



The Baseline Scenario 2009-11

Updated: 5-4
Update this newspaper

November 2009

Paper of the Year

James Kwak | 02 Nov 2009

As bankers' pay, at least for the fortunate ones at Goldman and JPMorgan, returns to pre-crisis heights, a paper by Thomas Philippon and Ariell Reshef is becoming everyone's favorite citation. The paper, "Wages and Human Capital in the U.S. Financial Industry: 1909-2006," got a first wave of attention from Paul Krugman, Martin Wolf, and Gillian Tett back in April (see Philippon's web page for links). It's also the subject of Justin Fox's column in *Time*; see Fox's blog for links to other discussions. (I also cited the paper in my ramblings provoked by Calvin Trillin.) The earlier references were mainly for Philippon and Reshef's finding that pay in the financial sector correlated strongly and negatively with the degree of regulation — pay was higher in both the 1920 and in the post-1980 period, and lower under the stricter regulatory system created during the Great Depression. More recent references, including Fox's column, have focused on the idea that people in finance are overpaid.

Since most articles have just focused on the headlines, I'm sure Philippon and Reshef are going to be misquoted all over the Internet. For example, at least two articles focus on a figure of "30% to 50% of financial-sector pay" in ways that are not quite correct. So I'll try to lay out what they actually say.

Section 1 (see Figures 1-3) lays out the facts. Jobs in the financial sector were more complicated and more mathematical, required more education, and were more highly paid both before 1930 and after 1980.

Section 2 asks why this happened. They regress relative education (the share of highly-educated people in the financial sector relative to the rest of the economy) and relative wage (the ratio of wages in the financial sector to wages in the rest of the economy) against several explanatory variables:

- the degree of information technology use in the financial sector
- the amount of financial innovation (represented by the number of patents)

- the amount and complexity of corporate finance activity (represented by the share of IPO activity and the amount of credit risk)
- the amount of deregulation (interstate banking, Glass-Steagall, etc.)

Not all regressions use all explanatory variables, but the results (Tables 3 and 4) are consistent: deregulation is the only explanatory variable with a strong significant effect on both relative education and relative wages. In Table 3, for example, “deregulation alone accounts for 90% of changes in education and 83% of changes in wages.” Patents and IT intensity affect relative education but not relative wages; indicators of corporate finance activity affect wages but not education.

Now, none of this so far implies that people in finance are not worth their higher salaries. Deregulation could have created an environment in which the productivity differential between higher- and lower-skilled people became higher in finance than in other industries, making them more valuable in finance than elsewhere. Section 3 analyzes this issue. Figure 7 shows that, since the mid-1980s, the earnings of people in finance have shot up relative to the earnings of engineers (outside finance), even with the same level of education.

Figures 10 and 11 are based on the concept of a “benchmark” wage for finance. This is the wage that you would expect people in finance to get based solely on their relative education level (which we know went up after 1980), the skill premium (the amount that more highly-skilled people earn throughout the economy, which has also gone up since 1980), and the relative risk of unemployment (if you are more likely to be fired, you should be paid more to compensate). Figure 10 shows that given all this, you would have expected finance salaries to go up about 20% relative to the rest of the economy since 1980, but in fact they have gone up about 65%. The excess wage (Figure 11) — the difference between the amount people in finance make and the amount you would expect them to make — reached about 0.4 this decade; that means that if the average American is making \$100, you might expect people in finance to make \$125 (based on education, skill premium, and unemployment risk), but instead they are making \$165.

The last set of regressions attempts to determine whether the excess wage in finance is due to characteristics of individuals in finance that are not observable in the previous regression. They do this by looking at the Census Bureau’s Current Population Survey, which is an individual-

level sample. They determine that over the entire sample period (1967-2005), even after controlling for individual characteristics, working in finance is worth a 4.4% wage premium (Table 5; 8.3% for people with post-graduate education). Looking at specific time periods (Table 6), the wage premium only appears in 1986; from 1986 through 2005 it averages 6.0%. Comparing these wage premiums to the excess wage for the industry as a whole, they conclude that 30-50% of the excess wage is *not* due to differences in ability, but represents pure rents.

Note that the wage premiums calculated here cannot be compared to the excess wage in Figure 11, because Figure 11 is estimated using industry-level data, and the estimates in Tables 5-6 use the CPS, which suffers from top-coding (incomes are reported in categories, and there are no categories for the super-rich). My interpretation is that Figure 11 is the best way to see the size of the excess wage, since it doesn't suffer from top-coding; Tables 5-6 are primarily useful for showing what proportion (30-50%, according to Philippon and Reshef) of that excess wage cannot be explained by differences between individuals.

So note in particular that the 30-50% number in the paper does not refer to the wage premium of people in finance; it is the proportion of the wage premium that cannot be otherwise explained. The excess wage itself depends on how you measure it. In Figure 11 (difference between finance wages and what finance wages would be expected to be based on education, skill premium, and unemployment risk) it gets up to 40%, but only in the last few years.

In any case, it's clear that people in finance make more than people not in finance, and that you can't explain it away just by saying they are more educated or their jobs are more risky. Now in one sense the defenders of high Wall Street pay are correct: people are probably getting roughly what they could make if they walked across the street and went to another bank. But that doesn't answer the question of whether the whole industry is making a mistake and transferring wealth to employees that should go to shareholders.

By James Kwak

CEO Statements That Should Make You Worry

James Kwak | 02 Nov 2009

“Our distinctiveness is we connect the world better than anyone else. We have a great capability of building a business around that. And we are in the process of building a culture around that.”

That’s Vikram Pandit on his company, Citigroup, as reported in The New York Times. What does it mean? Your guess is as good as mine.

What does it mean to “connect the world?” Sure, Citi is in a lot of places. But it is largely a *retail bank* — you know, the kind that you go to on the corner to take money out of your ATM. Most of its customers don’t move around the world very much. How do you “build a business” around connecting the world? This isn’t Cisco we’re talking about. And how do you “build a culture” around connecting to the world? To build a culture, you need to put together a group of people who understand the world, approach problems, and treat each other in a similar way. A new slogan won’t do it.

CEOs do have to speak in vague platitudes occasionally, but note that this was in an interview with reporters who were writing a feature article about the challenges facing Citigroup.

What Citigroup needs is a strategy. I can’t believe I’m saying this; after working at McKinsey, I thought that “strategy” was by far the most overused word in business. But what I mean is it needs some kind of story about what its customers need and what it can do well (better than its competitors), and that story has to somehow relate to what it is today. Think Lou Gerstner in the 1990s focusing IBM on services, or Larry Ellison deciding he would just buy all of his competitors and be done with it. If you’re making money, people will overlook the fact that your company doesn’t make any sense; if you’re struggling, like Citi is, they won’t.

Without such a story, it’s just a tangled mess of bad acquisitions that have no reason to be together. Now, the usual course of action in situations like this is to try to come up with a story that somehow justifies all the various bits and pieces, which gives you a story that is so weak as to be meaningless. The better answer is to come up with a story first, and then reshape the company to support that story. But that’s hard work.

Instead, a year after the crisis that would have put it out of business without extraordinary government assistance, instead of a strategy, all

Citi has is a pro forma financial statement: the arbitrary division between “Citicorp” and “Citi Holdings.” As other people observed at the time of the split, there was no sound logic for how the company was split up. For example, North American retail banking and credit cards are on one side, but mortgages, auto loans, and student loans are on the other. So their plan is to run a retail bank that doesn’t lend money to households? Oh right — they’ll take the deposits and invest them in CDOs.

By James Kwak

Note to Congress: You Are Not the People You Serve

James Kwak | 02 Nov 2009

From a [Washington Post article](#) on proposed legislation to regulate overdraft fees:

“Rep. Spencer Bachus (R-Ala.) said he avoided overdraft fees with a credit line and asked if many of the problems could be eased with consumer education.”

Good on you, Spencer. You have a credit line — which many of your constituents can’t get — and you have it linked to your checking account — which many of your constituents wouldn’t even know how to ask for.

Nessa Feddis of the ever-helpful American Bankers Association added that “most consumers can easily avoid the fees by keeping track of their balances.” (That’s a quote from the Post article describing her testimony, not from her testimony itself.) Hear that everyone? Keep track of your balances, and just in case, get a credit line and link it to your checking account. Problem solved.

The people who are financially sophisticated already know how to track their balances and turn off overdraft protection if they don’t want it. They are not the people that financial regulation is supposed to serve. You can’t discharge your duty as a representative of the people just by wishing that the people were more like you.

By James Kwak

Britain To Break Up Biggest Banks

Simon Johnson | 02 Nov 2009

The WSJ reports ([on-line](#)): “The U.K.’s top treasury official Sunday said the government is starting a process to rebuild the country’s banking system, likely pressing major divestments from institutions and trying to attract new retail banks to the market.” The British style is typically understated and policymakers always like to play down radical departures, but this is huge news.

Pressure from the EU has apparently had major impact – worries about unfair competition through subsidizing “too big to fail” banks are very real within the European market place. Also, strong voices from within the Bank of England have helped to move the consensus.

The US position on protecting everything about our largest banks is starting to look increasingly isolated and out of step with best practice in other industrialized countries. Time to start planning for the break-up of Citigroup.

By Simon Johnson

Do Smart, Hard-Working People Deserve to Make More Money?

James Kwak | 02 Nov 2009

Last weekend Yves Smith posted a story of a family that was down on their luck and struggling with high credit card bills, including plenty of fees. Yesterday she posted a follow-up. Apparently the story triggered a wave of vindictive snobbery from commenters. Here's one example:

"Sounds like someone doesn't know how to manage their money. I would bet they are making car payments and eat fast food at least 3 times a week. Probably have cable T.V. and deluxe cell phone plans. They probably get a new car like every two years. What happened to her reenlistment bonuses?"

Here is Yves's response:

"I think quite a few readers owe her an apology. But I am also sure those readers are so locked into their Calvinist mindset that they will find some basis for criticizing this family. Some people seem constitutionally unable to admit that success and prosperity are not the result of hard work alone."

First, I want to agree completely. There is the obvious fact that a person's income as an adult is highly correlated with his or her parents' income. (There was a recent debate about why in the blogosphere, but as far as I know no one contesting that this was the case.) But beyond that, we all owe a tremendous amount of whatever fortune we have to luck, pure and simple. Where would Bill Gates be if IBM hadn't decided to outsource development of the operating system for the first IBM PC? Rich, no doubt, but \$50 billion rich? I have worked hard at enough things, and failed at enough things, and succeeded at few enough things, to know how much luck is involved.

Second, I want to go beyond that to another point that seems obvious to me, but that some will probably find controversial. Even if differences in outcomes were entirely due to differences in abilities and effort (which they're not) — would that make it OK? I think most people would say that it's fine for smart people to make more money than other people. But why? Why are smart people any more deserving than anyone else? It's true that in many jobs being smart can make you more productive

and valuable, and as a result for many high-paying jobs being at least somewhat smart is a prerequisite. But the fact that a capitalist economy functions this way doesn't make it morally right that the "winners of the genetic lottery" (a phrase I picked up from some basketball announcer talking about Tony Parker) have better outcomes than the losers.

Surely at least people who work hard deserve to do well. In the hierarchy of American moral virtues, hard work must be right at the top. But I'm not convinced of that, either. The ability to work hard is something that you either inherit from your parents or that you develop in your early childhood as a function of the environment around you. Either way, whether or not you have it is as much a matter of luck as is your IQ. Again, it's obvious that working hard increases your productivity and therefore the wages you will be paid, all other things being equal. A small part of that differential seems "deserved," since you are forgoing leisure for work. But the differential goes far beyond that. For example, doctors don't just make more money than other people to compensate them for studying hard in school and working 36-hour shifts in residency; studying hard and 36-hour shifts are hurdles to clear in order to become a doctor and make a lot of money (if you're a specialist, that is — some people do go through all the work and then make comparatively little).

Take me, for example. I'm smart and hard-working. I don't know if it's because of my genes, or because my parents brought me up right. But whatever the cause, I didn't *do* anything to become smart or hard-working. And that's the reason why I was able to go to good schools, get a good first job, and make more money than the average person, at least for a few years there (before quitting to go to law school). When I was young and frankly immature, being smart gave me a sense of entitlement. Now I just feel sort of lucky ("sort of" because I've learned that there are many more important traits than intelligence).

I'm willing to acknowledge that morality simply isn't a factor when it comes to compensation. Seen from a utilitarian perspective, whether hard-working people deserve more than other people is a distraction. The key issue is that to maximize output in a more or less free market system, it has to be that way, since labor is supposed to be paid its marginal product. But there are still two implications of realizing that everything — even your initial endowments — is a matter of chance, not something you deserve.

The first is that you shouldn't look down on other people (1) because their parents weren't as rich as yours, or (2) because they aren't as smart as you, or even (3) because they don't work as hard as you. I think most people agree with (1); I think you should agree with (2) and (3), too.

The second is that the moral argument should be on the side of redistribution. I am willing to listen to utilitarian arguments against redistribution (e.g., high marginal tax rates reduce the incentive to work, blah blah blah blah blah); I may not agree with them, but they are a plausible position. However, I have little patience for the idea that rich people deserve what they have because they worked for it. It's just a question of how far back you are willing to acknowledge that chance enters the equation. If you are willing to acknowledge that chance determines who you are to begin with, then it becomes obvious (to me at least) that public policy cannot simply seek to level the playing field, because that will just endorse a system that produces good outcomes for the lucky (the smart and hard-working) and bad outcomes for the unlucky. Instead, fairness dictates that policy should attempt to improve outcomes for the unlucky, even if that requires hurting outcomes for the lucky. But given that society is controlled by the lucky, I'm not holding my breath.

Update: I want to respond to a comment below by Markel. He accuses me of slipping meritocracy in through the back door with the assumption that income is correlated with intelligence and work effort. I think he's right. The point I wanted to make is that *even if* income is correlated with intelligence and work effort, that isn't necessarily a good thing. I think he's saying that the premise itself may be wrong, and I agree it's not something we should assume without support. I wanted to assume it in the rhetorical sense, as in "even if we assume ..." I shouldn't have implied that it is a matter of fact.

By James Kwak

Ackermann vs. Hoenig: Take It To The WTO

Simon Johnson | 03 Nov 2009

Josef Ackermann, chief executive of Deutsche Bank and chairman of the Institute of International Finance (an influential group, reflecting the interests of global finance in Washington) is opposed to breaking up big banks. According to the FT, he said,

“The idea that we could run modern, sophisticated, prosperous economies with a population of mid-sized savings banks is totally misguided.”

This is clever rhetoric – aiming to portray proponents of reform as populists with no notion of how a modern economy operates. But the problem is that some leading voices for breaking up banks come from people who are far from being populists, such as the UK authorities (in the news today) and the US’s Thomas Hoenig.

Hoenig is an experienced regulator, who has dealt with many bank failures. He is also currently President of the Kansas City Fed and an articulate voice regarding how banks became so big, why that leads to macroeconomic problems, and how consumers get trampled (answer: credit cards, issued by big banks; p.6). He supports a resolution authority that would help deal with some situations, but also says (p.9):

“To those who say that some firms are too big to fail, I wholeheartedly agree that some are too big. However, these firms can be unwound in a manner that does not cause irreparable harm to our economy and financial system but actually strengthens it for the long run.”

Mr. Hoenig is, if anything, a little too polite. There is no evidence that huge banks, at their current scale, provide any social benefit. When these same banks were much smaller, in dollar terms and as a percent of the economy, the global economy functioned no worse than today.

Mr. Ackermann and his colleagues are pursuing a purely self-serving line. Reasonable centrist opinion is turning against them. Either the big banks need to shrink voluntarily or they will potentially face consequences that they cannot control.

Building on ideas from the Kansas City Fed, the Bank of England, the UK Financial Services Authority, and the European Commission, the

consensus is moving towards the view that state-supported banking (i.e., operating through implicit guarantees on Too Big To Fail banks) constitutes an unfair form of protectionism. Financial services in this guise do not currently fall within the remit of the World Trade Organization, but it would be a simple matter to extend its mandate in this direction.

In any reasonable judicial-type process, involving relatively transparent weighing of the evidence, Mr. Ackermann would be most unlikely to prevail.

By Simon Johnson

Peter Fox-Penner Replies

Simon Johnson | 03 Nov 2009

On October 24, we published [a guest post](#), “Patchwork Fixes, Conflicting Motives, And Other Things To Avoid: Some Lessons From the Regulated Non-Financial Sectors,” by [Peter Fox-Penner](#). Below is his response to some of your more than 200 comments.

As a stuck-in-the-last-century guy, I’m remiss in not replying to the many comments to [my guest post](#). As an I-O (industrial organization) economist, I learned a lot more than I contributed reading the many colloquies. Here are just a few general observations stimulated by the discussion:

To start off, there seems to be agreement on the difficulty of measuring risk, either because there is no transparency and/or the instruments are so darn complex. Incidentally, the best short piece I’ve ever read on the emerging science of systemic risk measurement is [Andrew Lo’s Senate testimony](#); perhaps all of you have other good pieces. The one thing I learned from Andrew’s piece is that we are a long way from knowing how to do it.

Many folks agreed that if you can’t measure – it you can’t regulate it. Bond Girl and others worry that regulation will stifle innovation. In my view, there is no question about it. There is no free lunch. Regulation reduces the variance in outcomes in a market – that’s its job. Innovation increases them and even disrupts the distribution. When disruptive events have large economic fallout, or violate our norms for justice, the cost of diminishing these risks via regulation outweighs the costs of reduced innovation.

More practically, however, this is not a question of zero innovation versus zero regulation. All regulation allows for innovation – it just reduces and controls it. New drugs are introduced – lots of them. New electric power pricing approaches are approved. And thank you, James Kwak, for reminding commenters that I don’t say “ban derivatives”, I say “oversee them properly.” Furthermore, it is not just the regulated products that evolve – it is also regulatory processes themselves. There is a steady stream of regulatory decisions that find their way into the courts precisely because the regulator did something different this time around and one party challenges whether this (dare I say it) innovation is consistent with the regulatory agency’s legal charter.

Every regulator allows innovation – some even encourage it. But under prudent regulation, you don't allow a product to be introduced in widespread ways that might undermine the whole goal of your regulatory scheme. Financial regulators did – though it was partly because their authority was balkanized so that new products had no natural regulator. In the end, that's Joskow's point and mine as well. Mind the gap, as they say in the London tube.

Redleg asked a simple, fair question: "Doesn't simplifying the regulatory system simplify how one might compromise it?" In my own limited experience: "No." Simpler systems are harder to compromise because many more people understand them and can therefore police them, formally or informally. Regulatory agencies don't need as high a level of skill. So let's be clear: regulation should be as complex as is necessary to do a good job, but not more so, and regulators **MUST** have the resources (educational and otherwise) necessary for their job.

Regulatory capture is unquestionably a huge and generally not solvable issue. It is an unavoidable aspect of regulation that civil society must seek to minimize. There is a century of experience with mechanisms that reduce capture: overlapping terms of regulators, requirements for political balance, revolving door rules, and so on. This is the hugely important day to day work of regulatory practitioners and legislative overseers.

Finally, Uncle Billy makes a number of points about Commissions, including the Pecora Commission. In the current ultra-polarized legislative climate, I think these commissions are extremely important and I have high hopes for what I will now call the Angelides Commission.

As to my background and motivation, my vita is posted on the *Brattle* website at www.brattle.com and more is at www.smartpowerbook.com. No *Brattle* client (or anyone else) knew that I was doing this post, much less reviewed it, much less paid for it. (However I do genuinely like Rowe and Joskow). See the disclaimer at the start of the post. And yes, we are proud to consider Simon a senior advisor to our firm. I sought out Simon to contribute to the discussion and he consented, not the reverse.

By Peter Fox-Penner

Peter is a leading expert on regulation at The Brattle Group. The views expressed here are his alone.

Same-Sex Marriage and Time

James Kwak | 04 Nov 2009

Yesterday Maine voted to restrict marriage to opposite-sex couples. It's a sad day for people who believe that all couples who love each other should be allowed to marry, full stop.

But the chart below may cushion the blow a tiny bit. It's from a paper by Jeffrey Lax and Justin Phillips, "Gay Rights in the States: Public Opinion and Policy Responsiveness," recently published in the *American Political Science Review* (via The Monkey Cage). What you are seeing is support for same-sex marriage in 1994-96, 2003-04, and 2008-09; solid dots indicate that same-sex marriage is equal, hollow dots that it is not.

Similarly, here's the picture of recent (2008) support for same-sex marriage by age group:

Barring a backlash even bigger than the one we've seen over the last ten years (during which support for same-sex marriage increased in every state except Utah), time is on the side of same-sex marriage. That may still be small consolation to elderly couples who have been together for decades.

By James Kwak

Free Markets and H1N1

James Kwak | 04 Nov 2009

In a free market, companies should be allowed to decide whether or not to offer paid sick leave to employees. At the margin, employees who value paid sick leave will flow to companies that offer it and employees that don't won't; also at the margin, companies that offer paid sick leave will be able to pay their employees a little less in other forms of compensation. Everything works out for the best.

Unfortunately, not offering paid sick leave creates a classic externality: People go to work even when they're sick, infecting their co-workers (or customers); employers internalize some of that cost (co-workers), but not all of it (co-workers going home and infecting their kids, who then go to school — because their parents can't stay home to take care of them — and infect their classmates, etc.). I've written before that we are far behind the rest of the developed world in requiring paid sick leave.

Now is when it will hurt us. The New York Times has an article today titled "Fears That Lack of Paid Sick Days May Worsen Flu Pandemic." (Economix has related data on *who* gets paid sick leave — public sector workers, people at big companies, and the highly-paid.) I'm not sure why they decided to throw in the word "may." We know that at the margin some people with H1N1 are going to work when they shouldn't. We know that H1N1 is highly contagious (5.7 million Americans affected so far). We may not know *how many* more people are getting H1N1 because of our non-policy on paid sick leave, but it can't be zero.

Of course, you can count on the business lobby to deny that there is a problem:

"‘The vast majority of employers provide paid leave of some sort,’ said Randel K. Johnson, senior vice president for labor at the United States Chamber of Commerce. ‘The problem is not nearly as great as some people say. Lots of employers work these things out on an ad hoc basis with their employees.’"

"According to the Bureau of Labor Statistics, 39 percent of private-sector workers do not receive paid sick leave."

Vast majority?

There's another dimension to this, too. Economix says this: "In both the private and the public sector, low-wage workers are far less likely to

receive paid sick leave than high-income workers, touching off fears that front-line workers at fast-food restaurants or child care centers might be spreading their illnesses.”

That’s an interesting interpretation: the problem is that readers of *Economix*, who presumably do not work in fast food restaurants or day care centers, might catch H1N1 from a fast-food worker or their child’s day care provider. No, it isn’t. The problem is that our non-policy *hurts the poor*. Rich people can stay home when they are sick or when their children are sick, which means the rate of transmission in rich communities will be lower. Poor people can’t, so the rate of transmission in poor communities will be higher. This is obviously a simplification; there are poor people with paid sick leave, and rich people without it (many small business owners, for example). There are also communities that include rich and poor people. But in the absence of public policy not only do we have a negative externality, we have one that disproportionately affects the poor.

By James Kwak

Obama In China: Breaking The Exchange Rate Deadlock

Simon Johnson | 05 Nov 2009

President Obama leaves next week for a high profile trip that includes meetings with other “Asia-Pacific” countries (in the APEC forum) and a visit to China. The President has had considerable diplomatic success on the economic front to date, including at the G20 summit in April and – to a lesser degree – at the follow-up September summit in Pittsburgh.

But the issues facing him now in Asia are particularly difficult, primarily because of China’s exchange rate policy. China essentially pegs its currency (known as the yuan or renminbi) against the US dollar, which means that it rises and – most recently – falls in tandem with the greenback.

Many countries operate de facto pegs of this nature, but China is problematic for three reasons: it is a large economy (10 percent of world GDP, if we adjust for purchasing power), it runs a big current account surplus (exporting more to the world than it buys from the world, in the range of 6-12 percent of the Chinese economy), and it consistently has a bilateral surplus with the US that is galling to many on both sides of the aisle on Capitol Hill (and their constituents).

The political backlash is not without foundation – jobs have moved and continue to move to China in part because Beijing’s exchange rate policy gives Chinese exporters an unfair trade advantage. This has long been recognized and China committed as long ago as 2003 to address this issue, but the Bush administration was unable to achieve any lasting success on this front – despite repeated head-to-head talks at the Cabinet Secretary level.

The Chinese currency remains at least 20 percent undervalued according to the Peterson Institute for International Economics (disclosure: I have a part-time position at the Institute but don’t work on this calculation); quietly, US officials do not disagree with such numbers. As a result, China continues to accumulate foreign exchange reserves at a dramatic rate – it reached \$2 trillion earlier this year and will like have \$3 trillion around the middle of 2010 (i.e., equivalent to 20 percent of US GDP; a huge number).

The Bush administration, quite reasonably, tried to give the job of handling China’s exchange rate to the International Monetary Fund – beefing up its long-established mandate in this area. Unfortunately, the IMF has proved unable to make any significant progress, largely because

it lacks the legitimacy necessary to wield any kind of stick on the issue. The Chinese just continue to say “no”, politely, and the IMF has backed down.

This is embarrassing for Mr. Obama, particularly as his strategy at the G20 has been to play up the importance of “global imbalances,” which implies that over the next 12 months, the focus will be on reducing both the Chinese current account surplus and the US current account deficit.

What should he say both to China and to its neighbors – who also increasingly find China’s exchange rate policy worrying, particularly as the dollar faces pressure to decline? Mr. Obama needs to find a carrot and at least the shadow of a stick, but he really does not want to go anywhere near a trade war (remember the tit-for-tat protectionism of the Great Depression).

A compelling argument is actually hiding in plain sight. As a result of easy monetary policy in the United States, combined with the rapid rebound of the Chinese economy, China now faces record capital inflows. These inflows are greatly encouraged by the inevitable prospect (in the minds of investors) that the renminbi will rise in value against the dollar within the foreseeable future. If you have access to cheap financing and implicit US government guarantees, for example as does Goldman Sachs, borrowing in dollars and investing (e.g., through private equity deals) in renminbi looks like a one-way bet.

The longer China resists appreciation and the more it protests that no one should interfere with this aspect of their sovereignty, the more the capital will pour in. This can have beneficial aspects, in any country that is trying to grow fast, but it can also be profoundly destabilizing – Mr. Obama should talk gently about the experience of Japan in the 1980s, the US this decade, and almost all emerging markets pretty much every decade.

Talking in public about big sticks never goes down well in Asia, and the administration should deny any inclination in this direction. But the mainstream consensus is starting to shift towards the idea that the World Trade Organization (WTO), not the IMF, should have jurisdiction over exchange rates. The WTO has much more legitimacy – primarily because smaller and poorer countries can bring and win cases against the US and Western Europe in that forum. It also has agreed upon and proven tools for dealing with violations of acceptable trade practices – tailored trade sanctions are permitted.

No one wants to take precipitate action in this direction, but extending the WTO's mandate in the direction of exchange rates would take time – and presumably warrant discussion at the G20 level. The US has great influence over the G20 agenda and Mr. Obama's staff should hint, ever so gently, that this is where they see the process going.

By Simon Johnson

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

Treasury and the Blogs

James Kwak | 06 Nov 2009

On Monday the Treasury Department (various officials, including Geithner, in shifts) had an informal meeting with eight prominent finance or economics bloggers. I've only read the accounts by [Tyler Cowen](#), [Steve Waldman](#), and [Yves Smith](#); Waldman names all of them and links to other accounts. This is Smith's sum-up:

"[T]hese guys are very smooth, very smart, and seemed quite sincere, which made it difficult to discern how much they really did believe and how much of what they said they had to say because they need to defend official policy and maintain confidence. Let's face it, they get prodded and roughed up by big dogs with some frequency. There was nothing we asked that would be new. They've covered this ground with other people of more consequence and therefore have answers ready. We are a pretty unimportant audience (yes, they did bother making time for us, but let us not kid ourselves on how far down the food chain bloggers are) and we cannot argue from a position of advantaged information, so it was inevitable that we would not get beyond standard responses."

I give Treasury big points for acknowledging us bloggers and inviting some pretty severe critics, such as Smith. I separately give them points for being good at their jobs. They understand that public opinion matters; they understand that bloggers have some influence on public opinion, if not that much; they understand that it's a little harder to criticize someone after you've met him and he's given you free cookies ("The free cookies were good and fresh, with a warm, fluid chocolate interior." – Cowen; note also that when the bank CEOs went to Washington in March all they got was water, no cookies.); and even if they couldn't possibly have expected to change anybody's mind, they understand that it's better to talk to your critics than to avoid them. Waldman talks about some of the techniques used to make the attendees feel like they were being treated as special guests.

On a substantive point, Waldman said this:

"A Treasury official pointed out that eliminating 'too big to fail' doesn't solve the problem, since institutions can be systemically

important because of their interconnections and roles along a wide variety of dimensions. I responded that ‘too-big-to-fail is too stupid a criterion,’ but pointed out that it would be possible to progressively tax several of the various markers of criticality so that it becomes uneconomic for an institution to remain indispensable.”

I think this whole “interconnectedness” theme is a clever rhetorical trick — a way of defusing the “too big to fail” argument by making a correct but ultimately minor point. I agree that if you simply cap balance sheet assets, that will not be enough. Technically speaking, a derivatives dealer can have ZERO balance sheet assets yet have an unlimited amount of open derivatives positions. If my memory of *When Genius Failed* is correct, LTCM just before its collapse had about \$130 billion in assets and \$1.4 trillion in open derivatives positions (that’s market value, not notional [**wrong, see below**]) on top of \$4 billion in capital.

But who said that “big” in “too big to fail” had to mean balance sheet assets? When I say “big,” the concept I am referring to is the overall shadow the institution casts over the financial system and the amount of collateral damage it would cause were it to fail. That damage can take various forms: debt that becomes worthless, derivatives positions that can’t be closed, hedge fund collateral that can’t be pulled back, etc. So call it “too interconnected to fail” or “too systemically important to fail” if you want, but you haven’t made the problem go away. The only thing you’ve done is pointed out that it can be tricky to measure overall importance, but none of us ever denied that to begin with.

Update: Sorry, I checked, and that \$1.4 trillion was notional value, not market value.

By James Kwak

Accounting at B of A and Fannie

James Kwak | 06 Nov 2009

Via Yves Smith, John Hempton analyzes the quarterly results of Bank of America (so-so) and Fannie Mae (terrible). The underlying issue is that bank quarter-to-quarter results are largely driven by the amount of provisions they take against future loan losses. You can think of this as a very rough approximation to marking-to-market — instead of waiting for the loans to default, you estimate how many loans will default in the future (that estimate should change as the economic situation changes) and put that amount of money into reserves. Then when the defaults actually happen, you take the money out of reserves.

Hempton argues that Bank of America and Fannie Mae are estimating extremely different future loan losses, and those differences cannot be attributed to differences in their current performance (the rate at which loans are defaulting now). If I wanted to be provocative I would only show you this quote:

“If Bank of America were to provide at the same rate its quarterly losses would be 50-80 billion and it would be completely bereft of capital – it would be totally cactus. It would be – like Fannie Mae – a zombie government property.”
[emphasis in original]

(“Totally cactus” — I like that.)

But to be fair, Hempton actually thinks that Bank of America is being only slightly optimistic and Fannie is being extremely pessimistic. Here’s his interpretation:

“[R]egulators are controlling Fannie in such a way that keeps it down. They are allowing Bank of America to act as if all is well whilst Fannie Mae appears to be a complete zombie. Which I think corresponds roughly to the new policymaker consensus that what is good for big banks is good for America.

“It is clear why BofA has chosen the 13 billion of provisions per quarter – which is that it roughly corresponds to their pre-tax pre-provision income. [Hempton is saying that if they took any more provisions they would be unprofitable.] Moreover – in my view the 13 billion per quarter is not far wrong so the decision is defensible. ...

“[A]lmost however I cut it the situation is getting worse for BofA at roughly the same rate as it is for Fannie Mae.

“Except for one thing. The government wants BofA alive. Lots of people want Fannie Mae dead.”

By James Kwak

Warren Buffett And The G20

Simon Johnson | 07 Nov 2009

The G20 Finance Ministers and Central Bank governors are meeting today in St. Andrews, talking about the data they will need to look at in order to monitor each other's economic performance and sustain growth (seriously).

The underlying idea is that if you talk long enough about the US current account deficit and the Chinese surplus, stuff happens and the imbalances will take care of themselves – or move on to take another form.

Warren Buffett seems to agree.

Buffett's big investment in railroads looks like a shrewd way to bet on growth in emerging markets – which is where most incremental demand for US raw materials and grain comes from. It's also a polite way to bet against the dollar or, even more politely, on an appreciation of the renminbi.

When China finally gives way to market pressure and appreciates 20-30 percent, their commodity purchases will go through the roof. You can add more land, improve yields, or change the crop mix of choice (as relative prices move), but it all has to run through Mr. Buffett's railroad.

Of course, Buffett is nicely hedged against dollar inflation – this would likely feed into higher inflation around the world, and commodities will also become more appealing.

And Mr. Buffett is really betting against the more technology intensive, labor intensive, and industrial based part of our economy. If that were to do well, the dollar would strengthen and resources would be pulled out of the commodity sector – the more “modern” part of our production is not now commodity-intensive.

The G20 will stand pat, waiting for the recovery and hoping for the best; “peer review” will turn out to be meaningless. But this raises three dangers.

1. China will overheat, with capital inflows fuelling a giant credit boom. Books with titles like “China as Number One” and “The China That Can Say No” will appear. The boom-bust cycle will resemble that of Japan in the 1980s – you don't need a current account deficit in order to experience a costly asset price bubble.

Other emerging markets may follow a similar pattern (think India, Brazil, Russia.)

2. US and European banks will be drawn into lending to China and other emerging markets, directly or indirectly. In a sense this would be a re-run of the build-up of debt in Latin America and Eastern Europe in the 1970s, leading to the debt crisis of 1982 (remember Poland, Chile, Mexico). Banks with implicit government guarantees will lead the way.
3. We hollow out the middle of the global economy – with a few people doing ever better and most people struggling to raise their living standards. Increasing commodity prices hit hard at poorer people everywhere (recall the effects of the relatively mild run-up in food and energy prices in the first half of 2008). Global volatility of this nature helps big business but at the cost of undermining the middle class.

By betting on commodities, Mr. Buffett is essentially taking an “oligarch-proof” stance. Powerful groups may rise to greater power around the world, fighting for control of raw materials and driving up their prices further. As long as there is growth somewhere in emerging markets, on some basis, Mr. Buffett will do fine.

As for the G20, they are already a long way behind the curve.

By Simon Johnson

Productivity and Layoffs

James Kwak | 09 Nov 2009

One reason I like reading Brad DeLong is that he's never afraid to admit a mistake — even when it isn't technically a mistake, just a question of interpretation. Here is his [comment](#) on productivity growth of 9.5% (annual rate) in the third quarter:

“Back in the 1930s there was a Polish Marxist economist, Michel Kalecki, who argued that recessions were functional for the ruling class and for capitalism because they created excess supply of labor, forced workers to work harder to keep their jobs, and so produced a rise in the rate of relative surplus-value.

“For thirty years, ever since I got into this business, I have been mocking Michel Kalecki. I have been pointing out that recessions see a much sharper fall in profits than in wages. I have been saying that the pace of work slows in recessions—that employers are more concerned with keeping valuable employees in their value chains than using a temporary high level of unemployment to squeeze greater work effort out of their workers.

“I don't think that I can mock Michel Kalecki any more, ever again.”

Productivity is the amount of output per unit of input. The productivity numbers you see quoted in the media are almost always growth in *labor productivity* — the rate at which the amount of output per unit of labor input (hour worked by a human being). In the long term, productivity growth is perhaps the most central component of rising material standards of living, since in aggregate it means that we get more stuff for working the same amount of time. (GDP growth on its own doesn't have this effect, because the population could be growing, or we could be working harder and thereby losing leisure time.)

In the short term, though, productivity growth can swing all over the map. Productivity often falls during a recession because output falls faster than companies lay off workers and spikes afterward because output is growing right while companies are laying off workers (and companies put off hiring until the recovery is well underway). This time the recession lasted long enough that companies had time to lay off

millions of workers and productivity growth started shooting up in the second quarter (6.9% annual rate).

One underlying issue is that not everyone in a company contributes at the same rate. When companies have layoffs, they theoretically try to lay off the less-productive people (although this often does not happen), which should cause productivity to go up. Having been a management consultant for several large companies, I can say with a fair degree of confidence that these companies could have laid off a significant number of people without any noticeable fall in output. In addition, because the rate of output today depends in a complex way on work done in previous quarters (imagine if GM laid off all its design people — the factories could keep humming for a while), sometimes you can keep output up even with less labor input in the current quarter; you don't pay the bill until later. Then there's the effect DeLong talks about: companies can use a bad labor market as a way to squeeze workers harder. This is why quarter-to-quarter numbers can be very noisy.

However, repeated layoffs don't work as a long-term strategy, and at some point you reach a point where you can't sustain output with fewer people, and companies start hiring again. So in the long term, productivity growth relies on things like improvements in technology and business processes. But in the short term it's often just noise.

By James Kwak

Things That Don't Make Sense, Yuan Edition

James Kwak | 09 Nov 2009

“World Bank Chief Economist Justin Yifu Lin staked out a strong position against forcing China to let its currency appreciate as a way to rebalance the world economy.

“‘Currency appreciation in China won't help this imbalance and can deter the global recovery,’ he said in a lecture Monday at Hong Kong University.

“In an interview after the lecture, he said other countries shouldn't intervene to keep their currencies cheap to boost their export sectors, calling it the ‘equivalent of protectionism.’”

You can read the rest at [Real Time Economics](#). No, it doesn't make more sense — except possibly as an expression of China's policy.

By James Kwak

The Too Big to Fail, Too Big to Exist Act of 2009

James Kwak | 09 Nov 2009

A BILL

To address the concept of “Too Big To Fail” with respect to certain financial entities.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the “Too Big to Fail, Too
5 Big to Exist Act”.

6 **SEC. 2. REPORT TO CONGRESS ON INSTITUTIONS THAT** 7 **ARE TOO BIG TO FAIL.**

8 Notwithstanding any other provision of law, not later
9 than 90 days after the date of enactment of this Act, the
10 Secretary of the Treasury shall submit to Congress a list

2

1 of all commercial banks, investment banks, hedge funds,
2 and insurance companies that the Secretary believes are
3 too big to fail (in this Act referred to as the “Too Big
4 to Fail List”).

5 **SEC. 3. BREAKING-UP TOO BIG TO FAIL INSTITUTIONS.**

6 Notwithstanding any other provision of law, begin-
7 ning 1 year after the date of enactment of this Act, the
8 Secretary of the Treasury shall break up entities included
9 on the Too Big To Fail List, so that their failure would
10 no longer cause a catastrophic effect on the United States
11 or global economy without a taxpayer bailout.

12 **SEC. 4. DEFINITION.**

13 For purposes of this Act, the term “Too Big to Fail”
14 means any entity that has grown so large that its failure
15 would have a catastrophic effect on the stability of either
16 the financial system or the United States economy without
17 substantial Government assistance.

Introduced by Senator Bernie Sanders of Vermont. That’s the *entire bill*.

Note that the bill puts the lie to the “interconnectedness” diversion I discussed last week. The administration’s own proposal requires the government to identify financial institutions that are “too [insert whatever adjective you want here] to fail” — the administration just calls

them “Tier 1 Financial Holding Companies.” The Fed has called them “systemically important financial institutions.” Sanders basically says, you were making the list anyway, so you can’t use that as an excuse.

The bill says that Treasury can break up the institutions *any way they want to*, so long as the resulting entities do not individually threaten the financial system (and thereby our economic well-being). So opponents can throw out all those arguments about why separating commercial and investment banking is bad, or why banks have to be global (a bit of an embarrassment to Wells Fargo) — now they need to argue that a well-functioning financial system *must* include institutions that could take down the financial system.

Here’s Nemo’s take.

Bernie Sanders’s petition here.

By James Kwak

The Political Problem with Resolution Authority

James Kwak | 09 Nov 2009

The administration is putting a lot of eggs in the resolution authority basket — the idea that, if it gets the power from Congress, it can take over large banks and wind them down, sell them off, or run them temporarily without taking the financial system down. I agree that taking over Citi last winter would have been preferable to what did happen. But I wrote somewhere (sorry, can't find it now) that resolution authority has a *political* problem — if, say, JPMorgan Chase runs into trouble five years from now, how much confidence do we have that the government would actually invoke the power and take over the bank when push comes to shove? Even if a Democratic administration were in place, the executives at JPMorgan would scream bloody murder, as would the Republican Party, and the administration would have to decide if it wants to fight that political battle (“Socialism!!!”) before pulling the trigger.

Adam Levitin has a more thought out variant on this concern that I just found. Here's his bottom line:

“[I]n most failures of too-big-to-fail institutions, the government will have to provide funding for the resolution, and this makes the resolution a political issue. For this reason alone, I think we are kidding ourselves if we believe that we can regularize the resolution of systemically important institutions. It would be great if we could regularize too-big-to-fail resolution, but I don't think it is possible to come up with any set of rules that we won't break at the first sign of them creating distributional results that we do not like. ”

I'm not saying the government shouldn't have resolution authority; I'm just saying we shouldn't assume that it will solve our problems.

By James Kwak

Global Bubbles: The Geithner-Brown Split

Simon Johnson | 10 Nov 2009

There are two broad views on our newly resurgent global bubbles – the increase in asset prices in emerging markets, fuelled by capital inflows, with all the associated bells and whistles (including dollar depreciation). These run-ups in stock market values and real estate prices are either benign or the beginnings of a major new malignancy.

The benign view, implicit in Secretary Geithner's position at the G20 meeting last weekend, is most clearly articulated by Frederic (Ric) Mishkin, former member of the Fed's Board of Governors and author of " The Next Great Globalization: How Disadvantaged Nations Can Harness Their Financial Systems To Get Rich", in the Financial Times this morning.

"The second category of bubble, what I call the 'pure irrational exuberance bubble, is far less dangerous because it does not involve the cycle of leveraging against higher asset values. Without a credit boom, the bursting of the bubble does not cause the financial system to seize up and so does much less damage"

In other words: keep monetary policy right where it is, and don't worry about financial regulation.

The second view is much more skeptical that "benign" bubbles stay that way. Remember that most damaging bubbles – or debt-based over-exuberance, if you prefer – during the past 40 years have involved two elements.

1. Borrowers in emerging markets (Latin America and Eastern Europe in the 1970s; Mexico in the early 1990s; Russia, Ukraine, East Asia, Brazil and many others in the early-mid 1990s; Eastern Europe in the 2000s).
2. Citibank (and its descendants), i.e., a bank that was large and global before any other US institution was so inclined. Rather than bringing us the wonderful benefits of financial globalization, Citi has almost failed at least twice – and been rewarded for its incompetence with gold-plated bailouts at least four times.

Of course, other banks from other countries have become involved at various moments, but the point is that the lending organizations behind every bubble come from more "developed" financial markets – even

when the origin of the capital flows is elsewhere (e.g., recycling oil surpluses in the 1970s). And the borrowers are always in places where the rules become lax during a boom – in this sense, the US became just like a classic emerging market after 2001 (and arguably earlier).

After months of painful procrastination, Gordon Brown has finally recognized that Adair Turner – head of the UK Financial Services Authority (FSA) and astute critic of Big Finance – is on to something in this regard.

At St. Andrews on Saturday, Brown actually proposed (and his mandarins briefed in private) on the need for a tax on financial transactions – a version of the “Tobin tax”.

Brown knows full well that such a tax is unlikely to get traction in the current environment, partly as it would be hard to implement (i.e., the scope for evasion through off-shore financial centers is enormous).

But the point of his announcement was to shock and awe finance ministers – and this worked. Secretary Geithner was provoked into uncharacteristically sharp pushback, which came across as the sort of rebuke that a minister of finance seldom directs at a head of government.

Brown and his team have at last understood that reigning in the financial sector needs to be front and center of the international agenda – and the troika structure of the G20 allows them (as outgoing chairs) to keep this issue hot.

It also provides political cover for the IMF, which is working hard on a tax for “excess risk taking” in finance. Dominique Strauss-Kahn (head of the IMF and leading candidate of the left for the next French presidential election) astutely provided more details in the aftermath of the Brown remarks – thus making it harder for the US to oppose the IMF technocrats (and the French), who now seem so very moderate compared to Brown.

And how we will measure “excess risk taking”? Volumes of technical papers are being written, much math has already been wasted, and ponderous reports will soon appear. But, at the end of the day (which is the G20 summit in June 2010) there is one central criterion around which you can get your hands: size.

Bigger banks pose more system risk, mega-banks pose the most risk, and all bubbles can quickly go bad in the presence of such gigantic institutions. They must face appropriately higher taxes — in fact, so high that the biggest voluntarily break-up in anticipation.

The ideas underlying Bernie Sanders's bill are becoming mainstream.
By Simon Johnson

Blankfein Defends Goldman Sachs Against Breakup Advocates

James Kwak | 10 Nov 2009

That's the title of a [Bloomberg article](#) that also cites [Bernie Sanders](#) and Simon. Here are the direct quotes from Blankfein:

"Our business is very complex, and I won't deny that, but it's far, far simpler than most of the competitors. I wonder myself how some of these things get managed."

"Most of the activities we do, and you can be confused if you read the pop press, serve a real purpose. It wouldn't be better for the world or the financial system [to change the firm's activities]."

"We pretty much stuck to our investment-banking knitting. That's why we have 30,000 people and many of our competitors have well over 200,000 or 300,000 people."

I more or less agree with most of this. It makes sense that investment banks should underwrite securities, trade those securities, and trade derivatives, and should advise corporate clients engaged in large financial transactions, although I'm less sure why Goldman needs to be in proprietary trading, private equity, and asset management. Goldman clearly makes more sense as an entity than, say, Citigroup.

But that's not the question. I don't think anyone doubts that at \$1 trillion in assets (plus derivatives exposures), Goldman is too big to fail. The real question is not whether Goldman should be in a different mix of businesses. The question is whether a \$1 trillion Goldman provides any value to the world that wouldn't be provided by four \$250 billion Baby Goldmans. (Each Baby Goldman would be about the size that Goldman itself was in 1998, when it was already one of the top two investment banks in the world, and the corporate world had no apparent constraints on financing.) I don't think Blankfein answered this question.

By James Kwak

Low Savings, Bad Investments

James Kwak | 11 Nov 2009

The article below first appeared in our [Washington Post column](#) yesterday. I'm reproducing it in full here because there is an important correction, thanks to a response by [Andrew Biggs](#). I've fixed the mistake and added notes in brackets to show what was fixed. Also, I want to append some additional notes about the data and some issues that didn't fit into the column.

Recent volatility in the stock market (the S&P 500 Index losing almost 50% of its value between September and March) has led some to question the wisdom of relying on 401(k) and other defined-contribution plans, invested largely in the stock market, for our nation's retirement security. For example, *Time* recently ran a [cover story](#) by Stephen Gandel entitled "Why It's Time to Retire the 401(k)."

However, the shortcomings of our current retirement "system" predate the recent fall in the markets, will not be solved by another stock market boom. The problems are more basic: we don't save enough, and we don't invest very well.

We ran several scenarios of what a typical two-adult household that entered the job market last year at age 22 might expect to receive on retirement at age 65 in 2051. For each scenario, we assumed that our household would earn the median amount for its age group every year. We began with data from the [U.S. Census Bureau](#) on 2008 earnings by age group, and assumed that real incomes would grow by 0.7% per year (the average growth rate for the 1967-2008 period). According to analysis by Andrew Biggs, medium earners typically accumulate Social Security benefits equivalent to 52% of their pre-retirement income, which comes to \$40,265 per year. (All figures are in 2008 dollars.) For our scenarios, we used different estimates of the household's savings rate and of the rate of return it would earn on its savings. [**Correction:** I initially used the online Social Security [Social Security benefits calculator](#), which says it provides estimates in "today's dollars," but actually uses wage-indexed dollars. See [Biggs's explanation of the difference](#).]

For the first scenario, we assumed the average economy-wide savings rate of 2.4% over the last ten years (1999-2008) and a real rate of return of 6.3% — the long-term average real return for the stock market. (In his book *Stocks for the Long Run*, Jeremy Siegel calculates the annual real rate of return from 1871 to 2006 as 6.7%; updating that figure through 2008, we get 6.3%.) At retirement, this yields accumulated savings of \$298,064.

Today, a 65-year old couple could convert \$298,064 into a joint life annuity of \$18,467 (we did an online search for annuity rates), meaning that they would receive that amount each year (not indexed for inflation, however) as long as either person were still alive. (Anything other than buying an annuity is gambling that you won't outlive your money.) \$18,467 is only 24% of the household's income at age 64. Combined with Social Security, the couple would receive \$58,732 per year, or a respectable 76% of its pre-retirement income of \$77,432. [**Correction:** Originally this was 59%; all later figures were also 17 percentage points too low.]

Savings were unusually low over the past decade. The current savings rate (first three quarters of 2009) is 3.6%. Plugging this into our spreadsheet, we get an annuity of \$28,092 and retirement income of \$68,357, or 88% of pre-retirement income.

But this overlooks the fact that people do not earn the rate of return of the stock market. Even assuming that people are investing in stocks, most do so via stock mutual funds which, on average, do worse than the stock market as a whole. For example, in the 1990s the average diversified stock fund had an annual return 2.4 percentage points lower than the Wilshire 5000 Index (which reflects the performance of the overall market). The main reason for this underperformance is that mutual funds have to pay fees to their managers — who, on average, do not earn those fees through superior stock-picking (to put it mildly).

If we use a 3.9% annual return instead of a 6.3% annual return, now our annuity is only worth \$15,347 per year, and combined with Social Security our household is only earning 72% of its pre-retirement income. But wait — it gets worse.

The average *investor* in mutual funds does not even do as well as the average *mutual fund*. The reason is that investors tend to chase returns. They take money out of funds that have recently done badly and move it into funds that have recently done well. Because of mean reversion (the tendency for trends away from the average to return back to the average), this means they take money out of funds that are about to go up and put it into funds that are about to go down. Among large blend stock funds (the category that includes S&P 500 index funds), research from Morningstar shows that the gap between mutual fund performance and investor performance ranges from 0.9 to 2.2 percentage points, depending on fund volatility. (It can be much higher — over 10 percentage points — for other types of funds.)

Taking an average gap of 1.6 percentage points, our expected annual returns are now just 2.3%. Now our cumulative savings are only \$172,853 and our annuity is only \$10,709; combined with Social Security our household is only earning 66% of its pre-retirement income.

Now, you can get close to that 6.3% expected return through a simple strategy: buy a stock index fund and don't touch it. But this has another problem — you are 100% invested in stocks, the riskiest of the major asset classes. Whatever your expected cumulative savings, there is a 50% chance that your actual savings will be lower, and they could be a lot lower.

Since we're talking about survival in old age, ideally our household would not take any risk at all. The closest you can get to this is to invest in inflation-protected Treasury bonds. 20-year TIPS (Treasury Inflation-Protected Securities) currently yield 1.96% on top of inflation. [**Note:** In the Post column I used 2.4%, the yield at the latest auction; however, that was back in July, and long-term bond yields have come down since then, so this is the current yield according to Bloomberg.] This provides a final annuity of \$9,925; combined with Social Security, that's 65% of pre-retirement income. That's not very much. And the only way to get higher returns is by taking on risk.

Bear in mind that we're assuming that Social Security will be around in its current form, as will Medicare (or else seniors will have sharply higher health care costs than they do today). Also, we've made a number of optimistic assumptions along the way: that life expectancies do not increase by 2051 (this would reduce the annuity you can get with the same savings); that *median*-income households save money at the *average* rate for all households, which is untrue (richer households save at a higher rate, making the average savings rate higher than the median savings rate); and that the savings rate is constant over age (since older people in fact save at a higher rate, the money has less time to build up). In addition, we haven't started talking about below-median households, who save at a lower rate. [**Note:** I assumed you can get an annuity yielding 6.2%, from [this online site](#); Biggs, who probably knows better than I, uses 5.4%, which yields lower annuities for the same amount of savings.]

The problems, in short, are that we don't save enough and we don't invest very well. One could argue that these are a matter of choice. People could save more, and they could make smarter investing decisions. But given that they don't, we could very well see tens of

millions of seniors without enough money to live decently in retirement. Given that prospect, perhaps we should question leaving retirement security to individual choices and free markets.

Andrew Biggs argues that the numbers show that the retirement system is doing OK. After all, if you assume just a 2.4% savings rate and a 6.3% real return, you get 76% of your pre-retirement income. The system is doing better than I thought it was before Biggs pointed out my error, but *that's almost entirely due to Social Security*. Social Security is replacing 52% of pre-retirement income (not 35% as I initially calculated) and private savings are replacing anywhere from 13% to 24%, depending on the scenario. I think the 13% scenario is the most accurate, since is the lowest-risk option; anything else is not retirement saving, it's retirement *gambling*.

Biggs also thinks (email to me) that my savings rates are too low, especially with auto-enrollment into 401(k)s on the rise. This is a plausible point; we don't really know where the savings rate will end up after this recession. If the median worker is auto-enrolled in a 401(k) — and, even better, if he gets an employer match — he may be OK. Then we may be talking about a problem that affects a significant number of lower-income households (who are less covered by 401(k)s and employer matches than higher-income households), though not the median household.

This is the spreadsheet with the scenarios. WordPress.com won't let me upload an Excel file, so I embedded it in a Word file and uploaded that.

There's a legitimate question about 2008 vs. 2051 living standards. For example, in our most pessimistic scenario, we still end up with an annuity of \$50,190 in 2008 dollars. That might not seem so bad. After all, median income in 2008 was only \$53,303, and this is all in real terms, right? However, I don't think that's the right approach to take. Living standards will improve on average between now and 2051, and therefore an income of \$50,190 2008 dollars will feel very different in 2051 than it felt in 2008. This is why I think the right comparison is to pre-retirement income; that tells you the *drop* in living standards that people will suffer at retirement. (In practice, most people probably won't buy annuities, and won't adjust their living standards down immediately — but that just means they have a higher chance of outliving their money.)

Another possible objection is that we're leaving out capital gains from housing. Even if the average return that investors get from stock mutual funds is only 2.3%, the fact is that many people invest in their houses and seem to get higher returns. However, I think that we can't count on these higher returns. First, these returns are largely a product of leverage and subsidized interest rates; real housing prices underperform the stock market. Second, a given house doesn't really change in real value (the utility it provides to people), even if its price changes; in general, its value goes *down*, unless you put money into it for maintenance and improvements. If the price of equivalent houses goes up in real terms, that just means that (on average) one generation of home owners is taking money from the next generation of home buyers in the form of higher prices. In other words, it's a multi-generational Ponzi scheme that can't go on forever. Third, of course, not everyone owns a house.

In doing the research for this column I came across a paper by Andrea Frazzini and Owen Lamont called "Dumb Money: Mutual Fund Flows and the Cross-Section of Stock Returns." They find that, at least when looking at historical data, you can make money by doing the *opposite* of what investors do with their mutual funds. That is, money flowing into mutual funds is a valid predictor that the stocks in those funds will, on average, go down relative to the market. The real beneficiaries are corporate issuers of stock, who are able to issue stock at high prices when demand for it is high. I also like the way they put their findings into context: "These facts pose a challenge to rational theories of fund flows. Of course, rational theories of mutual fund investor behavior already face many formidable challenges, such as explaining why investors consistently invest in active managers when lower cost, better performing index funds are available."

Finally, I hate making mistakes. So I wholeheartedly endorse Biggs's call for the Social Security Administration to fix its misleading calculator.

By James Kwak

Dollar Doom Loop

Simon Johnson | 12 Nov 2009

The American dollar is in the midst of a large fall in its value, or depreciation, as measured against other major currencies. The decline has been steady since 2002 and our currency is down about 35 percent from that peak. After strengthening slightly more than 10 percent during the global financial crisis of the past 18 months, the dollar is again falling back toward its pre-crisis lows, representing its weakest international value since 1967.

But there is a definite possibility that the dollar could soon decline further or faster.

At the level of general economic strategy, the American government has responded to a financial sector crisis with an expansionary fiscal policy, and the Federal Reserve is implementing loose monetary policy. Andrew Haldane, responsible for financial stability at the Bank of England, puts it this way:

“For the authorities, [excessive risk-taking by the financial sector] poses a dilemma. Ex-ante, they may well say “never again.” But the ex-post costs of crisis mean such a statement lacks credibility. Knowing this, the rational response by market participants is to double their bets. This adds to the cost of future crises. And the larger these costs, the lower the credibility of “never again” announcements. This is a doom loop.” ([link to the paper](#))

In addition to a financial crisis, we also have a large current account deficit, meaning that we buy more from the world than we sell. The deficit was \$100 billion in the latest available (second quarter) data, which is around 3 percent of gross domestic product, and we finance that with capital inflows from abroad. (The current account deficit is down from around 6 percent, but two-thirds of the decline is due to the lower price of oil).

In the past, many of those inflows have been private investments of various kinds, but as investors around the world question whether United States government debt, and its dollars, are really worth the paper, it is increasingly difficult for us to finance our deficit with the outside world.

What does this mean for the dollar?

Treasury Secretary Timothy F. Geithner continues to repeat that a strong dollar is “very important” for the American economy, but United States fiscal and monetary policy pushes toward depreciation. To bail out our banks, we need cheap money, and this implies some inflation. To finance our current account deficit, investors need to think they are buying inexpensive assets from us. Everything points to a cheaper dollar. (The same thing is happening in Britain, but the Bank of England is increasingly explicit about this point and the unsavory broader situation.)

A “hard landing” scenario for the dollar could be painful.

The 1980s classic, Stephen Marris’s “Deficits and the Dollar: The World Economy at Risk,” stresses that a rapidly falling dollar would push up United States inflation, resulting in higher interest rates and a deep recession (pp. lx-lxi). Writing in the latest edition of *Foreign Affairs*, Fred Bergsten emphasizes that such outcomes are still possible today. A weakening dollar will cause inflation fears, so yields on long-term government bonds will rise to compensate investors for inflation, and we will need to pay more and more to finance our large debts.

The idea that the American dollar might follow emerging markets such as Russia in 1998 and Argentina in 2002, or Britain in the 1970s — and so depreciate by 50 percent or more in a relatively short time — is certainly implausible now. But such a “doom scenario” is not unrealistic in the future without change.

In this context, the American government needs to control its budget deficit to keep this adjustment on track, and to stop confidence in the dollar from falling further. Our government collects far too little in taxes for what it spends. There is no choice but to raise taxes soon and rein in spending.

Short-term rates (controlled by the Fed) will stay low, while long-term rates (market-determined and affected by trust in our Treasury and Fed to keep the value of dollar strong) will rise as people fear their dollar investments will be debased. There is no doubt that both the Fed and the Bank of England know what is happening. The spread between short- and long-term rates (known as the “yield curve”) will rise, and banks will benefit; would-be home buyers and people with overdrafts or outstanding credit card balances pay more, while savers get little.

This is how the public pays for the past losses of our financial system.

We don’t have to do this again and again. We could start by changing our financial system from the roots. We need to credibly remove the

promise to bail out our large banks each time they fail. This means forcing them to hold more capital, dividing them up so they are smaller, and then letting them fail when they make poor gambles.

The Treasury's past and current close connections to Goldman Sachs, Citigroup and other major investment banks illustrate how our own doom machine functions. We need to break up these "banks" so they are small enough to fail, and also ensure that no bank, regardless of its connections, is able to demand that the Fed and the Treasury support its solvency in the future to prevent financial collapse.

In this context, a weakening dollar helps the administration to put an unstable financial system back on its feet — and to crank up our "doom machine."

By Peter Boone and Simon Johnson

This is a slightly modified version of a post that appeared this morning on the NYT Economix blog; it appears here with permission. If you wish to reproduce the entire post, please contact the New York Times.

Ask Sheila Bair

Simon Johnson | 12 Nov 2009

A producer at the Lehrer NewsHour just sent me this email:

“Just thought I’d alert you to something we’re advertising today on Paul’s blog, The Business Desk. Paul [Solman] is interviewing the FDIC’s Sheila Bair tomorrow, and she’s agreed to answer several questions from NewsHour viewers, which we’ll post in a special video.

I thought your readers might have some excellent suggestions.”

Follow the link embedded above to post questions.

By Simon Johnson

2 Down, 58 to Go

James Kwak | 13 Nov 2009

Byron Dorgan joins Bernie Sanders: “Abolish ‘too big to fail.’ If you’re too big to fail, you’re too big.”

By James Kwak

How Well Prepared Are Americans for Retirement?

James Kwak | 13 Nov 2009

The following guest post was contributed by Andrew Biggs. He has studied the issue of retirement savings for a couple of orders of magnitude longer than I, so I wanted to give him the opportunity to outline his perspective on the topic. He regularly blogs on his [own blog](#) and, along with about four dozen other people, [over here](#).

After our exchange regarding Tuesday's blog on [The Retirement Problem](#) in the *Washington Post* (which started [over at AEI's Enterprise blog](#) and continued [here](#)), James generously offered to let me guest-post my thoughts on Americans' level of preparation for retirement. Overall I'm not so pessimistic, although there are surely problems that must be addressed. But most of the detailed research out there points to problems, but not a crisis.

Both James's analysis and my own response were built on relatively simple projections using stylized workers who pay into Social Security and participate in 401(k) plans. These illustrations are useful for fleshing out basic issues – plus, in this case, finding how the SSA's online benefit calculator may have skewed some of the results.

But the best research on retirement preparedness is more involved than this. Most analysis of current retirees uses survey data, such as from the [Health and Retirement Study](#) (HRS), the [Survey of Income and Program Participation](#) (SIPP), the Fed's [Survey of Consumer Finances](#) (SCF) and the [Current Population Survey](#) (CPS). Each survey has strengths and weaknesses.

In addition, broader models of the population are built using this survey data. These models allow for simulations of how policy changes affect current retirees, as well as projecting the population into the future. Such comprehensive models include the Social Security Administration/Urban Institute [MINT](#) (Modeling Income in the Near Term) model, the Congressional Budget Office's [CBOLT](#) (CBO Long Term) and the Policy Simulation Group's [PSG suite of models](#), used by the Government Accountability Office and the Department of Labor for Social Security and private pension projections. While these models, like any others, rely on assumptions regarding a large number of factors, they are also the most closely scrutinized to ensure these assumptions are consistent with current trends.

I'll first run through what some of my own work has found, and then highlight some work from elsewhere. This paper, written with Glenn Springstead when I was at SSA, used the MINT model to analyze replacement rates for current retirees and, using projected data, for individuals retiring in the 2040s. We looked at income from a wide variety of sources, including Social Security, defined benefit and defined contribution pensions, earnings, co-resident income and government programs such as SSI. We examined individuals aged 64-66 in 2005 and projections for individuals aged 64-66 in 2040. The typical couple in 2005 had total retirement income equal to 185% of final earnings, while the median projected couple in 2040 has a replacement rate of 131%. Now, these are projections, but bear in mind that the MINT model is probably the most comprehensive and best-vetted projection model of retirement income, with a large number of economists, demographers and social scientists working on it and regularly assessing its results.

As second paper used the Policy Simulation Group models, which look only at Social Security and private pensions. In this paper I used a different definition of replacement rates and also adjusted replacement rates to account for differences in household size and the number of children. (Larger households have economies of scale; children consume income during working years that doesn't need to be replaced in retirement, so childless couples would need to save more for retirement than couples with children.) Here I looked at people born in 1940 and 1960 to track replacement rates from today through the 2020s. The median Social Security/pension replacement rate for the 1940 cohort was 92 percent while the median for the 1960 cohort was 82 percent. Working just an additional year would bring the 1960 birth cohort up to 1940 levels. While replacement rates do decline over time, due to a rising Social Security retirement age and declining DB pension coverage, most people at most income levels are doing ok.

This well-received paper by John Karl Scholz and Ananth Seshadri of the University of Wisconsin–Madison and Surachai Khitatrakun of the Urban Institute uses the HRS to examine how well the Baby Boomers are prepared for retirement. It uses a more sophisticated measure of retirement readiness than the replacement rates I used, but the basic idea is similar. They find that

over 80 percent of HRS households have accumulated more wealth than their optimal targets. These targets indicate the amounts of private saving households should have acquired at the time we observe them in the data, given their life cycle planning problem and Social Security and

defined-benefit pension expectations and realizations. For those not meeting their targets, the magnitudes of the deficits are typically small.

In a draft follow-up paper Scholz and Seshadri reach similar conclusions for younger cohorts.

Now, there have been good research projects that have come to alternate conclusions, the most prominent being the National Retirement Risk Index generated by the Center for Retirement Research at Boston College. Without doing a very detailed nuts-and-bolts comparison of the CRR's model to the others it's hard to say exactly what's driving the differences. While I really like the CRR's work, I would say that models like SSA's MINT are more comprehensive and have been around longer, so I would tend to favor those results. CRR's model was built for the NRRI research project and I'm not sure its general results fully match those from other models.

None of this is to say retirement preparation doesn't face problems. DC plans like 401(k)s present challenges to savers and both participation rates and asset management haven't been as good as we'd like, although policies to address both problems are being implemented. Likewise, Social Security is almost sure to reduce benefits in the future, at least for middle and high earners, and Americans will need to save more to make up for these losses. But the key is to look closely at who's unprepared for retirement, why, and what we should or can do about it. When we think about a "crisis" in retirement saving, hasty solutions might make things worse rather than better.

By Andrew Biggs

The Real Choice on Too Big to Fail

James Kwak | 13 Nov 2009

Gillian Tett has an article criticizing the idea that CoCos — contingent convertible bonds — will solve the “too big to fail” problem. (And yes, she calls it “too big to fail,” even though Gillian Tett of all people understands what interconnectedness means.)

Contingent convertible bonds, a.k.a. contingent capital, are the latest fad to hit the optimistic technocracy in Washington and London. A contingent convertible bond is a bond that a bank sells during ordinary times, but that converts into equity when things turn bad, with “bad” defined by some trigger conditions, such as capital falling below a predetermined level. In theory, this means that banks can have the best of both worlds. They can go out and borrow more money today, increasing leverage and profits (which is what they want). But when the crisis hits, the debt will convert into equity; that will dilute existing shareholders, but more importantly it means the debt does not have to be paid back, providing an instant boost to the bank’s capital cushion. In other words, banks can have the additional safety margin as if they had raised more equity today, but without having to raise the equity.

Tett is skeptical for all sorts of reasons — defining the trigger point (remember, Bear and Lehman were well-capitalized on paper when they collapsed), finding people willing to buy these things, the impact on the market of triggering a conversion, etc.

I’m skeptical for a more basic reason. Contingent capital, like any other type of capital requirement, assumes that we can predict in advance how bad the crisis will be and therefore how much capital will be necessary to avert a bank-killing panic. That means we have to be able to predict (a) just how fat the fat tail is, based on virtually no data points, and (b) how panicked people can get and for how long. That seems to me technocratic hubris of the first order.

So why is contingent capital so popular? (It’s even mandated by section 107(b)(1)(D) of the Dodd bill.) Well, the people don’t matter don’t listen to me or to Gillian Tett. Here is Tett’s explanation:

“Even amid all those hurdles, the CoCo idea currently has many fans, not just among investment bankers touting for business, but some western regulators too. The reason stems from a big, dirty secret stalking the financial world: namely that while global

“policymakers have spent a year wailing about the ‘Too Big to Fail’ problem, they have hitherto done almost nothing tangible to remove that headache in a credible manner.”

Tett says what we need is a cross-border resolution system for bank failures. I’m a little skeptical of that too, for reasons I think I’ve outlined elsewhere. In case I haven’t, this is the problem: When push comes to shove, would the U.S. government use whatever “resolution” powers it has to take over JPMorgan Chase or Goldman Sachs against its will (or let an international body do so)? Leaving aside the issue of political connections for the moment, the political hit it would take from the right (SOCIALISM!!!) would make the health care debate look like a friendly game of flag football. If we can’t even get meaningful derivatives regulation in 2009, what makes us think that any government would have the political capital to take over one of America’s biggest banks when it needed to? More technocratic hubris.

But I agree strongly with Tett on why contingent capital is suddenly so popular. Policymakers in Washington are looking for something, anything that will allow them to declare victory over the TBTF problem — without having to break up the banks. The idea that any clever regulatory scheme we come up with today, which by definition will be untested, can be counted on to come through in the next crisis seems hopelessly naive to me. I think it would be more honest to admit that there are really only two choices:

1. Break up any institution that is too big to fail.
2. Leave them in place (because “big companies need big banks,” or whatever other nonsense justification you want to use) and admit that we’ve done nothing to solve the TBTF problem.

That’s the real choice.

By James Kwak

Note to Jamie Dimon: Repeating Something Doesn't Make It True

James Kwak | 13 Nov 2009

Note: I've updated this post at the end with another response to Jamie Dimon, this one by James Coffman. Coffman served in the enforcement division of the SEC for over twenty years, most recently as an assistant director of enforcement, and previously wrote a [guest post](#) for this blog.

In the [Washington Post](#), Jamie Dimon asserts that we shouldn't "try to impose artificial limits on the size of U.S. financial institutions." Why not?

"Scale can create value for shareholders; for consumers, who are beneficiaries of better products, delivered more quickly and at less cost; for the businesses that are our customers; and for the economy as a whole."

I don't know of any serious person who believes this to be true for banks above, say, \$100 billion in assets. Charles Calomiris, who studies this stuff, couldn't find anything stronger to back up the economies of scale claim than a study saying that bank total factor productivity grew by 0.4% per year between 1991 and 1997 — a study whose author thinks that the main factor behind increasing productivity was IT investments.

"Artificially limiting the size of an institution, regardless of the business implications, does not make sense."

Uh ... obviously it makes sense. We all know that having banks that are TBTF is bad. One solution is making them smaller. Big banks may (theoretically) have benefits that outweigh the benefits of shrinking them. But shrinking them makes perfect sense unless those benefits are proven.

"To understand the harm of artificially capping the size of financial institutions, consider that some of America's largest companies, which employ millions of Americans, operate around the world. These global enterprises need financial-services partners in China, India, Brazil, South Africa and Russia: partners that can efficiently execute diverse and large-scale transactions; that offer the full range of products and services from loan

underwriting and risk management to providing local lines of credit; that can process terabytes of financial data; that can provide financing in the billions.”

Does Jamie Dimon really believe this? Doesn’t he run a bank when he isn’t writing op-ed articles? The last time Johnson & Johnson issued debt, it used eleven underwriters. The time before that, it used thirteen. (I only chose J&J because it was the example picked by Scott Talbott, a financial industry lobbyist.) Now, do J&J’s dozens of subsidiaries around the world all get local lines of credit from the same bank? Does J&J really want to be dependent on a single source of credit? (Actually, if that single source has a government guarantee, it could do worse.) If that’s actually true, someone please let me know. But the idea that one of the world’s largest companies would need a one-stop shop for financial services is what defies basic business sense.

Now, I’m willing to concede that there is value to having a global investment bank; at the least, you want trading operations covering all the time zones. And I’m willing to concede that there is some minimum scale to having a sophisticated trading and derivatives operation. But I go back to the number \$270 billion. That’s how big Goldman was in 1998, adjusted to today’s dollars. I still haven’t heard a good argument about why the nonfinancial world has changed in a way that requires investment banks that are larger than \$270 billion. I also haven’t heard a good argument why a \$270 billion investment bank needs to be attached to a \$1.5 trillion domestic retail bank (think of Bank of America).

“Capping the size of American banks won’t eliminate the needs of big businesses; it will force them to turn to foreign banks that won’t face the same restrictions.”

On one level, so what? If big American companies want to do business with UBS — a bank that gets bailed out by Swiss taxpayers when necessary — that’s fine with me, and fine with those companies as well. More seriously, of course, that means that Switzerland should *also* break up its big banks.

“Global economic growth requires the services of big financial firms.”

Just because you keep saying the same thing over and over again doesn't make it true.

By James Kwak

Update: *And here's the response by James Coffman.*

To the editor:

Jamie Dimon's opinion piece, "No more 'too big to fail'," bases its argument on a false dichotomy and glosses over, at best, the very real problem of interconnectedness.

First, the choice facing lawmakers is not an either/or choice between a resolution authority to wind down failing financial institutions and the imposition of artificial and arbitrary limits on the size of such institutions. While the establishment of a resolution authority is probably necessary, it is not a substitute for restructuring the financial system to prevent TBTF institutions in the future and to remove the threat they pose today. The best, most effective and only proven method for doing this is to separate commercial banking, which is supported by the government's guarantee in the form of deposit insurance, from the investment banking function, which involves much greater risk resulting from trading, securitization, development and sale of exotic financial products, etc. If those functions are separated, as they were for nearly sixty years until the 1990's, the market will help control size and risk.

To enhance the ability of market forces to affect size and risk, it is important that investment banks in the future be owned in large part by their employees. If the bankers have their own net worth at stake, they will control the risk the institution assumes. Self-interest is a strong disciplinarian. Investment banks should not be publicly owned. Many of the recent reckless practices can be traced back to the demise of investment banking partnerships. Instead of public shareholders, let them rely on the credit markets and their own equity to finance their activities.

In order for the credit markets to act as a restraining force, all financial institutions should be required to make detailed, uniform and understandable disclosure of their financial activities and balance sheets. Only when such information is available can markets measure risk before lending or investing. The market can discipline risk only when it can measure it.

Finally, Mr. Dimon's statement that the problem of interconnectedness of financial institutions is best handled by a resolution authority would

be funny if it weren't so dangerous and disingenuous. How can a resolution authority cure the interconnectedness problems of a failed institution that has billions of dollars of unhedged and unbacked credit default swaps or other derivatives outstanding? Interconnectedness problems must be identified and addressed before an institution fails. They can best be identified and measured if the underlying transactions that give rise to interconnectedness are known and understood by markets and regulators before the institution fails. The best means for accomplishing this is by establishing transparent clearing mechanisms and disclosure regimes. The banking industry is currently spending millions of dollars on lobbyists in an attempt to weaken such measures.

Our lawmakers need to resolve to never again allow financial institutions to become too big to fail. With the proper market structures in place, the markets can do that more effectively than micro-regulation. If the markets fail at this task, as they have in the past, regulators will have enough accurate and timely information to resolve such problems without huge slugs of taxpayer money and before such problems pose a threat to the world economy.

Who's Afraid Of A Falling Dollar?

Simon Johnson | 14 Nov 2009

This guest post was submitted by Joe Gagnon, a senior fellow at the Peterson Institute for International Economics. Joe is an expert on international economics has spent a great deal of time studying the effects of exchange rate depreciation. Even if the dollar depreciates sharply in the near term, he argues that is unlikely to have adverse effects – primarily because inflation will stay low.

Pundits and policymakers around the world are wringing their hands over the possibility of further declines in the foreign exchange value of the dollar. Predicting exchange rates is notoriously difficult; there is almost as much chance of the dollar rising next year as of it declining. But if the dollar were to fall further, should we be concerned?

A lower dollar is good news for US exporters and foreign importers and bad news for foreign exporters and US importers. However, if policymakers respond appropriately, there is no reason to fear overall harm either to the US economy or to foreign economies. Indeed, a lower dollar could jumpstart the long-overdue rebalancing of the global economy away from excessive US trade deficits and foreign reliance on export-led growth, putting the world on track for a more sustainable expansion.

The fear in economies that are appreciating against the United States is that a falling dollar will choke off exports and hobble economic recoveries. The correct response is to ease monetary policy and temporarily delay fiscal contraction. As I explain here, even in economies with short-term interest rates near zero, there is plenty of scope for central banks to stimulate aggregate demand, and doing so will help to limit the extent to which the dollar falls.

For the United States, the benefits of a falling dollar are obvious: stronger exports and a faster recovery. The fear is that a falling dollar would be inflationary. However, as I have shown in two recent papers, even very large currency depreciations in developed economies have no effect on inflation unless they are caused by policies that attempt to hold an economy's unemployment rate below its equilibrium level. With US unemployment currently at 10 percent, there is no chance that inflation will rise in the near term. Whether inflation rises in the longer run will depend on whether US monetary and fiscal policy stimulus is withdrawn appropriately as the economy recovers (and tighter

macroeconomic policies would tend to support the dollar). Many believe that US policymakers erred in not withdrawing stimulus soon enough in 2003-05, but policymakers now seem to be keenly aware of this mistake and have expressed their determination not to repeat it. Only time will tell, but my own view is that the Federal Reserve, at least, will not allow runaway inflation.

For economies that peg their currencies to the dollar (notably China) the costs and benefits of a falling dollar are the same as those facing the United States and so is the policy dilemma: how fast to tighten macroeconomic policy as the economy recovers? These economies differ on several dimensions, including financial market development and capital controls, strength of economic ties to the United States, and prospects for economic slack and inflation. These differences will determine the appropriate policy stance. To some extent these economies have forfeited the freedom to adjust monetary policy, but they retain the option of adjusting the levels of their dollar pegs. In some cases, a further decline in the dollar may represent an opportune moment to move to a floating exchange rate.

By Joseph E. Gagnon

One Cost of Too Big to Fail

James Kwak | 16 Nov 2009

A reader pointed out a quick analysis done by Dean Baker and Travis McArthur of the Center for Economic Policy and Research back in September. They estimate the value of being “too big to fail” by looking at the spread between the cost of funds for banks above \$100 billion in assets and banks below that level. The spread averaged 0.29 percentage points from 2000 through 2007, but rose to 0.78 percentage points from Q4 2008 through Q2 2009, an increase of 0.49 percentage points. Alternatively, the spread peaked at 0.69 percentage points from Q4 2001 through Q2 2002 at the end of the last recession; by comparison, the spread this time around was only 0.09 percentage points higher. Using 0.09 and 0.49 percentage points as their low and high estimates, Baker and McArthur come up with an estimate of the aggregate value of being TBTF that ranges from \$6.3 billion to \$34.2 billion per year.

That’s a huge range, and Baker and McArthur say we’ll need to see if the spread comes in over time to see if this represents a true long-term change in the importance of being big.

They also estimate that 9-48% of the big banks’ recent profits are due to the TBTF subsidy. Of course, to that must be added the excess profits that companies can gain simply by being big due to pricing power in oligopolistic markets.

Logically speaking large banks could plausibly provide benefits that outweigh these costs. I just haven’t seen many attempts at quantification of such benefits.

By James Kwak

Economics Puzzler of the Day

James Kwak | 16 Nov 2009

Gretchen Morgenson of The New York Times (hat tip Calculated Risk) reports that the recent Worker, Homeownership and Business Assistance Act of 2009 (which included the expansion of the homebuyer tax credit) included a curious tax break for money-losing companies:

“a tax break that lets big companies offset losses incurred in 2008 and 2009 against profits booked as far back as 2004. The tax cuts will generate corporate refunds or relief worth about \$33 billion, according to an administration estimate.

“Before the bill became law, the so-called look-back on losses was limited to small businesses and could be used to counterbalance just two years of profits. Now the profit offset goes back five years, and the law allows big companies to take advantage of it, too.”

Morgenson focuses on the fact that some of the biggest beneficiaries will be the massive home-building companies that raked in huge profits during the height of the boom, and that they have no apparent plans to hire new workers. “After spending its \$210,000, Pulte will receive \$450 million in refunds. And Hovnanian, after spending its \$222,000, will get as much as \$275 million.” (If you’re not enraged by the behavior of some of these companies, you should read Chapter Five of Our Lot by Alyssa Katz.)

But leaving aside the link to home builders, here’s the puzzler: what’s the plausible economic justification for this tax break?

We generally allow tax loss carry-forwards, which means that if a company loses money in one year it can count that loss against the profit it makes the next year. I can think of a few plausible justifications for this policy. The first is that tax years are arbitrary and it’s more fair to tax profits without regard to specific timing. The second is that without such a policy, companies would have even more motivation to cook their books to smooth out their profits over time than they already do. The third is that this helps startup companies that tend to lose money early in their lives, and we want to help startups.

What about tax loss carry-backs, where you get to match losses this year against profits in previous years and claim a cash refund? I guess

the fairness consideration still applies. The second doesn't, or it's much weaker, because the right incentive is already in place because of the carry-forward policy. The third doesn't apply. Actually, the opposite applies. Either the company will turn a profit in the future, in which case it will be allowed to take advantage of the carry-forward. Or it will never turn a profit in the future, in which case this is a huge benefit — but why do we want to be helping companies that will never turn a profit again?

Finally, though, what happens when you switch from a regime without carry-backs to a regime with carry-backs? In this case, you end up writing \$33 billion of checks to a group of companies that are selected solely on the basis that they are losing money now but made money in the past five years. Of all of the ways that the government could spend money to (a) stimulate the economy or (b) help people, how did this one make the cut?

By James Kwak

Steve Randy Waldman on Financial Regulation

James Kwak | 16 Nov 2009

I would like to strongly recommend Steve Randy Waldman's recent post on "Discretion and Financial Regulation." He begins like this: "An enduring truth about financial regulation is this: Given the discretion to do so, financial regulators will always do the wrong thing." It gets better from there.

In fact, I'd recommend it over anything I've written this morning, so why don't you head over now.

By James Kwak

Banking In A State

Simon Johnson | 17 Nov 2009

“Banking on the State” by Andrew Haldane and Piergiorgio Alessandri is making waves in official circles. Haldane, Executive Director for Financial Stability at the Bank of England, is widely regarded as both a technical expert and as someone who can communicate his points effectively to policymakers. He is obviously closely in line – although not in complete agreement - with the thinking of Mervyn King, governor of the Bank of England.

Haldane and Alessandri offer a tough, perhaps bleak assessment. Our boom-bust-bailout cycle is, in their view, a “doom loop”. Banks have an incentive to take excessive risk and every time they and their creditors are bailed out, we create the conditions for the next crisis.

Any banker who denies this is the case lacks self-awareness or any sense of history, or perhaps just wants to do it again.

The Haldane-Alessandri “doom loop” is fast becoming the new baseline view, i.e., if you want to explain what happened or – more interestingly – what can happen going forward, you need to position your arguments relative to the structure and data in their paper.

For example, at Mr. Bernanke’s reconfirmation hearing, these issues will come up in some fashion. The contrast between the hard-hitting language of the “doom loop” and Ben Bernanke’s odd statements on the dollar yesterday could not be more striking. Still, there is no reason to regard the Haldane-Alessandri version of the doom loop as the final word; in fact, this where the debate now heads. (This link gives a useful introduction to relevant aspects of banking theory, as well as Eric Maskin’s insightful personal take.)

To help move the discussion forward, here are some issues for Banking on the State raised in discussions with top experts (who prefer to remain anonymous):

1. The authors say that it is clear, in retrospect, that banks were excessively leveraged. But how did regulators/supervisors miss the implications of this at the time? Banks’ balance sheets started expanding from 1970 onwards (page 3) and by 2000 “balance sheets were more than five times annual UK GDP.” This was not an overnight development – see the last sentence on page 8 which says “Higher leverage fully accounts for the rise in UK banks’ return on equity up until 2007” . It may be difficult for a central

banker to come clean on who convinced whom that modern banking in this form is safe - but at a minimum the authors should draw lessons from earlier failures of regulators/supervisors when discussing prospective changes in the framework of regulation. Could some of the changes being proposed suffer the same fate as all previous attempts to regulate big banks? It seems the authors answer is that just moving things to Pillar I (from Pillar II) will help. This sounds like wishful thinking.

2. The author are right that US banks faced a leverage ratio constraint, which European banks did not. But US banks circumvented this by setting up SIVs – see the damage at Citi for details. Again, what were the regulators/supervisors thinking when they allowed this?
3. The authors assume that the equity owners of banks are almost always protected and therefore “the rational response by market participants is to double their bets”. This does not seem to have been true in practice. For example, why was it so difficult for banks to raise capital after the initial flurry of new capital from Sovereign Wealth Funds (SWFs)? Why did some banks share prices fall so much (Citi, Merrill Lynch, Morgan Stanley, etc)? This cannot not be characterized as a rational response by markets if equity holders were implicitly protected. In fact, new capital (either from the state, or even in some cases from SWFs) came in the form of (expensive) preferred stock and diluted existing holders. The doom loop is surely more about what happens to insiders (rich and powerful bank executives, with strong political connections) and creditors (investment funds run by rich and powerful nonbank executives, with strong political connections).
4. Part of the (relatively) reasonable performance of hedge funds was due to them being forced quite early on to reduce leverage and asset holdings because banks were short of capital and tightened lending conditions. This fortuitously allowed hedge funds to reduce exposure before the crisis became most acute. Haldane and Alessandri seem a little too inclined to believe the hedge funds’ own rhetoric at this stage. This is worrying – the intellectual origins of our last crisis lie with central bankers believing that the private financial sector has evolved into a safer form.
5. To be clear, and a little contrary to what the authors imply: Most hedge funds do not operate with unlimited liability. Often they

have “watermark” provisions, limiting their fees while the fund shows losses. But it is a simple matter to close down a failing fund and, a week or so later, open another (how many funds has John Meriwether closed?). This will feed the next doom loop.

6. The private sector is unlikely to be able to self insure (e.g., various proposals discussed on page 18) because of the potential size of losses in a systemic event. We know there was private insurance for a large portion of the assets (CDOs insured through monolines, for example) but these insurers did not have credible resources. Similarly, implicit state guarantees may also not be sufficient (e.g., Iceland). This suggests strict controls on size of the financial system relative to the economy (and the tax base) may be necessary.
7. The paper is also relatively weak on the role of monetary policy in fuelling the doom loop. But that is relatively easy to add on.

The overall conclusion of the paper follows uneasily from the main analytical thrust. How can we believe that for the regulators, “next time is different”? Most likely, next time will be exactly the same, with different terminology: the financial sector “innovates”, regulators buy their story that risks are now properly managed, and the ensuing bailout (again) breaks all records.

It’s all politics. Unless and until you break the political power of our largest banks, broadly construed, we are going nowhere (or, rather, we are looping around the same doom).

Barney Frank points out that small banks have political clout also, and of course he’s correct that this drives some issues. But how many small banks spend their time (and lobbying dollars) on Capitol Hill insisting that large banks must not be broken up?

Our core problem is that we now have banks that are Too Big To Fail; if you don’t agree, read and publicly refute Haldane. In theory, these big banks could be effectively regulated, but this is a leap of faith that experienced policymakers (e.g., Mervyn King and Paul Volcker) are increasingly unwilling to make.

The biggest banks must be broken up. This is not sufficient to end the doom loop, but it is necessary.

By Simon Johnson

Time For Coordinated Capital Account Controls?

Simon Johnson | 18 Nov 2009

This guest post was submitted by Arvind Subramanian, a senior fellow at the Peterson Institute for International Economics. Arvind is a leading proponent of the view that we need to rethink capital controls - he sees them as central to meaningful macroprudential regulation going forward. (He also has an op ed in today's Financial Times, on climate change, economic development, and the basis for an international agreement.)

The Bretton Woods Committee is organizing a panel (today, Wednesday) on the role of the G-20 in coordinating global growth with speakers from the IMF, US Treasury, and the G-24 group of developing countries. "Global imbalances" (the US current account deficit, the Chinese current account surplus, etc) will be discussed extensively. But I will also raise the question of whether there is a new imbalance in the world economy that threatens emerging markets, and what they should do about it.

Extraordinarily loose monetary policy and the resulting close-to-zero interest rates in many industrial countries are *pushing* capital out to emerging markets—Brazil, China, and India—whose growth prospects are buoyant and relatively unaffected by the crisis. Brazil's currency has appreciated by 30 percent this year, India's stock market soared by 70 percent, and China is once again furiously accumulating foreign exchange reserves, \$62 billion in September.

Now, foreign capital can be good for emerging markets because it brings down the cost of capital for domestic firms, provides finance, facilitates greater investment, and boosts growth. But, as my co-authors and I have shown in two papers, the evidence in favor of foreign capital is awfully hard to find.

In part, this is because foreign capital causes the exchange rate to appreciate which hurts exports, especially in manufacturing, and growth in the long run. Another reason is that domestic financial systems and their regulation are not strong enough to prevent and cope with financial crises that result when foreign capital bolts for the exits. Time and again we have learnt (or rather failed to learn) that large foreign capital flows to emerging markets are not sustainable (Latin America 1982; Asia 1997-98; and Eastern Europe 2008). Think of this: if sophisticated regulatory systems such as those in the US and Europe cannot avoid financial crises, how much more vulnerable are emerging markets?

So, how should emerging market countries respond? Is it time for them to impose serious restrictions on capital flows? In answering these questions, two points must be kept in mind: this policy challenge is going to be around for some time, at least as long as the Fed keeps interest rates low; and second, because the cause of the increased flows is common to all countries, namely Fed policy, it will be a policy challenge not just for individual countries but for emerging markets as a group.

Chile in the early 1990s and Malaysia in the wake of the Asian financial crisis in the late 1990s are the two poster boys for serious capital account restrictions. The evidence on their effects—in limiting flows and preventing currency overvaluation—is contested because restrictions can be circumvented. But Carmen Reinhart and Nicholas Magud suggest that their effects cannot be dismissed.

Going forward, there is the technical question of how best to design restrictions on flows: Should they be price-based or quantity-based? What kinds of flows are best addressed, debt or portfolio? When should they be withdrawn? The IMF should deploy its considerable technical expertise to help answer these questions.

But there is also the political issue of removing the stigma from countries that want to impose serious capital controls. Brazil recently botched its attempt at such controls because the policy action was half-hearted, anxious about the reaction of markets. One possibility could be *coordinated* restrictions on capital flows action by a set of emerging markets that could be blessed by the G-20. No doubt this would be risky, perhaps even counter-productive, but in these unusual times no policy option should be off limits, at least for discussion.

By Arvind Subramanian

Slow Cat, Fast Mouse

James Kwak | 18 Nov 2009

One of our readers pointed me to a paper by Edward Kane with the unfortunately complicated title “Extracting Nontransparent Safety Net Subsidies by Strategically Expanding and Contracting a Financial Institution’s Accounting Balance Sheet.” The paper is an extended discussion of regulatory arbitrage — not the specific techniques (such as securitization with various kinds of recourse) that banks use to finesse capital requirements, but the larger game played by banks and their regulators. This is how Kane frames the situation:

“Regulation is best understood as a dynamic game of action and response, in which either regulators or regulatees may make a move at any time. In this game, regulatees tend to make more moves than regulators do. Moreover, regulatee moves tend to be faster and less predictable, and to have less-transparent consequences than those that regulators make.

“Thirty years ago, regulatory arbitrage focused on circumventing restrictions on deposit interest rates; bank locations; charter powers; and deposit institutions’ ability to shift risk onto the safety net. Probably because regulatory burdens in the first three areas have largely disappeared, the fourth has become more important than ever. Today, loophole mining by financial organizations of all types focuses on using financial-engineering techniques to exploit defects in government and counterparty supervision.”

Large banks can increase the benefit to them of the government safety net by becoming larger, more complicated (less transparent to regulators), and more politically powerful; yet, as Kane observes, they do not exhibit increasing returns to scale. The implication? “As institutions approach and attain TDFU [too difficult to fail and unwind] or TBDA [too big to adequately discipline] status, value maximization leads them to trade off diseconomies from becoming inefficiently large or complex against the safety net benefits that increments in scale or scope can offer them.” In other words, mega-banks take on the inefficiencies of being complicated, unwieldy, bureaucratic, etc. because they are compensated for by greater safety-net benefits.

In this interpretation, the point of structured finance is not just to reduce capital requirements, but to make it harder for regulators to estimate systemic risk implications and easier for them to ignore what is going on. Unfortunately, regulators do not face incentives that motivate them to take appropriate corrective action. Instead, “history shows that top supervisory officials that respond in a market-mimicking way [that is, the way private creditors would respond] to these signals [of financial deterioration] at TDFU firms must expect to be pilloried rather than praised both in congressional hearings and in the press.” Instead, Kane proposes that heads of regulatory agencies be paid in part through deferred compensation that would potentially be forfeited based on the performance of the institutions they supervised during the subsequent years, including the years after they left office.

One conclusion we can draw is that the bigger and more complex a bank, the harder it will be for regulators to adequately monitor what is going on, and this is one reason that banks make themselves big and complex (it doesn’t just happen by itself). This seems important to bear in mind in assessing the likelihood that current regulatory reform proposals will do the job they are supposed to do.

By James Kwak

What Did TARP Do?

Simon Johnson | 19 Nov 2009

This morning, starting at 9:30am, the Congressional Oversight Panel holds a hearing to assess the performance of the Troubled Asset Relief Program (TARP). The hearing will be streamed live and also archived, featuring testimony from: Dean Baker (Center for Economic and Policy Research), Charles Calomiris (Columbia University), Alex Pollock (American Enterprise Institute), Mark Zandi (Moody's Economy.com), and me.

In late September 2008, Secretary of the Treasury Henry S. Paulson asked Congress for \$700 billion to buy toxic assets from banks, as well as unconditional authority and freedom from judicial review. Many economists and commentators suspected that the purpose was to overpay for those assets and thereby take the problem off the banks' hands – indeed, that is the only way that buying toxic assets would have helped anything. Perhaps because there was no way to make such a blatant subsidy politically acceptable, that approach was shelved.

In any case, after the TARP was passed on October 3, 2008, it was quickly overtaken by events. First the UK announced a bank recapitalization program; then, on October 13, it was joined by every major European country, most of which also announced loan guarantees for their banks. On October 14, the US followed suit by using TARP to fund injections of capital into banks, as well as unlimited deposit insurance (for non-interest-bearing accounts), and guarantees of new senior debt.

The overall US policy response to the crisis did well in terms of preventing spending from collapsing. Monetary policy responded quickly and appropriately. After some initial and unfortunate hesitation on the fiscal front, the stimulus of 2009 helped to keep total domestic spending relatively buoyant, despite the contraction in credit and large increase in unemployment. This was in the face of a massive global financial shock – arguably the largest the world has ever seen – and the consequences, in terms of persistently high unemployment, remain severe. But it could have been much worse.

There is no question that passing the TARP was an essential element in restoring confidence. In some countries, the government has the authority to provide fiscal resources directly to the banking system on a huge scale, but in the United States this requires congressional approval.

In other countries, foreign loans can be used to bridge any shortfall in domestic financing for the banking system, but the U.S. is too large to ever contemplate borrowing from the IMF or anyone else.

But if any country provides unlimited government support for its financial system, while not implementing orderly bankruptcy-type procedures for insolvent large institutions, and refusing to take on serious governance reform and downsizing for major troubled banks, it would be castigated by the United States and come under pressure from the IMF.

At the heart of every crisis is a political problem – powerful people, and the firms they control, have gotten out of hand. Unless this is dealt with as part of the stabilization program, all the government has done is provide an unconditional bailout. That may be consistent with a short-term recovery, but it creates major problems for the sustainability of the recovery and for the medium-term. Serious countries do not do this.

Seen in this context, TARP has been badly mismanaged. In its initial implementation, the signals were mixed – particularly as the Bush administration sought to provide support to essentially insolvent banks without taking them over. Standard FDIC-type procedures for failed institutions, which are best practice internationally, were applied to small- and medium-banks, but studiously avoided for large banks. As a result, there was a great deal of confusion in financial markets about what exactly was the Bush/Paulson policy that lay behind various ad hoc deals.

The Obama administration, after some initial hesitation, used “stress tests” to signal unconditional support for the largest financial institutions. By determining officially that these firms did not lack capital – on a forward looking basis – the administration effectively communicated that it was pursuing a strategy of “regulatory forbearance” (much as the US did after the Latin American debt crisis of 1982). The existence of TARP, in that context, made the approach credible – but the availability of unconditional loans from the Federal Reserve remains the bedrock of the strategy.

The downside scenario in the stress tests was overly optimistic, with regard to credit losses in real estate (residential and commercial), credit cards, auto loans, and in terms of the assumed time path for unemployment. As a result, our largest banks remain undercapitalized, given the likely trajectory of the US and global economy. This is a serious

impediment to a sustained rebound in the real economy – already reflected in continued tight credit for small- and medium-sized business.

Even more problematic is the underlying incentive to take excessive risk in the financial sector. With downside limited by generous government guarantees of various kinds, the head of financial stability at the Bank of England bluntly characterizes our repeated boom-bailout-bust cycle as a “doom loop.”

The implementation of TARP exacerbated the perception (and the reality) that some financial institutions are “Too Big to Fail.” This lowers their funding costs, enabling them to borrow more and to take more risk. The consequences appear in your tax bill and your job prospects.

By Simon Johnson

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

Auto Race to the Bottom

James Kwak | 19 Nov 2009

This guest post was contributed by Raj Date, head of the Cambridge Winter Center for Financial Institutions Policy and a former McKinsey consultant, bank senior executive, and Wall Street managing director. For further information on the auto dealer exemption, see the recent study by the Cambridge Winter Center.

Over the past several months, Congress has debated ways to strengthen and rationalize consumer protection in financial services. Central to that debate is the proposed creation of a new agency focused exclusively on this issue, the Consumer Financial Protection Agency (the “CFPA”).

Even among proponents, however, there are varying conceptions of the scope and function of the CFPA. For example, the CFPA as envisioned by the House Financial Services Committee would exclude auto dealers from the CFPA’s coverage. The Administration’s original proposal would have included them. Starting this week, the Senate Banking Committee will have to wrestle with the same question.

They shouldn’t have to wrestle long: Even by the low analytical standards applied to hastily arranged, crisis-driven corporate welfare initiatives, the exemption of auto dealers from the CFPA appears profoundly ill conceived. Exempting auto dealers would simultaneously be bad for consumers, bad for industry stability, and bad for what remaining sense of free-market integrity we still have.

First, and most obviously, exempting auto dealers from the CFPA would be a big step in exactly the wrong direction on consumer protection.

One the central premises of the CFPA is that it would provide comprehensive rule-making — that is, regardless of what a firm chooses to call itself (bank, thrift, finance company, ILC, investment bank, broker — whatever), if it sells financial products, then it should be subject to the same rules of the road as every other competitor. Absent the same rules applying to all players, the marketplace becomes a “race to the bottom”: all participants migrate to the most permissive system of rules, and customer practices degrade to the lowest common denominator. (And then one day you wake up, and everyone is marketing teaser-rate option-ARMs).

So by that logic, if auto dealers are selling loans, then they should be subject to the same rules as everyone else.

And auto dealers are certainly selling loans.

Dealers are not a niche part of some obscure and immaterial market; they are the single largest channel (with 79% market share) in the origination of auto loans and leases, a business that (at more than \$850 billion in outstandings) is larger than the entire U.S. credit card industry.

Not only are dealers a giant part of auto lending, but auto lending is a giant part of dealer economics. Over the past ten years, gross profit per new car has plummeted by a third. That would seem catastrophic in what was, even a decade ago, the brutally thin-margin business of selling cars. But dealers, somehow, still were profitable in 2008. The main reason: Over this same period, dealers were able to double their amount of higher-margin finance and insurance income.

Moreover, auto finance is demonstrably susceptible to unfair and deceptive practices, and those practices are demonstrably not held in check by private market forces alone. Just like mortgage brokers during the bubble, auto dealers have the opportunity to mark up interest rates; they routinely and confusingly cross-subsidize finance pricing and vehicle pricing; they can and do add “garbage” fees and add-ons of questionable provenance and dubious value. (Can I interest you in undercarriage coating? How about paint protection?).

So auto dealers are in the business of selling loans — a lot of loans — and their business model is susceptible to abuse. This is not a close call; they should be subject to the same rules as other players.

But this problem goes beyond consumer protection; it goes to the stability of the system.

The auto finance market consists of two basic distribution channels: the dealer (or “indirect”) channel, which is generally funded by a handful of large national banks and Wall Street capital markets platforms; and the retail (or “direct”) channel, which generally consists of credit unions and community banks. By artificially distorting the auto finance market in favor of the dealers’ distribution channel, the exemption encourages the primacy of Wall Street funding sources over traditional bank deposit funding. As evidenced by the crisis, intentionally chasing businesses from traditional banks and credit unions into Wall Street funding models creates the real potential for disruptive volatility over time.

Finally, the exemption also offends even the most basic principles of regulatory fairness. Free-market adherents should be dismayed by the notion of specially permissive regulatory treatment for some classes of politically powerful market participants. We should not be stacking the deck in favor of the already-dominant players with the most dubious customer practices (auto dealers and the captive finance companies and Wall Street houses that fund them), and thereby discriminating against competitors with more transparent, customer-friendly business models (community banks and credit unions chief among them).

By Raj Date

Written Testimony Submitted To The Congressional Oversight Panel

Testimony submitted to the Congressional Oversight Panel, hearing on “The overall impact of the Troubled Asset Relief Program (TARP) on the health of the financial system and the general U.S. economy,” Thursday, November 19, 2009. ([pdf version](#))

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of <http://BaselineScenario.com>.

Summary

1) In the immediate policy response to any major financial crisis – involving a generalized loss of confidence in major lending institutions – there are three main goals:

1. To stabilize the core banking system,
2. To prevent the overall level of spending from collapsing,
3. To lay the groundwork for a sustainable recovery.

2) IMF programs are routinely designed with these criteria in mind and are evaluated on the basis of: the depth of the recession and speed of the recovery, relative to the initial shock; the side-effects of the macroeconomic policy response, including inflation; and whether the underlying problems that created the vulnerability to panic, are addressed over a 12-24 month horizon.

3) This same analytical framework can be applied to the United States since the inception of the Troubled Asset Relief Program (TARP). While there were unique features to the US experience (as is the case in all countries), the broad pattern of financial and economic collapse, followed by a struggle to recover, is quite familiar.

4) The overall US policy response did well in terms of preventing spending from collapsing. Monetary policy responded quickly and appropriately. After some initial and unfortunate hesitation on the fiscal front, the stimulus of 2009 helped to keep domestic spending relatively buoyant, despite the contraction in credit and large increase in unemployment. This was in the face of a massive global financial shock – arguably the largest the world has ever seen – and the consequences, in terms of persistently high unemployment, remain severe. But it could have been much worse.

5) There is no question that passing the TARP was the right thing to do. In some countries, the government has the authority to provide fiscal resources directly to the banking system on a huge scale, but in the United States this requires congressional approval. In other countries, foreign loans can be used to bridge any shortfall in domestic financing for the banking system, but the U.S. is too large to ever contemplate borrowing from the IMF or anyone else.

6) Best practice, vis-à-vis saving the banking system in the face of a generalized panic involves three closely connected pieces:

1. Preventing banks from collapsing in an uncontrolled manner. This often involves at least temporary blanket guarantees for bank liabilities, backed by credible fiscal resources. The government's balance sheet stands behind the financial system. In the canonical emerging market crises of the 1990s – Korea, Indonesia, and Thailand – where the panic was centered on the private sector and its financing arrangements, this commitment of government resources was necessary (but not sufficient) to stop the panic and begin a recovery.
2. Taking over and implementing orderly resolution for banks that are insolvent. In major system crises, this typically involves government interventions that include revoking banking licenses, firing top management, bringing in new teams to handle orderly unwinding, and – importantly – downsizing banks and other failing corporate entities that have become too big to manage. In Korea, nearly half of the top 30 pre-crisis chaebol were broken up through various versions of an insolvency process (including Daewoo, one of the biggest groups). In Indonesia, leading banks were stripped from the industrial groups that owned them and substantially restructured. In Thailand, not only were more than 50 secondary banks (“Finance Houses”) closed, but around 1/3 of the leading banks were also put through a tough clean-up and downsizing process managed by the government.
3. Addressing immediately underlying weaknesses in corporate governance that created potential vulnerability to crisis. In Korea, the central issue was the governance of nonfinancial chaebol and their relationship to the state-owned banks; in Indonesia, it was the functioning of family-owned groups, which owned banks directly; and in Thailand it was the close connections between firms, banks, and politicians. Of the three, Korea made the most progress and was rewarded with the fastest economic recovery.

7) If any country pursues (a) unlimited government financial support, while not implementing (b) orderly resolution for troubled large institutions, and refusing to take on (c) serious governance reform, it would be castigated by the United States and come under pressure from the IMF. At the heart of every crisis is a political problem – powerful people, and the firms they control, have gotten out of hand. Unless this is dealt with as part of the stabilization program, all the government has done is provide an unconditional bailout. That may be consistent with a short-term recovery, but it creates major problems for the sustainability of the recovery and for the medium-term. Serious countries do not do this.

8) Seen in this context, TARP has been badly mismanaged. In its initial implementation, the signals were mixed – particularly as the Bush administration sought to provide support to essentially insolvent banks without taking them over. Standard FDIC-type procedures, which are best practice internationally, were applied to small- and medium-banks, but studiously avoided for large banks. As a result, there was a great deal of confusion in financial markets about what exactly was the Bush/ Paulson policy that lay behind various ad hoc deals.

9) The Obama administration, after some initial hesitation, used “stress tests” to signal unconditional support for the largest financial institutions. By determining officially that these firms did not lack capital – on a forward looking basis – the administration effectively communicated that it was pursuing a strategy of “regulatory forbearance” (much as the US did after the Latin American debt crisis of 1982). The existence of TARP, in that context, made the approach credible – but the availability of unconditional loans from the Federal Reserve remains the bedrock of the strategy.

10) The downside scenario in the stress tests was overly optimistic, with regard to credit losses in real estate (residential and commercial), credit cards, auto loans, and in terms of the assumed time path for unemployment. As a result, our largest banks remain undercapitalized, given the likely trajectory of the US and global economy. This is a serious impediment to a sustained rebound in the real economy – already reflected in continued tight credit for small- and medium-sized business.

11) Even more problematic is the underlying incentive to take excessive risk in the financial sector. With downside limited by government guarantees of various kinds, the head of financial stability at

the Bank of England (Andrew Haldane) bluntly characterizes our repeated boom-bailout-bust cycle as a “doom loop.”

12) Exacerbating this issue, TARP funds supported not only troubled banks, but also the executives who ran those institutions into the ground. The banking system had to be saved, but specific banks could have wound down and leading bankers could and should have lost their jobs. Keeping these people and their management systems in place serious trouble for the future.

13) The implementation of TARP exacerbated the perception (and the reality) that some financial institutions are “Too Big to Fail.” This lowers their funding costs, enabling them to borrow more and to take more risk.

14) The Obama administration argues that its regulatory reforms will rein in the financial sector in this regard. Very few outside observers – other than at the largest banks – find this convincing.

15) In fact, TARP also allowed the US Treasury to make it clear that some individuals are “Too Connected to Fail”. Financial executives with strong connections to the current and previous leadership of the New York Fed (e.g., through network connections of various kinds) have great power and enormous market value in this situation.

16) The US recovery strategy hinges on continued low interest rates (and a continuation of quantitative easing). This creates risks of a new global asset bubble, funded in dollars and driven by exuberance about prospects in emerging markets. The Fed has already signaled clearly that it will not raise interest rates for a long while.

17) Unless bank regulators limit the direct and indirect risk exposure of US financial institutions to this new supposedly low risk “carry trade”, we face the very real prospect of another, even larger crisis.

The remainder of this testimony provides supportive background material, in terms of the global macroeconomic context within which TARP has operated and some important details about the program’s implementation.

Global Macroeconomic Context

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

1. 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.

2. 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.
3. 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.

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.

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.

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.

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.

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.

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.

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.
- 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.

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.

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 and continued regulatory forbearance for banks. This reasoning is flawed.

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.

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?

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.

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.

TARP Specifics

In a financial panic, the critical ingredients of the government response must be speed and overwhelming force. The root problem is uncertainty – in our case, uncertainty about whether the major banks have sufficient assets to cover their liabilities. Half measures combined with wishful thinking and a wait-and-see attitude are insufficient to overcome this uncertainty. And the longer the response takes, the longer that uncertainty can sap away at the flow of credit, consumer confidence, and the real economy in general – ultimately making the problem much harder to solve.

Instead, however, the principal characteristics of the government's response to the financial crisis have been denial, lack of transparency, and unwillingness to upset the financial sector.

First, there was the prominent place of policy by deal: when a major financial institution, got into trouble, the Treasury Department and the Federal Reserve would engineer a bailout over the weekend and announce that everything was fine on Monday. In March 2008, there was the sale of Bear Stearns to JPMorgan Chase, which looked to many like a gift to JPMorgan. The deal was brokered by the Federal Reserve Bank of New York – which includes Jamie Dimon, CEO of JPMorgan, on its board of directors. In September, there were the takeover of Fannie Mae and Freddie Mac, the sale of Merrill Lynch to Bank of America, the decision to let Lehman fail, the destructive bailout of AIG, the takeover and immediate sale of Washington Mutual to JPMorgan, and the bidding war between Citigroup and Wells Fargo over the failing Wachovia – all of which were brokered by the government. In October, there was the

recapitalization of nine large banks on the same day behind closed doors in Washington. This was followed by additional bailouts for Citigroup, AIG, Bank of America, and Citigroup (again).

In each case, the Treasury Department and the Fed did not act according to any legislated or even announced principles, but simply worked out a deal and claimed that it was the best that could be done under the circumstances. This was late-night, back-room dealing, pure and simple.

What is more telling, though, is the extreme care the government has taken not to upset the interests of the financial institutions themselves, or even to question the basic outlines of the system that got us here.

In September 2008, Henry Paulson asked for \$700 billion to buy toxic assets from banks, as well as unconditional authority and freedom from judicial review. Many economists and commentators suspected that the purpose was to overpay for those assets and thereby take the problem off the banks' hands – indeed, that is the only way that buying toxic assets would have helped anything. Perhaps because there was no way to make such a blatant subsidy politically acceptable, that plan was shelved.

After the “Paulson Plan” was passed on October 3, 2008, it was quickly overtaken by events. First the UK announced a bank recapitalization program; then, on October 13, it was joined by every major European country, most of which also announced loan guarantees for their banks. On October 14, the US followed suit with a bank recapitalization program, unlimited deposit insurance (for non-interest-bearing accounts), and guarantees of new senior debt. Only then was enough financial force applied for the crisis in the credit markets to begin to ease, with LIBOR finally falling and Treasury yields rising, although they remained a long way from historical levels.

The money used to recapitalize (buy shares in) banks was provided on terms that were grossly favorable to the banks. For example, Warren Buffett put new capital into Goldman Sachs just weeks before the Treasury Department invested in nine major banks. Buffett got a higher interest rate on his investment and a much better deal on his options to buy Goldman shares in the future.

As the crisis deepened and financial institutions needed more assistance, the government got more and more creative in figuring out ways to provide subsidies that were too complex for the general public to understand. The first AIG bailout, which was on relatively good terms

for the taxpayer, was renegotiated to make it even more friendly to AIG. The second Citigroup and Bank of America bailouts included complex asset guarantees that essentially provided nontransparent insurance to those banks at well below-market rates. The third Citigroup bailout, in late February 2009, converted preferred stock to common stock at a conversion price that was significantly *higher* than the market price – a subsidy that probably even most *Wall Street Journal* readers would miss on first reading. And the convertible preferred shares that will be provided under the new Financial Stability Plan give the conversion option to the bank in question, not the government – basically giving the bank a valuable option for free.

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

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

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

The administration as much as said that the major banks will all pass the stress tests, making it appear that the results were foreordained. Essentially, this was used to signal that the government stood behind the 19 banks in the stress test and would not allow any of them to fail. Effectively, the government signaled which banks were Too Big To Fail.

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

their assets. From the banks' perspective, selling assets at prices below their current book values will force them to take writedowns, hurting profitability and reducing their capital cushion.

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

Ultimately, the stalemate in the financial sector is the product of political constraints. On the one hand, the administration has consistently foresworn dictating a solution to the financial sector, either out of deep-rooted antipathy to nationalization, or out of fear of being accused of nationalization. On the other hand, bailout fatigue among the public and in Congress, aggravated by the clumsy handling of the AIG bonus scandal, has made it impossible for the administration to propose a solution that is too generous to banks, or that requires new money from Congress.

One problem with this velvet-glove strategy is that it was simply inadequate to change the behavior of a financial sector used to doing business on its own terms.

This continued solicitousness for the financial sector might be surprising coming from the Obama Administration, which has otherwise not been hesitant to take action. The \$800 billion fiscal stimulus plan was watered down by the need to bring three Republican senators on board and ended up smaller than many hoped for, yet still counts as a major achievement under our political system. And in other ways, the new administration has pursued a progressive agenda, for example in signing the Lilly Ledbetter law making it easier for women to sue for discrimination in pay and moving to significantly increase the transparency of government in general (but not vis-à-vis its dealings with the financial sector).

And the Obama administration has pushed hard for a new agency to better regulate financial products offered to consumers. This is a commendable effort that is likely to succeed, despite opposition from the

financial sector. Unfortunately, there has been no parallel effort to rein in the economic and political power of our largest financial institutions.

The power of the financial sector goes far beyond a single set of people, a single administration, or a single political party. It is based not on a few personal connections, but on an ideology according to which the interests of Big Finance and the interests of the American people are naturally aligned – an ideology that assumes the private sector is always best, simply because it is the private sector, and hence the government should never tell the private sector what to do, but should only ask nicely, and maybe provide some financial handouts to keep the private sector alive.

To those who live outside the Treasury-Wall Street corridor, this ideology is increasingly not only at odds with reality, but actually dangerous to the economy.

By Simon Johnson

This testimony draws on joint work with Peter Boone, particularly “The Next Financial Crisis: It’s Coming and We Just Made It Worse” (*The New Republic*, September 8, 2009), and James Kwak, particularly “The Quiet Coup” (*The Atlantic*, April, 2009).

CRA Bashing, Nth Generation

James Kwak | 19 Nov 2009

The Community Reinvestment Act is a law originally passed in 1977 that directed federal regulatory agencies to ensure that the banks they supervised were not discriminating against particular communities in making credit available. The onset of the subprime mortgage crisis triggered a flood of sloppy, lazy attacks on the CRA claiming that since the crisis was created by excess lending to the poor, and the CRA was intended to increase lending to the poor, the CRA must have caused the crisis. These arguments suffered from a mistaken premise (subprime lending had a modest negative correlation with income, but many subprime loans were used by the middle class to buy expensive houses in the suburbs and exurbs of California and Nevada) and a failure to check their facts (“Only six percent of all the higher-priced loans were extended by CRA-covered lenders to lower-income borrowers or neighborhoods in their CRA assessment areas, the local geographies that are the primary focus for CRA evaluation purposes.” — Randall Kroszner, former Fed governor appointed by President George W. Bush, in a Federal Reserve study that also found that subprime loan performance was no worse in CRA-covered zip codes than in slightly more affluent zip codes not covered by the CRA.)

Yesterday at a Cato Institute conference, Edward Pinto, chief credit officer at Fannie from 1987 to 1989 and currently a real estate financial services industry consultant (according to recent Congressional testimony), rolled out the new line. The new argument is a curious mirror image of the old argument (which Pinto himself may not have made): now the subprime explosion did not cause the housing bubble, but was caused by the housing bubble and ... wait for it ... the CRA caused the housing bubble, along with the affordable housing goals of Fannie and Freddie.

Before going further, it’s time for my favorite lesson on correlation and causality.

The idea that the housing bubble caused the explosion in subprime lending is not crazy. The worst excesses in mortgage lending happened in 2003-06, after housing prices had already reached historical highs. The idea is that with prices so high, lenders had to offer exotic mortgages (and stop checking for documentation) in order to make the houses affordable for new borrowers. (Of course, there should have been

stronger safeguards against those exotic mortgages — consumer protection enforcement, better credit rating agencies, etc. — but that’s another topic.)

But the weirder part of the argument is that the CRA caused the housing bubble. A policy could push housing prices up by increasing the availability of credit in a way that increases borrowers’ buying power. However, that can only contribute to a bubble if (a) it increases the number of loans that cannot be paid off, making price rises unsustainable and (b) there is some continually-increasing aspect to the policy, without which prices should simply reset at a higher level.

Pinto gets into an argument with the Federal Reserve study (cited above) on the performance of CRA-covered loans, claiming that those loans are doing worse than the Fed claims; I can’t judge that without seeing something in more detail. But even so, there are a few missing elements to the causal chain. One is that the CRA should only have an effect in low-income communities, and unless the people buying houses in the Nevada desert were all people who had been priced out of low-income communities by the CRA, it’s hard to blame the real housing price craziness on the CRA. Another is that the CRA itself has provisions that say that lenders do not have to make loans that are unprofitable. A third is that if the CRA was forcing banks to make unprofitable loans, then you would expect the nonbank lenders to stay out of those market segments; in fact, we saw just the opposite.

Back in 2000, Cato had a different line on the CRA. Jeffrey Gunther wrote an article in a Cato journal arguing that the CRA should stand for “Community Redundancy Act” because competitive forces in the market made it unnecessary — lenders seeking profits would not discriminate against particular communities. Gunther cited subprime lending as an example of the type of profit-seeking innovation that made the CRA unnecessary. He noted exactly what CRA defenders argue today:

“If CRA were the driving force behind the recent increases in home-purchase lending in low-income neighborhoods, we would see evidence of a treatment effect. Lenders subject to the ‘CRA treatment’ [regulated banks] would have refocused their activity toward CRA objectives to a greater extent than lenders in the untreated control group [nonbank lenders]. However, there is little evidence of such a treatment effect. To the contrary, it was lenders in the control group that refocused their efforts in line with the mid-1990s boom in lending in low-income

neighborhoods. In fact, lending in low-income neighborhoods grew faster than other types of lending at institutions not covered by CRA, whereas low-income lending grew at the same rate as other types of lending activity for CRA-covered lenders.”

Gunther’s optimism about subprime lending seems naive in hindsight, although it was shared by many prominent economists and policymakers from Alan Greenspan on down.

For the CRA to be the problem, the causal factor would have to be availability of credit in low-income communities. But from what I’ve read, it seems like today’s problem is no longer redlining — plenty of lenders were willing to lend to the poor. It’s predatory lending — they found that for various reasons it was easier to steer poor people into unnecessarily high-cost loans. Now, I’m no fan of policies to encourage homeownership in general. I think we have too many of them. But the CRA is primarily a policy to discourage discrimination, and that is something we unfortunately still need.

By James Kwak

The AIG-Maiden Lane III Controversy

James Kwak | 20 Nov 2009

As everyone knows by now, Neil Barofsky, special inspector general for TARP, has a new report out on the decision by the Federal Reserve Bank of New York last Fall to make various AIG counterparties (primarily some very big banks with names you know) whole on the the CDS protection they had bought from AIG to cover their risk on some CDOs. The potentially juicy bit has to do with the Maiden Lane III transaction (New York Fed summary here).

There are a couple of details I can't quite reconcile (for example, the Fed balance sheet shows initial funding of \$29.3 billion, but everyone says Maiden Lane III paid \$29.6 billion for the CDOs), but essentially it went like this. The banks had bought CDS protection on \$62.1 billion of CDOs (some of those CDOs they owned — some they did not, meaning those were "naked" CDS*). As of November, the market value of those CDOs was \$29.6 billion. At that point, the banks already held \$35.0 billion in cash collateral from AIG to cover the difference. (If you have a derivatives contract with someone under which your counterparty may have to pay you a huge amount of money, you generally negotiate a term under which the counterparty has to give you money as the trade moves against him, to protect you from default. In this case, a lot of the collateral came from the \$85 billion credit line the Fed gave to AIG in September — otherwise AIG would have gone bankrupt because of collateral calls.)

In the transaction (I'm working off the New York Fed summary), first AIG contributed \$5 billion to Maiden Lane III and the New York Fed gave it a \$24.3 billion loan. Then Maiden Lane III gave all \$26.8 billion to the banks in exchange for the CDOs. (The banks accepted \$26.8 billion because they already held \$35.0 billion in collateral; together that makes \$61.8 billion — as I said, I can't get \$300 million to reconcile.) Then Maiden Lane III gave \$2.5 billion right back to AIG (this is the amount by which AIG had overcollateralized). As part of the deal, the banks agreed to tear up the original CDS on the CDOs, so AIG couldn't lose any more on the CDS (which, remember, are separate from the CDOs).

The controversy is not over paying \$29.3 (or \$29.6) billion for the CDOs, since that was the market price. The controversy is over whether AIG should have agreed to settle the CDS at 100 cents on the dollar (meaning that the banks get the difference between the face value of the

CDOs and their current market value). Bloomberg reported a while back that prior to the government bailout, AIG had been trying to negotiate a settlement at 60-70 cents on the dollar, but that that portion of the term sheet was crossed out in the final agreement. The implication is that paying the swaps off in full was a back-door, off-the-books way of funneling cash to banks that we didn't want to fail.

The argument for the NY Fed is that the banks had legal contracts that entitled them to the money. AIG might have been able to negotiate a haircut because it was going bankrupt and counterparties will take less money up front rather than risk getting even less in bankruptcy. However, once the government stepped in, it had no way to abrogate the contracts. The Agonist has a long post with much more detail than I have provided, arguing in conclusion that Federal Reserve Bank presidents are technocrats, and technocrats abide by the advice of their lawyers, which was almost certainly that AIG had to pay off the swaps in full. (He says the mistake was bailing out AIG in the first place back in September.)

Various people have argued, however, that the Fed could have negotiated a better deal. The Epicurean Dealmaker argues that, given the considerable powers of the Federal Reserve and the federal government in general, the banks could have been intimidated into accepting a modest haircut.

Robert Pozen, in his very worth reading book *Too Big to Save?*, says (p. 79) that AIGFP could have been forced into bankruptcy without putting the rest of AIG into bankruptcy; threatening to put AIGFP into bankruptcy would have provided the leverage to induce the banks to take a haircut. Lucian Bebchuk, a Harvard law professor, argued back in March that because AIG had guaranteed the obligations of AIGFP, this would constitute a default by AIG — but that wouldn't affect AIG's insurance subsidiaries, which could stand alone quite nicely (insurance companies get most of their money from customer premiums, not from debt).

I think that given the state of the world in November 2008, paying the banks off in full was definitely the easy choice — it's always easier to abide by the contract and pay up, especially when you have very deep pockets. And the fact that it helped out the banks as well was probably seen as another argument for it, given the perceived need within the government to bolster the banks' balance sheets by any means necessary.

* Apparently there is some controversy about this. In an interview, Representative Peter DeFazio said the following:

“Geithner would not answer my question when I said, ‘Were those naked credit default swaps by Goldman or were they a counter party?’ He said, ‘I will not answer that question.’”

From the New York Fed web site:

“AIGFP, the LLC and the New York Fed have entered into agreements with AIGFP’s credit derivative counterparties to terminate approximately \$53.5 billion notional amount of credit derivatives and purchase the related multi-sector CDOs. Of these, CDOs with a principal amount of approximately \$46.1 billion settled on November 25, 2008. **Settlement on the remaining \$7.4 billion is contingent upon the ability of the related counterparty to obtain the related multi-sector CDOs** and thereby settle with the LLC and terminate the related credit derivative contracts with AIGFP” (emphasis added).

By James Kwak

Government Debt Hysteria

James Kwak | 20 Nov 2009

I don't spend a lot of time trying to police the economic news media — [Dean Baker](#) and [Brad DeLong](#) are much better on that — but I found myself reading a two-week-old Newsweek column by Robert Samuelson that enraged me enough to type this out. (I read it on old-fashioned paper, but here's the [WaPo version](#).) The title of the WaPo version is "Could America Go Broke?" and here's the last paragraph:

"Deprived of international or domestic credit, defaulting countries in the past have suffered deep economic downturns, hyperinflation, or both. The odds may be against a wealthy society tempting that fate, but even the remote possibility underlines the precariousness and the novelty of the present situation. The arguments over whether we need more 'stimulus' (and debt) obscure the larger reality that past debt increasingly constricts governments' economic maneuvering room."

Deep economic downturns! Hyperinflation! "Precariousness and novelty of the present situation!" You'd think there was some actual reason to be afraid.

But not only does Samuelson provide no evidence that high debt levels lead to disaster, the evidence he does provide *contradicts* his alarmist conclusion. He says, "We have moved into uncharted territory and are prisoners of psychology. Consider Japan." Then he considers Japan — and points out that even though Japan has the highest debt of any advanced economy, interest rates on Japanese debt have fallen to historically low levels. Somehow he says the "correct conclusion to draw" from the Japanese example is that "[major governments] can can easily borrow as much as they want until confidence that they can do so evaporates — and we don't know when, how or whether that may happen."

That's not a conclusion from the Japanese example — that's a truism that Samuelson asserted before the Japanese example and just repeated after it. (How we are on "uncharted territory" when Japan is already on that territory also escapes me.)

Samuelson doesn't say anything that's demonstrably false, because basically his column can be boiled down to this:

“If a government loses the ability to borrow money, bad things can happen. A government will lose the ability to borrow money when people are no longer confident that the government will pay them back. We don’t know when people will lose confidence. It may have something to do with the total amount of government debt, but then again it may not (see Japan).”

But that column is obviously not worth writing. So instead we get hyperinflation.

I’m not a fan of massive and increasing government debts in the abstract, forever. Who is? And there are real arguments to be made on this topic. But that’s not an excuse for empty rhetoric that serves no purpose. But wait — it does serve a purpose — the purpose of scaring people and politicians into *not* doing something about massive unemployment (because doing something might lead to hyperinflation, of course).

(After deciding to write this I realized that Dean Baker beat me to it by two weeks, but I think I’ve added onto what he had to say.)

By James Kwak

Blaming It on Obama

James Kwak | 23 Nov 2009

Last week I wrote a post about “government debt hysteria” that has gotten a lot of attention because of a link from Paul Krugman. (As Felix Salmon, said, “blogging is a lottery on the individual-blog-entry level.”) The main point of last week’s post was not that it’s wrong to be concerned about the national debt (I think everyone is concerned about it — the question is what to do about it and when), but that it’s irresponsible to title a column “Could America Go Broke?” and talk about hyperinflation without providing some evidence, or at least a logical argument that goes beyond tautology, that hyperinflation is something we should be worrying about it.

Here’s something else that’s irresponsible. In that same column, Robert Samuelson says, “The Congressional Budget Office reckons the **Obama administration’s planned budgets** would increase the debt-to-GDP ratio from 41 percent in 2008 to 82 percent in 2019” (emphasis added).

Let’s take a look at that claim. I’m going to work with two versions of the CBO’s Budget and Economic Outlook, published in January 2008 (before we knew we were in a recession) and August 2009, and I’m going to use their baseline numbers, which show debt-to-GDP growing from 40.8% to 67.0% in 2018 and 67.8% in 2019. (I’m guessing Samuelson is citing the CBO’s additional analysis that assumes certain tax cuts will be extended; I’m not using that one because I can’t find the tables in sufficient detail.) I’m not contesting that debt-to-GDP will go up by a lot; I want to see *why* it’s going up. I’m also only going out through 2018 because the 2008 CBO report only went that far.

According to the 2008 report (Table 1-3), the budget from 2009 through 2018 shows an aggregate surplus of \$0.3 trillion. The 2009 report (Table 1-2, PDF page 20) shows an aggregate deficit of \$8.0 trillion, for a difference of \$8.3 trillion.* Where does that come from?

In the 2008 report, discretionary outlays for 2009-18 are \$12.4 trillion. In the 2009 report, that figure is now \$13.7 trillion, for a difference of \$1.3 trillion; that’s the most you can credibly blame on “the Obama administration’s planned budgets” — and even that includes the stimulus package from earlier this year, which was a response to a severe recession.

So where do the other \$7.0 trillion come from? Increases in mandatory spending are \$0.8 trillion. Increases in net interest payments are \$1.5 trillion. But the big whopper is on the revenue side, where revenues are projected to be \$4.6 trillion lower.** That is, you get a picture like this:

So far, of the \$8.3 trillion change in our projected fiscal situation, 16.1% is due to discretionary spending. 56.0% is due to lower revenues caused by ... the recession and the financial crisis.

But wait, that's not all. The increase in the national debt would only be from 40.8% to 60.9% (not 67.0%) of GDP if 2018 GDP remained where it was projected in 2008. However, between the 2008 and 2009 CBO reports, projected 2018 GDP has fallen from \$22.4 trillion to \$20.3 trillion. That's also due to the recession and the financial crisis. A smaller denominator means the same debt becomes a larger proportion of GDP.

In short, the problem is that the economy collapsed. Blaming our increasing debt problems on "the Obama administration's planned budgets," when they are responsible for one-sixth (or one-fifth, if you read footnotes) of part of the problem (the part not due to a shrinking denominator), is deeply misleading. It also leads to the wrong conclusion: cut spending.

What's the right conclusion? Simon, my co-author, has been going around saying that the real cost of the financial crisis would be an increase in government debt of 40 percentage points of GDP. I've been telling him that I'm nervous about that number, because the long-term debt problem has always been with us, and it's called Medicare. Well, it turns out Simon was right. The 2008 CBO report projected that by 2018, debt held by the public would be only 22.6% of GDP. The 2009 report projects 67.0%, for an increase of 44.4 percentage points. (I guess I should have trusted Simon; he is on the CBO's advisory panel, after all.) What happened between those reports? The financial crisis and a severe recession. And if we want to prevent that from happening again, we need to reform our financial system.

* Baseline Scenario readers are likely to have noticed that \$8.3 trillion is a lot more than 26% of GDP (even in 2018), yet the debt figure only goes up by 26 percentage points. The reason is that the CBO's debt figure only counts debt held in public hands; the rest of the increase in the debt is absorbed by Social Security and other government accounts. My point here is only to show the proportional contributions to the increase in the debt.

** You could argue that the Obama budgets should be charged a portion of the change in net interest expense. Since discretionary spending is responsible for about 20% of the change other than net interest, it should be charged 3.6 percentage points of the change in net interest, bringing discretionary spending's total contribution to 19.7% of the \$8.3 trillion.

By James Kwak

Morgan Stanley Speaks: Against Relying On Capital Requirements

Simon Johnson | 24 Nov 2009

Just when momentum was starting to build for increased capital requirements as the core element of an approach that will reign in reckless risk-taking, Morgan Stanley effectively demolishes the idea.

In “Banking – Large & Midcap Banks: Bid for Growth Caps Capital Ask,” (no public link available) Betsy Graseck, Ken Zorbo, Justin Kwon, and John Dunn of Morgan Stanley Research North America dissect the coming demands for more bank capital.

“In short, we think the demand for growth and access to credit will trump desire for unprofitable capital levels...

For the large cap and midcap banks, we expect normalized median common tier-1 ratios to come in at 8.4% and 10.0% respectively.”

That’s less capital than Lehman had just before it failed – 11 percent. (If you doubt this, read the transcript of the final Lehman conference call – [link is in this NYT.com piece](#) or [try this direct link](#); see p.7, for example)

The Morgan Stanley logic is strong, up to a point – they are carefully anticipating the likely outcome of the national and G20 regulatory process that will address capital standards in detail over the next two years. This research report also makes explicit a great deal of the current thinking on Wall Street and explains much – including the attitude towards bonuses.

“Banks need and investors require banks to earn a positive return over their cost of equity to fund them...

These capital levels [8.4% and 10%] driven median ROE [return on equity] estimates of 13.7% and 12.0%, sufficiently over normalized cost of equity of 9-12% to attract investors.”

In other words, if you don’t allow banks to leverage (the flip side of keeping capital low), they won’t be able to attract investors and won’t be able to make loans – so you’ll get less growth and fewer jobs.

This may sound like blackmail but it is not – this is the economics of banking, with spin. And just to make sure you get their bigger point, Morgan Stanley drives it home:

“Contrary to perceptions about [Sheila] Bair’s statements, we do not think there is any willingness to remove implicit support [for big banks]. In particular, we expect the discount window is unquestioned for banks, and TLGP [Temporary Liquidity Guarantee Program] type programs could exist in future crises. Regulators recognize the need for banks to make returns high enough to attract capital.”

And in case you are wondering about the talking points they give their lobbyists and now press upon the White House,

“Even with appropriate leverage, the taxpayer has occasionally paid for the benefit of growth when financial shocks occurred. Repayment comes with subsequent growth.”

The bottom line, translated: let us adjust our balance sheets (downwards to some degree) and continue with our existing business models (including unconstrained bonuses), and we will bring you back to growth eventually. If you mess with us, unemployment will stay high for a long time. And any future crises that may befall us are just a cost of doing business, and making us whole is just what you have to do.

But this is all wrong. The essential premise of the Morgan Stanley reasoning (heard much more widely on Wall Street) is that the size of our biggest banks cannot be constrained – because it would raise the cost of equity for these smaller units. This misses three points:

1. If you are sufficiently small, you can take more risk without jeopardizing the system. So the expected risk/return combination can attract investors and be fine for society. Most successful venture capital funds, hedge funds, and private equity funds are in the right size range from this perspectives and don’t have trouble attracting capital – except when the big banks blow up. As long as you are small enough to fail, go for it.
2. Morgan Stanley’s pricing of risk model implicitly assumes that big banks still exist as a comparison point and an alternative for investors. But if you put a size cap on the largest banks (e.g., assets cannot exceed 1% of GDP), this defines the asset class available –

so investors don't choose small vs. medium vs. large; they choose small vs. medium. Yes, this removes a choice for investors, but we routinely constrain investors ability to put money into activities that are potentially dangerous for society (e.g., try proposing a "new" high risk/high return approach to nuclear power).

3. There will always be financial shocks, but these do not always need to have such devastating effects. Our financial system worked fine in the post-World War II period, with a great deal of risk-taking and much nonfinancial innovation – our biggest banks were much smaller, in absolute terms and relative to the economy. The notion of "let us take any risks we want and, if it all goes bad, bail us out so we can make it up to you later" is simply preposterous and completely at odds with the historical record of US economic development.

The big banks' bonuses undermine their legitimacy. Every time these banks CEOs speak or write in public, they just underline their hubris and the danger this poses to financial system stability. And their own research strengthens the case for breaking up the megabanks.

By Simon Johnson

What's on TV

James Kwak | 24 Nov 2009

Frontline has a program on tonight about the credit card industry, which may be a useful accompaniment to the regulatory reform debate. They include this juicy paragraph in their press release:

"They're lower-income people-bad credits, bankrupts, young credits, no credits," Mehta [former CEO of Providian] says. Providian also innovated by offering "free" credit cards that carried heavy hidden fees. "I used to use the word 'penalty pricing' or 'stealth pricing,'" Mehta tells FRONTLINE. "When people make the buying decision, they don't look at the penalty fees because they never believe they'll be late. They never believe they'll be over limit, right? ... Our business took off. ... We were making a billion dollars a year."

Rings true to me.

By James Kwak

Data on the Debt

James Kwak | 25 Nov 2009

So far, my foray into the world of the national debt has consisted of this:

- Don't try to scare people with hyperinflation unless you have some basis for doing so.
- The recent deterioration in the projected debt situation is mainly due to the financial crisis and recession, not some kind of runaway spending under the Obama administration. (See Econbrowser for the deterioration over the last eight years.)

One of the curious things about the debt scare that is building in the media is that it is happening at a moment when long-term interest rates are very *low*. In other words, it's based on a theory that the market is *wrong* in its collective assessment of the debt situation. I've heard this blamed on "non-economic actors" (that is, foreign governments that buy U.S. Treasuries not as a good investment, but for political reasons), or on a "carry trade" where investors are exploiting the steep yield curve (free short-term money, positive long-term interest rates), as Paul Krugman discusses here.

Menzie Chinn crunches some numbers. He takes a model that he and Jeff Frankel created several years ago to estimate the impact on interest rates of inflation, the future projected national debt, the output gap (economic output relative to potential), and foreign purchases of Treasuries. That last term is important, because the oft-heard fear is that foreign governments will suddenly stop buying our debt.

Using the future growth in the debt projected by the CBO, this model predicts that real interest rates will ... go down by 7 basis points over the next year, assuming foreign purchases of debt are constant. The reason the impact of the debt is so small is that it's already priced in; since the looming debt is no secret, it should already be showing up in the data.

The counterargument is that it hasn't shown up in the data because of the "flight to safety" and foreign governments' irrational purchases of Treasuries. So Chinn also looks at what would happen if foreign purchases of U.S. debt fell to zero, nada, zilch (which is an extreme scenario). In that case, interest rates go up by 1.3 percentage points. That's not nothing, but it still keeps interest rates at reasonable levels by historical standards. In addition, the CBO is already incorporating higher interest rates into their forecasts; they expect the 10-year Treasury bond

yield to go from 3.3% in 2009 to 4.1% in 2010, 4.4% in 2011, and 4.8% in 2012-13, and that's built into their projections of future interest payments.

So I'll say again: none of this is good. But if we're going to make important policy decisions based on fear of the debt, we should have a rational way of thinking about the impact of that debt rather than just fear-mongering.

As for me, this is far from my area of expertise, but the first thing that comes to mind as far as a solution is some kind of binding commitment (or at least as binding as our government can make it) to raise taxes (or undo the Bush tax cuts) when the economy has fully recovered according to some objective metric like the output gap. That and, of course, fixing the health care system.

Updates: Whoops! Link fixed. Also, a reader says I should include the caveat from Chinn's post:

"These estimates were obtained using data that spanned a period without extraordinary Federal Reserve credit easing, and in the face of an unprecedented financial collapse. And, the relationship is not precisely estimated."

This implies that the model may not be accurate. On the broader issue, it's not as if quantitative easing is a secret, nor is it a secret that it's going to end sometime in the next few years. So this isn't something that investors in 10-year bonds don't know about.

By James Kwak

More on Goldman and AIG

James Kwak | 25 Nov 2009

Thomas Adams, a lawyer and former bond insurer executive, wrote a guest post for naked capitalism on the question of why AIG was bailed out and the monoline bond insurers were not (wow, is it really almost two years since the monoline insurer crisis?). He estimates that the monolines together had roughly the same amount of exposure to CDOs that AIG did; in addition, since the monolines also insured trillions of dollars of municipal debt, there were potential spillover effects. (AIG, by contrast, insured tens of trillions of non-financial stuff — people's lives, houses, cars, commercial liability, etc. — but that was in separately capitalized subsidiaries.)

The difference between the monolines and AIG, Adams posits, was Goldman Sachs.

Apparently while all the other banks were paying monoline insurers to insure their CDOs, Goldman wasn't, because the monolines refused to agree to collateral posting requirements (clauses saying that if the risk increased and the insurer was downgraded, it would have to give collateral to the party buying the insurance). Instead, Goldman bought its insurance in the form of credit default swaps from AIG, which was willing to agree to collateral posting requirements, as we all now know. This is one way in which Goldman was smarter than its competitors. Another way, which we also all know, is that at some point in 2007 Goldman began shorting the market for mortgage-backed securities — which would given extra incentive to make sure that they were fully insured.

Until, suddenly in September 2008, it turned out that maybe Goldman wasn't that much smarter than everyone else, when it seemed like AIG might not be able to post the collateral it owed. And so:

"I hate to get sucked into the vampire squid line of thinking about Goldman, but the only explanation i can think of for why AIG got rescued and the monolines did not is because Goldman had significant exposure to AIG and did not have exposure to the monolines."

There's more.

Yves Smith points out (in an update) another possible difference between AIG and the monolines — AIG's business in swaps allowing European banks to reduce their capital requirements, which meant that big European banks had a lot of exposure to AIG.

Another difference might be timing — AIG hit the fan at the same time as Lehman and a week after Fannie and Freddie were taken over. Another difference might be raw size: even if the monolines together were as big as AIG, that's precisely the point — their problems could be spaced out over time, allowing the markets more time to adjust, while AIG would go bankrupt in one big lump.

By James Kwak

Is It 1999 All Over Again?

James Kwak | 25 Nov 2009

The New York Times' Bits blog has a [post on Trefis](#), a Web 2.0 startup that apparently makes it easy for you to create your own valuation model for public companies. They give you starter models using public information, and you can then tweak the assumptions to come up with your own valuation. The pitch is that this puts the tools used by research analysts and professional investors in the hands of the retail investor. "Perhaps these new tools will put some added pressure on the sell-side professionals – many of whom are notorious for creating overly optimistic takes on the companies they follow."

Or maybe they will make retail investors think they have an advantage that they really don't. Advantages in stock valuation have to be based on superior information, which you can get by doing lots of market research (like some old-fashioned hedge funds do) or by having privileged access to company insiders. Superior information can include superior forecasting ability, so if you have some ability to predict the market size for routers better than anyone else, you can make money from it. But neither of these are things you get from models; they are things you plug into models. I'm sure the founders of Trefis don't see it this way, but this feels to me like a great way to lure people into individual stock-picking, and thereby a boon to stock brokers everywhere.

Update: The post also links to an [article about KaChing](#), which makes even less sense to me (except as a smart business idea that preys on people's willingness to believe in the existence of stock-picking genius). According to the article, hundreds of thousands of investors manage virtual portfolios in KaChing, which effectively grades them according to risk-adjusted return and other criteria. Then you can subscribe to someone else's portfolio, so that you make the same trades that she does (there is a monitoring mechanism to make sure that people are putting their money where their mouth is, according to the article), for which you pay an investment management fee to KaChing and presumably a brokerage fee to KaChing's partner.

This is what confused me. Marc Andreessen, an investor in KaChing, said, "The concept is great — the ability to tap into not just the wisdom of the crowd, but to be able to identify and invest with the particular geniuses in the crowd that stand out."

Market prices already reflect the wisdom of the crowd. If you create a small crowd and it doesn't agree with the market, which crowd do you go with? As for particular geniuses, isn't this just a clever way of marketing the coin-flipping phenomenon?

This is clearly why I will never make money investing in stocks.

By James Kwak

How Big Is Too Big?

Simon Johnson | 26 Nov 2009

As legislation on restructuring the banking industry moves forward, attention on Capitol Hill is increasingly drawn to the issue of bank size. Should our biggest banks be made smaller?

Senator Bernard Sanders, an independent from Vermont, introduced the “Too Big To Fail Is Too Big to Exist” bill in early November; this helped focus attention. Since then, in the legislative trenches where the detailed crafting takes place, Representative Paul E. Kanjorski — the Pennsylvania Democrat who is chairman of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises — proposed an amendment to the Financial Stability Improvement Act (currently before the House Financial Services Committee) that

would empower federal regulators to rein in and dismantle financial firms that are so large, inter-connected, or risky that their collapse would put at risk the entire American economic system, even if those firms currently appear to be well-capitalized and healthy.

In a major step forward, this passed the committee on Nov. 18.

The Kanjorski amendment recognizes that the systemic and societal danger posed by banks can be hard to recognize, and it proposes a number of potential objective criteria that could be used by the Financial Services Oversight Council (to be created by legislation in progress) to determine when banks need to be broken up, including the “scope, scale, exposure, leverage, interconnectedness of financial activities, as well as size of the financial company.”

The Kanjorski amendment does not impose a hard size cap on banks, but lawmakers in the House are discussing amendments that would do so.

There is, of course, a strong precedent for capping the size of an individual bank: The United States already has a long-standing rule that no bank can have more than 10 percent of total national retail deposits.

This limitation is not for antitrust reasons, as 10 percent is too low to have pricing power. Rather, its origins lie in early worries about what is now called “macroprudential regulation” or, more bluntly, “don’t put too many eggs in one basket.” This cap was set at an arbitrary level — as

part of the deal that relaxed most of the rules on interstate banking — and it worked well (until Bank of America received a waiver).

Probably the best way forward is to set a hard cap on bank liabilities as a percent of gross domestic product; this is the appropriate scale for thinking about potential bank failures and the cost they can impose on the economy.

Of course, there are technical details to work out — including how the new risk-adjustment rules will be enacted and the precise way that derivatives positions will be regarded in terms of affecting size. But such a hard cap would be the benchmark around which all the specifics can be worked out.

What is the right number: 1 percent, 2 percent, or 5 percent of G.D.P.? No one can say for sure, but it needs to be a number so small that we all agree any politician who cares about our future would have no qualm letting it fail, and when doing so have confidence that our entire financial system is not at risk as it fails.

So to us, 2 percent of G.D.P. seems about right. This would mean every bank in our country would have no more than about \$300 billion of liabilities.

A large American corporation would still be able to do all its transactions using several banks. They would even be better off — competition would ensure that margins are low and the banks give the corporates a good deal. This would help end the situation where banks take an ever-increasing share of profits from our successful nonfinancial corporations (as seen in the rising share of bank value added in G.D.P. in recent decades).

Indeed, the whole world would soon realize that our banks are more competitive and offer better pricing than others.

If, as might occur, the Europeans subsidized their big banks with cheap finance and implicit subsidies, we should let our nonfinancial corporates benefit and understand that our banks may become ever smaller. We can let Europeans subsidize banking because we all get better deals through their taxpayer subsidies, and then our corporates will have more profits to bring back to America.

Today our politicians and regulators lack credibility. They have bailed out too many banks and need to show they have truly regained the upper hand — by showing that they are installing such a hard size cap rule without exception.

The litmus test is simple. Does Goldman Sachs continue to grow, and continue to be regarded as almost as good a risk as the United States government (Goldman's Credit Default Swap spread is only 70 basis points above that of the United States today), because it has demonstrated it is too big to fail? Or, will the government impose a cap on the size of such institutions and require Goldman Sachs to find sensible ways to break itself into pieces – becoming small enough so that it will not be bailed out again next time?

We'll see. Indeed, by the midterm elections, we will have an opportunity to decide. Is the Obama administration in favor of the status quo or, by November 2010 will they have sent a message that "too big to fail" has become "fail if you remain too big"?

By Peter Boone and Simon Johnson

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Does Dubai Matter? Ask Ireland

Simon Johnson | 28 Nov 2009

Presumably the rulers of Dubai and Abu Dhabi are currently locked in negotiations regarding the exact terms that will be attached to a “bailout” for Dubai World. We’ll never know the details but if, as seems likely, the final deal involves creditors taking some sort of hit (perhaps getting 75 cents in the dollar, at the end of the day), does that matter?

Dubai probably has around \$100bn in total liabilities, if we include off-balance sheet transactions, so total credit losses of \$30-50bn need to be assigned. The direct effects so far seem small. HSBC leads the pack, in terms of exposure, but our baseline estimate is a 3 percent loss relative to its equity – not good, but manageable (and the stock already fell 5 percent on the news). The impact among other financial institutions that lent to Dubai seems fairly spread out and mostly within continental Europe.

Korean construction companies and Ukrainian/Russian steelmakers are also affected by the likely fall off in construction activity, but the broader boom in emerging markets is unlikely to be disrupted. The repricing of risk so far does not apply significantly to East Asia or Latin America.

However, there is a worrying impact on Ireland.

The credit default swap spreads for Irish banks have widened significantly — even relative to HSBC, with its direct Dubai involvement. In part, this is hedge funds betting that others will want to insure against the rising risk of an Irish default, but what’s the connection?

The thinking is that a partial bailout – with creditor losses – for Dubai from Abu Dhabi implies something about how Ireland will be treated within the European Union (and the same reasoning is also more vaguely in the air for Greece). This may make sense for three reasons.

1. If Dubai can effectively default or reschedule its debts without disrupting the global economy, then others can do the same.
2. If Abu Dhabi takes a tough line and doesn’t destabilize markets, others (e.g., the EU) will be tempted to do the same (i.e., for Ireland and Greece). “No more unconditional bailouts” is an appealing refrain in many capitals.
3. If the US supports some creditor losses for Dubai (e.g., because of its connections with Iran), this makes it easier to impose losses on

creditors elsewhere (even perhaps where IMF programs are in place, such as Eastern Europe).

The main effect will be to strengthen the hand of Ben Bernanke in Fed policymaking discussions – so US interest rates will stay low for a long while. If financial intermediaries draw the appropriate lessons from Dubai, Ireland, and Greece (and Iceland, the Baltics, Hungary, etc), they will be more careful about extending credit to places that are becoming overexuberant – even when it is cheap to increase debt levels.

But an outbreak of caution and care on the part of our biggest banks (and other investment managers) does not seem likely.

By Simon Johnson

Coordinated Capital Controls: A Further Elaboration

Simon Johnson | 29 Nov 2009

This guest post is by Arvind Subramanian, a senior fellow at the Peterson Institute for International Economics. His recent proposal that countries consider coordinated capital controls has stimulated a great deal of discussion, and here he explains how discouraging capital flows relates to arguments about the attractiveness of a Tobin-type tax.

Paul Krugman, in his Friday column for the New York Times, endorsed a tax on financial transactions, proposed recently by Adair Turner, Britain's top financial regulator. It is important to distinguish this Turner proposal from the original Tobin tax on international flows and these two taxes in turn from the kind of coordinated capital controls I proposed in this blog post two weeks ago.

Tobin's original idea was to discourage speculation by taxing flows of international capital. The Turner variant is to tax all financial transactions, domestic and international. What they have in common is that both are seen as structural measures to be applied regardless of the state of the macroeconomic cycle.

In contrast, the capital controls that are now being proposed are more in the spirit of "macroprudential" measures, to be taken in response to *surges* in international capital flows (and not to steady and permanent flows) to emerging markets that have the potential of creating bubbles in asset prices, including exchange rates. Such measures are therefore intended to be taken during the upswing of the cycle and not at all times.

The case for a number of emerging market countries coordinating such measures under the auspices of the G-20 is to avoid the stigma of being labeled market-unfriendly, a stigma that is a consequence of the strong—but misguided—belief system that all foreign capital in all quantities is always good. This is important because the magnitude of the tax that emerging market countries may need to impose could be substantial in magnitude and not-so-short-term in duration. Effectively deterring inflows would require a tax that has to substantially narrow the return differentials that drives flows in the first place. With near zero interest rates in the US, these differentials could be as high as 5-7 percent for a typical emerging market country and could persist because the US Fed is likely to keep rates low for some time. Few countries would be willing, on their own, to risk imposing such "drastic" measures.

A second argument for coordination is that if only a few countries threw “sand in the wheels” (to use Tobin’s famous phrase) of international finance, the flows could simply be diverted to other emerging market destinations, aggravating the problem for them.

Clearly the magnitude and type of action should vary across countries depending on their macroeconomic situation and the alternative policy choices available to them: for example, if capital inflows are creating a housing bubble, then one country may be able simply to take prudential measures such as higher provisioning requirements for real estate lending but another may have to stop or moderate the flows in the first place.

But a third argument for coordination is that the magnitude of the tax that any one country imposes will also depend on actions taken by other emerging markets. For example, the more China persists with its exchange rate policy, the less willing other emerging market countries will be to allow their currencies to appreciate, and therefore the stronger the brakes that they may have to apply. Coordination will also serve as an accountability mechanism for emerging market countries. To prevent indiscriminate controls, countries should be able to justify their actions to each other. For example, Korea may have less basis for applying taxes than say Brazil, whose currency has appreciated more significantly.

Fourth, an important risk with taxing inflows is that it simply leads to the tax or restriction being evaded (through under or over-invoicing of trade) or to transactions shifting offshore. Coordination, including the cooperation of industrial country jurisdictions to which these transactions could shift, could then become a way of minimizing this risk (it can never really be eliminated) of such circumvention of controls. The possibility of evasion or circumvention of restrictions on inflows cannot in itself be decisive in rejecting restrictions. We do not abandon levying income or other taxes just because they can be evaded, we just design and implement them in a manner that maximizes their impact while minimizing the risks of evasion.

Paul Krugman noted in his column that United States officials are dead set against the financial transactions tax. For the same reason, they are likely to oppose actions by emerging market countries to impose and coordinate controls on foreign flows. Another test for the G-20 looms. If it, and the old G-7 within it, can respond to emerging market concerns we can be hopeful. Otherwise, it will just be the G-7 (plus who?) all over again.

By Arvind Subramanian

What's Wrong with Our Health Care Debate

James Kwak | 29 Nov 2009

Uwe Reinhardt has a post on [Economix](#) that zeroes in on Senator Kay Bailey Hutchinson's criticism of the new mammogram guidelines. Here's the quote from Hutchinson:

"So this task force says all of a sudden we're going to change the guidelines that we have had for all these years. And now the public option may not pay for those, and that means the insurance companies are going to follow. The key is that these are covered by insurance so women will not have to decide if they're going to spend \$250 to get a mammogram because they and their doctors believe it is right to do so."

Basically, the critics of the mammogram guidelines* are bemoaning the fact that certain women may not be able to get mammograms paid for by insurance — without mentioning the fact that many women don't have insurance to begin with.

Or, to paraphrase Reinhardt: If certain medical procedures are so important to people's health — shouldn't everyone get them regardless of income or insurability?

* On which, let me make clear, I have no opinion, nor any qualified basis on which to have an opinion.

By James Kwak

Details

James Kwak | 30 Nov 2009

Now that the financial regulatory reform bills are progressing in both houses of Congress, it means that to really be on top of things, you not only have to read the bills, you have to read the amendments. One example is the Miller-Moore amendment ([full text here](#)), which passed the committee 34-32, only to run into criticism from [Andrew Ross Sorkin](#) and [Yves Smith](#), among others, as well as defenses by [Felix Salmon](#).

The amendment applies to cases where (a) a systemically important (TBTF) financial institution is taken over by the government and (b) the government has to take a loss on the transaction (that is, the assets cannot be liquidated for enough to cover the secured creditors and the insured depositors). In those cases, it says that the receiver can choose to treat up to 20% of a secured debt as unsecured. (A mortgage is an example of secured debt; if you can't pay off your mortgage, the bank gets the house instead. For financial institutions, we are largely talking about repos — transactions where Bank A sells securities to Bank B and promises to buy them back later, which is effectively a secured loan from Bank B to Bank A — and collateral held provided by Bank A to Bank B when derivatives trades move against Bank A.)

Why? One reason is to recover some money for the taxpayer. In the last round of bailouts, the imperative of keeping creditors whole meant that gaps had to be filled by taxpayer money. But there are two forward-looking reasons as well. One cited by Representative Brad Miller himself (in a [comment on Smith's first post](#)) is to deter counterparties from seizing more and more collateral in the last days of a financial institution's death spiral. A related reason that [Salmon discusses](#) is to generally deter financial institutions from relying on repos for their funding needs, since repo funding can evaporate overnight; that's part of what killed Bear Stearns and Lehman Brothers last year.

The concern that some people have, including Smith, is that the fear of a 20% haircut will cause repo funding to dry up sooner and faster than it otherwise would, possibly making banks more susceptible to runs. Miller addressed this fear in [another comment](#). His first point is that the amendment might not even apply to repos, since repos are (on paper at least) sales with an agreement to repurchase, not debt. Even if it does apply, he argues that the amendment will only kick in "even after all shareholders, bondholders and general unsecured creditors lose

everything.” The language of the amendment is “amounts realized from the resolution are insufficient to satisfy completely any amounts owed to the United States or to the Fund.” Since secured creditors’ claims can only be reduced after unsecured debt and uninsured deposits are written down to zero, it seems like we could only get to this point if a bank (a) were overwhelmingly funded by repos to begin with or (b) pledged all of its assets as collateral in a desperate attempt to raise cash right at the end. Furthermore, Miller says the haircuts would be discretionary, meaning that the receiver could choose not to impose them on creditors who had secured debt long before the crash (say, old-fashioned commercial mortgages).

I’m going to stop here, but I would like to give props to Miller for not only reading the blogs but bothering to weigh in on them multiple times. It makes you feel like we actually live in a participatory democracy.

By James Kwak



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