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The Nature of Modern Finance

Simon Johnson | 01 Sep 2009

Is modern finance more like electricity or junk food? This is, of course, the big question of the day.

If most of finance as currently organized is a form of electricity, then we obviously cannot run our globalized economy without it. We may worry about adverse consequences and potential network disruptions from operating this technology, but this is the cost of living in the modern world.

On the other hand, there is growing evidence that the vast majority of what happens in and around modern financial markets is much more like junk food – little nutritional value, bad for your health, and a hard habit to kick.

The issue is not finance per se, i.e., the process of intermediation between savings and investment. This we obviously need to some degree. But do we need a financial sector that now accounts 7 or 8 percent of GDP? (For numbers over time, see slide 19 in my June presentation.)

As far as we know, finance was about 1 or at most 2 percent of GDP during the heyday of American economic innovation and expansion – say from 1850. The financial system of the nineteenth century worked well, in terms of mobilizing capital for new enterprises.

Those banks had much higher capital-asset ratios than we have today. Even the dominant players were smaller in absolute terms and relative to the economy – JP Morgan, at his peak, employed less than 100 people.

No one is suggesting we go back to the nineteenth century (although abolishing our central bank would certainly have undesirable consequences in that direction). But is it really healthy – or even sustainable – to have a finance sector as large as what we face today? (It is surely not a good idea for finance to account for 40 percent of total corporate profits, see slide 16 – such performance, in an intermediate input sector, suggests someone else in the economy is being severely squeezed.)

There is a great deal of research that finds finance is positively correlated with growth, but this work has a couple of serious limitations – if you want to derive any robust implications for policy.

First, it is about the amount of financial aggregates (e.g., money or credit, relative to GDP) rather than the share of financial sector GDP in total GDP. I know of no evidence that says you are better off with a financial sector at 8% rather than, say, 4% of GDP.

Second, the research shows correlations not causation. So all we really know is that richer countries have more financial flows relative to GDP, not that more finance raises GDP in any linear fashion. Attempts to dig into causation tend to show that financial development is not the bonanza that it is cracked up to be.

Third, we know finance can become “too big” relative to an economy. Ask Iceland.

The work in this area is still at any early stage. Given what we’ve seen over the past 12 months, which way should we lean: towards believing in the positive power of finance, until the opposite is proven; or towards being skeptical of finance in its modern form, until we see evidence that this actually makes sense?

Surely out skepticism should extend to financial innovation. Show me the evidence that this kind of innovation really adds value, socially speaking – rather than providing a very modern way to extract amazing “rents”.

By Simon Johnson

Address of this post: <http://baselinescenario.com/2009/09/01/the-nature-of-modern-finance/> (an experiment to help Kindle readers access the comments section more easily)

“Paying for” Health Care Reform

James Kwak | 01 Sep 2009

This week’s Washington Post health care column is on the question of whether we can afford health care reform – meaning whether we can afford to subsidize poor and middle-class people who cannot otherwise pay for health insurance. This has a different meaning depending on you interpret “we” as the U.S. economy in general or the federal government, but in either case we think the answer is “yes.” Or at least, as far as the federal government is concerned, the answer is that we can’t afford not doing some form of health care reform, although it’s not certain that the reforms currently on the table will be sufficient to solve our government’s long-term fiscal problems.

In summary:

“If you are for fiscal discipline, you should be for health-care reform. If our government cannot produce some kind of reform, that will only reinforce the perception that our political system is incapable of resolving our largest, most difficult problem — and that is what will make investors think twice about investing in America.”

By James Kwak

The March of Science and Health Care Reform

James Kwak | 02 Sep 2009

On a Planet Money podcast two weeks ago, economist Charlie Wheelan weighed in on the significance of genetic testing – the advancing ability of science to determine your genetic makeup, including your propensity to develop various serious or costly illnesses. This really crystallizes one dimension of the health care debate.

If insurers know what your projected long-term health care costs are, because they can read your genetic code, then they are going to price accordingly – and *that's exactly what insurers should do* in an unregulated market. This produces the dystopian world where not only are some people unlucky because their genes make them more likely to suffer in various ways, but on top of that they can't get health insurance and therefore health care.

The first-order solution is obvious, and it's a part of every health care reform proposal: prohibit insurers from engaging in medical underwriting. As is also generally understood, this means that insurers will have to overcharge healthy people, which creates an adverse selection slippery slope – especially when healthy people have scientific evidence that they are, in fact, healthy – that ends when insurance is very expensive, and only rich sick people have it – that is, today's individual market. So it has to be accompanied by a mandate, to force healthy people to buy insurance and thereby subsidize the sick.

Wheelan points out that there's a second-order problem, which is that if insurers have to charge everyone the same price, they will compete by marketing to the healthy and trying to hide from the sick. The insurance exchange(s) should limit this problem, but may not be able to eliminate it, since people will have choice on the exchange, and are free to choose the plan that successfully markets itself as the plan for healthy people. Eventually you get to a point where insurers cannot compete on price, and they cannot compete on risk selection, and they start to look a lot like regulated utilities. That's not terrible – they can still compete on cost – but it's what happens when you harness the private sector to do something that is essentially redistribution.

In any case, the other lesson is that widespread genetic testing will only make the unfairness of unrestrained competition in the health insurance sector even more glaringly obvious, since it will increase the divergence between rates for sick people and healthy people. And no

one will be able to blame the difference in rates on anyone's "lifestyle." Which is another reason why we need to reform our health care system, and establish the principle that everyone deserves a basic minimum of care regardless of their genes, before things get much worse.

By James Kwak

Healthcare Rationing Is Good

James Kwak | 02 Sep 2009

This guest post was contributed by StatsGuy, a regular commenter on this blog.

In the current healthcare debate, Conservatives warn us that a single payer system will bring government rationing... Progressives argue that we already have rationing, based on wealth. Both sides are right, but both pretend that rationing is bad. Yet as every economist knows, the allocation of scarce resources is the basis of economics itself. The question is not whether we will have rationing – the question is how to structure a system of rationing that accomplishes our goals.

Two primary themes dominate this debate:

The Uninsured: In the past two decades, both the total number and the percentage of uninsured have increased in spite of some modest programs designed to expand coverage (like CHIP). (Original chart is [here](#).)

The graph above, which extends through 2007, has surely worsened since 57% of US citizens are insured through their workplace (down from 63% in 2000) and unemployment increased from under 5% to 9.4% in the last couple years.

Rising Costs: During the same time, costs have increased dramatically. (Original chart is [here](#).)

Part of this is because of the availability of new treatments and technology in the last 20 years... Part of this is because the population in the US suffers greater morbidity than 20 years ago. But much of the increase is due to systemic issues caused by gross market failures in the healthcare market, as described by Baseline [here](#) and elsewhere.

However, costs and coverage interact. Businesses (especially smaller ones) drop insurance because they cannot afford premiums. On the other side, lack of coverage drives up costs... The uninsured may overuse emergency room care, delay basic care until a disease worsens or fail to get vaccinated (which harms themselves and others). At the systemic level, administrative costs (which largely consist of managing payments and coverage) are growing much faster than overall costs.

So what can we do?

1) Fix the broken incentives

The current systems for federal and private reimbursement of health care expenses (via Medicare and Medicaid) are rate of return systems – a type of cost-plus regulation. In other words, health care providers are reimbursed for the **quantity** of care provided. The more they provide, the more they are reimbursed. Only HMOs do not compensate through this structure, and they have been credited with holding down costs vis-à-vis PPOs. (Moreover, they are now equaling or exceeding PPOs on other dimensions than cost.)

Even worse, the reimbursement schedule in existing government programs is broken; Medicare compensates primary care services at rates that are often below costs (which have increased faster than inflation adjustments), while richly compensating certain medications (because the govt. is banned from negotiating prices) and equipment intensive procedures (which have decreased relative to inflation in the same way that microchips have gotten cheaper). We have a vast amount of data that tells us that primary physician care is far more cost effective than treatment by teams of specialists, but the current rate schedule contributes to a substantial undersupply of primary care physicians that is likely to get worse as we see substantial year-on-year declines in the percentage of new graduates entering family medicine. Previous government reports suggesting that everything is fine contradict what many doctors are saying.

The best of the current proposals (the House bill, with summary here) does take steps to restructure rates, but needs to do more. We need to increase reimbursement for basic care, reduce reimbursement for the most expensive care, and set up a rational system for updating fee structures. New legislation should:

1. Create an independent, self-funded agency with rate setting authority.
2. Establish a set of advisory commissions to recommend rates and coverage using evidence-based analysis; commissions should be primarily staffed by doctors (with minimal conflicts of interest) that balance across regions, private practice, hospital staff, etc. Primary care providers should be well represented. Patients rights, public interest, and budget-watching public interest groups should also be represented.
3. Mandate rates that adjust for cost-of-service by region; uniform national incentives encourage over-treatment in low cost regions and under-treatment in high cost regions.

4. Shift away from a model that compensates purely based on *quantity of care*. We need a system that rewards cost-effective care (i.e. quality care that is worth the price). What might such a system look like?

In the 1990s, HMOs experimented with capitation – rewarding doctors based on number of patients they managed rather than services. Unfortunately, this incited doctors to under-treat and also to avoid taking on unhealthy patients. To address this, we should deploy a hybrid system that rewards primary care doctors partly based on services they provide (with rates determined as noted above), and partly based on a risk-adjusted capitation model. The fee-portion of the system would ensure that doctors do not lose money on patients that require more treatment than anticipated, but would not drive profits. That way, doctors have less incentive to insist patients come in for an office visit when an email would suffice. The risk-adjusted capitation portion of their compensation would pay providers based on the morbidity of the patients they enrolled (with sicker patients generating more income since they take more time to manage). Electronic records would enable us to measure provider performance based on outcomes. Properly balanced, this would help minimize both the incentives to over treat and the incentives to under treat.

2) Focus coverage-enhancing proposals on cost-effective basic care:

Current proposals that dramatically expand coverage without focusing on cost containment (like the Senate Health, Education, Labor, and Pensions Committee version) had hoped to pay for themselves through efficiency enhancement. The notion was simply this: if we can improve preventative care, lower administrative costs, and teach doctors that better care is not always more care, then consumption will decline by itself. This optimistic view hit a roadblock when the CBO estimated that these proposals would not achieve their cost reduction targets due to insufficient incentives to reduce consumption. The CBO analysis may be pessimistic, but is not easily dismissed.

As an alternative to providing the best care to everyone, an efficiency-focused regime could focus on expanding cost-effective *basic coverage* for everyone, and allow individuals to purchase *supplemental coverage* at their own expense. This enables those who want more care to buy more care (wealth permitting); those who cannot afford to buy private supplemental insurance would be subject to government rationing.

Extending cost-effective basic care to everyone would lower costs associated with overuse of emergency rooms, administrative billing, public health issues (like failure to vaccinate), etc. While not overly generous, it could offer a basic social safety net, and for reasons that Baseline has covered, it makes a great deal of sense for a Public Option to exist that covers cost-effective basic care.

Private supplemental insurance would need to be well regulated. In particular, rescission should be banned outright (which would front load application costs), or tightly regulated and managed by accelerated legal review (a 6 month legal delay for a chronically ill person will create serious distortions).

Denial of coverage due to pre-existing conditions must be addressed, but not by simply banning it. Insurance companies will attempt to evade the regulation – for example, by deploying marketing campaigns that target healthy individuals and avoid unhealthy ones (should they advertise in *Cycling* magazine, or *Coping with Cancer*?). If we want to subsidize care for people with pre-existing conditions we should do so directly, rather than shifting the burden to insurance companies and pretending we aren't paying it. Indeed, we'll end up paying more as insurers spend money on rent-seeking activities to cherry pick patients.

3) Infrastructure

The current proposals do a decent job at expanding infrastructure, so I will limit comments to:

1. The scarcity of general care physicians is a structural issue that will take time to respond to new incentives. Until this balance is restored, the federal government should provide tuition support (via loan forgiveness) for medical students that enter primary care and remain in primary care for at least 10 years (10% loan forgiveness per year).
2. More needs to be done on malpractice insurance. Many factions argue the root problem is growth in tort awards. And in the long term the correlation is clear, but since the tort reform movement in 2001 insurance company payouts have actually declined in real dollars, even as rates have spiked by 120% so that the payout ratio is now less than 45%. (also, here) The problem now seems to be the insurance companies more than the lawyers.
3. We should do more in meeting standards for physical hospital infrastructure and best-practice dissemination that reflect our

current state-of-knowledge; this is a public health concern. These types of efforts can have a huge payback.

4. The current proposals hit the mark on building a nationwide electronic system for managing patient records, and the CBO review does not give full credit to this initiative. While the administrative savings would be substantial, the greater value is in knowing what actually works, what is a waste of money, where the problems are, and which providers are performing well. Imagine monitoring the H1N1 flu in real time. Comparing the efficacy of treatments and drugs with statistically robust samples of hundreds of thousands of patients. Measuring whether costly new procedures yield better outcomes. Tracking drug interactions. Monitoring whether hospitals are following best practices at infection control. The decentralization of information that usually helps a free market system work so well is working against us in health care.

In conclusion...

Some of the proposals in Congress that focus primarily on expanding coverage (especially the Senate HELP committee version) are likely to incur massive costs by subsidizing the growth of a system with underlying structural problems. This is precisely the same critique that Baseline has leveled against the currently weak proposals to fix regulation in the financial system. The House bill does much better (which CBO acknowledges), but should do more. The painful truth is that if we are going to seriously keep health care costs from destroying our federal budget, we are going to need to accept rationing. Unless the political will suddenly emerges to move wholesale to a Canadian system of rationing, health care reform may have a better chance of success by fixing the broken incentive system, focusing public subsidies on cost-effective basic care, and augmenting infrastructure.

By StatsGuy

Revisionist History

James Kwak | 02 Sep 2009

Probably most of you have already read David Cho's Washington Post [article](#) on how the Big Four banks (a) have gotten bigger through the crisis, (b) have increased market share ("now issue one of every two mortgages and about two of every three credit cards"), (c) are using their market clout to increase fees (while small banks are lowering fees), and (d) enjoy lower funding costs because of the nearly-explicit government guarantee.

I just want to comment on this statement by Tim Geithner: "The dominant public policy imperative motivating reform is to address the moral hazard risk created by what we did, **what we had to do** in the crisis to save the economy." (Emphasis added.)

Um, no.

There were all those nuts saying that Treasury should have taken over the banks. This would have allowed the imposition of haircuts on creditors and limited moral hazard. There was also the less controversial option of making real, lasting constraints on banking practices a condition of the bailouts; the conditions that were imposed were peripheral and timed to evaporate when the TARP money was paid back. As a result, now Geithner has to bargain with Congress and an increasingly confident industry to get his regulatory reform.

It's also important to differentiate between September 16-October 14, when you could give the government the benefit of the doubt because of the intense panic and uncertainty caused by the collapse of Lehman, and November-February (when the follow-on bailouts of Citigroup and Bank of America took place), when the government was able to choose among a range of options.

Saving the economy was a good thing. Doing it a particular way was a choice.

That said, I'm glad that Geithner says that undoing this situation is "the dominant public policy imperative motivating reform."

By James Kwak

What Is Finance, Really?

Simon Johnson | 03 Sep 2009

At one level and in most economics textbooks, this is an easy question with a rather encouraging answer. The financial sector connects savers and borrowers – providing “intermediation services”. You want to save for retirement and would obviously like your savings to earn a respectable rate of return. I have a business idea but not enough money to make it happen by myself. So you put your money in the bank and the bank makes me a loan. Or I issue securities – stocks and bonds – which you or your pension fund can buy.

In this view, finance is win-win for everyone involved. And financial flows of some kind are essential to any modern economy – at least since 1800, finance has played an important role in US economic development.

Unfortunately, two hundred years of experience with real world finance reveal that it also has at least three serious pathologies – features that can go seriously wrong and derail an economy.

First, the financial sector often acquires or aspires to political power. The fact that banks have a great deal of cash on hand always makes it easy or tempting to buy some political favors, and to obtain privilege and power for big financial enterprises. President Andrew Jackson had exactly this struggle with the Second Bank of the United States in the 1830s.

Second, the financial sector can obtain disproportionate power over industry. The “money trust” idea of the early 20th century may have been somewhat exaggerated – money cannot be corralled as effectively by private players as can, say, copper or steel – but there is no doubt that 100 years ago, Wall Street banks dominated the process of consolidating railroads and of creating pernicious industrial trusts. Trust-busting required taking on the country’s most powerful financiers (pdf).

Third, finance can also go crazy, running up speculative frenzies. This is what happened the 1920s, leading to the Great Crash of 1929 and the struggle to effectively constrain finance during and after the long, depressed 1930s.

Which kind of financial sector pathologies do we face today? Unfortunately: all of the above. And, not just in nature but also in size, we face a financial sector much more potentially debilitating than anything stared down by A. Jackson, T. Roosevelt, or F.D. Roosevelt.

In our previous showdowns with finance, the sector was small. During the nineteenth century, the value of financial intermediation services was no more than 1 or 2 percent of GDP, and in the early 20th century, the extent to which real resources – including talented people – were drawn into this sector remained very limited. J.P. Morgan, in his heyday, had great economic and political power, but he never employed more than 100 people.

With the growth of a much bigger and more diversified economy after World War II, there was some increase in financial activity as a share of GDP, but the really big jump came after the deregulation of the 1980s. Just a few years ago, finance accounted for an astonishing – and unprecedented for the US – 40 percent of all corporate profits, and even today the sector generates around 7% of what we measure as GDP (for more numbers over time, see this presentation.) Even ardent defenders of finance now concede that the sector may or even should end up significantly smaller as a share of the economy (James Surowiecki; Adair Turner).

But at current scale, the financial sector has great ability, through political donations and other means, to maintain its lightly regulated environment – there is nothing (other than the proposed consumer protection agency for financial products) to which the industry has ever objected in the administration's financial reform proposals. And yet the amount of risk-taking that this sector can pursue remains mind-boggling, and its ability to “put” the cost of big failed bets onto the government is undiminished. Financial “innovation” remains mad and bad, and when it all goes wrong – you know who gets the bill. The implications for your future taxes and job security are not good.

We need finance, but finance as it currently operates in the United States has become a problem. Yet, with the headline numbers for the economy beginning to improve, the impetus for any real reform of this sector – within the US or internationally – starts to fade. The likely future is: more of the same, at least until we find a Jackson or a Roosevelt.

By Simon Johnson

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Football, Statistics, and Agency Problems

James Kwak | 04 Sep 2009

The most interesting part of Monday's post on TARP may have been this little football example:

In honor of the changing seasons, imagine it's the first quarter of a football game and you have fourth-and-one at the other team's 40-yard line. Anyone who studies football statistics will say you should go for it; it's not even close. (Some people have run the numbers and said that a football team should never – that's right, never – kick a punt.) If the offense fails to make it, the announcer, and the commentators the next day, will all say that it was a bad decision. That's completely wrong. It was a good decision; it just didn't work out.

One of my friends was particularly intrigued by the theory that a football team should never punt. I recall reading this somewhere, but I couldn't find it actually demonstrated anywhere, although this high school football team implemented the strategy – and won the state championship. That article cites "Do Firms Maximize? Evidence from Professional Football" by David Romer, who analyzes the punting question in detail.

He calculates the point value of a first down at any point on the field, and from that the point value of the "kicking" and "going for it" options at any point on the field; the point value of the punt option is based on the opponent's expected field position, while the point values of the field goal and go for it options are based on your expected points and the expected resulting field position.

The conclusion (PDF p. 14) is that over most of the field you should go for it if you have four or fewer yards to go; there is a big spike around the opponent's 33-yard line where you should go for it even on fourth and nine, because the net field position benefit of punting is low and the expected point value of attempting a field goal is low.

The implication, of course, is that football teams don't maximize. Romer concedes that making the right decision on fourth down would lead to about one more win every three years, and this is probably outweighed by the asymmetric returns: you are more likely to be penalized (as a coach) if you go against convention and are wrong than if

you follow convention, since the fans (and the owners) are more likely to notice departures from convention. So the incentives of football coaches are not simply to maximize points, but also to maintain their reputations.

It probably wouldn't be too hard to come up with a banking analogy at this point, but I won't beat a dead horse.

Update: Commenter Ian M. helpfully links to this [analysis of the "never punt" strategy](#). Taunter also says that Gregg Easterbrook (Tuesday Morning Quarterback at ESPN) has been advocating this strategy.

By James Kwak

Expert Panels and Bipartisan Consensus

James Kwak | 04 Sep 2009

Last week, Planet Money aired an interview by Adam Davidson with Barney Frank, the blunt and colorful chairman of the House Financial Services Committee. Davidson and Frank had a pitched disagreement over the question of whether it made sense to appoint a bipartisan, expert panel to take some time – figures between one and three years were thrown around – to study the causes of the financial crisis and, on that basis, recommend regulatory changes. Davidson thought it was a good idea; Frank thought it was nonsense.

I'm with Frank on this one, and the argument applies to the Financial Crisis Inquiry Commission, also known hopefully as the "New Pecora Commission," appointed by Congress to study the causes of the crisis.

A parallel is commonly drawn to the 9/11 Commission, which I believe is widely considered to have been both genuinely bipartisan and worthwhile. However, I think the differences are more important here. On September 12, 2001, most people – certainly including most people in government and policy, and almost certainly including even the most highly-placed people in the country – had only the vaguest idea of how nineteen terrorists had infiltrated the country and managed to hijack four plans, using three of them successfully as bombs. The Commission's mandate was to understand how that happened, and in particular how our intelligence and security agencies had failed to prevent this attack. That is, there was a shortage of information, and most of the information was classified anyway, so a thorough investigation was called for.

By September 16, 2008, most people in the business already knew the causes of the financial crisis: cheap money, new and predatory mortgage products, lax underwriting practices, the transfer of risk through securitization, dependence on ratings by overwhelmed rating agencies, failure of regulatory agencies to regulate, greediness on the part of banks and bankers who ate up their own AAA-rated dog food, unhealthy dependence on short-term funding, etc. There has been argument about the relative importance of these factors, but the basic story is so well known that it has spawned multiple cartoon caricatures. There is little fact-finding necessary to determine the causes of the crisis; we should already be at the phase of analyzing empirical data, and I can predict with confidence that seventy years from now there will be economic

historians arguing both sides of this question; after all, that's what happened with the Great Depression.

I expect, and hope, that the Financial Crisis Inquiry Commission will uncover some especially sordid details of bankers laughing about screwing their customers, or regulators on the take from the banking industry. And if that happened, then those people should be sued or put in jail. But we already know that bankers were screwing their customers, and we know that regulatory agencies were friendly toward the banking industry (whether because of corruption, simple ideological alignment, or orders by political appointees makes little difference in the broad story).

I am skeptical that months or years of study will bring us any closer to consensus on the major questions, because the crisis is so *overdetermined*; there is plenty of evidence to construct multiple plausible narratives about how it happened, each one of which points to a different regulatory solution (and whether you could get that solution through Congress is yet another question).

Thinking cynically, spending 1-3 years studying the problem could also be cover to let the issue fade away; the impetus for reform is already far weaker today than it was in, say, February when Citigroup was going through its third near-death experience. I know that's not Davidson's intent, but I'm sure there are others who would be only too happy to bet that the economy and the popular mood will return to normal. Remember Sarbanes-Oxley? It was weaker than originally imagined, and by 2007 there was a movement afoot to repeal it, since people had already forgotten Enron and Worldcom. Let's hope that doesn't happen again.

By James Kwak

Krugman on Economics

James Kwak | 04 Sep 2009

This weekend's *New York Times Magazine* has the 7,000-word article about the state of macroeconomics that Paul Krugman has been hinting at for some time now. It's a well-written, non-technical overview of the landscape and the position Krugman has been presenting on his blog, which for now I'll just summarize for those who may not have the time to set aside just now.

Like many, Krugman faults the discipline for its infatuation with mathematical elegance:

"[T]he central cause of the profession's failure was the desire for an all-encompassing, intellectually elegant approach that also gave economists a chance to show off their mathematical prowess.

"Unfortunately, this romanticized and sanitized vision of the economy led most economists to ignore all the things that can go wrong. They turned a blind eye to the limitations of human rationality that often lead to bubbles and busts; to the problems of institutions that run amok; to the imperfections of markets — especially financial markets — that can cause the economy's operating system to undergo sudden, unpredictable crashes; and to the dangers created when regulators don't believe in regulation."

His history of post-Depression macroeconomics goes through roughly three phases: Keynesianism; Milton Friedman and monetarism, which, he argues, was relatively moderate compared to the positions of some of his self-styled followers; and the period from the 1980s until 2007, which he describes as the conflict between the Saltwater (coastal, pragmatic, New Keynesian) economists and the Freshwater (inland, efficient markets, neo-classicist) economists. According to Krugman, these two schools had differences on a theoretical level, but those differences were papered over by practical agreement on government policy: namely, monetary policy was superior to fiscal policy at managing the economy.

This false peace was exploded during the financial crisis by the zero bound, something Krugman has invoked often. The agreed-upon way to stimulate the economy in a recession is to lower interest rates. When

interest rates hit zero, they can't be lowered anymore (rather than lend you money and expect to get less back in the future, I should put it under my mattress), and then the policy question is what if anything else should be done. This provoked the fallout between people who favored the stimulus as a way of propping up demand and those who thought that for theoretical reasons a stimulus could not possibly have any positive impact.

In addition, Krugman argues, the two sides shared the same desire to represent the world using elegant mathematical models: "But the New Keynesian models that have come to dominate teaching and research assume that people are perfectly rational and financial markets are perfectly efficient." Instead, we need to look to behavioral finance and behavioral economics, which has just gone from a hot fad in economics to the bandwagon to end all bandwagons. Krugman mentions Larry Summers's "There Are IDIOTS" paper, which must now be the world's most-cited-although-unpublished article, Robert Shiller, Andrei Schleifer, and Robert Vishny in particular.

This is from Krugman's conclusion:

"So here's what I think economists have to do. First, they have to face up to the inconvenient reality that financial markets fall far short of perfection, that they are subject to extraordinary delusions and the madness of crowds. Second, they have to admit — and this will be very hard for the people who giggled and whispered over Keynes — that Keynesian economics remains the best framework we have for making sense of recessions and depressions. Third, they'll have to do their best to incorporate the realities of finance into macroeconomics."

In other words, the world is messy and people are irrational, and as a result the world breaks down occasionally.

The field of economics has been going on a massive land-grab over the past few decades. It's ironic that the area it seems to understand the least well is how an overall economy functions.

By James Kwak

Good Finance Gone Bad

Simon Johnson | 05 Sep 2009

As the Lehman anniversary approaches, defenders of the financial sector struggle into position – partly in response to [your comments](#) ([also here](#)). They offer three main points:

1. We need finance to make the economy work.
2. Financial innovation delivers value, although it's not perfect (but what is?)
3. Don't kill the goose that laid the golden egg.

Point #1 is correct, but this does not necessarily mean we need finance as currently organized. The financial sector worked fine in the past, with regard to supporting innovation and sustaining growth. Show me the evidence that changes in our financial structure over the past 30 years have helped anyone outside the financial sector.

On #2: Financial innovation has obviously benefited the people who run and operate large financial companies. [Has it helped anyone else](#), including their own shareholders? And if you can show broader social benefits (e.g., lower cost of capital, better ability to take nonfinancial risks that make sense, or anything else), do these outweigh the massive social/fiscal costs that are now apparent?

Which leads to point #3: what kind of egg did the finance goose lay? Obviously we now need to go back and recalculate economic growth – if much of what was done by finance was issue loans that were not likely to be repaid (while not recognizing the probable losses).

But the unfortunate side effects of finance lie much more in the future than in the past. It's not lowering recent growth by some fraction of a percentage point that should bother us, it's the likely behavior of large-scale finance, now more powerful and with greater concentration of power.

Private sector capture of the state is bad enough, wherever it happens in the world. But when the capturers have an unparalleled ability and willingness to "tax" the rest of us, we should really be afraid.

The business model of big finance is not to consolidate their position and live on comfortable annuities. It's to take as much as they can ("otherwise the competition will hire our best people") while stuffing the risk ("which ordinary people don't understand") onto the taxpayer. The

technical details of this arrangement are loosely referred to as “financial innovation”.

Modern finance is more than quack medicine. This is state capture, an old tradition for bankers – and in the modern American version their hands are in the deepest set of pockets ever. Why would they ever let go?

By Simon Johnson

The Myth of Consumer Choice

James Kwak | 07 Sep 2009

I'm such a public radio groupie that David Kestenbaum and Chana Joffe-Walt are minor idols of mine. I get excited on the very occasional occasions when David calls to ask me a question, and Chana . . . well, if I were in my twenties and single, I would probably have a crush on her. So I was disappointed to listen through their recent Planet Money episode on health care, waiting for them to tell the other side of the story, but finally being left to yell at my radio. (No, I don't actually yell at inanimate objects, but you know what I mean.)

David and Chana use the metaphor of an all-you-can-eat buffet to illustrate the well-known problem in health care that end consumers don't bear anything near the full costs of their choices, which ordinarily leads to overconsumption. One problem with our health care system is high costs, so it's common to blame high costs on the all-you-can-eat buffet.

Planet Money hosted the usual version of this debate. David Goldhill argued that, since Americans spend \$1.7 million on health insurance in their lifetimes (I'm not sure what that number is, since it's clearly not out-of-pocket premiums, but maybe it includes the full value of Medicare policies), they should basically be given the \$1.7 million instead and forced to make their own health care choices; this, he claims, would increase quality. (He didn't say, at least on the air, that it would reduce costs, but most people favoring this approach think it will.) Richard Kirsch argued that this is nuts, because people have little to no ability to make good health care choices given the vast information gap between them and their doctors, and the likely outcome is that people will skimp on necessary care and end up paying more later in their lives. I'm in the Kirsch camp – I think the information problem is so great that people would either blindly do what their doctors say, or they would skimp on health care expenses in ways that are likely to hurt them* – but that's not the point here.

No, the missing element in this story – not only on Planet Money, but almost every time it is told – is distribution. Any health care system in any advanced democracy plays a redistributive function. Let's start with an example.

Goldhill's \$1.7 million figure ignores the fact that different people get different amounts of health insurance benefits over their lifetimes. His

idea is that instead of having your premiums paid for by your employer, you should get the cash instead and put it in some form of health savings account. If you have a serious illness when you are young, he says you should be able to get an advance on your future benefits. (Just who would give you that advance was unclear on the radio, but I'll assume he has a solution.) But what if you are a twenty-something waiting tables and you currently get *zero* health insurance paid for you? Then you would be getting *zero* cash instead of your "employer benefits," your health savings account would include *zero*, and there is no reason to be sure it will ever include more than *zero*. (I guess when you're 65 you'll get Medicare, but who says you'll live until 65?) So to make something like Goldhill's system work, you have to start off by guaranteeing every person some large amount of money over the course of his life to pay for health care.

Let's say we've gotten over that problem and somehow everyone has access to \$1.7 million over the course of his lifetime. Then you have the even bigger problem of variance in outcomes. Some people will incur \$250,000 in actual health care costs; others will incur \$5 million. Simply having \$1.7 million handed to you doesn't protect you against risk. Goldhill suggests buying a policy with a \$50,000 annual deductible and paying the rest out of your health savings account. But the fact remains that for many people, the health savings account will run out; actuarially speaking, if \$1.7 million is the average and other things do not change, then exactly half of all people will run out of money.

This just illustrates that a core function of any health insurance scheme is redistribution. People start out in different economic circumstances, and they suffer different fates in their lives. Without redistribution in some form, the ones who are poor and get sick will simply not be able to afford health care. Cashing out their employer health benefits and giving them "choice" won't change that – especially if they don't have employer health benefits to begin with. Yes, insurance can play a redistributive role on its own, but it only works if poor people can afford to buy insurance that will cover them against serious illness. And once they have that insurance, then the price signals so beloved of conservatives won't function anymore. The problem is really very simple: for price signals to work, you have to be willing to let consumers run out of money, since no one can predict his future health care needs. And then they die.

So what really frustrates me about this whole "consumer choice" fraud is the premise it begins with. It starts out by framing health care as a

problem of consumer incentives – health care is too cheap. This is a factually accurate framing that leads you to a dead end (unless you think people who underestimate their future sickness should die). I think the right way to frame this issue is with this question: Given a poor person and a rich person who have the same potentially fatal disease, should both of them live, or only one?

* Goldhill argues that consumers don't have to be medical experts because as long as some people are, that will ensure that the market rewards quality, and therefore only quality providers will remain in the market. This may address the quality issue, but I don't see how it helps consumers decide whether or not they need an MRI when they have a potential diagnosis they don't understand.

By James Kwak

Consumer Protection Redux: The Lessons of History

For your Labor Day reading enjoyment, we bring you this guest post by Lawrence B. Glickman, who teaches history at the University of South Carolina and is the author of Buying Power: A History of Consumer Activism in America.

"We're proposing a new and powerful agency charged with just one job: looking out for ordinary consumers," said the president on June 17th. The centerpiece of his proposed overhaul of the nation's financial system, the Consumer Financial Protection Agency (CFPA), is designed to end what the president called "failure of...government to provide adequate oversight" by monitoring banking transactions, including mortgages, credit cards and checking and savings accounts. It did not take long for the predictable critics to denounce the agency with predictable rhetoric. "It's bad for the consumers," said Steve Bartlett, president of the Financial Services Roundtable, a lobbying group for banks. The institution will add "yet another regulatory layer" while advancing "the agenda of activist special interests," according to the U.S. Chamber of Commerce. The new agency represents "an unprecedented grant of power to mandate business practices" claims the American Bankers Association.

This is the language of conservative populism, a mainstay of the Republican party from Ronald Reagan to Newt Gingrich to Karl Rove. Conservative populism, wrote Jonathan Chait in the New Republic last year, "dismisses any inference that the rich and the non-rich might have opposing interests" and defines elites in cultural rather than economic terms as "intellectuals and other snobs who fancy themselves better than average Americans." Several decades of repetition have made this rhetoric familiar: federal efforts to help ordinary people—consumers—will inevitably hurt them; government is the problem rather than the solution; bureaucracy is "bumbling" (to use the words of a Crain's New York Business poll about the proposed Agency); federal agencies designed to serve the public good actually serve narrow special interests. It has been, in no small measure, through the ready deployment of this language that the Republicans have positioned themselves as simultaneously the party of big business and working Americans while denouncing Democrats as representing both intrusive government and elitism. This meme has been devastating for liberals since any expansion of government services can be dismissed with a quip—Bureaucrat!, Red Tape!, Nanny State!—rather than an argument. Recently, for example,

Senator Lindsay Graham said that the American people would never tolerate the public choice option in health insurance because “you’ve got a bureaucrat standing in between the patient and the doctor.” For similar reasons, Senator Kit Bond dismissed the CFPFA proposal as a “bad idea.”

To understand how Republicans have married free market homilies with the anti-elitist sympathies of ordinary Americans we must look back even before Reaganism to the 1960s and 1970s when policies favoring big business were first dressed up in the language of sympathy with ordinary folks. One of the first successful efforts in this idiom was the battle against an earlier consumer protection proposal. From 1969 to 1978 efforts to enact a Consumer Protection Agency (CPA) came tantalizingly close to passage in Congress. With its leader appointed by the president, the CPA was to represent the consumer interest before federal agencies and courts and to serve as a clearinghouse for consumer complaints. The CPA had widespread popular support and seemingly overwhelming Congressional support: the Senate passed a CPA bill 74-4 in the 91st Congress (1969-1971); the House passed a similar bill 344-14 in the 92nd Congress; and in the 94th Congress both the House and Senate passed the bill but without a big enough margin to overcome an expected veto from President Gerald Ford. Yet the CPA ran into a buzzsaw of lobbying and never became law. This fight against protection sheds light on the rise of a style of conservatism that continues to veil itself as populism today.

Obama’s efforts to reignite consumer protection suits the current historical moment in which for the first time in two generations reflexive antiliberalism appears to have lost its rhetorical punch. Passing consumer protection legislation may well be a way to advance and modernize the stalled and seemingly moribund liberal project. Although President Obama stresses the twenty-first century nature of his proposals, the architect of the CFPFA, the Harvard Law Professor Elizabeth Warren draws explicitly on the unfinished agenda of the earlier campaign for consumer protection. Her 2007 article that first proposed the agency was entitled, “Unsafe at any Rate.” Not only did she take her title from Ralph Nader’s 1965 blockbuster, *Unsafe at any Speed*, Warren noted that the model for “such safety regulation is the U.S. Consumer Product Safety Commission,” the product of many consumer-friendly laws passed between the mid 1960s and mid-1970s. Safe appliances came under the government’s mandate in the 1960s, Warren notes, and incorporating financial services fulfills the goals of consumer

protection by expanding it to the less tangible but equally important category of family finances.

The lessons from past consumer battles are not only ideological but organizational. Unwilling to be out-lobbied again, a coalition of 200 consumer groups has created Americans for Financial Reform, which will aim to influence Congress and vows to respond vigorously to the opponents talking points. President Obama has also indicated his willingness to take the offensive. "The American people sent me to Washington to stand up for their interests," he said in his weekly radio address on June 20th. "And while I'm not spoiling for a fight, I'm ready for one."

Such a fighting attitude may well be necessary if the earlier consumer protection battle is any indicator. In the first fight against CPA legislation, conservative business leaders, lobbyists, and politicians successfully took aim at liberalism by first taking on the consumer movement. With a well-financed and well-coordinated campaign facilitated by an informal consortium of lobbyists called the Consumer Issues Working Group, CPA opponents described consumer protection as exemplifying the flaws of American liberalism and as standing in for the twentieth-century liberal project as a whole.

The revived consumer movement of the 1960s and 1970s was central to what the political scientist Jeffrey Berry has called "postmaterial liberalism," a politics concerned not just with economic growth but with improving the quality of life. "For half a century we called upon unbounded invention and untiring industry to create an order of plenty for all of our people," as president Lyndon Johnson said in his "Great Society" speech in 1965, which exemplified this postmaterial view. "The challenge of the next half century is whether we have the wisdom to use that wealth to enrich and elevate our national life, and to advance the quality of our American civilization." Consumer protection was to Johnson and many others central to that mission, and a variety of popular laws, including "truth in lending" and "truth in packaging" were enacted. In his administration and in the Nixon presidency that followed it. Consumers Union doubled in membership between 1966 and 1972 as it joined the battle against pollution and suburban sprawl to its mission of scientific product testing. Presidents of both parties from John F. Kennedy—who declared a "Consumers' Bill of Rights" in 1962—to Johnson—who appointed a White House advisor on Consumer Affairs in 1964—recognized the political salience of appearing pro-consumer, to Nixon and Ford who also appointed consumer affairs deputies. The high

point came in Jimmy Carter's campaign for the presidency in 1976 when he told an audience that he hoped to rival Ralph Nader "for the title of top consumer advocate in the country." (It may be hard to recall today, in the wake of Nader's unpopular actions in the 2000 election and beyond but throughout the 1960s and 1970s he consistently ranked as one of the most admired Americans. When Carter wooed Nader to meet him in Plains it was seen as a coup for Carter's effort to establish his liberal bona fides.)⁵ Between 1969 and the late 1970s consumer activists, notably Nader, and many Congressional leaders of both parties, including the Republicans Jacob Javits and Charles Percy, put their weight behind the plan for a federal agency to protect and promote consumer interests. In 1973 the *New York Times* conveyed the conventional wisdom when it declared that "there is in the air the possibility that consumerism will become a mass movement of untold economic and political power." The CPA seemed the minimum achievable goal of that movement.

From its beginnings, however, the revived consumer movement alarmed opponents. As early as 1964, the advertising trade journal, *Printers Ink* called it an "ominous phenomenon." By 1967, the consumer affairs reporter Sidney Margolius noted that the "business backlash has been unusually sharp and surprisingly effective." Ever since the consumer movement began in the 1930s, business groups organized to weaken its power, creating counter-organizations, attacking the motives and personnel of consumer groups, and predicting the terrible consequences of consumer protection. With the popularization of the consumer movement in the 1960s, business groups once again organized, and they shifted into high gear in 1969 when Benjamin Rosenthal (D-NY) sponsored legislation for the CPA.

Several key organizations played an especially prominent role in opposing consumer legislation, notably the U.S. Chamber of Commerce, the Business Roundtable, the Grocery Manufacturers Association, the National Association of Manufacturers, and the American Enterprise Institute. These groups carried out what the veteran Congressional leader and future Speaker of the House Tip O'Neill called the most "extensive lobbying" he had witnessed in his quarter of a century in Washington. The anti-CPA lobby's biggest success came in the promotion of a series of talking points which, in sum, amounted to a repudiation of American liberalism, and became familiar aspects of conservative discourse. Outspending complacent pro-CPA forces by a huge margin, they ensured that their message would be heard through a

series of press releases (often published verbatim in small-town newspapers throughout the country) and advertisements ("The Last Thing Consumers Need is Another Government Agency," declared a full-page ad paid for the by US Chamber of Commerce in the *New York Times* in 1977.)

Although the proposed agency was relatively modest with an initial budget of \$15 million/year, opponents depicted it as exemplifying a new and dangerous bureaucracy favored by overzealous liberals. According to critics, the authorization of a consumer protection agency would result in "big government," a symptom of which was "red tape and lawyers," as well as "onerous" and "mind-numbing" regulations. The CPA bill would lead to "immense harassment of employers," concluded the *Nation's Business*, published by the U.S. Chamber of Commerce. But the opponents went further than merely condemning the excessive paperwork the CPA might generate. It represented a "bureaucratic nightmare," according to James J. Kilpatrick who was one of many syndicated columnists—among them, Patrick Buchanan, William F. Buckley and George Will—to criticize the CPA in his columns, because the CPA was authorized with inappropriate and excessive powers, which would turn it into a "meddlesome" and "out of control" body, a "superagency," even a "monster superagency." Critics agreed that the CPA would hold what they variously framed as "irresponsible power," "unbridled power," "absolute power," and "enormous power." The CPA would produce a group of potentially "despotic" and dangerous "super snoops." According to the US Chamber of Commerce, the CPA bill marked "the most serious threat to free enterprise and orderly government ever to be proposed in Congress."

The flip-side of bureaucratic arrogance and over-reach, according to the critics of the consumer movement, was the assumption of incompetence on the part of ordinary consumers. The very call for an agency on behalf of consumers was an expression of the bureaucrats' lack of faith in the abilities of their countrymen and women. Ronald Reagan, the ex-Governor of California, criticized the consumerists—whom he compared to Orwell's "Big Brother," in several op-ed pieces and radio commentaries in 1975—for "promoting the notion that people are too dumb to buy a box of corn flakes without being cheated." Reagan concluded that "professional consumerists are, in reality, elitists who think they know better than you do what's good for you." A group of Senators who opposed the CPA also rejected the view, which they claimed was implicit in CPA legislation, "that all consumers

are mental midgets who must look to Washington to find out how to manage their personal lives from some bureaucratic consumer 'representative' who will have neither the time nor the knowledge to shop for and cook a decent supper." According to the advertising executive, Arthur Fatt, the consumer movement sees "the typical consumer as a moron." The celebration of the intelligence of ordinary Americans became a component of conservative anti-elitism and an element of its populism. If consumer advocates were snobs condescending toward those they claimed to protect, it was easy to dismiss their proposal as tainted since, as the business journalist Mary Bennett Peterson wrote, "those the Movement is designed to protect can actually wind up as its victims."

In time such dismissals of liberal proposals became rote but in the 1970s this was a new line of criticism, one that successfully consolidated conservative ideology. As the CPA bill languished after its final defeat in 1978, conservative groups correctly foresaw the opportunity for what Jeffrey H. Joseph, of the U.S. Chamber of Commerce called a political and legislative "bonanza." And indeed the terms of that victory foreshadow the rhetorical (and electoral) victories of Reaganism and the concomitant delegitimation of liberalism. The *Wall Street Journal* did not exaggerate when it noted that the CPA bill was "killed by words" and those words continued to resonate long after the once-popular federal consumer protection idea faded from public memory.

In recent years the hold of this ideology has weakened, creating space for a renewal of liberal politics, such as that represented by the renewed call for consumer protection after a thirty year hiatus. But this is no time for complacency. As Travis Plunkett, the legislative director of the Consumer Federation of America has observed, "the financial industry is sharpening its knives" against the CFPA idea. Yet although the old rhetoric has been revived—regulation is always strangling, bureaucracy remains dangerous, and the free market is inevitably the friend of the little guy—opponents have gone out of their way to acknowledge the problems and to agree that some regulation might be in order. Even though the Chamber of Commerce has recently launched a multi-million dollar defense of the free enterprise system, Tom Donohue, its president, has acknowledged that economic realities "certainly justified some out-of-the-ordinary remedial actions by government." According to the *Huffington Post*, one opponent said, "Opposing a consumer protection agency sounds really terrible, no matter how you try to spin it." This cautious response suggests in part the moderate nature of Obama's

proposal but also the exhaustion of the anti-liberal rhetoric which has sustained the Republic Party for the last forty years. It also provides an opportunity to make consumer protection once again a linchpin of modern liberalism.

By Lawrence Glickman

CFPA and Non-Banks

James Kwak | 07 Sep 2009

Elizabeth Warren has a new op-ed at [New Deal 2.0](#) arguing for, surprise, the [Consumer Financial Protection Agency](#), but this time with a different emphasis – non-bank lenders.

The opponents of the CFPA – not only banks, but the head of just about every current financial regulatory agency – argue that consumer protection should be combined with prudential regulation, so that one agency should be both making sure that a bank doesn't collapse and that it isn't abusing its customers. Many people have pointed out the flaws with this argument: first, consumer protection invariably slips down on the priority list; second, regulators become hesitant to crack down on abusive practices because those abusive practices generate the profits that make the bank "healthy" to begin with.

In addition, this combination makes the fundamental mistake of regulating financial institutions rather than financial functions, and therefore lets abusive practices simply escape to unregulated institutions. Banking regulation in the U.S. has historically been focused on making sure that banks don't collapse, so depositors can get their money back (without bankrupting the FDIC). The result was that non-bank mortgage lenders and consumer finance companies were notoriously under-regulated. This created another opportunity for regulatory arbitrage: as Warren writes, "the [Center for Public Integrity](#) found that 21 of the 25 largest subprime issuers leading up to the crisis were financed by large banks." In other words, banks outsourced their abusive practices to unregulated entities that they financed. How can that be a good thing?

The CFPA is many things, but it is also an example of regulating a financial function rather than a financial institution, and therefore makes regulatory arbitrage that much harder; to get outside its reach, you have to define the thing you are doing as not a financial service. (Although I think it has a weird exception for insurance products, which could turn out to be a big problem.) Since regulatory arbitrage seems to have been a core business strategy of many financial institutions over the last decade, that seems to be a good place to start.

By James Kwak

I Have a Big Head

James Kwak | 08 Sep 2009

That, at least, is the first thing you might conclude from my Bloggingleads debut, in which my half of the screen is almost completely filled by my head. I was on with Felix Salmon, who was gracious and charming as usual. If you read this blog and Felix's blog, a lot of the ground we covered might seem familiar.

At the end, however, I did press Felix on the subject of wine, which is one of his favorites. Felix has written that who wins a blind taste test is essentially random, even with reputed wine experts doing the tasting, and he has verified this independently through his own blind tasting parties. Yet he says nevertheless that in an ordinary context, it is perfectly rational to enjoy an expensive wine more than a cheap wine, since you are not tasting blind; you are tasting with full knowledge of what you are drinking. I asked him why his knowledge of the empirical studies didn't undermine the pleasure he got from drinking "good" wine. You can listen to his answer. The line I didn't think of in time to use is that's it's like getting a placebo effect from a drug when you know it's a placebo.

By James Kwak

G20 Summit, IMF Meeting: What To Expect?

Simon Johnson | 08 Sep 2009

As we wade through a long line of international economic meetings – G20 ministers of finance last week, G20 heads of government in Pittsburgh coming up, IMF-World Bank governors meeting in Istanbul early October (and all the associated “deputies” meetings, where the real work goes on) – it seems fair to ask: where is regulatory reform of our financial system heading?

Long documents have been produced and official websites have become more organized. Statements of principle have been made. And the melodrama of rival reform proposals has reared its head: continental Europeans for controlling pay vs. the US for raising capital vs. the UK not really wanting to do anything. But what does all of this add up to, and what should we expect from the forthcoming summit sequence?

Nothing meaningful.

This is a sophisticated delaying action and you are seeing masters of economic policy spin at work. When something goes wrong on a colossal, global scale, here’s the playbook (e.g., as applied to capital requirements).

1. Agree that there is a problem, but be very vague about it. “It’s complicated” is a good watch phrase.
2. State some completely bland principles to which no can object.
3. By all means, have a spat with the French or Germans. But then patch it up amicably at the big summit; agree to do a bit of everything, in principle. People are wowed by your leadership.
4. Send the job of formulating technical details to a committee of experts, asking them to report at the end of 2009 – and then make adjustments through the end of 2010.
5. Rely on the experts to produce a report of mind-numbing detail, which few really understand. The experts know their job and will deliver.
6. Provide leaks of this work and your “true feelings” to sympathetic reporters. They will help declare victory against great, albeit vaguely specified, odds.
7. At this point, it’s 2011 and either (a) new people are in power, or (b) other things have gone sufficiently well that everyone has forgotten about the financial fiasco of 2008-09.

The brilliance of this approach is that you can say, whenever someone objects that capital requirements are not being increased as much: “we are doing that, but the details are not yet fully settled,” or “but we agree with that principle; of course the details are complicated.”

And, in this context, the point of a G20 or IMF meeting is to have the world’s economic policymakers show mutual support. After all, our opinion leaders reckon, if everyone is on board, then this must be the right way to go.

There will be some minor changes, and these will be much trumpeted. But what will really change in or around the power structure of global finance – as it plays out in the United States, Western Europe, or anywhere else?

Nothing – and you know this because otherwise the CEOs of all our top financial institutions would be mounting massive PR campaigns against the proposals, with op eds, Internet ads, innumerable cable appearances, and a virtually constant presence at Treasury. Just think back to how active they were earlier this year, when FDIC-type resolution for big banks was on the table.

Unless and until our biggest financial players are brought to heel, we are destined to repeat versions of the same boom-bust-bailout cycle. If you find a government willing to state this problem clearly and really take action to confront the relevant powerful people, let me know.

By Simon Johnson

Capital Is Good. Now What?

James Kwak | 08 Sep 2009

This week in the WaPo column we are switching from health care back to financial regulatory reform. Our column summarizes and comments on Tim Geithner's recent white paper on capital requirements. The paper makes a lot of points that are good – more capital is better, higher quality capital is better, risk weighting of assets should reflect risks accurately, and so on. But in this form the principles, while we agree with them, are too uncontroversial to have much in the way of teeth. Ultimately what will matter are the numbers – how *much* more capital will Tier 1 systemically important financial institutions have to hold – and how hard the administration will fight for real reform. One rule of thumb: if the banking lobby isn't bitterly against it, it's probably not enough.

By James Kwak

The Crisis Next Time: Role Of The Fed

Simon Johnson | 09 Sep 2009

The Federal Reserve is taking a victory lap (e.g., Ben Bernanke at Brookings, next Tuesday morning; no weblink yet available), and the emerging consensus is that its leadership has done a great job over the past 12 months. But we should also take this opportunity to reflect on the longer run role of the Fed, both in the past decade or two and since its founding.

Over on The New Republic website (and in the latest hard copy), Peter Boone and I suggest that in the absence of effective financial regulation – i.e., both during the 1920s and again since 1990 – the Fed has operated in a manner that encourages the formation of sequential bubbles. This destabilization of our financial system is not a minor matter; the damage caused – human, financial, social – is already enormous.

And we are very far from being done.

Don't take my word for it. Lou Jiwei, the chairman of China's sovereign wealth fund said recently, "It will not be too bad this year. Both China and America are addressing bubbles by creating more bubbles and we're just taking advantage of that. So we can't lose."

By Simon Johnson

Boring and Exciting Finance

James Kwak | 09 Sep 2009

Taunter has a comprehensive proposal about how to regulate financial services, dividing them into Boring and Exciting. Boring services are the following:

- retail deposits
- loans to retail customers, including mortgages
- retail insurance, including annuity products
- any custodial service beyond traditional settlement (i.e., if you hold something after T+3, you're a custodian)

If you do any of those, then you are a Boring institution, you can do all Boring services, you face some significant regulations, and you get bailed out when necessary. If you do none of those, then you are an Exciting institution, you can do almost anything you want, and there is an ironclad rule preventing the government from bailing you out. Boring institutions cannot offer Exciting services (I think) and Exciting institutions cannot offer Boring services (that's certain).

It feels like a modern version of Glass-Steagall (although I'm probably not doing it full justice) – create an explicit linkage between tight regulation and a government backstop, and protect the part of the financial system that affects ordinary people.

A key requirement of this system is that you have to be willing to accept the consequences of the collapse of an Exciting institution. I'm not sure that Taunter has sufficiently sealed off the real economy from Exciting firms, however. For example, suppose an Exciting firm offers revolving credit accounts to companies that they dip into to make payroll (to smooth out fluctuations in cash flow over the month). I don't think this qualifies as Boring in Taunter's scheme. But if the Exciting firm goes down, suddenly thousands of companies might be unable to make payroll.

I'm not saying this is a fundamental flaw; maybe the lines just need to be drawn differently. Or maybe I'm missing something. In any case, it's an interesting way to think about the problem, especially for people who want to combine closer regulation of financial services that affect ordinary retail customers with free markets and financial innovation for sophisticated actors.

By James Kwak

The Perfect Product

James Kwak | 09 Sep 2009

I wasn't planning to write about this weekend's [New York Times article](#) about the securitization of life settlements after reading [Felix Salmon's post](#) saying there was no new news there. But I was thinking about it some more and thought it was an interesting concept, whether or not it gets off the ground.

Life settlements already exist. The idea is that someone has a whole life insurance policy with a death benefit of, say, \$1 million. The insured bought it when he was 35 and had two kids; now he's 70, the kids are working on Wall Street and don't need the death benefit, but they've cut him off and he needs some cash to fill the prescription drug donut hole and pay his Medicare co-pays. The insurance company will give him a cash settlement value of, say, \$100,000. I don't know what this actual number is, but the key point is that it is less than \$1 million at the insured's expected date of death, discounted back to the present (let's call that the current actuarial value of the policy). In a life settlement, an investor pays the insured a lump sum that is greater than \$100,000 – say, \$200,000 – and makes the premium payments (if any are left to be made) on his behalf; in return, the investor becomes the beneficiary on the policy. Again, this already happens, although there are concerns about churning, misrepresentation, the whole deal.

In a securitization, an investment bank would buy a whole lot of life insurance policies, pool them, and issue bonds in tranches (just like a CDO) to fund the purchase of the policies. The idea is that investors would get an asset that is uncorrelated or only loosely correlated with other assets, while insureds would get higher prices for their policies because there would be greater demand for them. This is not happening, although the Times articles makes it seem like it is going to start.

I think this is conceptually interesting because basically it is just securitizing an arbitrage trade. The obvious thing to compare it to is residential mortgages. When you securitize residential mortgages, you are expanding the pool of people willing to invest in buying houses, which spills over quite significantly into construction of new houses or improvement of existing houses. That is, you are moving capital to places where it is (theoretically) being productively invested. I've written several times about how this went too far, but the basic point is that securitization is promoting value-generating investment.

A life settlement, by contrast, is pure arbitrage: the ultimate thing you are investing in is just a financial product. Today, insurers make money because the cash settlement value is less than the current actuarial value; some people alternatively let their premiums lapse, and then they lose their death benefit, which is even better for the insurer. Expanding the market for life settlements would help those insureds because they would get the current actuarial value (less fees) instead of the cash settlement value. So the first order effect would be a transfer of money from insurers to insureds. But life insurance is a reasonably competitive industry; insurers will predictably raise premiums on everyone since they can't count on people taking the paltry cash settlement values or letting their policies lapse. So the second order effect will be a transfer of money from insureds who keep their policies until death to insureds who sell them prior to death, with the insurers just as well off as before.*

So at the end of the day, all we've done is pushed cash around – except for those fees! So the people involved in originating, packaging, and selling the securitized life settlements take home their 4%, and the rest is a zero-sum game. I'm not sure any value has actually been destroyed, since investment bankers are people, too. It's just that there used to be \$100 shared among insureds and their beneficiaries, and now there are only \$96 to share between insureds, their beneficiaries, and investors, and \$4 to share among the brokers and the bankers.

Now arguably the way the \$96 is being shared is more efficient than the way the \$100 was being shared, since you no longer have the people who take cash settlements subsidizing the people who collect death benefits like in the current system. But I don't think that we've gotten any aggregate social welfare in exchange for those \$4 in fees. I suppose there might be third-order benefits from efficiency here (might the insurance market function better in some sense? would this increase demand for life insurance? and is that a good thing?), but I'm skeptical.

* I got in an argument about this yesterday with someone who thought premiums could go down, but I can't tell you the details because it was off the record.

By James Kwak

Lessons Learned and Soon Forgotten

Simon Johnson | 11 Sep 2009

One year after the collapse of Lehman, the controversial “rescue” of AIG, and the ensuing collapse of world financial markets there are two questions: what have we learned, and what good will it do us?

The second question is essential, because we have learned so much about the functioning of our financial system – and the three main lessons are all rather scary.

First, our financial system has become dangerous on a massive scale. We knew that the banks were playing games, e.g., with their so-called off-balance sheet activities, but we previously had no idea that these huge corporations were so badly run or so close to potential collapse.

Second, we also learned the hard way – after many revelations – that pervasive mismanagement in our financial system was not a series of random accidents. Rather it was the result of perverse incentives – bank executives felt competitive pressure to behave as they did and they were well-compensated on the basis of short-term performance. No one in the financial sector worries too much, if at all, about risks they create for society as a whole – despite the fact that these now prove to be enormous (i.e., jobs lost, incomes lowered, and fiscal subsidies provided).

Third, weak government regulation undoubtedly made financial mismanagement possible. But poorly designed regulations and weak enforcement of even the sensible rules were in turn not a “mistake”. This was the outcome of a political process through which regulators – and their superiors in the legislative and executive branches – were captured intellectually by the financial system. People with power really believed that what was good for Wall Street was great for the country.

But how much good does all this new knowledge now do for us? There is very little real reform underway or on the table. We can argue about whether this is due to lack of intestinal fortitude on the part of the administration or the continued overweening power of the financial system, but the facts on the ground are simple: our banks and their “financial innovation” have not been defanged.

In fact, they are becoming more dangerous. The “Greenspan put” has morphed into the “Bernanke put”, to use the jargon of financial markets, where “put” means the option to sell something at a fixed price (and therefore to limit your losses). The Greenspan version was always a bit vague, involving lower interest rates when a speculative bubble ran into

trouble; the Bernanke version is huge, involving massive cheap credits of many kinds (as well as interest rates set essentially at zero).

Bernanke's Federal Reserve has shown that, when the chips are down, it can save the financial system even in the face of unprecedented global panic. But this will now just encourage more reckless risk-taking going forward. In the absence of full re-regulation of the financial system, the Fed's policies are asking for trouble.

Lou Jiwei, the chairman of China's large sovereign wealth fund, summed up the view of big international financial players last week, "It will not be too bad this year. Both China and America are addressing bubbles by creating more bubbles and we're just taking advantage of that. So we can't lose."

We have lived through a massive crisis – and learned how close we came to a Second Great Depression – yet nothing is now happening to prevent a repeat of something similar in the near future.

By Simon Johnson

This is a slightly edited version of a post that appeared first on the NYT's Economix blog. It is reproduced here with permission.

Recovery – or Not – in Words and Pictures

James Kwak | 11 Sep 2009

First, the pictures. Paul Swartz of the Council on Foreign Relations has a new version of his charts on the current recession in historical perspective, which I first linked to in June. The overall impression? We are still considerably worse off today than in other postwar recessions at this point (21 months in), although some indicators appear to be bottoming out.

Now the words. Edward Harrison of Credit Writedowns has a guest post at naked capitalism presenting the arguments for a robust recovery and for no recovery at all. He cites Joseph Stiglitz for the proposition that statistical GDP growth isn't everything, and extends the point to argue that you can have "low-quality" GDP growth if that growth is financed by debt without corresponding investment. When you happen to control the world's reserve currency you can do this for quite some time, and there's no saying we can't do it for a while longer. So one possibility Harrison foresees is a reasonable growth fueled by cheap money, yet no change to some of our underlying economic problems, including a financial sector with a put option from the federal government.

By James Kwak

Can Openers for Beginners

James Kwak | 11 Sep 2009

We haven't had a Beginners post in a long time, but David Kestenbaum's Planet Money post about [traffic court](#) got that part of my brain going again.

Kestenbaum's story is that he went to traffic court and the judge was a friendly populist, but not an economist:

"The judge went on to say that this was the "people's court" and explained that if she gave probation on a ticket, no points would appear and the insurance companies wouldn't find out. 'This court is not in the business of enriching the insurance companies,' she said."

Aha! Kestenbaum, who after a year on Planet Money is an economist, even if his Ph.D. is in physics, points out that whether or not people get points on their licenses doesn't affect insurance company profits. They need to charge bad drivers more because their loss payments for those drivers will be higher; if they can't find out who the bad drivers are, they will just raise premiums on everyone.

You can take this line of reasoning further.

- The first-order effect of hiding information from insurers is that those drivers will enjoy lower premiums than they otherwise would have paid.
- The second-order effect is that insurers will raise premiums on all drivers to make up the difference.
- The third-order effect is that fewer people will buy insurance. The reason is that the value of insurance is different for different people; if you are a good driver, insurance is worth less to you than if you are a bad driver. (Let's leave aside the very real problem that most people think they are good drivers, even though they aren't.) If the price curve for insurance flattens out (same price for all levels of riskiness), then the price for good drivers will exceed the value of insurance to them, and they will elect to "go bare" (that's the term used in the commercial insurance world, honest). This is bad because if fewer people are buying insurance, then the economy is producing less than the socially optimal amount of insurance.

- The fourth-order effect is adverse selection. If the good drivers drop out of the pool, the insurance companies know this (they will find out after a year when the accident rates are higher than they would be if all drivers were in the pool), and they will raise rates for everyone left. Now the middling drivers are being overcharged for insurance (the bad drivers are still being undercharged), so then they will drop out, and after another year the insurers will raise rates again. Theoretically this could go on until only one person is being insured, though in practice it obviously doesn't.

So by this line of reasoning it's a very, very good thing that bad drivers get points on their licenses and insurers use that information to set premiums.

There are a couple of other angles you can take on this scenario. For example, if only one traffic court judge is behaving this way, then her customers are getting a break, and what you have is a transfer of wealth from every other insured driver in the country to the people in her courtroom.

There. Now you know how to sound like an economist at a cocktail party.

But like much of this kind of economic speculation, which you will find all over the Internet, including here (hey, at least I'm aware of my shortcomings), is that it rests on a host of implicit assumptions. One of the big assumptions is perfect competition. Perfect competition is what makes things "balance out" all the time. Insurers can't simply fix premiums arbitrarily high above *everyone's* willingness to pay for insurance, because then each individual insurer would have a marginal incentive to lower premiums until all of the profits were competed away. Perfect competition lets you say that more or less nothing will affect an industry's profits.

But there is no such thing as perfect competition. If you consider a world where some companies happen to be better than others, then things get more interesting. You could argue that giving insurers information about driving violations (points) helps the better insurers, because they will be able to use that data more effectively in their pricing models. You could also argue the reverse: state-assessed points are an easy way for all insurers to get data, and hence they level the playing field; if they couldn't get that data, then the best insurers would find other ways to predict the likelihood of accidents (credit reports, for

example, although that is highly controversial and I believe illegal in some states), which would give them more of a competitive advantage. Without assumptions, things get messier.

Another common assumption is no regulation. In all states, however, drivers are required to buy liability coverage (though not collision and comprehensive), just like in most states companies are required to buy workers' compensation insurance. When there is a legislated captive market, the third-order effect above doesn't apply, and the adverse selection problem becomes more complicated (it doesn't go away as long as people can choose different attributes of their policies, like limits and deductibles).

Then of course there is the assumption of rational actors. Because everyone thinks he or she is a good driver, people underestimate the value of insurance. Or at least, they would underestimate it if they actually thought about it. But they don't actually try to calculate the value of insurance to them and make a buying decision on that basis – they just buy it from whoever offers them the lowest price for some package of coverages they decide they need based on certain rules of thumb, like “whatever my parents told me to buy the first time I had a car.” Without rational actors, most of this type of cocktail party economics breaks down – but where's the fun in that?

So now you should be familiar with a large proportion of the arguments made by economists. Extra credit to those who can explain the title.

By James Kwak

Another Year, Another Decline in Employer-Based Coverage

James Kwak | 11 Sep 2009

Ezra Klein shows the new Census figures on the uninsured. The long-term trend is absolutely clear: employer-based coverage is declining and public coverage is increasing, but not enough to make up the gap. Looking at the underlying data, we can see that 2008 was the eighth consecutive year in which the proportion of people covered by employer-based health insurance declined.

This is a point I've also tried to make before. Not only is employer-based coverage deteriorating, but the reasons for that deterioration imply that it is likely to only accelerate. As health care costs continue to increase, even if the rate of increase stays the same, the rate of deterioration will increase, because each year health care costs become a larger proportion of total costs and therefore harder to absorb. (Put another way, if health care cost inflation remains around 7% per year, each year it will be 7% of a larger proportion of employers' costs.) Deterioration will take three forms – some employers will drop health coverage altogether, some will increase the share paid by employees, and some will shift toward less-generous plans.

Klein's point is that it may be dangerous to premise health care reform on the idea that the employer-based system will remain what it is, because it won't. My point was that because the employer-based system is slowly dying, people with employer-based coverage should not be thinking, "I don't need health care reform, I've got my employer-based plan;" they should be thinking, "I'm afraid of what will happen when my employer drops its plan, so I need health care reform." Unfortunately, I think both of us are right.

By James Kwak

Economic Donkeys

Simon Johnson | 13 Sep 2009

Early in the First World War, British generals decided to attack German trenches with an initial light bombardment, followed by infantry walking in close order across No Man's Land. The result was tens of thousands killed in a series of military disasters, but the generals reacted with only small adjustments to their approach and essentially persisted in repeating the same mistakes for years. "The English soldiers fight like lions," one German general remarked. "True. But don't we know that they are lions led by donkeys?" was the reply.

Today, a year after global financial collapse and the ensuing tragedy for millions, our economic leaders are lining us up to suffer again (and again) through the same horrible experiences.

The collapse of Lehman Brothers in September 2008 demonstrated just how far our economic system in general and bank management in particular have gone awry. Lehman borrowed at low interest rates in global credit markets, and invested over half a trillion dollars of other people's money in assets which, today, are worth next-to-nothing: failed ski hills in Montana, now empty suburban housing in California, and crazy bets on derivatives (options to buy or sell securities, in various complex combinations).

Worries about these failed investments sparked a run on the bank. And, after a mad weekend of trying to save Lehman, the U.S. "authorities" – meaning Henry Paulson (Secretary of the Treasury), Ben Bernanke (chairman of the Federal Reserve Board), and Timothy Geithner (President of the New York Fed) – decided to let it go bankrupt. Creditors, realizing no major bank is safe if our leaders might now let them fail, pulled cash from major financial institutions and bought relatively safe US Treasuries and UK Gilts.

Today Lehman's senior debt trades at a mere 10 cents on the dollar, suggesting its \$600 billion in assets were a mirage. This outcome is even more startling when compared to senior debt at Kazakhstan's defaulting large banks, where management is now accused of serious malfeasance, yet that debt trades at 20 cents on the dollar – twice the price of Lehman's debt.

At the G20 meeting of finance ministers last week, political leaders united behind two key steps which they claim will "prevent another Lehman": tighter controls on the pay of executives and more capital for

banks. France and Germany blame the crisis on lax regulation in Anglo-Saxon markets and excessive pay packets that encourage irresponsible risk taking. The British and Americans counter that European banks have too much debt (i.e., in the jargon, are “overly leveraged”), and need to raise more capital. The final communiqué proposes to do both, and we will hear more of the same at the upcoming G20 heads of government summit in Pittsburgh. But, in reality, both sides want only minor adjustments that cannot solve the real problems posed by our financial system.

Tim Geithner, now US Treasury Secretary, is pushing for higher capital requirements for banks, i.e., they need to have more shareholder funds to protect against future losses. But he surely knows that two weeks prior to its bankruptcy, Lehman’s management reported they were well-capitalized, with a tier one capital ratio of 11% — roughly twice what the United States currently considers is needed for a well-capitalized bank, and much higher than the American side is proposing in private conversations.

Christine Lagarde, France’s Finance Minister, and Angela Merkel, President of Germany, helped convince the G20 that bank compensation policies need to be amended to encourage long term incentives. They want compensation packages to be limited and bonuses to be locked up, so we can be sure employees’ incentives are consistent with the long term survival of their banks.

President Merkel and Minister Lagarde need to look no further than Lehman for a model of how to introduce a good policy to align incentives. The top management and many employees in the company were largely compensated in shares of the company which vested over many years, so when Lehman Brothers went down, it brought crashing down the lives and finances of its 20,000 employees. Dick Fuld, the highly compensated head of Lehman, lost many million dollars – and presumably a large part of his total wealth. Apart from criminal penalties (of the kind not seen for banking in a century), can we think of a better way of aligning incentives with the outcomes for a bank?

The real problem with our financial system is that our economic and political system work together to encourage excessive risk, and this risk in turn leads to cycles of prosperity and collapse. In 1998, a much smaller Lehman Brothers was placed in financial peril by the aftermath of the Asian financial crisis and failure of Long Term Capital Management, a major hedge fund. The Federal Reserve responded by lowering interest

rates and other central banks followed suit. This reduced the cost of obtaining funds, effectively bailing out Lehman and other institutions in trouble.

As markets have grown to recognize how quick the Federal Reserve is to bail out institutions (and executives) in trouble, they naturally respond. In the 1990s, people talked about the “Greenspan Put” a term which derisively suggests that it is always safe to invest in risky assets, because the Federal Reserve is ready to bail out investors (a put is effectively a promise to buy an asset at a fixed price if you are unable to sell it to someone else at a higher price – this is a way to lock-in profits or limit losses on investments). However, in months following the collapse of Lehman, we learned that the “Bernanke Put” is even more valuable since Chairman Bernanke, alongside the Bank of England, the European Central Bank, and central banks in much of the rest of the world, is prepared to take drastic measures to prevent asset prices from falling when there are risks of global collapse.

This policy of responding to the aftermath of bubbles, rather than addressing them before they get going, through tighter regulation, has become the mantra of most central banks. It is usually combined with fiscal policy stimulus and other measures to support the economy. Each time banks fail, by bailing the system out again, we teach our finance sector a lesson: you can safely take too much risk because, when you lose, the taxpayer will pick up the bill. We also send a simple message to creditors: it is safe to lend to Goldman Sachs, or Barclays Bank, because taxpayers and our nations’ savers are standing by to cover your losses. Rational bank executives and creditors respond as any person would: creditors lend to banks at low interest rates, and our banks gamble heavily hoping to make large profits. Such a system is destined to fail, but the party can run for a long time.

While Ben Bernanke has done a wonderful job of preventing financial meltdown, his calls in 2002-2003 for very low interest rates, without fixing our financial system, contributed to the credit expansion that led us into the current mess. In the United Kingdom, the Conservatives plan to transfer regulatory powers to the Bank of England, despite the fact that, like the Federal Reserve, the Bank of England has been a key component of our ever growing cycles of credit expansion and bust.

The “collapse or rescue” decision forced by Lehman’s failure is a symptom of a much larger systemic problem. We need leaders, both in the financial world and in public service who recognize that our financial

sector too often causes social harm. There is no doubt that it also provides valuable services that are vital to the well-being of our pensioners and savers, and help manage and mitigate risk for our corporations. Yet too often these activities cause losses, which, either directly or indirectly, become a burden on the rest of society.

The pre-crisis activities and portfolios of Barclays, Goldman Sachs, and other “survivors” of this crisis were only slightly different from Lehman Brothers or Bear Stearns, which failed. The “good” banks also securitized subprime assets, helped build the intricate web of IOUs between banks and insurance companies, and leveraged their balance sheets to enormous levels. The winners were not better, they were just smart enough to make sure someone else held the bad assets when the music stopped, and they were powerful enough to win generous bailout packages from their governments.

The danger we face is that, by bailing out these institutions and rewarding failed managers with new powerful positions, we have now created a much more dangerous financial system. The politically well-connected, knowing they will most likely do fine in the next crisis, is now highly incentivized to take even greater risk.

Once we admit this profound problem in our system, we can begin to think of the radical measures needed to solve it. There is no doubt these solutions will include much greater capital requirements, so that bank shareholders know that they face substantial losses if their ventures fail.

But, we also need to ensure that our regulators are not captured by the banks that they are meant to oversee. This means we need to put checks on financial donations to political parties, and we need to buttress our regulators with more intellectual firepower and financial resources, along with rules that ensure independence, in order to be sure they can act in the interests of the broader population.

We also need to close the revolving door, through which politicians and regulators leave office to earn their nest eggs in finance, and “financial experts” move directly from failing banks to designing bailout packages. The conflicts of interest are abundant and most dangerous.

Last week the UK’s chief financial regulator, Adair Turner, faced heavy criticism from the City, Chancellor Darling, Boris Johnson, and editorials in the Financial Times and Wall Street Journal. His main offense was daring to raise the issue of whether parts of our financial system have become socially dysfunctional, in an interview with Prospect Magazine. He called for greater capital requirements at banks,

and he pondered how it would be possible for regulators to preserve the valuable parts of our financial system, while ensuring that regulation limited the harmful parts. These are eminently sensible questions which anyone with a public spirit should understand are critical policy issues today.

Sadly, these public rebukes to Lord Turner are a further indication that very few of our leaders are prepared to even discuss the real problem, let alone seek a sufficient solution. Smart people and well-organized governments can, as in the past, behave like donkeys.

By Peter Boone and Simon Johnson

An edited and shorter version of this post appeared today in the Sunday Times (of London).

Where Are We Again? (Pre-G20 Pittsburgh summit)

Simon Johnson | 14 Sep 2009

This revision to our Baseline Scenario is required reading for my Global Entrepreneurship Lab (GLAB) class at MIT this week. For those classes, please also look at [these updated slides](#).

Financial markets have stabilized – people believe that the US and West European governments will not allow big financial institutions 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](#)). Small and medium-sized banks, however, will continue to fail as problems in commercial real estate continue to mount.

The economic recovery, in the short-term, may be surprisingly strong in terms of headline numbers; this is a standard feature of emerging markets after a crisis (e.g., Russia from 1998 or Argentina after 2002). [Official short-term forecasts](#) are probably now too low, as the IMF and other organizations make the case for continued fiscal stimulus and very loose monetary policy.

However, a [two-track economy](#) appears to be developing: one part will do well (e.g., around big banks on Wall Street), and another part will struggle (many consumers and firms around the world want to reduce their debt; the same thing happened in [Japan's "lost decade"](#)). During the 1990s, Japan had some years with good growth, but overall the decade was a disappointing deceleration of growth; the same could be true now at the global level.

Longer term U.S. growth prospects remain particularly 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)? The implication, presumably, is higher taxes on the productive nonfinancial part of the economy – to pay for the implicit subsidies and ongoing rents of the financial sector. While many entrepreneurs understand and resent this math, they are strikingly unwilling to do anything about – or even speak out on – reining in the power of the biggest banks. Even the smaller banks – who have really been hammered by the actions of larger banks – are only just now

figuring this out and beginning to express resentment; sadly, this is too late to make much difference.

There has been a great deal of attention recently on income distribution (WSJ; NYT), with the argument being that the long financial boom made some people richer and the bust is bringing them back down. But this misses the point that (a) some of the mega-rich will do very well; think about how Carlos Slim took over large parts of the Mexican economy after 1995, and watch Wilbur Ross acquiring assets in the US today, (b) billionaires becoming millionaires is hardly something to get worked up about.

The real damage is for 10-15 percent of American society, mostly without college education, who lost jobs, houses, and education opportunities. The First Great Depression was a decade of effective poverty and other terrible outcomes for around 25-30 percent of American society. We have avoided a Second Great Depression but the social costs are still huge. Think through the political implications of that.

The collapse of Lehman Brothers in particular and the ensuing financial crisis in particular exposed serious weaknesses in our banks, insurance companies, and financial structures more generally. We were “saved” by radical central bank action and additional government spending. Over the past 20 years, crises have become more severe and more expensive to counteract. We are on a dangerous and slippery slope.

Yet there is no real reform underway or on the table 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 (and even there, the final achievement looks likely to be limited).

The latest New York Times assessment of financial sector reforms is bleak. The Washington Post is running an excellent series on exactly how and why the banks have become stronger (part one; part two). Big banks have risen greatly in power over the past 20 years and were already strong enough this winter to ensure there was no serious attempt to rein them in.

Financial innovation is under intense pressure in both popular and technocratic discussions, but does not face any effective regulatory controls (our view; Adair Turner). This is a dangerous combination.

Unless and until there is real re-regulation of finance, repeated major crises seem hard to avoid. Wall Street responds, “we have changed how we behave,” but this must at best be cyclical – after any emerging market crisis, the survivors are careful for a while. But then they go on another spree and you re-run the same boom-bubble-bust-bailout sequence, in a slightly different form and with potentially more devastating consequences. The potential for serious crisis will not decline unless and until you change incentives – and this frequently requires a change in power structure (think Korean chaebol, Thai banks, or Indonesia under Suharto).

The consensus from conventional macroeconomics is that there can't be significant inflation with unemployment so high, and the Fed will not tighten before mid-2010. The financial markets are not so convinced – 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. The conventional oil market view is that there is plenty of spare capacity so we cannot experience the price spike of early 2008; we'll see if this proves complacent.

Emerging markets, in particular in Asia, are increasingly viewed as having “decoupled” from the US/European malaise. Increasingly, we hear that Asia's fundamentals allow strong growth irrespective of what is happening in the rest of the world. This idea was wrong in early 2008, when it gained consensus status; this time around, it is probably setting us up for a new round of financial speculation – based in part on a “carry trade” that now runs out of the US. Most Asian currencies are a one-way bet against the US dollar over the medium-term, as they are already considerably undervalued and their central banks actively intervene to prevent significant appreciation. The appetite for this kind of risk among investors is up sharply.

What should we expect from the Pittsburgh summit on September 24-25? “Nothing much” seems the most likely outcome. The leadership of industrial countries does not want to take on the big banks, and the technocrats have contented themselves with very minor adjustments to key regulations (“dinky” is the term being used in some well-informed circles.) The G7/G8/G20 is back to being irrelevant or, worse, mere cheerleaders for the financial sector.

Overall, the global economy begins to recover, but the crisis created huge lasting costs for many poorer people in the US and around the world. Recovery without financial sector reform and reregulation sows the seeds for the next crisis. The precise timing of crises is always uncertain but the broad contours are clear – just like many emerging markets over past decades, the US, Europe, and the world economy look set to repeat the boom-bailout cycle. This will go on until at least until one or more major countries goes completely bankrupt, or until a real financial reform movement takes hold either among technocrats or more broadly politically – and the consensus then shifts back towards the kind of much tighter financial regulation that was established after the last major global fiasco in the 1930s.

By Simon Johnson

The Importance of Outcomes

James Kwak | 14 Sep 2009

Last week, Bill Moyers interviewed Jim Yong Kim, a distinguished medical professor and leader of nonprofit organizations and the new president of Dartmouth College. A lot of Kim's work is dedicated to improving health in the developing world, so you might think he is some sort of soft-hearted lefty. But one of his main points about our health care problems was that our health care delivery system is not sufficiently tough-minded and calculating, and that health care providers can learn a lot from the business world. For example:

"JIM YONG KIM: So a patient comes into the hospital. There's a judgment made the minute that patient walks into the emergency room about how sick that person is. And then there are relays of information from the triage nurse to the physician, from the physician to the other physician, who comes on the shift.

"From them to the ward team, that takes over that patient. There's so many just transfers of information. You know, we haven't looked at that transfer of information the way that, for example, Southwest Airlines has. Apparently they do it better than any other company in the world.

"BILL MOYERS: Computers?

"DR. JIM YONG KIM: No, they have taken seriously the human science of how you transfer simple information from one person to the next. And in medical school, and in the hospitals that I've worked in, we've done it ad hoc. Sometimes we do it well. Sometimes we don't do it well. But what we know is that transfer of information is critical. Now to me, again, that's the rocket science. That's the human rocket science of how you make health care systems work well."

In other words, to take just this example, we know that the way information is transmitted can have a major impact on the quality of health care, yet most people in the field neither study it or pay attention to it. Why is this? Kim points to a few reasons.

First, there is the myth of technology: "I think for many, many years, we've been working under the fantasy that if we come up with new drugs and new treatments, we're done."

Second, there is the peculiar nature of the health care delivery market: “What we’ve learned about organizations is that it is very difficult to get a complex organization, a group of people, to work consistently toward a goal. In the business world, if you don’t do it well, the market gets rid of you. You go out of business. But many hospitals executing very poorly persist for a very, very long time.”

And third, there is a cultural aspect: “I’ve noticed over the years that when it comes to our most cherished social goals, not only do we tolerate poor execution, sometimes we celebrate poor execution. Sometimes it’s part of the culture. You know, these folks are trying to solve this terrible problem. They can’t keep their books straight. They really don’t know what they’re getting. They don’t measure anything. But they’re on the right side, so that’s okay.”

Kim’s solution is something that the Dartmouth Institute has been doing: study outcomes, and study them scientifically, so you can identify what inputs lead to what outputs. I don’t think this is a sufficient solution, because even if you know exactly how to deliver high-quality, low-cost health care, if physicians are still being paid more to conduct unnecessary tests, they will conduct those tests. But if you don’t know how to deliver high-quality, low-cost health care, then you are just wandering around in the dark.

By James Kwak

Obama, the Light Touch?

James Kwak | 14 Sep 2009

Edmund L. Andrews and David E. Sanger have an article in The New York Times today that is sure to infuriate some people, including me. Here's one excerpt:

"Far from eagerly micromanaging the companies the government owns, Mr. Obama and his economic team have often labored mightily to avoid exercising control even when government money was the only thing keeping some companies afloat.

"A few weeks ago, there were anguished grimaces inside the Treasury Department as the new chief executive of A.I.G., Robert H. Benmosche, whose roughly \$9 million pay package is 22 times greater than Mr. Obama's, ridiculed officials in Washington — his majority shareholders — as 'crazies.'

"Causing even more unease to policymakers, Mr. Benmosche insisted that A.I.G. — one of the worst offenders in the risk-taking that sent the nation over the edge last year — would not rush to sell its businesses at fire-sale prices, despite pressure from Fed and Treasury officials, who are desperate to have the insurer repay its \$180 billion government bailout.

"But in the end, according to one senior official, 'no one called him and told him to shut up,' and no one has pulled rank and told him to sell assets as soon as possible to repay the loans.

"A similar hands-off decision was made about the auto companies. Shortly after General Motors and Chrysler emerged from bankruptcy, some members of the administration's auto task force argued that the group should not go out of business until it was confident that a new management team in Detroit had a handle on what needed to be done.

"But Mr. Summers strongly rejected that approach, and the Treasury secretary, Timothy F. Geithner, agreed.

"'The argument was that if the president said he wasn't elected to run G.M., then we couldn't hire a new board and then try to run any aspect of it,' one participant in the discussions said. The auto task force took off for summer vacation in July, and it never returned."

The political argument for this position makes sense. Basically, Obama and his administration are afraid of being charged with “socialism” or “big government,” so they are doing what they can to defuse this charge. (Not that that will help given the way political rhetoric is thrown around these days.)

I’m not sure the policy argument makes as much sense. Think about GM, for example. The Treasury Department owns 60% of GM. In the private sector, if you were a private equity fund manager who owned 60% of a deeply troubled company, and you *didn’t* play an active role in its reconstruction, your investors would accuse you of being negligent. In a turnaround situation, the majority investor is supposed to be actively involved, especially when he’s doing it with other people’s money, since he has a fiduciary obligation to those other people. Yet the administration is going out of its way to *not* be involved in GM. This is from the June 1 fact sheet:

“As a common shareholder, the government will only vote on core governance issues, including the selection of a company’s board of directors and major corporate events or transactions. While protecting taxpayer resources, the government intends to be extremely disciplined as to how it intends to use even these limited rights.”

The phrase “common shareholder” is probably intended to emphasize the fact that the government is a shareholder, not the board or management, but it conveniently overlooks the fact that the government owns 60% of the common shares – which most majority owners usually use to install a majority of the board of directors.

Leaving political arguments aside, what are the possible justifications for this policy? One is that an active government presence will scare away new private investors. I think we can safely dismiss that fear in the case of GM, at least for the next year or so, since those new private investors do not exist.

Another possible justification is that government involvement will become a channel for political influence from Congress. But this was not true, for example, of the administration’s automotive task force, which operated independently of Congress.

The other possible justification is that the government is somehow incompetent in a way that a private equity investor – say, Cerberus, the previous owner of Chrysler – is not. I know there are many people who

think this is the case. But first of all, even if you are the Treasury Secretary and you happen to think that the people who work for you are incompetent, there are still other solutions; for example, you could hire KKR to be the trustee for your 60% stake in GM and act on your behalf, rather than just turning your back on your multi-billion-dollar investment of taxpayer money. (I'm not recommending this, just pointing it out as an option.)

And more importantly, why is President Obama – the man who, last Wednesday night, said, “[Our predecessors] also understood that the danger of too much government is matched by the perils of too little; that without the leavening hand of wise policy, markets can crash, monopolies can stifle competition, and the vulnerable can be exploited” – subscribing to the anti-government caricature of right-wing talk radio? Does he really think that the federal government, and the dozens of talented people he hired and appointed, is too incompetent to do what any twenty-something Ivy League graduate with the connections necessary to raise a \$100 million fund can do?

By James Kwak

Kindle Comments?

James Kwak | 15 Sep 2009

As a few of you have figured out, you can [read our blog on the Kindle](#). I know a few of you know this because I have received a very small amount of money from Amazon – a good deal less than the annual expenses of maintaining this blog, and those expenses are probably only in two figures anyway.

Simon pointed out that not being able to read comments on the Kindle is a problem. The reason for this is that WordPress.com separates posts and comments into two separate feeds. So I was just over at the Kindle Publishing site, about to publish the comments feed as a separate Kindle blog, when I realized I had no idea what the copyright status of comments is. In particular, if I do publish the comments feed on Kindle, I will make (a paltry amount of) money from other people's work.

Now, I am guessing I am probably on firm legal ground doing that, since there are lots of blogs that make money (though few that make a lot of money), and they are all to some degree making money off of their comments. I think I'm on firm ethical ground as well, since the amount of money is so small that there is just no way to distribute it to the commenters that would not cost more to implement than the revenue I would receive. But I wanted to know: (a) if anyone knows of a good discussion of this topic (I can't be the first person to think of it) and (b) if any of our regular commenters cares one way or the other.

Thanks.

By James Kwak

Obama And Brandeis

Simon Johnson | 15 Sep 2009

President Obama's speech yesterday was disappointing. As a diagnosis of the problems that let us into financial crisis, it was his clearest and best effort so far. He didn't say it was a rare accident for which no one is to blame; rather he placed the blame squarely on the structure, incentives, and actions of Wall Street.

But then he said: our regulatory reforms will fix that. This is hard to believe. And even the President seems to have his doubts, because he added a plea that – in the meantime – the financial sector should behave better.

The audience was comprised of our financial elite, but the Wall Street Journal reports “not one CEO from a top U.S. bank was in attendance” (p.A4). How's that for demonstrating respect, gratitude, and a willingness to behave better?

Louis Brandeis, of course, would have seen things differently. The author of “Other People's Money: And How The Bankers Use It,” was under no illusions concerning the underlying financial power structures and how they operated. He would have regarded an appeal to the better nature of bankers as somewhere between humorous and sad.

The only thing that will make a difference is regulation. This is the lesson of the 1930s in the US – the regulations imposed at that time created a financial sector that did not impede growth after World War II; basic intermediation (connecting savers and borrowers) worked fine and destabilizing frenzies were avoided. During this period, the financial sector came up with venture capital, ATMs, and credit cards – arguably the three most important financial innovations of the past 100 years, and much more helpful of real innovation than anything you've seen since 1980.

President Obama claimed that three regulatory proposals will make the system safer.

“First, we're proposing new rules to protect consumers and a new Consumer Financial Protection Agency to enforce those rules.” This is a very good thing, and of course the banks are adamantly opposed. But this Agency will not by itself bring us financial stability; that requires change at the level of how banks and other financial institutions are operated.

Second, he talked about “gaps in regulation”; this is international finance bureaucrat code for mush (doesn’t the President know this?). The specific potentially interesting pieces he put under this heading were run together in this paragraph,

“While holding the Federal Reserve fully accountable for regulation of the largest, most interconnected firms, we’ll create an oversight council to bring together regulators from across markets to share information, to identify gaps in regulation, and to tackle issues that don’t fit neatly into an organizational chart. We’ll also require these financial firms to meet stronger capital and liquidity requirements and observe greater constraints on their risky behavior. That’s one of the lessons of the past year. The only way to avoid a crisis of this magnitude is to ensure that large firms can’t take risks that threaten our entire financial system, and to make sure they have the resources to weather even the worst of economic storms.”

Making the Fed responsible for the largest firms could work, but only if the Fed throws out pretty much everything about the Greenspan doctrine of cleaning up after financial messes, rather than preventing them. There is no indication they are moving in this direction.

The oversight council is unlikely to make a difference. If you ask someone, “Who is responsible for this problem?” and they answer, “Well, we have a committee,” does that make you feel better or worse?

The administration will not tell anyone the exact capital and liquidity requirements they are proposing, but close observers of the internal administration process have taken to calling the likely increases “dinky”. Remember, the last time our financial system showed this taste for risk and a comparable level of incompetence (prior to 1935), it had equity relative to assets roughly three times current levels (e.g., put into tier one-equivalent terms). There is no proposal on the table, either in the US or within the G20, that is even remotely in the right ballpark. President Obama has put his finger on the problem but is apparently unwilling to do anything about it.

The most remarkable phrasing is probably, “Even as we’ve proposed safeguards to make the failure of large and interconnected firms less likely, we’ve also proposed creating what’s called “resolution authority” in the event that such a failure happens and poses a threat to the stability of the financial system. This is intended to put an end to the idea that some firms are “too big to fail.””

It is very hard to understand how the administration can say this with a straight face. Certainly a resolution authority would help, but all bank interventions are negotiated receiverships or conservatorships of some kind. When banks are failing, they need a lot of money fast and you have them over a barrel. But if they are vast, complex, and – remember this – cross-border, then taking them over or shutting them down can be scary, whether or not you have a “legal authority”. Please point out to me (a) what the US is pushing the G20 to implement in terms of a cross-border resolution authority, and (b) how you would intervene in a bank like Citi without a cross-border authority. This rhetoric around this issue is completely not serious – in fact, it’s a distraction from the real issues.

And, of course, the real issues were not mentioned at all.

1) The largest financial institutions have to be made smaller — aim to make them under \$100bn in assets, roughly the size of CIT Group which even this Treasury was willing to leave to its own devices. We can do it with legislation now or by regulatory fiat next time the behemoths get into trouble, but we should do it before they ruin us.

2) The people who run banks like to talk about “skin in the game” in various contexts, but they generally have only a small proportion of their wealth at risk in these financial institutions. This is not a panacea of course, but it is completely fair to ask them to stake a large part of their fortunes. If they respond that this is not fair because all kinds of things can happen that are beyond their control, you should say, “Agreed – so split your bank up and manage something much smaller.”

3) The revolving door between Wall Street and Washington is out of control. There is no way people should be able to go directly (or even overnight) from a failing bank to designing bailout packages to benefit such banks. In any other industry, in any other country, and at any other time in American history, this would have been seen as an unconscionable conflict of interest. Let’s get our principles back and impose a 5 year moratorium on such flows in either direction.

4) The way the Fed operates means that, in the absence of tough regulation, the finance industry has at its disposal the world’s greatest ever bailout machine. Our financial elite knows this and is acting accordingly.

Brandeis was scathing about the individuals behind the financial structures. For him, it was about power and it was about control. He was appalled by how big finance operated and he worked hard – an uphill slog – to rein it in.

But Brandeis never saw anything like what we have now experienced, with regard to the amount of taxpayer money that the banks are able to expropriate when downside risks materialize. The big banks that Brandeis feared did not, in the end, dominate the 20th century. But they are back now, with unfettered power and an arrogance that spells trouble.

Ultimately, we will put the banks back in their regulatory box or they will bankrupt us all.

By Simon Johnson

Moral Hazard, Moral Hazard, and Moral Hazard

James Kwak | 15 Sep 2009

Everyone is writing a Lehman anniversary post these days, and ours is up as our weekly Washington Post column. Our topic is the many forms of moral hazard involved in the banking business these days – for employees, shareholders, and creditors – and whether or not the proposed regulatory reforms will be up to the task of dealing with the problem.

By James Kwak

No, Wait! This Is What I Really Want!

James Kwak | 16 Sep 2009

I try not to comment on purely political issues, but sometimes they are just too infuriating.

Over the last few days, Max Baucus has been leaking “his” health care proposal, which should be made public. Regular readers will know I’m no fan of Max Baucus, whose main goals seem to be killing the public option (I know, it’s not as big deal as it’s made out to be, but it isn’t irrelevant) and cutting subsidies to poor people. But supposedly, the whole point of the Baucus/Group of Six approach was that it would result in a bipartisan bill that could clear the Senate. The tradeoff was very simple; a plan that isn’t as good as it could be, but one that could pass.

Yesterday, The New York Times reported two of the three Republicans in the Group of Six, Charles Grassley and Michael Enzi, are *against* the Baucus proposal, and even Olympia Snowe wants changes.

The Republican demands:

- Not shifting some of the increased Medicaid costs onto states. To be clear, the federal contribution to the new Medicaid costs will be *higher* than the federal contribution to existing Medicaid costs; Medicaid is already jointly funded. Still, though, this seems like a reasonable objection to me, since it is just hiding part of the cost of the bill by shifting it to the states.
- No (or lower) new fees and taxes on “health insurance companies, clinical laboratories and manufacturers of medical devices,” which are part of Baucus’s plan to pay for subsidies (which he has already cut relative to the other bills). Again, this is reasonable as long as the Republicans have some other way of paying for the subsidies; if they just want to cut the subsidies, that sounds like a tactic to kill the bill altogether, because without significant subsidies health care is simply unaffordable for the middle class and the whole thing breaks down.
- A prohibition on using federal subsidy money for abortions. This is a clear revival of the culture wars. The only way I could see to implement it would be to say that anyone who gets a subsidy cannot get an insurance-funded abortion – which means that poor *and* middle-class people can get abortions if they have employer-based coverage (which is subsidized by the employer health

insurance tax exemption), but not if they have subsidized individual coverage (which is subsidized directly). How that is a good policy outcome escapes me.

- A five-year waiting period before *legal* immigrants can receive subsidies. More culture wars. We should *want* legal immigrants. Legal immigration is one reason we do not have the looming demographic problems of Japan and Western Europe. A large and increasing proportion of the graduate students at American universities are foreign citizens; we should want them to stay here. My parents are immigrants. Simon *is* an immigrant.
- No individual mandate, according to Grassley. Where has Grassley been the last three months? An individual mandate is the glue that holds all of reform together – because if private insurers can't charge higher premiums to the old and sick, they need the young and healthy to come into the market. A health care system has to have a redistributive component, or it will be simply unaffordable to the people who need it.
- Olympia Snowe also has an idea about allowing private insurers to offer national plans.

Sorry that took so many words. Because my main point isn't that these are stupid objections – only some of them are – but this: what were you doing for the last two months? These are not new issues, or they shouldn't be. Grassley is criticizing Baucus for pushing forward according to some "Democratic" timetable when they need more time. Time for what? It's not like there is new information coming in.* Grassley is really using one of the oldest negotiating tactics in the book – drag things out, pretend to go along, wait until the other side is running up against time pressure, and then escalate your demands. And now Baucus has nothing to show for his supposed third way of bipartisan negotiations.

Either Grassley is using Baucus to (a) pretend he is interested in a bipartisan bill so he can (b) blame the breakdown on Democrats, forcing them to (c) try to pass the bill on their own, which is more difficult than it would have been in July. Or Baucus ... Baucus has some trick up his sleeve that I can't see that will make him come out of this looking good. (I'm no expert on Congressional politics, so he very well might.) Or the entire Group of Six is being played for fools by the rest of the Republicans. Check this out, also from The New York Times:

“Most Republicans have been deeply unhappy with the Democratic health care proposals so far, and Republicans on the Finance Committee were said to be bracing for two possibilities: a partisan proposal that they were going to oppose, or a bipartisan proposal that they were going to oppose.

“The Republican leader, Senator Mitch McConnell of Kentucky, said he would be surprised if any Republicans ended up backing the proposal by Mr. Baucus.”

Well, there you have it. The one thing that makes me hopeful is that Baucus’s reputation rests on his getting something out of his committee, so I expect he will do it one way or another, whether it is with zero or one Republican vote. But a massive raft of concessions to get Olympia Snowe’s vote (and maybe lose some liberal Democrats) doesn’t sound to me like a brilliant legislative tactic.

* Actually, there is new information, and it isn’t good. There were the Census figures on the uninsured and the decline in employer-based coverage, and now there is the new Kaiser Family Foundation study showing that, once again, insurance costs rose much faster than inflation overall. (We wrote about the previous version of that study here.)

By James Kwak

The CFPA and Small Banks

James Kwak | 16 Sep 2009

To be clear, I favor the Consumer Financial Protection Agency. I favor it because I think it will be good for consumers. I also like to think that it will be good for small banks relative to big banks. My main argument for this is that should not harm the main competitive advantages of smaller banks, which should be customer service and local underwriting. But I'm still in favor of the CFPA even if it doesn't help small banks.

John Pottow (hat tip Mike Konczal) agrees on the small bank point. His main argument is that the CFPA should lower fixed regulatory costs by making it easier to get approval for basic products. He also adds this point:

"The current credit market, with its indecipherable multi-page contracts, is not competitive. Actually, that's not true: It's perniciously competitive — the competition focuses on better hiding fees in small print. Burying terms in legal documents is an activity where larger banks again hold the advantage. By contrast, a true plain vanilla market would remove the obfuscation and refocus the competition on price. Once more, smaller lenders would benefit from this increased transparency and leveled playing field."

Now, Stephen Ranzini, an executive at a small bank did write in with this comment on Pottow's article:

"Since the penalty for offering any product that isn't 'plain vanilla' will be severe if that product is 'after the fact' found to be not to the liking of these new CFPA bureaucrats, only plain vanilla products will be offered. Since large banks can leverage economies of scale and a lower compliance burden per dollar of assets to outprice smaller banks and we won't be able to compete anymore by crafting niche products to serve niche needs, we will be screwed (as will our customers). Gov't needs to better regulate the non-banks. Michigan has only 15 bank examiners for all the mortgage firms in the state. These non-banks created 95% of the toxic exotic mortgages because they aren't effectively regulated."

Now, there's a fair amount of hysteria and blame-the-other-guy in here. First, he throws in the insult of calling CFPB regulators "bureaucrats," while later in the comment he says there should be *more* regulators – to regulate non-banks, not him. Note that he doesn't call those other regulators "bureaucrats;" he calls them "bank examiners." I agree that non-banks need more regulation, but I don't agree with the implicit assumption that this can be done by traditional prudential regulators; we've already seen where that got us. Also, blaming subprime lending on "non-banks," is disingenuous, although they did play a major role. Not only did the top 25 subprime lenders include banks such as Citi, Wells, Wachovia, Chase, HSBC, IndyMac, and National City, but most of the others were supported by large banks that provided financing by buying up their mortgages.

Still, though, if the commenter is right that the small bank strategy is "niche products to serve niche needs," then he may have a point. I'm still skeptical, because his entire argument rests on the premise that regulation will be so severe that it will be chilling to the market – and when have we seen that in the last thirty years? – but there could be something there.

By James Kwak

Voodoo Cost Savings

James Kwak | 16 Sep 2009

If you really want to know about Max Baucus's bill, head on over to [Ezra Klein's blog](#), which is all Baucus, all day. If you want to complain about fake cost-saving measures, stay here.

A major selling point of the Baucus bill (can't really call it the Group of Six bill with zero Republican support; can't call it the Democratic bill with questionable Democratic support), at least in the media, is its lower cost – \$860 billion according to Baucus, \$770 billion according to the CBO. This compares to the \$1 trillion cost of the House bill. But this is a meaningless number, for two reasons.

The first is that this is just the cost side; it doesn't take into account how those expenses are financed. The House bill has a *net* cost of \$239 billion, not \$1 trillion; why everyone focuses on the \$1 trillion number while talking ominously about government deficits makes no sense to me. So if you really want to be selling the Baucus bill, you should be pointing to the \$49 billion that the CBO says the bill will *save* the government over the next ten years.

The second is that the cost number is an accounting fiction. One reason the Baucus bill is "cheaper" than the House bill is that it has lower subsidies. For illustration, let's assume that the whole \$140 billion difference is due to lower subsidies. Relative to the House bill, then, the Baucus bill costs the government \$140 billion less; but it costs middle-income people exactly \$140 billion *more*, since they have to buy health insurance. The difference is that in the House bill, the money comes from taxes on the very rich; in the Baucus bill, it comes out of the pockets of the middle-class people who are getting smaller subsidies. Put another way, the Baucus bill is the House bill, *plus* a \$140 billion tax on people making around \$40-80,000 per year. That's not only stupid policy; it's stupid politics.

In reality, there are more differences between the bills than just that, and, in its defense, the Baucus bill seems to raise more revenue than the House bill. But this idea that reducing subsidies saves money is just an illusion created by selecting a particular frame of reference. If you start with a different frame of reference, reducing subsidies is just increasing taxes – on the wrong people.

By James Kwak

Why Didn't The Major Bank CEOs Show Up On Monday?

Simon Johnson | 17 Sep 2009

Speaking on Wall Street at noon Monday, President Obama laid blame for the crisis and recession of 2008-09 squarely at the feet of the financial sector. The diagnosis was sound but the rest of his speech was disappointing – the administration's draft regulatory reforms look lame, banks are fully mobilized against the only proposal with any teeth (a consumer protection agency for financial products), and the President's call to "please don't do it again" surely fell on deaf ears.

In fact, were any of the most relevant ears even listening? The real news from Monday was not the substance of the speech or the stony silence of the financial elite in the audience, but rather that not a single chief executive officer (CEO) of a major bank was in attendance.

This is striking because CEOs were the natural and repeated point of contact for the President and his staff throughout the crisis – as seen, for example, at the pivotal White House meeting in March. This makes sense, because it was the CEOs whose jobs and reputations were on the line – people like Lloyd Blankfein (Goldman Sachs), Kenneth Lewis (Bank of America), Jamie Dimon (JP Morgan Chase), and John Mack (Morgan Stanley). And these same CEOs are today the key decision makers for everything the President wants to urge: careful risk management, responsible compensation schemes, and improved business ethics.

These CEOs are, of course, busy people and no doubt many or all had good excuses and sent nice apology notes. But their collective absence is beyond remarkable. The President saved their jobs, bonuses, pensions and much more after he came in office; this was a gutsy call on his part and one that may still sully his legacy. And in this endeavor, the President represented both the Congress of the United States – for example, in deciding how to implement the Troubled Assets Relief Program (TARP) – as well as all taxpayers and every citizen. Usually, you have to stand in line for a long time to sit in the same room as the President of the United States.

But not a single big bank CEO apparently had the time to show a little respect or gratitude, and to pay even lip service to better behavior in the future?

More than any technical discussion of raising capital standards or tightening leverage ratios, this presumably uncoordinated failure to

show up speaks volumes about current attitudes on Wall Street. The CEOs of our biggest banks have weighed the man and done the trade. They have no more use for this President, no fear for what he can do to them, and see no reason to show support. They have moved on – presumably back to whatever they were doing before the events of September 2008 so rudely interrupted. And their obvious presumption, contrary to the words and body language of the President on Monday, is that next time – when they need it – the representative of the taxpayer will be there for them again, with generous bailout packages and extraordinary kindness.

By Simon Johnson

This is a slightly edited version of a post that originally appeared on the NYT's Economix, and it is used here with permission. If you would like to reproduce the entire post, please contact the NYT. Short quotes may be used under the usual fair use rules.

Good for You, Barney

James Kwak | 18 Sep 2009

With the waves of criticism that come out of this website, I wanted to acknowledge someone for doing the right thing. Bloomberg reports that Barney Frank, chair of the House Financial Services Committee, barred Michael Paese, a former committee staff member and now Goldman Sachs lobbyist, from lobbying anyone on the Democratic side of the committee until the end of 2010. Paese was already barred from lobbying his old committee for one year after he left the staff in September 2008, so Frank is effectively extending the ban for another year and a bit.

The government-lobbyist revolving door has been around for a long time, and a one-year prohibition is just not long enough; it shifts the incentives too far to the side of using government service as a way to build friendly contacts in industry. Conceptually, I think the ban should be longer and pay for government employees should go up, in order to push the incentives the other way. But I'm not holding my breath.

By James Kwak

Regulatory Arbitrage 2.0

James Kwak | 18 Sep 2009

Gillian Tett has the latest perspective on a curious deal that Barclays did earlier this week (hat tip Brad DeLong). The deal goes something like this. Two former Barclays execs are starting a fund called Protium Finance. Protium has two equity investors who are putting in \$450 million. Barclays is lending Protium \$12.6 billion. Protium is using the cash to buy \$12.3 billion in what we used to call toxic assets from Barclays. Protium's 45 staff members get a management fee of \$40 million per year (presumably from the equity investors, although that seems steep). Returns from the investments will be paid as follows, in this order (and this is important): (1) fund management fees; (2) a guaranteed 7% return to investors; (3) repayment of the Barclays loan; and (4) residual cash flows to the investors.

Barclays emphasized that it was *not* participating in regulatory arbitrage, because it is keeping the toxic assets on its balance sheet for regulatory purposes. That is, because it has a lot of exposure to those assets through its huge loan, it will continue to hold capital against those assets. So far so good.

But regulatory capital arbitrage is only one kind of arbitrage. For ordinary accounting purposes, the toxic assets are *not* on its balance sheet. So if they fall in value, Barclays will not have to recognize a loss – at least not until Protium defaults on its loan, which could be as far as ten years in the future. So the bank has the same true economic exposure, but can pretend it isn't there for a long time.

Or does it have the same true economic exposure? If things go badly, yes, since Protium will default on the loan. If things go well, however, Protium's investors get all the upside since they get the residual cash flows after the loan is paid off. So Barclays is left with all the downside and none of the upside. In return for giving away the upside, they should have gotten a good interest rate on the loan. The interest rate is LIBOR + 275 bp, and I have no way of calculating if that's a good rate or not. But even assuming it is a good interest rate, this is what Nassim Taleb calls a nickels strategy – picking up nickels (the nice interest rate) in front of a steamroller (the risk of the assets falling in value).

Finally, we have the other kind of arbitrage. Although Barclays is recognizing its exposure to Protium, Protium is a different company, and it's *not a bank*. That's important these days, and this is Tett's main point.

In particular, because it's not a bank, British regulators can't do anything to it. In particular, they can't prevent Protium from paying its managers whatever they want to pay it, and they probably can't force Protium to even tell them what its managers are making.

So here we have the ultimate form of regulatory arbitrage. If you're a bank exec worried about public exposure or, even worse, regulation of your compensation, go create a new special-purpose vehicle to manage bank assets, entice the equity investors in with a sweetheart deal, and pay yourself whatever you want. Given the size of Barclays, the shareholders won't notice \$40 million here or there, especially if it looks like it's coming from someone else. Everyone wins.

By James Kwak

Protect Consumers, Raise Capital, And Jam The Revolving Wall St-Washington Door

Simon Johnson | 20 Sep 2009

Ben Bernanke has a great opportunity to lead the reform of our financial system. His standing in Washington and on Wall Street is at an all-time high, as a result of his bailout/rescue efforts. He is about to be reappointed with acclaim for a second term as chairman of the Federal Reserve's Board of Governors. And he has a lot to answer for.

Look, for example, at his speech of May 17, 2007, which discusses some of the problems in the subprime market and contains the memorable line: "Importantly, we see no serious broader spillover to banks or thrift institutions from problems in the subprime market; the troubled lenders, for the most part, have not been institutions with federally insured deposits" (full speech; marks in the margin are from an anonymous and careful correspondent.)

Three points jump off these pages.

1. With the kind of analytical capacity and world view demonstrated in this speech, there is no way that Fed can be regarded as capable of protecting consumers vis-a-vis financial products going forward. The Fed's claims to that effect undermine their legitimacy and plausibility. They failed consumers completely, and they should reflect deeply on the organizational culture and internal incentives that brought them to this sad point. "Give us another chance" is not convincing; there is too much at stake.
2. If the Fed is capable of such mistaken views as Bernanke expressed in May, 2007, you must assume that regulation will break down again in the future. Tightening the rules on bank behavior is fine, but the banks will down the road again fool the Fed, other regulators, and perhaps even themselves on the true risks they face. It is therefore essential that our financial system carry much more capital than has been the case in the recent past. We should go back to pre-1935 or even pre-1913 levels (see slide 40 in this presentation). In a New York Times op-ed today, Peter Boone and I call for at least tripling current capital requirements as the right goal (of course, this should be phased in over a few years.)
3. The intellectual capture of Washington by Wall Street was well underway in May 2007; it is now complete. This is why the

banking barons felt no need to show up and show respect for the President on Monday. They have so many of their people (mindset-wise) placed throughout the administration, and the principle of revolving between Wall Street and Washington so well established, that they know: If they ever need another massive bailout, the people standing behind this or any future President will say there is no alternative. That's why Peter and I also call for a 5 year gap between holding a responsible position on Wall Street and a top job in Washington, and vice versa. Stop with the political appointment of regulatory "doves" and end the notion that you can go directly from a failing bank to directing efforts to rescue such banks.

Ben Bernanke can play the broad reformist role of Marriner Eccles, chair of the Fed during the Great Depression. Or he can go back to being a cheerleader for the financial sector, following in the discredited footsteps of Alan Greenspan.

This is his choice.

By Simon Johnson

You Cannot Be Serious: US Strategy for the G20

Simon Johnson | 21 Sep 2009

According to the WSJ this morning ([top of p.A1](#)), the US is pushing hard for the G20 to adopt and implement a “Framework for Sustainable and Balanced Growth,” which would amount to the US saving more, China saving less, and Europe “making structural changes to boost business investment” (and presumably some homework for Japan and the oil exporters, although that is not stressed in the article).

This is pointless rhetoric, for three reasons.

1. Such an approach has been tried before, mostly recently in the [Multilateral Consultation](#), run by the IMF. This achieved little, as the WSJ article points out.
2. This approach will always be fruitless unless and until you can put pressure on surplus countries to appreciate their exchange rates. But the IMF, with US connivance, just punted on this exact point – [letting China off the hook](#). Tell me exactly, in detail, how the administration’s proposal would change this, particularly with Mr. Geithner and Ms. Clinton [so keen to be deferential](#) to Chinese official buyers of US government securities.
3. Where is the evidence that this kind of “imbalance” had even a tangential effect on the build up of vulnerabilities that led to the global financial crisis of 2008-09? I understand the theoretical argument that current account imbalances could play a role in a US-based/dollar crisis, but remember: interest rates were low 2002-2006 because of Alan Greenspan (who controlled short-term dollar interest rates); the international capital flows that sought out crazy investments came from Western Europe, which was not a significant net exporter of capital (i.e., a balanced current account is consistent with destabilizing gross flows of capital); and the crisis, when it came, was associated with appreciation – not depreciation – of the dollar.

The main argument for the revolving Wall Street-Washington door is that this lets an administration bring in [top minds from the financial sector](#), with the practical experience necessary to tackle our most pressing problems. It is hard to understand the prioritization here, unless the goal is to create a smokescreen that will both postpone real policy action (“because correcting imbalances takes time”) while also covering

up for the crimes and misdemeanours of the Greenspan era (“it was all about imbalances, which were out of our control”).

Granted, big current account imbalances are not a good thing and should be on some list of problems to address. But are they really on the top ten list of pressing issues for this G20 summit, which should include: much tougher financial regulation, substantially raising capital standards, workable cross-border rules for handling failed banks, a timetable for downsizing our biggest banks, how credit rating agencies are paid, and reforming – top to bottom – financial sector compensation?

By Simon Johnson

The Fed, Regulation, And The Next Recession

Simon Johnson | 21 Sep 2009

This op ed appeared in the New York Times yesterday (9/20/2009).

SPEAKING at the Brookings Institution last week, the chairman of the Federal Reserve, Ben Bernanke, remarked that the recession in the United States is “very likely over.” He’s surely right that a recovery is under way; in fact, the short-term bounce back may actually turn out to be faster than he thinks — rapid growth is not uncommon right after a severe financial crisis.

Mr. Bernanke commands great respect because of his impressive efforts to head off financial collapse, but his speech was deeply worrisome on the bigger questions: what caused the financial crisis, and how can we prevent another such calamity?

Mr. Bernanke still refuses to acknowledge the Fed’s role in creating financial boom-bust cycles, and therefore his diagnosis and solutions sound overly technocratic and somewhat hollow. He has called for requiring banks to hold more liquid assets and increase their equity cushions, and passing legislation that would permit the Fed to effectively close large financial institutions when they are failing. He also wants the Fed to be responsible for regulation of such large banks.

But none of this is enough. Why should we believe that the Federal Reserve could regulate banks and avert financial bubbles when that agency has repeatedly failed to do so over the past 30 years? The greatest failure of all time happened from 2002 to 2007, and for most of that time Mr. Bernanke was on the Fed’s board of governors. To make financial regulation workable again, the chairman needs to admit the institution’s recent failures and call for deeper reforms in the operation of the Fed to make financial regulation workable again. Otherwise, the United States and the rest of the world are being set up to face another — much larger — financial crisis.

As someone who came to government from academia rather than banking, Mr. Bernanke is not beholden to business, and that puts him in a good position to make the kind of basic changes to the culture of regulation that are most needed — in particular, changes that would stop so many regulators from moving back and forth into the finance industry. He is also a student of the history of the Fed and knows how, after 1934, his predecessor Marriner Eccles helped lead a redesign of the financial system that served America well for 50 years. So he should also

realize that if he truly wishes to end our cycles of boom and bust, he needs to fight for a stronger regulatory system and against the powerful financial interests that encourage policy makers to avoid real reform.

In successive financial boom-busts over the past 30 years, the Fed undertook smaller versions of what Ben Bernanke did over the past 12 months. In the Latin American debt crisis of 1982, the savings-and-loan crisis of the late 1980s, the Asian financial crisis and the collapse of Long-Term Capital Management in 1998 and during the bursting of the dot-com bubble in 2001, you saw the same pattern: First, of course, the financial system grew rapidly, bank profits were large and a bubble emerged. At a certain point, we reached the market peak and stared down the mountain. Bankers frantically called the Fed, and it dutifully stepped in to prevent an economic collapse — by lowering interest rates and providing credit to “maintain liquidity.”

In his speech last week, Mr. Bernanke indicated that interest rates are now likely to stay low for a long time. That means that if you are running a major bank, you have good reason now to take on more “leverage” (debt). If collapse threatens again, bank executives know the Fed will support them. And lenders know that it is a far better risk to make loans to banks supported by the Fed than to firms that can go bankrupt, like automakers or high-technology companies.

All of this facilitates a short-term recovery, of course, and is the cornerstone of Mr. Bernanke’s strategy. But it also feeds a new financial frenzy — making it harder to sustain real growth, and also making it less likely that a broad cross section of society will benefit.

There is nothing wrong with having the Federal Reserve in place to deal with financial shocks. This was the original idea that emerged from the 1907 financial crisis, and from the subsequent National Monetary Commission reports — that the United States needed a central bank to manage downturns. At that time, Democrats were rightly suspicious that the commission, led by Senator Nelson Aldrich, Republican of Rhode Island, was looking for a way to give private banking interests influence over federal money.

When it was created in 1913, the Federal Reserve was meant to be a compromise — a way for private bankers to have a say in the operation of the national bank but also a way for the government to keep private bankers in check. And that is how it worked from 1935 to 1980, when the Fed and other agencies ensured that banks’ activities did not put the public purse at risk.

Both before 1935 and again after 1980, however, the Fed's financial regulation was and has been weak. At the heart of this weakness are the large profits that can be earned by taking advantage of lax regulation in the financial sector. The phenomenal growth of the derivatives market over the past 30 years, for example, has made all our big banks far more interconnected, and hence systemically risky; if one bank falls the others fall with it. Yet our regulators, many of whom remain in office today, watched as this time bomb grew and then exploded with the collapse of the American International Group.

Since our top regulators are political appointees, it should be no surprise that, in the face of heavy lobbying by the financial sector, they often turn out to be regulatory doves. We've permitted our mid- and high-level regulators to revolve between jobs in finance and officialdom. To name just two examples, during the Clinton administration, Robert Rubin left Goldman Sachs to become secretary of the Treasury, then returned to the industry to take an oversight role at Citigroup, while Henry Paulson, the secretary of the Treasury during the last years of the George W. Bush administration, came straight to government from Goldman Sachs.

A high-level position at the Federal Reserve, the Treasury, the White House National Economic Council or at a Congressional committee overseeing banking can be a ticket to riches when public service is done. The result is that our main regulatory bodies, including the Fed, are deeply compromised. Rather than act as the tough overseers of the public purse that we need — and that we had before 1980 — they have become cheerleaders for the financial sector.

These cheerleaders, in turn, generate financial cycles by letting our financial system grow too fast, with far too little capital for the risks it takes. When the Federal Reserve inevitably bails banks out, it receives great applause (particularly from the financial sector). Yet with each cycle of failure and bailout, the financial system grows ever larger and more dangerous.

Not all of this, of course, is under Ben Bernanke's control. Like Alan Greenspan before him, when he provides bailouts and facilitates recovery, Mr. Bernanke can say he is only doing his job. But the true and original responsibility of the Fed is much broader than that. The central bank is supposed to prevent crises that threaten to bankrupt the country.

In today's nascent global recovery, we are already seeing bubble-like rises in the prices of real estate and assets, from Hong Kong and

Singapore to Brazil. And many more emerging markets will likewise soon boom. The details of who makes which crazy loans to whom will no doubt be different from what they were from 2002 to 2007, but the basic structure of incentives in the system is unchanged. The same people are running the American banks, and the same regulators are regulating them, so you can easily get the same outcome here as we have just seen.

We should prohibit companies and senior managers in regulated financial industries from making donations to political campaigns. We should also restrict public employees involved in regulatory policy from working in those industries for five years after they leave office. And we should prohibit people who move to government from the finance sector from making policy decisions on bailout and regulatory-related matters for a minimum of five years.

Our regulators need to be smart people who understand finance, but they don't need to be drawn from the upper echelons of the financial industry. There are many proven, dedicated professionals in our regulatory agencies today, and we should support the development of an even stronger cadre of career regulators. It should be up to the financial sector to make its practices clear and simple enough for these professionals to understand, and any that are too complex should not be approved.

Finally, we should significantly raise capital requirements for the financial sector — and the bigger the bank, the more capital you should need. (Of course, this would discourage banks from growing too large.) The Obama administration should at least triple the current requirements.

Our financial system provides valuable services to the public, but it also poses serious risks. If we can't re-regulate more strongly to better protect public funds, the next crisis could be worse than the last one.

By Peter Boone and Simon Johnson

Financial Regulation, the Pessimistic View

James Kwak | 21 Sep 2009

Satyajit Das, who knows more about derivatives than I know about *anything*, has a guest post on [naked capitalism](#) about derivatives regulation. The quick summary? Don't bet on it.

“‘Holy water’, ‘hosanna’s’ or other utterances (based on particular religious convictions) will be sprinkled or said in the form of initiatives to improve disclosure, increase capital and a new centralised counterparty (‘CCP’) to reduce the risk of a major dealer failing. Fundamental issues – the use for derivative for speculation, mis-selling of instruments to less sophisticated market participants, complexity, valuation problems – will not be substantively addressed.”

In particular, Das points out that the industry is already aiming to weaken what regulations Treasury has proposed, including centralized clearing of standardized derivatives.

“On 17 September 2009, Robert Pickel, ISDA’s CEO, argued before the U.S. House Agriculture Committee: ‘Not all standardized contracts can be cleared.’ He argued that that even if they have standardized economic terms many derivatives contracts will be ‘difficult if not impossible to clear’ because the CCP depends on such factors as liquidity, trading volume and daily pricing. This would, Pickel argued, make ‘it difficult for a clearinghouse to calculate collateral requirements consistent with prudent risk management.’

“Dan Budofsky, a partner at Davis Polk & Wardwell LLP, who testified on behalf of the Securities Industry and Financial Markets Association, agreed that ‘it may be more appropriate for products that trade less frequently to trade over-the-counter.’”

How these debates work out will depend on a few Congressional committees and the regulatory agencies that end up writing the actual rules. That’s why it is important for these debates to happen in the full glare of public attention. Unfortunately, public attention has moved on, which is exactly what the industry is counting on.

By James Kwak

Financial Regulation, a Slightly Optimistic View

James Kwak | 21 Sep 2009

The big news on the regulatory front last week was the Wall Street Journal's revelation that the Federal Reserve will give its regulators the ability to reject *any* pay package for *any* bank employee that encourages excessive risk-taking. The Fed is apparently claiming this authority on the grounds that as a safety-and-soundness regulator, it has the right to prohibit any bank practices that threaten the safety and soundness of the bank. Sounds good to me.

Now, there are certainly reasons to be skeptical, which Yves Smith abundantly outlines. This could be a ploy to gain some populist credentials and head off more Congressional oversight of the Fed. The Fed has been willing to trust banks to tell it what their risks are, so it is not equipped to identify compensation packages that create excessive risk. The Fed will be looking (according to the WSJ) for outliers among the group of the top 25 banks – so as long as all 25 banks are engaged in the same silly compensation practice, the Fed will let it go.

Still, though, I am a little bit encouraged that this is on the table. Only a few months back, Treasury was trying to convince us that the best it could do on banker compensation was (1) say-on-pay legislation (non-binding shareholder up-or-down votes on executive pay packages) and (2) increased independence of compensation committees. As I wrote at the time, these proposals both suffer from the near-fatal flaw of relying on shareholder governance, which (a) is weak and (b) suffers from the same skewed incentives that managers do.

The idea of Fed civil servants vetoing traders' pay packages just shows how tepid the Treasury proposal was. While I share much of Smith's skepticism, I at least hope that this will move the ball in the right direction.

By James Kwak

Health Care Reform and Fairness

James Kwak | 22 Sep 2009

Over at the Washington Post this week, it's back to health care reform, and our topic is fairness. Specifically, *somebody* has to pay if we're going to have near-universal coverage. Do you think it should be the people who benefit immediately (the uninsured middle class*) or do you think the payment mechanism should have nothing to do with the beneficiaries (like Medicare and, to an extent, Social Security)? I think this comes down to two concepts of what government programs are for. If the former, you probably want low (or zero) subsidies; if the latter, you probably want to tax the rich, tax gasoline, auction off emission permits, or something like that.

* This is a simplification, I know. But basically, the very poor have Medicaid and will still have Medicaid after reform; most of the insured middle class have employer-based coverage or Medicare, and that isn't going anywhere in the short term. In the long term, as we've argued elsewhere, everyone benefits (except the super-rich) because of increased health care security.

By James Kwak

G20 Thinking: “In The Medium Run We Are All Retired”

Simon Johnson | 22 Sep 2009

It looks like the G20 on Friday will emphasize its new “framework” for curing macroeconomic imbalances, rather than any substantive measures to regulate banks, derivatives, or any other primary cause of the 2008-2009 financial crisis.

This is appealing to the G20 leaders because their call to “rebalance” global growth will involve no immediate action and no changes in policy – other than in the “medium run” (watch for this phrase in the communiqué).

When exactly is the medium run?

That’s an easy one: it’s always just around the corner. Not today, of course; that would be short run. And not in 20 years; that’s the long run.

The medium run is perhaps in 3 years or perhaps in 5 years. It feels close enough not to be meaningless at the press conference, but it’s not close enough to be meaningful.

And – here’s the key – whatever you agree on for the medium-term, you know that the world will change, quite dramatically, 2 or 3 times before you get there. At that point you can say, quite reasonably: But the conditions today are quite different from what they were when we made this medium-term commitment, so we really need to rethink it.

Of course, having the IMF report back every year on progress towards these medium-term goals is equally pointless. This is what the IMF has been doing since 2006 and what it was preparing diligently to do just as the global crisis broke out.

Expectations for the G20 summit are low. But unless and until the leaders take any steps to address our pressing financial sector vulnerabilities, the summit is not worth its carbon footprint.

Remember what the financial experts said at the previous summit (April) and the one before that (November): we can’t fix the financial system in the height of the crisis. True enough, although the opportunity to break the power of the largest players was squandered in both the US and Europe.

So, now the crisis is over – as the G20 heads of government will affirm – where are their efforts to fix the financial system? Please don’t tell me, “that’s what we’re doing, in the medium-term.”

By Simon Johnson

The Good Part of the Baucus Bill

James Kwak | 23 Sep 2009

I've been generally critical of the Baucus Bill, primarily because of the reduced subsidies, which I see as an increased tax on the currently uninsured middle class. But luckily Ezra Klein has been providing detailed coverage of what's good about it – notably, the proposed reforms to the health care delivery system. See his interview with Peter Orszag and his post about Chris Jennings and most of his other posts from yesterday. On my reading, the Baucus Bill will kick off a number of initiatives that will test different ways of reducing costs or improving quality, such as ways of linking payments to outcomes.

I think this is promising because, as I've said before, even though we have a general idea of what the problem is – economic incentives that are cut loose from outcomes – we're not sure how to solve it. As a result, any master plan to reduce costs without sacrificing quality is easy to attack, and given the political dynamics people will be eager to attack it. The answer is that, in the medium term, we have to figure out what does work, and the way to do that is to try lots of different things. This is exactly what a smart business would do, so it's good to see the government doing it.

By James Kwak

Bank of America \$4 Billion, Taxpayers \$425 Million

James Kwak | 23 Sep 2009

I'm trying to figure out if I should be infuriated about the agreement allowing Bank of America to walk away from the asset guarantees it got as part of its January bailout in exchange for a payment of \$425 million. I can piece together part of the story from The New York Times, Bloomberg, and NPR, but the complete story is a bit hazy.

The initial deal was that Treasury, the FDIC, and the Fed would guarantee losses on a \$118 billion portfolio of assets; B of A would absorb the first \$10 billion and 10% of any further losses, so the government's maximum exposure would be about \$97 billion. Part of that guarantee was a non-recourse loan commitment from the Fed, basically meaning that the Fed would loan money to B of A, take the assets as collateral, and agree to keep the assets in lieu of being paid back at B of A's option. In exchange, the government would get:

(a) An annual fee of 20 basis points on the Fed's loan commitment, even when undrawn (if B of A drew down the loan, which it didn't, it would pay a real interest rate). The loan commitment could be interpreted to be only \$97 billion, so this comes to \$194 million per year.

(b) \$4 billion of preferred stock with an 8% dividend. That's a dividend of \$320 million per year; B of A can buy back the preferred stock by paying \$4 billion.

(c) Warrants on \$400 million of B of A stock. B of A was at \$7.18 the day the bailout was announced and yesterday it closed at \$17.61, so if Treasury had gotten an exercise price of \$7.18, those warrants would be worth about \$580 million now.

Now, at this point I was furious, but then I found this provision in the term sheet:

"Institution has the right to terminate the guarantee at any time (with the consent of USG), and the parties will negotiate in good faith as to an appropriate fee or rebate in connection with any permitted termination."

The question is, what does this mean? As far as the Fed loan commitment, it's clear: Bank of America can walk away from that. Since they had the loan commitment for about nine months, their fee should be about 9/12 of \$194 million, or \$145 million. I'm fine with that.

But what about the preferred stock and the warrants? Is B of A getting all that back as part of the \$465 million payment? The news stories aren't specific on this point, but I'm pretty sure B of A is getting it back. I say that because all three stories refer to the government holding \$45 billion of preferred stock in B of A. That \$45 billion is quite clearly the \$25 billion cash investment from October and the \$20 billion cash investment from January – which implies that the \$4 billion in preferred stock that Treasury got in exchange for the asset guarantee is gone.

B of A's position must have been – actually, I'm having a hard time making their position in a reasonable way, because it's so untenable – something like this: "In January, we all thought we would need that guarantee for a long time, and that's why we gave you \$4 billion in stock for it, but now it turns out we don't need it, so let's pretend we never gave you that stock."

But this is clearly ludicrous. The deal was very clear. The government did something for B of A. In exchange, B of A gave the government \$4 billion in stock. If the idea had been for the government to get, say \$400 million in stock for each year the guarantee was in force, then that's what they would have written into the term sheet. The economics of the deal were also very simple. B of A was in trouble; only the government was willing to give them an asset guarantee; that guarantee was worth at least \$4 billion to B of A, and probably a lot more; so the government got \$4 billion worth of stock.

So I'm still left wondering what this could mean: "the parties will negotiate in good faith as to an appropriate fee or rebate in connection with any permitted termination." If I'm the government, I'm thinking: "I gave you something that was worth \$4 billion at the time; you gave me \$4 billion. Now you don't want the thing I gave you; fine, throw it away. But what's to negotiate? You already got something worth \$4 billion."

So the government negotiators should have been asking for \$4 billion, plus nine months' worth of dividends (\$240 million), plus the value of the warrants (\$580 million), plus nine months' worth of the loan commitment fee (\$145 million), for a total of \$4.965 billion. But what did they ask for? According to an earlier (no longer available except in [Google search results](#)) version of the Bloomberg story, regulators were asking for "\$300 million to \$500 million." And they got \$425 million – which is basically the loan commitment fee plus one year of dividends on the preferred stock, meaning they got *nothing, nada, zilch* for the preferred stock or the warrants.

What possible explanation is there for this? Here are a few:

(1) B of A somehow convinced the government negotiators that the deal was really for \$4 billion over some period of time, and hence the government didn't have a right to it, no matter what the term sheet said.

(2) That "negotiate in good faith" clause was meant all along as a way for B of A to get out of the deal. That is, in January the government wanted to claim for PR purposes it was getting \$4 billion in exchange for the guarantee, but nudged B of A and said that if things worked out, it wouldn't actually be \$4 billion.

(3) B of A threatened to go even more public with the claim that it only closed the Merrill Lynch acquisition under government pressure (remember, this asset guarantee was widely believed to be a quid pro quo for closing Merrill – see the Bloomberg headline, for example), and the government didn't want that episode in the news again.

(4) As Bloomberg reports, "while the guarantee was announced in January, an agreement was never signed." Wait a second. The deal was never signed? What? Why isn't this a front-page scandal? Remember, the announcement of the guarantee bolstered confidence in B of A's survival. (It may not have been good for the stock price because of the dilution, but it was a signal that the company would not be allowed to go bankrupt.) Even if nothing was ever signed, there is no way the government would have been able to back out after going public with the guarantee. So the taxpayer was committed. And somebody forgot to get B of A to sign the piece of paper? Or was this a conscious oversight to make it easier for B of A to get out of the deal later?

OK, now I'm infuriated. Shouldn't you be?

Update: A Congressional source tells me that the deal was never closed because the parties could never agree on which assets to include in the pool to be guaranteed. This, of course, raises the question of why they couldn't agree – after all, we did it with Bear Stearns, and we did it with AIG. (Did we do it with Citigroup or do we have another of these problems hanging out there?) The point is there's no reason Treasury couldn't have gotten this done. But B of A had *no reason* to want to close the deal – it got a benefit in the markets strictly from the announcement, and if it ever needed the guarantee there's no way the government would refuse simply because nothing had been signed. So it was up to Treasury to close the deal and get the \$4 billion in preferred stock.

My source also says the \$425 million payment is supposed to represent the benefit that Bank of America got from the guarantee over the last

nine months. But it doesn't. A guarantee is insurance. Let's say you pay \$1,000 for a one-year insurance policy for your house. At the end of the year, can you go to your insurance company and ask for the \$1,000 back because your house didn't burn down? If B of A and Treasury agreed on a price of \$4 billion, then that's the price; it has nothing to do with what happens later. So even if the deal was never closed, the "regulators" should have been asking for a lot more than \$300-500 million as the value that Bank of America got from the relationship. As StatsGuy points out below, they could have gone to court for it; as even a first-year law student knows, an agreement doesn't have to be written down and signed to be binding (and I assume at least the term sheet was signed by both parties).

By James Kwak

Just Baffling

James Kwak | 24 Sep 2009

PPIP finally launches, Mike Konczal lays bare the subsidy, everyone just move along ... hey, wait a second!

From the Times article: “[FDIC] officials announced that they had reached a deal to sell \$1.3 billion in mortgages from Franklin Bank, a Houston-based lender that failed last November and was taken over by the F.D.I.C.”

Konczal, of course, also caught this:

“The first argument is that it would take banks that were otherwise healthy and allow them to start lending again in the middle of a credit crunch. We taxpayers pay to help unload these loans onto other private markets, so that the bank can start lending again.

“But as financeguy points out, the bank in question, Franklin Bank, is dead. FDIC took it over around a year ago, with its balance sheet deep in the red and after losing double digits in loans since 2007. It took a huge gamble in the real estate market, and it got destroyed. This isn’t an otherwise healthy bank with one bad asset on it.”

But I think he is altogether too cool about this. Let me try for a little more indignation. Our government is providing large subsidies to private investors to buy toxic assets. The only possible justification for these subsidies is that they are necessary to restore health to the banking system, by taking toxic assets off the balance sheets of banks. But these toxic assets are already the property of the U.S. government. This means that the government owns 100% of the upside and 100% of the downside on those assets.

Or at least it did until last week. Then it gave half the upside to an investment fund – “Residential Credit Solutions of Fort Worth, a three-year-old company founded by Dennis Stowe, a veteran of the subprime mortgage industry” – and kept all of the downside to itself. What could they possibly have been thinking?

(And wasn’t there supposed to be an auction in there somewhere? The Times story doesn’t mention one (although that doesn’t mean there

wasn't one). Without an auction, how do we know this isn't more of a giveaway than it already looks like?)

Update: Thanks to commenter On the Mountain, who points out that there was an auction, and provides a link to the FDIC press release. So that part of the deal is in the clear.

By James Kwak

The G20 Summit in Pittsburgh: Should You Care?

Simon Johnson | 24 Sep 2009

On Thursday evening and all day Friday, heads of government from countries belonging to the G20 will meet in Pittsburgh. On paper, this looks important – 90 percent of world economic output and 67 percent of world population will be at the table: the G7 (US, Canada, Japan, UK, Germany, France, and Italy), plus the European Union, the largest emerging market countries (including China, India, Brazil, Mexico, and South Africa) and a few others. And unlike the G7, which is really a club for rich industrialized countries, every continent and almost all income levels are represented in the G20.

The last time this group met – in London at the beginning of April – they had one of the most productive summits in living memory, agreeing to triple the resources of the International Monetary Fund (IMF) so that it could help troubled countries, while also projecting an image of determination to “do whatever it takes” to avoid a Second Great Depression.

There could still be dramatic moments at or around the summit. There will be some street protests, mavericks could rock the boat (President Sarkozy of France is always threatening to do this), and there is always scope for mini-drama and quirky photos when so many heads of government rub shoulders.

But in terms of the economic agenda – and this meeting is supposed to be about the global economy – the likely deliverables look thin. Three issues are up for discussion.

First, whether the countries can agree on “rebalancing” global growth, which means – in its current iteration — that the US would commit to save more and China would commit to save less. But “commit” will not mean that the countries agree to any penalties if they fail to comply. The US may well save more as it struggles along the road to recovery – after all, households have been saving very little for over a decade – but this won’t be much or at all affected by any agreement at Pittsburgh.

Second, whether lower income countries can have more representation at the International Monetary Fund. This is a long-standing issue, which should eventually help the IMF rebuild the legitimacy that was sorely damaged by its handling of the Asian Financial Crisis in the late 1990s. Unfortunately, real progress on this issue is blocked by some rich West European countries, who are overrepresented at the IMF for historical

reasons and who would lose out in any reshuffle; they will not be in Pittsburgh and there is no sign of any new concessions from this side.

Third, to what degree and precisely how financial regulation will be tightened around the world. Here there is scope for a deal, with the US pushing for higher capital requirements for banks, while the Europeans (and Mr. Sarkozy in particular) are demanding changes in how bankers are compensated. These are crucial question, but here we face our greatest potential disappointment.

The open secret is that even the US is not pushing for significantly higher capital requirements – the US Treasury view is that our largest banks currently “have enough capital,” even though Citi and JP Morgan have roughly only about as much of an equity cushion against losses as did Lehman Brothers the day before it failed. So the US proposal is largely meaningless – which does not prevent the continental Europeans from opposing it; many of their banks are very thinly capitalized but their governments don’t want to draw attention to this fact.

The Europeans want, instead, to focus on how bankers are paid. Compensation systems in big banks encourage reckless risk-taking, but more this is more of a symptom than a cause. Unless the underlying causes are tackled – the excessive size of our biggest banks, their thin level of capital, and the revolving door that has top Wall Street people running bailout strategy in Washington – changing compensation rules would just increase the effort that smart lawyers and accountants put into figuring out new ways to pay people.

If the G20 fails to deliver, is it really possible that we are doomed to repeat the same mistakes with regard to building up vulnerabilities in our financial system? Amazingly, the answer is: a definite yes. How can this happen, with so many smart people in government? Unfortunately, it is not about having clever individuals on the job; it is about their incentives, their world view, and whether or not they really face pressure for change.

During World War I on the Western Front, well-educated British generals with great practical experience insisted on repeating the same mistakes again and again, at great cost. Democratic oversight, in that context, was worth little. If you delegate to “experts” and they fall into dangerous groupthink – and are allowed to construct sophisticated sequential cover-ups – expect the worst.

By Simon Johnson

This is a slightly edited version of a post that first appeared on the NYT's Economix. If you would like to reproduce the entire post, please contact the NYT for permission.

Neal Wolin And The Bankers

Simon Johnson | 25 Sep 2009

Deputy Treasury Secretary Neal Wolin addressed the Financial Services Roundtable today. His prepared remarks included the following key paragraphs,

“The days when being large and substantially interconnected could be cost-free – let alone carry implicit subsidies – should be over. The largest, most interconnected firms should face significantly higher capital and liquidity requirements.

“Those prudential requirements should be set with a view to offsetting any perception that size alone carries implicit benefits or subsidies. And they should be set at levels that compel firms to internalize the cost of the risks they impose on the financial system.

“Through tougher prudential regulation, we aim to give these firms a positive incentive to shrink, to reduce their leverage, their complexity, and their interconnectedness. And we aim to ensure that they have a far greater capacity to absorb losses when they make mistakes.

“..... Leading up to the recent crisis, the shock absorbers that are critical to preserving the stability of the financial system – capital, margin, and liquidity cushions in particular – were inadequate to withstand the force of the global recession.

“While the largest firms should face higher prudential requirements than other firms, standards need to be increased system-wide. We’ve proposed to raise capital and liquidity requirements for all banking firms and to raise capital charges on exposures between financial firms.”

There is nothing wrong with this statement of principles, although I would prefer a much blunter statement of “Too Big To Fail is Too Big To Exist”.

But where are the numbers? How much is the administration proposing to raise capital requirements, and how will these steepen as banks and other financial firms move into the “red zone” above \$100bn total assets? Without specific figures on the table, it is simply impossible to evaluate whether this is a good proposal or window dressing.

Don’t tell me leading administration figures don’t have a view on the numbers – with the lobbyists and behind the scenes with journalists they

are happy to provide more specific briefings, and you know that Treasury/Federal Reserve Board guidance or “input” into the regulatory process will have huge weight. And all the background information – including Treasury’s recent actions vis-à-vis big banks, this week and last – point in the same direction: window dressing.

Mr. Wolin, for your proposals to have credibility and to win support, you must answer the question: in the view of the administration, how much capital is “enough”?

By Simon Johnson

More on Managing Systemic Risk

James Kwak | 25 Sep 2009

David Moss wrote a good [article in Harvard Magazine](#) about systemic risk and regulation; it's based on an earlier [working paper](#) of his. The problem statement is not particularly original, but very clearly put: Depression-era regulation brought an end to recurring financial crises because deposit insurance was combined with strict prudential regulation to guard against moral hazard. Half a century of stability, however, was undermined by a philosophy that regulation was not only unnecessary but harmful in financial markets, at precisely the same time that financial institutions were becoming dramatically larger in proportion to the economy as a whole. For example, as Moss points out, "the assets of the nation's security brokers and dealers increased from \$45 billion (1.6 percent of gross domestic product) in 1980 to \$262 billion (4.5 percent of GDP) in 1990 to more than \$3 trillion (22 percent of GDP) in 2007."

The problem today, in Moss's words, is that "implicit guarantees are *particularly* dangerous because they are typically open-ended, not always tightly linked to careful risk monitoring (regulation), and almost impossible to eliminate once in place." The solutions he outlines basically boil down to renewing that tradeoff, so that government guarantees are explicit and financial institutions pay for them through more stringent regulation and cash.

On stricter prudential regulation:

"[A]n important advantage of the proposed system is that it would provide financial institutions with *a strong incentive to avoid becoming systemically significant*. This is exactly the opposite of the existing situation, where financial institutions have a strong incentive to become 'too big to fail,' precisely in order to exploit a free implicit guarantee from the federal government."

On making systemically important institutions pay for their guarantees:

"One option for doing this would be to create an explicit system of federal capital insurance for systemically significant financial institutions. Under such a program, covered institutions would be required to pay regular and appropriate premiums for the

coverage; the program would pay out 'claims' only in the context of a systemic financial event (determined perhaps by a presidential declaration); and payouts would be limited to pre-specified amounts."

Moss thinks there needs also needs to be a receivership process in place as a backstop should both prudential regulation and capital insurance fail.

I think this all makes sense in concept, although I still prefer the idea of simply breaking up the large financial institutions and preventing them from reassembling, either through size caps (yes, I know, this is a complicated issue) or new antitrust laws. One problem I see is that better regulation is based on the premise of better regulators, and until that problem is solved (pay them more? inspect them more closely?) nothing else follows. Moss favors a new agency dedicated to systemic risk regulation (read: not the Fed). However, I previously referred to this as the "posit a good regulatory agency" premise. I prefer the idea of just having smaller financial institutions because it doesn't require this particular can opener.

By James Kwak

The IMF Should Move To Europe

Simon Johnson | 25 Sep 2009

The headline news from the G20 summit in Pittsburgh is that progress has been made on “IMF reform,” meaning increased voting power for emerging markets relative to rich countries – remember that West Europeans are greatly overrepresented at the IMF for historical reasons. But further change in a sensible direction is being blocked by the UK and France – because they have figured out that this logic implies they would lose their individual seats on the IMF’s executive board.

The way to break this impasse is (1) for the European Union to consolidate into a single seat or membership, and (2) for the Union to assert its right to be the headquarters of the IMF (under the Articles of Agreement: “The principal office of the Fund shall be located in the territory of the member having the largest quota...”).

The US will push back hard – arguing that only countries can be members of the IMF. But what’s a country for these purposes? The UK, for example, has elected assemblies in constituent parts of its union (and different soccer teams), but can still belong to the IMF: “Membership shall be open to other countries at such times and in accordance with such terms as may be prescribed by the Board of Governors. These terms, including the terms for subscriptions, shall be based on principles consistent with those applied to other countries that are already members.”

Ultimately, this kind of decision is more about high politics than international law. The only part of the world where the IMF currently has the legitimacy to make a difference is in Eastern Europe, and most of the additional resources for helping that region should come from Western Europe – after all, Brussels had the not-so-good idea that “convergence” through EU accession meant that running massive current account deficits was somehow a good idea.

Europe still insists on the right to nominate one of its own to be managing director of the IMF, which is an awful anachronism at this point. The New IMF could be based in London with a French boss, or in Paris with a British boss. The EU would have a powerful voice and the US would keep its veto. The emerging markets, outside of Eastern Europe, would still be annoyed and with good reason – but they should really stop complaining and just set up their own fund (building on the

Asian Chiang Mai initiative); China, India, Russia, Brazil, and Saudi Arabia have more than enough financial firepower to make this happen.

By Simon Johnson

Was The G20 Summit Actually Dangerous?

Simon Johnson | 26 Sep 2009

It is easy to dismiss the G20 communique and all the associated spin as empty waffle. Ask people in a month what was accomplished in Pittsburgh and you'll get the same blank stare that follows when you now ask: What was achieved at the G8 summit in Italy this year?

Perhaps just having emerging markets at the table will bring the world closer to stability and more inclined towards inclusive growth, but that seems unlikely. Should we just move on – back to our respective domestic policy struggles?

That's tempting, but consider for a moment the key way in which the G20 summit has worsened our predicament.

There is broad agreement that capital requirements need to be increased and a growing consensus that very large banks in particular should be required to hold bigger equity cushions. This is a pressing national priority – if our financial system is to become safer – and reasonable people are starting to put numbers on the table, ever so quietly: Joe Nocera is hearing 8%, but Lehman had 11.6% tier one capital on the day before it failed and the US banking system used to carry much more capital – back in the days when it really was bailout free (think 20-30% in modern equivalent terms (see slide 40 here)).

Obviously, raising capital standards in the US is going to be a long and drawn out fight. The G20 could help, if it set high international expectations, but the opposite is more likely. As Nocera suggests this morning, the inclination of the Europeans – largely because of their funky “hybrid” capital, but also because they have some very weak banks – will be to drag their feet.

Why should we care? This administration seems to think that we need to bring others with us, if we are to strengthen capital requirements. Our progress will be slowed by this thinking, the glacial nature of international economic diplomacy, and the self-interest of the Europeans.

Instead, the US should use its power as the leading potential place for productive investments to make this point: If you want to play in the US market, you need a lot of capital. If you would rather move your reckless high risk activities overseas, that is fine.

It's time to get past the thinking that our economic prosperity is tied to the "competitiveness" of the financial sector, when that means doing whatever finance wants and keeping capital standards low.

As we discovered over the past 12 months, undercapitalized finance is not a good thing – it is profoundly dangerous and expensive. Other countries should be encouraged to raise capital standards also, but if they can't or won't, then their financial institutions will (a) not be allowed to operate in the United States, and (b) be allowed to interact in any way with a US bank only to the degree that the US entity carries an extra (big) cushion of capital in those transactions. Any US entity found circumventing these rules will be punished and its executives subject to criminal penalties.

Of course, this process needs to be WTO-compliant and the G20 is as good a place as any to manage the high politics of that. But stop worrying about what other countries might or might not do. Establish high capital requirements in the US, and make this a beacon for safe and productive finance.

And prepare for the crises that will sweep undercapitalized parts of the world financial system in the years to come.

By Simon Johnson

Escape from Punchbowlism

James Kwak | 27 Sep 2009

This post was written by StatsGuy, a regular commenter here and very occasional guest contributor. We asked him to expand on the ideas he put forward in [this comment](#) on the relationships between monetary policy, international capital flows, and bank capital requirements.

Former Fed Chairman William McChesney Martin is most famous for his notorious quip that the job of the Fed is to “take away the punchbowl just as the party gets going.” It seems this has evolved into a full fledged theory of monetary management.

Unfortunately, structural problems – like trade imbalances, inadequate capital ratios, and weak financial regulation – severely constrain Fed monetary policy options by impacting currency flows and the value of the dollar. (Some specific mechanisms are listed in the [previous comment](#).)

Why does this matter? Because it means the Fed cannot use monetary policy as effectively to keep the country going at full throttle and avoid a prolonged fall in utilization rates (unemployment and idle machines). How can it be that capacity utilization is still lower than at the bottom of the 81/82 recession and we’re ALREADY raising the bubble/inflation alarm? (Paul Krugman discusses this [here](#), and the answer is that the output gap is itself defined against neutral inflation, not just capacity utilization.)

Here is a less semantic answer: When the Fed pumps money into the system to prevent deflation, the disincentive to holding cash/reserves is supposed to get money moving and thus restore the savings/investment equilibrium. In a sense, the goal is to decrease the incentive to use money as a store of value and therefore increase its use as a medium of exchange. Unfortunately, many conventional macroeconomists (unlike their brethren in the real-world finance schools) haven’t admitted that this monetary stimulus “leaks” out of their models (which focus on closed domestic economies without moral hazard). Where does it go?

Partly, it gets sopped up by large financial institutions with asymmetric reward functions (aka, government owns the downside) and government guarantees (Too Big To Fail) that give them cheap access to credit. Rather than forcing it into the real US economy, it flows into financial assets (some of this is good, since it’s necessary reflation, but

too much creates a new bubble, and the asymmetric reward function certainly creates massive distributional inequities).

The monetary stimulus also “leaks” due to globalization of capital flows. It flows out of the country through a variety of mechanisms that traders might describe as dollar hedging (into commodities, foreign assets, and an anti-dollar carry trade). This is one of the most dominant trading features in the current market environment.

In order for the Fed to actually be able to fully use monetary policy to keep the economy humming at full throttle, we need financial regulation (to avoid new liquidity being channeled into bubbles instead of real investment), better capital asset ratios (to help moderate moral hazard and asymmetric risk), and limited *expectations* of future dollar devaluation (which currently result from our huge debts, and China’s continued mercantilist policies that keep the dollar propped up). This latter point is not entirely intuitive, and I might argue that the best way to avoid future expectations of devaluation is get the Renminbi/Yuan revaluation (which everyone expects, but over which there is massive uncertainty) over and done with. China, however, is not too keen on this idea.

So in these regards, Team Obama seems to “get it”. I concede that they have identified the right issues. How well they execute depends on many factors. As Professor Johnson notes, focusing on currency valuations (a very sensitive issue in China) on a highly public world stage like the G20 may not be productive. By contrast, quietly moving a bill through Congress might be a better option.

But what happens if we fail to fix the structural issues? Well, the answer is not good. Without the right scalpels and scaffolding, the Fed will use a sledgehammer – taking away the punchbowl during booms and giving it back during busts. Except that it will almost always get the timing wrong – taking away the punchbowl too fast and give it back too late, due to poor regulation and dollar instability, and its own anti-inflation intellectual bias and obsession with its credibility.* If it tries to support a weak economy by keeping the punchbowl on the table (as in 2003-2005, when we had a “jobless recovery”) then we get a really bad bubble.

That is what a central bank staffer called “Second Best Punchbowlism” on Brad DeLong’s blog, and it is a very scary prospect indeed. Remember when the Fed kept rates tight in August and early September 2008 (arguably to fight the commodity bubble/dollar run)? And when,

in the post-September 2008 crisis, the Fed continued its deflationary policies, even though it was abundantly clear to the entire world that aggregate demand was (to paraphrase Warren Buffett) falling off a cliff? The Fed didn't bring out the heavy weapons until March of 2009, until things looked pretty bleak indeed. This is what we can look forward to if the Fed's new paradigm becomes Second Best Punchbowlism.

It's also important to recognize that we can't just kill the Fed right now. We NEED monetary policy to be effective in order to implement new financial regulation (especially higher capital asset ratios) without killing the US (and world) economy by reducing the total supply of money. As we phase in higher capital asset ratios and other regulations, we must compensate by injecting liquidity to offset a decrease in velocity. This must be done in a highly coordinated fashion. Otherwise, financial regulation that aims at a long term equilibrium with a more stable overall money velocity (which I would argue is a good thing) could risk deflation in the near future (which will undoubtedly cause people to blame the administration currently in charge).

*"I'm acutely aware that the current FOMC has inherited the inflation policy credibility that was hard won by our predecessors. One thing that has impressed me since taking my position last year is the seriousness with which my colleagues approach the duty to protect that legacy. I am confident that the Federal Reserve's institutional commitment to maintaining low and stable inflation will prevail."

– Dennis Lockhart, President, Atlanta Fed, August 2008

By StatsGuy

When a Nudge Becomes a Shove

James Kwak | 28 Sep 2009

Richard Thaler, co-author of *Nudge*, wrote an op-ed in *The New York Times* this weekend arguing that we should change the default option for organ donation. Reading the article helped crystallize for me a vague concern I've had with all this behavioral economics-inspired, benevolent-paternalistic behavior modification that has gotten so much attention lately among the smart set. But I'm getting ahead of myself.

The poster child for "changing the default option" (I'll explain that in a minute) is 401(k) enrollment. We all know that, in general, people don't save enough for retirement. It has something to do with overly high discounting, or fallacies in how we perceive present and future utility, or something like that, but that's not relevant here. One problem is that not many people enroll in their 401(k) plans, even though a 401(k) plan is free money from the government, because of the tax deduction. The solution is to change the default option so that people are automatically enrolled in the 401(k) when they join the company, and some modest amount of their salary (like 2%) is automatically directed to an appropriate investment, like a stock index fund (not a money market fund, which is another bad default option). The arguments for doing this are: (a) you're not forcing anyone into anything, since it's easy and free to switch out of the 401(k) if you want to; and (b) it works – by changing the default option, you can get higher 401(k) participation, which we've posited is a good thing.

Thaler extends this argument to organ donation. 12,000-15,000 people each year end up brain dead but temporarily on life support. It's good for society if more of them agree to become organ donors in advance. However, in most (or all?) states, you have to explicitly sign up to be an organ donor, which most people don't get around to doing, even if they would like to. The alternative to this "opt in" system is an "opt out" system, where everyone is automatically a organ donor, but it is free and easy to opt out.

The results? "Consider the difference in consent rates between two similar countries, Austria and Germany. In Germany, which uses an opt-in system, only 12 percent give their consent; in Austria, which uses opt-out, nearly everyone (99 percent) does."

Thaler recognizes that making everyone organ donors by default is politically impossible, so he ends up recommending a "mandated

choice” system, where you have to choose one way or another. Before I move on, let me say that I agree with this. But let’s go back to the opt out system (default option = organ donor) and ask, leaving aside political issues, whether this is a good thing.

The thing that started me thinking was this paragraph:

“In the world of traditional economics, it shouldn’t matter whether you use an opt-in or opt-out system. So long as the costs of registering as a donor or a nondonor are low, the results should be similar. But many findings of behavioral economics show that tiny disparities in such rules can make a big difference.”

The general argument for changing the default option is twofold. First, you are preserving free choice; second, you are getting better outcomes. The thing that bothers me is that you are getting outcomes *that people would not have chosen*. The default option is getting some people to do what they don’t want to do. Let’s put this in the 401(k) context. I’m going to make up the numbers, but the principle is sound.

Let’s say that, if people thought about it carefully, 75% would enroll in their 401(k) plans. The other 25% absolutely need the money now (college debts, sick children, sick parents), or they are rationally income-smoothing over their lifetimes (taking income now because they expect their incomes to go up in the future). If the default option is not to enroll, you get only 35% participation, because people are busy and don’t think about it carefully. But if the default option is to enroll, you get 90% participation, for the exact same reason.

Now how does this look? The arguments are still pretty strong. The participation rate is closer to what it would be if people thought about the question carefully, because the default option *is* what a majority would choose. But now you’ve swung too far the other way. You have fewer people doing something they wouldn’t have chosen, but you’ve still tricked 15% of the people into doing something they wouldn’t have chosen.

However, you can partially justify this: some people who, on reflection, would not enroll, really should enroll. That is, part of the error in low enrollment rates is due to the default option; but part of it is due to people making mistakes about whether they should save or spend, and those mistakes are due to cognitive fallacies we all suffer from. But

this is much shakier ground to be on. Protecting people from mistakes due to inattention is a form of paternalism I am perfectly comfortable with; using their *inattention* to protect them from logical mistakes they would have made I am less comfortable with.

This becomes more visible when we move from 401(k) plans to organ donation. There are well-meaning people who think that *everyone* who is eligible should be participating in a 401(k) plan – it is free money, after all. So if the default option gets more people to sign up than would otherwise, you can rationalize it by saying (a) it's good for them anyway and (b) it's good for society (people not saving for retirement creates an externality). With organ donation, though, (a) falls away completely; while many people (including me) don't care what happens to their organs, some people care a lot; if you make them donors by default, not all of them will make the effort to opt out, and now you've tricked them into something that is bad for them. You can balance that against the social welfare created by having more organ donors, and I think that's a legitimate position to take, but it's not one that flies very well in our society.

To be clear, again, Thaler is arguing for mandated choice, not making everyone organ donors by default. But I think the reasons that I (and probably others) are uncomfortable with the latter apply, perhaps to a varying extent, to all of these attempts to use the default option to change people's behavior – even when changing their behavior is in their own interests.

By James Kwak

Robert Shiller and the Danger of Metaphors

James Kwak | 28 Sep 2009

Financial commentators use metaphors* all the time. Derivatives are “financial weapons of mass destruction,” for example. Actually, *people* use metaphors all the time. But what is the substantive content of a metaphor? More technically, if A is (like) B, then why should we believe that A has some attribute that B has?

I’ve been meaning to write about this for a while, but then Robert Shiller handed me a perfect example in the *Financial Times*, in his “defense of financial innovation:”

“The advance of civilisation has brought immense new complexity to the devices we use every day. A century ago, homes were little more than roofs, walls and floors. Now they have a variety of complex electronic devices, including automatic on-off lighting, communications and data processing devices. People do not need to understand the complexity of these devices, which have been engineered to be simple to operate.

“Financial markets have in some ways shared in this growth in complexity, with electronic databases and trading systems. But the actual financial products have not advanced as much. We are still mostly investing in plain vanilla products such as shares in corporations or ordinary nominal bonds, products that have not changed fundamentally in centuries.

“Why have financial products remained mostly so simple? I believe the problem is trust. People are much more likely to buy some new electronic device such as a laptop than a sophisticated new financial product. People are more worried about hazards of financial products or the integrity of those who offer them.”

The point of this metaphor is to convince you that, since houses and consumer devices like laptops have become immensely more complex in the last hundred years, financial products should as well – and the fact that they have not is a problem.

This is a perfect example of a misleading metaphor. No one today would want to live in a house from 100 years ago (not the house itself, but all the stuff in it, is what Shiller means), nor do we want to give up our laptops. Because most of our financial products were around 100

years ago, we must be missing out on all sorts of potential improvements. But nowhere does Shiller *show* – or even argue – that there is some underlying feature of financial products that makes them like technological products in this respect. In technology, for example, we have Moore’s Law – the observation that every 18 months (originally two years) the achievable density of transistors doubles – which implies that products can get smaller and cheaper. Shiller makes no equivalent claim for financial products. The point of our Democracy article was to argue that there is in fact no equivalent for financial products, because financial innovation is fundamentally different from technological innovation. You may not agree with us, but at least we argued the case, instead of relying on a metaphor.

I think metaphors are a great way to illustrate abstract concepts, especially to beginner audiences. I use them all the time. But their value is solely *illustrative*; they don’t ever prove a point. If you say A is like B, and you want to show that A has some attribute that B also has, you have to prove it *without reference to B*. A good example is Paddy Hirsch’s video comparing a CDO to a pyramid of champagne glasses; there, he walks you through *why* a CDO has the properties of a pyramid of champagne glasses, instead of simply asserting it.

Getting back to Shiller’s article, this is where he goes after the passage quoted above. (Sorry for the long quotes, but I want to be clear that I’m not leaving things out to help my case.)

“The problem is that financial breakdowns come with low frequency. Since flaws in the financial system may appear decades apart, it is hard to figure out how some new financial device will behave. Moreover, because of the low frequency of crises, people who use financial instruments often have little or no personal experience with the crises and so trust is harder to establish.

“When people invest for their children’s education or their retirement, they are concerned about risks that will not become visible for years. They may not be able to rebound from mistaken purchases of faulty financial devices and they may suffer if circumstances develop that create risks that could have been protected against.

“Thus, to facilitate financial progress, we need regulators who ensure trust in sophisticated products.”

Note the rhetorical flow. Shiller has deflected our attention away from the real question – is financial “progress” good? He has taken care of that with his metaphor, and now he can deal with a different question – why we haven’t had as much financial progress as he would like.

Then he goes from there to argue (this time it is an argument) that people are *overly* cautious about financial products – something that would come as a surprise to the millions of people facing foreclosure because they didn’t understand the mortgages they purchased. This is another clever device: use a good example (I think Shiller may be right about excess conservatism in long-term investments) to try to prove a broader point (but he is wrong about other financial products like Option ARM mortgages or reverse convertibles).

These clever rhetorical moves take him to his conclusion: regulation should promote the use of sophisticated products.

From there, the article actually gets better, because Shiller gives us examples of areas where he thinks financial innovation would be good. And here I don’t really disagree with him that much. I agree with him that reliance on housing as an investment vehicle is bad. I don’t really agree that target-date mutual funds are such a good idea (since as far as I can tell the conventional wisdom about switching from stocks to bonds as you age is the equivalent of an old wives’ tale), but they are probably better than many of the things people are currently invested in. Retirement annuities, another thing he recommends, would definitely be useful if you could get them at a decent price. (I believe now they suffer from a significant adverse selection problem.)

For the sake of argument, I am willing to concede that these are useful innovations that would make people better off. But you cannot use three useful innovations to argue that, in general, financial innovation should be promoted. You have to do one of two things. You could make a conceptual argument that shows that, in general, financial innovation is a on balance good thing (benefits exceed costs). Or you could make a list of *all* the financial innovations that have taken place in some domain in some period of time and show, empirically, that their actual benefits exceed their actual costs. But Shiller does neither; he uses a metaphor instead of a general argument, and he cherry-picks his examples without mentioning those toxic innovations that exist solely for investment banks to separate money from their “high net worth” clients. I’m disappointed, because Shiller is (a) brilliant, (b) right about a lot of things, and (c) clearly not in the head-in-the-sands, efficient market, financial-markets-

are-always-right camp (much of his career has been spent debunking that nonsense).

I'm still looking for a defense of financial innovation that rises to this basic standard.

* Warning for sticklers: I'm going to use "metaphor" and "simile" interchangeably. If that bothers you, stop reading now.

By James Kwak

More on Bank of America

James Kwak | 28 Sep 2009

Last Wednesday I wrote a highly critical post about the agreement between Bank of America(BAC) and the government (Treasury, the Fed, and the FDIC) to terminate BAC's asset guarantee agreement in exchange for a payment of \$425 million. I've learned some more about this and I think I can reconstruct the government's perspective on this issue, with the help of someone knowledgeable about the transaction.

A good place to start is Schedule A of the Termination Agreement. A few relevant facts:

- BAC requested the termination on May 6. Note that this is the day after the stress test results were released, although I'm not sure how much of a factor that was. Apparently at this point BAC felt comfortable going without the guarantee. It took an additional four months to work out the terms, but Treasury and BAC decided to use January 16-May 6 as the period that the guarantee was in effect. You could argue that the guarantee was really in effect until the Termination Agreement was signed, because BAC could have changed its mind, but I don't think using May 6 as an end date is too unreasonable.
- The \$118 billion pool of assets was identified in advance of the announcement, but not down to the level of individual securities. Because the assets were mainly or entirely from Merrill Lynch, the vast majority of them were already marked to market. One of the things the government had to do was verify BAC's marks. Another thing they had to do was verify that the assets did not violate any of the conditions of EESA, the bill that governed the usage of TARP money. This is one reason that negotiations on the initial deal took time.
- By May 6, the parties had already agreed to exclude \$14 billion of assets, and disagreed about another \$42 billion. For purposes of calculation, then, they assumed that they would have excluded half of that \$42 billion, or another \$21 billion. This brought the "covered pool" down to \$83 billion. (This is a bit of a fiction since the final pool was never identified, but the only purpose of the fiction was to calculate the termination fee.)

If you accept those assumptions, the calculations on Schedule A for the Fed's loan commitment fee (\$57 million) and the foregone dividends (\$69

million) more or less make sense. The calculation for the warrants also seems right. They used a strike price of \$13.30 and the market price on May 6, pro-rated for the reduction in the asset pool from \$118 billion to \$83 billion, and came up with a warrant value of \$140 million.

I have two quibbles with this so far. The first is this practice of using a preceding 20-day average stock price for the exercise price. Given that most banks are coming to the government when their stocks have just fallen precipitously, this seems like a surefire way to set your exercise price too high. But given that this has been standard practice since early in the bailouts, that has nothing to do with this deal in particular.

The second is pro-rating the amount of preferred stock and warrants by the size of the asset pool. On January 15, when they agreed on \$118 billion as the size of the asset pool, both sides knew that the pool had to be verified, and they probably knew that the pool would likely get smaller. In that case, since they both knew that the pool would be adjusted when they agreed on \$4 billion as the premium, \$4 billion was the appropriate premium for the post-adjustment pool, not the pre-adjustment pool; the adjustment was already priced in.* But that's a relatively small issue.

The big issue is that BAC and the government pro-rated the \$4 billion in preferred stock by the effective term of the guarantee – 4 months, while the original term was 5-10 years, depending on the type of security. Because they came up with a weighted average term of 5.4 years (which I don't dispute) this reduced the premium for the insurance from \$4 billion to about \$230 million (pro-rating by the size of the post-adjustment pool brings it down to \$159 million).

The government's argument for this is, roughly, that if you prepay the annual premium on your homeowner's insurance at the beginning of the year, but then you sell it after four months, you get a rebate for the last eight months. Put another way, if \$4 billion is the right price for 5.4 years' worth of insurance, then \$230 million is the right price for four months' worth. (BAC's argument, presumably, is that since no definitive agreement was signed they shouldn't have to pay anything.)

My argument, on the other hand, is that it's more like buying a homeowner's policy when there's a 50% chance that your house has asbestos (which would increase your liability premiums). Four months into your policy period, you get your house inspected and find out there's no asbestos. Now you can't get a rebate from your insurer, because in this conceptual example the insurer already priced in a 50%

chance of asbestos. A similar example would be someone buying health insurance (in the individual market) at the moment that he has a 50% likelihood of having cancer. In either case, there are two possible states of the world, and you are buying insurance against the bad state of the world. When the good state occurs, you can't get your money back.

Another way to think of this is as an option. If BAC had bought an asset guarantee for four months, I agree that the premium would have been a lot less than \$4 billion because these assets could take many years to deteriorate. (However, you could also argue that since these assets are marked to market, their values deteriorate as soon as expectations of default increase; you don't need to wait for the actual defaults). But even though BAC only used the guarantee for four months, they got more than that: they got four months of insurance, plus an option to buy another five years of insurance if they found themselves in the bad state of the world.** If the first four months were worth \$230 million, then the option was worth a lot more than \$230 million.

The other thing that can be said in defense of the Termination Agreement is that to get more, the government would have had to go to court to enforce a term sheet that was largely performed but never finalized as a definitive agreement, and that's not what the government should be doing with its time these days. I'd say that's a matter of opinion.

* Alternatively, perhaps the working assumption was that as assets got disqualified from the pool, other assets would be added. In that case, had things gone badly, BAC would have been pushing to replace the assets that got disqualified with new assets, and the effective coverage would have been \$118 billion. That is, the fact that the pool only got smaller *already* reflected the fact that things got better for BAC after January 16, not worse, and therefore that fact should not be used when estimating the value of the guarantee.

** Actually, it's more complicated and slightly better for BAC, because for some reasonable amount of time (six months?) they had short-term insurance *and* they had the right to exercise the option on long-term insurance by signing a definitive agreement. Furthermore, if you accept the underlying logic of the Termination Agreement and the metaphor of selling your house and getting an insurance rebate, even *after* signing the definitive agreement BAC still had the option to terminate the agreement and get a rebate. Refundable level premiums make sense when the risk of loss is uniformly distributed and unchanging over time; when the risk

of loss changes over time and the buyer of insurance can see how it changes, then they are an invitation to moral hazard. Come to think of it, if you live in the fire zone of the Oakland Hills and you buy your insurance policy on July 1, should you get a 50% rebate if you cancel it on January 1 after fire season is over?

By James Kwak

The G20, The IMF, And Legitimacy

Simon Johnson | 29 Sep 2009

Strong advocates of our new G20 process are convinced that it will bring legitimacy to international economic policy discussions, rule-making, and crisis interventions. Certainly, it's better than the G7/G8 pretending to run things – after all, who elected them?

But who elected the G20? The answer is: No one. And, in case you were wondering, there is no application form to join the G20 (although you can crash the party if you have the right friends, e.g., Spain). The G20 has appointed themselves as the world's "economic governing council" (to quote Gordon Brown).

Is this a good idea?

Not really – it would be much better to have a structure in which all countries were represented, probably with some weighting according to their economic and financial importance in the world.

The problem is that we have what is supposed to be exactly that structure, at the International Monetary Fund, and it doesn't work very well. The IMF has 186 members, represented by 24 executive board members, who live in Washington DC and work every day (almost) at the Fund.

The IMF's resident executive board members are often not very senior, meaning they are long way below the real decision makers in their respective bureaucratic structures; this is cumbersome. But twice a year, finance ministers representing the 24 board seats meet as the International Monetary and Financial Committee (IMFC) to oversee the work of the Fund – with the next meeting in Istanbul, October 6-7.

You might think that Istanbul will advance the G20 agenda – because the people meeting as the IMFC are almost the same people who will meet in November as the G20 ministers of finance. But they are not the same and many other people will be in the room at Istanbul. This is all very awkward and will further slow down whatever progress there is at the global financial reform level. In fact, the G20 suggested that the next productive meeting would be of its finance ministers in November, i.e., implying that Istanbul is a waste of time.

The relationship of the G20 to the IMF is extremely delicate – smaller countries are already beginning to complain, and with some reason. If the goal is to rebuild the legitimacy of the IMF and to encourage

countries to trust it to lend fairly in a crisis, this is not going very well. The rules around who will be supported and on what basis are becoming increasingly murky and not rules-based - e.g., Eastern Europe is almost certainly getting deals that would never have been offered to troubled countries in Asia.

It would be better for emerging markets to form their own Fund (let's call that the EMF). They have plenty of "hard" currency in hand to do so and no shortage of economic expertise; \$1 trillion of paid up capital would be more than enough to get it started (and this would also take the pressure off China with regard to its "excess" reserves).

The EMF can cooperate with the IMF but also operate independently – and just as much (vaguely) under the auspices of the G20. This would go a long way towards restoring emerging market and developing country confidence in the international financial system – and towards assuring they will get timely and appropriate help in the event of another world crisis.

By Simon Johnson

Real Problems, No Easy Solutions

James Kwak | 30 Sep 2009

On Monday I wrote a post criticizing the sloppy way that Robert Shiller argued for financial innovation, which focused primarily on the use of metaphor and secondarily on the use of a valid example (people are overly cautious about some financial products) to make an invalid general point (people are overly cautious about *all* financial products). Then I threw in a sloppy paragraph, because I wanted to get to the end of a long post:

“From there, the article actually gets better, because Shiller gives us examples of areas where he thinks financial innovation would be good. And here I don’t really disagree with him that much. I agree with him that reliance on housing as an investment vehicle is bad. I don’t really agree that target-date mutual funds are such a good idea (since as far as I can tell the conventional wisdom about switching from stocks to bonds as you age is the equivalent of an old wives’ tale), but they are probably better than many of the things people are currently invested in. Retirement annuities, another thing he recommends, would definitely be useful if you could get them at a decent price. (I believe now they suffer from a significant adverse selection problem.)

“For the sake of argument, I am willing to concede that these are useful innovations that would make people better off.”

Felix Salmon rightly points out that I shouldn’t have conceded it for the sake of argument. Really, what I should have said was that I agreed with Shiller that people face real problems — relying on housing for investment is bad, and it “would definitely be useful” if you could get inflation-adjusted annuities for retirement. (I don’t like target-date funds, and I said so.) But since I had already made my main point (the one about metaphor), I didn’t look into the specific innovations that Shiller was proposing to solve these problems. Salmon points out accurately that the proposed solutions rely on embedded options that ordinary consumers are likely to get screwed by. I recommend reading his post.

By James Kwak

Back-Door Resolution Authority

James Kwak | 30 Sep 2009

Tyler Cowen quotes from Robert Pozen's yet-to-be-released book:

"In my view, the adverse repercussions of Lehman's failure could have been substantially reduced if the federal regulators had made clear that they would protect all holders of Lehman's commercial paper with a maturity of less than 60 days and guaranteed the completion of all trades with Lehman for that period."

Back when people cared about these things, I wrote a couple of posts on the issue of selective protection of creditors.

The point I was trying to make at the time was that it should be at least conceptually possible for a regulator to determine what the ripple effect of default would be and impose haircuts in such away that systemic failure did not result. This would provide a middle way between bankruptcy (complete uncertainty and panic) and blank-check bailout (100% taxpayer guarantee, no losses by creditors). I was envisioning this in the context of government receivership, but I also had this tentative idea:

"I think that the government could let AIG fail, if – and this is a big if – it can first identify which creditors and counterparties would be hurt, determine which of those cannot be allowed to fail (which should not be all of them), design a program to provide them enough capital directly, and announce everything on the same day. The net cost to the taxpayer cannot be higher than under the Too Big To Fail strategy, which implies a 100% guarantee for all counterparties and creditors."

But if I am interpreting Pozen correctly, he is suggesting a more elegant way to achieve the same objective. Once the government has determined which liabilities and exposures will have systemic ripple effects (he says short-term CP and outstanding trades), it could just announce a guarantee on those liabilities and exposures and let everything else go into bankruptcy. Now maybe they didn't have time to make such a determination the weekend before Lehman failed (although arguably they had since March to figure it out), but by the time Citi and

BAC and the last AIG bailout rolled around arguably they did. I'm not enough of a markets person to be sure this would work, but it seems like a viable proposal.

By James Kwak

Good-Bye, Vanilla Option

James Kwak | 30 Sep 2009

I realized I didn't say anything about the death of the vanilla option from the Consumer Financial Protection Agency proposal. I was going to right something targeted and biting, but it ended up as a much broader column for the Washington Post about the Obama Administration's commitment to regulatory reform.

Mike Konczal, fortunately, has two good posts on the topic: one a eulogy for plain vanilla, one on the underlying problems that plain vanilla would have helped solve. He also points out at least three ways the federal government can achieve some of the same goals through other means:

- Banning prepayment penalties on mortgages
- (Citing Alyssa Katz): using the government's historically large and now even bigger influence in the secondary market to encourage plain vanilla mortgages
- (Citing Steve Waldman): a government charge card (think "public option")

All of those posts are worth reading. If we're not going to have plain vanilla, we need other new ideas about how to channel innovation into things that provide consumer benefit and put a floor under the quality offered by the private sector. More disclosure won't work (that already failed).

Update: The Raven compares the Obama administration to the Johnson administration, each with its "devil's bargain."

By James Kwak

How to Waste 45 Minutes (Like I Just Did)

James Kwak | 30 Sep 2009

Start here. Then keep reading. It has nothing to do with economics, but a lot to do with statistics.

Or don't, if you need to get something done this morning.

Update: One reader writes in:

"I beg to differ that this link has nothing to do with economics: The same technique it uses to detect possible making-up of poll numbers was used in a recent paper to detect possible making-up of National Accounts statistics in some developing countries in a widely used economic dataset:

<http://www.bepress.com/bejm/vol7/iss1/art17/>."

By James Kwak



www.feedbooks.com
Food for the mind