poor, who make up 12.9% of the population. (An alternative, discussed in the paper, would be to compare the disparate impact figures not against national population percentages, but against the minority percentages in the local metropolitan area, or in the firm’s workforce.) At the extremes, the disparities can be large; for example, for ExxonMobil – the 9th-biggest polluter in the U.S. – 55.1% of its

pollution impact is borne by African-Americans, largely because of two Baton Rouge facilities that together generate 60% of its total pollution.

One of the goals of the Justice in the Air project is to raise awareness of these environmental impact disparities to encourage corporations – via socially-conscious investors, or pesky grass-roots organizers – to improve their ways. Another potential avenue is litigation, although in most spheres it is difficult to make a claim based on the equal protection clause (of the Fourteenth Amendment) without evidence of conscious racial discrimination. The report’s authors also recommend new regulations, for example to limit pollution emissions based on the cumulative impact of all facilities on a given community, not simply on a facility-by-facility basis. Ultimately, though, the question comes down to how much our society wants to round off the harsh edges of the free market, which otherwise would shift even more of its negative externalities onto politically less-powerful groups.

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May 5, 2009 10:51 AM

Comment Etiquette

I am surprised and a little impressed, but not happy, about the lengths some people will go to to promote their views in our comments. I’ve noticed two disturbing bits of behavior recently. One is “replying” to the first comment on a long comment stream in order to boost your own comment up to the top of the page, when you are not responding to that first comment substantively. The second is posting comments under multiple identities in order to agree with yourself or, worse, to insult or attack other commenters. On one recent post, one person posted eight comments under five different names, only two of which were substantive.

There are various measures I could take to try to solve this problem, but all of them will create overhead for the community as a whole. So please stop.

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May 5, 2009 8:02 AM

Vote For Ben Bernanke

Ben Bernanke [testifies this morning](#) (10am) - [vote now on The Hearing](#) for the line of questioning you'd like the Joint Economic Committee to pursue. Or write in your own question.

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May 5, 2009 8:02 AM

All About Optics (Predicting Stress Test Outcomes)

[The bank stress tests](#) are beginning to create a perception problem, but not – as you might think – for banks. Rather the issue is top level Administration officials' own optics (spin jargon for how we think about our rulers).

At one level, the government's approach to banks – delay doing anything until the economy stabilizes – is working out nicely. This is the counterpart of the macroeconomic [Summers Strategy](#) and in principle it is brilliant. “Don’t just do something, stand there,” is great advice in any crisis – eventually everything bottoms out and you can take the credit, justified or not (unless an election catches up with you first; check with Herbert Hoover.)

But American bankers apparently just cannot cooperate by lying low, keeping their mouths shut, and refraining from anything that looks like picking other people's pockets.

As the banks' financial prospects improve, their political clout picks up and they increasingly [resist the Fed and Treasury on many fronts](#), including the stress tests. Then we find out this weekend that Charles Munger, Vice Chairman of Berkshire Hathaway, walks softly and [carries a big pitchfork](#); speaking of bankers, he said:

“This is an enormously influential group of people, and 90 percent of that influence is being spent to gain powers and practices that the world would be better off without,” Munger, 85, said yesterday in an interview with Bloomberg Television. “It will be very hard to accomplish the kind of surgery that would be desirable for the wider civilization.”

Monday morning, [we learn](#) that Stephen Friedman, the chairman of the New York Fed (a) did not divest his Goldman stock when Goldman became a bank holding company and thus subject to the Fed's jurisdiction (not good), (b) bought more Goldman stock in late 2008 (looks bad, [including to Senate Banking](#)), and (c) did not disclose this purchase to

the Fed (very bad, optically speaking). Berkshire Hathaway owns a great deal of Goldman stock – is this part of what Mr. Munger was [trying to tell us?](#)

“We need to remove from the investment banking and the commercial banking industries a lot of the practices and prerogatives that they have so lovingly possessed,” Munger said. “If they are too big to fail, they are too big to be allowed to be as gamey and venal as they’ve been — and as stupid as they’ve been.”

In any case, this is a serious problem for Treasury’s optics. After long negotiations, the bank stress tests were [set to show](#) most banks are close to have their Goldilocks level of capital (i.e., just right) Given that we generally agree (and [the President has long stressed](#)) this is the biggest financial crisis since the Great Depression, we seemed to be on the the verge of a capital adequacy miracle.

But instead of this being seen as some combination of good luck and smart policy, “everyone is basically fine” would look like the banks are running the show. My Treasury friends swear up and down this is not true, but that is now beside the point. Whatever the reality, it looks increasingly to everyone like the banks really are in charge. It’s a nasty rule of politics that you are damaged by where perceived blame lands, rather than by what you actually do.

How should Treasury handle this? They’ve tried the standard stalling tactics, but pushing the stress tests into the weekend news cycle would be a bit too blatant; “late on Thursday” remains the current announcement time.

If only [Charles Munger hadn’t been quite so eloquent.](#)

Munger said the financial companies spent \$500 million on political contributions and lobbying efforts over the last decade. They have a “vested interest” in protecting the system as it exists because of the high levels of pay they were earning, he said. The five biggest U.S. securities firms, only two of which still exist as independent companies, paid their employees about \$39 billion in bonuses in 2007.

“They would like to get back as closely as possible to business as usual, and they have enormous political power,” he said.

[Back in February](#), I suggested that we were about to witness a showdown between Secretary Geithner and US banking interests. Some very smart people are working nights, trying to figure out how to prevent the full outcome of this confrontation from becoming focused in the public’s mind. My guess is that Charles Munger [is not at this point on the team](#),

Berkshire Hathaway Inc. Vice Chairman Charles Munger, whose company is the largest private shareholder in Goldman Sachs Group Inc. and Wells Fargo & Co.,

said banks will use their “enormous political power” to prevent changes to the industry that would benefit society.

Munger said policy makers should seek to impose limits on banks that are deemed “too big to fail” after financial institutions worldwide suffered more than \$1 trillion in losses. The U.S. government and the Federal Reserve have spent, lent or committed \$12.8 trillion, an amount that approaches the value of everything produced in the country last year, to stem the recession.

What Treasury really needs is a distraction. Doesn’t anyone have a big positive, or at least controversial (and not related to banking), announcement they’d like to make on Thursday?

You could, of course, make the stress tests appear more meaningful by focusing on a headline, “10 out of 19 banks need capital” (but how much?) Given the recent market rebound and stronger general confidence, this [may be where we are going](#). Presumably Treasury will give banks plenty of time to raise this capital and provide extensions as needed.

Treasury wants to wait and essentially do nothing, at the same time as appearing decisive. This is a tough combination to pull off. And what will the banks get up to while you are waiting?

By Simon Johnson

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May 4, 2009 5:53 PM

Guest Post: Size Really Does Matter

This guest post was contributed by Lawrence Baxter, a member of the faculty at Duke Law School and formerly a divisional executive in a large banking organization. He takes a look inside the large mergers that created the behemoth financial institutions we know today, and the assumptions that encouraged and allowed those mergers.

A friend recently observed to me that he had maintained zero interest in banks and banking all his life—until the past year. Now everyone is engaged in a swirl of emotions and punditry as we focus as experts, taxpayers or consumers on almost every dimension of the financial crisis, from bailouts to complex executive compensation schemes. Yet throughout the commotion we have not lost our faith in one quintessential American

value: bigger is better. How quickly we forget such disasters as Daimler Chrysler and Travelers-Citicorp, even as we hail Chrysler-Fiat.

True, a *consequence* of great scale has informed the public policy debate on banks: what do we do with a financial institutions that is “too big to fail”? Yet answers to this question have, for the most part, turned on whether a particular company should be allowed to fail, or be propped up by government action. The underlying pathology receives only passing attention. Why do we let these institutions get so large in the first place? Is it not likely that many of the institutions requiring massive injections of public capital and other forms of subsidization and public assistance are, and have been for some time, *simply too big to manage*?

America’s obsession with bigness has led us to assume glibly that organizational growth, vertical and lateral, is a natural consequence of business success and must be respected, even celebrated. Armies of consultants, lawyers and investment bankers devote their businesses to the science of corporate enlargement, encouraged by economists who celebrate not only economies of scale, but even “economies of *super scale*.” Ken Thompson, then CEO of one of the most venerated banks in the United States, Wachovia, spoke for an industry when he declared in 2006, at the very moment the company was making its fatal acquisition of Golden West Financial, that “[c]onsolidation continues to make economic sense. Done right, size enhances competitive power. With economies of scale, a company can better afford the technology and longer branch hours that customers demand.”*

Mr. Thompson was not saying anything controversial. His own company had enjoyed years of success in the wake of several large acquisitions and scores of smaller ones. The entire industry was reveling in size. Regulators, from the Fed to the Justice Department, were approving almost every M&A in sight. The stock market was on a veritable sugar high after the brief setback of 2001 and 2002. A college of academic theorists was urging US adoption of the universal bank idea. Great engines of technology seemed capable of automating almost anything, from back office processing to customer relationship management. Large-scale offshoring offered enticing opportunities for global labor arbitrage. The nirvana of rising revenue and declining costs seemed tantalizingly close to reach. Who could object to rewarding handsomely the corporate superstars who were making this exquisite success possible? Few questioned whether the logic of financial consolidation actually made sense, even as ominous clouds gathered on the horizon. In its [2009 outlook](#) *The Economist* accepted, albeit gloomily, that “Western finance will be increasingly dominated by a few huge universal banks, with a new aversion to risk”—as if such institutions could, let alone would, actually be able to *avert* risk.

America’s financial institutions grew at brisk pace once the first spigots of deregulation began to open in 1980. Consolidation not only aggregated assets and capital at stupendous rates; it also meant that the people and systems of each of these organizations had been ramped from relatively small operations into gargantuan ones that many bank employees had never dreamed of. Many a small town banker suddenly found himself at

the helm of a business line or operating unit far larger—sometimes four or five times larger—than had been those of the great major money center banks of 1980. And many a customer experienced an involuntary re-introduction to a rapidly growing bank that hardly knew them anymore. Bits and pieces that did not fit the vision were sold off into an even further removed world of outsourced services.

Nor did these big new adventures feel all that scary. For those in control, compensation escalated to match the bold new responsibilities such executives had now acquired. The word “leadership” was substituted for “management” as the new corporate big leaguers learned the art of articulating grand vision while delegating detail. A reassuring chorus of supporting consultants produced reams of PowerPoint highlighting challenges and providing scientific graphs and charts filled with solutions. Boards enjoyed their exciting Sunday meetings to approve new deals that would enhance prestige and stun Monday morning markets. Beamingly confident CEOs assured credulous investment analysts and reporters that their big new adventures would render amazing efficiencies by exploiting technological scale, juicy new customer bases in “fast growth regions,” and cost redundancies (i.e. employees). Brand experts eagerly made travel reservations from Madison Avenue to victorious headquarters where they would compete breathlessly for assignments that would anoint new companies with visionary logos and stunning customer value propositions.

Meanwhile, back at the office, the games would begin. Systems would be identified for selection or elimination—a magical opportunity to take the best of each world. Employees, locations, operations and lines of business would be analyzed to ensure that overlaps would be eliminated and customers served better than ever. HR consultants would be brought in to hasten the adoption by employees of new cultures. Generous severance packages and retention bonuses—all surely offset in their expense by the seductive efficiencies of the merger—would be secretly prepared and offered to surplus employees. This was American bio-corporatism at its finest.

Where were the regulators? We talk of deregulation as if this was a phenomenon introduced by the Bush Administration in 2002. Yet the deregulation movement had been building for twenty years or more on many fronts. In the financial world it was represented by a number of iconic developments, beginning with the deregulation of interest rates in 1980 and accelerating with the demise of restrictions on geographic expansion by banks (1979–1994), the repeal of the Glass-Steagall Act (which tried to separate commerce and banking, and investment and commercial banking) in 1999, and the emergence of a gigantic “shadow financial system” that cast itself well beyond the traditional balance sheets of banks. Potentially tough regulation developed in the wake of the S&L Crisis with legislation in 1989 and 1992 was itself offset by a growing deregulatory philosophy based on deep faith in the discipline of market mechanisms. The federal deposit insurance funds were so flush in the absence of bank failures and the rapid growth of assessable deposits that banks were relieved of the need to pay insurance assessments altogether.

And the truth is that much of the modernization was needed. The rickety structure of bank regulation in America was not only odd by comparison to some foreign competitors, but the system of “non-bank” finance companies, securities and insurance companies purveying credit and other “bank-like” products had reached a scale that all but rendered the traditional framework of banking regulation a farce. It is hard to gainsay the wisdom of many actions taken by the deregulators, at least as far as well established and well understood financial products were concerned, and at least as far as deregulation sought to break down the very real barriers to competition that genuinely archaic restrictions provided.

The net effect of all of this progress was a rapid expansion in the scope of “banking” activity and a remorseless expansion in size of the players engaged in such activity. All the while it was also largely assumed that the *large-scale* management of such financial activities was itself not a problem. Far from creating the potential for concern, bigger had to be better, particularly if such non-American behemoths as HSBC, Deutsche, ING, and others were dwarfing our own. American bank consolidation became a veritable patriotic duty and a merger spree began.

Sadly, a lot of things happen inside mergers that no one likes to talk about.

First, the best technology systems are not always chosen. Far from it. Unless the larger partner to a merger is at the point of collapse, an inevitable dynamic in most mergers is that the larger company wins. Even where it is recognized that the smaller company has better technology (as is often the case because the larger company tends to have older systems), the possibility of damage to the larger customer base during system and database conversions leads risk-averse IT executives to choose the inferior systems. Intense management might sometimes produce acceptable results, but usually it will be years before problems created by a downgrade to inferior systems can be fixed. The connection between the original merger and later, consequential expense is therefore hard to discern.

Another thing that happens is that a lot of expertise gets thrown out the door. Industrial researchers have warned of the damaging loss of intellectual capital resulting from the recent trend to earlier retirement. Add to this the sheer intellectual devastation wrought by the elimination of hundreds of thousands of longtime financial employees, conveniently dismissed as “redundancies” (or, more quietly by the survivors, as corporate “deadwood”). This loss of institutional memory and knowledge is an important yet hidden cost of many mergers, in which the elimination of real people is treated for investment purposes as an elimination of “headcount” expense.

Then there is the awkward problem of culture. Anyone who has worked in a genuinely high performance culture (and not just one like Lake Wobegone whose children are “all above average”) will know that people provide much more value to an organization when they are motivated and develop effective relationships within and beyond the organization. Motivation itself comes from various sources, including raw compensation, but one of the sources large entities rely upon more than they even recognize is a *culture*

of performance, itself generated by a sense of shared commitment. Walk into an Apple store if you aren't following me.

The reality, however, is that it takes a long time to evolve a culture. Trust is the bedrock of culture and trust is earned through repeat engagement. Once a culture emerges, all kinds of "efficiencies" start to occur. Employee interactions become efficient ongoing relationships. Insecurities recede and so does destructive territoriality. People start to cooperate with each other. With such cultures some companies have proven that they can become genuinely high performing, outstripping competitors and adding real shareholder value.

Alas not so for rapid mergers. Employees caught up in merger situations often tend to become deeply suspicious of their new associates. Territoriality escalates, driven by a justified belief that this is necessary for survival. Employees start to under-perform or, sometimes, even to act directly contrary to the interests of the new combination. Reliable information about what is actually happening becomes increasingly difficult to uncover, even for the most assiduous of managers.

A very salient aspect of the Financial Crisis is the failure of risk management. Not only do risk managers appear to have been asleep at the switch in many instances. It is also evident that even when they were aggressively trying to manage risk they did not know what they were managing. Scientists of risk management have explanations for why this has been the case. Whatever the theoretical explanations, there is also one very simple but frequently overlooked additional element: our faith in technology has lulled us into believing that highly diverse metrics could be correlated if only good systems are in place.

Yet systems, no matter how good they might be in conception and even implementation, are merely engines that convert input into output. If people load garbage in, garbage always comes out. This is not because those who provide input are dishonest: in complex environments such as those created by "efficiencies of scale and scope" (i.e. rapid combinations of lines of business with clashing cultures and denuded of the institutional memory of recently laid off employees and relying on patchwork quilts of uneven technology) the providers of input, no matter how diligent, cannot properly understand what it is they are being asked to put into the pipeline.

For technologically illiterate executives, bored by risk management at best and frustrated by its necessary impediment to revenue generation at worst, complex systems render an illusion of control. "Dashboards" coded in red, yellow and green suggest that scientific management is afoot, that IT systems have worked their wonders in processing right data. The output presents a familiar, manageable set of executive decision points. Perplexed regulators feel reassured that the organization has a handle on things—after all, the company has put so much effort into developing a scientific system for measuring and managing its risk.

What does this mean for public policy?

At the very least we ought to re-examine our assumptions about letting banks, or any financial institution the actions of which generate systemic concerns, grow to whatever size they desire. Antitrust analysis has taken a back seat to “market discipline.” Yet it is not at all clear that markets have the information or power necessary to ensure that the discipline of the market will prevent the growth of institutions that are too big to handle. Optimal size assumptions, ones that do not rely upon surreptitiously externalized or postponed risk and costs, ought to be an important yardstick in antitrust analysis.

Secondly, we should not assume that corporations are internally coherent. Employees operate in large divisions, frequently strangers to each other; sometimes they even have to operate in environments fragmented by cultural misalignment and division. Incentive structures are widely different and do not necessarily ensure that everyone acts for the good of the shareholder. Conflicts of interest remain even after complex formal controls are imposed—indeed these controls often create more opportunities than ever for inimical arbitrage within the organization. It is quite possible that something like the re-imposition of some Glass-Steagall type constraints is needed to prevent unnatural combinations and impose structural curbs on the risk-taking that has created the present crisis.

Third, when corporate executives claim that they can live large safely, directors, shareholders, analysts and reporters should apply healthy doses of skepticism. It would be more effective to require executives to account, without excuses, for their success in actually delivering and preserving what they already promised the last time than to accept promises of future performance.

America has always celebrated competition. Our recent experience suggests that our obsession with size has diverted the focus from this critical element of our economic strength and it is high time to question whether it is how corporations can really perform, not how big they can get, that should be the foundation for sound merger and acquisition policy.

* “Wachovia Chief’s Vision: A Handful of Dominant Firms,” interview with Barbara A. Rehm, American Banker, May 19 2006.

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May 4, 2009 2:01 PM

Stress Tests for Beginners

The big news on the banking front this week will be the public release of the stress test results, currently scheduled for Thursday (originally it was supposed to be today). Over at

[The Hearing](#), I wrote an overview post recapping the context for the stress tests and the current dilemma the administration faces: whether to keep quiet about the details, and risk undermining the credibility of the exercise, or whether to release significant bank-specific information, and risk undermining the reputation of certain weak banks.

There is nothing wrong with the concept of the stress tests, and arguably regulators should have been doing them constantly as the crisis worsened, so that this particular iteration would not create such a political challenge. The idea is that not only do you want to know how much capital a bank has right now, but you want to know how much capital it will have left if the economy continues to get worse. If you did this analysis in a way that was credible with the market, it would go a long way toward restoring confidence in the financial system, since the current lack of confidence is based on people's not trusting the information they are getting.

However, right now the stress tests face a number of risks:

- They have partially undermined themselves by using a “more adverse” scenario that is roughly in line with what most forecasters think is actually going to happen, so they are not very stressful.
- The administration has already as much as said that the banking system is well capitalized and no banks are going to fail, which makes it seem like the results are preordained.
- There is a widespread expectation, [fostered by the administration](#), that any capital deficiencies will be plugged by converting preferred to common stock in an attempt to boost [tangible common equity](#), rather than providing real cash money to banks.
- Most importantly, the announcement of the results was delayed so that the administration could negotiate with Citigroup and Bank of America over their report cards, which does not exactly foster confidence in the results that will eventually be announced. The term “stress test” was borrowed from medicine; do patients negotiate with their doctors over their diagnoses?

While this may have started out as a technical, regulatory exercise, it has become an exercise in political communication. The goal is to be harsh enough on a few specific banks to maintain confidence in the stress tests, but be nice enough so as not to undermine confidence in the entire financial system. That’s ultimately what this is about.

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May 3, 2009 9:01 PM

The Need for New Antitrust Laws

The great corporations which we have grown to speak of rather loosely as trusts are *the creatures of the State*, and the State not only has the right to control them, but it is duty bound to control them wherever the need of such control is shown.

Theodore Roosevelt, “Address at Providence,” 1902 (emphasis added)

By “creatures of the State,” Roosevelt meant not that corporations were created by the state, but that their existence and power existed because of and in concert with the state. A few years ago, someone reading this quotation would have probably thought first of Halliburton; today, it evokes the large banks that are too big to fail.

That quotation was pointed out to us by Zephyr Teachout, a law professor at Duke, who has been proposing [new antitrust laws](#) aimed at reducing the political power of large firms.

U.S. antitrust law was rooted in late-nineteenth-century hostility toward large corporations, but in practice became focused less on size than on specific anti-competitive practices. The Sherman Act of 1890 was aimed at collusion among companies to constrain freedom of trade, while the Clayton Act of 1914 went further in specifying anti-competitive practices, such as bundling or mergers that create excessive concentration in an industry. Over the past few decades, in part under the increasing influence of free-market economic theory, antitrust enforcement by the Department of Justice has become more tolerant of size and concentration in themselves, and has focused instead on whether mergers will benefit or harm consumers. On the one hand, increased concentration increases the ability of large firms to raise prices, hurting consumers; on the other hand, or so the argument goes, larger firms gain economies of scale that enable them to reduce costs and therefore reduce prices to consumers. (If you believe that, take a look at the price of [text messaging](#) on your mobile phone bill.)

So it seems likely that existing antitrust laws, as currently enforced, would be unlikely to do the trick of breaking up large banks. Even though the four largest banks hold about 60% of assets in the U.S. banking system, that’s not nearly concentrated enough to attract the attention of the DOJ. And while there may very well be illegal collusion among large banks, there is no smoking gun that I’m aware of, and you certainly wouldn’t need collusion to explain the events of the last decade, or the uniformly high prices charged for services such as equity underwriting. (One of the major implications of game theory, which was standard fare in first-year graduate micro by the 1990s, if not earlier, is that what looks like collusive behavior could also result from individual rational action.)

Teachout’s response is clear: [write new laws](#). In particular, she argues, existing antitrust law does not address the problem of political influence.

There are many reasons a “too big to exist” conception of antitrust law makes good sense for a democracy. Perhaps most importantly, large companies have proven to have disproportionate power over the political process. Concentrated financial power often leads to concentrated political power; if you have a lot of

cash, one of the most efficient uses of it to maximize profits is to petition the government to change the rules in your favor. Economies of scale might work all too well when it comes to influencing government.

This argument would barely have gotten a hearing in the 1990s and earlier this decade, when companies were scrambling over each other trying to merge, and the business media were constantly congratulating the “winners” in the battle to become big (even though, in most mergers, any actual gains go to the shareholders of the acquired company, since the acquirer invariably overpays). Now that we have official endorsement from a Republican administration that even the third-largest investment bank (Merrill) was too big to fail (and widespread regrets over letting the fourth-largest investment bank fail), and we have increasing recognition of the linkages between Wall Street and the federal government, the need for new laws may receive serious consideration. In addition, there is evidence (I’ll try to post on this another time) that, at least when it comes to banks, there is a size beyond which any economies of scale are outweighed by coordination problems, most tellingly in risk management. (And, there is the simple fact that large banks tend to charge higher fees, charge higher interest rates on loans, and pay lower interest rates on deposits than small banks.)

There is another, minority view, which is that a new approach to enforcing existing laws could be used against large banks. The general principle is that laws are defined by their interpretation. For an example, look no further than TARP, which gave Treasury the power to purchase “assets” of troubled banks, meaning things on the asset side of their balance sheet – and was promptly interpreted to mean that Treasury could buy preferred stock in those banks, which is only an “asset” from the perspective of the buyer, not the seller. Of course, to get your interpretation to stick, you may have to convince a court, in the antitrust case probably the Supreme Court. But it would not be the first time the Court has changed an interpretation that was once considered settled. For example, when the Court found an individual right to bear arms in the Second Amendment in *District of Columbia v. Heller*, 128 S.Ct. 2783 (2008), it was reversing a precedent that had not even bothered revisiting since 1939.

What would the argument be? Well, for one thing, having banks that are too big to fail, and then having to bail them out to the tune of hundreds of billions of taxpayer dollars, is clearly bad for “consumer welfare” in general. However, consumers under this argument are only being affected indirectly, so that argument may not stick. But perhaps someone can come up with a better legal theory here.

By James Kwak

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May 2, 2009 8:11 AM

Ponzi Schemes Of The Caribbean (A Weekend Comment Competition)

The IMF has just released a [new working paper](#), with more detail than you likely ever wanted to know about how Ponzi schemes work – particularly in and around the Caribbean.

Ponzi schemes are everywhere and, at least in some environments, new versions arrive frequently. But why are they so hard to prevent and shut down once they appear? The paper contains some strong hints, albeit couched in very diplomatic language.

The comment competition is: what, if anything, does the failure of governments to shut down blatant Ponzi schemes imply about the prospects for a potential [“macro-prudential” system/market-stability regulator](#) implementing [cycle-proof rules](#) in the United States? Is there a better way to prevent the kind of behavior that led to our current financial crisis?

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May 1, 2009 7:26 AM

Zombie Oligarchs

At this stage in any economic stabilization process, the state-sponsored lifeboat for oligarchs starts to get a little crowded. Governments don't have enough resources to save everyone, and not all major borrowers can have their debts rolled over. In emerging markets, it's usually the shortage of foreign exchange that sets a limit on government largesse (see the start of our [Atlantic article](#) for more detail on this cycle); in the US and other industrial countries, it's more complicated – mostly about constraints around bailout politics ([Lorenzo Bini Smaghi made this point effectively in the fall](#)).

The survival-failure decision is taken at the highest level. In April 2008, after the failure of Bear Stearns, [Dick Fuld](#) had dinner with Hank Paulson and [reportedly concluded](#), “We [Lehman] have a huge brand with Treasury.” As the broader problems within the financial system worsened, this proved worth less than he thought.

Fuld is still in shock, and seething. How could Paulson let Lehman go? “Until the day they put me in the ground, I will wonder [why we weren't saved],” [he told Congress](#).

This week, Daniel Bouton resigned from running SocGen, in the face of [what he called “incessant” verbal attacks](#) – a reference presumably to lack of support from Mr. Sarkozy; it’s not good when the President of France calls your proposed pay package “a scandal”. And Ken Lewis may take a [further battering](#) – due in part to not being the best-connected with top people in Washington.

Some powerful people, naturally, can take this opportunity to elbow others out of the way. A better reputation in the right circles or somewhat deeper pockets or the ability to pay higher compensation will carry you a long way while your competitors are having a hard time getting back on their feet.

[Mancur Olson](#) famously argued that crises can break the power of vested interests. That’s possible, but only happens when the crisis brings the right kind of reformer to power. More often, crises lead to greater concentration of economic power and political influence.

This can be consistent with the resumption of rapid growth – after crises, some emerging markets just as fast, or even faster, than before. But such an outcome seems unlikely today for the US and for the world.

There are three reasons why today’s surviving oligarchs are not likely to prove immediately dynamic.

1. They have a lot of debt. In emerging markets, this is the prevailing problem. The debts of powerful people are being rolled over, but at high interest rates. There is nothing in this part of our broader balance sheet issues that points towards new investment and expansion.
2. They are worried about future reshuffles of power. Obviously, the U.S. Treasury is involved in an awkward parent-adolescent [shouting match with big banks](#) (who is who?). The banks likely reckon that they will win on the whole, but individual banks or particular CEOs may still suffer blows – through the politics of stress tests, the way compensation caps are limited, or something else. This kind of uncertainty and continuing struggle is unlikely to encourage expansion.
3. The most significant difference between the US today and many emerging market crises in the past is the exchange rate. Post-crisis booms are often triggered by big nominal exchange rate depreciations – if you can hold the line on inflation (the IMF can help, and you can blame them for unpopular measures; perfect), then exports become hypercompetitive and you start a new cycle of capital inflows. Even Japan had a strong export sector throughout the zombie bank doldrums of the 1990s. The dollar, of course, is still the world’s preeminent reserve currency and problems in the eurozone mean this will continue for the foreseeable future; significant real depreciation is unlikely in the near future. And at the global level, we can’t export our way out of this – there is no way that Mars can develop quickly enough as an export market.

Some new entry and productive reallocation of talent is possible in this situation. For example, [John Mack is saying](#) that pay caps mean his bankers are leaving – among other things – for “other industries”. But the G20 policy of stabilization-through-rollover, at the national and corporate level, means that incumbents’ implicit subsidies actually go up. The environment for starting businesses in the US has not completely collapsed, but it has also definitely not improved.

So we get to keep many of our oligarchs, but relative to the recent past they will hunker down. You might be fine with that – although remember that it does not prevent reckless risk-taking and an increase in your taxes down the road. [Larry Summers says](#) this happens only twice per century, but his own argument is that we have moved away from the kind of financial system that was built in the mid-20th century. If we’ve gone back to the wilder days of the 19th century, the cycles could be quite different (look at [the NBER’s data](#)). If the US has really become more like an [emerging-market-with-a-reserve-currency](#), that is also not encouraging.

We’re looking at a near term dominated by the existing economic power structure. The remaining big banks (in the US) and big banks/corporates (elsewhere) are made invincible by campaign contributions, political connections, and everyone’s reasonable fear of a great depression. It will be hard for outsiders to challenge that structure effectively – either as new companies or with new ideas. But you won’t see a great deal of innovation, investment, and growth coming from these survivors.

How do we eventually escape the grip of zombie oligarchs? We’ll have a fair amount of time to think that through.

By Simon Johnson