



The Baseline Scenario 2009-10

Updated: 5-4
Update this newspaper

October 2009

The Economics of Models

Simon Johnson | 01 Oct 2009

Economic and financial models have come in for a lot of criticism in the context of the global financial crisis, much of it deserved. One of the primary targets is models that financial institutions widely used to (mis)estimate risk, such as Value-at-Risk (VaR) models for measuring risk exposures (which we've discussed elsewhere) or the Gaussian copula function for quantifying the risk of a pool of assets.

In September, the Subcommittee on Oversight and Investigations of the House Science and Technology Committee held a hearing on the role of risk models in the financial crisis and how they should be used by financial regulators, if at all. The hearing focused largely on VaR models, which attempt to quantify the amount that a trader (or an entire bank) stands to lose on a given day, with a certain confidence level. (For example, a one-day 1% VaR of \$10 million means that on 99% of days you will lose less than \$10 million.)

Although the witnesses ranged from Nassim Taleb, who has been arguing for years that VaR models are toxic, to Gregg Berman, who heads a company that develops VaR models for customers, there was surprising agreement on the problems of VaR. As Richard Bookstaber put it, VaR depends on three assumptions, all of which are generally false: not all assets, particularly illiquid ones, are included in the VaR calculation; estimates are based on past data that is unrepresentative of the future; and because financial returns exhibit "fat tails" (extreme outcomes are more likely than you would expect), VaR estimates tell you very little about how bad things can get that last 1% of the time.

The question, then, is what to do about it. One thing that seems clear is that risk models that are designed to function in normal market conditions should not be relied upon to predict outcomes in times of crisis. On this account, VaR doesn't kill banks; executives who don't recognize the limits of VaR kill banks. As Bookstaber put it, "one has to look beyond VaR, to culprits such as sheer stupidity or collective management failure: The risk managers missed the growing inventory [of risky assets], or did not have the courage of their conviction to insist

on its reduction, or the senior management was not willing to heed their demands. Whichever the reason, VaR was not central to this crisis.”

Given that everyone is agreeing sophisticated risk models are worthless in crises, it seems particularly remarkable that regulators allowed some banks to use their in-house models in determining their own capital requirements – since one of the purposes of capital requirements is precisely to provide a cushion that protects banks (and their creditors, and taxpayers) in the event of a crisis. The obvious solution is that regulators should rely on cruder constraints, such as an absolute limit on leverage that banks cannot arbitrage around (one of the recommendations of Treasury’s recent white paper on capital requirements, which we discussed here), or periodic stress tests that estimate how bank asset portfolios will perform in a real crisis.

But there is a more interesting question to ask as well: why did VaR become so popular? It’s important to remember that competition among models is shaped by the human beings who create and use them, and those human beings have their own incentives.

David Colander made this point about economic models: the sociology of the economics profession gave preference to elegant mathematical models that could describe the world using the smallest number of parameters. “Common sense does not advance one very far within the economics profession,” he says.

A similar point can be made about VaR models. Sure, maybe all the financial professionals who design and work with VaR know about its shortcomings, both mathematical and practical. But nevertheless, using VaR brought concrete benefits to specific actors in the banking world. If common sense would lead a risk manager to crack down on a trader taking large, risky bets, then the trader is better off if the risk manager uses VaR instead.

Not only that, but imagine the situation of the chief risk manager of a bank in, say, 2004. As Andrew Lo has argued, if he attempted to reduce his bank’s exposure to structured securities such as CDOs, he would be out of a job; VaR gave him a handy tool to rationalize a situation that defied common sense but that made his bosses only too happy. And at the top levels, CEOs and directors who probably did *not* understand the shortcomings of VaR were biased in its favor because it told them a story they wanted to hear.

In other words, models succeed because they meet the needs of real human beings, and VaR was just what they needed during the boom.

And we should assume that a profit-seeking financial sector will continue to invent models that further the objectives of the individuals and institutions that use them. The implication is that regulators need to resist the group think of large financial institutions. If everyone involved is using the same roadmap of risks, we will all drive off the cliff again together.

By Simon Johnson and James Kwak

This is a slightly edited version of a post that first appeared on the NYT.com's Economix, and it is used here with permission. Anyone wishing to reproduce the entire post should contact the New York Times.

Too Connected To Fail

Simon Johnson | 02 Oct 2009

Over on the Economist Roundtable, my colleague Daron Acemoglu makes several important points.

1. We now have some financial institutions (and perhaps nonfinancial firms also) that have such strong and deep political connections, they will not be allowed to go bankrupt. This is a reality we must face.
2. Assuming that we can address such a deep political problem with a tweak of our regulatory arrangements is a dangerous illusion.
3. And it is less than convincing to assert that central bank “independence” offers either a model for regulators or even something that works well at present on its own terms.

The same roundtable also features separate comments by Raghu Rajan, Charles Goodhart, and me.

By Simon Johnson

Fed Chest-Thumping for Beginners

James Kwak | 02 Oct 2009

I generally avoid writing about monetary policy, since every economics course I've taken since college has been a micro course, and besides Simon is a macroeconomist, among other things. But since just about everyone in my RSS feed has been linking to Tim Duy's recent article on the Fed, I thought I would try to put in context for all of us who don't understand Fed-speak.

Duy takes as his starting point a series of statements by Fed governors and bank presidents indicating "hawkishness," which in central banker jargon means caring primarily about inflation, not economic growth. ("Doves" are those who care more about economic growth and jobs, although, just like in the national security context, no one likes to be known as a dove. This itself is a disturbing use of language, since it implicitly justifies beating up on poor people, but let's leave that for another day.)

Hawks also like to talk a lot about "credibility," which means a reputation for being willing to fight inflation. People use the word credibility in this context because the conventional wisdom *used* to be that national governments would not be willing to take tough steps (raising interest rates) against inflation because that would cost jobs, and hence votes in the next election. So central banks had to *prove* that they were willing to raise interest rates and put people out of work, even though that might be politically unpopular. Now that our Fed governors and bank presidents are accountable to just about no one, beating on their chests and proclaiming how willing they are to be tough in the face of the political winds rings a little hollow to me — especially in a "middle-class" country that considers inflation to be a greater evil than unemployment. Arguably, the situation has reversed; it has become so accepted that the primary job of a central bank is to fight inflation, despite the Fed's dual mandate (to both fight inflation and promote stable economic growth), that fighting inflation has become the politically *safe* thing to do. But I digress again.

This is what Duy sees:

- Kevin Warsh of the board of governors: "If 'whatever it takes' was appropriate to arrest the panic, the refrain might turn out to be equally necessary at a stage during the recovery to ensure the Fed's institutional credibility."

- Richmond Fed president Jeffrey Lacker, from Bloomberg: “The Federal Reserve will need to raise interest rates when the economic recovery is ‘firmly’ in place, even if unemployment lingers near 10 percent, Federal Reserve Bank of Richmond President Jeffrey Lacker said.”
- Philadelphia Fed president Charles Plosser: “[J]ust as the Fed has taken aggressive steps in flooding the financial markets with liquidity during this crisis to reduce the possibility of a second Great Depression, it will also have to take the necessary steps to prevent a second Great Inflation. Our credibility depends on it. ... The Fed will need courage because I believe we will need to act well before unemployment rates and other measures of resource utilization have returned to acceptable levels.”

Can you feel the testosterone?

Duy argues that all this manliness is misplaced. The Fed hawks’ basic argument seems to be that, because it acted so aggressively to stimulate the economy last year, it will have to act equally aggressively to dampen growth at some point — just to send a message. And to send that message, they need to be willing to raise interest rates while unemployment is still 10% (Lacker) or “well before unemployment rates and other measures of resource utilization have returned to acceptable levels” (Plosser).

Now, there may be something to this. Duy points out that the hawks seem to be worried about recreating the debt bubble of the last decade through too much cheap money. If cheap money is going to flow straight into overvalued houses, then that’s a problem. But Duy says that that is a failure of *regulation*. Low rates are supposed to stimulate capital investment by businesses, which is what long-term economic growth depends on. But earlier this decade, despite low rates, capital investment never returned to 1990s levels, because all the cheap money was flowing into housing instead — for reasons we know.

“Are we really worried about a lending explosion by itself, or that the regulatory environment remains so weak that financial institutions will quickly repeat the experience of this decade’s debt bubble? ...

“With the primary build out of the internet backbone complete, the US appeared to experience a dearth of traditional investment opportunities (I suspect that the need to expand production

domestically was made moot by an international financial arrangement that favored the establishment of productive capacity overseas), and, like water flowing downhill, capital was thus allocated this decade to residential investment, which, we now know was more about consumption than investment, and the resulting economic activity was anemic by historical standards.”

The solution, then, is better regulation to protect against misallocation of credit to the next asset bubble. Simply raising rates will choke off an asset bubble, but it will also choke off real investment by businesses.

This goes back to what StatsGuy said in a post here:

“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). ...

“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.”

In other words, if you’re going to throw in the towel on regulation, then there is no place for cheap money to go *except* the next asset bubble. You might as well try to prevent that, but then you are consigning the real economy to a long, slow decline since you have no way of getting monetary stimulus where you need it (factories, not new condo towers).

So there seem to be two possible futures. If we repeat the Greenspan policy of low rates during a boom, we’ll just create a bubble all over again, since none of the underlying factors (weak consumer protection, weak bank regulation, etc.) have changed. Or if the hawks win (both in the Fed and in Congress, which controls fiscal stimulus), we’ll have high

unemployment for a long, long time, since no one will have the guts to risk higher inflation. Being a “hawk” has become the safe, comfortable choice — even in a week when monthly job losses were up and weekly new unemployment claims were up.

By James Kwak

A Short Question For Senior Officials Of The New York Fed

Simon Johnson | 03 Oct 2009

At the height of the financial panic last fall Goldman Sachs became a bank holding company, which enabled it to borrow directly from the Federal Reserve. It also became subject to supervision by the Federal Reserve Board (with the NY Fed on point) – hence the brouhaha over Steven Friedman's shareholdings.

Goldman is also currently engaged in private equity investments in nonfinancial firms around the world, as seen for example in its recent deal with Geely Automotive Holdings in China (People's Daily; CNBC). US banks or bank holding companies would not generally be allowed to undertake such transactions - in fact, it is annoyed bankers who have asked me to take this up.

Would someone from the NY Fed kindly explain the precise nature of the waiver that has been granted to Goldman so that it can operate in this fashion? If this is temporary, is it envisaged that Goldman will cease being a bank holding company, or that it will divest itself shortly of activities not usually allowed (and with good reason) by banks? Or will all bank holding companies be allowed to expand on the same basis. (The relevant rules appear to be here in general and here specifically; do tell me what I am missing.)

Increasingly, the issue of “too big to regulate” in the public interest is being brought up – an issue that has historically attracted the interest of the Department of Justice's Antitrust Division in sectors other than finance. Should Goldman Sachs now be placed in this category?

Given that the Fed has slipped up so many times and in so many ways with regard to regulation over the past decade, and given the current debate on Capitol Hill, now might be a good time to get ahead of this issue.

In addition, there is the obvious carry trade (borrow cheaply; lend at higher rates) developing from cheap Fed dollar funding to the growing speculative frenzy in emerging markets, particularly China. Are we heading for another speculative bubble that will end up damaging US bank balance sheets and all American taxpayers?

By Simon Johnson

Shareholder Value for Beginners

James Kwak | 05 Oct 2009

Ever wondered how the private equity industry works? The New York Times has the story for you. (Thanks to a reader for pointing it out to me.) Yves Smith has a summary of the juicy bits.

The game is basically this. Thomas H. Lee Partners bought Simmons in 2003 for \$327 million in real money and \$745 million in debt. But that's debt issued by Simmons, not by THL. To buy the company, they needed to pay the previous owners \$1.1 billion in real money. The previous owners didn't care where the money came from, so as long as THL could find banks or bond investors willing to lend \$745 million to Simmons, the deal could go through. Since THL put up 100% of the equity in the new version of Simmons, they owned 100% of the company.

In 2004, Simmons borrowed more real money (by issuing new debt) and promptly gave \$137 million of that real money to THL as a special dividend. In 2007, Simmons borrowed \$300 million more in real money and paid \$238 million of it to THL. So THL got \$375 million in special dividends in exchange for its \$327 million investment (plus an additional \$28 million in fees). Simmons is now going into bankruptcy, unable to pay off all that debt, a casualty of the collapse in the housing market (houses => beds).

Now, there's nothing illegal about this. If I own 100% of the equity in something, I can do whatever I want with it (subject to any covenants imposed by lenders). Since THL was the sole shareholder in Simmons, it was perfectly justified in pulling cash out of the corporate treasury, and I'm sure it *told* Simmons's creditors that this is precisely what it was going to do with the 2004 and 2007 bond proceeds. They were just maximizing value to the shareholders — themselves. And they did it using their core competency — at every chance they got, they prettied the company up for the debt markets and convinced investors to lend it even more money.

So why doesn't all of American capitalism come tumbling down in an orgy of shareholders raiding their own companies' bank accounts? Two reasons. First, most companies have widely distributed ownership, which means that the managers call the shots, not the shareholders. Managers are unlikely to destroy the companies that pay their salaries, and it's also harder for managers to raid their own companies' bank accounts (that's called executive compensation, which has to be justified

to someone). Second, most of the time, a company is worth more as a long-term going concern than as a piggy bank to be broken open. So even if there is only one shareholder, the rational thing is to invest in the company's long-term health, not to borrow absolutely as much money as possible and stuff it in your pockets. (THL's returns on the deal, though positive, are far below what they would like to see from an investment.)

But what if there is only one shareholder, and the company is not worth more as a long-term going concern? Let's say you know the market for your product is going to implode, and you know you can make more money by borrowing money to stuff in your own pockets than by running the company for the next ten years and then selling it. Then the rational, shareholder value-maximizing thing to do is precisely to load up on the debt and pay yourself off.

So, two final points. First, this is one reason why I don't think all corporate evils can be ascribed to managers not acting in the best interest of the shareholders. Because acting in the best interest of the shareholders, in a time of crisis (or simply given inside information that the bond market doesn't have), can lead to what Yves Smith, following Akerlof and Romer, calls looting.

Second, the theoretical "solution" to this problem is that the creditors should never have loaned Simmons the extra money in 2007. But it's possible that they will learn, since it is the creditors who are being taken to the cleaners in bankruptcy. Had Simmons been too big to fail, then this would have simply repeated over and over again.

Update: See [this comment](#) for a reasonable counterpoint.

By James Kwak

Did Anything Happen In Istanbul?

Simon Johnson | 06 Oct 2009

Sunday's communiqué from the International Monetary and Financial Committee (of the Board of Governors of the International Monetary Fund) is incredibly bland, even by their usual standards. The degree of self-congratulation and complacency is slightly less pronounced than what we saw from the G20 in Pittsburgh, whose final statement contained a classic moment of hubris when the entirety of paragraph 5 read: "It worked."

Still, the IMFC (representing all IMF member countries) seems to be in the same cloud cuckoo land as the G20 leaders.

This is not surprising, as the IMF appears to be increasingly under the auspices of the G20 – despite the fact that this is extremely awkward from a formal governance point of view. The IMF has 186 members; the G20 has 19 or perhaps up to 25, depending on how many Europeans manage to gate crash on a continuing basis. Who elected the G20 to run the world?

Perhaps this arrangement would be tolerable if the G20/IMFC had an agenda for really avoiding a recurrence of our recent financial crisis and crash, but they do not.

"We will remain vigilant to prevent financial sector excesses and reaccumulation of unsustainable global imbalances." (paragraph 2) is about the scariest wording you can imagine in this context. Do you really think the financial sector respects or will even notice official "vigilance"? They are giggling on Wall Street.

And, in this context, is reference to "global imbalances" anything other than a smokescreen (or another strange kind of joke) – see our Washington Post online column, for more on this point.

"We intend to adopt an open, merit-based and transparent process for the selection of IMF management at our next meeting" (paragraph 5) is moderately interesting, but only because it appears to step back from committing to appoint a non-European (and non-US) person as the next managing director of the IMF. The current incumbent is presumed on his way to campaign for the presidency of France (and as a smart politician, likely wants to quit while he's ahead), and appointing a replacement from India, China, Brazil, or another major emerging market could be a significant move. But signs, behind the scenes, from both Europe and the White House are not exactly encouraging in this regard; they just don't

want to give up “jobs for the boys” and the option value that creates – in some future crisis, you might want your guy in the managing director job, which comes with great discretion and no constraints under the usual rule of law.

The quota reform (paragraph 4) adds nothing new, and certainly not enough to really restore Asian confidence in the IMF. The Flexible Credit Line (paragraph 9) is a sensible and long overdue innovation. But why has it been taken up by only three countries (Poland, Mexico, and Colombia)? Unless there are more customers in the pipeline soon, the lack of use for this facility will further underline the IMF’s continuing issues with legitimacy among emerging market member countries. Tripling the IMF’s resources (paragraph 8) could only help stabilize the world’s economy if countries are willing to borrow on a precautionary basis or when they first come under pressure.

And, given the clear international commitment not to tackle growing problems in the global financial system, intense pressure is what we should expect.

By Simon Johnson

Actions Vs. Words At The IMF

Simon Johnson | 06 Oct 2009

Buried in the avalanche of meaningless press releases from Istanbul is a highly significant item. Dominique Strauss-Kahn, Managing Director of the IMF, “has proposed the appointment of Naoyuki Shinohara, to the position of Deputy Managing Director. Mr. Shinohara, a former Vice Minister of Finance for International Affairs of Japan, will succeed Takatoshi Kato.”

This is a disaster.

I have nothing against Mr. Shinohara, who is most likely a distinguished and accomplished public servant.

But the G20 said, at its April 2009 London summit, that (paragraph 20, bullet #4), “we agree that the heads and senior leadership of the international financial institutions should be appointed through an open, transparent, and merit-based selection process.”

And the background briefings, from all sides, stressed that “senior leadership” included Deputy Managing Director positions at the IMF.

To replace one Japanese national with another in this fashion is to break a critical symbolic and substantive G20 pledge – the signal it sends is that the next Managing Director of the IMF will be European, the next President of the World Bank will be American, etc, as they have always been. This further undermines attempts to rebuild the legitimacy of these institutions.

No doubt, Japan and its G7 allies put great pressure on the IMF to make this appointment. But the signal this sends to emerging market leaders is evident and, quite frankly, insulting.

It would have been a brilliant gesture, for example, to appoint a distinguished Chinese bureaucrat to this position – in fact, this was the hope of pro-IMF people among emerging markets (and there are still a few).

We are not back to zero in terms of meaningful IMF governance reform. We are deep in negative territory: All the G7 and G20 rhetoric has been exposed as empty.

By Simon Johnson

Cash for Trash: Better Never than Late

James Kwak | 07 Oct 2009

The following guest post was written by Linus Wilson, a finance professor at the University of Louisiana at Lafayette, the media's go-to guy on calculating the value of transactions between the government and the banks, and an occasional commenter on this blog. Linus also analyzes government-bank transactions at Seeking Alpha.

The U.S. government does few thing better than create debt. After a year of talking about it, the government is going to have the chance to throw their good debt, Treasury bills notes and bonds, after bad, non-performing toxic loans and securities. The Federal Deposit Insurance Corporation (FDIC) and the U.S. Treasury are going their separate ways on their cash for trash schemes at this point. Accountants and investors should be wary of the big prices they see coming from the FDIC's auctions, but taxpayers should be afraid of the U.S. Treasury's efforts to re-inflate the securitization bubble.

The FDIC is nearing the century mark of bank failures this year and it has a lot of bad assets to unload. On Tuesday, October 6, 2009, it announced that it sold a \$4.5 billion, festering pool of condo loans from the failed lender Corus Bank. The last 10-Q for the failed Chicago lender said that it had \$3.3 billion in non-performing loans with heavy concentrations in busted condo markets of Miami and Los Angeles. Yet, zero-coupon, FDIC-guaranteed debt and a billion dollar line of credit led to the price of \$2.8 billion. That price of about 60 percent of par seems rich when almost 70 percent of the loans are non-performing. A few weeks earlier the FDIC did its first Legacy Loans Program auction. My paper "Slicing the Toxic Pizza: An Analysis of FDIC's Legacy Loan Program for Receivership Assets" found that the nearly 6-to-1 government subsidized leverage in the first Legacy Loans Program sale boosted prices by over 20 percent. Yet, the irony is that these subsidies don't help the FDIC and ultimately taxpayers because the FDIC is offering cheap financing to sell assets it already owns. Any higher prices just offset the subsidized financing if the auctions are competitive. Yet, any marks obtained from these auctions are certainly inflated.

The Legacy Securities Program run by the U.S. Treasury with an initial taxpayer outlay of \$30 billion is set to launch soon. More asset managers are closing their investment funds every week. The problem with the Legacy Securities Program is that the government will probably use

cheap leverage to finance the sale of trash assets that it does not already own. That means that the taxpayer subsidies are enjoyed by the banks selling the assets. My research shows that the most troubled banks will be reluctant to part with their toxic securities. Yet, the healthy banks will be all too eager to unload those assets at inflated prices. Come Halloween the U.S. Treasury will be handing out the goodies. Unfortunately, taxpayers will be getting none of the treats but all of the cavities.

By Linus Wilson

Dollar Down, Obama Up?

Simon Johnson | 07 Oct 2009

Recent weakness in the dollar is a stroke of luck for the administration, but they have also played their cards well at the international level. This could really help the Democrats in the 2010 midterm elections, but it's quite a gamble. I discuss [the details here](#).

Imbalances, Schmalances

James Kwak | 07 Oct 2009

We've been at first amused but more recently alarmed at how "global imbalances" are becoming many people's preferred explanation of the financial crisis. At first you could brush it off this way: "global imbalances (read: 'blame China') . . .". But this explanation is going mainstream, not least because it is always more convenient for policymakers and bad actors to blame someone far away. For example, Dealbook (New York Times) kicked off a roundtable on the causes of the financial crisis this way:

"There is a conventional view developing on the financial crisis. The Federal Reserve's policy of historically low interest rates spurred a worldwide search for higher risk and return. Concurrently, the entrenched United States trade imbalance led to a huge transfer of dollar wealth to Asian and commodity-based countries. The unwillingness of Asian economies, particularly China, to stimulate their own domestic consumption led these countries to reinvest the proceeds into the United States. This further contributed to lower American interest rates and further fueled the search for return."

(Mortgage securitization gets mentioned, but only in the fourth paragraph!)

Simon and I took this on in our Washington Post online column this week, but I thought it was interesting enough to repost here in full, below.

The time is here for our nation to actually do something about the recent financial crisis — that is, do something to prevent it from happening again. But instead, many people are finding it easier to pass the buck than to, say, regulate the financial sector effectively.

The recent Group of 20 conference in Pittsburgh was replete with talk about "global imbalances," which means — in the spirit of the "South Park" movie — "blame China!"

According to this story, the global financial crisis was caused by hardworking Chinese factory workers who committed the sin of over-saving, which created a glut of money that needed to be invested,

conceptualized in a great episode of public radio's "This American Life" as the "giant pool of money." (Japan and the oil exporters also had large surpluses, but for political reasons, the finger generally gets pointed at China.)

This beast from the East, seeking higher yields than it could find in Treasury bonds, flooded into the housing market, pushing down interest rates and pushing up housing prices, and creating a bubble that finally collapsed, with the results we all know. (More nuanced proponents of this theory hold, in a "fair and balanced" sort of way, that over-savers in China and under-savers in the United States — and other countries, like Spain, Britain and Ireland — are equally to blame; in any case, it's the imbalance that's the problem.) This is a convenient story because it absolves us of any need to put our own house in order through better regulation.

Like most errors, this story contains an element of truth. In general, it is not a good thing for a country to consume more than it produces indefinitely because to pay for its excess consumption it must borrow money from the rest of the world, and that country can consume more than it produces only if some other country produces more than it consumes. In particular, the U.S.-China imbalance is due in part to the Chinese policy of keeping its the value of its currency artificially low — encouraging Americans (and other foreigners) to buy Chinese exports and discouraging its citizens from buying imported goods.

But the "blame China" story (or the "half-blame China" variant) suffers from serious problems. First, it takes two to tango. No one put a gun to the American consumer's head and forced him to buy a new flat-screen TV or to do so by taking out more debt. (Nor are the Chinese somehow morally superior to us; one reason why they save so much more than Americans is that, with no social safety net to speak of, they have to.)

Second, the Chinese government did not lend to American home buyers directly. China bought U.S. Treasury and agency (Fannie Mae, Freddie Mac, etc.) bonds, which put more money into housing and also crowded other people's money into housing. But the vast majority of Chinese money went into the safer bits of the U.S. financial system; the speculative money came largely from European banks. And all the actual lending decisions were made by financial intermediaries (banks, mortgage lenders, etc.), which made plenty of bad decisions along the

way while regulators, from Alan Greenspan on down, looked the other way.

Third, there is no particular reason why a “giant pool of money” should produce a bubble. A savings glut should lower interest rates, which should increase the value of housing; a bubble occurs when prices go up more than dictated by fundamentals like as interest rates. If the run-up in housing prices was a direct result of over-saving in China, then housing prices should have fallen only if China stopped over-saving — which has not happened.

While Chinese over-saving was a contributing factor to the recent crisis, it was neither necessary nor sufficient. Cheap money is not bad in and of itself — all other things being equal, it’s better to have people lending to you at low rates than at high rates. The problem is what we did with the cheap money.

For the long-term health of the economy, we want that money to flow into capital investment by the business sector because that is the best thing we know of to boost long-term productivity growth. Instead, though, Tim Duy has a great chart, showing that the rate of growth of investment in equipment and software in the 2000s was far below the rate in the 1990s, even with all the cheap money of this decade.

This may seem like an obscure point, but basically it means that even with the low rates of the Greenspan Fed, and even with all that cheap money from overseas, we couldn’t get it where we needed it to go because it was being sucked up by the housing sector. And it was being sucked up by the housing sector because lenders earned fees for making loans that could not be paid back, and banks earned fees for packaging those loans into securities, and credit rating agencies earned fees for stamping “AAA” on those securities, and all sorts of financial institutions — including those same banks — loaded up on these securities because they offered high yield and low capital requirements. In short, we had a dysfunctional financial system that failed at its most fundamental job — allocating capital to where it benefits the economy the most.

Encouraging productive investment by businesses and preventing the next bubble go hand in hand — both require fixing the financial system. Blaming global imbalances — a consequence bereft of either a subject (an actor) or a verb (an action) — is only a way of avoiding our real problems.

By Simon Johnson and James Kwak

The Problem with Securitization

James Kwak | 07 Oct 2009

The New York Times has a story on “Paralysis in the Debt Markets” which says, basically, that credit has dried up because of lack of demand for asset-backed securities. In English, that means that since no one wants to invest in securities that are made out of home mortgages, the people who originate mortgages have no place to sell the mortgages to, so they don’t have any money to lend. And this is also true of commercial real estate, student loans, and so on. For example, “A once-thriving private market in securities backed by home mortgages has collapsed, from \$744 billion in 2005, at the peak of the housing boom, to \$8 billion during the first half of this year.”

The response of the Fed has been to prop up the securitization market by buying the stuff itself when no one else will buy it. But that program is reaching its provisional limit — according to the times, the Fed has bought \$905 billion out of a budget \$1.25 trillion in securities — and with the Fed hawks on the warpath, it is likely to be pulled before the private market recovers.

This is especially true since the private market may *never recover*. The boom in securitization was based on investors’ willingness to believe what investment banks and credit rating agencies said about these securities. Buying a mortgage-backed security is making a loan. Ordinarily you don’t loan money to someone without proving to yourself that he is going to pay you back (or that the interest rate you are getting will compensate you for the risk that he won’t pay you back). The securitization bubble happened because investors were willing to outsource that decision to other people — banks and credit rating agencies — who had different incentives from them.

Are investors going to go back to that mindset? Do we want them to? It seems to me the rational investor response is this: “I have no idea what is in those securitization trusts. I don’t trust the banks, since they are taking fees out of each deal. I don’t trust the credit rating agencies, since they are being paid by the banks, and don’t have enough staff and expertise to do the job properly. I don’t trust the models, because they’re wrong. There’s no way I can do the analysis myself. So I’m not buying.”

Maybe what’s happening is the only people buying asset-backed securities are (a) a few bold (or stupid) hedge funds who think they can do the valuation themselves and (b) recent immigrants from Mars who

haven't heard about the financial crisis. And maybe that's where the securitization market will be for a long, long time. I agree that people have irrational optimism and are prone to bubbles, but it doesn't have to be *this bubble*. People in Silicon Valley are waiting for the tech bubble to come back, but it may not happen — we got a housing bubble instead. Next time maybe it will be a buy-plots-of-land-in-the-rainforest-and-use-them-for-carbon-offsets bubble. There's no reason it has to be a securitization bubble.

Besides, as Paul Krugman writes, why does it have to be securitization, anyway?

The banks don't need to sell securitized debt to make loans — they could start lending out of all those excess reserves they currently hold. Or to put it differently, by the numbers there's no obvious reason we shouldn't be seeking a return to traditional banking, with banks making and holding loans, as the way to restart credit markets. Yet the assumption at the Fed seems to be that this isn't an option — that the only way to go is back to the securitized debt market of the years just before the crisis.

By James Kwak

Casey Mulligan's Straw Man

James Kwak | 07 Oct 2009

Casey Mulligan argues that bank recapitalization under TARP was a failure because it did not lead to increased bank lending. He argues that this was a necessary outcome, because (a) public purchases of bank capital crowd out private purchases of bank capital, and (b) new capital does not necessarily flow into lending, and concludes: "This episode is an expensive example of public policy promises that were doomed to failure because they were known at the outset to defy economic theory."

I have often argued that there were many things wrong with TARP. But this is not one of them.

First, public capital may crowd out private capital in some theoretical world between the covers of an economics textbook. But what about a world when *no one wants to buy private capital*? That is a fair description of the state of the world on October 13 last year, when Henry Paulson convinced his former Wall Street colleagues to accept a gift of cheap capital. Yes, Buffett and Mitsubishi had made investments in Goldman and Morgan Stanley, but everyone's CDS spreads were *still going up*. Mulligan says, "The market might well react to Treasury share purchases by reducing private holdings of bank capital," but I don't know by what mechanism I could take a share of Citigroup down to Midtown and demand cash for it. (Sure, I could sell it, but that doesn't change the amount of private capital.)

(b) is correct — more capital does not necessarily increase new lending, especially when banks are fearful for their day-to-day survival. But this is where the straw man comes in. The overriding purpose of bank recapitalization was not to increase lending. It was to *prevent major banks from failing*. The banks were facing both a liquidity and an insolvency crisis. The promise of virtually unlimited liquidity by the Fed had not so far succeeded in stopping the wholesale (as opposed to retail) run on major banks. They needed capital, and they couldn't get it from anyplace else, so the government stepped in.

Yes, some politicians *said* that the purpose of TARP was to increase lending. But that's what they had to say, especially after the House Republicans succeeded in killing the first version of TARP. The main purpose was to prevent a collapse of the financial system, and it succeeded there. Besides, you could argue that TARP did increase lending, because there will be more lending in a world with Citigroup

and Bank of America than in a world without them, at least in the medium term. (Yes, the textbook says that supply will meet demand somehow, but the real world doesn't reach equilibrium instantaneously.)

Now, I could go criticizing TARP for the rest of the day. In short, I would say it succeeded in its most essential mission, but it did so via excessive subsidies to the banking industry, and it left us with a stabilized but sick financial system (remember those toxic assets?) instead of a healthy one. I think the finding that TARP did not increase lending is actually an important one, because it highlights one of the flaws of the government's response — a more aggressive response could have resulted in a healthier system. But using it as an example of the superiority of Chicago-school economic theory over public policy is a bit much.

By James Kwak

Too Politically Connected To Fail In Any Crisis

Simon Johnson | 08 Oct 2009

Over the past 30 years Wall Street captured the thinking of official Washington, persuading policymakers on both sides of the aisle not to regulate (derivatives), to deregulate (Gramm-Leach-Bliley), not enforce existing safety and soundness regulations (VaR), and to stand idly by while millions of consumers were misled into life-ruining financial decisions (Alan Greenspan).

This was pervasive cultural capture or, to be blunter, mind control. But when the crisis broke it was not enough. Having powerful people generally on your side is not what you need when all hell breaks loose in financial markets. Official decisions will be made fast, under great pressure, and by a small group of people standing up in the Oval Office.

If you run a big troubled bank, you need a man on the inside – someone who will take your calls late at night and rely on you for on the ground knowledge. Preferably, this person should have little first-hand experience of the markets (it was hard to deceive JP Morgan and Benjamin Strong when they were deciding whom to save in 1907) and only a limited range of other contacts who could dispute your account of what is really needed.

Goldman Sachs, JPMorgan, and Citigroup, we learn today, have such a person: Tim Geithner, Secretary of the Treasury.

We already knew, from the NYT, that most of Geithner's contacts during 2007 and 2008 were with a limited subset of the financial sector – primarily the big Wall Street players who were close to the New York Fed (including on its board). And the announcement of his appointment was widely regarded as very good news for those specific firms.

But Geithner himself has always insisted that his policies are intended to help the entire financial system and thus the whole economy.

“SECRETARY TIMOTHY GEITHNER: I’ve been in public service all my life. I’ve spent all my life working in government on ways to make our financial system stronger, better economic policy for this country. That’s the only thing I’ve ever done. And I would never do anything and be part of any policy that’s designed to benefit some piece of our financial system. The only thing that we care about and the only obligation I have is try to make sure this financial system is doing a better job of meeting the needs of

businesses and families across the country.” Interview on Lehrer NewsHour, May 8, 2009

Geithner’s defenders insist that his specific contacts while President of the NY Fed were a function of that position; “he was only doing his job.”

But today’s AP report, based on looking at Geithner’s phone records, from the inauguration through July, suggest something else. How can anyone build an accurate picture of conditions in the entire crisis-ridden financial sector primarily from talking to a few top bankers?

The list of phone calls is not the largest banks, because some of the biggest are hardly represented (e.g., Wells Fargo), it’s not the most troubled banks (e.g., Bank of America had little contact), and it’s not even investment banker-types who were central to the most stressed markets (Morgan Stanley was not in the inner loop). And small and medium-sized banks (and others) always bristle at the suggestion that their interests are in alignment with those of, say, Goldman Sachs.

Geithner’s phone calls were primarily to and from people he knew well already - who had cultivated a relationship with him over the years, shared nonprofit board memberships, and participated in the same social activities. These are close professional colleagues and in some cases, presumably, friends.

The Obama administration had to rescue large parts of the financial sector, given the situation they inherited. But it absolutely did not have to run the rescue in this exact fashion – bending over backwards to be nice to leading bankers and allowing their banks to become even larger. Saving top executives’ jobs under such circumstances is not best practice, it’s not what the US advises to other countries, it’s not what the US tells the IMF to implement when it helps clean up failed banking systems, and it’s not what the FDIC implements for failed banks under its auspices.

The idea that you could leave big US bank bosses in place (or let them get stronger politically) and do meaningful regulatory reform later has always seemed illusory – and this strategy now appears to be in serious trouble. But presumably Mr. Geithner’s financial advisers told him this was the right thing to do.

By Simon Johnson

Tonight On Bill Moyers Journal, This Morning On NPR, And Louis Brandeis

Simon Johnson | 09 Oct 2009

On PBS this evening (first airs at 9pm eastern; on the web from about 10pm), Bill Moyers, Rep. Marcy Kaptur, and I discuss where we stand – and what we’ve learned – a year after the US financial system almost collapsed.

There’s a detailed preview on Bill’s website – our conversation moved back-and-forth between people losing their homes in Ohio, how bank behavior brought us to this point, and where we go from here.

We also discussed the latest revelations that, at the height of the crisis earlier this year, Treasury Secretary Tim Geithner spoke primarily to a very small group of top bankers (at Citi, Goldman, and JP Morgan). Further implications are taken up in my Daily Beast column this morning.

Also today, coincidentally, on NPR’s morning edition (about 21 minutes into the first hour; will be on-line around 9am), Alex Blumberg, Charles Calomiris, and I role play whether the administration’s reform proposals are “Jamie Dimon-proof”, meaning that Too Big To Fail will really be brought under control. I’m Jamie Dimon, Charles is Charles, and Alex is the President. It doesn’t go well for the taxpayer.

On behalf of the administration, Diana Farrell (Larry Summers’s deputy at the National Economic Council, NEC) responds by saying effectively: “big has its benefits”, and the best we can hope for is to regulate our massive banks. As I said in my NYT Economix column yesterday (reproduced after the jump here), I take the position of Louis Brandeis on this one: our biggest banks have simply become Too Big To Regulate.

The NPR story didn’t get into the tragic human dimensions of the crisis, but Rep. Kaptur was forceful on this point during the Moyers conversation. In part, this strengthens the case for a consumer protection agency focused on financial products - a point on which we agree with Ms. Farrell and her colleagues.

But, hopefully, senior staff at the NEC will have a chance to review the Moyers segment (it only takes 30 minutes or so) and reflect on whether big banks are really ever so beneficial when they make,

facilitate, and now refuse to renegotiate loans that have ruined so many lives.

Big is Bad Again

At about this time after the near-collapse of its banking system, any democracy goes through a phase of soul-searching regarding its broader economic model. Around almost every water cooler in the U.S., people ask: Does the severity of our financial crisis reflect the disproportionate influence of a few incompetent investment bank executives, something about how dangerous our financial sector has become, or a deeper breakdown of capitalism?

The deeper breakdown view is, without doubt, gaining center stage – debated now in movies, TV, and radio shows. And of course this position is not just about the crisis; it builds on serious longer term concerns, particularly rising inequality, that are real and quite disturbing.

At least in general terms, opinion leaders begin to point the finger at big corporations, including both their stupidity and greed in economic terms and their ability to generate political cover through campaign contributions and simply stunning amounts of lobbying.

The US experienced a similar phase of reaction against “bigness” in the early 20th century, spurred both by the 1907 financial crisis (which led, among other things, to the creation of the Federal Reserve, at the time a radical new component of the US capitalist system) and also by the rise of industrial trusts – huge companies that began to form in the 1890s and which, by 1910, dominated the American commercial landscape.

In the 1912 Presidential campaign, there were three main views on how to handle mega-trusts: do nothing (President Taft), build up federal power to counterbalance and regulate concentrated industrial power (ex-President Theodore Roosevelt, running as the Bull Moose Progressive independent candidate), and break up big companies to reduce their power (Woodrow Wilson, advised by Louis Brandeis).

Brandeis’s views are the most relevant for our modern discussion. In 1985 Thomas McCraw won a Pulitzer Prize for *Prophets of Regulation*, in which he criticized Brandeis for not understanding basic economics when he argued that big business was too big to manage effectively and undermined the individualism that was essential to American democracy.

McCraw rightly pointed out that some big U.S. firms have been well run over the past century – in fact, many of the best jobs in this country continue to be with large employers (look at the pay packages and benefits around you). It's also true that the undoubted power of major corporations has not prevented waves of productive technological change, mostly brought to us by start-up entrepreneurs.

But Brandeis was right on the politics of size and what that meant in turn for the US economy – and he is very much in tune with the cutting edge of modern economics. When large firms can (1) shape their regulatory environment, (2) take advantage of lax regulation to take on more risk than they can manage, and (3) “put” the downside losses onto the taxpayer, we should be very afraid.

This exact problem has repeatedly slapped us in the face over the past 12 months with almost every development in the financial sector, and it remains inherent in every “too big to fail” bank. Brandeis was exactly right on the dangers that could arise from the financial system – even though he could not foresee how the creation of the Federal Reserve would, when combined with weak regulation, lead to even worse outcomes.

But we should not suffer another failure of imagination or apply Brandeis to our modern circumstances too narrowly. The problems before us now are not limited to the financial sector. Just as Brandeis argued, beginning with a piece entitled “Our Financial Oligarchy” in Harper’s Weekly, November 1913, we have allowed other parts of our economy to become “too big to regulate”. Any company that can set its own rules and then behave in a reckless fashion is potentially very damaging to both prosperity and democracy.

Teddy Roosevelt thought you could regulate and control monopolies, and his idea that “big corporate” could be controlled by “big government” was taken forward with some success by FDR, the reforms of the 1930s, and the way our system operated for 30-40 years after World War II. But the complete breakdown of financial regulation under great political pressure in the 1980s and 1990s should serve as a wake-up call, both with regard to banking and much more broadly.

We need to go back to Brandeis who, with his extensive experience on the interface between politics and law, thought that breaking up big firms was essential: “We believe that no methods of regulation ever have been or can be devised to remove the menace inherent in private monopoly and overweening commercial power” (Urofsky, p.346).

If we can update and apply Brandeis to finance and more broadly, we still have a chance to save the positive features of our American model.

By Simon Johnson

The material after the jump is a slightly edited version of my NYT Economix column yesterday. Anyone seeking to republish that material in its entirety should seek permission of the NYT. However, the material before the jump can be distributed freely, subject only to providing an appropriate credit and a link back to BaselineScenario.

What Is Consumer Freedom?

James Kwak | 09 Oct 2009

This guest post was contributed by Lawrence B. Glickman, who teaches history at the University of South Carolina. He put the fight for the Consumer Financial Protection Agency in historical perspective in his [previous post](#) on this blog.

A recent ad taken out by the “The Center for Consumer Freedom” marks the latest assault by business lobbyists and conservatives on the idea of consumer protection. This organization’s motto — *Promoting Personal Freedom and Protecting Consumer Choice* — defines consumer freedom as “the right of adults and parents to choose how they live their lives, what they eat and drink, how they manage their finances, and how they enjoy themselves.”

Like other critics of consumer protection, this organization (“supported by over 100 companies,” according to its website) speaks in the name of freedom and depicts consumer protection as an assault not only on the liberty but on the intelligence of ordinary people. The ad begins with the following rhetorical question, “Are you too stupid...to make good personal decisions about foods and beverages”? Arguing against the “campaign to demonize soda” the advertisement blasts “food cops and politicians” for “attacking food and soda choices they don’t like.” Another of their ads warns about “Big Brother” in the “Big Apple” because New York City is considering taxes on junk foods and sugar-laden sodas. [The group’s print ads can be seen [here](#).]

A nearly identical line of criticism is currently being deployed against President Obama’s proposed Consumer Financial Protection Agency. Richard Shelby, the Republican Senator from Alabama, finds the proposal “disturbing and somewhat offensive” because it relies on the “concept of the intellectually deficient consumer.” Jeb Hensarling, a Congressman from Texas, worries that “un-elected bureaucrats” might “decide if we can have a credit card.” Scott Garrett, his fellow Republican colleague from New Jersey, is worried about the “Orwellian, government-bureaucrat-knows-best mentality” evinced by the proposal.

Opponents of consumer protection have long spoken in the name of individual liberty. They have done so by misconstruing the nature of human agency and freedom in the modern world.

At least as far back as the Progressive era, many Americans noted that industrial society—in which consumers did not produce their own food

and drink and often lived far from such sites of production—called for federal regulation and protection to insure that the food we bought was safe. This was the essence of the landmark 1906 Pure Food and Drugs Act and it was the meaning of presidential candidate Woodrow Wilson’s statement in 1912 that “freedom today is something more than being let alone. The program of a government of freedom must in these days be positive, not negative merely.” Wilson and other progressives—including members of the Republican Party, such as Theodore Roosevelt—recognized that extending freedom in the twentieth century required a federal government capable of regulating business. In Wilson’s view, federal regulation of the sort provided by the 1906 Pure Food law did not substantially restrict the freedom of individual Americans. It instead instilled confidence that the market for food and drugs would be stripped of poisonous and dangerous goods.

The freedom that is restricted by consumer protection laws is the freedom of businesses to sell dangerous or even poisonous goods. By preserving confidence in the marketplace, such regulations allow consumers the freedom to make choices, and therefore esteem the intelligence of the American people.

Of course, regulation can become excessive and Americans need to balance individual autonomy with federal protection. (So too can federal assistance go in the other direction: one of the reasons businesses ply Americans with unhealthy food is that subsidies to agribusiness make possible the cheap production of high fructose corn syrup. Thus, these defenders of the free market ignore the inconvenient fact that the playing field is not truly level.) The claims of business lobbyists that common sense regulation amounts to incipient totalitarianism, however, demonstrate their unwillingness to accept what has become over the last century a fundamental part of the social contract, and which makes tangible true freedom of choice.

By Lawrence Glickman

What's Wrong with a Phone Call?

James Kwak | 09 Oct 2009

Yesterday Simon pointed out the AP story highlighting Tim Geithner's many contacts with a few key Wall Street executives — primarily Jamie Dimon, Lloyd Blankfein, Vikram Pandit, and Richard Parsons — while leading the government's rescue efforts as Treasury secretary. It's certainly useful for the nation's top economic official to talk to people in the banking industry, and it's also useful for him to talk to banks that are being bailed out by the government. But the AP story did come up with a few important distinctions. Geithner talked to these Wall Street executives more than the key people in Congress — Barney Frank and Christopher Dodd — that he needs to pass his regulatory reform plan. And he talked to them much more than to, say, Bank of America, which is equally big and equally in debt to the government. So to be clear, Geithner is talking to these people more than dictated by the requirements of his job (or he's not talking to Ken Lewis enough).

Still, you could say, what's wrong with that? Can't Tim Geithner talk to whomever he wants to talk to?

Of course he can, in a legal sense, and no one is saying he is doing anything illegal. All the evidence is that Geithner is a man of unassailable integrity, and a modest, courteous guy to boot.

But as the lobbyists have known for decades, the key to political power in the United States is access. Under-the-table bribes are relatively rare. The revolving door (government officials taking lucrative jobs at the companies they used to oversee) is important, but of little use when it comes to the very top people. Paul O'Neill, John Snow, and Henry Paulson were already easily rich enough to overlook such temptations (although Snow did leave Treasury to become chairman of Cerberus); Geithner may not be a mega-millionaire, but he already turned down his shot at being CEO of Citigroup in 2007.

Instead, if you want to sway some of the top people in government, the most important thing is to talk to them. All of us are influenced by the information and opinions that we are exposed to. Many people have a tendency to agree with either the first person or the the last person they spoke to on a particular issue, regardless of what other information they take in. (Where Geithner falls on that spectrum I have no idea.) This is why lobbyists make so much money; they sell access.

If, in the midst of a financial crisis, you get a disproportionate share of your advice from a few select Wall Street veterans with enormous personal interests in your decisions, you will be swayed a certain way. This is particularly worrying if you have spent the last several years even more deeply steeped in that circle, because you will be getting information and ideas that are confirming your prior beliefs. It is also worrying if, as was the case this past year, you do not have the time for detailed fact-finding or empirical studies, and instead you have to make important decisions based purely on logic and conjecture. Instead, you (and the public) would be better served going out of your way to talk to people who do not share your prior perspective and are likely to disagree with you. Now, the Obama administration is nowhere near as bad as the Bush administration, which disdained talking to its critics; this administration has reached out to its intellectual opponents, for example in the famous White House dinner with Krugman and Stiglitz. But one dinner does not balance eighty phone calls.

There's nothing scandalous about the fact that Tim Geithner talks to the CEOs of Goldman, JPMorgan, and Citi a lot. It's just a fact. It's a fact that demonstrates the deep linkages between the thinking inside Treasury and the thinking on Wall Street (and yes, I know Citi and JPMorgan are in Midtown). It's also one reason I have little interest in conspiracy theories — who needs a conspiracy when you have a sympathetic ear in the Treasury Department that you can get access to regularly? As we've said before, the key factor throughout this financial crisis has been political power. And if that power is composed of the power of ideas and the power of relationships, so much the better.

By James Kwak

What Is Risk Adjustment?

James Kwak | 12 Oct 2009

I think I know what it is, and if I'm right it's very important to health care reform, but it hasn't gotten a lot of attention.

Risk adjustment is the solution to the following problem. Imagine you tell all the health insurers that they have to accept the healthy and the sick, and they have to charge each the same insurance premium. You may not have to imagine for much longer; this is at the core of all the proposed health care reform bills. (In the Finance Committee bill you can discriminate based on a small number of factors, like age and tobacco usage, but that's it.)

If you're a profit-maximizing insurer, what do you do? You try to cherry-pick the healthy, since the revenues will be the same as for the sick and the costs will be lower. If you can do this successfully — say, by only advertising in gyms and in Runner's World, or maybe by offering additional benefits that only the healthy will want — then you can dump the sick on someone else. That someone else will eventually (after all the private insurers get smart or go out of business) be the public option or the non-profit cooperative, whichever we end up with, which will end up losing money; the net effect is a transfer from taxpayers to private insurers. Now, the fact that insurers participating on exchanges have to take everyone should mitigate this problem, but it won't go away. In effect, insurers will compete by marketing in ways that attract the healthy and hide from the sick, instead of competing to offer better health care at lower cost.

Risk adjustment is a transfer mechanism whereby money flows in the reverse direction, from insurers with healthy customers to insurers with sick customers. It requires some means of calculating the expected healthiness of a pool of people and the fair transfer payment. You can't (I don't think) base your transfers on actual healthiness, because then you are penalizing insurers that are actually good at making people more healthy. So the transfers need to be based on some measure of how sick the customers were when the insurers got them at the beginning of the year.

I haven't found much on the blogs (maybe I'm reading the wrong blogs); when I searched Ezra Klein, my first resource on health care, for "adjustment," I only came up with [these](#) [three](#) [posts](#). What I really want

to know is how risk adjustment will work under our proposed health care reform. But in the Baucus Bill, this is all I found:

“Risk-adjustment. All plans in the individual and small group markets would be subject to the same system of risk-adjustment. Risk-adjustment will be applied within rating areas (described below).

“The Secretary would be required to pre-qualify entities capable of conducting risk-adjustment and the states would have the option to pick among those entities. The entities pre-qualified by the Secretary cannot be owned or operated by insurance carriers. The Secretary of HHS would define qualified risk-adjustment models which can be used by states. States can also choose to develop their own risk-adjustment model but it must produce similar results and not increase Federal costs. After risk-adjustment is applied, reinsurance and risk corridors (described below) would apply.”

So it seems like the government will designate certain organizations that are allowed to do the risk adjustment calculations, and states can pick between them. (This reminds me of nationally recognized statistical rating organizations, but that’s perhaps an overreaction.)

There is also a reinsurance mechanism under which all insurers in a state have to pay an amount proportional to their insurance premiums into a reinsurance fund, which then pays out to insurers based on how many high-risk customers they have. That is probably a good thing, but it only applies for three years (2013-2015), and it doesn’t eliminate the incentive to cherry-pick; since contributions into the fund do not come from insurers with disproportionately healthy customers, you are still better off attracting the sick.

The overall goal here is to channel private-sector competition in a socially beneficial way. It does seem simpler to just have single payer and be done with it (then you don’t need any of these rules), but the basis of our proposed system is getting insurers to compete in some ways (lower administrative costs, lower medical costs through intelligent use of negotiated payment schedules) and not in other ways (cherry-picking). As far as I can tell, the bill points in the right direction, but it still seems terribly vague to me. Am I just missing something that’s in a different part of the bill?

By James Kwak

Who Needs Big Banks?

James Kwak | 12 Oct 2009

At a panel discussion at the Pew Charitable Trusts (captured for posterity by [Planet Money](#)), Alice Rivlin floated the idea of breaking up big banks. Luckily for us, Scott Talbott of the Financial Services Roundtable (a lobbying group for big banks) was there to slap that idea down.

Talbott: “We need big companies, and they can be managed, and they are being managed ...”

Alex Blumberg (Planet Money): “But why, why do we need big companies?”

Talbott: “They provide a number of benefits across the globe. We have a global economy, and these institutions can handle the finances of the world. They can also handle the finances of large, non-bank institutions like General Electric or Johnson & Johnson. They need these institutions [that] can handle the complex transactions. Simply breaking them up ... then you’re discouraging a company from achieving the American Dream, working hard, earning money, producing products, and getting bigger.”

There are two things I object to strongly. The second is easy. The American Dream is for people, not companies. And people dream of working hard, being successful, making money, and having an impact on the world. The American Dream does not imply any particular company size. There are situations in which your products are just so much better than anyone else’s that your company becomes big as a result; Google comes to mind. But Citigroup is the product of no one’s American Dream. When Talbott says “American Dream,” what he really means is “American Bank CEO’s Dream” — because, as we all know, CEO compensation in the financial sector is extremely correlated with assets.

The first is this “we need big banks to serve global corporations” line. I’ve heard this before and I don’t buy it, for a number of reasons.

First (sorry, I have this habit of embedding numbered lists inside numbered lists), how global is Bank of America? Until it bought Merrill Lynch, it was pretty much a midget overseas compared to, say, Morgan Stanley, which was a small fraction of its size. How global is Wells Fargo? Yet those are two of our four biggest banks.

Second, the argument doesn't pass the test of basic business logic. My company did (and does) business in many countries around the world. We had different alliances and different service providers in each one. There were overlaps — we worked with some consulting firms in multiple countries — but we made the decisions independently in each country, because every country is *different*. And in each country, you want the people who are the best in that country. Sometimes that will be a division of an American multinational; often it won't. If I'm "General Electric" or "Johnson & Johnson," I'm not going to do all my banking with Citigroup out of some misplaced customer loyalty.

Third, what global services is Talbott talking about? Sure, as an individual, it would be nice if my bank had offices in every country I might ever travel to. But that's because I'm an individual, and I don't want to have more than a few bank accounts. I would guess that General Electric has, oh, *thousands* of bank accounts around the world, with dozens if not hundreds of banks. The "one-stop shop" idea applies — barely — to people like me, who would like the convenience of doing all of our financial stuff with one company, but generally figure out that it's impossible, because my bank offers crappy investment products, and crappy insurance products, and ... you get the idea. It's laughable for a big company, which has hundreds of P&Ls, each of which is different, and has different objectives and preferences.

Fourth, let's take a big, global transaction — say, a debt offering. Here, arguably, it might be good to have a single bank with global scale, since you want to sell bonds in as many markets as possible in order to get the broadest possible pool of investors. In 2008, J&J issued \$1.6 billion (face value) of bonds. Who got the deal? Goldman, JPMorgan, Citi, Deutsche Bank, Bank of America, Morgan Stanley, Williams Capital Group, BNP Paribas, HSBC, Mitsubishi UFJ, and RBS Greenwich Capital. Eleven investment banks based in five countries, including five U.S.-based banks. (In 2007, J&J issued 500 million pounds of debt, using thirteen underwriters — six of whom were not involved in the 2008 offering; two out of three book-running managers were European banks.) So when push comes to shove, our beloved mega-banks are nowhere near up to the task. What this tells me is that it's the big companies that call the shots, and they like parceling out business to lots of banks. This is another basic principle of business: it's better to have multiple suppliers than one supplier, so you can keep them in competition.

This whole argument, that global companies need massive banks, is one of those things that sound plausible until you actually start thinking about them. Is there something big that I'm missing here?

By James Kwak

Further Proof That Nothing Has Changed

James Kwak | 12 Oct 2009

Overheard on the streets of New Haven, just ten minutes ago:

Two young women, almost certainly Yale undergraduates, are walking down York Street, discussing their efforts to get jobs as bankers.

Student #1: "Why does everyone want to go into banking?" [Note: When an Ivy League undergrad says "banking," he or she invariably means "investment banking," meaning underwriting or trading.]

Student #2: "We should advertise – 'Being a lawyer is so much better than banking.'"

Student #1 (after a pause): "Seriously, everyone wants to go into banking."

End scene.

Also further proof that no one does campus recruiting better than a Wall Street investment bank. Or do undergrads these days *want* to work in investment banking after the financial crisis? At least, after the last twelve months, no one can claim that he didn't know what kind of business he was getting into.

Update: I edited out a crack I made that, on reflection, was gratuitous. I'll let the rest speak for itself.

By James Kwak

Diana Farrell And The White House Theory Of Bank Size

Simon Johnson | 13 Oct 2009

On Friday morning, Diana Farrell – a senior White House official – made a significant statement on NPR’s Morning Edition, with regard to whether our largest banks are too big and should be broken up.

“Ms. DIANA FARRELL (Deputy Assistant for Economy Policy): We understand Simon Johnson’s views on this, and I guess the response is the following....

“Ms. FARRELL: We have created them [our biggest banks], and we’re sort of past that point, and I think that in some sense, the genie’s out of the bottle and what we need to do is to manage them and to oversee them, as opposed to hark back to a time that we’re unlikely to ever come back to or want to come back to.”
(full transcript)

Ms. Farrell is Larry Summers’s deputy on the National Economic Council and the former director of McKinsey Global Institute, and she has a strong background on banking issues – based on extensive professional experience with global financial institutions.

Her statement contains three remarkable points.

First, “we have created them” is exactly right. Today’s mega-banks were not created by any market process. They are the result of a series of government actions and inactions, particularly over the past 18 months. Banks failed due to their own mismanagement but how those failures were handled – bankruptcy vs. bailout – was a conscious official decision. This administration deliberately chose to be very nice to the biggest banks and to the people who run them.

Second, “we need to... manage them and oversee them”. Here she is presumably referring to the administration’s regulatory reform plan, which does not appear to be going well. Once the massive banks were created, and implicitly backed by the government, it became (already by April or May of this year) very hard to reregulate them. As Joe Nocera pointed out on Saturday, the biggest banks have essentially bitten the Obama administration hand that fed them – most obviously by opposing the new Consumer Financial Protection Agency. It is already abundantly clear that the White House cannot control our big banks. What hope do mere regulators have?

Third, “we’re unlikely to ever ... want to come back to”. Ms. Farrell’s specifics on this point were summarized by the interviewer, Alex Blumberg, “The problem with Johnson’s approach, [the administration] decided, is that bigness also has its benefits. Sure, the economy used to be simpler and financial institutions weren’t so big and dangerous, but GDP was smaller then, too, and people were poorer.”

I’ve reviewed the available work of Ms. Farrell, the McKinsey Global Institute, and other publicly available sources on this issue (e.g., [this book](#), [profile](#), and [article](#)).

I haven’t found even an assertion that our largest banks should get bigger, in absolute size or relative to the economy, let alone any facts or relevant empirical evidence. If I have missed a convincing quantification for “bigness also has its benefits,” please draw that to my attention.

Perhaps there is a reason that today’s nonfinancial companies need a financial sector that is more concentrated and more powerful politically than ever seen in living memory – maybe this emerges from the [Financial Services Roundtable](#) or the government’s more confidential interactions with CEOs. But my conversations with people who run companies or who work closely with nonfinancial executives suggest quite the opposite – they see our current financial system as dangerous, with the likely costs of big banks (e.g., future bailouts) greatly outweighing any benefits.

Here’s the end of the NPR segment, where Alex Blumberg gives a fair summary:

“BLUMBERG: In the end, what we should do about the genie comes down to how you think about it. Farrell’s view and the view of economists like Calomiris from Columbia is that the genie does lots of good things for us and that we can learn to restrain it.

For Johnson, the good things that the genie does are outweighed by the bad things and we should be thinking hard about how to get it back in that bottle before it wreaks havoc once again.”

If Ms. Farrell and the White House (or anyone else) has hard numbers we can put on the benefits of big banks, please make these public. We can then weigh these against the obvious costs of running our financial system in this fashion – on this round alone: fast approaching 40 percent of GDP, i.e., the increase in government debt as a direct result of our

financial fiasco; plus persistently high unemployment; millions of homes lost; likely permanent loss of output, etc.

Philipp Hildebrand, now head of the Swiss National Bank (SNB), expressed a more moderate official position in June, "A size restriction would of course be a major intervention in an institution's corporate strategy... Naturally the SNB is aware that there are advantages to size. [But] in the case of the large international banks, the empirical evidence would seem to suggest that these institutions have long exceeded the size needed to make full use of these advantages."

By Simon Johnson

Calvin Trillin's Theory

James Kwak | 14 Oct 2009

According to Calvin Trillin (or, more accurately, the probably-at-least-semi-fictional interlocutor he meets at a bar in Midtown), the financial crisis was caused by smart people going to work on Wall Street. In the old days, the story goes, it was the lower third of the class that went to Wall Street, and “by the standards that came later, they weren’t really greedy. They just wanted a nice house in Greenwich and maybe a sailboat. A lot of them were from families that had always been on Wall Street, so they were accustomed to nice houses in Greenwich. They didn’t feel the need to leverage the entire business so they could make the sort of money that easily supports the second oceangoing yacht.”

Then, however, as college debts and Wall Street pay grew in tandem, the smart kids started going to Wall Street to make the money, leading to derivatives and securitization, until finally: “When the smart guys started this business of securitizing things that didn’t even exist in the first place, who was running the firms they worked for? Our guys! The lower third of the class! Guys who didn’t have the foggiest notion of what a credit default swap was.”

It’s a cute story. But there may be an element of truth to it. In their well-known paper, “Wages and Human Capital in the U.S. Financial Industry: 1909-2006,” Thomas Philippon and Ariell Reshef measured the relative wage and relative educational levels of workers in the financial sector over the last century. The picture looks like this:

The relative wage I knew about — that’s something we also charted in our Atlantic article. The relative education I did not know about (although there was lots of anecdotal evidence).

Now, Philippon and Reshef calculate relative education using the share of workers with more than a high school education; the left axis is the difference between this share in the financial sector and in nonfinancial industries. So all college students are treated equally — there’s no differentiation by where you went to college or how you did there. But there’s no reason not to think that, as finance became more complicated and required more math aptitude (see Figure 3 in the paper), the level of academic achievement went up as well.

I read somewhere that of the CEOs of the largest banks, only Vikram Pandit at Citi was a true “quant,” and he only came in when Citi bought his hedge fund in 2007, after the bulk of the damage was done. (I’m not

endorsing Pandit's job as CEO, only saying that the mess was there before he arrived.) So there probably was this situation where the executive ranks were filled with old-style relationship-builders and dealmakers, and the increasingly quantitative traders were doing things they didn't understand. A similar story has been told about Salomon under John Gutfreund in the 1980s (and LTCM under John Meriweather in the 1990s).

Technology firms also face a similar problem. In technology, as in most businesses, the way to make it to the top is through sales, so you end up with a situation where the CEO is a sales guy who has no understanding of technology and, for example, thinks that you can cut the development time of a project in half by adding twice as many people. I have seen this have catastrophic results. Even when you don't have the generational issue that Trillin talks about, the problem is that the sociology of corporations leads to a certain kind of CEO, and as corporations become increasingly dependent on complex technology or complex business processes (for example, the kind of data-driven marketing that consumer packaged companies do), you end up with CEOs who don't understand the key aspects of the companies they are managing. And the underlying problem is that, for all the blather that CEOs and boards spit out about succession planning and the importance of people, the fact remains that the market for CEOs is deeply flawed, as shown for example by Rakesh Khurana.

By James Kwak

The Chamber of Commerce Has It Backwards

Simon Johnson | 15 Oct 2009

The US Chamber of Commerce is opposing the administration's proposed Consumer Financial Protection Agency, on the grounds that it would hurt small business. Their argument is that this agency will extend the dead hand of government into every small business.

For the Chamber of Commerce, government is the enemy of small business and should always and everywhere be fought to a standstill. Chamber Senior Vice President (and former Fred Thompson campaign manager) Tom Collamore sees this as “advocacy on behalf of small businesses, job creators, and entrepreneurs” (quoted in the WSJ link above), and the Chamber has launched the “American Free Enterprise” campaign.

Somewhere, the Chamber's senior leadership missed the plot. What brought on the greatest financial crisis since the 1930s? What has hurt, directly and indirectly, small business of all kinds to an unprecedented degree over the past 12 months? What is killing small and medium-sized banks at a rate not seen in nearly 80 years?

It's the behavior of the financial sector, particularly big banks and their close allies – by consistently mistreating consumers. And the letter and spirit of the regulatory regime let them get away with it.

Some members of Congress honestly believe that consumers should have a free choice, unfettered by any kind of restriction, regarding the financial products they buy.

But spend time talking to any marketing professional or call them to testify before your committee – or just ask Mr. Collamore, who was previously at Altria. The state of knowledge regarding how to persuade people to buy stuff is impressive, the degree of potential manipulation for consumer preferences is simply stunning, and the “innovations” in this area are not slowing down.

The scope for taking advantage of consumers in subtle ways, or outright duping them, is probably higher for finance than for any other sector. For fairly obvious reasons, people are more likely to misunderstand credit than, say, furniture. Ambitious executives have therefore hammered hard on borrowers. And the implications – as you have seen and are still seeing – of systemic financial misbehavior are awful in terms of human impact and essentially without limit in terms of ultimate macroeconomic downside.

Unscrupulous Finance has brought us down and will do it again. Those most damaged now and in the future include small and medium-sized business owners who are trying to treat customers fairly.

The Chamber of Commerce is fighting the last war (or the one before that). Their small business membership should wake up to the current reality and press the Chamber hard to change its position before it is too late.

President Obama needs to go over the heads of the Chamber's leadership, reaching out to and running ads directly targeted at its small business membership. The White House has to tackle this head on, framing the issue clearly for people with the help of very clear TV and radio ads. The Chamber of Commerce is arguing that unfettered finance is good for small business. They are wrong.

By Simon Johnson

Move Along

James Kwak | 16 Oct 2009

Yves Smith has a very good post on how hard much of the mainstream media has fallen for the “everything is OK, go on with your lives” theme. She cites the Pew Research Center to show that media coverage of the financial crisis and recession has focused primarily on political battles – stimulus, bailouts, etc. – rather than on problems in the real economy. What’s more, economic coverage in general has fallen off since the stock market rebound earlier this year and the Obama administration’s “all clear” signal. She also discusses psychological research that shows that people can be easily influenced to believe things that are not true, simply because people around them seem to believe those things.

Smith traces this phenomenon to two main sources: the steady evolution of journalism into a traditional profit-oriented business than can no longer afford to invest heavily in investigative journalism; and the increased ability of political leaders, following the lead of private corporations, to control the message that is transmitted via the media. The Bush administration was allegedly the master of the latter, although the fact that they were so obvious about it sort of undermines that claim. (Although probably their attitude was that they didn’t care if the “New York liberal elite” saw how they were manipulating press coverage.) But the Obama administration is no slouch either.

I had my first experience with modern PR during the Internet boom, when I was in marketing at Ariba. (Remember us? Market value of \$40 billion at a time when our *revenues* were less than \$100 million per quarter.) We would be planning an acquisition, and I would meet with these nice people from our PR firm who understood nothing about our technology, or our products, or our markets, or the company we were buying. And they would decide that our top-level messages needed to be X, Y, and Z, which were so devoid of content that they couldn’t even be accused of being false. And that’s what we would use in our press release and our analyst call, and a few hours later we would see it echoed in the news stories and the analyst comments.

Now, if you’re a company of only middling interest (even when we were the hottest thing in Silicon Valley, we were not one of America’s major companies), this is easy. You don’t have the *New York Times* or *Wall Street Journal* trying to bust you, and, it’s true, most of the people covering you tend to be nice — in part because they don’t want to lose

their access, but probably more because, at the time, they wanted to be a part of our success. Calling a spade a spade would not only have been impolite, but it would have exposed the lie that all these Internet-era financial journalists and research analysts were living just as much as we were.

However, it should be a little harder for the government. But the fear of alienating sources no doubt plays a big role. And then there is the fact that the financial crisis and the recession are just *complicated*. On some levels they are simple, but on others — like the relationship between banking profits and bank lending (there isn't necessarily one), they are complicated. In a situation like that, the person with the biggest megaphone has an advantage — *if* he can tell a simple, plausibly believable story. And the administration and the Fed have hit on one: "We were on the brink of the abyss, so we had to do a lot of unpleasant things to pull us back. But now things are back to normal in the financial system, and we're just dealing with an ordinary recession, so things will be tough for a while, but we'll pull through."

Smith and I probably agree on the major problems with this story: it enables the government to avoid tackling the flaws in our financial and political systems that caused the crisis in the first place, and so, in a real sense, nothing has changed; it also minimizes an extremely severe recession and implies that there is little more to be done at this point to help the millions of people who are hurting from it. But that's the message the government is putting out, and there's not a lot that a few people who are crazy enough to spend their free time writing blogs can do about it.

I should add that there are good people doing good work in the mainstream media. Off the top of my head (apologies to people I leave out), there were the articles David Cho wrote about the aftermath of the crisis and, in particular, the concentration of the banking system; Joe Nocera still has his outrage; and there is Bloomberg's lawsuit trying to force the Federal Reserve to comply with Mark Pittman's FOIA request. But this is wonk stuff for crisis and policy junkies, not top-of-the-evening-news material. Out on Main Street, people may be out of work, unhappy, and confused, but there's no political momentum for change, at least not on the real issues that affect their economic well-being.

By James Kwak

“If they’re too big to fail, they’re too big” – Greenspan

James Kwak | 16 Oct 2009

Bloomberg story.

“If they’re too big to fail, they’re too big,” Greenspan said today.
“In 1911 we broke up Standard Oil — so what happened? The individual parts became more valuable than the whole. Maybe that’s what we need to do.”

My jaw is still on my desk.

By James Kwak

Who is Carlos Slim?

Simon Johnson | 17 Oct 2009

The US increasingly displays characteristics that we have seen many times in middle-income “emerging markets” – new dimensions of vast inequality, forms of financial instability that benefit the best connected, and consistently easy credit for the privileged. But this raises the question: who exactly is going to dominate our economic and political landscape moving forward?

In most emerging markets, a major crisis means that some powerful people and their firms fall from grace. After the Asian Financial Crisis (1997-98), some of the biggest Korean chaebol disappeared or broke up, numerous Thai bankers lost their top positions, and there was a discreet reshuffle among the Malaysian business elite. Russian oligarchs rise and fall with the price of oil; the process in Ukraine is similar, although somewhat murkier.

With every sharp turn of the cycle, new people rise to the front – taking advantage of low asset prices and the fact that most people struggle to borrow on reasonable terms. In Mexico, after the crisis of 1994-95, Carlos Slim consolidated his position in telecoms and used this as a launching pad to become one of the world’s richest people.

Three sets of players look positioned to do the same in the US today, mostly based on the amazing set of “carry trades” available if you have access to large amounts of cheap short-term funding (e.g., along the yield curve, from dollars into other currencies, and – arguably – into equity in some parts of the world).

First, obviously nothing can stop Goldman Sachs and JP Morgan. With unfettered access to the Federal Reserve and no effective controls on their ability to take risk, they are in the catbird seat. The weakness of other big banks is further icing on their cake. GS and JPM are symbols will loom large over the national and international economy for a long time to come, with the main threat (to them) coming from their rather too blatant market share in many products.

Second, the surviving big hedge funds will do very well (partial list). They can move fast, they have no regard for anything other than profit, and they will not be effectively regulated. Their access to credit runs through the biggest banks and this can be a double-edged sword – expect more instability in the future from hedge fund-bank dynamics (as Morgan Stanley found out last fall).

Third, foreign players with sovereign backing are also going to clean up. Their credit access comes not from the Fed (although our low rates help their funding costs), but from the fact that they control or are controlled by creditworthy government elites. These foreigners will be relatively diverse (European and Asian, with perhaps some others in the mix) and they have learned to be discreet within the United States. But a great deal of the speculative business to be had is cross-border, with a funding leg in the US and a high-risk asset piece in emerging markets; they are in great position to do this.

Top people in the Obama administration now begin to understand what they have wrought. The body language becomes uncomfortable when you bring up this topic and they are eager to discuss alternative ways forward.

But we are entering a new, more global era of state capture, and the US government (or, more precisely, its credit) was handed over – rather meekly – during the past 12 months.

Many states have been taken over by bankers; there is no shame in fighting and losing against what Jefferson called the “monied aristocracy.” But few governments, even the weakest, have handed over the keys as quietly as we did. As Lloyd Blankfein said, to an aide, on their way to the greatest sales job in the history of the republic, “You’re getting out of a Mercedes to go to the New York Federal Reserve. You’re not getting out of a Higgins boat on Omaha beach.”

The winners among our financial elite are very far from the Greatest Generation, but they are the Best Paid Generation for a reason.

By Simon Johnson

Cognitive Dissonance and Global Macroeconomics

James Kwak | 19 Oct 2009

One of our readers not only suggested this post, but even sent me all the links; I'm just now getting around to writing it up. Thanks.

There has been a lot of talk about global imbalances, with most opinions varying from somewhat important (us) to very important (many global policymakers). Here's Jean-Claude Trichet, for example, president of the European Central Bank, as reported by Reuters:

"The G20 has to address the issues of the domestic large imbalances between savings and investments, and of the set of unsustainable external imbalances.

"We know that these imbalances have been at the roots of the present difficulties. If we don't correct them, we'll have the recipe for the next major crisis. And this of course would be totally unacceptable."

People agree what the biggest imbalance is: it's over-consumption in the United States and over-saving in China, thanks to an artificially low renminbi/yuan, which creates an artificially high dollar.

Yet in the same statement, "Trichet said U.S. policy makers' commitment to a strong dollar was important in keeping currency markets and the global economy stable, repeating a long-held position." Separately, French finance minister Christine Lagarde said, "Everyone needs a strong dollar." Tim Geithner, like every senior government official for decades, has been repeating that we have a "strong dollar policy," whatever that means.

But if no one wants the dollar to depreciate — which is the standard solution to a trade imbalance — what does it mean to be against global imbalances? No one will come out in favor of tariffs. Using fiscal policy to encourage domestic sourcing of goods and services did not go over well with the Europeans. I guess that leaves exhorting Americans to buy less and save more, which is a little like asking Goldman to pay smaller bonuses.

So the EU complains about our huge trade deficits and overconsumption, yet at the same time (along with China) seems to desperately want us to continue to play that role. This is a convenient position, since it allows them to blame us for the financial crisis, while

continuing to export to us. (Germany, the largest economy in Europe, is surprisingly export-dependent, compared to the U.S. and the U.K.) Unfortunately, it's also logically inconsistent.

By James Kwak (with a major assist)

Where Else Are You Going to Go?

James Kwak | 19 Oct 2009

Yves Smith returned from book-writing land to catch up on the Andrew Hall story, which is one that I pretty much decided to ignore from the beginning. Hall is the Citigroup trader who, according to his compensation agreement, was due a \$100 million bonus. The bonus was so big because Hall and his team were due 30% of the profits from their trades, which is even more than typical hedge fund fees. (This tradition of particular trading groups negotiating a share of their profits dates back at least to Salomon in its heyday; AIG Financial Products also had this type of deal.)

But Smith focused on one element that got me thinking. Hall's division, Phibro, was bought by Occidental Petroleum. "Oxy paid \$250 million, the current value of Phibro's trading positions. There was NO premium, zero, zip, nada, for the earning potential of the business. Zero. *Oxy bought the business for its liquidation value.*" Smith infers that no one was willing to pay more because the success of Phibro depended on its being part of Citigroup and benefiting from Citi's low cost of funding; in other words, the massive profitability of Phibro was in part due to an accounting error — not charging it an appropriate cost of capital given the risk it was taking.

This made me think of something else, though. The typical excuse for paying traders enormous amounts of money is that if you don't, they will leave for somewhere else. During the boom, it was certainly true that they would have left. (Whether anyone would have missed them is another question — it seems to me that some of the reasons to be skeptical of mutual fund managers apply equally to proprietary traders.) But after the crisis, the options for someone hoping to leave a major investment bank must have declined.

I've written so many times that reduced competition has helped the survivors increase market share and margins, but I never realized the other consequence: it gives them more bargaining power relative to their employees. There are fewer banks to go to; some of them (Citi, Bank of America) are in no shape to be paying top dollar; and while some hedge funds are doing just fine, their cost of funds must have gone up relative to the big banks in the current environment. With less competition for talent, compensation should go down, at least a little.

So why is Goldman reportedly on track to pay record or near-record bonuses this year? I imagine they would say something about how, in order to maximize long-run firm value, they shouldn't take this opportunity to screw their employees. But if I were a shareholder, I would think a small amount of employee-screwing would be in order. This is a company that claims to live and die by the free market, after all.

By James Kwak

Hey, Where's My Free Advance Copy of Superfreakonomics?

James Kwak | 19 Oct 2009

Just kidding. I don't have time to read it anyway (nor am I all that interested).

In case you've missed it, there has been an enormous controversy (by blogosphere standards) over a chapter in Superfreakonomics (to be released tomorrow, I think) on climate change, carbon reduction, and geo-engineering. Brad DeLong has the most coverage (I believe this was his first post; read backwards from there), including links to some people who are supportive of the book. The summary is that a number of people have accused Levitt and Dubner of saying silly things about climate change (bad), accepting an "expert's" opinion without doing due diligence (more bad), and possibly distorting the opinion of another expert (very bad), with the assumed goal of being contrarian and controversial. Levitt and Dubner disagree. Paul Krugman has some interesting thoughts on the dynamics involved.

This did, however, make me think a little about the difference between blogs and books. [Note: After finishing this post -- which is over 1,300 words -- I realized it is not as interesting as I thought it would be. So feel free to go do something else fun.]

On the Internet, it is fairly common for people to cite sources without investigating them thoroughly. How do I know this? Well, several times I have clicked through people's footnotes and found that the sources they cited did not in fact say what they were purported to say. For example, I was writing a post about health care and the curious fact that Republicans have converted themselves into defenders of Medicare. I found an article claiming that John Boehner had, while George W. Bush was president, endorsed exactly the types of Medicare spending reductions that are in the bills in Congress. Aha! I thought. But when I clicked through to the source, it was an anodyne press release praising Bush's *entire proposed budget*, of which the Medicare spending reductions were one of no doubt thousands of line items. I actually thought for half a second about just citing the article, because that would be convenient, but then I realized that of course I can't do that. It's sloppy not to check the source; it's dishonest to check the source and then pretend you didn't.

And so I've been bothered by a four-part takedown of Megan McArdle that Thomas Levenson wrote. (Here's [part four](#), via [DeLong](#).) Here's the part that bothers me:

"Here's the deal: in science journalism — in any attempt to write about technical material for the public — it's not enough simply to read an abstract or even the whole piece and call it done.

"You can't just read the paper and assume —unless you are genuinely expert in that subdiscipline of the field you wish to cover, and often not even then — that you know what its authors' actually have done and what it means. [...]

"So what you do if you are a properly trained and ethical science journalist/popular writer is read first, of course, with care and attention to all the places you either or both don't understand and/or get the sense of an important subtlety...and then you call.

"You talk to someone, lots of someones if necessary.

"You get people in the field to explain what they are doing; you allow yourself to appear dumb to yourself; [...] you ask simple questions, and then more complicated ones, until you and your interlocutor agree you've got what you need.

"You have to persist — and if someone says check out this or that, you do, looking up the papers if necessary and then calling back...and so on. You do what a good reporter does: you cover the story."

Why does it bother me? Because I do what Levenson accuses McArdle of — I cite papers having read through them (and sometimes I even skim certain bits), without talking to the author, and certainly without talking to other people in the field (although I may read their papers). (Levenson, by the way, is a professor of science writing at MIT.) I think I'm more careful than the average blogger, although two of my habitual critics are sure to disagree. If I don't know what a word means, I look it up; if someone's explanation doesn't make logical sense to me, I go over it until it does (or I don't use it). I check people's sources (if I can do it online — I don't put off blog posts so I can go to the library) before I repeat their facts. But I do write about things I'm not an expert in, and I click Publish before becoming an expert.

For the most part, I think this just comes with the territory. I tend to have a utilitarian moral sensibility, and I believe I am doing more good

than harm here, even if I make a mistake here or there. The Internet does have the nice property of exposing people's mistakes pretty quickly, often in the comment stream. But there is the problem that Megan McArdle has a much bigger audience than Thomas Levenson, and, like an urban myth in a mass email, error can spread much faster than truth can catch up with it. And I have the nagging sense that I have set my standards where they are convenient for me, not where they are best for the world. (But as I said, I'm no Kantian.)

Anyway, to get back to our subject, it seems to me that Levitt and Dubner's critics are accusing them of bad blogging — but doing it in a book. When someone writes a blog post (or a newspaper op-ed) that is obviously a piece of advocacy where the author has mined the facts to find whatever supports his or her argument, a few people blast it in what has come to be known as a "takedown," and then everyone moves on. If it's in a book, though, then things get more serious.

I can think of four reasons for this.

- First, a book is disproportionate to its reviews. All Internet posts are formally equal, even if some people have bigger audiences than others; but no one is going to write a book debating Superfreakonomics, and if someone did, it wouldn't sell as many copies.
- Second, a book is meant to be read by many people who do not follow debates on the Internet. With a book, the authors are reaching beyond the presumably skeptical and sophisticated audience of the blogs, out to the "general audience" where it can potentially do more damage.
- Third, books last in ways that Internet posts don't. (At least they are assumed to.) There is an assumption that they are serious, well-researched, and fact-checked, while there is an opposite assumption that blog posts are none of those. Books are more likely to be cited in Congressional testimony than their meticulous takedowns on the Internet.
- Fourth, authors might stir up controversy in a book in order to generate sales.

In other words, it's because The Book has a special place in our cultural environment. What's ironic, however, is that few people read books anymore. Although Superfreakonomics will no doubt do well, people in publishing have told me that 50,000 copies sold will pretty much guarantee you a spot on the nonfiction bestseller list. By contrast,

our Financial Crisis for Beginners page has gotten almost 200,000 pageviews, and a quick post on health insurance rescission that I banged out in a few minutes got over 80,000 pageviews on one day, thanks to the Huffington Post. (And our Atlantic article got over a million pageviews by mid-summer.)

So ... I don't really have a conclusion here. I think it's good that people care about whether Levitt and Dubner cited their sources accurately. But I also think that this applies equally (or almost equally) to writing of the online type. And I worry that there really is no good mechanism to enforce accuracy on the Internet. Even among print newspapers, I've noticed that op-ed articles are not fact-checked, and some print magazines don't fact-check either. Blogs, of course, have never been fact-checked. Counting on writers' internal sense of duty isn't going to work. And the marketplace of ideas is better at valuing heat than light. Ultimately the Superfreakonomics controversy is a sign of a much, much bigger problem, and one for which I have no solution.

Update: Mark Thoma wonders along the same lines. Also, I highly recommend StatsGuy's comment below (it's the first one).

By James Kwak

Fox, Henhouse?

James Kwak | 19 Oct 2009

One of our readers emailed in a link to this [Bloomberg story](#) about the new “chief operating officer” of the enforcement division of the SEC: Adam Storch, “a 29-year-old from Goldman Sachs Group Inc.’s business intelligence unit” who “had worked since 2004 in a unit at that reviewed contracts and transactions for signs of fraud.”

I went back and forth about posting this because, as far as I can tell, it’s not that important a job; according to the [WSJ](#), “Mr. Storch will oversee division operations that include budget, information technology and administrative services. He will also supervise the workflow associated with the collection and distribution of fair funds to harmed investors.” It’s back-office administration, not deciding whom the SEC is going to pursue. I don’t think this is in the same league as, say, Goldman’s chief lobbyist becoming the Treasury secretary’s chief of staff. (Note, however, that [Zero Hedge](#) says it is “arguably the most critical post at the SEC.”)

But still, even if it is a routine back-office job, why someone from Goldman who makes Neel Kashkari look like an elder statesman? As our reader pointed out, there are some relevant themes here. One is the revolving door. Another is cognitive capture: why does the SEC think it needs a Goldmanite to handle its budget, IT, and administrative services? There are other good companies out there, really, somewhere, or we have a much bigger problem on its hands.

Maybe he’s independently wealthy and immune to job offers from Wall Street. Maybe he’s a genius and aced his job interview. You’d think there must be something special about him that convinced the SEC to give him the job despite all the additional “Government Sachs” fodder it creates. I hope he does a wonderful job.

By James Kwak

Why Is The Chamber Of Commerce Defending Big Banks?

Simon Johnson | 20 Oct 2009

On Warren Olney's radio show *To The Point* yesterday, I had a chance to talk with US Chamber of Commerce management directly regarding the issue posed here last week: Why would an organization representing 3 million small businesses come out in support of our largest banks? My question was picked up and focused by the host.

Warren Olney (at the 36:35 mark): "Mr. Hirschmann, back to you. Are you serving the interests of your own members, if you resist the idea of breaking up the big banks?"

David Hirschmann (leading the Chamber's financial lobbying efforts): "I just don't think the question is whether we need to break up the big banks. The question is how do we ensure that the kinds of practices that they engaged in — and others outside the banking system — don't happen any more. Which is why we pointed to transparency in areas like derivatives and leverage." [my transcription]

Mr. Hirschmann then goes on to talk about the consumer protection agency (he's opposed).

The conflict between the Chamber's principles and its actions becomes increasingly clear.

Hirschmann made some good statements, along the lines of: no one should have permanent access to the taxpayer's pocket, and any firm — no matter how large — should go out of business if its managers make the wrong decisions. This is exactly what the representative of small business should say.

But, despite being given repeated opportunity to say something at least generally along the lines of Alan Greenspan last week (e.g., "too big to fail is too big to exist"), Hirschmann retreated into platitudes about the need to modernize our entire regulatory system.

At the same time, he emphasized that the Chamber is adamantly opposed to the main piece of this modernization — as proposed by the administration — which is a new agency to protect consumers vis-à-vis financial products.

He didn't dispute that the actions of our largest financial players have seriously hurt small business people — through bringing about a

massive financial crisis and deep recession – but the Chamber apparently favors just reshuffling regulatory responsibilities and more “transparency” on all sides.

There is a long tradition in the United States of big business trampling on independent entrepreneurs, and of those entrepreneurs fighting back through the ballot box. This time around, big banks captured their regulators, badly damaged small firms, and look set to do it again.

Why is the Chamber of Commerce refusing to stand up for small business?

By Simon Johnson

Revisiting the Crime Scene

James Kwak | 21 Oct 2009

Mike Konczal has a post featuring the Grayson/Clay/Miller amendment to the current Consumer Financial Protection Agency proposal. The basic idea is that the agency would be required to do a periodic, statistical analysis to identify those financial products that were most implicated in causing bankruptcies and foreclosures in each state. The CFPA would then have to announce what these products are and who sold them, and could then take corrective action to restrict those products.

This reminds me of something that Andrew Lo said in his Congressional testimony back in November, of which I've discussed other aspects in the past. Lo recommended creating a Capital Markets Safety Board modeled on the National Transportation Safety Board:

“[T]he financial industry can take a lesson from other technology-based professions. In the medical, chemical engineering, and semiconductor industries, for example, failures are routinely documented, catalogued, analyzed, internalized, and used to develop new and improved processes and controls. Each failure is viewed as a valuable lesson, to be studied and reviewed until all the wisdom has been gleaned from it, which is understandable given the typical cost of each lesson.

“One successful model for conducting such reviews is the National Transportation Safety Board (NTSB), an independent government agency whose primary mission is to investigate accidents, provide careful and conclusive forensic analysis, and make recommendations for avoiding such accidents in the future. In the event of an airplane crash, the NTSB assembles a team of engineers and flight-safety experts who are immediately dispatched to the crash site to conduct a thorough investigation, including interviewing witnesses, poring over historical flight logs and maintenance records, and sifting through the wreckage to recover the flight recorder or ‘black box’ and, if necessary, reassembling the aircraft from its parts so as to determine the ultimate cause of the crash. Once its work is completed, the NTSB publishes a report summarizing the team’s investigation, concluding with specific recommendations for avoiding future occurrences of this type of accident. The report is entered into a

searchable database that is available to the general public (see <http://www.nts.gov/nts/query.asp>) and this has been one of the major factors underlying the remarkable safety record of commercial air travel.”

Lo was talking more about financial crises than about individual bankruptcies, but the analogy still holds. If a regulator notices that a lot of people are dying in a particular kind of accident in a particular kind of car, it will investigate to find out what is going on.

Now, the statistics could actually be a bit tricky. It’s entirely possible that the most toxic products on the market will *not* be the ones that are involved in the most bankruptcies and foreclosures. Most bankruptcies are (I believe) caused by illness, job loss, or divorce, which strike people independently of whatever mortgage they happen to have. If we just count up the mortgages of people who go bankrupt, we might find that more had 30-year fixed mortgages than had option ARMs, simply because more people in general have 30-year fixed mortgages than option ARMs. But for now I will make a bold assertion that these statistical problems could be addressed — it doesn’t seem like the world’s most complicated model to estimate.

The Grayson/Clay/Miller amendment attempts to sidestep the banking industry’s main contention, which is that the CFPA will have a “chilling” effect on financial innovation. It also plays a kind of “sweeper” position (“free safety” is the American football metaphor) in that it can catch products that do not on their face seem all that bad, but turn out to be homewreckers later. The common-sense argument for it is that no one could reasonably oppose a provision that simply asks the CFPA to investigate existing problems and clean up after them. Still, the industry will no doubt come up with arguments against it. That, at least, is what Felix Salmon assumes, reading the overall trends.

By James Kwak

The Consensus On Big Banks Begins To Move

Simon Johnson | 21 Oct 2009

Just when our biggest banks thought they were out of the woods and into the money, the official consensus in their favor begins to crack. The Obama administration's publicly stated view – from the highest level in the White House - remains that the banks cannot or should not be broken up. Their argument is that the big banks can be regulated into permanently low risk behavior.

In contrast, in an interview reported in the NYT this morning, Paul Volcker argues that attempts to regulate these banks will fail:

“The only viable solution, in the Volcker view, is to break up the giants. JPMorgan Chase would have to give up the trading operations acquired from Bear Stearns. Bank of America and Merrill Lynch would go back to being separate companies. Goldman Sachs could no longer be a bank holding company.”

Volcker may not have the ear of the President (as the NYT points out), and Alan Greenspan – also arguing for bank breakup, but along different lines – might also be ignored. But watch Mervyn King closely.

Mervyn King is governor of the Bank of England and a hugely influential figure in central banking circles. Time and again he has proved to be not only ahead of his peers in terms of thinking about the latest problems, but also the person who is best able to frame an issue and articulate potential solutions so as to draw support from other officials around the world.

Mervyn King also does not mince words. In a major speech last night, he said, “Never in the field of financial endeavour has so much money been owed by so few to so many. And, one might add, so far with little real reform.” (full speech)

He hits hard (implicitly) at the White House's central idea on large banks: “The belief that appropriate regulation can ensure that speculative activities do not result in failures is a delusion”. And he lines up very much with Paul Volcker's views – breaking up big banks is necessary, doable, and actually essential.

Remember and repeat this Mervyn King line: “Anyone who proposed giving government guarantees to retail depositors and other creditors, and then suggested that such funding could be used to finance highly

risky and speculative activities, would be thought rather unworldly. But that is where we now are.”

The big banks will push back, of course. But Mervyn King’s words mark the beginning of a new stage of real reform; the consensus starts to crack.

By Simon Johnson

The Problem at Moody's

James Kwak | 21 Oct 2009

Kevin Hall of McClatchy has an article about Moody's that goes beyond the usual — giving AAA ratings to products “structured by cows” and taking money from the cows (actually, the “cows” comment was from S&P). He documents how Moody's forced out executives who questioned the lax rating policies, replaced them with executives from the structured finance division, and filled its compliance division with people from that same division.

In this week's column at The Hearing, we discuss this as an example of a common tension within businesses — between the revenue-generating side of the business and the people responsible for product quality. The problem is that in the short term, you can maximize revenues by cutting corners on quality, but in the long term, cutting those corners can come back to hurt you. Or it can hurt your customers. Or the whole economy, as it turns out. Unfortunately, however, there is no particular reason to believe that companies will resolve this tension in a way that is good for them in the long term, let alone the economy.

By James Kwak

Big Banks Fail

Simon Johnson | 22 Oct 2009

In the Wall Street Journal on Tuesday morning, Charles Calomiris, a leading banking expert, published an op ed entitled “In the World of Banks, Bigger can be Better.” It begins,

“Legitimate concern about the risks to taxpayers and the economy posed by banks that are “too-big-to-fail” has prompted some observers, among them Simon Johnson, former chief economist of the International Monetary Fund, to favor draconian limits on financial institution size. This is misguided. There are sizable gains from retaining large, complex, global financial institutions—and other ways to credibly protect taxpayers from the cost of government bailouts.”

And the article goes on to make the detailed case for keeping intact our largest banks – in contrast to the recently expressed views of two former Federal Reserve chairs (Paul Volcker, Alan Greenspan) and – late Tuesday – the current governor of the Bank of England (Mervyn King), who are calling for these banks to be broken up in some fashion.

Professor Calomiris, to his credit, emphasizes (in his second paragraph) that we cannot currently deal with the failure of large cross-border financial institutions and this huge hole in our regulatory structures has helped and will help large banks to press for bailouts. But he also insists “the challenge of coordinating the efforts [when a bank fails] among different countries’ regulators can be met through prearranged, loss-sharing arrangements that assign assets to particular subsidiaries based on clear rules. This would make it possible to transfer control over the assets and operations of a large international financial institution in an orderly fashion, in case of its failure.”

Theoretically, he may be right. But how far are we from being able to implement such a process?

The G20 should have taken this on as an essential priority at Pittsburgh, but it did not. The IMF has for years pushed the European Union or at least the eurozone to adopt the kind of framework that Calomiris advocates, but to little avail.

Perhaps this is due to bureaucratic inertia. More likely it is, once again, the blocking power of big banks.

In any case, once this hurdle is overcome, we can talk in more detail about the Calomiris arguments that big firms need big banks (odd,

because big firms can go directly to securities markets), that the latest banking mergers created great value (possible, just not generally what most research finds), and that the rise of banking-as-derivatives-trading over the past 30 years has had big positive effects on the rest of the economy (strange, as there is no supporting evidence in the literature).

Competition between banks is good – on this Calomiris and I agree. We differ with regard to whether allowing large quasi-monopoly banks to dominate the landscape (e.g., Goldman Sachs and JP Morgan Chase today) is helpful to competition in any sense.

We should also throw into the mix three additional considerations.

First, the expected costs of allowing “too big to fail” banks to continue to operate are huge. The Calomiris benefits might be positive, you need to weigh these against what we have just seen: a huge recession (and the risk of worse), a big increase in government debt (perhaps 40% of GDP, when all is said and done), and almost 6 million jobs lost. Calomiris wants to assume these away, with an “immaculate regulation”, but this is simply implausible.

Second, the big banks definitely create some private benefits – mostly for the insiders, in the form of upside (e.g., bonuses) when times are good. The costs are born by society and not just by people who lose their homes – it’s businesses all across America that have lost income, fired people, and are now struggling to stay afloat. This is not only unfair, it is inefficient. Excessive risk taking by big banks generates massive negative externalities. You can either price this appropriately (and good luck with imposing that tax) or break up the banks – down to a size where we know the FDIC can handle bank failures (see the latest failed bank list).

Third, our big banks have demonstrated an unmatched ability to take over regulators and to convince politicians that a dangerous financial structure is good for America. These same people will almost certainly render ineffective whatever new regulations you put in place. More broadly, how can you run a well-functioning political system when a few large banks are so powerful?

The key insight at the heart of breaking up Standard Oil in 1911 was that it was too big to regulate. That breakup may have been good for competition; it was certainly good for democracy.

As Nicolas Trist – secretary to President Andrew Jackson – said about the incredibly powerful privately owned Second Bank of the United States, “Independently of its misdeeds, the mere *power*, — the bare

existence of such a power, — is a thing irreconcilable with the nature and spirit of our institutions.” (Schlesinger, *The Age of Jackson*, p.102)

By Simon Johnson

A slightly edited version previously appeared on the NYT's Economix; it is used here with permission. Please ask the New York Times if you would like to republish the entire post.

Too Complicated to Work

James Kwak | 23 Oct 2009

Yves Smith has a long excerpt from testimony by Robert Johnson before the House Financial Services Committee on regulation of OTC derivatives. (Johnson's testimony is not up at the committee site.) Johnson brings together the issues of too big to fail and derivatives regulation: "Absent a drastic simplification of derivative exposures and a transparent and comprehensive improvement in the monitoring of those positions when imbedded in large firms, complex derivatives render these behemoth institutions Too Difficult to Resolve (TDTR)."

In short, he argues that even if you give regulators the ability to "resolve" a Tier 1 financial institution in the event of a crisis, regulators will be afraid to pull the trigger as long as there is still this complicated web of non-standardized derivatives linking it to the rest of the financial system. In addition, this creates a bizarre incentive: if you think that you can escape being shut down by having an intimidatingly complex derivatives portfolio, then you will go out and create such a portfolio.

I think there is a real risk in financial regulation that it becomes too technical and technocratic. We already know that the people who are into finance, economics, and economic policy are suckers for complicated models — the new flavors are contingent capital and size-based capital requirements. But we have to weigh their theoretical elegance against the chances that they will not work, or will be overridden by other considerations, in a crisis. For example, here's Mervyn King on contingent capital:

"[E]xperience has shown that it is difficult to assess risks of infrequent but high-impact events, and so it is dangerous to allow activities characterised by such risks to contaminate the essential – or utility – services that the banking sector provides to the wider economy. Both of these drawbacks mean that it is almost impossible to calculate how much contingent capital would be appropriate."

In other words, since crises are by definition tail events, there is no good way to estimate the amount of contingent capital that will be needed beforehand, so there is a high risk that financial institutions won't have enough and we'll be left where we are today. Assuming perfect regulation is no different from assuming any other can opener.

By James Kwak

Financial Regulation on the Front Burner?

James Kwak | 23 Oct 2009

Nate Silver thinks that financial regulation will be the big political issue of the first half of next year. And for better or for worse, he thinks the central political issue — the “public option,” if you will — will be TBTF and breaking up banks.

I have been skeptical of this. I have been following the conventional wisdom that public anger has receded into confusion, health care has taken over the stage, and no one can get interested in financial regulation — it’s just too boring. Also, I thought the fact that financial regulation doesn’t break down along party lines hurts its popular appeal. In particular, it leaves liberal Democrats very confused (conservative Republicans have an easier time — oppose anything Obama wants). But I suppose I could see breaking up banks — now that it’s come back from several months in the wilderness — becoming a rallying issue. And health insurance is intrinsically boring, too. In any case, Nate Silver knows politics a lot better than I do.

(Also, according to Silver, we are “Volckerists” and the other side are the “Summersists.” We could do worse.)

By James Kwak

Dan Tarullo Gets New Talking Points

Simon Johnson | 23 Oct 2009

On Wednesday, Dan Tarullo, a governor of the Federal Reserve and distinguished law school professor, dismissed breaking up big banks as “more a provocative idea than a proposal” and instead put almost all his eggs in the “creation by Congress of a special resolution procedure for systemically important financial firms”. He stressed: “We are hopeful that Congress will, in its legislative response to the crisis, include a resolution mechanism and an extension of regulation to all systemically important financial institutions” (full speech).

This put him strikingly at odds with Mervyn King, governor of the Bank of England, who said Tuesday night, quite bluntly,

“There are those who claim that such proposals [involving breaking up the largest banks] are impractical. It is hard to see why. Existing prudential regulation makes distinctions between different types of banking activities when determining capital requirements. What does seem impractical, however, are the current arrangements. Anyone who proposed giving government guarantees to retail depositors and other creditors, and then suggested that such funding could be used to finance highly risky and speculative activities, would be thought rather unworldly. But that is where we now are.”

Tarullo’s speech actually framed today’s problem just right: “I would suggest ... that the reform process cannot be judged a success unless it substantially reduces systemic risk generally and, in particular, the too-big-to-fail problem.” This is consistent with the tone of King’s remarks (even if less pointed than what Neal Barofsky said).

Tarullo also made some astute comments on how “too big to fail” emerged in its current specific form in the US and threatens us in a general form always.

“First, no matter what its general economic policy principles, a government faced with the possibility of a cascading financial crisis that could bring down its national economy tends to err on the side of intervention. Second, once a government has obviously extended the reach of its safety net, moral hazard

problems are compounded, as market actors may expect similarly situated firms to be rescued in the future.”

“The fact that the largest financial firms will account for a significantly larger share of total industry assets after the crisis than they did before can only add to the uneasiness of those worried about the too-big-to-fail phenomenon. It is notable that current law provides very little in the way of structural means to limit systemic risk and the too-big-to-fail problem.”....

“I only urge that we all keep the too-big-to-fail problem front and center as the regulatory reform effort moves forward.”

But the “resolution authority” idea the Obama administration is pushing (and Tarullo endorsed) is a theoretical construct that would have no discernible practical effect. Charles Calomiris hit that particular nail on the head Tuesday in the WSJ – in his second paragraph, he explains that bank failures are hard to handle because “there is no orderly means for transferring control of assets and operations, including the completion of complex transactions with many counterparties *perhaps in scores of countries via thousands of affiliates*” (emphasis added).

The Bank of England will tell you, for example, that their experience with BCCI – a bank that was closed nearly two decades ago – pointed clearly to the need for cross-border agreement between regulators on exactly how to handle bank failure.

But talk to any dozen or so central bank officials, and they will confirm that we do not have and are not close to having such cross-border agreements. And there is no sign that the G20 has this issue in its sights.

Still, the Tarullo-King gap – which loomed so large on Wednesday – finds potential closure in the Fed’s proposed “guidance” (read: orders) on executive compensation, announced Thursday. (WSJ; FT versions).

The proposal is obviously flawed, particularly in the quaint notion that there are only 28 financial institutions that can damage the system through excessive risk-taking (has the Fed really forgotten LTCM?) And the stock market yawned deeply on the announcement – presumably believing that the Fed cannot currently organize a regulatory tightening along any dimensions.

But the proposal is actually quite brilliant and – given the logic of our politics, including Mr. Bernanke’s impending re-confirmation hearing – is likely to have real impact.

For the first time, the appropriate regulators have recognized that excessive risk-taking generates a large negative externality, i.e., a spillover that has pernicious effects on the rest of the economy, and that this can be dealt with in a reasonable manner.

Attacking compensation is not the only way (nor ultimately the likely best way) to address this externality, but it does get everyone thinking along the right lines.

And the bottom line is clear: if your financial institution is big relative to the system, you will be at a systematic disadvantage relative to the smaller firms due to the way pay is regulated; “talent” (or, if you prefer, excessive risk-takers) will move from large firms to small.

My read of the Fed’s current intentions is that they do not intend the differential tax on size to be too great, so dangerously big firms could still survive. But once Capitol Hill understands the opportunity created by these compensation rules, all things are possible – think about the transparency and accountability implications for the Fed and the banks in question.

And remember two things: the midterm elections at the end of next year still lack an obvious and appealing theme, and the big banks are completely unable to cut back voluntarily on their compensation practices, their lobbying, or their egregious public behavior and obnoxious remarks (e.g., the latest AIG example).

The Fed’s press release quotes Dan Tarullo as saying, “In customizing the implementation of our compensation principles to the specific activities and risks of banking organizations, we advance our goal of an effective, efficient regulatory system.”

My translation: Now it gets interesting.

By Simon Johnson

Patchwork Fixes, Conflicting Motives, And Other Things To Avoid: Some Lessons From the Regulated Non-Financial Sectors

Simon Johnson | 24 Oct 2009

This guest post was submitted by Peter Fox-Penner, a leading expert on regulation at The Brattle Group. The views expressed here are those of the author alone.

Improving the regulation of the financial sector is a prime topic of conversation amongst financial economists, and appropriately so. Most agree that massive failures of financial regulation were one, if not perhaps the largest, cause of the 2008 meltdown.

When the conversation turns to the specifics of what needs to be regulated, how regulation should work, and what agencies should be involved, the range of views is tremendous. There is agreement that some kind of prudent regulation is needed, as is investor and consumer protection, but that's about it. Fueled by billions of dollars of lobbying and purchased research, everyone has their own idea. One super-regulator? Council of regulators? Control bankers compensation schemes? Exchange-trade them? The cacophony is deafening.

As an industrial organization economist, I think this discussion would benefit greatly from a consensus on the role and goals of financial regulation. Paul Joskow, a dean in the IO economics community, recently noted that:

“. . .The one thing that we can be sure of is that we have no shortage of regulatory agencies with overlapping responsibilities for investor protection, financial market behavior and performance, and systemic risk mitigation (prudential regulation) that collectively were supposed to work to keep this kind of financial market mess, as well as scams that were allegedly employed by Madoff and others, from occurring. These regulatory agencies have overlapping jurisdiction, opaque goals, arbitrarily limited authorities, and histories that can often be traced back to Great Depression era financial markets and economic conditions. These regulatory institutions have evolved over the last seventy-five years in a haphazard fashion that has not responded effectively to the evolution of financial institutions, products, and market but more as a series of fingers

in the dike to try to keep new leaks from damaging the integrity of the entire dam. Regulatory changes, such as the 1999 repeal of the provision of the Glass-Steagall Act of 1933 that prohibited bank holding companies from other types of financial service companies, the SEC's decision to end the uptick rule for short sales, and decision to allow "sophisticated investor" to fend for themselves, have been idiosyncratic... and increasingly driven more by ideology as financial markets began to change quickly than by the find of comprehensive framework for regulatory reform that has now become widely accepted by microeconomists in other industry contexts." (<http://econ-www.mit.edu/files/3875>)

In short, patchwork fixes don't work. You have to reform all of the institutions and markets that are sufficiently linked to the imperfections and externalities you need to fix. As Joskow notes, it wasn't that there weren't any financial regulatory agencies – "the list of these agencies is as long as my left arm" — it is that there were too many of them, too many cracks between them, and no comprehensive analysis of what kind of processes, tools, and agencies modern financial markets need. [As Exhibit A, see [this list of agencies regulating consumer financial products from USA Today](#)]

I agree with Joskow that a comprehensive assessment is lacking from the financial regulatory debate. There is fairly broad agreement that some kind of regulation is needed for banking and other credit institutions (prudent regulation), regulation of securities and commodity markets, regulation of insurance markets, and [more acrimoniously] regulation of other consumer financial products. I search in vain, however, for serious analyses of whether the same regulator, using the same enabling statutes and the same regulatory instruments, is right for each of these jobs.

It doesn't appear likely. The history of regulation shows that effective regulators should not have conflicting, complex, or multiple missions. An agency should not have conflicting incentives, such as those posited by Raghuram Rajan, between the Federal Reserve's role as inflation fighter and its role promoting bank stability via regulation. Similarly, it seems obvious that the objectives of a bank regulator to promote well-capitalized and solvent banks conflicts directly with the objectives of consumer financial product regulation.

Regulatory agencies also should not have many non-regulatory tasks that interfere with their focus and compete for this leaders' attention. It is hard enough for a public agency to get good at regulating one kind of market or instrument. Stand-alone agencies also have a better chance of getting the resources they need to do a good job, avoiding government budget processes and their attendant limits and delays. This is not an argument for duplication, but rather for separating agencies that might have conflicting objectives.

Another lesson from regulation's history is to keep the mechanics of regulation as simple and as transparent as possible. Yes, regulation always creates incentives for the regulated firm to exploit information asymmetries, and regulators have imperfect incentives as well. But experience suggests that regulatory mechanisms have to be fairly simple to work – often a lot simpler than most economists would prefer.

One essential corollary of keeping it simple is that one has to sacrifice some product variety and customized trading for a more constrained set of regulated products that can be understood, measured, and watched. Effective regulation *always* constrains product choices and trading options. Intended or not, that's what it does. It is one way of making sure nothing falls through the cracks. Nonetheless, today's airwaves are filled with arguments that regulatory reform will stifle financial product innovation and attending benefits.

In addition to limiting product variety within firms, successful regulation often has to limit the complexity of firms' financial organization and size. The history of utility regulation and liberalization suggests that there is a limit to the complexity of the firms that can be regulated effectively by regulators with limited time and resources. I expand on this "too big to regulate" idea in a second post following.

Finally, it is widely accepted that regulatory agencies must strike the right balance between independence and accountability. The agency should not be subject to immediate political pressure from industry or politicians, but through a process of checks and balances, such as staggered regulator terms, bipartisan appointments, post-employment restrictions, and a high requirement for expertise, the probability of capture should be minimized. This is another reason to separate regulatory from non-regulatory organizations. Similarly, stand-alone regulators are more likely to be free of burdensome government budget processes and are more likely to have the freedom to hire and pay for the expertise needed to understand complex, fast-changing markets.

In the 1930s, Congress responded to the financial crisis with three extensive studies, the Pecora Commission, the Federal Trade Commission's seven-year, 101-volume study of utility financial practices, and a similar two-year study by the House Commerce Committee. I sincerely hope that Congress' financial reform commission or some alternate forum fills this need. An earlier Baseline post reports that the initial signs were that the Commission will not delve as deeply as is needed. Since then, the commission has been largely silent in public. I hope this is an indication that the commission is working hard away from prying political and media eyes to do a thorough, objective, and compelling look at the full scope of reforms that are needed.

The rolling discussion of financial regulation in this and many other blogs is a fantastic innovation in academic and policy discourse. Perhaps it is the 21st century version of the Pecora Commission and its multi-year, multi-volume reports. Perhaps, it seems hard to imagine, a political consensus for comprehensive change will emanate from a blogosphere dialog amongst us policy wonks alone.

By Peter Fox-Penner

Are Big Banks Better?

James Kwak | 26 Oct 2009

Last week, Charles Calomiris wrote an op-ed in the Wall Street Journal arguing that big banks are better for various reasons. Simon wrote last week saying that Calomiris underestimated the political dimension, and that his proposed solution — a cross-border resolution mechanism for large institutions — is the policy equivalent of assuming a can opener.

I wanted to look at Calomiris's specific claims. I think I've already dealt with the myth that banks "need to be large to operate on a global scale—and they need to do so because their clients are large and operate globally." Calomiris also argues that there are economies of scope (it's better to be big because you can play in multiple businesses). Here's his evidence:

"True, some empirical studies in the field of finance have failed to find big gains from mergers. But those studies measured gains to banks only, and measured only the performance improvements of recently consolidated institutions against other institutions, many of which had improved their performance due to previous consolidation.

"Yet even unconsolidated banks have improved their performance under the pressure of increased competition following the removal of branching restrictions, which permitted the consolidation wave in banking. And when an entire industry is involved in a protracted consolidation wave, the best indicator of the gains from consolidation is the performance of the industry as a whole. One study of bank productivity growth during the heart of the merger wave (1991-1997), by Kevin Stiroh, an economist at the New York Federal Reserve, found that it rose more than 0.4% per year."

Note that Calomiris concedes that you can't find benefits from mergers by looking at merged banks directly; this is why he falls back on an industry average.

First of all, there must be a joke to be made here about correlation and causality. Wait, here it is.

Second, 1991-97 was only the beginning of the merger wave; The Riegle-Neal Interstate Banking Act wasn't passed until 1994. Let's

assume that mergers after 1995 wouldn't show up in the 1991-97 data. That includes Nations-Boatmen's, Nations-Barnett, Nations-Bank of America, B of A-FleetBoston, Chemical-Chase, Bank One-First Chicago, J.P. Morgan-Chase, Wells-First Interstate, Wells-Norwest, and Wachovia-First Union.

Third, I was interested by that statistic, because 0.4% annual productivity growth from 1991 to 1997 seems like nothing to write home about – labor productivity growth (the figure you usually read about) over that period was about 1.7% per year for the economy as a whole. So I tracked down the source: Kevin J. Stiroh, "How did bank holding companies prosper in the 1990s?," *Journal of Banking & Finance*, Volume 24, Issue 11, November 2000, Pages 1703-1745. (I'm not sure if anyone can download the paper or I could only do it because I'm on the Yale VPN.)

I found out that Stiroh is measuring *total factor productivity*, not labor productivity, so 0.4% is better than average for the non-manufacturing sector. (The economy average was 0.3%, but the manufacturing sector was 1.9%, so by implication the non-manufacturing sector was less than 0.3%.) So far, so good.

But what does Stiroh say *about* this productivity growth? His main explanation for the productivity growth is not consolidation, but information technology: "The finding of steady productivity growth, in particular, is important since it is consistent with the idea that the massive investment in new technology is working to improve the performance of the banking industry." This is not proven in this paper, but Stiroh went on to write a bunch of other papers on the link between information technology and productivity. For example, this paper (on the entire economy, not just banking) concludes:

"IT-producing and IT-using industries account for virtually all of the productivity revival that is attributable to the direct contributions from specific industries, while industries that are relatively isolated from the IT revolution essentially made no contribution to the U.S. productivity revival. Thus, the U.S. productivity revival seems to be fundamentally linked to IT."

That second paper also finds (Table 2) that productivity acceleration — the difference between productivity growth in the 1995-99 period relative to the 1987-95 period — was lower in finance, insurance, and real estate than in the economy as a whole, including the services sector. I

don't know exactly what this means, but at first glance it doesn't look good for banking consolidation.

Going back to the first paper (the one Calomiris cites), what does Stiroh say about bank size? "Despite the strong overall performance, roughly 10% of costs were due to inefficiency and 30-40% of potential profits were missed. Moreover, efficiency does not significantly increase with bank size as one might expect if economies of scale are an important determinant of success. Rather, there are efficient and profitable BHCs in every size class and increased size does not guarantee success." Figures 6 and 7 show that there is no difference in cost efficiency across size classes and that the largest banks actually seem to have lower profit efficiency.

However, Stiroh also says that continuing consolidation seems to offer the possibility of reducing these inefficiencies, so on balance I would say he is slightly positive about size. Stiroh also has a [paper](#) on banks in Switzerland which I didn't read, but whose abstract says:

"We find evidence of economies of scale for small and mid-size banks, but little evidence that significant scale economies remain for the very largest banks. Finally, evidence on scope economies is weak for the largest banks that are involved in a wide variety of activities. These results suggest few obvious benefits from the trend toward larger universal banks."

I wish I had more time to read more of these papers. It seems to me that Stiroh has done a lot of serious empirical research on banking productivity and finds the evidence mixed — consolidation should be good, but it doesn't really show up in the data. I haven't read much of his work (or talked to him) and I certainly don't want to imply that he is against big banks. I just think that citing a study he did of the 1991-97 period to back up a claim that banking mergers are good is a bit of a stretch.

By James Kwak

Bank Switching Costs

James Kwak | 26 Oct 2009

One of the Free Exchange bloggers (some people know who is who by name, but I don't — if anyone wants to enlighten me, I'm listening) admits choosing his bank because it was big, and staying there because it is big. He also links to James Surowiecki, who asks in the "notes" to his latest column,

"[W]hy, given the broader backlash against the big banks and the less-than-inspiring performance they've turned in over the last couple of years, are people still sticking with them? What makes this even more curious is that the big banks, which have historically offered their customers worse deals than smaller banks, have not changed their ways: they pay less for deposits, charge more for loans, make billions from overdraft fees, and have jacked up credit-card rates."

When it comes to retail customers (you and me), Surowiecki highlights switching costs (add your own example) and brand ("It's nearly impossible for consumers to evaluate how healthy a bank is. So, at a time when banks are failing with some regularity, the size and ubiquity of these big banks is reassuring."). Free Exchange thinks the issue is the implicit government guarantee:

"[I]f bigness is associated with security, then real bank competition means convincing customers, along with everyone else, that the government has a plan to unwind its implicit guarantee for banks and that ultimately the country's largest banks will be as subject to failure as everyone else. If that can't be achieved—if real market pressures aren't ever going to apply—then it may be time to start thinking of large banks as natural monopolies, to be treated like regulated utilities."

I'm a little skeptical of the brand/security argument, since most people don't have more than \$250,000 (the FDIC insurance limit) in their bank accounts. But maybe people don't really trust the FDIC, or don't realize how seamless the process is for them, and they would rather trust the Citibank logo.

The switching costs certainly are high, and I can provide some anecdotal details. I'm in the process of switching out of Bank of America. Moving all my bill payments and direct debits from B of A to another bank was pretty easy, although in some cases I had to call someone to get the right form. Moving my safe deposit box was a pain that cost several hours of time. Moving my direct deposits was pretty easy, although again it required paper forms. The trick was the ATM fees, but I found a checking account (PeoplesBank in Holyoke, Massachusetts, with branches in the Springfield-Holyoke-Northampton area) that refunds other banks' ATM fees. (In the interest of fairness, I should also put in a plug for my other local bank, Greenfield Savings, which pays 0.75% on checking accounts.)

It can be done. But a bigger question would be, why? I feel like I need to as a matter of principle, given my well-known positions on this issue. But I don't expect the average person who is frustrated by big, unfriendly, bailed-out banks — even the average reader of this blog — to invest the few or several hours it takes to switch. Most people probably don't have enough money in their deposit accounts for the higher rates you can get at local banks to matter. When it comes to most political issues, I think most people feel individually helpless; when it comes to Too Big To Fail, which, let's face it, is a pretty technocratic issue, I suspect we feel even more helpless.

Update: One reader wrote in to say that Florence Savings Bank (also in Western Massachusetts) also refunds depositors' ATM fees incurred at other banks.

By James Kwak

Tax Credits, Screwdrivers, and Supply and Demand Curves

James Kwak | 27 Oct 2009

Our Washington Post online column today is another cry in the wilderness against the homebuyer tax credit.

There are many arguments against the tax credit. One argument we make is that the tax credit is a benefit for sellers of houses more than for buyers of houses. This is simplest to see if you imagine a permanent credit available for all buyers: “Imagine the credit were expanded to all home buyers and made permanent. This would simply boost housing prices at the low end of the market by close to \$8,000, since all buyers would be willing to pay \$8,000 more. (Prices would rise by a little less than \$8,000 because at higher prices, more people would be willing to sell.)”

It turns out Nemo had made a similar argument already.

Small point: Nemo (in a follow-up post) says that the tax credit should boost prices by *exactly* \$8,000 (leaving aside leverage for now), because in the short term the supply curve is vertical. I’m not convinced. The reason we said “close to \$8,000” is that the supply curve is typically upward-sloping, not vertical, as shown on the graph in that follow-up post. The supply of houses can shift quickly, because people can decide to sell their houses (say, retirees planning to move to apartments in the city can move that decision forward). Also, if the credit is not available to everyone, it won’t shift the demand curve by exactly \$8,000 at every point, because the demand curve for houses is the sum of every individual’s demand for houses, so only some people’s demand will change. This is why expanding the tax credit to everyone is such a bad idea. When you restrict it to first-time homebuyers, they get at least some of the benefit.

Bigger point: Nemo points out that the \$8,000 increases the homebuyer’s ability to make a down payment; since mortgages provide leverage, this means the potential impact on prices is much higher. If you are buying a house with 3.5% down, then arguably an extra \$8,000 in cash (which some states will advance you) can boost your buying power by \$200,000. Now, this is a complicated issue, since unless you can get a no-doc loan, you still need to qualify for the monthly payments. (Nemo discusses this here.) But I think it’s fair to say that at least some buyers are constrained by the down payment more than by the monthly payments, especially with interest rates so low (I saw this in my summer

legal services job). So the potential impact on a household's buying power could be a lot more than \$8,000, as Nemo says.

The net effect is that the buyer pays an inflated price for a house, which will get deflated when the tax credit prop gets taken away. I believe in some places you can effectively use the tax credit as your down payment; this means you will have close to zero equity when the credit goes away, unless housing prices rise.

By James Kwak

More Too Big to Fail

James Kwak | 28 Oct 2009

Simon and Charles Calomiris were quoted on NPR this morning on the topic of the day — too big to fail.

I thought one of Calomiris's examples was interesting. He cited Mexico, where banking was dominated by six families that wouldn't lend to potential competitors. After the Mexican financial crisis and the entry of foreign banks, now it is easier for companies to raise money. It seems to me that story could be used by either side.

By James Kwak

Homebuyer Tax Credit Update

James Kwak | 28 Oct 2009

Calculated Risk says there is a deal (bullet points are from his post):

- Income eligibility for first-time home buyers stays at \$75,000 for individuals, and \$150,000 for couples.
- For move-up buyers, income eligibility is \$125,000 for individuals and \$250,000 for couples.
- There is a minimum 5 year residency requirement – in their current home – for move-up home buyers.
- The tax credit is the lesser of \$7,290 or 10% of the purchase price.
- The credit runs from Dec. 1, 2009 to April 30, 2010, with an additional 60 day period to close escrow. (So end of April to sign contract, end of June to close escrow)
- Expect bill to be signed by Friday, packaged with the unemployment benefit extension.

So my wife and I fit under the \$250,000 couples limit. We've lived in our house for eight years. So now the government is willing to give *me* \$7,000 to buy a new house? That would be a sale that wouldn't have happened otherwise — but what good would it do the economy?

As I tried to explain previously, an \$8,000 credit for first-time homebuyers will raise prices by less than \$8,000 (leaving aside the effect of leverage for simplicity), because demand at any price point only goes up for first-time homebuyers, not all homebuyers. That means that the buyer gets a fair chunk of the subsidy. But vastly expanding eligibility like this (about 67% of households own houses, and probably about half of them have been in the same house for five years) increases the amount by which prices will go up, which lowers the buyer's share of the subsidy and increases the seller's share.

By James Kwak

Paging Jamie Dimon

James Kwak | 28 Oct 2009

Surprise, surprise — GMAC needs more money. As you may recall, GMAC was the one institution that got a C- on the stress tests this spring that were impossible to fail. I imagine the analysts at the Fed really wanted to give it an F, but they couldn't. In any case, it seems that GMAC is too big to fail, because of its importance to the auto industry. Yves Smith says, "The reason for more dough to GMAC is so GM and Chrysler can continue to finance auto purchases, not as a result of greater than expected losses on its existing portfolio. So this is cash for clunkers under another brand name."

Again, not surprisingly, the government is treating the 50% ownership threshold as some sort of magic line. From the *Times* article:

"With all three helpings of federal aid, it is possible that the government could wind up owning at least half of the company. But GMAC and Treasury officials are discussing ways to structure the investment in a way that could limit the government's ownership interests. One possible option would be to also ask some of its private preferred stockholders to convert their investments into common stock."

So I have two ideas. The first is that if we put more money in GMAC, we should divide it in two and let the mortgage lending part fail. If we insist on keeping the whole thing afloat, that means we are subsidizing both the auto lending part (which is supposedly critical to the economy) and the mortgage lending part (which isn't).

The second is that this would be a great time for JPMorgan Chase to get some good PR by stepping in and offering to replace GMAC as the funding source for GM and Chrysler dealers, so the government can abandon GMAC. Or even buying GMAC outright, including assuming all its debt and committing to subsidize the auto business, for \$1 or so. Yes, that would make JPMorgan bigger, which I'm not thrilled about. But from Jamie Dimon's perspective, it would show the potential benefits of having big banks that are willing to act in the national interest now and then, and it would be a little like Goldman declining to haggle over the price of buying back its warrants from Treasury.

Now the idea of *relying* on big banks to serve the national interest obviously sounds like bad policy to me. But if Jamie Dimon wants to take this problem off the taxpayer's hand, I think he would be welcome to it.

By James Kwak

How Big?

James Kwak | 28 Oct 2009

You hear a lot these days that banks need to be big to serve their clients. Charles Calomiris said this morning that we can't run the global economy with "mom-and-pop banks." Sure, I'm willing to concede that. But how that's a silly debating tactic. More seriously, how big do they need to be?

Yves Smith, no friend of the mega-banks, says, "The elephant in the room is derivatives. The big players have massive OTC derivatives exposures. You need a really big balance sheet to provide OTC derivatives cost effectively."

How big?

Here's a starting point. In 1998, Goldman Sachs had \$217 billion of assets. (Lehman had \$154 billion.) In today's dollars (using the GDP price index), that would be about \$270 billion. I think that they were probably doing a perfectly good job of serving their clients at the time. Adjusting for inflation, I don't think their clients are substantially bigger or more global now than they were then. So the question is (multiple choice):

(a) Has the financial world changed so much that Goldman now needs more than \$270 billion to serve clients effectively (and if so, is that change we want)?

(b) Is \$270 billion enough?

I don't claim to know the answer to this one, but if it's (a), I'd like to see some evidence.

By James Kwak

Naming Systemically Dangerous Firms

Simon Johnson | 29 Oct 2009

This guest post was submitted by David Moss, professor at Harvard Business School, author of When All Else Fails: Government As The Ultimate Risk Manager, and founder of the Tobin Project.

As currently drafted, the Financial Stability Improvement Act of 2009 (released by the House Financial Services Committee on 10/27/09) contains several important elements for reducing systemic risk. It aims (1) to identify systemically dangerous financial firms, (2) to apply heightened regulation to these firms, (3) to establish a stabilization system to prevent or quell panic during periods of systemic distress, and (4) to create a resolution mechanism that would wind down complex financial firms when necessary. These could represent very important steps forward.

Unfortunately, these reforms may ultimately be undermined by one very significant weakness – the explicit requirement in the bill that the identification of systemically dangerous financial firms by federal regulators remain entirely secret, and never be revealed to the public. This is the bill's Achilles heel.

The decision that there be “no public list of identified companies,” as the bill currently reads, stems from a belief that secrecy about the identity of these firms will limit moral hazard. However, after more than a year of costly bailouts, the federal government's implicit guarantee of major financial firms is, sadly, rock solid. To try to make it magically disappear by refusing to name the most systemically dangerous firms not only won't work, but will severely jeopardize the effectiveness of the regulation itself.

To maintain the pretense of secrecy, the bill includes some very unfortunate compromises:

- First, the bill does not require the systemic regulator to adopt a consistent (or universal) set of tough standards for all systemically dangerous firms, presumably to avoid compromising the secrecy surrounding these “identified” financial institutions.

- Second, the desire to hide these firms' regulatory status (as systemically dangerous) means that they cannot be assessed fees in advance to cover their share of a resolution or stabilization fund; instead, the bill envisions ex post assessments on a much larger pool of firms,

including a great many that are not systemically dangerous. (This would be like charging renters to cover the fire losses of homeowners.)

● Third, the attempt to ensure secrecy requires that all of the regulators' reports to Congress themselves remain strictly confidential, thus weakening – and perhaps crippling – the essential process of democratic oversight.

Perhaps most disconcerting, all of these compromises will most likely be for naught, since the desired secrecy seems almost impossible to achieve. Virtually everyone already knows the identities of the most systemically dangerous firms; and, beyond that, leaks are inevitable.

Moreover, to the extent that secrecy was somehow maintained, it would leave the systemic regulator highly vulnerable to capture by the very financial institutions it was charged with regulating. Just imagine how weak regulations would become if the regulated firms themselves were the only parties that could weigh in on a proposed regulation, since the regulatory process was required to be hidden from everyone else.

The proposed legislation has many strengths. But without greater transparency, it will inevitably fall short – both in eliminating “too big to fail” financial firms and, most importantly, in preventing the next financial crisis. To be successful, the final legislation must require the creation of a *public* list of all systemically dangerous financial institutions; and it must ensure that these firms are subjected to dramatically heightened regulation to control excessive risk taking. In fact, the regulation of these firms must be so tough that they feel a strong incentive to slim down or break up in order to get off the list. Such a vital public mission will never be achieved in the shadows. (For more on this, see my recent piece on financial regulation in [Harvard Magazine](#).)

By David Moss

Does Ben Bernanke Have The Facts Right On Banking?

Simon Johnson | 29 Oct 2009

Ben Bernanke, chairman of the Federal Reserve, has stayed carefully on the sidelines while a major argument has broken out among and around senior policymaking circles: Should our biggest banks be broken up, or can they be safely re-regulated into permanently good behavior? (See the recent competing answers from WSJ, FT, and the New Republic).

But the issues are too pressing and the stakes are too high for key economic policymakers to remain silent or not have an opinion. On Cape Cod last Friday, Mr. Bernanke appeared to lean towards the banking industry status quo, arguing that regulation would allow us to keep the benefits of large complex financial institutions.

Note, however, that Bernanke's quote making this point in the NPR story (at the 45 second mark) is from his spoken remarks; the prepared speech does not contain any such language. And Mr. Bernanke is wise to be wary of endorsing the benefits of size in the banking sector – the evidence in this regard is shaky at best.

There are three main types of evidence: findings from academic research on the returns to size in banking; current and likely future policy in other countries; and actual practices in the banking industry.

First, while academic research is not always the primary driver of policy choices, it is relevant when we can readily see the costs of big banks (in the crisis around us) but the supporters of those banks claim they bring important benefits. In fact, the available research indicates that in the banking sector, economies of scale exist only up to a (relatively low) level of total assets, while economies of scope are elusive. The benefits from diversification across countries or lines of business are also small; moreover over the last few months we learned that correlations among different markets and asset classes increase rapidly during a crisis – thus reducing even more the benefits of diversification. [See "Consolidation and efficiency in the financial sector: A review of the international evidence," by Dean Amel, Colleen Barnes, Fabio Panetta, Carmelo Salleo; *Journal of Banking & Finance* 28 (2004) 2493–2519. Note that one of the authors works at the Federal Reserve Board, and all four work in a central bank or ministry of finance.]

Second, policy in other countries matters because some fear that breaking up big US banks would somehow put us at a competitive

disadvantage vis-à-vis big European or other banks. But on this issue the European Commission spoke loudly this week – ordering the break-up of ING, and the presumption is that they will also soon put similar pressure on big UK banks.

Interpretations of this action vary – some see it as an implementation of competition policy, while others feel the Commission is (rightly) concerned about the unfair subsidies implicit in government ownership and support for large banks. The Commission itself is being somewhat enigmatic, but the exact official motivation doesn't matter – the important point is that the leading pan-European policy setting organization, which does not rush into decisions, has determined that whatever the benefits of size in banking, the public interest requires smaller banks.

Third, in terms of actual business practice, any big investment banking transaction is done with a syndicate or group of banks – there is sometimes a lead bank with a favored relationship, but that role is definitely shopped around.

Take, for example, General Electric's October 2008 share offering, in which there were seven lead managers. Or look at the prominent Microsoft bond offering, which had Bank of America, Citi, JPM, Morgan Stanley as lead managers and Credit Suisse, UBS, and Wachovia as "joint lead" (in this context, "joint lead" is the junior partner). If a nonfinancial corporate entity takes out a large bank loan, this is also shopped around and syndicated – even for medium sized companies – so as to divide up the risk.

Similarly, if a company wants to do a foreign exchange transaction, it searches for offers and take the best deal. It would be unwise to rely exclusively on one bank – they will naturally hit hard you in terms of higher fees.

One area where banks benefit from size is in terms of being able to put their balance sheet behind a transaction – e.g., to get a merger done they may offer a bridge loan, with the real goal being to get merger fees. Bigger banks with a large balance sheet have an advantage in this regard. However, this kind of risk taking is also what gets banks in trouble (e.g., in the 1997-98 Asian Financial Crisis). In the past, both Morgan Stanley and Goldman Sachs did not have large balance sheets but still did well in mergers and acquisition.

Goldman is an interesting case because it had \$217 billion in assets in 1998 (that's \$270 billion in today's dollars); it now has around \$1 trillion.

Goldman was considered a strong global bank in the late 1990s. Can it really be the case that the idea size for banks has risen so dramatically over the past decade? (Lehman had \$154 billion assets in 1998 and above \$600bn when it failed).

For derivatives (and other instruments) it's important to have deep markets, but not necessarily big banks. If you want to buy and sell stock you want a liquid market, and the same is true for derivatives.

If you are a large oil company, and you want to hedge future risk, your choices are:

1. Hedge with a "too big to fail" bank, because you know taxpayers will bail you out and these banks are subsidized by their government support, so they can give you a better price.

2. Or you can hedge with several banks to minimize counter party risk. They then sell off some of the risk – taking less risk themselves as they are small enough to fail.

If you were hedging you'd prefer the "too big to fail" system because it comes with a nifty subsidy. But this is not what the Federal Reserve should be supporting – Mr. Bernanke may still come out in favor of markets-without-subsidies.

By Peter Boone and Simon Johnson

An edited version of this post appeared previously on the NYT.com's Economix; it is used here with permission. If you would like to reproduce the entire post, please contact the New York Times.

Baseline Scenario, October 30, 2009

Yesterday morning I testified to a Joint Economic Committee of Congress hearing (**update:** that link may be fragile; here's the JEC general page). The session discussed the latest GDP numbers, the impact of the fiscal stimulus earlier this year, and whether we need further fiscal expansion of any kind.

I argued that a global recovery is underway and in the rest of the world will likely be stronger than the current official or private consensus forecast, but growth remains fragile in the United States because of problems in our financial sector. While our situation today is quite different in key regards from that of Japan in the 1990s, the Japanese experience strongly suggests that fiscal stimulus is not an effective substitute for confronting financial sector problems head on (e.g., lack of capital, distorted incentives, skewed power structure).

We are well into the adjustment process needed to bring us back to living within our means. Although such a process always involves an initial fall in real incomes, growth can resume quickly as the real exchange depreciates. The idea that we necessarily are in a “new normal” scenario with lower productivity growth seems far fetched, but continuing failure to deal effectively with the “too big to fail” banking syndrome delays and distorts our adjustment process – it also makes us horribly vulnerable to further collapses.

The fiscal stimulus enacted in early 2009 had a major positive impact, particularly as it was coordinated with other industrial countries – this prevented the global recession from being even deeper (disclosure: I testified to the need for a major fiscal stimulus in October 2008). But a further broad stimulus at this time is not warranted and the first-time homebuyers tax credit should be phased out. We should extend unemployment insurance and focus our future efforts on improving the skills of people with less education, e.g., through strengthening community colleges.

Like all industrialized countries, we also need to look ahead to “fiscal consolidation” in order to stabilize our debt-GDP levels (and pay for the rising cost of Medicare). The large contingent government liabilities implied by the existence – and potential collapse – of big banks are a major risk to medium-term outcomes.

My written testimony (with some small updates indicated) is below (pdf version). This is now our revised Baseline Scenario.

Main Points

1. The world economy is experiencing a modest recovery after near financial collapse this spring. The strength of the recovery varies sharply around the world:

a. In Asia, real GDP growth is returning quickly to pre-crisis levels, and while there may be some permanent GDP loss, the real economy appears to be clearly back on track. For next year consensus forecasts have China growing at 9.1% and India growing at 8.0%; the latest data from China suggest that these forecasts may soon be revised upwards.

b. Latin America is also recovering strongly. Brazil should grow by 4.5% in 2010, roughly matching its pre-crisis trend. We can expect other countries in Latin America to recover quickly also.

c. The global laggards are Europe and the United States. The latest consensus forecasts are for Europe to grow by 1.1% and Japan by 1.0% in 2010, while the United States is expected to grow by 2.4% (and the latest revisions to forecasts continue to be in an upward direction). Unemployment in the US is expected to stay high, around 10%, into 2011. **[Update: the latest quarterly GDP data do not make us want to revise this view]**

2. The current IMF global growth forecast of around 3 percent is probably on the low side, with considerably more upside possible in emerging markets (accounting nearly half of world GDP). The consensus forecasts for the US are also probably somewhat on the low side.

3. As the world recovers, asset markets are also turning buoyant. Recently, residential real estate in elite neighborhoods of Hong Kong has sold at \$8,000 US per square foot. A 2,500 square foot apartment now costs \$20 million. Real estate markets are also showing signs of bubbly behavior in Singapore, China, Brazil, and India.

4. There is increasing discussion of a “carry trade” from cheap funding in the United States towards higher return risky assets in emerging markets. This financial dynamic is likely to underpin continued US dollar weakness.

5. One wild card is the Chinese exchange rate, which remains effectively pegged to the US dollar. As the dollar depreciates, China is becoming more competitive on the trade side and it is also attracting further capital inflows. Despite the fact that the Chinese current account surplus is now down to around 6 percent, China seems likely to accumulate around \$3 trillion in foreign exchange reserves by mid-2010.

6. Commodity markets have also done well. Crude oil prices are now twice their March lows (despite continued spare capacity, according to all estimates), copper is up 129%, and nickel is up 103%. There is no doubt that the return to global growth, at least outside North America and Europe, is already proving to have a profound impact on commodity markets.

7. Core inflation, as measured by the Federal Reserve, is unlikely to reach (or be near to) 2% in the near future. However, headline inflation may rise due to the increase in commodity prices and fall in the value of the dollar; this reduces consumers' purchasing power.

8. This nascent recovery is partly a bounce back from the near total financial collapse which we experienced in the Winter/Spring of 2008-09. The key components of this success are three policies.

- First, global coordinated monetary stimulus, in which the Federal Reserve has shown leadership by keeping interest rates near all time lows. Of central banks in industrialized countries, only Australia has begun to tighten. **[Update: and Norway, obviously affected by rising oil prices]**
- Second, global coordinated fiscal policy, including a budget deficit in the US that is projected to be 10% of GDP or above both this year and next year. In this context, the Recovery Act played an important role both in supported spending in the US economy and in encouraging other countries to loosen fiscal policy (as was affirmed at the G20 summit in London, on April 2nd, 2009).
- Third, after some U-turns, by early 2009 there was largely unconditional support for major financial institutions, particularly as demonstrated by the implementation and interpretation of the bank "stress tests" earlier this year.

9. However, the same policies that have helped the economy avoid a major depression also create serious risks – in the sense of generating even larger financial crises in the future.

10. A great deal has been made of the potential comparison with Japan in the early 1990s, with some people arguing that Japan's experience suggests we should pursue further fiscal stimulus at this time. This reasoning is flawed.

11. We should keep in mind that repeated fiscal stimulus and a decade of easy monetary policy did not lead Japan back to its previous growth rates. Japanese outcomes should caution against unlimited increases in our public debt.

12. Perhaps the best analysis regarding the impact of fiscal policy on recessions was done by the IMF. In their retrospective study of financial crises across countries, they found that nations with “aggressive fiscal stimulus” policies tended to get out of recessions 2 quarters earlier than those without aggressive policies. This is a striking conclusion – should we (or anyone) really increase our deficit further and build up more debt (domestic and foreign) in order to avoid 2 extra quarters of contraction?

13. A further large fiscal stimulus, with a view to generally boosting the economy, is therefore not currently appropriate. However, it makes sense to further extend support for unemployment insurance and for healthcare coverage for those who were laid off – people are unemployed not because they don’t want to work, but because there are far more job applicants than vacancies. Compared with other industrial countries, our social safety net is weak and not well suited to deal with the consequences of a major recession.

14. The first-time home buyer tax credit should be phased out.

15. GMAC should not receive a further infusion of government money. It should be turned down for any kind of additional bailout; as with CIT Group earlier in the summer, this would force a negotiation with creditors and some losses for bondholders (most likely through a pre-packaged bankruptcy process). This would not cause a general financial panic; probably it would actually strengthen the overall process of economic recovery, as it would move incentives in the right direction.

16. The lack of skills among people who did not complete high school or who did not attend college is a critical longer term problem in the United States. The impact of the recession will exacerbate the problems in this regard. We should respond by further strengthening community colleges, allowing them to offer more vocational skills classes and to provide a viable way for more people to work their way into four-year colleges.

17. America is well-placed to maintain its global political and economic leadership, despite the rise of Asia. But this will only be possible if our policy stance towards the financial sector is substantially revised: the largest banks need to be broken up, “excess risk taking” that is large relative to the system should be taxed explicitly, and measures implemented to reduce the degree of nontransparent interconnectedness between financial institutions of all kinds.

The remainder of this testimony reviews current U.S. macroeconomic issues in broad terms, assesses the lessons of Japan’s experience in the

1990s, and make proposals for further essential reform (both fiscal and financial).

Current U.S. Issues

To be a strong global leader in the future, America needs to generate an environment where entrepreneurship, technological innovation, and immigration ensure that the nonfinancial private sector can continue to propel the US economy.

It is premature to argue that the US economy has stumbled into a “new normal” paradigm that involves slower growth. The factors that drove our growth over the last 150 years, particularly entrepreneurial startups and the commercialization of invention, remain despite the crisis. Indeed, these drivers of growth may become even stronger in the future, if we can reduce the wasteful financial sector activities that grew since the 1980s (and really flourished over the past decade) and allocate resources to more productive activities in the future.

America needs a new framework to harness that growth. That framework needs to address the following problems with our current economic structure.

Problem 1: With the recent financial sector bailouts, we have sent a simple message to Americans: The safest place to put your savings is in a bank, even if that bank is so poorly managed, and has such large balance sheet risks, that just six months ago it almost went bankrupt.

Despite being near to bankruptcy six months ago, Bank of America credit default swaps now cost only 103 basis points per year to protect against default, and the equivalent rate for Goldman Sachs is a mere 89 basis points. Goldman Sachs is able to borrow for five years at just 170 basis points above treasuries. This is not a sign of health; rather it indicates the sizable misallocation of capital promoted by current policies. American’s leading nonfinancial innovators would never be able to build the leverage (debt-asset ratio) on their balance sheet that Goldman Sachs has, and then borrow at less than 2% above US treasuries. The implicit government guarantee is seriously distorting incentives.

Problem 2: We have not changed the incentive structures for managers and traders within our largest banks. Arguably these incentives are more distorted than they were before the crisis. So the problems of excessive risk taking and a new financial collapse will eventually return. Financial system incentives are a first-order macroeconomic issue, as we have learned over the past 12 months.

Today bank management is strongly incentivized to take large risks in order to raise profits, increase bank capital, and pay large bonuses to “compete for talent”. Since they have access to a pool of funds effectively guaranteed by the state through being “too big to fail”, there is the potential to make large profits by employing funds in risky trades with high upside. Such activities do not need to be socially valuable, i.e. it could be that the expected return on the investments is negative, but as the downside has limited liability, the banks can go ahead.

Problem 3: We have not changed the financial regulatory framework in a substantive way so as to limit excessive risk taking. The proposals currently proceeding through Congress are unlikely to make a significant difference.

Problem 4: The policy response to this crisis, with very low interest rates and a large fiscal stimulus, is merely a larger version of the response to previous similar crises. While this was essential to stop a near financial collapse, it reinforces the message that the system is here to stay.

Problem 5: The public costs of this bailout are much larger than we are accounting for, and people who did not cause this crisis are ultimately paying for it. Taxpayers and savers are the big losers each time we have these crises. We are failing to defend the public purse.

Our financial leaders have emphasized that our banks are well capitalized, and no new public funds are likely to be needed to support them. This is misleading. The current monetary stance is designed to ensure that deposit rates are low, and the spread between deposit rates and loan rates is high. This is a massive transfer of public funds to the private sector, and no one accounts for that properly.

It is striking that the Chairman of the Federal Reserve himself, in a recent speech, stated that no more public funds were needed to bail out banks. His institution continues to provide massive transfers to the banking system through loose credit and low interest rate policy. That credit could instead go to others; the Federal Reserve has chosen to transfer those funds to banks. This policy was used in the past to recapitalize banks (e.g., after 1982), but we have now a very different financial sector – with much more capacity to take high risks and a greater tendency to divert profits into large cash bonuses.

Today, depositors in banks earn little more than the Federal Funds rate and are effectively financing our financial system. We are giving them very low returns on their savings because the losses in the financial

system were so large in the past. This is essentially public money – it is the pensioners, elderly people with savings, and other people who have no involvement in the financial system, that are being required to suffer low returns to support the banks.

We Are Not Japan

After the bursting of its real estate bubble, at the end of the 1980s, Japan faced a serious problem in its financial sector. This fact has inspired many people to look for parallels with the current US situation, and – in some cases – to draw the implication that we should pursue further large-scale fiscal stimulus today.

There is a cautionary tale to be learned from the Japanese experience – on the need to promote, rather than to prevent, appropriate macroeconomic adjustment. But this does not encourage a further expansion in the budget deficit at this time.

The property bubble and general credit bubble in Japan were actually much larger than what we recently experienced in the U.S. The implied price of the land in the Emperor's Palace, in central Tokyo, was worth more than all of California (or Canada) at its peak. Land prices collapsed and never recovered. US house and land prices never got so far out of line with the earning capacity of homeowners.

The Japanese stock market rose to price-earnings ratio of around 80 (depending on the exact measure), also as a direct result of the credit bubble. The US did not experience anything similar in the last few years.

Japan was – and largely remains – a bank-based finance system. And their nonfinancial corporate sector was generally much more indebted (often using borrowed money to buy land, but also over-expanding their manufacturing capacity) than was the case in the US. Total Japanese corporate debt was 200 percent of GDP in 1992 – more than double its value in 1984. The implication was a long period of disinvestment and saving by the corporate sector – in fact, this change from the 1980s to 1990s explains most of Japan's increased current account surplus after the crisis. Since Japanese corporates had accumulated too much capital, they exhibited low returns in the post-crisis period. The US has strong bond and equity markets, and our corporate sector is not heavily indebted – so the cash flow of the nonfinancial sector should bounce back strongly.

In contrast to Japan, the US consumer has much more debt and saves less – in fact, on average over the past decade, the our household sector has saved roughly nothing (partly due to the effects of rising wealth,

from higher house prices). This sector will be weak in the US. In contrast, in Japan during the 1990s there was no significant increase in household saving (and thus no contribution from this sector to their current account surplus.)

The obvious solution for any country in the situation faced by the US is to let the economy adjust, which implies and requires that the real exchange rate depreciates – so our exports go up, our imports (and consumption) go down. This is a level adjustment downward in our GDP and standard of living, but then growth will resume on this new basis.

In contrast, Japan did not grow largely due to their over-investment cycle (in real estate, but also plant and equipment). This created a much more difficult adjustment process, which worked for manufacturing primarily through depreciation of installed capacity and a gradual movement of production off-shore (e.g., to China and other Asian countries).

In addition, another major cause of Japan's poor performance was its demographics, and the relatively lackluster growth of its trading partners in Asia due to the Asian crisis. With its working population peaking in 1995, Japan lost a major driver of growth. The country still has strong enterprises and decent productivity growth in the manufacturing sector, which allows them to grow. But the pace is naturally slower than when they were "catching up" through the 1980s. During the last ten years Japan's has grown around the same pace as some of the continental European nations with better but also poor demographics, such as Italy and Germany (the comparison is from Q1 1998 to Q1 2008).

The Japanese policy reaction was to run budget deficits and maintain very loose monetary policy for over a decade, in an attempt to stimulate the economy and obviate the need for painful adjustment (including job losses, recognizing losses at major banks, and properly recapitalizing those banks). Today Japanese gross debt to GDP is at 217%, and it is still rising (net debt, even on the most favorable definition, is over 110% of GDP). The working population of Japan is now declining quickly, and so those people that are required to pay back the debt face ever rising burdens. There is a real risk that Japan could end up in a major default, or need a large inflation, to erode the burden of this debt since their current path is clearly unsustainable.

Japan's policy approach from the 1990s – repeated fiscal stimulus and very easy money – is not an appealing model for the U.S. today. All dynamic economies have a natural adjustment process – this involves allowing failing industries to decline, and letting new businesses develop where there are new opportunities.

In fact, while Japan hesitated for over a decade to let this process work (particularly protecting the insiders at their major banks), it has finally moved in this direction. Unit labor costs in Japan have declined sharply over the last ten years, helping making the country a more competitive exporter. The forced recapitalization of some major banks, at the end of the 1990s, was also a move in the right direction.

The process of deflation – spoken of with terror by some leading central banks around the world today – actually makes industry more competitive, and while there are negative aspects to it (particularly if the household sector is heavily indebted, as in the US), the modest price declines seen in Japan are not a disaster. In fact, real GDP per worker in Japan – annualized over the past 20 years – has increased by 1.3 percent per annum; while the comparable number in the US is 1.6 percent. Over the past 10 years, real GDP per worker (annualized) increased by 1.3 percent in both Japan and the US – and now it turns out that much of the GDP gains in the US financial sector may have been illusory.

The Japan-US comparison is not generally compelling, particularly as Japan ran a current account surplus even during its destabilizing capital inflows of the 1980s. The current US experience more closely matches the experience in some emerging markets, which have in the past run current account deficits, financed by capital inflows – with the illusion that this was sustainable indefinitely.

The long and hard experience of the International Monetary Fund (IMF) with such countries that have “lived beyond their means” – or over-expanded in any fashion – is that it is a mistake to try to prevent this process of competitive adjustment, i.e., bringing spending back into line with income, which implies a smaller current account deficit or even a surplus. The adjustment can be cushioned by fiscal policy – and here the IMF has changed its line over the past few years, now offering sensible support for this approach. But attempting to postpone adjustment with repeated fiscal stimulus is almost always a mistake.

Japan did not want to force its corporate sector to adjust (i.e., in the sense of going bankrupt and renegotiate its debts), so it offered repeated stimulus. As a result, it has become stuck with a “permanent” fiscal

deficit program which is now threatening their survival as a global economic power, and will – regardless of the exact outcome – burden future generations for decades.

Some analysts further claim that Japan's early withdrawal of stimulus is a major factor explaining why they have not returned to robust growth rates. It is true that Japan introduced a new VAT tax in April 1997 not long before the Asian Financial Crisis began, and the Bank of Japan raised interest rates by 25 basis points in August 2000. Subsequent to these changes the economy slowed down.

However, each of these measures were relatively small. The Bank of Japan reversed course on interest rates quickly, and a negative turn in the economy was surely already in the cards – this occurred at the same time as the global economy slowed down, and a great stretch to argue that a 25 basis point move could explain the poor performance of Japan's economy for years or decades subsequent.

As long as there are not major adverse shocks from the rest of the world, the US will experience higher savings, a fall in consumption, a recovery in investment, and an improvement in its net exports (so the current account deficit will become smaller, or stay at its current level even as the economy recovers). Growth will resume, driven by demographics, technical progress, and entrepreneurship. The high level of unemployment also implies that rapid growth will be fuelled by willing workers, subject to the right skills being available.

Proposals For Change

The main threats to the recovery scenario come from the financial system, which has developed serious and macro-level pathologies over the past two decades.

We have weak bank regulation and supervision. Politically we can't let banks fail: they bend or lobby to change the rules in order to grow big, and then we bail them out.

New theories of deflation and zero interest rate floors attempt to explain why we need unprecedented large bailouts – with the experience of Japan and the Great Depression of the 1930s offered as partial justification. More likely, we are on an unsustainable fiscal path with the potential for new financial bubbles.

The following changes should be priorities.

1. Reduce the impact of financial sector lobbying on bank regulation and supervision. Today the US Treasury is filled with former finance

sector workers in key positions responsible for financial sector reform and bailouts. This is too large a conflict of interest. We need to close the revolving door between government and the financial sector.

2. Put far greater regulation and closer supervision on the large remaining banks that are clearly too big to fail. These should be broken up into much smaller pieces, so we have a more competitive system.

- When major financial institutions request additional help from the government, such as GMAC, they should be turned down. This would force their bondholders to take a loss and lead to better incentives for the future. It is highly unlikely that it would cause a major financial panic. The financial system is experiencing a sharp bounce back more broadly and GMAC can likely arrange a pre-packaged bankruptcy that would actually allow its debt to rise in value.
- Banks can syndicate if they need to do large transactions. This is actually what they do for most capital raising transactions.
- Banks should draw up “living wills” and raise additional capital as they become larger relative to the system.

3. We should also toughen our monetary policy to send a clear message that we will not maintain a pro-cyclical monetary policy which bails out banks at the end of each crisis. The cross-liabilities on banks’ balance sheets should be reduced as far as possible to lower the risks involved with letting one fail. By doing this, we would free the hands of those running our monetary policy to take tougher actions to stop the next bubble.

4. We need to address the inequality driven by our bailouts as a gesture to show that we will defend the public purse beyond the simple accounting in the budget.

- Increasingly, there is discussion of taxing “excess risk taking” (reflected in high profits and bonuses) in the financial sector, particularly if that is large relative to the system. The terms in this debate have not yet been clearly defined and this initiative could go in the wrong direction. But we should recognize that mismanagement at major banks has created huge negative externalities both for the financial system and for the economy as a whole. Taxing activities that generate such externalities is entirely appropriate in other sectors, and the same reasoning is likely to be applied for banking also.

- In addition, we should also require that Goldman Sachs, GMAC, and other non-banks (i.e., those operating without deposit insurance) with access to the Federal Reserve's window pay a substantial long term annual fee to compensate taxpayers for that access. This is a valuable insurance policy which they have – at this point – been given for free.

5. We should withdraw the fiscal stimulus over 5 years and aim for fiscal consolidation, including Medicare costs, at that time. We should use extra spending to target specific issues that will help people improve their skills, but wind down the temporary public works programs that build jobs in the public sector.

6. All industrialized countries need to make a substantial fiscal adjustment over the medium-run, in order to stabilize public debt levels. The size of this adjustment depends on assumptions (and policies) regarding longer-run medical costs as the population ages and medical technology becomes more expensive. The US and almost all other members of the OECD most likely require a fiscal adjustment in the range of 4-8 percentage points of GDP. In that context, further unfunded or nontransparent contingent public liabilities vis-à-vis the financial sector are untenable; the Japanese experience should be taken as a warning sign in this regard.

7. For the longer-run, we should focus on measures that improve skills for people with fewer years of formal education. Supporting the expansion of community colleges and other practical skills training is the best way forward, although this will take some time to scale up.

By Simon Johnson, Peter Boone, and James Kwak



www.feedbooks.com
Food for the mind