



## The Baseline Scenario 2009-06

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# Newspaper Item

## China Pushes Hard

Simon Johnson | 01 Jun 2009

On his China visit, Secretary Geithner is immediately on the defensive. The language he is using on the Chinese policy of exchange rate undervaluation-through-intervention is the mildest available. And the commitment he is making, in terms of bringing down the US deficit – which we all favor – is an extraordinary thing to put numbers on in a foreign capital. Such commitments are of course unenforceable, but still the wording indicates – and is understood by China – great US weakness.

Not surprisingly, China seems likely to push for more. Their main idea is that some part of their US dollar holdings be transferred to a claim on the International Monetary Fund, which would shift it from being in dollars to being in Special Drawing Rights – and therefore a claim against (a) the IMF's whole membership, and (b) presumably, the IMF's gold reserves.

This is a bad idea.

No one asked China to build up a huge level of reserves. If one country wants to run a current account surplus that is big relative to the international economy, then someone else has to run a deficit – it's a zero sum game because “reserves” are a claim on another country (preferably a strong one, with a convertible currency). No one has ever offered a guarantee on the real value of reserves, i.e., what China now wants.

We can agree that the US should have a higher savings rate, but if we did have more savings – or even if we ran our a current account surplus of our own – China's desire for foreign exchange reserves would still mean undervaluation for them (as long as they can sustain the intervention) and a current account deficit for some set of countries in the rest of the world.

There is nothing wrong with wanting to have foreign exchange reserves, and sometimes these are accumulated just through the natural cycle of activity (e.g., commodity producers are well advised to build up reserves in a boom, because the prices of their exports also crash with some regularity). But the way China has operated within the global

system has not been responsible and it has not – an important point – been in conformance with the rules (as reflected most recently in the IMF's Surveillance Decision, which is heavy on the legalese but quite clear on this point: no sustained undervaluation through intervention in the currency market is allowed).

China needs to acknowledge that it too has responsibility for the stability of the international system. Current account surpluses feel good for surplus countries – this has been a consistent feature of the modern global payments system – but policies that sustain big surpluses are destabilizing for that system, because they imply that someone else will run a deficit and, more than likely, eventually have to bring that deficit down through costly adjustment.

What we really need is a complete reform of the IMF – or the introduction of a new international payments body - so that countries don't feel the need to run massive surpluses to protect themselves against external shocks.

In the meantime, we need China to allow its currency to appreciate. If they double their holdings of US dollar assets over the next couple of years (let's say, going towards \$4trn), effectively financing our budget and current account deficit, will we all end up safer or more vulnerable?

Is Mr. Geithner trying to persuade China to reflate a new version of our financial bubble?

*By Simon Johnson*

## Posner, Part 1: Two Conceptions of Blame

James Kwak | 01 Jun 2009

A few readers have asked us for our thoughts on Richard Posner's recent writings on the economic crisis, beginning with his [new book](#) and continuing with his epic blogging for [The Atlantic](#). (To read his account from the beginning you need to find the well-hidden [Archives](#) section in the right-hand sidebar of the blog.) The challenge is that every time I try to catch up Posner has written another couple of thousand words. So I'm going to have to do this in pieces.

Posner is a giant of legal scholarship and in the theoretical branch of law and economics, which (judging from my own education) is the dominant paradigm for several fields of law, including torts and contracts. To simplify his importance greatly, he helped shift the legal profession, including both the academy and the courts, from a focus on justice – law should redress the harm suffered by the victim – to a focus on incentives – law should create incentives that will produce the greatest good for society in the future. For example, in general, firms should only be held liable for injuries they negligently cause if the expected total damages they cause exceed the cost of preventing those injuries; if we require firms to conduct inspections whose cost exceeds the cost of the injuries that those inspections would prevent, then we are reducing aggregate utility.

As you might guess, Posner is also generally a pragmatic conservative, who thinks that free markets usually lead to better societal outcomes than government intervention, and that public policy should focus on making sure that independent rational actors have the right incentives to behave in ways that will benefit society as a whole. Not surprisingly, his account of the crisis focuses not on the actions of people in the financial industry but on the failings of people in government.

From his [May 5 post](#):

The government has conveyed to business and the public the message, which misunderstands the causes of the economic crisis, that “Wall Street” should be blamed (or China too, as Geithner once suggested) and must be punished. This hostility and air of menace make financial firms reluctant to get into or stay in bed with the government, and thus impede the bailout efforts. . . . In fact the major culprits in our present economic distress are

government officials, such as Alan Greenspan, and academic economists, but they are getting off lightly, because they are obscure and there is more political mileage in denouncing “Wall Street.” How many Americans actually know who Alan Greenspan is, or what a macroeconomist is?

Now, I have also written that if you want to blame one person, then Alan Greenspan is your guy – because, of all the people who could have helped prevent or mitigate the crisis, he was the most important. But I also think that “Wall Street” – or various actors in the financial sector – should be blamed.

There are two different senses of “blame,” and Posner – true to his decades of scholarship – focuses only on one. His approach to law and policy is thoroughly utilitarian. The question you always ask, reading his opinions, is what incentives this decision will create for firms and individuals, and how their behavior will change in the future. Moral blameworthiness does not enter the equation. For example, Posner is a famous proponent of the “efficient breach:” the idea that if you find a better use for your goods than honoring a contract, you should breach the contract, as long as you are prepared to pay damages to the party you have injured. According to Posner, this maximizes social utility (measured in dollars and cents). (Incidentally, not all legal scholars agree – it depends on how you measure transaction costs.)

Posner does not care about moral blameworthiness; insofar as fault is concerned, he only cares about causation. And from that standpoint, no individual Wall Street executive is a necessary part of the chain of causation that produced the crisis; if he had walked away in disgust, someone else would have taken his place and done the exact same thing. (Greenspan, by contrast, could have changed things, had he so chosen.)

From that standpoint, if you want to focus on how the system should change in the future, it makes sense to look at what government can do and not at what individuals in the financial sector should do. If mortgage brokers cut corners and investment banks marketed toxic securities and rating agencies gave AAA ratings to those securities, they are not to blame; it’s the fault of the legislators who didn’t make those activities illegal and the regulators who didn’t enforce the rules that did exist.

But that is an unsatisfying, academic, and patronizing concept of blame.

Take the mortgage broker who steered his client into a subprime mortgage when the client could have qualified for a prime mortgage (because the subprime mortgage paid a higher commission), thereby saddling him with interest payments the broker knew he couldn't afford; or the bankers who sold small towns in Wisconsin synthetic CDOs without making sure the customers knew what they were buying (but covered themselves by shipping hundreds of pages of unreadable disclosures). From a pragmatic perspective, there's nothing you can do about people like that; they exist, they will do whatever they can within the rules to make money, and the only answer is to tighten the rules.

But from a common sense, everyday perspective, of course they are to blame. They were making money for themselves by hurting other people, and they knew it. There's nothing wrong with President Obama criticizing them. And if there's a way to punish them – legally, and to an extent proportionate to their culpability – we should do it. If the only way to punish them is to drag them before Congressional committees and make them endure the spotlight, then that's fine by me.

But, Posner says, "This hostility and air of menace make financial firms reluctant to get into or stay in bed with the government, and thus impede the bailout efforts."

There are two answers to that claim. First, it assumes that we need the financial firms we have now, in the form they are in now, with the directors and officers they have now, and therefore we have to plead with them to let the government bail them out. This is an unnecessary assumption. Unfortunately, it is one that seems to be shared by the current administration.

Second, and more importantly, it amounts to coddling bullies. The implicit principle is that whenever a major institution does something wrong – but not illegal – we have to overlook it, because we are more dependent on that institution than it is on us. Actually, the principle would still apply even in the case of illegal behavior. Let's say a large bank had done something illegal. They would still be too big to fail, we would still have to bail them out, Posner would still oppose a government takeover – "because of the manifest inability of the government to manage banks competently" – and so we would still have to make nice, for fear of scaring away the banks we depend on.

If I wanted to take the economicistic approach, I could say something about moral hazard at this point. But I don't want to take that path. The idea that people can commit egregious misdeeds at the expense of other

people, yet cannot be criticized by our own government – the body that is supposed to represent our interests – violates a simple, common sense notion of justice. At least the one that I hold.

*By James Kwak*

# Explicit and Implicit Guarantees

James Kwak | 02 Jun 2009

*Note: I wrote this post on May 18 but somehow forgot to publish it; I just found it in my drafts. It's a bit out of date, but I think the point still stands.*

I'm not sure if it's official, but it's been widely rumored that large banks that want to repay their TARP money will have to be able to sell new debt without the FDIC guarantee they got back in October. As a result, banks are falling over themselves with new, non-guaranteed debt offerings. The idea, I guess, is that banks that can raise money without the guarantee are showing that they are sound enough to operate without government support.

But I think all we've done is replace an explicit guarantee with an implicit guarantee. In October, no one was sure whether the U.S. government would bail out bank creditors in a pinch; after all, Lehman creditors got back less than 10 cents on the dollar, and AIG creditors took a big haircut because the Fed's credit line came in senior to them. So the explicit guarantee was necessary for banks to issue debt.

Since then, however, the government has shown in many ways that it isn't going to let major banks fail or force a restructuring (indeed, it insists that it can't force a restructuring). The message of the stress tests, ultimately, was that Treasury is standing by to provide whatever capital is needed. In that situation, what risk do bank creditors face? Virtually none, except maybe political risk (the risk that the government's policy will change). So the banks get to raise money without the stigma of a guarantee, they don't have to pay a premium to the FDIC, then they get to pay back their TARP money, and the government can say that the banking sector is healthy. Everyone's happy.

And if things go badly, the taxpayer is still there to make good on all those non-guaranteed bonds – at least for the banks that are, still, too big to fail.

*By James Kwak*

# Help: Why Are SUVs More Profitable?

James Kwak | 02 Jun 2009

Many discussions of auto company economics include the assertion that SUVs and pickup trucks are more profitable than small cars, and so a shift from the former to the latter – as discussed by [Felix Salmon](#), for example – will not be good for the auto companies, particularly GM and Chrysler (since they are in the news these days). I accept that as a historical statement, but I don't understand *why* that is the case.

Textbook micro tells you that price equals marginal cost, so the gross margin on every product is zero; that's clearly no help here. Profit margins should be higher in product segments with less competition, but basically every manufacturer makes a small, midsize, and large SUV, so I don't think that's the explanation.

I can think of a few other possibilities:

1. Small cars help manufacturers meet their [CAFE targets](#), and so manufacturers are willing to accept lower profit margins on them. That is, each small car allows them to sell one more big car, so the marginal benefit of selling the small car includes the profit on the big car. There may be something to this, but not as much as you would think, because CAFE targets are scaled by vehicle footprint (length x width), so big cars have lower fuel economy targets; the more big cars you sell, the lower your overall target. It's possible that the targets are carefully engineered so that, all other things being equal, it is easier for small cars to hit the small-car targets than for big cars to hit the big-car targets; if so, that would lead to manufacturers accepting lower profits on small cars.
2. The customer lifetime theory: The goal is to get a loyal customer for life and upsell him to bigger and bigger cars – you sell him a Civic out of college, an Acura RSX when he gets his first bonus (oh, wait, no more bonuses . . .), an Accord when he gets married, an Acura MDX when he has kids, and an S2000 when the kids go to college. In that model, the Civic can be a loss leader, because it pays for itself with the later models.
3. There's more scope for differentiation with big cars. The bigger the car, the more bells and whistles you can throw in. Differentiation from the competition creates pricing power.
4. Big-car buyers are less price sensitive; they are buying the cars with their bonuses (sorry, forgot about that) or their home equity

lines (whoops, none of those, either), while small-car buyers are saving up tips from waiting tables.

However, except for #1, all of these theories just say that you get higher profit margins on cars that you sell to people later in life (2), that are fancy (3), and that are expensive (4). And I don't see any reason why these have to be big. You can imagine a world in which most cars are small-to-medium-sized, but they range from undistinguished ones like a low-end Honda Fit to expensive luxury cars with all the bells and whistles, like self-parking systems and haptic warnings when a car is in your blind spot, and with the latest fuel-efficiency technologies. In that world, manufacturers could rake in the profits on the high-end small-to-medium cars.

Anyway, is it really all about CAFE standards? Or is there another reason why big cars are inherently more profitable than small ones? I figure someone out there must know.

Thanks.

**Update:** There have been many helpful comments, so I'm not going to single any out. I would say there are two main explanations.

The first is that SUVs offer a better ratio of perceived value to production cost. That is, there's an amount of stuff you need to build a functioning car; once you've done that, it doesn't cost twice as much to make it twice as big, because you're just adding raw materials. (I'm simplifying, obviously.) But people, being not that bright, think something is worth twice as much if it is twice as big. I still think competition should eliminate this larger profit margin, but see the second argument . . .

which is that SUVs and pickup trucks have been less exposed to foreign competition, so instead of having twelve or so viable competitors in the small-car segment, you mainly had three for SUVs. (Some commenters did not agree with this, pointing out that Toyota and Honda have been building pickup trucks for a long time.) With fewer suppliers, you can charge higher prices.

I should clarify that I don't think there is anything wrong with the hypotheses I listed above; my point was that hypotheses 2-4 do not depend on SUVs/pickups being bigger, but on other characteristics of them. So there is no fundamental reason why, in the future, the profit margin on big things should be bigger than the profit margin on small things. Similarly, if the advantage is due to less foreign competition, then I think that would have gone away in any case, since just about everyone

makes an SUV now (every major Japanese or Korean manufacturer, Volvo, Mercedes, BMW, VW, etc.) – though maybe not a pickup.

If the answer is the perceived value/production cost advantage, then that is arguably fundamental to big things as opposed to small things.

*By James Kwak*

# What Would Gorbachev Say? On The US, China, And Saudi Arabia

Simon Johnson | 02 Jun 2009

President Obama is on his way to Saudi Arabia, and Secretary Geithner is done with his major initiative in China. In part, this is just the US normalizing its relations with the rest of the world and rebuilding some basic diplomatic niceness. But it's also about reshaping – or not – the way the world's economy works after the crisis.

From all appearances, President Obama will ask the Saudis to continue their efforts to stabilize the oil market, including by bringing new production on stream, and the Saudis will offer – to the best of the abilities – to play exactly this role within OPEC. Of course Secretary Geithner just asked the Chinese to continue their efforts to stabilize the market for long Treasuries, including by investing their current account surplus in US securities, and the Chinese have agreed – with some pretend grumbling – to play this role.

It looks like adding up to a big mistake – just ask Mikhail Gorbachev.

You don't have to take a completely pro-Reagan view to agree that the US boxed the Soviet Union into overinvesting in an unproductive rent-seeking sector (the military-industrial complex), which wasted a huge amount of productive resources and undermined the economy's broader innovative potential – as well as its ability to put basic consumer goods on the table. Even worse, when Gorbachev did try reform, the system proved so brittle and the capture of policy so complete that the whole empire collapsed in debt, inflation, and catastrophic tunneling (in turn leading to a new wave of oligarchs, etc).

If we continue to depend on "cheap enough" oil, that's dangerous enough in geopolitical terms. But if we run our economy so we finance our oil imports by borrowing heavily from the outside world (not all from China; the Middle East and Japan are also big providers of net savings), we are asking for trouble.

The collapse of the dollar is not necessarily imminent, and the temporary use of deficit spending makes sense as a way to get through this deep recession. But when exactly do we plan to wean ourselves off (a) the oil, and (b) the borrowing from abroad? This doesn't have to be done tomorrow, but it has to be done – unless it is somewhere written that the US will stay powerful and solvent forever.

We should be committing ourselves to energy prices (and carbon prices) that rise over time, hence creating an incentive for innovation in fuel efficiency (and lower emissions) throughout the economy. The Saudi swing-producer role means that, if things go well, they keep pushing oil prices down below the pain point, thus limiting longer-term moves away from oil (and they are quite explicit about this as their goal). The Chinese swing-investor role means that, at best, long-term interest rates will remain low enough for us to feel like we can keep borrowing (you can draw your own conclusions on their true goals).

Show me the policies-in-place that bring down our external payments deficit, and explain the commitments that will really make this happen. Or even start the conversation in these terms, domestically and with our various kinds of allies overseas.

Just don't tell me that the financial sector will collapse if we make any moves in the right direction, e.g., cutting back on our current budget-breaking implicit subsidies to that enormous rent-seeking sector; we're on our way to doubling our debt/GDP ratio, from around 40% to near 80%, directly because of the way this sector has behaved. Remember the excessive power of particular sectors (and all their policymaking friends) consistently hampers sensible efforts to reform any economy. If that's too vague for you, look at how and why Gorbachev failed – and all the awful consequences.

There are people who attribute the entire subprime debacle to irresponsible borrowers. Personally, I would spread the blame more broadly, including lenders, the way the financial system has come to operate, and the way US and European governments looked the other way – or supported the prevailing ideology – as a megabubble developed.

But it is true that someone has to step up and take responsibility any time you see a potential debt bubble developing. And for our current level of international indebtedness and where this is headed, who will now take responsibility? Or, if that's too complicated a question, let's try a simpler version: who will tell the President?

*By Simon Johnson*

## The View from the Top

James Kwak | 03 Jun 2009

One of our longtime readers recommended “The Death of Kings,” Nick Paumgarten’s “notes from a meltdown” in The New Yorker (subscription required, or \$5 for this issue alone) a few weeks back. The article is mainly color rather than analysis; it’s a series of portraits of people on “Wall Street,” ranging from the merely rich to the astoundingly rich, and what they think of the crisis. Paumgarten paints a picture of people who know that we are all screwed but regard the phenomenon with a mix of intellectual superiority, self-righteousness, and resignation. The vignettes are certainly not representative; I’m sure most bankers and traders, though perhaps not working quite as hard as in 2005, are still scrambling to make the next killing. But they are still a window into a world most of us will never see.

There are two passages in the article I thought were particularly . . . “insightful” isn’t the quite word . . . maybe “poetic” is better. The first is a quotation from Colin Negrych, a successful money manager and the article’s Voice of Wisdom:

“What constituency is there for pessimism? People believe optimism is necessary, an American right. The presumption of optimism is the problem. That’s what creates the debt we have now.”

A few years ago I wrote an essay for a *Vanity Fair* contest about the American spirit (I think they were offering a lot of money, and it was just a few pages, so . . .), in which I discussed the societal compulsion to be optimistic. I guess you can see why I didn’t win. I’m not as dark as Negrych, who seems to think that a complete financial implosion is the natural order of things. But as a generally pessimistic person, I’ve always been confused by this idea that optimism is inherently good.

This is the second passage:

“It can be startling to discover how many offices in Manhattan have spectacular views. The first time you gain admission to an aerie in the G.M. Building or some other blue-chip tower and look out across Central Park, SoHo, New Jersey, or Queens, you think that this particular office must be the finest in town, the seat of secret power, the heart of the plot. But the city is full of them.

It's one of the things about tall buildings: you can see a lot, such as other office towers of different vintages, commenced in past booms. The takeoffs and landings at the airports, the shipping lanes, the humans below reduced to units: it is easy to begin to think abstractly about the armature of empire. Sitting up there and talking for hours about pools of securitized debt, and seeing them depicted on dryboards or PowerPoint slides as rectangular blocks, divided into tranches, you can find yourself viewing the buildings out the window as manifestations of that debt – the conversion of financial cunning into steel, brick, and glass. You also happen to be looking at the collateral."

Why do I like this passage? When I worked in McKinsey's San Francisco office, I shared an office on the 48th floor of the Bank of America building. I can't remember my exact view, but from some offices you could see the sailboats on the Bay, and the hills of Marin, and the Golden Gate Bridge, and the fog rolling in in the evening. It made me feel like I was on top of the world; if I had an office with a view like that, I must have been important. The view alone doesn't do the trick (McKinsey's New York office was generally shabby and had no views to speak of), but it illustrates the seductiveness of the world of the self-appointed corporate elite. Towering above the common people, whether in San Francisco or in Midtown Manhattan, it's not hard to think that they simply don't understand the way the world works; we know that many people on Wall Street think that way about the politicians in Washington, for instance. (By contrast, Silicon Valley startups – some of them, at least – take pride in having the cheapest, most unremarkable offices possible, since every dollar saved is one dollar less you have to raise from investors.)

I think that temptation to arrogance is part of the reason why some people in the financial sector thought they could do no wrong, and that the markets could never turn against them. So blame it on the view.

*By James Kwak*

## Stimulus Watch: Your Input Solicited

Simon Johnson | 03 Jun 2009

The folks who run US Budget Watch are interested in your thoughts about how best to redesign their page that watches over the fiscal (and other) stimulus. Post your comments here.

I've already given them some ideas on how to organize and prioritize the data, as well as suggestions about background material that would help reach a broader readership. More thoughts on style or substance would be greatly appreciated. They're on a deadline, so don't delay.

*By Simon Johnson*

## Legacy Loan Program Called Off

James Kwak | 04 Jun 2009

New York Times:

The Federal Deposit Insurance Corporation indefinitely postponed a central element of the Obama administration's bank rescue plan on Wednesday, acknowledging that it could not persuade enough banks to sell off their bad assets. . . .

Many banks have refused to sell their loans, in part because doing so would force them to mark down the value of those loans and book big losses. Even though the government was prepared to prop up prices by offering cheap financing to investors, the prices that banks were demanding have remained far higher than the prices that investors were willing to pay.

I don't think I've ever done this before, but . . . Simon and I, March 24:

The problem in the market today is that the prices demanded by the banks are much higher than the prices that private buyers (hedge funds, private equity firms, sovereign wealth funds) are willing to pay. The government has no way to bring down the banks' minimum sale prices . . .

The subsidy may not be sweet enough to close the deal. According to one analysis, a specific mortgage-backed security was held on a bank's books at 97 cents, while its market price was about 38 cents. Even if you limit the buyer's potential loss to the capital he put in, it's unlikely he will raise his bid from 38 cents to anything near 97 cents. . . .

Just last week at least some banks wanted to participate in the program – to buy assets from themselves. Once Sheila Bair rejected that idea, I guess they lost interest. Essentially the stress tests placed a big government stamp of approval on their balance sheets, so their current strategy is to wait out the recession and hope the prices of their legacy loans recover. There's no downside risk, because if the economy gets worse and they ever need to unload those loans, they can count on the plan being resurrected.

I guess we were, however, wrong to worry about inter-bank collusion in the legacy loans program.

(Note that this does not apply to the legacy securities program, which may still be going ahead.)

*By James Kwak*

## Bernanke Didn't Go Far Enough

Simon Johnson | 04 Jun 2009

Ben Bernanke gave a good speech yesterday, warning about the dangers associated with not putting the federal budget immediately on a path to credible fiscal consolidation. But he didn't push his points hard enough – see my column, joint with Peter Boone, on the NYT's [Economix this morning](#).

U.S fiscal policies helped break the recent panic by showing that the government will support aggregate spending, irrespective of what the private sector fears. But once households and firms calm down, you need to demonstrate that the national debt is not on an explosive path.

Mr. Geithner's speech in China this week, trying to make this claim, was not convincing. Mr. Bernanke, politely but firmly, pointed this out yesterday.

We should also worry about the Fed, of course, because there is no indication that they are ready, willing or able to curtail their quantitative easing if the real economy definitely turns more positive. David Wessel's column in the WSJ today (page A2) has a sensible discussion.

*By Simon Johnson*

## Latvia: Should You Care?

Simon Johnson | 05 Jun 2009

In the current field of grand economic strategy, against crisis and for recovery, Latvia looms small. This is a country with just two million residents, best known recently for a huge current account deficit – the excess of imports over exports peaked out around 25 percent of GDP. Ordinarily, there is nothing here that should move the world economy.

Yet, there are some intriguing and somewhat disconcerting signs that point towards our common future – much like a close study of Iceland, back in October 2008, told us a great deal about what was to come.

First and foremost, we are looking at a creditor bailout-type situation. Latvia is receiving large amounts of foreign financial assistance – from the IMF and the European Union – with the express purpose of making all payments due on its debts (mostly owed to West European banks; thank you, Sweden). This is strikingly reminiscent of Latin America after 1982: above all else, protect the foreign banks.

Second, the bailout – at Latvia's request – focuses on keeping the exchange rate peg. The payments adjustment (exports up, imports down) must still come entirely from lower wages and prices. This is an incredibly difficult task, which brings to mind Argentina's struggles within its currency board in the 1990s. If you make it very costly to change an exchange rate, you won't devalue – until you absolutely have to, and then of course it is very costly.

Third, there is a fundamental contradiction in the approach favored by Latvia and the European Union. They say they can't consider devaluation, because so many households have borrowed so heavily through mortgages denominated in foreign currency. But what happens to real debt payments as wages fall? Is debt default being avoided or just deferred until the banks have got their money out – and the IMF has come in to the full extent possible?

My takeaway: we are still not ready for hard economic conversations anywhere in the world. Wishful thinking prevails, in Europe as much as in the United States. No one wants to start the difficult and messy task of restructuring – i.e., reducing – debt payments. Everyone feels entitled to a bailout. And the banks get one.

Or put it to your elected representative like this – we're transferring Latvia's debts from European banks onto the IMF, which is underwritten

by our future tax dollars; then there will be default and devaluation for which no one is prepared.

Brussels, you're doing a heck of a job.

*By Simon Johnson*

## The Little Pension Funds That Could?

James Kwak | 05 Jun 2009

Those following the Chrysler bankruptcy know that the final holdouts are a set of Indiana pension funds, who have appealed the bankruptcy judge's approval of the restructuring plan, attempting to force the company to explore other alternatives under a trustee who is independent of the government. They were lustily cheered on by The Wall Street Journal, elated to find good sturdy workingmen and -women willing to stand up to the Obama Administration and its "disdain for legal contracts," and who could not be dismissed as speculators.

Well.

The pension funds in question bought the Chrysler debt in question last July for 43 cents on the dollar. (They stand to get 29 cents on the dollar in the restructuring.) I guess the difference between that and speculation is that "speculation" is something that bad people do; when pension funds buy distressed debt, it's called "investment." I have no problem with pension funds buying modest amounts of risky investments, but they are taking the same risks that hedge funds are taking, and if they lose money on bad investments, that's the fault of the pension fund managers.

Now, the popular defense of the Indiana pension funds is that they have a fiduciary duty to their beneficiaries to maximize the value of their assets. (Hedge funds should have the same duty to their limited partners, unless I'm missing something, but let's set that aside.) There is a deal on the table worth 29 cents on the dollar. Apparently they think Chrysler can do better by finding a higher bidder (not likely at this point), or they can get more in liquidation. But that is far from a certainty, and the value of Chrysler is deteriorating as time passes; and if they manage to drag this out past June 15, Fiat can back out of the deal. So it's not at all clear that their actions have a positive expected value for their beneficiaries.

Their cheerleaders, like the Journal, think that the little pension funds are standing up to the big evil government and defending the rule of law – namely, the order of priority of creditors in bankruptcy. (The issue is the relative treatment of the UAW and the bondholders.) But that's not the job of a fiduciary; a fiduciary isn't supposed to stand on legal principles and win Pyrrhic victories that harm the people it is supposed to serve.

Indiana Treasurer Richard Mourdock claims:

This is about the law, the law, the law. This is an unprecedented action to say that secured creditors can have their rights stripped away. We think it's clearly illegal. As a fiduciary, I had no choice but to act.

The fiduciary duty is to get the most for the beneficiaries, not to enforce the law; Mourdock's "no choice" language is pure bravado, especially when the law is as unclear as it is.

Steve Jakubowski wrote the most in-depth analysis I've seen. In short, there is a tension between the competing principles of (1) following the order of priority and (2) the "fresh start" policy of Chapter 11. There is a question of whether the Chrysler plan is an asset sale or a surreptitious reorganization. And there is also a question of whether it is more important to follow the order of priority or to get the most for the secured creditors. In that case, those might not imply the same outcome, since some of the key parties, including the government and Fiat, are free to walk away from the deal instead of giving the secured creditors a bigger share of it; that would lead to liquidation, which may be even worse for the secured creditors. (That was the conclusion of all the other secured creditors, although granted many had their arms twisted by the government.) Jakubowski says that the pension funds have a reasonable legal argument – perhaps a better one than Chrysler – but it's by no means an easy case. And from a financial standpoint, they could still be shooting themselves in the foot.

Joe Donnelly, a Democratic Indiana congressman, is opposing Mourdock, saying that the action is likely to leave the pension funds worse off than the restructuring plan, and in addition threatens thousands of Chrysler jobs in Indiana (many in his district).

So what's going on here? Either Mourdock really thinks that the chances of getting more than 29 cents outweigh the very real risk of getting less (and of blowing up Chrysler in the process). Or Mourdock (and Mitch Daniels, the Republican governor of Indiana?) believes that the order of priority of creditors in bankruptcy is more important than maximizing value for their retirees. Or Mourdock is trying to shift the blame for losing pension fund money on distressed Chrysler debt. Or he wants to score political points and embarrass President Obama.

In politics, anything is possible.

**Update:** If you care about this issue, you should read [Steve Jakubowski's latest](#).

*By James Kwak*

# The Economics of RSS

James Kwak | 05 Jun 2009

I rarely write about blogging itself – I take it for granted – but Felix Salmon, one of the real proponents of the medium, has a new post on [RSS feeds](#) and why they matter. First you should read his [original post](#)\*, which argues that information providers (such as blogs) should provide full RSS feeds (including the full content of the article), like we do here, rather than truncated feeds (showing just the first few lines), which most but not all ad-supported web sites do. His argument is that the success of a blog depends on getting other bloggers and journalists to link to it, and those bloggers and journalists are far more likely to read your blog if you publish a full RSS feed. I believe his argument, but as he says in the new post, it would be nice to see some empirical research to know if we are wrong.

Like Felix, I read blogs through my RSS reader – Google Reader – and I basically never click through to read the full post if all I get is a truncated feed. So if a blog doesn't publish a full feed, I am only likely to read a post if it is recommended or excerpted in a blog that does, such as Calculated Risk, Economist's View, Marginal Revolution, etc. (I do scan a few online newspapers the old-fashioned way – on their web sites.)

Of course, I'm just one blogger, and if the really big guys like Paul Krugman and Andrew Sullivan are happy with truncated feeds, then Felix and I could be wrong. If anyone knows of any empirical research out there, please let us know.

\* Yes, that post is by Felix, not by Ryan Avent, who replaced him at Portfolio earlier this year. In an impressive display of technical incompetence, Portfolio has not figured out how to show that some posts have one author and other posts have another offer. I know that they are going through hard times, but this can't be that difficult.

*By James Kwak*

## The Problem with Opinion Polls

James Kwak | 06 Jun 2009

Back in December, when people actually had debates about whether or not Chrysler and GM would go bankrupt, one of the claims made by the anti-bankruptcy camp was that 80% of people would not buy a car from a bankrupt automaker. That number came from a CNW survey; here's a summary from [Motor Trend](#) (hat tip [Jane Hamsher](#)):

A recent study from automotive market research firm CNW surveyed 6000 people intending to buy a new car within six months, and discovered that more than 80 percent of them would switch brands if the vehicle they wanted came from an automaker that went bankrupt. Breaking it down by company, Americans were more likely to abandon domestic automakers than foreign ones, with Chrysler faring the worst — a full 91 percent of buyers wouldn't take home an Auburn Hills product if the company went bankrupt.

The theory was that bankruptcy would lead to an immediate collapse in sales which would lead to liquidation. (A later study, [cited here](#), said that if the government were involved in the bankruptcy, the number of people who wouldn't consider buying from GM would be 51%.)

This is what [I said in December](#):

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

Well, now we know. In May – during which Chrysler was in bankruptcy – Chrysler sales were down 47% from the year-ago period.

Overall sales were down 34%, which means non-Chrysler sales were down around 33%. So as a crude estimate, if Chrysler were like the average automaker, for every 100 cars it sold last May, it would have sold 67 cars this May. Instead, it sold 53. That's a 21% decrease – a lot less than the 91% predicted.

I'm not claiming I can predict auto sales better than other people – I know virtually nothing about auto sales. I'm just saying you shouldn't rely on polls that ask people what they would do under some hypothetical scenario, since they don't know what they would do.

*By James Kwak*

# Global Crisis And Reform: Starting A Long Journey

Simon Johnson | 07 Jun 2009

I spoke Friday afternoon to MIT Sloan graduates (Reunion Weekend; slides attached), arguing that while we are likely done with a panic or “free fall” phase, we have only just begun to deal with the deeper problems revealed by the global financial crisis.

Think of it this way. The United States has done well over the past 200 years or so because it was founded with strong institutions – rules and laws that mean we're protected against government or powerful elites becoming too powerful – and over time these have generally improved, or at least not collapsed under pressure. Yes, you can complain about (and aim to improve) many aspects of our society, but where would you prefer to set up a technology-based business or make any kind of productive investment or build your own human capital?

Call this the rule of law, or protection against being expropriated, or sufficient constraints on executive power, but it adds up to roughly the same thing. We strongly limited the power of the most powerful in our society – and this is in striking contrast to what happens in much of the rest of the world.

But over the past 20-30 years, we took our eye off this ball.

The financial sector, under our noses, amassed enormous economic clout and mystique, and leveraged (pun intended) this into tremendous political power – both in terms of the belief that Wall Street can do no wrong, and that we should defer to financial “experts” both on the way up and during the crash (despite the fact their interests are not necessarily our interests).

Our institutions have been undermined by powerful people. We've seen this before, of course, both around the world and also in the United States. It's Andrew Jackson vs. the Second Bank of the United States, or Teddy Roosevelt against the great railroad trusts and big oil, or the Pecora Hearings on the financial shenanigans that helped bring on the Great Depression.

Disproportionate power does not prevent economic growth; there are plenty of booms in banana republics. But “banana booms” never prove sustainable. You get reasonable rates of growth, perhaps even for a decade or more, but then a collapse. Weak institutions are strongly associated with instability, crises, and lost decades. In fact, a lot of what we think of as decisive macroeconomic policy – which the IMF, for

example, traditionally focuses on – turns out to matter much less than how much you undermined sensible rules and norms during the boom.

When the crisis hits, you see the problems with glaring clarity – the political connections, the excessive and irresponsible behavior of financial elites, and the extent to which the executive has been captured by whatever branch of oligarchy was boosted by the boom.

The crisis per se does not weaken the powerful. Sure, a few of them may go bankrupt, but this just increases further the concentration of economic power or, if you prefer, their market share. It is for good reason that Jamie Dimon, ever the master of CEO semiotics, said to his shareholders recently: 2008 “might have been our finest year ever.”

Most countries are doomed to this oligarchy-boom-bust-oligarchy cycle. The US broke free or at least temporarily broke away from versions of this cycle, arguably, three times already (Jackson, Roosevelt I, Roosevelt II). Each time the reform process took 5-10 years; perhaps longer from start to finish.

Can we do it a fourth time and how long will that take?

*By Simon Johnson*

## The State and Local Hole

James Kwak | 08 Jun 2009

Although you may pay more taxes to the federal government, there is a good chance that the public services you are more likely to actually encounter in your life are provided by state or local governments – schools, swimming pools, police, fire, etc. While a lot of attention has focused on the federal government's deficit problems, the problem for state and local governments, which generally have less fiscal flexibility (and cannot print money) is at least equally serious.

Here is the projected aggregate state/local government budget gap under two scenarios. First the “low gap” (optimistic) picture:

And here's the high-gap (pessimistic) scenario:

The charts are from a presentation by Don Boyd of the Rockefeller Institute at the Chicago Fed. The space between the solid blue and dashed green lines is the impact of federal aid to states in the most recent stimulus package.

**Update:** Some readers asked for state-by-state information. You can find that here courtesy of the Center on Budget and Policy Priorities.

*By James Kwak*

# Annoying Bank Propaganda

James Kwak | 08 Jun 2009

JPMorgan Chase has a “community support” page entitled “[The Way Forward](#).” It features a report by JPMorgan executive Michael Cembalest on the credit crisis called “[The Big Dig](#),” which tries to argue that bank lending has actually increased during the credit crisis. Many more accomplished people than I have debunked this myth in the past, but I couldn’t let this pass.

Here’s the main claim: “Changes in credit are often thought to have been wrought by banks. But a simple exercise in forensics reveals that not to be the case: the rise and fall of securitized loan markets have a much larger impact. Bank lending has remained stable throughout, while securitized markets collapsed.”

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And here’s the evidence:

Looking at data on outstanding bank credit is misleading, because it doesn’t capture changes in bank behavior. Here’s the same data, except these are the flows rather than the levels (Table F.109 from the [Flow of Funds data](#)):

Besides the blip in Q3 2008, the picture is pretty simple: we have a steady decrease in bank lending from the beginning of 2008. So what happened in Q3?

Well, as anyone at JPMorgan should know, JPMorgan acquired the assets of Washington Mutual. Washington Mutual was technically a thrift, not a commercial bank, so its assets were not counted as commercial banking assets . . . until September 25, 2008, when they became JPMorgan’s assets. At the end of Q2, Washington Mutual had [\\$310 billion in assets](#), of which the vast majority counted as bank credit. So \$300 billion of the “new” bank credit in Q3 was just the result of WaMu’s collapse. Since the chart above shows annual rates, that accounts for \$1.2 trillion, or over two-thirds of the total for Q3.

What else was going on in Q3? For one thing, many large banks were forced to move assets from their off-balance sheet entities onto their balance sheets, which caused one-time increases in “bank credit.” There is also \$100 billion in “open market paper” (\$400 billion annualized), which includes both asset-backed and regular commercial paper; this line that had a value of exactly zero in all periods back to 2004. Looking at the table for open market paper, it’s clear that everyone else (money market funds, mutual funds, etc.) was dumping open market paper, so most likely the banks (who issued a lot of the stuff during the boom) were forced to keep it on their balance sheets.

In short, the increase in bank credit in Q3 – without which Cembalest’s chart would look very different – was due to exceptional items that were a product of the credit crunch, not any actual increase in bank lending.

Nomura did a more sophisticated analysis of bank lending trends (hat tip James Hamilton), and here is their key chart:

Note the huge spike in the reported data in late 2008, which vanishes in the adjusted data.

Cembalest then makes a claim that banks are lending money at lower costs:

Here’s the same data, from the same Federal Reserve series, only showing spreads instead of nominal rates:

Note that the decline in Cembalest’s chart from late 2007 to early 2009 is completely reversed when you look at loan spreads.

So far, this is just a story about the misleading use of data. But it gets really Orwellian when Cembalest tries to blame the credit crunch on “securitized loan buyers:”

Individuals, small businesses and large corporations finding credit conditions tight are more likely impacted by the wholesale departure of securitized loan buyers than by changing bank credit conditions. There is only so much the banking sector could have done, given the collapse of another lending market that grew to be larger than itself.

Yes, you read that right. JPMorgan Chase is blaming the credit crunch on “another lending market that grew to be larger than [the banking sector].” You would think this market was created by Martians.

Here are the parties that Cembalest blames for the problems of securitization:

- Rating agencies (p. 3)
- Lazy investors (p. 3 – “investor apathy”)
- Household borrowers (pp. 3-4)
- “Non-dedicated buyers” (pp. 4-5), including enhanced income funds, securities lenders, structured investment vehicles, and broker-dealers

Nowhere does he mention that the “banks” he wants to defend were major players in enhanced income funds, securities lending, and SIVs, and the big ones, including JPMorgan, doubled as broker-dealers. More fundamentally, though, it never occurs to him that the banks who manufactured these securities – who paid mortgage lenders to drum up the borrowers, who created the models that rating agencies used to rate the securities, and who went out and sold the securities to those lazy investors – had anything to do with the credit crisis. This is free-market ideology taken to the point of nonsense: there was supply (household borrowing) and demand (hedge funds seeking yield), so we were forced to sell products that provided slightly higher yield at much higher risk. It’s the fault of the “lazy investors” for not realizing they were defective products – and it’s also their fault because they stopped buying them when they found out.

The major banks cranked out mortgage-backed and other asset-backed securities of increasing toxicity as long as they could until the bottom fell out of the market in 2008. When the crash came, they were unable to dump the securities they had in their pipelines and forced to hold onto them, causing a one-time increase in the “bank credit” on their balance sheets. As a result, they slammed the brakes on their lending, as documented in the Fed’s Survey on Bank Lending Practices. Trying to use the collapse of the securitization market as proof of the virtue of the banking sector is, as someone said of Kissinger’s Nobel Peace Prize, a bit much.

*By James Kwak*

## Small Bank Big Trouble?

Simon Johnson | 08 Jun 2009

One of the more interesting counter-arguments against the idea that big banks should be broken up comes from people who play close attention to the behavior of small banks. They point out that small banks are a powerful political lobby, a point nicely illustrated by the NYT's explanation of how changes to bankruptcy law were recently derailed.

The big banks, in this view, are no more oligarchic in their tendencies than small banks.

It is definitely the case that small banks can get together and demand political favors. You need transparency and a strong open debate to offset that – and, according to leading congressional figures, you also need the Obama administration to show up, help out, and resist capture:

“Moreover, Timothy F. Geithner, the Treasury secretary, did not seem to share Mr. Obama’s enthusiasm for the bankruptcy change.

Mr. Geithner was lobbied by the industry early. Two days after he was sworn in, he invited Mr. Fine from the community bankers to his office for a private meeting. The association, with influential members in every Congressional district, is one of Washington’s most powerful trade groups.”

The more interesting question is whether many small banks could copy each other’s behavior and create a situation where they are all “too big to fail” at more or less the same moment. Some call this lemming behavior, but that may be unfair on the little critters.

Surely this is very hard to pull off in practice. In his Logic of Collective Action, published in 1965, Mancur Olson argued that it’s hard for large groups to cooperate effectively, particularly when there’s an incentive to “free ride”.

What would free riding mean in this context, which is somewhat different from the public goods provision issue that Olson focused on? Probably it would mean pretending that you’re just like the rest of the pack, but quietly hanging back as the pack heads towards the next subprime-type cliff – and then buying up everything you want from the wreckage.

Then you get to run ads like JP Morgan currently has over at the Atlantic – in a nice, but surely coincidental irony, this currently shows above the top of The Quiet Coup. And, less likely to coincidental, the JP Morgan campaign has almost the same name as the main “constrain the big banks” movement: A New Way Forward. (Presumably, Jamie Dimon, head of JP Morgan, couldn’t persuade McDonalds to part with the relevant rights to I’m Lovin’ It.)

The failure of big banks endangers financial systems and their rescue – as organized by the Bush and Obama administrations – results in a massive increase in the public debt. The failure of small banks is an issue in some countries, but in the U.S., the FDIC takes them over for breakfast – here’s how they spent Friday.

Lemmings of the world, watch out for Jamie Dimon.

*By Simon Johnson*

## **“There Were Ratings That We Saw That Made No Sense To Us.”**

**James Kwak | 09 Jun 2009**

This American Life had another good [financial crisis episode](#) by the Planet Money team this past weekend. There's a story on regulatory holes by Chana Joffe-Walt and one on rating agencies by Alex Blumberg and David Kestenbaum. The latter had some money quotes (starting around the 40-minute mark).

Jim Finkel, Dynamic Credit, which creates structured products: “There were ratings that we saw that made no sense to us. We knew the rating agency models and metrics, and we could replicate them ourselves, and we couldn’t make sense of what they were doing.”

Felicia Grumet (sp?), Bear Stearns, who was involved in creating structured products: “It makes me feel really bad, so actually it’s very hard for me to acknowledge . . . I knew what I was doing. I knew I was doing things to get around the rules. I wasn’t proud of it, but I did it anyway.”

One of the heroes is Mabel Yu, a buy-side bond analyst at Vanguard, who couldn’t get the rating agencies to explain the ratings they were giving to structured products – and therefore refused to recommend them internally at Vanguard. Who knew? Not only do you get lower costs at Vanguard, but better fund management, too? (I have most of my money at Vanguard, but it’s in all in index funds or near-index funds, so I guess I wasn’t benefiting from Yu’s research.)

*By James Kwak*

## Posner, Part II: What Now?

James Kwak | 09 Jun 2009

*Note: After writing this, I read Brad DeLong's [better review](#) of Posner's book (hat tip [Felix Salmon](#)). I won't be offended if you go read that instead.*

Part I of my comments on [Richard Posner's epic blog](#) discussed the concept of blame. Today I am going to discuss his approach to some policy questions.

Posner's crisis book is boldly titled "A Failure of Capitalism." The problem is that when the lens through which you see the world is capitalism – or, more precisely, a flavor of economics that works out to justify capitalism in virtually every instance – it's not clear what's left over when capitalism fails.

Posner's method is simple, and I can do it, too. Basically, for any policy, extrapolate out its effect until you can demonstrate that it will lead to a bad (and preferably non-intuitive) outcome – typically by changing the incentives for rational actors so that they no longer maximize profits and thereby social utility. When you do this enough, it becomes such second nature that you forget to spell out your arguments. Here's a [simple example](#):

While cramdown would have benefited some homeowners, it would have hurt lenders and thus have undermined the bank bailouts.

That's the whole argument. Filling in the blanks, Posner is saying that because you have decided (a) to bail out banks, you cannot undertake another policy (b) - which may have its own costs and benefits – because it is in some way contrary to policy (a).

And here is [Posner's entire argument](#) against "trillions of dollars of proposals of long-term social reform" being pushed by "the administration:"

Apart from creating enormous economic risks, the ambitious long-run proposals are ill timed; by further unsettling the business environment, they will further slow the economic recovery.

Leave aside the fact that the “social reform” proposals go unnamed – maybe he means health care – and that the “enormous economic risks” are unexplained. Focus on the second half of that sentence. Posner is saying that policies that create uncertainty for business necessarily impede growth. First off, this is not the situation here. Let’s assume he’s talking about health care or carbon emissions: in both cases, the uncertainty is created by the fact that everyone knows our current non-policies are unsustainable, and therefore it is precisely businesses who *want* systemic reform. They may not want it in the form Barack Obama wants, but they want to know what the future looks like; that’s why many major carbon emitters are lobbying for cap-and-trade (and free emissions permits), because they want to avoid a carbon tax. Second, even if uncertainty is bad for growth, Posner assumes that the benefits of those policies will not outweigh their costs; there is a tacit assumption that the benefits of government policy can never outweigh their effect on economic growth.

Obviously, I’m just warming up for the main course. Here’s Posner on fixing the banking sector:

Impatience with the [Public-Private Invesetment Program] leads some economists to advocate the government’s “nationalizing” the weak banks [I assume by this he means FDIC-style takeovers], but that would be a mistake. This is not only because of the manifest inability of the government to manage banks competently, but also because the vexing problem of valuing the overvalued assets cannot be avoided in this way. The banks are not broke; if the government takes them over, it will have to compensate the owners for the net value of the assets that the government takes, including any overvalued assets that, despite being overvalued, have some value. Perhaps what the government could do would be to take (with compensation) all the good assets of the bank, leaving the overvalued ones with the shareholders; then the bank’s balance sheet would be “clean.” But then what would it do with the bank? Run it? Sell it? The practical complications would be immense.

First, the “vexing problem of valuing the overvalued assets” does go away. If the government takes over a bank, it can transfer assets from the bank to another entity (the famous “bad bank”) at any price, or no price at all, because there is no one to negotiate with. The government does

have to recapitalize the thing that is left over, and the less it “pays” for the assets the more capital it will have to add later; but how much capital the bank requires does not depend on the assets that have been removed from its balance sheet. Even if you accept that the bank in question is not broke, the amount the government might have to compensate shareholders is not the book value of their equity, but the market value – which, for Citigroup, was down in the \$20 billion range at one point.

Second, and more importantly, Posner simply assumes that government ownership – in any form – is a bad thing. This is in keeping with his legacy. By contrast, though, he is relatively sanguine about the UAW’s retiree benefit trust.

Concern has been expressed that, subject to possible modifications by the bankruptcy judge, Chrysler will be controlled by the United Auto Workers and therefore managed inefficiently, as worker-managed firms typically are. But it is not true that the UAW will manage Chrysler. Not the union, but the Chrysler retirement plan, will be a shareholder in the reorganized company (in fact the principal shareholder), and it will have a fiduciary duty to maximize shareholder value rather than to increase the earnings and benefits of the current workers.

Posner clearly understands that majority owners are not managers, and that they have fiduciary duties to all shareholders. And he is willing to give the benefit of the doubt to the UAW, of all organizations. The retiree benefit trust he refers to has a board of overseers, slightly under half of whom are nominated by the UAW. But most if not all sensible advocates of bank takeovers recommended selling cleaned-up banks back into the private sector and – if that is not feasible, as would be likely for the big ones – putting the government’s stake in a trust with independent trustees. The “manifest inability of the government to manage banks competently” is just a talking point; no one thinks that pension funds, mutual funds, and life insurance companies can manage banks competently, either, yet no one is bothered by the fact that they are the primary shareholders of most public companies.

Once you recognize that free-market answers are not necessarily, unequivocally, always right, then you realize that most interesting questions can be argued one way or the other. And so Posner takes his issues on a case-by-case basis – which ends up being unsatisfying.

Take his post on banking regulation, which is full of intelligent thoughts but ultimately no recommendations. Systemic risk regulator? Bad idea, Posner says. It would deter banks from becoming big; he implies that bigness is good, without coming out and saying it – “the result may be a less efficient banking industry, *if* scale and position in financial markets confer substantial benefits” (emphasis added). And 100 small banks are just as risky as 20 big banks, he asserts. (I think that depends on the risk you are protecting against; it’s hard to see how five little insurance companies could have replicated the damage that AIG caused.) And it would only add to bureaucratic turf wars, because “presumably” the other regulatory agencies would be left in place.

What about going back to the old rules? Also bad. It would “reduce the availability of credit” – which is bad by assumption. And, besides, it’s impossible, because financial intermediation naturally escapes regulation through the magic of competitive markets – the activities you want to regulate will simply shift to unregulated institutions. Here’s an example:

The regulators could put a ceiling on the bank’s debt-equity ratio to limit the downside risk. But how would they determine the ratio? And would they impose a ceiling on the debt-equity ratio of *all* potential lenders?

This amounts to saying: (a) if there’s no perfect way to set a leverage cap, there’s no point in bothering; and (b) there’s no point in trying to regulate all institutions that could lend money.

Then Posner veers toward the theory that the Community Reinvestment Act, along with Fannie and Freddie, is really to blame. You would think he would agree, since those are forms of government intervention. But he knows that, in fact, the CRA, Fannie, and Freddie were bit players in the subprime debacle, so that can’t be the answer, either.

So in the end, Posner’s answer to the question he poses, “How Should the Banking Industry Be Regulated?,” is “not any way that anyone has suggested so far.” It seems that instead of using his talents to defend free-market capitalism, he is using those talents to shoot down any proposal anyone might make as hopelessly naive. Which is unfortunate, because I’m sure he could contribute more to the debate.

*By James Kwak*



# Innovation, Regulation, and Credit Cards

James Kwak | 10 Jun 2009

Fresh Air had an excellent [interview](#) with Georgetown law professor Adam Levitin, who blogs [here](#). It's only 21 minutes and I recommend it if you are interested in credit cards or in financial regulation in general.

Credit cards are an interesting if perhaps extreme case of the interplay between "innovation" and regulation in the financial industry. A long time ago, someone invented the credit card. This was a real, beneficial innovation, because it allowed people to make medium-sized purchases on credit. (You could already buy a house on credit, if you put 30% down.) Let's say that without credit, it would take you nine months to save enough money to buy a refrigerator. Now you could buy the refrigerator and then save the money; it might take you ten months with the interest, but you get to use the refrigerator for that whole time. (A refrigerator could also save you money, because it might allow you to go shopping less often, buy in bulk, and eat at home more.) All good so far.

Someone also invented the charge card (like the old American Express card), which gave you the convenience of not having to carry around cash, and the ability to make long-distance purchases immediately, rather than having to mail a check and wait for it to clear. Also a good thing. All credit cards have this feature in addition to the credit feature.

Since then, however, Levitin argues that all the innovation in the credit card industry has been in pricing – specifically, making prices less transparent, so issuers can "compete" over interest rates while they really make money on fees (late fees, cash advance fees, foreign transaction fees, etc.) and billing practices (like double-cycle billing). The actual product you get – the ability to take out a modest unsecured loan on an instant's notice – is the same as it always was.

From my personal perspective, credit cards are a lot better than twenty years ago, but that's because I pay no annual fee and I get rewards (cash back). This is pure reallocation of money, since all that has happened is that the interchange fees charged to merchants are now going to fund my rewards, and those interchange fees get passed on to consumers as higher prices. More generally, Levitin says, the innovation has gone into more and more complex combinations of different price terms (teaser rate, long-term rate, ability to change rates, late fee, reward program, etc.) that simply make it harder for consumers to understand what they are paying.

If innovation doesn't give us new products, does it at least give us the same product at a lower price? Not so much. Here is a graph of credit card interest rate spreads (interest rate minus Fed funds rate) since the end of 1994:

Data are from the [Federal Reserve](#); credit card rates are from Table G.19, credit card rates on accounts assessed interest; Fed funds rates are from Table H.15. Since credit card rates are only available quarterly, I used a 3-month trailing average of both series. That spike at the end is not particularly ominous, at least not yet; the Fed funds rate has collapsed over the last two years, and credit card rates haven't had time to catch up.

Given this situation, Levitin argues that the usual approaches to regulation are ineffective. Disclosure alone is insufficient when consumers lack the ability to estimate the total cost of credit based on complex interest rate and fee schedules. (I would add that disclosure also doesn't work when people have biased estimates of their own future behavior – as in, "I'm not going to miss any payments.") Prohibiting specific practices, as in the recent credit card bill, only motivates card issuers to find new things to charge money for.

Instead, he says, regulation should constrain the number of things issuers can charge money for – like the interest rate, the annual fee, and the transaction fee – and then let them compete on price. The basic product will be the same, since it's never changed. And there will be no caps on prices or fees, so even risky borrowers will be able to get credit at some price. The main difference is that people will have a clear understanding of what the price actually is.

**Update:** Earl Killian has an interesting [comment below](#) arguing that there should be minimum minimum payments – that is, card companies should be prevented from setting the minimum payment so low that you will only run up more and more debt. The idea is that if you insist on reasonable amortization schedules, then consumers will better understand the cost of credit, and won't carry their balances for as long. This is one of those proposals that the libertarians will hate and (some of) the utilitarians will like.

*By James Kwak*

## The G8 Meeting This Weekend (A Viewer's Guide)

Simon Johnson | 11 Jun 2009

If you'd like to attend the G8 Ministers of Finance meeting this weekend, the Italian Ministry of Finance has put out a handy travel guide.

Alternatively, take a look at my preview on The New Republic's website. Our leadership appears to be resting on its laurels after the April G20 summit – or perhaps they think the next G20 summit in September is the place for real discussion. Regulatory reform still needs (a) to happen in a meaningful sense for the financial sectors in all industrial countries, and (b) to be closely coordinated across countries – if your bank is too big to fail in my country, whose problem is that and whose taxpayers are on the hook? But gone completely from the G7/G8 ministerial level is any sense of urgency; all we'll hear is self-congratulation.

And in terms of macroeconomic policy, discussed in a piece with Peter Boone on the NYT's Economix this morning, current global early warning signs (higher oil and other commodity prices; rising long-term yields) are being interpreted by policymakers as indicators of success and return to "normalcy". It reminds me of official discussions in early 2007 – no matter what weakness you could point out in US housing and European banking, leading G7 policymakers were completely in denial, with articulate arguments about why they were right.

Incrementalism is the preferred policymaking culture of G7 ministries of finance and central banks, and they are very much back in that mode. But if you put incrementalism together with refusing to really change the rules for banks and huge, unconditional support for credit that is hard to withdraw, what do you get?

*By Simon Johnson*

## Does the Administration Care About Executive Compensation?

James Kwak | 11 Jun 2009

They certainly want you to think they do. Yesterday was Executive Compensation Day in Washington. The Treasury Department appointed Kenneth Feinberg to oversee executive pay at seven companies that have received extensive government aid – AIG, Citigroup, Bank of America, and the car companies and their finance companies. The administration, which always seemed uneasy with the popular outrage over bonuses earlier this year, seems willing to throw the seven sinners to the wolves, while letting the bulk of the financial sector off the hook. Feinberg will only provide advice to other TARP beneficiaries, and banks that pay back TARP money will not even have to deal with that.

This, of course, solves precisely nothing. The problem with “executive compensation” – no, make that just “compensation” – in the financial sector was its structure. Huge end-of-year bonuses tied to short-term metrics, with no corresponding downside risk, motivated people to take on excessive risk in hopes of maximizing those bonuses. And the companies we need to worry about most are not the ones that are most beaten-down today, but the ones that are (relatively) the strongest and will be taking the biggest bets.

So the administration is also thinking about addressing these structural issues. Tim Geithner made a statement on compensation yesterday that lays out five reasonable-sounding principles (compensation should reward performance, compensation should be “aligned” with risk management, etc.). On closer examination, it’s remarkably short on verbs that aren’t prefaced by “should.” For example, “I *met* with SEC Chairwoman Mary Schapiro, Federal Reserve Governor Dan Tarullo, and top experts to *examine* . . .” Or, “in *considering* these reforms, we *start* with a set of broad-based principles . . .” Or, “by *outlining* these principles now, we *begin* the process of *bringing* compensation practices more tightly in line . . .” (Emphasis added, obviously.)

At its heart, there are only two proposals: first, “say on pay” legislation, which requires *non-binding* shareholder votes on executive compensation packages and, according to Geithner, “would encourage boards to ensure that compensation packages are closely aligned with

the interest of shareholders;" and second, new standards for independence of board compensation committees.

If you're wondering how a non-binding shareholder vote could possibly solve the problems with executive compensation, you're not alone. I think "say on pay" is slightly better than nothing, because there is a chance that in some cases the additional attention will shame boards into more reasonable packages. But in general, shareholders' ability to influence corporate governance is pretty weak. Outside shareholders, even major institutional investors, face many challenges: fragmentation of ownership, which makes it hard to build a big enough coalition; the control of information by management and the board; the usage of compensation consultants to insulate pay packages from criticism; and the tendency of small shareholders to either not vote or vote the way the board recommends. Even if dissident shareholders can muster a "no" vote, the likely outcome would be a cosmetically modified package that is simply harder to understand – or no change at all (non-binding, remember?).

Independent compensation committees are also a nice idea, but without many teeth, at least in the proposal floated yesterday. The key question is, what incentive do the compensation committee members have to really crack down on executive compensation? The proposal draws a parallel to Sarbanes-Oxley and audit committees. But audits turn out to be right or wrong, and if there is a restatement, that is deeply embarrassing to the people involved. Excessive compensation is a matter of judgment, and it's hard to see compensation committee members ever being held personally liable for giving away too much money.

Over at The Hearing, Brett McDonnell is similarly underwhelmed, although he does suggest some additional ideas, such as allowing regulators to evaluate the effect of compensation on safety and soundness requirements.

This reluctant approach to regulating executive compensation should come as no surprise. In his press briefing the day he announced the Public-Private Investment Program, Geithner responded to a question about TARP executive compensation conditions by saying, "the comp conditions will not apply to the asset managers and investors in the program." When the Washington Post reported on April 21 that that was not what the lawyers were saying, Treasury rushed out a new FAQ (see the April 21 FAQ) trying to assuage investors' fears.

This looks to me like a strategic choice. The administration has decided that the economy depends on the banks, and therefore it needs to keep the existing bankers happy. Or it has decided that executive compensation is just not such an important issue, and it would rather focus on others. (What, though? The Wall Street Journal reported on Tuesday that the administration is backing off plans to consolidate regulatory agencies.) Or, more likely, both.

These are reasonable positions, even if I don't agree with them. But they are more evidence that the financial sector of 2010 will look more like the financial sector of 2006 than anyone would have thought possible just six months ago.

*By James Kwak*

## More on Executive Compensation

James Kwak | 12 Jun 2009

I was surprised at the number of commenters on [yesterday's post](#) who thought that executive compensation is a red herring or a political talking point or "populist pablum." I agree that some of the outrage over compensation by TARP recipients is a bit overblown. But I also think that the incentives created by current compensation structures were a serious contributor to the financial crisis – which was, after all, largely about banks taking one-sided risks because of asymmetric payouts (lots of upside, limited downside) – and that fixing those incentives is an important task for regulatory reform.

So, I decided to call on some reinforcements. Lucian Bebchuk, a leading researcher of executive compensation ([book](#); [important paper discussed here](#)), and Holger Spamann have a new paper called "[Regulating Bankers' Pay](#)" that discusses precisely this issue. They conclude not only that regulation of banks' executive compensation would be a good thing, but that it may actually be better than the traditional regulation of banks' activities.

Section II (PDF pages 11-28) lays out, with simple examples worthy of a Beginners post, what I thought was already generally accepted (but apparently isn't): leverage, combined with the bank holding company structure, combined with compensation in the form of stock options, combined with deposit insurance, combined with the implicit guarantee on uninsured liabilities, creates large incentives to take excessive risks – defined as actions that have a negative expected value for the bank's assets, but a positive expected value for bank executives. First of all, in a highly leveraged financial institution, shareholders already have the incentive to take excessive risks, because their downside is limited. This is amplified for executives holding stock options, whose downside is even more severely limited. Finally, explicit or implicit guarantees on liabilities reduce the incentive for creditors to adequately monitor banks' activities.

As a result, Bebchuk and Spamann argue that executives' incentives should be tied not to the value of shareholder's equity, but to the value of all of the bank's assets. Wait a second, though – isn't the whole point of corporations that managers' incentives should be aligned with those of shareholders? Yes, that is one consideration. But there are two other considerations that matter.

First, banks are unusual in that a large portion of their liabilities is guaranteed by FDIC deposit insurance, which already helps distort executives' incentives as described above. As the insurer, the government needs to protect itself from moral hazard – and one way of doing that is reducing managers' incentives to take actions that are good for shareholders but bad for the insurer.

Second, as we should now know, the incentive to take excessive risks, when shared across all the largest banks, is a major contributor to systemic risk. A systemic crisis leads to both government bailouts to protect non-guaranteed creditors, and to severe collateral damage for the economy at large. Therefore, the government should attempt to reduce those incentives, both to protect taxpayer money and to protect the economy.

Traditional regulation attempts to deter excessive risk-taking by limiting the set of activities that banks are allowed to engage in. Currently, however, bank executives have strong incentives to try to get around those regulations. In addition, Bebchuk and Spammann argue that regulators should at least monitor executive pay structures in determining whether safety and soundness risks exist. Ideally, they would link executive compensation not to the value of common shares, but to the aggregate value of common shares, preferred shares, and bonds. This would take away the incentive to take actions that have positive expected value for shareholders but negative expected value for the assets in aggregate.

The idea is that, in principle, it's better to give executives the incentive to do the right thing than to give them the incentive to do the wrong thing and then try to hem them in with regulations.

Indeed, if pay arrangements are designed to discourage excessive risk-taking, direct regulation of activities could be less tight than it should otherwise be. Conversely, as long as banks' executive pay arrangements are unconstrained, regulators should be more strict in their monitoring and direct regulation of banks' activities.

Would the banks go for incentive compensation tied to the entire balance sheet rather than just common shares? It's an interesting question. Under Bebchuk and Spammann's proposal, they could still have enormous bonuses; from this perspective, it's the structure that matters, not the size. But if the banks insist on tying their bonus packages to common shares, then we know that they are perfectly happy taking

excessive risks. In that case, then this passage becomes particularly relevant:

In principle, well-designed incentive pay can improve the management of firms. . . . That being said, our analysis above identified major problems with the current incentive structure for bank executives. From this perspective, scaling down financial incentives may be a good thing. No financial incentives may be better than bad ones. Thus, if incentive compensation remains structured in ways that provide perverse incentives, limits on incentive pay can actually improve matters.

(On a related note, [Marketplace](#) and [ProPublica](#) ran a story yesterday on TARP recipients that figured out ways to give their executives golden parachutes.)

*By James Kwak*

## Snowball: Strategies For Banking Reform

Simon Johnson | 12 Jun 2009

I was on a Capitol Hill panel yesterday morning, organized by the National Community Reinvestment Coalition, with Jim Carr and Mike Lux; Nancy Cleland was the moderator. We had a wide-ranging discussion about the origins of our current economic crisis (the banks, their regulators, their lack of regulation), progress to date with financial sector reform (not much), and what should be the legislative agenda (a long list, ranging from protecting individuals to better safeguarding the system; if you can get any sensible measure past the lobbies, take it).

I was particularly struck by one point made by Mike Lux. Sometimes it seems the administration talks in terms of having limited political capital and of needing to decide where to spend it – perhaps, for example, it has all been stored up to address health care. Mike's model is somewhat different – once you defeat one powerful industrial lobby, it becomes easier to defeat others; success can snowball. Drawing on the experience of FDR, in particular, Mike stressed that early success (e.g., initial recovery measures that were opposed by industry) laid the political foundations and generated the kind of public support necessary for further achievement (e.g., the introduction of social security).

What does that mean in today's context?

It means that the banking reform agenda is likely to run for a long while. Sensible measures may not at first succeed and, let's be honest, the prospects for the fall legislation do not currently look encouraging – various parts of the financial lobby are flexing their muscle already. But that is not necessarily the end of the conversation.

In particular, if banks make further mistakes – even if not on the recent scale – this will shift opinion towards reform. Jamie Dimon, for example, has another brilliant statement on why banking, or at least JP Morgan Chase, should be allowed to go back to "business as usual". But his reasoning rests largely on the idea that JP Morgan has a culture that can manage risk, forever.

From all accounts, Dimon's personality and demeanor are a critical determinant of the firm's culture in general and the fact that it (partly) sat out the housing craze. Everything we know about the evolution of firms is that while some aspects of culture survive growth and a rise to predominance (and JP Morgan is now #1, in case you're keeping score), generally attitudes change as top people change. And

any rise to power brings with it potential sclerosis of various kinds – just ask Citigroup or Bank of America.

So major banks will run into some variety of trouble, probably sooner rather than later – remember there is a potential global credit boom underway (check your local oil prices for details). If enough transparency, accountability, and public discussion is preparing and waiting for that moment, attitudes towards permissible banking behavior can change quickly.

And this administration will at some point, hopefully, prevail against some powerful industrial group or other. If they can just get some political momentum vs. recalcitrant lobbies going, such success can be brought over into the financial sphere.

The wave of “reforms” this fall will likely not solve anything. But this is not the end of attempts to better regulate the functioning of finance and to make sure it can never again run us into a crisis that results in doubling the national debt. What we are looking at now is just the beginning of a 5 or 10 year struggle for real change in the structure of economic and political power around finance in the United States.

*By Simon Johnson*

## The Financial Regulation Debate in One Post

James Kwak | 12 Jun 2009

Tim Geithner will be testifying before both Senate and House committees next Thursday on the administration's proposal for financial regulation. In the meantime, there will be a lot of talk about financial regulation.

The [Wall Street Journal](#) (subscription required) and [Washington Post](#) (subscription not required) have been reporting on how the administration's plans have been "pared back." Those articles mainly dwell on the likelihood that the administration will not try to abolish and consolidate agencies as had once been thought possible (although OTS and OCC may be merged). This is interesting, given that [Larry Summers](#) just said that eliminating regulatory arbitrage was one of his key principles.

[Tyler Cowen](#) has some intelligent thoughts on why consolidation may not be such a great idea. My feeling is that consolidation could be good insofar as the current situation is clearly bad. I agree with [Felix Salmon](#):

The current regulators have clearly failed at their jobs, there's no reason for entities like the OCC and the OTS to continue to exist, and it's worth remembering at all times that the number of large American financial-services companies with intelligent and sophisticated and effective regulation is, currently, zero.

(On just how bad the OTS is, see [Planet Money's](#) podcast from last Friday.)

However, I agree with Cowen that consolidation in itself will not accomplish a lot. The real key, as in most things, is power, and here Cowen has another good point: "Many of the real regulatory problems are due to the preferences of Congressional committees and it is high time we admitted this. How about reforming them?"

Finally, over at The Hearing, we have started an occasional series on various aspects of financial regulatory reform. So far we've had [Lawrence Baxter](#) and [Joel McPhee](#), [David Zaring](#), [Dan Immergluck](#), [Brett McDonnell](#), and blogging star [Mark Thoma](#). More to come next week.

*By James Kwak*

## Where Are We Now? Five Point Summary

Simon Johnson | 13 Jun 2009

1. Financial markets have stabilized – largely because people believe that the government will not allow Citigroup to fail. We have effectively nationalized any banking system losses, but we'll let bank executives enjoy the full benefits of the upside. How much shareholders participate remains to be seen; there will be no effective reining in of insider compensation ([my version](#); [Joe Nocera's view](#)). For more on how we got here, see the Frontline documentary [that airs on Tuesday](#) and [Paul Solman's explainer wrap up](#).

2. The real economy begins to bottom out, although unemployment will not peak for a while and could stay high for several years. Longer term growth prospects remain uncertain – has consumer behavior really changed; if finance doesn't drive growth, what will; [is the budget deficit under control or not](#) (note: most of the guarantees extended to banks and other financial institutions are not scored in the budget)?

3. More broadly, there is sophisticated window dressing in the pipeline [but no real reform on any issue](#) central to (a) how the banking system operates, or (b) more broadly, how hubris in finance led us into this crisis. The financial sector lobbies appear stronger than ever. The administration ducked the early fights that set the tone (credit cards, bankruptcy, even cap and trade); it's hard to see them making much progress on anything – with the possible exception of healthcare.

4. The consensus from conventional macroeconomics is that [there can't be significant inflation](#) with unemployment so high, and the Fed will not tighten before late 2010. The financial markets beg to differ – presumably worrying, in part, about easy credit leading to dollar depreciation, higher import prices, and potential commodity price inflation worldwide. In all recent showdowns with standard macro models recently, the markets' view of reality has prevailed. My advice: pay close attention to oil prices.

5. Emerging markets are increasingly viewed as having "decoupled" from the US/European malaise. This idea was wrong in early 2008, when it gained consensus status; this time around, it is probably setting us up for a new bubble – based on a "carry trade" that now [runs out of the US](#). The "appetite for risk" among investors is up sharply. The G7/G8/G20 is back to being irrelevant or merely cheerleaders for the financial sector.

Comments welcome.

*By Simon Johnson*

## You Don't Get a Vote!

James Kwak | 15 Jun 2009

Barack Obama came to office as the conciliator, the bipartisanizer, the anti-Bush. But this is going too far.

The administration's style has been to float policy proposals in public, listen to the responses (from other politicians, from the private sector, and from the blogs that Obama does not read), and adjust accordingly. When it comes to the financial regulation proposal that Tim Geithner is scheduled to deliver on Thursday, there may be little left after all the adjusting.

We heard last week that the initial plans to consolidate regulatory agencies have been scrapped, with the exception of closing the hapless Office of Thrift Supervision. Now The New York Times has a story that is ostensibly about the feud between John Dugan, the Comptroller of the Currency (and regulator of many large national banks), and Sheila Bair, head of the FDIC, but is also about the compromises that have dictated the administration's regulatory plan.

The Treasury secretary, Timothy F. Geithner, the main author of the administration's plan, in recent weeks has refereed among the competing views of Ms. Bair, Mr. Dugan and Ben S. Bernanke, the Federal Reserve chairman. . . .

With the administration and crucial lawmakers rejecting a single agency, the four officials have often disagreed on just how to streamline and strengthen regulation. Some points of contention include views on which agencies should play central roles in overseeing financial companies whose troubles could pose problems for the overall system, and whether to create a new agency to protect consumers from abusive mortgages or credit cards.

Officials say the latest version of the plan, in large part, is a compromise of various viewpoints.

I don't want to get into the merits of these issues here. But when you are reforming the regulatory structure of an industry where the existing regulators got it horribly, embarrassingly, catastrophically, world-historically wrong, the last thing you want to do is strike a compromise between the positions of the existing regulators. Members of Congress

get votes, and they already have enough ties to the banking industry to worry about; letting the regulators, who don't have votes, shape the deal makes it more likely that the final result will be watered down into nothingness. Which, of course, is exactly what the industry wants:

Most of the banking industry couldn't be happier with the current system. Bank executives and lobbyists say that the system, while flawed, enables regulators to tailor rules for a variety of financial institutions.

I know that it's not as simple as saying that regulators don't have votes, because they certainly have allies that do have votes, and they have allies who give money to the people who have votes. But the underlying problem is that somehow the Obama Administration managed to back itself into a corner where it had no one but the existing regulators to turn to. Geithner, Bernanke, Dugan, and Bair were all manning the ship when it hit an iceberg, and only Bair can claim that she arrived late enough not to share in the blame. (Bernanke, though he became chairman of the Fed only in 2006, was on the board of governors from 2002 and then was head of the Council of Economic Advisors.)

Shouldn't someone with an independent perspective have been charged with this task? Paul Volcker, whom we heard so much about during the transition? Warren Buffett, whose name Obama liked to use on the campaign trail? Austan Goolsbee? Christina Romer? What happened to the best and the brightest?

All I can think is that Obama basically doesn't think that financial regulation is that important. Or he thinks that the existing system is close enough. Or he figured that Congress would have the final word, anyway.

Or maybe Larry Summers will pull a rabbit out of his hat since, according to [the Times](#), he is in charge anyway. While I have criticized his anti-regulatory positions of a decade ago, by his reputation – brilliant, strong-willed, etc. – I would expect more from him than from the bank regulators who helped bring us the crisis.

*By James Kwak*

## How to Sell Toxic Waste

James Kwak | 15 Jun 2009

One point I've made a couple of times is that complex structured financial products are sold, not bought. If you want to see how they are sold, check out [Zero Hedge's post](#) on the lawsuit brought by those same Wisconsin school districts that were the subject of the [Planet Money/New York Times feature](#) back in November. The second attachment is the [Stifel Nicolaus](#) PowerPoint presentation used to sell those school districts a levered bet on a AA- tranche of a synthetic CDO.

It really takes you back to 2006, doesn't it?

*By James Kwak*

# Today's Foundation, Tomorrow's Crisis: The Geithner-Summers Proposals

Simon Johnson | 15 Jun 2009

Writing in the Washington Post this morning, Tim Geithner and Larry Summers outline a five point plan for dealing with the underlying problems in our financial system, entitled *A New Financial Foundation*.

The authors are not completely clear on what they think caused the current crisis, but you can back out some points from their reasoning – and the implicit view seems quite at odds with reality.

1. Their view: Regulation is overly focused on safety and soundness of individual banks. Reality: There was a complete failure of safety and soundness supervision. This must be fundamental to any financial system – without this, you'll get mush every time.
2. Their view: “A few large institutions can put the entire system at risk,” so we need a system regulator. Reality: you need to control the behavior of large institutions, more than a few of which got us into this mess. If you can’t come up with a proposal to prevent them from taking system-damaging risk (and there is nothing in today’s article about this), then break them up. The article mentions penalties for being large - higher capital and liquidity requirements for larger banks; we’ll see the details in/after Geithner’s speech tomorrow, but I am not holding my breath for anything meaningful.
3. Their view: All large firms will be subject to consolidated supervision by the Federal Reserve and there will be a council of supervisors. Reality: we have plenty of layers, up to “tertiary” regulators (and beyond, in some senses) and there is already enough opportunity for regulatory arbitrage. What prevents the biggest banks from capturing or manipulating regulators? There is no mention in today’s document of the extent to which everyone, including the authors, believed in the big banks’ risk management abilities last time – and continue to rely on the advice of their people today.
4. Their view: The originator “of a securitization” will be required to “retain a financial interest in its performance.” Reality: It was a big unpleasant shock when everyone realized that Lehman, Bear Stearns, and others had retained a large exposure to dubious financial products, some of which they had issued. We are back to

the Greenspan fallacy here – if financial firms have an incentive not to screw up on a massive scale, they won’t.

5. Their view: “[T]he administration will offer a stronger framework for consumer and investor protection across the board.” This sounds incredibly vague and may be the worst news today. It looks like they are backing away from the idea of a Financial Products Safety Commission, for example as proposed by Elizabeth Warren.

And of course the complete omissions from this document are breathtaking. No mention of executive compensation or the structure of compensation within the financial sector. Not even a hint that the complete breakdown of corporate governance at major banks contributed to excessive risk taking. And no notion of regulatory capture-by-crazy-ideas of any kind.

There are a couple of positive notes towards the end. The administration will seek a resolution authority for dealing with failed banks, but we knew this already. And the authors recognize the need to change how financial systems operate around the world; unfortunately, there is zero detail on this crucial point.

Overall, there are no surprises here. Brick by brick, we are building the foundation for the next financial crisis; by all indications, it will be more disruptive and a great deal more damaging than the crisis of 2008-09. But presumably by then the authors will be out of office.

*By Simon Johnson*

## Recovery – or Not – in Pictures

James Kwak | 16 Jun 2009

Simon's [weekend summary](#) included this sentence on the macroeconomic situation: "The real economy begins to bottom out, although unemployment will not peak for a while and could stay high for several years."

We are now in that phase of the crisis when there is a lot of arguing about whether things are going well or poorly, and that largely comes down to whether the current slowdown in the rate at which things are getting worse (that's all it is so far) will be followed by a healthy recovery, a prolonged period of stagnation, or an accelerated contraction brought on by higher oil prices, a new bank panic caused by defaults in credit cards and commercial mortgage-backed securities, or one of any number of other factors. I discussed this topic [somewhat impressionistically](#) a month ago; this time I'm going to highlight some analyses done by other people around the Internet.

Last time I cited [James Hamilton](#) and [Calculated Risk](#), both of whom thought that a peak in the four-week moving average of new unemployment claims was a good predictor of the end of a recession. Hamilton in particular has been following this closely, and while we may have passed the peak, the number isn't falling like it should. Here's Hamilton's picture from [last week's post](#):

Look at the smooth line in each chart and note how it falls in 1991 and 2001 but doesn't fall in 2009. The original post also has charts for the three previous recessions.

[Paul Krugman](#) looks at the same data and estimates that even though new claims are down from their recent peak, as long as the number remains above 400,000 aggregate employment is still going down, not up.

If charts are your thing, Paul Swartz of the Council on Foreign Relations has [eight pages of them](#) (hat tip [Brad Setser](#)), comparing the current recession to all postwar recessions (it's the worst on most measures) or to all postwar recessions and the Great Depression. Here's one striking example:

Fascinating late-night reading.

*By James Kwak*



# President Obama's Regulatory Reforms Announcement: A Viewer's Guide

Simon Johnson | 16 Jun 2009

At 12:30pm on Wednesday at the White House (someone: please update the Treasury's schedule of events), President Obama is due to "unveil" his proposals for reforming the functioning of our financial system. The content has already been foreshadowed in some detail, most notably by the Geithner-Summers op ed in the Washington Post on Monday, but what the President himself stresses is still important – everyone who matters for the reform of financial regulation will be in attendance and his remarks (and perhaps those of Secretary Geithner) can absolutely set the tone of the debate.

In particular, the implicit story the President tells will frame our collective discussions going forward and – on some points – could even help tip the balance against established lobbies.

There are at least 10 important questions the President may address or shy away from tomorrow. Add your own suggestions below.

1. Does President Obama buy the idea that what happened to our financial system was a "rare accident," or does he think that something more systematic has gone wrong?
2. Does he think that the crisis itself will take care of many problems – for example by chastening the remaining bankers to behave well indefinitely or somehow making their organizations less stupid? Or does the crisis serve just as a wake-up call to all of us: Unless and until we fix the system, we will be vulnerable to further damaging crises?
3. Does the President realize and stress sufficiently the damage that has been done by bankers, for example as seen in the increase in our national debt that arises directly from their malfeasance – from around 40% of GDP to 70% (administration estimate) or 75% (IMF yesterday) or above 80% (my view). He needs to say clearly: This cannot happen again – we simply can't afford another financial calamity on this scale.
4. Does he state plainly and unequivocally that the way the financial system has been run – and continues to be run – has damaged the national interest of the United States and pushed millions of people, both here and around the world, closer to poverty?

5. Most important, does the President stress the need to protect consumers from the financial industry going forward, specifically with a strong Financial Products Safety Commission. Messrs. Geithner and Summers seem, at best, lukewarm to this idea – in fact, we have no clear indication that they buy into the idea of consumer protection at all. The President's position on this issue will be decisive.
6. If a bank or other financial institution is “too big to fail,” how exactly does the President plan to deal with it in the future? Even if a wind-down can be managed by Treasury, with its new resolution authority (if granted), what will be the expected cost to the taxpayer? If “too big to fail” is not in the President's view “too big to exist,” kindly explain why not.
7. Can the President bring himself to state in public the obvious: The extent of political influence in the hands of our financial system – large banks in particular, but small banks also in some instances – is out of control and dangerous? Where is the administration's reform agenda on this crucial point? To those of us who frequent Capitol Hill, it looks very much like business as usual, albeit with higher political market share for the big banks that remain in business.
8. Has the President really been briefed on the supposed benefits of having large financial institutions with great economic power and pervasive political influence? Don't just claim that these are a good thing – tell us, in detail and preferably with numbers, what we the public gain from the presence of these behemoths among us. Keep in mind that “everyone has them” is no kind of argument – something so manifestly dangerous is not to be blindly copied.
9. Why was executive and other compensation so notably absent from the latest Geithner-Summers joint statement of our problems and likely solutions? Does the President really expect us to believe that any set of reforms will work if they do not directly constrain the amounts that can be earned from misunderstanding risk today and hoping that the consequences do not appear on your watch? Does he have any idea of how the people who run big financial firms will game whatever controls try to limit their risk-taking?
10. Can President Obama finally talk about the much broader break down of corporate governance in this country, with boards of directors serving no discernible purpose in terms of limiting the excesses of corporate executives in the financial sector but also

more broadly? Surely, without a reform package that includes measures to address this core issue, we will get exactly nowhere.

**Update:** Also see my latest video blog on the topic at [The New Republic](#).

**Update:** Typo fixed in point #6; thanks “oliver” for catching this in your comment.

*By Simon Johnson*

# Regulatory Reform For Finance: Three Views

Simon Johnson | 17 Jun 2009

There are three views on who exactly is behind financial regulatory reform package that will be officially presented Wednesday lunchtime (**update: NYT.com has the draft**). Each view has distinct implications for political dynamics going forward.

The first view is that Tim Geithner and Larry Summers have genuinely become radical reformers. They see the error of the ways they pursued during the 1990s – both in terms of financial deregulation for the United States and in their advice to other countries, particularly through the capital market liberalization policies urged upon the IMF. They now seek to put globalized finance back in its box and will pursue any sensible means possible to this end.

This view is not widely held.

The second view is the consensus: Geithner and Summers want a minimal degree of reform with a great deal of window dressing. This interpretation is supported by the fact that most of the specifics with regard to large financial firms look like moderate technocratic tweaks, i.e., hardly what you'd expect in the aftermath of what the President himself called, "the worst financial crisis since the Great Depression".

It's true – and always pleasing to officials – that you can get a nice media bump with background briefings on all the effort that has gone into the proposals. But honestly, what in the administration's proposals is strong enough to have prevented this crisis, let alone preempt the next crisis which, by all indications, could be even larger – now that big financial players know for sure they are too big to fail?

The administration could have taken over Citigroup – e.g., placing it into negotiated conservatorship – at several points in the last nine months. It did not. Draw your own conclusions and think for a moment about how this will influence future actions in the financial sector.

The third view is more interesting and also controversial: Geithner-Summers have exercised an effective veto over measures that would have constrained large firms directly, but they are not at this time strong enough to prevent sensible consumer protection measures from also going forward.

In this view, someone (Cass Sunstein?) and his/her allies have managed – at least so far – to promote the idea of a consumer protection

agency focused on financial products. The details are not yet clear enough to see how what will emerge, and we also don't yet know how vigorously Treasury will defend this idea against the financial sector lobbies. But at least this is something new and potentially powerful in all the right ways.

Sunstein, of course, is known for the idea of a Nudge – pushing consumers ever so gently towards better decisions. It's a fine principle to guide thinking, but lobbies, opponents within the administration, and members of congress with their own agenda will not be moved through gentle means.

This is going to be quite a fight.

*By Simon Johnson*

## More Financial Innovation

James Kwak | 17 Jun 2009

Felix Salmon discusses reverse convertibles, inspired by a Larry Light article in the Wall Street Journal.

In a reverse convertible, you give \$100 to a bank for some period, like a year; it pays you a relatively high rate of interest, say 10%. The \$100 is virtually invested (no one actually has to buy the stock) in some underlying stock, like Apple. If at the end of the period the stock is above a threshold, like \$80, you get your \$100 back; if it is below the threshold, you get the stock instead. (The terms can depend on whether the stock ever went below the threshold and where it is at the end of the period, which makes the deal worse for the investor, but that's the basic idea.)

The simplest thing to compare this to is just buying the stock. Compared to buying the stock, there are three outcomes:

1. The stock ends up below \$80: In this case, the reverse convertible is slightly better, because you got the \$10 in interest, which is probably more than the dividends you gave up.
2. The stock ends up between \$80 and \$110: Again, the reverse convertible is better, because you got \$110 (your principal plus interest); it's a little better if the stock ends up close to \$110, a lot better if the stock ends up at \$81.\*
3. The stock ends up above \$110: Here, you do anywhere from a little worse (if the stock ends at \$111) to much, much, much worse (if the stock goes over \$200).

The expected value for \$100 of stock after one year is about \$108 (6% real return on equities plus 2% inflation), so the chances of a gain and a loss (relative to buying the stock) are roughly equal; however, the distribution of returns is asymmetric, because if the stock does poorly your gains are capped, while if the stock does well your losses are not capped. Whether a given reverse convertible is a good deal or not depends on the specific terms – the interest, the term, the threshold, the volatility of the stock, and the transaction fee. But the question I want to ask is . . .

What the hell is the point of this product?

Here's Ben Bernanke on financial innovation:

"We should also always keep in view the enormous economic benefits that flow from a healthy and innovative financial sector.

The increasing sophistication and depth of financial markets promote economic growth by allocating capital where it can be most productive.”

This product isn’t allocating capital anywhere – at least not to the company you are betting on. It’s allocating your capital to the bank, which has one year to figure out how to make more money than it has to pay you back, but this serves the same allocation function as an old-fashioned bond (plus some additional risk). Or the bank might be an intermediary with another investor on the other side of the transaction, in which case you are simply betting each other and the bank is taking a fee.

A reverse convertible is just a made-up security that creates a different return distribution than conventional securities. It doesn’t help Apple raise capital. And there is no investor who woke up one day thinking he needed the wacky return distribution it provides: basically, a stock with a 10% cap on gains and a small sweetener in case of losses, with some weird behavior in the middle (the \$80-110 range). The complexity only serves two real purposes. First, it creates transaction fees for the bank that it can’t charge you for buying a stock; and second, it makes it harder for investors to understand what they are buying, which means that at least some of them will buy it, even if it’s bad for them. In other words, this is an innovation that creates no value, but just redistributes it between investors and banks, with the banks taking a transaction fee just like 0 and 00 on a roulette wheel.

Or, as Salmon said:

“This is the kind of thing that a Financial Product Safety Commission should exist to regulate — and, frankly, to outlaw entirely. The number of people buying these notes who are qualified to price them is exactly zero. Reverse converts are a scam, and it’s high time US regulators put an end to them.”

\* Note however that in the standard terms according to [Wikipedia](#), in many of these situations you would end up with the stock rather than cash, if the stock had ever closed below the \$70 threshold. So instead of doing a lot better – getting \$110 in cash instead of stock worth \$81 – you would only do a little better, because of the \$10 interest.

**Update:** This post has gotten a fair amount of attention, including criticisms by from [Nick Schultz](#) and [Daniel Indiviglio](#) (who calls this

“Simon Johnson’s Baseline Scenario blog,” but whatever). But I think Mike at [Rortybomb](#) does the best job discussing this type of security in wonky detail.

*By James Kwak*

## When Market Incentives Lead to Bad Outcomes, Continued

James Kwak | 18 Jun 2009

A couple of weeks ago, I wrote a [post](#) about Atul Gawande's [New Yorker article](#) about health care spending and outcomes. I didn't claim to have any particular insight about health care economics; I just thought that people should read his article – which, to summarize greatly, argues that there is no correlation between high spending and good outcomes, because the current system does not motivate doctors to seek good outcomes. (Apparently Barack Obama agreed, since [the Times](#) reported that "the article became required reading in the White House.")

That post got a lot of interest, so here is a follow-up.

A lot of the data on regional variations in spending and outcomes come from the Dartmouth Atlas of Health Care, whose findings are summarized in the first paragraph of Jonathan Skinner's [Economix post](#):

"For the last three decades, John Wennberg and his Dartmouth colleagues have documented regional variation in Medicare spending and a puzzling lack of association between spending and better health outcomes. Regions that spend more on medical care don't necessarily have sicker people, and they don't get better results. It isn't clear what benefit they are receiving for all the money they're spending."

Skinner's post cites and then responds to criticisms mentioned in the aforementioned [Times article](#) and in a [Wall Street Journal editorial](#). The most direct criticism, it seems to me, is that the Dartmouth study does not control for the sickness of populations; however, as Skinner says, studies that do control for population differences still find major spending gaps. In *Economix* yesterday, [David Leonhardt](#) provides an overview of this debate.

Finally, [Leonhardt's column](#) yesterday addresses the political flavor of the same issue: rationing. His position is summed up here:

"Milton Friedman's beloved line is a good way to frame the issue: There is no such thing as a free lunch. The choice isn't between rationing and not rationing. It's between rationing well and rationing badly. Given that the United States devotes far more of its economy to health care than other rich countries, and gets

worse results by many measures, it's hard to argue that we are now rationing very rationally."

Leonhardt argues that the current health care "system" implements three kinds of rationing. First, businesses faced with higher health care costs compensate by reducing wage growth (to zero, in some cases) – so expensive health care comes at the cost of everything else. Second, higher health costs mean that many businesses do not provide health insurance; the rationing here is that some people get semi-comprehensive health care, and some don't. Third, the current economic incentives lead doctors to provide some types of care (expensive procedures) at the expense of other types of care (spending time with patients, preventive medicine), even though the latter may be more important than the former; here, rationing is preventing access to some forms of care.

With financial reform watered down to "minor technocratic tweaks" (although I hold out some hope for the Financial Product Safety Commission, or whatever it will be called), the established health care interests must be encouraged.

**Update:** Atul Gawande was on Fresh Air yesterday.

*By James Kwak*

## Too Big To Fail, Politically

Simon Johnson | 18 Jun 2009

What is the essence of the problem with our financial system – what brought us into deep crisis, what scared us most in September/October of last year, and what was the toughest problem in the early days of the Obama administration?

The issue was definitely not that banks and nonbanks could fail in general. We're good at handling some kinds of financial failure. The problem was: a relatively small number of troubled banks were so large that their failure could imperil both our financial system and the world economy. And – at least in the view of Treasury – these banks were so large that they couldn't be taken over in a normal FDIC-type receivership. (The notion that the government lacked legal authority to act is smokescreen; please tell me which statute authorized the removal of Rick Waggoner from GM.)

But instead of defining this core problem, explaining its origins, emphasizing the dangers, and addressing it directly, what do we get in yesterday's 101 pages of regulatory reform proposals?

1. A passive voice throughout the explanation of what happened (e.g., this preamble). No one did anything wrong and banks, in particular, are absolved from all responsibility for what has transpired.
2. A Financial Services Oversight Council, which sounds like a recipe for interagency feuding, with the Treasury as the referee and – most important – provider of the staff. The bureaucratic principle is: if you hold the pen, you have the power.
3. Some of the largest banks ("Tier 1 Financial Holding Companies", or Tier 1 FHCs) will now be subject to supervision by the Federal Reserve Board – although under the confusing jurisdiction also of the Financial Services Oversight Council in many regards (e.g., in the key setting of material prudential standards) and subsidiaries can have other regulators.
4. Tier 1 FHC should have higher prudential standards (capital, liquidity and risk management), but "given the important role of Tier 1 FHCs in the financial system and the economy, setting their prudential standards too high could constrain long-term financial and economic development." Sounds like a banker drafted that sentence. None of the important details/numbers are specified,

although the Fed should use “severe stress scenarios” to assess capital adequacy. Is that the same kind of actually-quite-mild stress scenario they used earlier this year?

5. In terms of risk management, “Tier 1 FHCs must be able to identify aggregate exposures quickly on a firm-wide basis.” There is no notion here that risk management at these big banks has failed completely and repeatedly over the past two years. How exactly will FHCs be able to identify such risks and how will the Fed (or anyone else) assess such identification?
6. In case you weren’t sufficiently confused by the overlapping regulatory authorities in this plan, we’ll also get a National Bank Supervisor (NBS) within Treasury. Regulatory arbitrage is not gone, just relabeled (slightly).
7. There is no greater transparency or public accountability in the regulatory process. We still will not know exactly what regulators decided and on what basis. Such secrecy, at this stage in our financial history, clearly prevents proper governance of our supervisory system.
8. There appears to be no mention that corporate governance within these large banks failed totally. How on earth can you expect these banks to operate in a responsible manner unless and until you address the reckless manner in which they (a) compensate themselves, (b) destroy shareholder value, (c) treat boards of directors as toothless wonders? The profound silence on this point from the administration – including some of our finest economic, financial, and legal thinkers – is breathtaking.

There’s of course more in these proposals, which I review elsewhere and Secretary Geithner’s appearances on Capitol Hill today may be informative – although only if his definition of the underlying “too big to fail” issue uses much stronger language than yesterday’s written proposals.

But based on what we see so far, there is little reason to be encouraged. The reform process appears to be have been captured at an early stage – by design the lobbyists were let into the executive branch’s working, so we don’t even get to have a transparent debate or to hear specious arguments about why we really need big banks.

Writing in the New York Times today, Joe Nocera sums up, “If Mr. Obama hopes to create a regulatory environment that stands for another six decades, he is going to have to do what Roosevelt did once upon a time. He is going to have to make some bankers mad.”

Good point – but Nocera is thinking about the wrong Roosevelt (FDR). In order to get to the point where you can reform like FDR, you first have to break the political power of the big banks, and that requires substantially reducing their economic power - the moment calls more for Teddy Roosevelt-type trustbusting, and it appears that is exactly what we will not get.

*By Simon Johnson*

# TARP for Regulators!

James Kwak | 19 Jun 2009

We've had TARP for banks, TARP for auto companies, and now, with the Obama Administration's plan for financial regulatory reform, we have TARP for regulators. After AIG, Citigroup, Bank of America, and General Motors, the administration has decided that all the existing regulators are Too Big to Fail – except for the Office of Thrift Supervision, which must play the role of poor Lehman Brothers in this saga. (Actually, they are more like Merrill Lynch, since they are getting merged into the new National Bank Supervisor, so most of them will probably keep their jobs.)

There is actually a serious issue here, and one with no obvious solution. One question that has gotten a lot of ink, both before and after the unveiling of the plan yesterday, has been the identity of the systemic risk regulator: new agency? council of agencies? the Fed? What this really shows is that it's easier for the media, the administration, and Congress to focus on the how the agency acronyms will be reshuffled, which is a bit like covering a sporting event, than on the underlying issues, like how to make those agencies more effective.

(Warning: I'm about to argue three sides of an issue.)

(1) So, for example, it's a little ridiculous that the Federal Reserve is being given the role of systemic risk regulator, since the Fed (under Greenspan, but with no dissent from Bernanke) completely missed the housing bubble, the risks of a massive derivatives market, and the systemic implications of toxic mortgages that it was actually supposed to be regulating – and, in fact, contributed to the financial crisis by keeping interest rates low for the first half of this decade, and then helped aggravate it by letting Lehman fail. Yes, I know, most economists didn't predict the crisis, either, but no one is nominating them for systemic risk regulator.

(2) But what's the alternative? You could posit a new regulatory agency focused on systemic risk; let's call it Bill. But you have no right to simply assert that Bill will do any better than the Fed. In fact, since Bill will start out with no building, no computers, and no staff, you could argue that the Fed, after being given an appropriate pep talk, would do better than Bill. It's likely that many of the people working for Bill would be people who used to work for the Fed. Planet Money had a story a while back (I think it's in this episode) about how when the Federal

Home Loan Bank Board was abolished in the wake of the savings and loan crisis, its employees just kept on working and eventually the sign on the building was changed to Office of Thrift Supervision.

So given those alternatives, it's easy for someone as smart as Larry Summers to argue that the Fed is a better choice than a new agency, or a committee, as he did on All Things Considered today. Basically he is positing an ideal Fed – one with the technical skills it has today (according to Summers) but not the huge blind spots it had in the past. I can posit an ideal Bill, but it won't be any better than his ideal Fed.

(3) The real issue behind this reshuffling of agencies and responsibilities is how you can get better regulators – people with the skills, motivation, and stomach to stand up to both banks and politicians who are screaming at them to get out of the way of progress and prosperity. And here I don't think the administration's plan gives us anything.

What could it have done? Here's one idea: it could have spun the regulatory agencies off into semi-independent bodies, so their heads aren't replaceable at will by political figures (as is currently true of the Fed); established a long prohibition (5 years?) on making any money from the financial sector after leaving the agency; and then doubled the salaries of every single regulator. (I know there are some transition issues you would have to deal with, like getting rid of a lot of the people who were asleep at the wheel.)

That would be a step toward increasing the status of regulators and reducing the threat of regulatory capture. I'm sure there are problems with these proposals, but at least they address the real problem.

**Update: Krugman:**

Tellingly, the administration's executive summary of its proposals highlights "compensation practices" as a key cause of the crisis, but then fails to say anything about addressing those practices. The long-form version says more, but what it says — "Federal regulators should issue standards and guidelines to better align executive compensation practices of financial firms with long-term shareholder value" — is a description of what should happen, rather than a plan to make it happen. . . .

In short, Mr. Obama has a clear vision of what went wrong, but aside from regulating shadow banking — no small thing, to be sure — his plan basically punts on the question of how to keep it

from happening all over again, pushing the hard decisions off to future regulators.

Ezra Klein:

The question with this package is not if it's well-suited to a world where regulators *want* to regulate. It's if it's well-suited to a world in which they don't. A world in which growth is quick and greed looks good. A world in which Wall Street seems to be helping Main Street buy, if not houses, then a surprising number of wind turbines. One of the lessons of the past few years is that regulation has to be impartial and disinterested because regulators, and even Fed chairman, get swept up in the cultural manias behind asset bubbles as surely as traders do.

*By James Kwak*

## TARP for Rating Agencies

James Kwak | 19 Jun 2009

I would have thought that the credit rating agencies would be at least one group that everyone could agree to throw under the bus. We know that the powerful chieftains of Wall Street are trying to pin the credit crisis on rating agencies – see page 3 of JPMorgan's blame-shifting attempt, for example. Yet the new Financial Regulatory Reform plan has almost nothing on the subject. Apparently the rating agencies, too, are Too Big to Fail.

Reuters catalogs the provisions relating to the rating agencies. Here's the summary:

The plan urges Moody's Corp's Moody's Investors Service, McGraw-Hill Cos Inc' Standard & Poor's and Fimalac SA's Fitch Ratings and others to bolster the integrity of their ratings, especially in structured finance.

It also calls for reduced conflicts of interest and for regulators worldwide to tighten oversight.

But the blueprint does nothing to address what critics call the industry's key shortcoming: That the biggest agencies are paid by issuers whose securities they rate, creating an incentive to win more business by assigning high ratings. . . .

"The overall impact of existing and proposed regulatory changes on rating agencies is extraordinarily easy to summarize: They reward abject failure," said Jonathan Macey, deputy dean of Yale Law School.

Also see the Huffington Post, which has this understated but damning criticism: "Today, the agencies welcome the government proposals, saying that they favored improved ratings quality and transparency."

Perhaps this is one area where Congress can improve on the administration's plan.

**Update: Krugman:**

The plan says very little of substance about reforming the rating agencies, whose willingness to give a seal of approval to dubious securities played an important role in creating the mess we're in.

*By James Kwak*

# Shadow Banking for Beginners

James Kwak | 20 Jun 2009

Last Friday, [Mark Thoma](#) wrote a guest post for [The Hearing](#) arguing that the “shadow banking system” was a significant contributor to the financial crisis and needed to be regulated. This prompted a series of posts either attacking or defending his position; for a rundown, see [today’s Hearing post](#).

For now, I just want to highlight the analysis by Mike at [Rortybomb](#) (hat tip [Mark Thoma](#)). (Those who have read [Gary Gorton’s new paper](#) can probably skip this post.) Mike points out that people mean at least three different things by “shadow banking system:”

- 1) Subprime lenders, who were not subject to the same regulatory burden as depository institutions.
- 2) A market that trades “informationally insensitive” debt as the result of the repo market and securitized debt as collateral. Where depositors are corporations and money market funds and where lenders are financial firms.
- 3) Traditional firms who took big bets in the investment markets while their regulators were not present or asleep at the wheel.

For Mike, #2 is the the one that matters. Here’s his explanation:

A bank is, in abstract, an institution that borrows short and lends long.

Your local bank borrows short deposits and lends long investments. If it needs liquidity it can always go to the central bank’s discount window. The central bank’s discount window is the market maker of last resort for this banking system. [Regulated banks can *always* borrow money from the Fed at a pre-set interest rate, so they always have access to cash.] This prevents bank runs. In exchange it is regulated by the government.

Your local shadow bank took in money in the repo market as deposits, and used senior tranches of debt as the collateral. Now what happens when it needs liquidity? *There is no market maker of last resort who the system as a whole could turn to.* Repeat that again. It exists in the shadows, there is nowhere to turn to for

emergency liquidity. There is no regulation/liquidity tradeoff here. This is what is meant by being unregulated – not that there weren't any government agents in sight.

I'll take that last paragraph a little slower. A repo, or repurchase agreement, is a transaction where one party (the "shadow bank") sells some securities to another party (the "depositor") in exchange for cash and simultaneously agrees to buy those securities back at a predetermined (higher) price at some date in the (near) future (like tomorrow). In effect, the depositor is lending cash to the shadow bank, and holding the securities as collateral; the difference in the two prices is the interest. It wants the collateral because nothing else is guaranteeing its loan to the shadow bank (as opposed to ordinary FDIC-insured deposits). The collateral is generally worth at least as much as the amount of the loan, to minimize the risk to the depositor; but the remaining risk is that the shadow bank won't make good on the repo and the collateral will fall in value.

Why would this happen? The depositors do it because they get higher interest rates than they can get in an ordinary deposit account at a commercial bank. Why would the shadow bank offer higher interest rates? It wants to attract the cash so it can lend it out at a yet higher interest rate ("lend" here could mean buying up subprime mortgages to package into securities that are then used as the collateral for more repurchase agreements to start the cycle again); it doesn't want to become a commercial bank because commercial banks were traditionally more highly regulated. For example, the major commercial banks were significantly less leveraged than the investment banks during the boom.

The problem that Mike highlights is that there was no liquidity backstop for the shadow banking system. So when the "depositors" got nervous about investment banks like Bear Stearns, they refused to roll over their repo agreements (that is, when the shadow bank closed a repo by buying back the securities, the depositor refused to lend new cash via a new repo), or they imposed a larger "haircut" – they lent less cash for the same amount of collateral. The result is a bank run – only this time the run is on the shadow bank. (Gorton focuses on a slightly different problem, which is that when the same collateral doesn't bring in as much cash, you have to shrink your balance sheet by dumping assets.)

Mike's analysis draws heavily on Gorton's paper, which is helpfully summarized by [Ezra Klein](#). The basic conclusion of both Mike and Gorton is that banking systems need to be reliable, the shadow banking

system is a banking system, and hence the shadow banking system must be regulated to some degree. Robert Lucas, quoted in Mike's post, puts it well:

The regulatory problem that needs to be solved is roughly this: The public needs a conveniently provided medium of exchange that is free of default risk or "bank runs." The best way to achieve this would be to have a competitive banking system with government-insured deposits.

But this can only work if the assets held by these banks are tightly regulated. If such an equilibrium could be reached, it would still be possible for an institution outside this regulated system to offer deposits that are only slightly more risky but that also pay a higher return than deposits at the regulated banks. Some consumers and firms will find this attractive and switch their deposits. But if everyone does, the regulations will no longer protect anyone. The regulatory structure designed in the 1930s seemed to solve this problem for 60 years, but something else will be needed for the next 60.

*By James Kwak*

## The McAllen Problem

James Kwak | 21 Jun 2009

What is the lesson of McAllen, Texas, the focus of Atul Gawande's celebrated [article](#) (discussed [here](#) and [here](#))? This is my attempt at an answer:

Currently, our health care system has high-cost and low-cost areas; the high-cost areas have no better outcomes than the low-cost areas. So theoretically we can solve our health care cost problem by making the high-cost areas behave like the low-cost areas.

However, the market incentives go in the other direction; the economically rational thing for providers (doctors, hospitals, etc.) to do is to run up procedures and thereby costs. It would be better if providers focused more on patient outcomes or organized themselves into accountable care organizations, as Gawande prefers; but there is no economic reason for them to do so. People are not magically going to become more altruistic overnight. Even shame has only a temporary effect on behavior. Here's Gail Wilensky from a [Health Affairs roundtable](#):

It's only by being able to offer compelling evidence that it's the physician that is the outlier relative to his or her peers, that the patients really aren't different, and in fact they are not having better outcomes, that you are able to pull back physician behavior — although *there seems to be a high recidivism rate*.

(Emphasis added.)

In some ways McAllen isn't the aberration; according to the old Chicago economics department, everywhere should be like McAllen.

Remember all the people who said that you can't blame mortgage brokers and investment bankers for being greedy, because that's how a capitalist economy works? Well, you could make the same defense for the McAllen doctors. We long ago stopped expecting lawyers and accountants to behave contrary to their economic interests; now we simply expect them to conform to the law and to certain professional codes of conduct, and otherwise make as much money as possible. Why should we expect anything different from doctors?

In a capitalist economy, the thing that is supposed to keep prices in check is the buyers. If someone offers me a product that costs more than

it is worth to me, then I won't buy it. But we can't count on patients to play this role in health care, because there is no way to make patients internalize all of the costs of their care; they simply don't have the money. Furthermore, most people don't understand the health production function (the relationship between treatments and outcomes), so they don't have the ability to select treatments that provide benefits that are worth their costs. (And, in many cases, it's not obvious even to professionals that a treatment isn't worth the cost; it's only obvious when you look at the data in aggregate.)

What about payers (health insurers?) A "market" solution would be to change the reimbursement rates for different procedures – increase payment for things that doctors should do more of and reduce payment for things that doctors should do less of. Theoretically, payers should be doing this already. However, in the current situation, a private payer who tried to reduce the rates for popular, expensive procedures would find itself unable to attract providers. The only payer with any real negotiating power is Medicare. The private payers have little ability to control costs. Or, if they have the ability, they aren't exercising it.

In short, prices will only go up. As a result, the cost of health insurance goes up, and the market finally kicks in in the crudest possible form: people who can't afford it become uninsured. At some point, if we have enough uninsured people, the health care industry will hit a point where it cannot increase revenues anymore, because it has fewer and fewer paying customers.

The proposed public health insurance plan would have the power to negotiate lower rates with providers. That's why some providers don't like it. That's also why private payers don't like it; they would be at a cost disadvantage to the public plan. (They can live with Medicare because Medicare leaves them the entire under-65 market.) Maybe that's unfair. But the current situation isn't working.

*By James Kwak*

# Efficient Markets and Innovation

James Kwak | 22 Jun 2009

Our little Internet debate about reverse convertibles (my contribution [here](#)) prompted [this post](#) by Mike at Rortybomb. To simplify a little, some commentators defended reverse convertibles by saying, “it’s basically the same as writing a put option” – or, looking at it from the other side of the trade, “there are valid reasons to want insurance against a stock price falling.” To which Mike says, “just sell (or buy) the put option.”

But this is just a specific case of an important point that Mike has [made before](#), but that is more clear when seen in the context of a specific security. Mike’s basic point is that efficient markets imply that financial innovation does *not* create value. The efficient markets hypothesis says that the prices of financial assets already reflect all available information; in other words, there is no such thing as a free lunch.

Here’s Mike’s example for those who may be unfamiliar with the idea:

Let’s look at regular markets: Let’s say that everyone knows that the energy market is a big deal over the next 10 years. You could buy land where oil is buried very deep and innovate digging techniques, you could start an innovative research firm to get better solar energy going, you could try and make an innovative super-carburetor. All of these, if you pull them off, are going to be very profitable and welfare enhancing. Markets work, so you’ll probably find capital and labor more willing to work with you.

Now what about financial markets. Let’s say that everyone knows that the energy market is going to be a big deal over the next 10 year. If you invest in energy stocks, are you going to make a killing? No. The prices of energy stocks have already been bid up to account for the fact that everyone knows this. The price of financial instruments moves to handle all possible information that is available. This is what it means for financial markets to be efficient.

If markets are efficient, the only way you can get higher expected returns is by taking on more risk. If some broker comes to you with a new product that offers higher returns with the same or lower risk – like a super-senior, “safer than AAA” tranche of a collateralized debt

obligation – then there are two possibilities: (a) the product exploits some market inefficiency; or (b) the product doesn't do what the broker says it does. Mike says that if you believe that markets are efficient, you also have to believe that (b) is more likely to be the case than (a). (The corollary is that financial innovation does create value when it exploits some market inefficiency.)

But wait, you may be thinking, didn't the crisis just prove that markets are not efficient? Well, yes and no. I've been reading Justin Fox's new book, The Myth of the Rational Market, which is basically an intellectual history of financial economics in the twentieth century, centered on the rise and fall of the efficient markets hypothesis. The strong form of the efficient markets hypothesis is that market prices, such as stock prices, accurately reflect fundamental values; in Eugene Fama's words, "the actions of the many competing participants should cause the actual price of a security to wander randomly about its intrinsic value" (Fox's book, p. 97). This proposition has not held up well recently – and has been on the defensive since at least the 1980s – unless you are willing to let prices wander very, very far from intrinsic values.

But there's another version of the efficient markets hypothesis that I happen to believe holds for many markets: in the short term, you cannot beat the market. For example, stock prices can be irrationally, crazily high – when I was at Ariba, our market valuation went up to \$40 billion, even though our annual revenues were less than \$300 million and we had never turned a profit – but you still have no way of knowing if they will go up or down in the short term. That's exactly what happens in a bubble; everyone knows that prices are no longer related to fundamentals, but enough people think they will be able to sell before the bubble bursts that prices keep on going up.

And if this is true for stocks, then it is even more true for derivatives linked to stocks, since the value of an equity-linked derivative is just a function of expectations about the price of the underlying stock. So coming back to reverse convertibles, if the basic purpose is to sell a naked put option on a stock, then you should go to the market and sell a naked put option instead of buying a reverse convertible, which has all sorts of complicated features. Here's how Mike puts it:

I believe the best price of a put option on a stock is going to the market and getting the price of a put option. I believe that the implied price of a put option, married with odd extra risks and transaction costs, in this reverse convertible bond instrument is a

worse price for the put option than the market one, because I believe the more markets vet prices the better they are. Nemo's point is absolutely correct – if they were much different, the market would be arbitraging them away.

So . . . if you think the stock price of Coca-Cola will be higher in 2019 than the market thinks, then it may make sense for you to buy it, since it's possible that the price is irrationally low at the moment. (Of course, it could be irrationally even lower in 2019.) But if you think you found a way to get a higher price for a one-year put option on Coca-Cola stock than just going to the market for one-year put options, you are probably wrong.

This brings us back to the main question: why do these things exist?

Some defenders of financial innovation say that because reverse convertibles exist, they must have value. This is the old "Chicago-school" assumption that even though individuals are irrational, markets behave as if people are perfectly rational. This assumption is at least plausible (though almost certainly wrong) when it comes to prices for heavily-traded stocks; there the argument is that a few well-capitalized, rational hedge fund managers are enough to counteract the irrational hordes. But the assumption completely breaks down when you are dealing with complex products that are sold by individual brokers to individual retail investors; it would be crazy for the retail investor in that situation to assume that the price must be fair, because otherwise the broker wouldn't be offering it. (Do you make the same assumption about a used car salesman?) Or, as Larry Summers wrote in a now-famous though unpublished paper, "THERE ARE IDIOTS. Look around" (Fox, p. 199).

Here's one answer, suggested by a friend of mine (who has been working in the financial sector for the last two decades):

I think given the existing array of financial instruments available, it is generally possible to construct a return profile of most things you can imagine, so it is hard to create something that has value over existing alternatives. [He gives a positive example, but it isn't reverse convertibles.] . . .

I think that people may buy these instruments because they are new. Outside the financial sector, "new" generally implies "better" or "improved". Computers, cars, phones, detergent, etc.

all get a marketing lift on new models, since in order to stay competitive in most of these industries, your products have to get better and better. In finance, almost everything is zero sum, so generally there is no better, just different packaging. So unless the packaging has some value (which in some cases it does), consumers are not getting a better product. But since it's "new", people might assume that they are getting something better.

That sounds about right to me.

(Note: In following Mike's links I found that Ezra Klein raised this question about financial innovation a couple months ago on his old blog; he now blogs [here](#).)

*By James Kwak*

## What Next For The Global Crisis?

Simon Johnson | 23 Jun 2009

*Slides for speech to World Bank conference (Lessons from East Asia and the Global Financial Crisis), Tuesday in Seoul (1pm local time), are attached. This post summarizes my main points.*

There are two views of the global financial crisis and – more importantly – of what comes next. The first is shared by almost all officials and underpins government thinking in the United States, the remainder of the G7, Western Europe, and beyond. The second is quite unofficial – no government official has yet been found anywhere near this position. Yet versions of this unofficial view have a great deal of support and may even be gaining traction over time as events unfold.

The official view is that a rare and unfortunate accident occurred in the fall of 2008. The heart of the world's financial system, in and around the United States, suddenly became unstable. Presumably this instability had a cause – and most official statements begin with “the crisis had many causes” – but this is less important than the need for immediate and overwhelming macroeconomic policy action.

The official strategy, for example as stated clearly by Larry Summers is to support the banking system with all the financial means at the disposal of the official sector. This includes large amounts of cash, courtesy of Federal Reserve credits; repeated attempts to remove “bad assets” in some form or other, and – the apparent masterstroke – regulatory forbearance, as signaled through the recent stress tests.

But most important, it includes a massive fiscal stimulus implying, when all is said and done, that debt/GDP in the United States will roughly double (from 41% of GDP initially, up towards 80% of GDP).

Not surprisingly, funneling unlimited and essentially unconditional resources into the financial sector has buoyed confidence in both that sector and at least temporarily helped shore up confidence in financial markets more broadly.

And now, in striking contrast to the dramatic action they call for on the macroeconomic/bailout front, the official consensus claims relatively small adjustments to our regulatory system will be enough to close the case – and presumably prevent further recurrence of problems on this scale. If the exact causes and presumed redress are lost in mind-numbingly long list of adjustments, so much the better.

This is, after all, a crisis of experts – they deregulated, they ran risk management at major financial firms, they opined at board meetings – and now they have fixed it.

Maybe.

The second view, of course, is rather more skeptical regarding whether we are really out of crisis in any meaningful sense. In this view, the underlying cause of the crisis is much simpler – the economic supersizing of finance in the United States and elsewhere, as manifest particularly in the rise of big banks to positions of extraordinary political and cultural power.

If the size, nature, and clout of finance is the problem, then the official view is nothing close to a solution. At best, pumping resources into the financial sector delays the day of reckoning and likely increases its costs. More likely, the Mother of All Bailouts is storing up serious problems for the near-term future.

We'll double our national debt (as a percent of GDP), and for what? To further entrench a rent-seeking set of firms that the government determined are "too big to fail," but will not now take any steps to break up or otherwise limit their size.

We need to disengage from a financial sector that has become unsustainably large (see slides before and after #19; the cross-country data should be handled with care).

We can do this in various ways; there is no need to be dogmatic about any potential approach – if it works politically, do it. But the various current proposals for dealing with this issue – both from the administration and the leading committees of Congress – would make essentially zero progress.

As moving in this direction does not seem imminent, the probable consequences or – if you prefer – collateral damage looks horrible. You can see it as higher taxes in the future, lower growth, a bigger drag on our innovative capacity, fewer startups, and less genuinely productive entrepreneurship. Plenty of people will be hurt, and they are starting to figure this out – and to think harder about what needs to be done and by whom.

"Small enough to fail" may well prevail eventually – at least sensible ideas have won through in past US episodes – but it will take a while. The official consensus always seems immutable, right up until the moment it changes completely and forever.

*By Simon Johnson*

## Modeling Everything, Public Plan Edition

James Kwak | 24 Jun 2009

Ezra Klein and Paul Krugman are both highlighting Nate Silver's analysis of campaign contributions and the public health plan option. The quick summary? Campaign contributions matter – in this case, by about nine senators. Mainly I'm impressed and encouraged that people can use publicly-available data to quickly whip together plausible models answering questions that otherwise we would all just pontificate about.

Coincidentally, I was getting my car inspected this morning and picked up an October 2008 copy of New York Magazine in the waiting room, which had an article about . . . Nate Silver. The article includes a picture of the presidential electoral map as Silver predicted on October 8, in which he called every state correctly except Missouri (which, remember, took a few weeks to figure out whom it had voted for). Most of the article is about how the empirical approach to baseball turns out to be useful in other areas, like politics and public policy.

**Update:** Mark Thoma points out this counterargument by Brendan Nyhan (who long ago wrote a blog with the brother of one of the best developers at my company). Nyhan says "studies have typically found minimal effects of campaign contributions on roll call votes in Congress," and cites a Journal of Economic Perspectives paper as backup.

OK, Nyhan may be right. But he may not be.

I looked at that paper. First, it cites a stack of papers that support Silver's view (that campaign contributions do influence policy). (Of course, it's common to cite the papers you are trying to refute.) Then it describes a logical argument against Silver's view ("Tullock's Puzzle"), which makes no sense to me, at least as summarized there. The argument is that campaign contributions are pitifully small given the amounts of money at stake, and so firms cannot possibly see contributions as an investment in policy. For example:

Dairy producers, who since 1996 have had to have subsidies renewed annually, gave \$1.3 million in 2000 and received price supports worth almost \$1 billion in the Farm Security and Rural Investment Act of 2002.

I don't see the puzzle; if I can get \$1 billion in subsidies by paying \$1.3 million, why would I pay any more? It seems to me that the explanation here has to do with special-interest politics; no other constituency is sufficiently mobilized to fight *against* dairy producers, so they get their subsidy. Here's the conceptual argument: "The figures above imply astronomically high rates of return on investments. In a normal market, with such high rates of return, existing donors should want to increase their contributions." But this assumes that the "investment return" on campaign contributions is a smooth, monotonic (always increasing) function, which seems fundamentally at odds with the way Congress works. But as I said, maybe Tullock did a better job explaining his puzzle.

Finally, they do a regression of "roll call" votes in Congress against campaign contributions and find little influence. But this analysis has serious limitations in the present context.

First, the dependent variable is the aggregate rating of each legislator by the U.S. Chamber of Commerce. (They got similar results using other organizations.) That is, it's an average of a large number of votes made in the course of a session on a large number of issues. So the finding is that corporate contributions only pull a legislator a couple of points toward the Chamber of Commerce's positions overall; but that doesn't mean that on a given issue, he might switch his vote because of one or two large campaign contributors from the affected industry.

Second, it ignores the complexities of the legislative process. On many key issues, there is no roll call. For example, whether the public plan even comes to a meaningful vote will depend on Harry Reid – who may not even want the public plan – and whether he thinks he has the votes. The power of some members of Congress goes well beyond their individual votes.

Third, the data are from 1978-1994. I'm not a student of American politics, but casually reading The New York Times indicates a few changes in politics since 1994: there is more money; there is more money that is not controlled by political parties (weakening bonds to party, which historically explained a lot of votes); and there is more money that gets spent directly on advertising and is not contributed to political campaigns. This last factor could cut either way, but I think it's fair to assume that if a company gave you \$50,000, they are probably also donating to soft-money groups that take the same positions.

So here we have: on the one hand, a quick-and-dirty model on *this specific question* by a guy without a Ph.D. in anything (I think), which correctly picks the positions of 87 out of 99 senators (but it's possible that the model would have done just as well without campaign contributions); on the other hand, a guy with a Ph.D. in political science and a research fellowship in health policy at a very good university, citing a paper by three MIT professors that's *more or less on the same general topic*, arguing that campaign contributions don't affect policy.

*By James Kwak*

## Goldman's Best Year Ever?

James Kwak | 24 Jun 2009

A reader pointed me to [this story](#) in The Guardian citing Goldman insiders saying this could be the investment bank's most profitable year ever.

Staff in London were briefed last week on the banking and securities company's prospects and told they could look forward to bumper bonuses if, as predicted, it completed its most profitable year ever. Figures next month detailing the firm's second-quarter earnings are expected to show a further jump in profits.

A couple months back I said that it would be unlikely for the banks to repeat their spectacular first-quarter results in the second quarter, because it depended on fixed-income revenues being even higher than during the peak of the boom. It looks like I was wrong.

Like most things, there are two ways to interpret this. For the optimists, if some of the big banks are making big profits, that gets us back to a normally functioning financial sector sooner and reduces the chance that they will face a panic in the short term. As many people have pointed out, including us, this is basically the Obama Administration's strategy.

For the pessimists, the phoenix-rising-from-the-ashes profitability of the big banks is a direct result of massive government aid in the form of cheap money, liquidity programs, and let's not forget the bailout of AIG; it's also the result of reduced competition resulting from the consolidation of Bear Stearns into JPMorgan, the failure of Lehman, and the weakened state of Citigroup and Bank of America/Merrill. So the government bought a partially healthy banking sector (the big question is what Citi and B of A will report) with public funds, the few winners (Goldman, JPMorgan) are more powerful than ever, and the government is hoping to get an anemic regulatory reform package through Congress in exchange.

*By James Kwak*

## It Takes A Citi

Simon Johnson | 25 Jun 2009

Washington-based policy tinkerers seem increasingly drawn to the idea that greater reliance on market information can forestall future problems – e.g., providing input into an early warning system that can be acted upon by a “macroprudential system regulator”. And while leading critics of the administration’s proposed approach to rating agencies make some good points, they also seem to think that the market tells us when big trouble is brewing.

The history of Citigroup’s credit default swap (CDS) spread is not so encouraging.

It’s true that in some instances during the past two years, CDS spreads have indicated pressure points, e.g., within types of lenders or across countries. And if you can tell me how Citi survives going forward with a CDS spread around 450 basis points, I would be grateful.

The people who price CDS obviously have every interest in assessing risk in a hard headed and accurate manner. But Greenspan’s Lament applies to CDS traders just as much as to incentives within mismanaged banks – where in the Citi CDS spread chart do you see the build up of risk through the end of 2006? If anything, the market for default probability was saying that Citi – and by implication the financial system with all its growing subprime vulnerabilities – was becoming less risky.

You can hope that, in the future, the market will not be so generally exuberant, but 400 years of modern financial history begs to differ.

The WSJ gets this right: regulatory capture is not only pervasive, it is by design. But what’s the implication?

All regulators must ultimately fail and, when that happens, markets may well also misprice risk. The question is: When this Twin Failure occurs next time, how much will be on the line?

You cannot design a financial system that is immune to crash – this would be like declaring earthquakes illegal. But in the aftermath of unexpectedly high damage from a serious earthquake, it makes sense to completely overhaul your building code and retrofit vulnerable buildings. In fact, if you largely ignored what the earthquake revealed in terms of structural weakness, wouldn’t that be negligence?

*By Simon Johnson*



## Conventional Wisdom About Credit Default Swaps

James Kwak | 25 Jun 2009

*I originally published this post over at [The Hearing on Monday](#), but it feels more like a [Baseline Scenario](#) kind of post.*

One part of the Obama Administration's [financial reform plan](#) is tighter regulation of credit default swaps – those previously unregulated derivatives that brought down AIG and nearly the entire financial sector with it. One of the problems with AIG was that its regulators were apparently unaware that it had amassed a huge, one-sided portfolio of credit default swaps that amounted to a massive bet the economy would do just fine; another problem was that, because credit default swaps were "over the counter," custom transactions between individual private parties, they created a large amount of counterparty risk – the risk that the party you were trading with might not be there to honor the trade.

In response, the [administration proposes](#) to "require clearing of all standardized OTC derivatives through regulated central counterparties (CCPs)." In addition, "regulated financial institutions should be encouraged to make greater use of regulated exchange-traded derivatives." Major players in the market will also be subject to conservative capital requirements (making sure they have enough money in case their trades go badly) and reporting requirements. These provisions aim to increase regulatory oversight and minimize the chances that a derivatives dealer will fail and take its counterparties down with it, and as far as they go they are a good thing.

However, there is one potential loophole that, according to UCLA law professor Lynn Stout (on Friday's [Morning Edition](#)), is "potentially big enough to put the state of Texas into." The loophole is that "customized bilateral OTC derivatives transactions" would remain out of the reach of both exchanges and CCPs.

Custom derivatives would still have to be reported to regulators, so what's the problem? The small problem is that unnecessary customization of financial products is a great way for derivatives dealers to jack up unnecessary transaction fees. The big problem is that custom derivatives are by their nature harder to oversee. Regulators want to be able to estimate a firm's potential exposure across all its transactions under various scenarios; the more complex those transactions, the more difficult this becomes. Regulators already had the power to demand access to banks' books before the financial crisis; the problem was that

they lacked the staff and skills to understand the complex structured products those banks were manufacturing and trading. As a result, custom products become a way for market participants to hide risks from oversight, and a potential means for systemic risks to build up out of sight.

The conventional wisdom is that some firms have unique needs and therefore there have to be customized derivatives contracts. But the real question to ask is why we need customized derivatives in the first place. For example, you can only buy U.S. Treasury bills and bonds that mature on specific dates, and in specific denominations (although perhaps there are banks that will custom-manufacture a Treasury-like security for you, and charge you a transaction fee – while throwing in counterparty risk for good measure). What's wrong with a world where you can buy a credit default swap on any fixed-income instrument, but only for certain maturities (including the maturity of the underlying instrument) and on standard terms (such as the definition of a credit event and how the swap will be settled)?

I know the high-level answer (in fact, I already said it): firms have unique hedging needs. But I want to hear some good examples. On that same Morning Edition segment, Cory Strupp, a lobbyist at the Securities Industry and Financial Markets Association, gave this example: "If you have a company that wants to hedge a credit exposure in an odd amount of money – \$156,217.25 – they can enter into a credit default swap that covers exactly that amount of credit risk, to the penny." This is a terrible example, because if I'm a company of any size, and I have a credit exposure of \$156,217.25 but I can only buy credit default swaps in multiples of \$10,000, that's perfectly fine with me. Strupp must know it's a terrible example, but must have decided the better examples were too complicated for NPR.

And once we know what the good examples are – and I imagine there are some – the question is whether the benefits they provide to the parties involved outweigh their costs. And by costs, I don't mean just the transaction costs; I mean the fact that customized derivatives make regulation harder and increase the risks of a costly failure. This is an externality, pure and simple, and it should be deterred or taxed.

(I'm guessing someone will point out that the Constitution limits the ability of the government to interfere in the freedom of contract. But remember, this is a regulated industry. Custom derivatives increase the cost of regulation; it would be perfectly constitutional to say that firms

that trade in custom derivatives must pay a hefty tax on those products to offset the increased regulatory cost. If the tax is big enough, that would deter banks from using custom derivatives when standardized ones would do.)

There's actually an interesting point behind this question. Someone – I think it was [Felix Salmon](#), but now I'm not so sure – said that the real problem wasn't that firms weren't perfectly hedged; it's that they believed they could be perfectly hedged. Risk never goes away; if you think you've eliminated it, it's just gone someplace else to hide. Instead of a system where companies think they can hedge their risks perfectly because financial products are infinitely flexible – and therefore don't manage their risks effectively – it would be better to have a system where companies can't hedge their risks perfectly, and know that, and behave accordingly.

*By James Kwak*

# Hedge Funds Make A Political Mistake

Simon Johnson | 26 Jun 2009

The political flavor of the month is to push back against even the Obama administration's mildly reformist inclinations on finance (e.g., Peter Weinberg [in today's FT](#) is a nice example). And, of course, once you hire a lobbyist, he or she tells you that "winning" means stirring up Congress in favor of the status quo. Measured in these terms, the hedge fund industry has had a string of notable [recent victories](#) effectively preventing tighter regulation.

Advocates have a point, of course, when they argue that [big banks rather than hedge funds](#) were primarily responsible for crisis. But this misses where we are in the long-cycle of regulation/deregulation. Look at [this picture](#) (source: [WSJ](#); more on [Ariell Reshef's webpage](#)).

If we're at the top of the long deregulation wave and likely headed for tighter control of the financial sector – if not this year, then soon – where do you want to be in the political equation?

You can resist change, but this is just asking for trouble. You know that individual (lightly regulated) funds – whether or not these are officially "hedge funds" is irrelevant - will have high profile trouble. The latest alleged [tunneling](#) details in [the case of Danny Pang](#) are a precursor to broader social fascination with this phenomenon – you know that a dozen screenwriters are already at work. Sooner or later, there will be a more focused backlash against specific practices revealed or implied in this kind of case.

At the same time, the broader Treasury attempt to respond with only milder controls over big banks will likely also run into trouble (see [my latest Economix column](#)), so more social pressure will appear from that direction also. Big banks repeatedly get into serious scrapes, but their political clout consistently allows them to deflect attention onto others. The idea that big banks and hedge funds have some natural congruence of political interests in this space is simply wrong.

In fact, if hedge funds dig in too deeply with "the crisis was not our fault" position, that is just asking for trouble – and to be scapegoated – down the road. It would be much smarter to get out ahead of the political dynamic, and to propose ways to measure, control, and regulate risk.

Voluntarily keeping hedge funds "small enough to fail," without endangering the system, would also make sense – particularly if

accompanied by a complementary political strategy that emphasizes that it is big banks that have done almost all the damage.

*By Simon Johnson*

## Questions about Doctors

James Kwak | 26 Jun 2009

Greg Mankiw posts data showing that doctors in the U.S. make much more than doctors elsewhere. From a 1999 paper by Uwe Reinhardt, among others:

As a dollar amount, U.S. per capita spending for physician services was the highest in the OECD in 1999: \$988, compared with an OECD median of \$342. . . .

In 1996, the most recent year for which data are available for multiple countries, the average U.S. physician income was \$199,000. The comparable OECD median physician income was \$70,324.\* The ratio of the average income of U.S. physicians to average employee compensation for the United States as a whole was about 5.5. Germany's was the next highest, at only 3.4; Canada, 3.2; Australia, 2.2; Switzerland, 2.1; France, 1.9; Sweden, 1.5; and the United Kingdom, 1.4.

Mankiw posts three discussion questions. I'm just going to take a stab at the second one:

**On the issue of doctor training:** Suppose that in country A physicians get free training through a taxpayer-financed educational system, while in country B physicians finance their own education and then, once trained, are paid higher fees. (a) If country A classifies these training expenses as education rather than healthcare spending, which country would report higher healthcare costs? (b) Is that difference in healthcare costs real or an artifact of labeling? (c) In which country would doctors, once trained, have more incentive to work long hours? (d) In which country would there be more doctors? (e) Which country's system, in your judgment, is more efficient and equitable?

(a)-(b) I get Mankiw's rhetorical point. And I guess it makes sense to count educational costs as part of the production costs of healthcare. But  $\$199,000 - \$70,000 = \$119,000$ . (Updated – I made a subtraction mistake the first time.) So the higher med-school costs people pay in the U.S. get made up in two years out of a career of 30-40 years.

(c) The short answer is that physicians would have more incentive in country B (the U.S.), because the marginal return on labor is higher. But do we want doctors working longer hours? Medicine is not like, say, baking bread – the more hours you put in, the more good stuff you end up with. We are already the country with the highest hourly wages, and one of our major problems is not lack of doctoring capacity, at least not in aggregate; on the contrary, we have the problem of overutilization of many types of services (the expensive ones). Put another way, because we have higher wages for expensive procedures, we have doctors working longer hours doing those procedures by prescribing more of those procedures than are medically appropriate. Because we overcompensate for some services and undercompensate for others (relative to each other), we have too few of some kinds of doctors (family practice, for example) – but that is a product of the way we pay for healthcare, not the way we produce doctors.

(d) You should get more doctors in whichever country gives you the higher aggregate returns to being a doctor. Right now that's the U.S. But the key point here is not the financing of medical school; it's the constraint on the number of doctors enforced by the American Medical Association. That's why, as Mankiw points out, we actually have fewer doctors per capita than the average OECD country.

(e) I'll leave that as an exercise for you.

\* Yes, it says "average" for the U.S. and "median" for the OECD. I can't tell from the original paper if that is accurate or not. The rest of the paragraph says it is dealing with averages. In any case, I think it's fair to assume that the median U.S. doctor made well over \$70,324 in 1996.

# The Danger of Discretion

James Kwak | 27 Jun 2009

Justin Fox says that financial regulation should be simpler and should give less discretion to regulators.

The argument goes like this: the biggest flaw in current financial regulation is not that there is too little of it or too much, but that it relies on regulators knowing best. We regulate because financial systems are fragile, prone to booms and busts that can have harmful effects on the real economy. But regulators aren't immune to the boom-bust cycle. They have an understandable habit of easing up when times are good and cracking down when they're not.

As I've said before, the Obama Administration's plan is likely to give us more sophisticated regulation, but if it doesn't give us more powerful regulators with more incentive to stand up to the industry, all the sophistication in the world won't matter. Regulators didn't use the tools they had – the Fed could have policed risky mortgages (and raised interest rates), the bank regulators could have insisted on higher capital requirements, etc. – because they lacked the motivation to use them in the face of overwhelming opposition from the banking industry and, probably, the power to resist Congress and the administration, whichever party controlled them.

As Ezra Klein puts it: "When evaluating a particular financial regulation proposal, ask yourself this question: Would these regulations have worked if Alan Greenspan hadn't wanted to implement them?" That's a good question, although it's a bit unfair: if you posit a regulator who doesn't believe in regulation, then virtually any regulatory scheme is bound to fail. This is why Fox and Klein argue for ironclad rules that don't leave room for discretion. In addition, though, I think we also need to think about how to make sure we get regulators who are not cheerleaders for or captives of the financial services industry.

*By James Kwak*

# The Paradox of Strategic Defaults

James Kwak | 29 Jun 2009

[Real Time Economics](#) and [Calculated Risk](#) both discuss new research by Paola Sapienza, Luigi Zingales, and Luigi Guiso on homeowners defaulting on mortgages even though they have the money to pay them. According to their research, 17% of households would default when their negative equity reaches 50% of the house's value. The argument is that public policy has not sufficiently addressed this problem, focusing instead on homeowners who cannot afford their mortgages.

Let's make this a little more concrete. Let's say you bought a house with zero money down for \$300,000 in early 2006. A few years later, the house is now worth \$200,000, so your negative equity is 50% of the market value. Yet only 17% of people in your situation would walk away from the house. The other 83% would continue to pay the mortgage, essentially throwing money away. Apparently people value the transaction costs of moving and the damage to their credit ratings at \$100,000 (I think my numbers are approximately on the right scale – if anything they are probably low) – even after the fact that you can live in a house for free for several months before being evicted.

Or people are not as rational as economists would assume.

*By James Kwak*

## Debating the Public Plan

James Kwak | 29 Jun 2009

Greg Mankiw weighs in directly (as opposed to beating around the bush) on the public plan. Here's the summary:

Recall a basic lesson of economics: A market participant with a dominant position can influence prices in a way that a small, competitive player cannot. . . .

If the government has a dominant role in buying the services of doctors and other health care providers, it can force prices down. Once the government is virtually the only game in town, health care providers will have little choice but to take whatever they can get. . . .

To be sure, squeezing suppliers would have unpleasant side effects. Over time, society would end up with fewer doctors and other health care workers. The reduced quantity of services would somehow need to be rationed among competing demands. Such rationing is unlikely to work well. . . .

A competitive system of private insurers, lightly regulated to ensure that the market works well, would offer Americans the best health care at the best prices.

Whenever someone uses the phrase "basic lesson of economics" when discussing the U.S. health care system, you should be suspicious. As Paul Krugman says, "the standard competitive market model just doesn't work for health care: adverse selection and moral hazard are so central to the enterprise that nobody, nobody expects free-market principles to be enough."

I earlier tried to make this point in more detail: "lightly regulated" private health insurance is a fantasy, because the whole point of a for-profit insurer is to charge premiums that expect the expected payout under the policy; as a result, no sick person would be able to afford insurance. You don't need adverse selection or moral hazard to explain this: if I know someone has an expensive form of cancer, I'm going to charge him \$100,000 for health insurance, and he won't be able to pay. The free market for health care is one in which sick people die, and smart people who ignore that point are being less than honest. (Or maybe they

are hiding behind the phrase “lightly regulated” – if they consider the prohibition of medical underwriting “light regulation.”)

And if dominant market participants are the problem, then we already have that problem. Check out page 6 of [this report](#) (hat tip [Krugman](#)). In the *median* state in the U.S., the top two insurers have a combined market share of 69%.

Finally, it’s clear that the current system isn’t working – we have both 50 million uninsured people (plus many millions more who are not sufficiently insured against a major medical problem), and we have rising health care costs that will destroy the federal budget over the next several decades. So when Mankiw says we need “a competitive system of private insurers, lightly regulated to ensure that the market works well,” what is he saying? That we need less regulation than we have now? Or is he just talking about abstract principles?

**Update:** Once again, you may be better off reading [Brad DeLong’s response](#) to Mankiw.

*By James Kwak*

## No Way Out: Treasury And The Price Of TARP Warrants

Simon Johnson | 29 Jun 2009

Buried in the late wire news on Friday – and therefore barely registering in the newspapers over the weekend – Treasury announced the rules for pricing its option to buy shares in banks that participated in TARP.

The Treasury Department said the banks will make the first offer for the warrants. Treasury will then decide to sell at that price or make a counteroffer. If the government and a bank cannot agree on a fair price for the warrants, the two sides will have the right to use private appraisers.

This is a mistake.

The only sensible way to dispose of these options is for Treasury to set a floor price, and then hold an auction that permits anyone to buy any part – e.g., people could submit sealed bids and the highest price wins.

In Treasury's scheme, there is significant risk of implicit gift exchange with banks - good jobs/political support/other favors down the road – or even explicit corruption. For sure, there will be accusations that someone at Treasury was too close to this or that bidder. Why would Treasury's leadership want to be involved in price setting in this fashion?

Treasury apparently sees corruption as an issue about personalities (i.e., WE aren't ever corrupt) rather than about institutional structure. For example, if you create an arrangement that easily permits corruption, such as through nontransparent decision making or negotiation around warrant pricing, you set up incentives to be corrupt. Either existing people change their behavior, or new people will seek appointment in order to participate in corruption.

This is also a point, by the way, that Treasury has been making for years through its representatives at the International Monetary Fund – including during the Clinton Administration, when the same people were running U.S. economic policy as now. It's a good point and never easy for countries-with-potential-corruption to hear. It applies as much to the United States as to anywhere else.

Treasury will argue the disposal of warrants is a one-off event, but this is not a plausible line: it is part of a much longer series of nontransparent

decisions over finance. The attitude that “we can be nontransparent because we will never be corrupt” creates reputational risk for both Treasury and participating banks. If extraordinary support for the financial sector lasts several years, we will likely have at least one time-consuming and damaging investigation into all the details of these settlements.

In any crisis, technical mistakes are made due to high pressure, lack of information, and political considerations; this is unavoidable. But this proposed pricing for TARP warrants looks like a pure unforced error, and should be quietly overridden by the White House – hopefully, senior congressional leaders will quickly make this point behind the scenes.

There is obviously unappealing midterm election risk in this pricing scheme and making a correction now – before major banks have participated – would be relatively straightforward.

(Primer on option pricing, applied to warrants; background on how we got here)

*By Simon Johnson*

## The Cost of Life

James Kwak | 30 Jun 2009

Mark Thoma links to a medical paper that brings up the issue that few people want to talk about: at what point is the cost of medical care to extend life not justified? Like Thoma, I don't have a great answer, except to point out that in a world of scarce resources, the answer cannot be that any effort to extend life by any small amount is always a good idea. (And as David Leonhardt explained, our health care system is certainly constrained by scarce resources, whether we like it or not.)

I just have one observation and one recommendation.

The observation is that our political and legal systems already put price tags on life routinely. If you die on the job, the workers' compensation system calculates how much your life was worth; if you are killed as a result of someone else's negligence, the tort system does the same. In either case, the calculation is primarily based on your expected earnings for the rest of the life; in other words, young high-earners are worth more than old poor people. And for virtually everyone, the number you end up with is much less than the value implied by the cancer treatment discussed in the paper Thoma cites.

I'm no fan of that system. I'm just surprised that as a society we can be so brutal and inegalitarian in one sphere and so touchy in another (health care, where the thought that any life-extending treatment might be too expensive is probably considered morally abhorrent by most people).

The recommendation is that if you are interested in this issue, you should listen to Dr. Robert Martensen on Fresh Air. Martensen is not only a doctor and a bioethicist, but at the time of the interview I believe (my memory might be failing me) he was dealing with the imminent death of one of his parents, and the medical choices involved.

*By James Kwak*

## Benefits of Size?

James Kwak | 30 Jun 2009

Felix Salmon points out that Bank of America can now charge customers overdraft fees ten times a day (up from five). (Read the original Washington Post article if you want to be aggravated.) Well, I can do one better.

I recently had to track down some past bank records. Local banks? No problem, no fee. At Bank of America, however, they insisted on charging me \$5 per page – *even though they were breaking a state law forbidding them from charging a fee*. (All I'll say is that they weren't allowed to charge a fee because of the characteristics of the person I was getting the records for and the purpose for which he needed the records.) I pointed out to the drone at the bank that she was breaking the law, but she insisted she couldn't do anything about it and we would have to sue them to get the money back. And I believe her; the problem is almost certainly that requests go from the local branch to some central processing center, and there is no way for the local branch to tell the central processing center not to deduct the fee from your account.

Now perhaps this central processing center setup reduces costs for Bank of America. But do they charge lower mortgage rates? No. Do they offer higher savings rates? No. Are they too big to fail? Absolutely. Do things have to be this way?

**Update:** Some people have pointed out that you don't actually have to sue B of A to get your money back. That is correct. In my state you can send them a demand letter and they should pay you. However, the problem is that because you are dealing with *your bank*, they can just deduct the money from your account and force you to fight them to get it back. And most people don't want to deal with that.

*By James Kwak*

## The Two Sides of the Balance Sheet

James Kwak | 30 Jun 2009

Noam Scheiber at The New Republic has [the inside scoop](#) (hat tip [Ezra Klein](#)) on why Treasury is letting the Public-Private Investment Program die a quiet death (although at this point the legacy securities component may still go ahead). In short, the argument is that the point of PPIP was to help banks raise capital by cleaning up their balance sheets; since they have been able to raise capital themselves, there is no need for PPIP. According to one person Scheiber spoke to: "If you had asked—I don't want to speak for the secretary—what's problem number one? I think he'd say capital. Problem two? Capital. Problem three? Capital."

This represents the latest swing of the pendulum between the two sides of the balance sheet. As anyone still reading about the financial crisis is probably aware, a balance sheet has two sides. On the left there are assets; on the right there are liabilities and equity; equity = assets minus liabilities. (There are different definitions of capital, depending on what subset of equity you use.)

The goal has always been to provide confidence that there is enough capital to withstand the impact of market and economic turmoil – in particular, its impact on the toxic assets that litter banks' balance sheets. However, there are two alternative approaches to doing this. One is to add more equity to the right side by issuing new stock (preferred or common). (This would add cash to the left side to keep them in balance.) The other is to reduce the uncertainty of the left (asset) side by helping banks sell toxic assets; even if the banks have to sell them for a little less cash than their current balance sheet value, this would have the salutary effect of reducing vulnerability, since cash does not lose value (at least not in an accounting sense). Alternatively, you could achieve the same effect by insuring the value of the assets while leaving them on bank balance sheets, because then the risk transfers to the insurer.

The initial Paulson Plan last September focused on the left side; the idea was to buy toxic assets off of bank balance sheets. Then in October Treasury did an about-face and switched to the right side, recapitalizing banks by buying preferred stock from them (TARP). In November and January, Treasury and the Fed did combined bailouts of Citigroup and Bank of America, in which they both provided fresh capital and guaranteed certain assets against falls in value. In February and March, Treasury shifted all the way over to the left (asset) side with the PPIP,

which was hailed (by its supporters, at least) as a way to cleanse bank balance sheets – something that had not been accomplished by TARP. Now, it seems, we are back to the right side; as long as banks can raise more capital, everything is fine, no matter how many toxic assets they may hold.

One key to the financial crisis has been nervousness about toxic assets on bank balance sheets. It's nice that people aren't so nervous anymore. But as Raghuram Rajan said to Klein, "if we reenter the downturn, and the banks begin to look shakier – we'll wish we had moved the assets when the market was calm and stable, rather than leaving them to create uncertainty and volatility at the center of the banking system."

*By James Kwak*

# Statistics and Basketball for Beginners

James Kwak | 01 Jul 2009

I think that the general difficulty that many people have in understanding statistics is an important problem, because it leads people to misinterpret the world around them. General managers of baseball teams overpay for free agents coming off of good years because they underestimate the chances that the recent good year was just the result of variance around a mediocre mean – or at least they did until the Billy Beane era. Retail investors plow money into expensive mutual funds that have beaten the S&P 500 index for a few years in a row because they underestimate the chances that recent success is the result of pure, dumb luck; more importantly, the scandal of mutual fund expenses goes unchallenged because of the conventional wisdom that you should pay more to get into “better” funds. (I think it is possible, though unlikely, that some fund managers could actually be better than the market; but with all the statistical noise, you are not going to find them unless you look at a very long period of time.)

So I was happy to learn that my second-favorite radio show, Radiolab, was doing an episode on randomness. (You can stream it at that link, or download an MP3 from their podcast.) Their first segment does a good, clear job of debunking the human tendency to make too much of seemingly improbable events. For example, a woman in New Jersey wins the lottery in two consecutive years; what are the chances? But if you look at all the lotteries and all the lottery winners everywhere, it would be shocking if you didn’t have repeat winners.

Here’s an even simpler example from the show. Imagine blades of grass are sentient. There are millions of blades of grass in a fairway. Someone hits a drive and the golf ball crushes a single blade of grass. From the perspective of that blade, it’s a cruel freak of chance. But from the perspective of the fairway as a whole, it’s a near-certainty that some blade of grass will be crushed.\*

But in the second segment, they take up that favorite example of statisticians everywhere: There are no streak shooters in basketball! (And if you think there are, you are just a weak creature of habit and prejudice who refuses to accept the pure truth of numbers.)

The story goes like this. Basketball players, announcers, and fans all believe that in certain games, or at certain times in a game, a player may become “hot” – he can’t miss, he’s on fire, he’s in the zone, etc. At that

point, that player is shooting especially well, so his team should get him the ball. Well, say the statisticians, if you actually look at shooting percentages, you'll see that his shooting percentage after making three consecutive shots is the same as it always is. In other words, if a player's shooting percentage is 50%, and he hits five consecutive shots, that's just random variation – there's a 1/32 chance of that happening for any given sequence of five shots – so there's no particular reason to think he'll make the next one. Case closed.

This story has become such an article of faith in the “statistics are right/intuition is wrong” camp that it bears a little examination.

It dates back to a 1985 paper called [The Hot Hand in Basketball: On the Misperception of Random Sequences](#), by Thomas Gilovich, Robert Vallone, and Amos Tversky. (It hasn't hurt that Tversky was one of the modern founders of behavioral economics and almost certainly would have won the Nobel Prize with Daniel Kahneman had he not died in 1996 at the age of 59.) They define the “hot hand” hypothesis as “the belief that the performance of a player during a particular period is significantly better than expected on the basis of the player's overall record” (pp. 295-96) and conclude that this belief reflects “the operation of a powerful and widely shared cognitive illusion.”

However, they actually prove something more modest: that the chances of a given player making a given field goal attempt are not related to the success or failure of his immediately preceding attempt or attempts (see Table 1, p. 299, and Table 2, p. 302). I can raise some quibbles here, like the fact that they don't look at how much time passes between those shot attempts; if you hit two shots in the second quarter and then miss one in the fourth quarter, that's the same to them as if you shoot on three consecutive possessions. (I believe some of their analyses even span separate games.) Remember, the median starter – say, your power forward or center on most teams – only takes about ten shots over the course of two hours. But the big issue is one they acknowledge: “The failure to detect evidence of streak shooting might also be attributed to the selection of shots by individual players and the defensive strategy of opposing teams” (p. 303). If someone is actually shooting better than usual, the other team will guard him more tightly, and he will also (rationally) choose to take slightly more difficult shots, both of which will push his actual field goal percentage down to his long-term average or even below it.

The authors deal with this objection in a clever way. They conducted an experiment with Cornell players, each of whom took 100 shots in succession from a variety of spots at a fixed distance from the basket. Then they analyzed those sequences of shots to look for correlations between one shot and the next, and also found that the results were remarkably similar to random sequences. However, it only takes about 10 minutes to take 100 shots (I assume someone was keeping the shooters fed with balls to make the experiment go more smoothly), so arguably those 100 shots are just one snapshot of a person's shooting performance at one point in time. (Remember, it can easily take an NBA player in the rotation three weeks to take 100 game shots.)

So I will buy the conclusion that data about recent field goal attempts cannot be used to predict the outcome of the next field goal attempt. This is an analog to the efficient market hypothesis – you cannot predict which way an asset price will go based on its recent price movements. But I don't think this proves that basketball players don't shoot better in some periods and in some games than in others. The authors' statement about the "performance" of a player is only necessarily true if we define performance narrowly to mean the likelihood of making his next field goal attempt, not if we define it to mean his shooting ability at that time.

Why do I cling to this difference, when I'm willing to believe that no one has the ability to beat the stock market? When it comes to stock prices, there is a very persuasive theory of *why* you can't beat the market consistently; beating the market requires information, and if you have the information, then the people you are trading with already have that information, too. When it comes to basketball, it strains belief to think that your ability to shoot the ball is a constant, day after day, play after play, all the time. For one thing, sometimes you are tired, or sick (and few of us can replicate Michael Jordan's "flu game"), or injured, or distracted; the idea that this wouldn't affect your shooting seems preposterous. If your actual field goal attempts end up looking like random patterns, then I think that's more likely a result of the complex and un-modelable way in which you, your team, and the other team adapt to each other.

\* However, they did make one of those frustrating mistakes that leave you powerless in the car, helpless to stop the radio from saying things that are *just not true*. In the story, Jad and Robert flip a coin 100 times, and come up with a streak of 7 tails in a row. The chance of 7 tails in 7 flips is  $1/128$ . The chances of getting a streak of 7 tails within a series of 100 flips is obviously much higher. But in the show they say that because

$100/7$  is about 14, there are 14 sets of 7 flips that you have to look at, and they calculate that the chance of getting a streak of 7 tails within a series of 100 flips is about  $1/6$ .

This is just wrong; a series of 100 flips has not 14, but 94 different sets of 7 flips within it, so the chances of getting 7 consecutive tails are much higher than  $1/6$ . Those 94 sets are not all independent, however, so it's not as simple as calculating  $1 - ((1 - 1/128) ^ 94)$ . I used the brute force method and simulated 100 trials of 100 flips, and 31 of those trials had a streak of 7 tails. But 7 heads are just as remarkable as 7 tails, so you have to count those streaks, too; there were 36 of them. In total, 53 trials had a streak of 7 tails or a streak of 7 heads – meaning that such a streak is completely unremarkable.

*By James Kwak*



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