



The Baseline Scenario 2009-12

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Feudal Lords Of Finance

Simon Johnson | 01 Dec 2009

In some influential circles, these questions are now asked: What's wrong with high levels of inequality in general, and with having very rich bankers in particular. After all, human societies have survived the presence of extremely wealthy individuals in the past – in fact, some now argue, the presence of such a “new aristocracy” can finance growth and spur innovation.

This argument is deeply flawed along three dimensions.

1. Such super-elites care very little for anyone other than themselves. Certainly, there will be some charity – but remember that John D. Rockefeller's greatest donations came after he had been dragged through the mud by some very persuasive rakers ([Ida Tarbell](#)).
2. It is a mistake to assume that any country's institutions (the laws, rules and norms that govern behavior) are fixed for all time. In reality, institutions change all the time – partly in reaction to who has wealth and power, and what they are trying to do. What are the odds that our financial super-rich will want to build democracy and strengthen the middle class?
3. Can the rich and powerful really be counted on to save the system, or just themselves? Go back carefully through the early history of the Great Depression (see [Lords of Finance](#)). Certainly the big New York players saved banks and securities firms that were seen to be part of their club (e.g., Kidder Peabody), but they – and the New York Fed – were not so inclined to save financial institutions they regarded as less than central (e.g., [Bank of the United States](#)), even if this meant thousands of people lost their life savings.

When the Bank of England's Andrew Haldane speaks of a “doom loop,” he is describing the declining future for our middle class. Powerful financiers, by and large, did just fine during the Great Depression.

By Simon Johnson

Never a Good Sign

James Kwak | 02 Dec 2009

The board of GM asked Fritz Henderson to resign as CEO. I don't have an opinion on Fritz Henderson. But here's the worrying bit, from the New York Times article:

“Fritz was just not enough of a change agent,’ [a person with direct knowledge of the board's deliberations] said. ‘The board wants a world-class C.E.O. and now they have enough breathing room to find one.’”

Having tried and rejected the inside option (Henderson was a longtime GM executive chosen to replace Rick Wagoner, who was forced out earlier this year), the board is certain to go looking for a superstar CEO from outside the company and probably outside the industry. The phrase “world-class CEO” is always a dead giveaway for delusion.

My favorite source on this is Rakesh Khurana, who wrote a book called Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs, but since you can't read a book for free online I'll quote from a couple of his articles.

The number one pitfall in CEO succession, his research shows, is “missing the chance for organizational introspection.” In other words, it's important to figure out what's wrong with your company, not what you didn't like about your last CEO.

Another common delusion is believing that a superstar CEO can turn around a bad company. As Khurana wrote in an op-ed article several years ago,

“Although we want to believe that a charismatic chief executive will be able to burnish even the most tarnished business, there is no conclusive evidence that a company's top leadership actually has much impact on its performance at all. Studies show that external factors, such as general industry and economic conditions, have a far greater influence over a company's results than does its chief executive.”

The basic issue is that the chances that one person will be able to transform a company of one hundred thousand people are pretty low. Yes, it can happen. It's also possible that your mutual fund manager can

beat the stock market consistently without taking on additional risk. But another pitfall is “equating candidates with their past companies.” To be clear, I think there are many more good CEOs (meaning that they improve their companies) out there than there are good stock mutual fund managers. But having seen them from the inside, CEO searches also suffer from this bias.

Khurana’s op-ed discusses Jack Welch as the prototype of the modern charismatic CEO, and concedes that Welch was a successful CEO. And yes, GE’s stock has plummeted since Welch left. But a lot of that crash has been due to GE Capital, which Welch built up to be the major source of GE’s profits. I haven’t done a minute of research on this, but how much of Welch’s success was due to excessive risk-taking during a boom?

I know I’m a bit of a broken record on this, but it’s probably because of the time I spent in the world of technology startups. It is absolute conventional wisdom among VCs that founder CEOs have to be replaced by “world-class” external CEOs, and that the way to find a world-class CEO is to select among people who have already been CEOs. Yet many promising companies have been killed this way, and when you look at the huge winners, most of what you see are counterexamples — Bill Gates at Microsoft, Larry Ellison at Oracle, Scott McNealy at Sun, Tom Siebel at Siebel, Dave Duffield at Peoplesoft, Steve Jobs at Apple (compared to the outsiders of the 1980s and 1990s), Hasso Plattner at SAP, William Hewlett and David Packard at HP, Robert Noyce and Gordon Moore at Intel, etc.

Khurana also cites Warren Buffett: “Most academic research merely confirms Warren Buffett’s observation that when you bring good management into a bad business, it’s the reputation of the business that stays intact.” Let’s hope that GM proves Buffett wrong — especially since I believe we own most of it.

By James Kwak

Iron Cage for Nothing

James Kwak | 02 Dec 2009

When I gave away many of my old books a year ago, I kept my college copy of Max Weber's *The Protestant Ethic and the Spirit of Capitalism*. Now Tyler Cowen cites a paper by Davide Cantoni demonstrating that Protestantism had nothing to do with economic development. (Cantoni also co-authored a paper with Simon and others on the impact of the French Revolution — via the Napoleonic conquests — on economic development.) He uses the “natural experiment” created by the division of the Holy Roman Empire (very roughly, modern-day Germany and Austria) into Protestant and Catholic states.

As a fan of Weber and a former historian, the first thing I checked was Cantoni's treatment of Calvinism vs. Lutheranism. The last chapter of *The Protestant Ethic*, “Asceticism and the Spirit of Capitalism,” focuses on Calvinism: “For everyone without exception God's Providence has prepared a calling, which he should profess and in which he should labour. And this calling is not, as it was for the Lutheran, a fate to which he must submit and which he must make the best of, but God's commandment to the individual to work for the divine glory” ((London: Unwin Paperbacks, 1985), p. 160). Section 4.4 and Table 8, however, find no difference either between Calvinist (Reformed) cities and all other cities, or between Calvinist and Catholic cities.

A defender of Weber could argue that what he was really talking about was the English strain of Calvinism known as Puritanism; that last chapter starts off by talking about English Puritanism only as an ideal type of Calvinism in general, but it when it talks about real economic impact it is mainly about England and the North American colonies (us). But tying the “Protestant ethic” to one historical form of Calvinism weakens Weber's thesis considerably, since religious doctrine can no longer be seen as the prime mover of economic development.

Which leaves a question. This is probably the most famous passage Weber wrote:

“The Puritan wanted to work in a calling; we are forced to do so. For when asceticism was carried out of monastic cells into everyday life, and began to dominate worldly morality, it did its part in building the tremendous cosmos of the modern economic order. ... In Baxter's view the care for external goods should only

lie on the shoulders of the ‘saint like a light cloak, which can be thrown aside at any moment.’ But fate decreed that the cloak should become an iron cage.”

So could we have gotten the spirit of capitalism without the Protestant ethic? Probably Weber would have said that no matter how you get there, capitalism itself is the iron cage. But maybe not.

By James Kwak

Some Questions For Mr. Bernanke

Simon Johnson | 03 Dec 2009

On Thursday, Ben Bernanke will appear before the Senate Banking Committee, to begin his reconfirmation process as chairman of the Federal Reserve Board.

Based on committee members' public statements, Bernanke already appears to have enough votes on his side. But Thursday's hearing and the subsequent floor debate are an important opportunity for senators to raise important issues about how the Fed will operate moving forward.

This is more than a ritual. Questioning (the monetary) authority and politely insisting on a coherent answer is an important part of our political governance structure – and something that was sorely lacking during the Greenspan era.

There are three possible lines of enquiry that could draw Mr. Bernanke out. These questions could be separate or part of a sequence:

1. Andrew Haldane, head of financial stability at the Bank of England, argues that the relationship between the banking system and the government (in the UK and the US) creates a “doom loop” in which there are repeated boom-bust-bailout cycles that tend to get cost the taxpayer more and pose greater threat to the macroeconomy over time. What can be done to break this loop?

2. Senator Aldrich and the National Monetary Commission explicitly sought to establish a bailout mechanism that would replace the role played by JP Morgan in saving the financial system during the panic of 1907, and Aldrich saw the creation of the Federal Reserve in 1913 as the lynchpin of that system. But this approach has a fatal flaw. As we saw in the 1920s, a lightly regulated financial sector can produce a boom, based on a high degree of debt, that causes major disruption when it crashes and leads to a Great Depression — even if the major banks are (initially) saved. How should we modify the Aldrich system to remove such risks?

3. Mervyn King, governor of the Bank of England, argued in his recent Edinburgh speech that re-regulating the financial system will not effectively reduce its risks. And history suggests that Big Finance always gets ahead of even the most able regulators. Governor King insists instead that the largest banks should be broken up, so they are no longer “too big to fail.” Paul Volcker and Alan Greenspan, in recent statements, have supported the same broad approach. Can you explain why you

differ from Mervyn King, Paul Volcker, and Alan Greenspan on this policy prescription?

In the history books, the Bernanke era at the Fed will be divided into three parts. Through September 2008, Bernanke operated in the shadow of the Greenspan legacy: laissez-faire with regard to bank regulation, taken to the point of absurdity.

In the second phase, once the global financial crisis broke in earnest, Bernanke moved with alacrity to rescue the financial system. History will likely judge him as too generous to the bankers at the center of the mess, but the real point person on bank-by-bank bailouts was NY Fed President/Treasury Secretary Tim Geithner. Bernanke will be reappointed because our Worst Crash did not turn (yet) into a Great Depression.

The third phase is for Mr. Bernanke to decide. Will he become a great reformer, like Marriner S. Eccles in the 1930s, leading the charge to rein in the damage that investment banking, writ large, could cause? Or will his legacy be closer to that of George L. Harrison, head of the New York Fed as the stock market crashed in 1929. Harrison led vigorous efforts – sometimes stretching his legal authority to its limits – to save big banks and by the fall of 1930 was congratulating himself that no major financial institutions had failed. At that point, Harrison thought his work was substantially done; sadly, he was very wrong.

By Simon Johnson

A version of this post appeared on the NYT's Economix this morning and is used here with permission. If you would like to reproduce the entire post, please contact the New York Times.

Buffett and Geithner

James Kwak | 04 Dec 2009

Andrew Ross Sorkin's *Too Big to Fail* sure is a page-turner; even for events that I already knew about in general, it's full of new details and juicy quotations.

For example, on page 508 it lays out the details of Warren Buffett's October 2008 proposal for a "Public-Private Partnership Fund," which would eventually become the PPIP announced by Tim Geithner in March 2009. I knew that Buffett, Bill Gross, and Lloyd Blankfein had supported the idea, but I didn't know the details. Buffett's idea was slightly different from the eventual PPIP.

PPIP ended up having two flavors. In the toxic loan version, the equity would be split 50-50 between private investors and Treasury, and then the FDIC would provide leverage via a non-recourse loan (technically, I think it was some kind of loan guarantee); in the examples, it would be six to one. Buffett, by contrast, proposed leverage of four to one. Like PPIP, money would go first to pay off the government loan. However, then private investors would get all the money, until they had gotten their money back plus the same interest rate that the government got. After that point, investors would get 75% of the upside, and the government would get 25%.

I was curious about how the payoffs differed under these two proposals, so I graphed them. Note that this is for the legacy loans version of PPIP; leverage ratios do matter.

Thin lines are the Buffett proposal, thick lines are PPIP; blue is private investors, red is the government. I assume a single period and a 5% interest rate, but the interest rate doesn't affect the shape of the curves. Private investors get a lot more upside under PPIP, but that's basically because they have a lot more leverage (and hence get wiped out faster on the downside). In PPIP, they contribute 1/14th of the money and get half of the upside; under Buffett's proposal, they contribute 1/5th of the money and get 3/4 of the upside. Curiously enough, the government also does better on the upside with PPIP. That doesn't seem possible, except that the government is putting up a larger proportion of the money in PPIP than in Buffett. So moving from Buffett to PPIP, the returns for private investors and the government both go up, but that's because the weighting is shifting from private investors (the higher returns in either case) to the government (the lower returns).

In the toxic securities version of PPIP, the leverage ratio was lower, bringing the thick blue line down closer to the thin blue line.

There's nothing too scandalous here that I can see. But I thought someone else who made it to page 508 of *Too Big to Fail* might have had the same question, so here's the answer.

By James Kwak

Why Did Bank of America Pay Back the Money?

James Kwak | 04 Dec 2009

Everybody knows by now that Bank of America is buying back the \$45 billion of preferred stock that the government currently owns. While the reason why they are doing this is obvious, I'm going to pretend it isn't for a few paragraphs.

Buying back stock costs money — real cash money. Why would a company ever do such a thing? The textbook answer is that a company should do it if it doesn't have investment opportunities that yield more than its cost of capital. The cash in its bank account, in some sense, belongs to its shareholders, who expect a certain return. If the bank can't earn that return with the cash, it should return it to the shareholders. In this case, though, the interest rate on the preferred shares is only 5%, which is far lower than usual cost of equity. In fact, Bank of America just issued \$19 billion of new stock in order to help buy back the government's preferred stock. The cost of that new equity (in corporate finance terms) is certainly higher than 5%. In other words, Bank of America just threw money away.

In practice, companies buy back stock in order to increase their earnings per share. Fewer shares outstanding and the same earnings mean higher earnings per share and a higher stock price. In theory, this shouldn't work: the benefit of having fewer shares should be exactly balanced by the fact that the company is now worth less (because it has, say, \$45 billion less cash than it had yesterday). But in practice, it seems to work, probably because of signaling. But that doesn't make sense in this case, either, since these are preferred shares that Bank of America is buying back, which have no claim on earnings. In effect, Bank of America is paying off cheap (5%) debt it doesn't have to pay off — and to do that, it's issuing new common shares, which will *dilute* existing shareholders.

Paying back its TARP money also has the effect of making Bank of America weaker. From a liquidity perspective, it now has about \$20-25 billion (\$45 billion minus \$19 billion raised from new equity minus a few billion from other asset sales) less cash than it did before paying the money back. From a capital perspective, using cash to buy back preferred shares reduces your Tier 1 capital ratio. (I know there is disagreement about this, but the term sheet explicitly said that Treasury's preferred shares counted as Tier 1 capital.)

So why?

The answer ... which most of you know already ... is to avoid executive compensation caps. From the Times article:

"It is a particularly delicate time for Bank of America, which has struggled to find a replacement for Mr. Lewis. By paying back the money that it received under the Troubled Asset Relief Program, or TARP, Bank of America will free itself from exceptional federal oversight of its executives' pay — a thorny issue in recruiting a new chief executive."

In retrospect, the executive compensation caps inserted by Congress into the stimulus bill back in February are having a perverse effect. Because the caps applied only to financial institutions that took TARP money — and they applied much more heavily to institutions that received "exceptional assistance," like Citigroup and Bank of America — it tilted the paying field even more heavily against them. This gives them an incentive to take steps that weaken their financial condition, even as conditions in the real economy (to which Bank of America is highly exposed) remain bleak.

I support restrictions on the form of compensation in financial institutions, such as requiring them to be distributed in restricted stock that vests over several years (which is already standard practice at some banks, such as Goldman Sachs) and making bonuses in good years subject to clawbacks in bad years. But those restrictions have to apply to *all* financial institutions, not just some of them; otherwise, you get this situation where Bank of America is making a silly financial decision because it has to in order to hire a new CEO. (The fact that nobody will be CEO of America's largest bank because of executive comp restrictions is another issue, but there's not much we can do about that. I would do it, but I don't want to move to Charlotte.)

Update: Ted K. pointed out to me that Wells Fargo, which is generally considered less of a basket case than Bank of America, is not paying back its TARP money yet.

By James Kwak

Measuring The Fiscal Costs Of Not Fixing The Financial System

Simon Johnson | 05 Dec 2009

This post is a slightly edited version of remarks prepared for delivery at Unwinding Public Interventions in the Financial Sector: Preconditions and Practical Considerations, IMF High-Level Conference, Thursday, December 3, 2009, Washington D.C. I participated in Session 2: Managing Fiscal Risks—Public Finance Aspects of Unwinding.

The Problem

- 1) The underlying fiscal problems of the U.S. have significantly worsened as a direct result of how the financial crisis of 2008-09 was handled.
- 2) The U.S. economic system has evolved relatively efficient ways of handling the insolvency of nonfinancial firms and small or medium-sized financial institutions. A large number of these institutions have failed so far this year, without causing major disruption to the economy.
- 3) The U.S. does not yet have a similarly effective way to deal with the insolvency of large financial institutions. The dire implications of this gap in our system have become much clearer since fall 2008 and there is no immediate prospect that the underlying problems will be addressed by the regulatory reform proposals currently on the table. In fact, our underlying banking system problems are likely to become much worse.
- 4) The executives who run large banks are aware that the insolvency of any single big bank, in isolation, could potentially be handled by the government through the same type of FDIC-led receivership process used for regular banks. However, these executives also know that if more than one such bank were to fail (i.e., default on its obligations), this could cause massive economic and social disruption across the U.S. and global economy. The prospect of such disruption, they reason, would induce the government to provide various forms of bailout. They also invest considerable time and energy into impressing this point onto government officials, in a wide range of interactions.
- 5) 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 implication is repeated bailout and fiscal stimulus-led recovery programs.

6) The implementation of the Troubled Asset Relief Program (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 include a contingent fiscal liability – both for specific bank rescue measures and, on a larger scale, the fiscal stimulus needed to offset a potential future credit crisis.

7) U.S. national debt will increase substantially as a result of direct bank bailouts and, more importantly, the discretionary fiscal stimulus needed to keep the economy from declining – as well as the standard deficit due to cyclical slowdown (a feature of the “automatic fiscal stabilizers.”) Privately held net government debt will increase from around 40 percent of GDP to the 70-80 percent of GDP.

8) 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. Yet this is the approach that the U.S. has implemented.

9) 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. Again, this is the problem in the U.S. looking forward.

10) 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.

Towards a Solution

1) 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?

2) There is 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.”

3) 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).

4) 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.

5) 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.

6) A hard cap at 4 percent of G.D.P. seems about right for a bank with the most conservative possible portfolio. This would mean no bank in our country would have no more than about \$500 billion of liabilities, even with a relatively low risk portfolio. On a risk-adjusted basis, most investment banks would face a cap around 2 percent of GDP.

7) 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).

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

9) If, as might occur, the Europeans subsidized their big banks with cheap finance and implicit subsidies, the U.S. 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.

10) 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.

11) 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 currently around only 70 basis points above that of the United States), 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?

In the Absence of Real Reform

1) Real progress towards reducing the risks inherent in the U.S. financial system is unlikely. As long as there are financial institutions that are Too Big To Fail, we face a potential fiscal cost. We should recognize this in our government budget and balance sheet accounting.

2) The overriding principle behind IMF fiscal assessments is the need to capture true total fiscal costs. Best practice for the U.S. needs to reflect this approach.

3) All subsidies and taxation — including the entire cost of supporting the continued existence of large banks — should be reflected transparently in the budget and subjected to the prioritization of the budgetary process.

4) Our current accounting for guarantees and governments' assumption of other contingent liabilities create the impression that government actions to support the banking system are costless. This is a dangerous illusion — as seen in the recent increase in US federal government deficit and debt.

5) If we don't recognize these costs explicitly, we run the risk of taking on ever more contingent liability. If the financial system reaches the point where its failure cannot be offset by fiscal (and monetary) stimulus, then a Second Great Depression threatens.

6) Next time, we cannot be certain that the available size of fiscal stimulus — either in the US or worldwide — will match the negative shock to demand caused by the credit crisis. Either we will already have too

much debt or we will be constrained by the consequences of taking on even more debt. Or – just as in 1930 – the financial decelerator will simply be too large to be offset by any feasible fiscal measures.

By Simon Johnson

Revolution and Reform

James Kwak | 07 Dec 2009

Many of us bloggers are better at criticizing than at proposing anything — especially when the world makes it so easy to be a critic. The Epicurean Dealmaker, who has sent the occasional volley of criticism my way (I'm not linking to examples because my ego is too fragile), recently decided to deal with this head-on and wrote a "reformist manifesto," complete with an epigraph from *The Communist Manifesto*, with a list of specific proposals.

Basically these include cleaning up the regulatory structure, expanding the scope of regulation (consumer protection, hedge funds), moving "virtually all" OTC derivatives onto exchanges or clearinghouses (I believe that "virtually all" means the currently-proposed exemption for "end-user" hedges would be drastically reduced), and increasing Fed transparency. There is also this one: "Ban political campaign contributions by the financial industry." I think that would be great, although there is at least one constitutional problem and possibly two there.

There's nothing on the list that I disagree with.

However — and there's always a however — I worry that it won't be enough. TED consciously leaves the details to what he hopes will be "strong, competent, and well-informed regulators." Several of his proposals, such as rationalizing Congressional oversight (to eliminate the current situation where the industry can arbitrage between the Senate Agriculture and Banking Committees), should help mitigate the problem of political interference and regulatory capture, but will it be enough? After all, George Stigler's paper on regulatory capture wasn't about the financial sector in particular — it was about all regulation, all the time.

In a sense, this comes down to whether you place more faith in Congress or in regulatory agencies. I know defending Congress is a tough sell these days, but for example they did pass something called the Clean Air Act about forty years ago. And when, under the Bush administration, the EPA decided that greenhouse gas emissions didn't fall under the Clean Air Act, the Supreme Court told the EPA it had to enforce the law. That said, there is also a famous 1984 case in which the Court said that in general regulatory agencies were free to interpret statutes how they choose, so this is not a black-and-white topic.

As far as what I would do instead or in addition, I lean toward Simon and Peter's [earlier post](#), although Simon and I have had some discussion of the details since then.

You'll note that TED's post is not on his personal site, but on [The New Decembrists](#), a new site where he hopes to aggregate discussion regulatory reform in particular. (Bonus points for the historical reference, although that's nothing new for TED.)

By James Kwak

The Importance of Capital Requirements

James Kwak | 07 Dec 2009

Arnold Kling of [EconLog](#) has done the hard work of setting out his theory of the financial crisis and what we should learn from it in a fifty-page but highly readable paper [available here](#). I have some quibbles but think it is worth a read.

Here are the causes of the crisis in one table:

Basically, Kling says that the crisis was composed of the things along the top, which were caused by the things on the left. You can see that he places the blame squarely on poor capital requirements regulations, which gave various banks incentives to (a) originate-to-distribute instead of originate-to-hold; (b) securitize every which way they could; (c) use credit default swaps to reduce capital requirements even further; (d) stuff toxic securities into SIVs; etc.

I was surprised at the low weight Kling places on financial innovation, but this turns out to be a function of his conceptual structure: “Apart from practices that were developed for the purpose of regulatory capital arbitrage, financial innovation played a small role in the crisis.” He categorizes CDOs, credit default swaps, and SIVs as forms of innovation that arose for regulatory capital arbitrage purposes, and so the real villain there is lousy regulations in the first place. I could insert a long discussion here of what it means for something to be a cause of something else. Suffice it to say that at you could argue that the end of the day everything is always the government’s fault, since the private sector *always* does what it does in response to the incentives created by the government; put another way, from a public policy perspective the only actor is the government, since we have no control over the other ones. But I see Kling’s point. (That said, he gives exotic mortgages a pass — I’d be curious to know if he thinks those are also a consequence of bad capital requirements.)

Kling also gives industry structure a relatively low weight, which I think is because he doesn’t think Glass-Steagall would have prevented the crisis. I think he’s probably right there, since Lehman and Bear managed to become too big to fail despite remaining investment banks. (Although I hesitate because if Citi, JPMorgan, and Bank of America were not holding onto trillions of dollars of toxic MBS and CDOs, would the government have had to rescue Bear?) But I think he may overlook the importance of bank size, which made it easier for banks to place bad

bets because of the implicit government guarantee. Which brings up the question: Did bank CEOs before, say, 2007 really make decisions because they thought they were too big to fail? It seems unlikely, but David Wessel does have that great story in *In Fed We Trust* about Goldman Sachs, all the way back in 1991, lobbying to change Section 13(3) of the Federal Reserve Act to allow the Fed to lend to an investment bank in a crisis.

Jumping ahead to the conclusion, Kling doesn't talk a lot about what specifically should be done, but he does have this good distinction:

"If economic stability inevitably gives way to financial euphoria, then it may not be possible to devise a fool-proof regulatory regime. Instead, it may be more effective to aim for a system that is easy to fix than a system that is hard to break. This means trying to encourage financial structures that involve less debt, so that resolution of failures is less complicated. It also means trying to foster a set of small, diverse financial institutions."

As you can imagine, when I see "easy to fix" I think that the key institutions should be smaller so they are not too big to fail. Kling instead focuses on scaling back securitization and the various incentives to take on debt, like the mortgage interest tax deduction and the tax preference for corporate debt over equity. But I don't disagree with most of his recommendations.

My biggest quibble is the emphasis Kling puts on government pressure on Fannie and Freddie to lower their underwriting standards. I think he knows that the truth is somewhere in the middle here. He has a section called "CRA and the Under-Served Housing Market" which, when you read it, barely touches on the CRA (except to make the case that the CRA had nothing to do with the crisis: "Many mortgage loans that met the standards for CRA were of much higher quality than the worst of the mortgage loans that were made from 2004–2007. Thus, one must be careful about assigning too much blame to CRA for the decline in underwriting standards."). Most of the section talks about the deterioration of mortgage underwriting standards in general, without linking that deterioration to the CRA, and the links to Fannie and Freddie are weak. For example, discussing why Fannie and Freddie were not able to stop private lenders from offering no-doc loans, he says:

“This time, the GSEs were not able to take a stand against the dangerous trends in mortgage origination. Their market shares had been eroded by private-label mortgage securitization. They were under pressure from their regulators to increase their support of low-income borrowers. Finally, they had been stained by accounting scandals in which they had allegedly manipulated earnings.”

I think that Fannie and Freddie contributed to the craziness in the mortgage market and to the housing bubble, but that they were relatively small factors compared to the originators themselves and the investment banks that were buying their toxic loans for securitization.

By James Kwak

Gerry Corrigan's Case For Large Integrated Financial Groups

Simon Johnson | 08 Dec 2009

Increasingly, leading bankers repeat versions of the argument made recently by E. Gerald Corrigan in his Dolan Lecture at Fairfield University. Corrigan, former President of the New York Fed and a senior executive at Goldman Sachs for more than a decade, makes three main points.

1. "Large Integrated Financial Groups" – at or around their current size – offer unique functions that cannot otherwise be provided. The economy needs these Groups.
2. Breaking up such Groups would be extremely complex and almost certainly very disruptive.
3. An "Enhanced Resolution Authority" can mitigate the problems that are likely to occur in the future, when one or more Group fails.

These assertions are all completely wrong.

Gerry Corrigan's first claim (p.4), that Large Groups are indispensable, is completely at odds with the data. The current size of our biggest financial firms is a recent phenomenon. In 1998, when Corrigan already worked there, Goldman Sachs was roughly $\frac{1}{4}$ of its current size and was regarded a top international investment bank.

More generally, in the mid-1990s today's big six "Large Integrated Financial Groups" added together had assets worth less than 20 percent of GDP – with no bank being larger than 4 percent of GDP (including off-balance sheet liabilities). Today, these six are over 60 percent of GDP combined and still growing.

What has changed for the better in the functioning of our financial system, in how it assists the real economy, or in how it facilitates government fiscal policy since the mid-1990s?

The financial system worked fine (not great, but fine) in the mid-1990s. It should be rolled back to that level. Hard size caps, as a percent of GDP, are the way to achieve this (e.g., no high-rolling investment bank can exceed 2% of GDP; no boring commercial bank can be bigger than 4% of GDP).

Corrigan's second claim, that breaking up banks would be hard to do, is based on assessing a "straw man" proposal – that the government

dictate the microstructure of any bank downsizing. But no one serious has put forward such an idea.

A hard size cap for total assets would operate just as the hard cap (10%) on share of total retail deposits was envisaged by the Riegle-Neal Act. The bank itself is responsible for complying with this regulation, subject to supervision by the authorities.

If any bank complies with any regulation in a way that reduces shareholder value, its shareholders are going to be very upset. Goldman Sachs is filled to the brim with smart people; they can figure this out.

Corrigan's final claim, that an Enhanced Resolution Authority can deal with the manifest problems of Too Big To Fail, is simply wishful thinking.

It is a fantasy to think that any national Resolution Authority would make a difference. All banking experts, when pressed, agree that you need to have a cross-border Resolution Authority in order to deal with the failure of a Large International Integrated Financial Group. Show me the G20 process in place or any other international initiative that can achieve this faster than in 20 years. (I made this point recently to leading financial officials; one of the most influential people present said, in effect, "it will never happen".)

At moments in his speech, Corrigan is brutally honest.

"First; it is inevitable that at some point in the future, asset price bubbles, financial shocks and seriously troubled financial institutions will again occur." (p.6)

"Unfortunately, events – and not only those associated with the current crisis – have graphically illustrated that the threat associated with financially driven systemic risk has not diminished but has sharply increased [since 1987]" (p.7)

But if you combine that blunt assessment with his policy prescription, what do you get? Our top bankers are publicly and blatantly proposing the recipe for repeated debilitating bailouts. This is an anti-growth and anti-jobs agenda.

By Simon Johnson

How To Kill OTC Derivatives Reform in Two Sentences

Mike | 09 Dec 2009

The post below, which looks like it could be extremely important, is by Mike Konczal, author of the popular (for those in the know) [Rortybomb](#) blog, a previous guest blogger on this site, and now a fellow at the Roosevelt Institute – James

Have lobbyists snuck another major loophole into the OTC Derivatives bill? This week the final touches are being put on Barney Frank's financial regulation bill – [H.R. 4173](#) – "Wall Street Reform and Consumer Protection Act of 2009." One of the centerpieces of this reform is Title III: Over-the-Counter Derivatives Markets Act. And one of the goals of this reform would be to get as many derivatives as possible to trade on exchanges.

An initial hurdle for Barney Frank was what to do with an "end-user exemption." This would exempt certain types of derivative buyers who use derivatives, say corporations hedging interest rate risk without speculating, from the extra scrutiny and regulation that comes with the exchange/clearing system. One of the narratives of financial reform so far has been that this initial end-user exemption was too large a loophole at first, and instead of just handling 10-20% of the market, it would let a large majority of the market sneak through, but ultimately Barney Frank was convinced by consumer groups and people pushing for stronger financial regulation and fixed this issue. See [Noah Scheiber](#) here in "Could Wall Street Actually Lose in Congress?" for this story, and it shows up as well in a recent profile of Barney Frank [in Newsweek](#).

I thought it was a little too early to declare victory, and sure enough instead of attacking and weakening how people will have to use the exchanges, lobbyists have re-focused their attack on the idea of the exchange itself. For a while, reformers have been worried about an "alternative swap execution facility." This would be a way of essentially allowing the current way things are done to be allowed to count as an exchange. Fighting [off this loophole](#) was a battle from a month ago, and it had appeared to be won. Now [many](#) are worried that this language appears to have snuck back into the final bill now.

Colin Peterson (D-MN), Chairman of the House Committee on Agriculture, along with Barney Frank, has added [an amendment to the OTC Bill](#) (opens large pdf). There are two relevant sentences for reformers from the long document. The first is on page 32:

(49) SWAP EXECUTION FACILITY.—The term ‘swap execution facility’ means a person or entity that facilitates the execution or trading of swaps between two persons through any means of interstate commerce, but which is not a designated contract market, including any electronic trade execution or voice brokerage facility.

This replaces other language in the original bill (opens even larger pdf), on page 546:

SEC. 5h. SWAP EXECUTION FACILITIES.

(a) REGISTRATION.—

(1) INGENERAL.—

(A) No person may operate a swap execution facility unless the facility is registered under this section.

(B) The term ‘swap execution facility’ means an entity that facilitates the execution of swaps between two persons through any means of interstate commerce but which is not a designated contract market.

So notice any differences? First the definition of a swap execution facility has been expanded to include “a person” (different from the “or entity”). It’s also expanded to an “or trading” definition, and includes voice brokerage firms. So now we are moving from the definition of something that is a platform for swaps to be traded on to instead something that simply helps swaps get traded. This could, quite simply, be a telephone over which two people trade a derivative (with one person declaring himself to be the exchange?). Instead of changing the way business is done for reform it looks like it redefines reform as the way things are currently done, and just calls it a victory.

Now on page 89 of the amendment:

(2) RULES FOR TRADING THROUGH THE FACILITY.—Not later than 1 year after the date of the enactment of the Derivative Markets transparency and Accountability Act of 2009, the Commission shall adopt rules to allow a swap to be traded through the facilities of a designated contract market or a swap execution facility. Such rules shall permit an intermediary, acting as principal or agent, to enter into or execute a swap, notwithstanding section 2(k), if the swap is executed, reported,

recorded, or confirmed in accordance with the rules of the designated contract market or swap execution facility.

The second sentence here allows an intermediary to execute a swap, ignoring the section 2(k) which is the meat of the reform, as long as the swap is recorded somewhere. Now we already have, from above, that a swap execution facility can be something other than the exchange. This is a rule that guts the regulation right out the door, and for no apparent benefit to reform. Many of these alternative swap facilities will be owned by the banks, so it won't necessarily force the price transparency that has been promised. To trust regulators to simply do the right thing is naive at best when the ability to follow fixed rules is available.

From what I'm hearing, it is possible Frank doesn't even know that this language, once in the bill as an amendment but removed, has snuck back into his reform legislation. Things are moving very quickly on the hill right now, and this is scheduled to be wrapped up by tomorrow. However this new language runs counter to the reforms Frank has promised to deliver to the American people. Either this language needs to be clarified before the bill is complete, or removed entirely.

The Funniest 750 Words of the Financial Crisis

James Kwak | 10 Dec 2009

Hat tips to Uncle Billy and [Felix Salmon](#):

"A FORMER INVESTMENT BANKER ANALYST FALLS BACK ON PLAN B.

"1. Explain why you want to attend law school.

"I want to attend law school because I want to make a difference in the world. My desire to attend law school has nothing to do with the fact that I was recently fired from my job as an analyst at an investment bank, where I worked in the mergers and acquisitions group. Since January, I've worked on approximately one merger, zero acquisitions, have played Spider Solitaire 434 times and updated my Facebook status, on average, five times a day."

It only gets better.

(Unfortunately, I suspect it's about nine months too late — I imagine most analysts at Goldman and Morgan Stanley are quite happy there these days, thank you.)

By James Kwak

Jamie Dimon Has Another Good Year

Simon Johnson | 10 Dec 2009

In May, Jamie Dimon, the head of JP Morgan Chase, told his shareholders that the bank just had probably "our finest year ever." Despite being close to the epicenter of the worst financial crisis since the Great Depression, Dimon's bank was able to make a great deal of money, obtain government support when needed, and reduce that support level quickly when the overall situation stabilized – thus freeing the bank of constraints on its pay packages (and other activities).

It looks like the full year 2009 may turn out even better than Mr. Dimon expected in May. Speaking at the Goldman Sachs US Financial Services Conference on Tuesday (December 8), Jamie Dimon presented JP Morgan Chase's third quarter results (year-to-date). His slides are informative, but if you want to pick up the nuances in his message, listen to the audio webcast (you have to register, but it's free; here are back-up/alternative links).

Mr. Dimon's remarks were informative at two levels: how JP Morgan Chase operates, moving forward; and how that reflects the likely outlook for the US economy.

According to Mr. Dimon, JP Morgan Chase has 6 "standalone pieces": Investment Bank, Retail Financial Services, Card Services, Commercial Banking, Treasury and Security Services, Asset Management (p.3 of his slides). These businesses help each other, although Mr. Dimon was studiously vague about exactly how.

In fact, there is nothing concrete about synergies or economies of scope in the slides. In his oral presentation, Mr. Dimon makes some high level remarks about "business flows and fees" but the exact meaning is unclear. For example, presumably clients of the Asset Management business get the best possible pricing if they buy or sell over-the-counter (OTC) derivatives through the Investment Bank. But then what exactly is the advantage to the client of having these two businesses owned by the same company? There's always more transparency in arms-length transactions.

As Mr. Dimon talks through the various businesses and their prospects, he treats them very much as independent businesses – all dealing with distinct parts of our collective need for very different types of financial services.

Investment banking is performing very well, presumably mostly because of trading activities (the details are not clear, but JPMorgan has a very high market share in OTC derivatives).

The retail bank has become the number one provider of auto loans in the United States, while mortgages and credit cards are doing “really poorly”. Credit losses overall are higher than expected, given the unemployment rate – consumers are not in good shape and the rising losses on prime mortgages (p.14) imply further trouble ahead. Unemployment may fall in the second quarter of 2010, but – in Dimon’s view — it’s too early to say that the overall credit situation has done more than stabilize.

JPMorgan Chase continues to grow, including in credit card services, commercial banking, and asset management. Mr. Dimon doesn’t say this, but the weakness of his competitors creates great opportunity to build an even bigger bank, with more market share and heftier political clout.

His views on the pending legislative/regulation reforms are not in the slides, but from about the 21 minute mark in the webcast, he is quite candid. He doesn’t see major impact on his business from what is in the pipeline, e.g., any kind of progressive capital requirement that would force bigger banks to hold substantially more capital. To the extent there is tougher consumer protection in new legislation, he says – rather bluntly – the consumer will pay the price, not JPMorgan.

Mr. Dimon insists, at minute 23, that we should “get rid of the concept of Too Big To Fail”, and he suggests that a new Resolution Authority – giving government more power to shut down or take over big banks – would make this possible. Unfortunately, he glosses over the “international coordination” issues that make this impossible to achieve in the foreseeable future.

Overall, we are left with a big bank that is getting bigger. It has been (relatively) well run by Mr. Dimon, but there are no assurances for the future. Given that the “Resolution Authority” is at this point a mythical beast – with no potential effect on the problem of “Too Big To Fail” – we should worry a great deal.

We could set a hard size cap on banks like JPMorgan Chase (e.g., on assets relative to GDP), which could force them to find ways to spin-off businesses – and return to the much smaller and more manageable size of the early 1990s. There is no evidence this would be disruptive or cause any economic difficulties. But, for political reasons, this won’t happen

any time soon – the size and power of banks like JPMorgan is put to good use on Capitol Hill.

Massive financial collapses do not emerge unheralded from periods of economic stagnation. They are preceded by great booms, including rapid expansions of “successful” banks.

By Simon Johnson

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

A Partisan Post, You Have Been Warned

James Kwak | 11 Dec 2009

Last night I read a post by [Brad DeLong](#) that made me so mad I had trouble falling asleep. (Not at DeLong, mind you.) There's really nothing unusual in there — hysteria about the deficit, people who voted for the Bush tax cuts and the unfunded Medicare prescription drug benefit but suddenly think the national debt is killing us, political pandering — but maybe it was the proverbial straw.

First, let me say that I largely agree with DeLong here:

“I am—in normal times—a deficit hawk. I think the right target for the deficit in normal times is zero, with the added provision that when there are foreseeable future increases in spending shares of GDP we should run a surplus to pay for those foreseeable increases in an actuarially-sound manner. I think this because I know that there will come abnormal times when spending increases are appropriate. And I think that the combination of (a) actuarially-sound provision for future increases in spending shares and (b) nominal balance for the operating budget in normal times will create the headroom for (c) deficit spending in emergencies when it is advisable while (d) maintaining a non-explosive path for the debt as a whole.”

Now, let me tell you what I am sick of:

1. People who insist that the recent change in our fiscal spending is the product of high spending, without looking at the [numbers](#), because their political priors are so strong they assume that high deficits under a Democratic president must be due to runaway spending. And it's not just Robert Samuelson.
2. People who forecast the end of the world without pointing out why the world is ending. Here's Niall Ferguson, in an article entitled “[An Empire at Risk](#):”

“The deficit for the fiscal year 2009 came in at more than \$1.4 trillion—about 11.2 percent of GDP, according to the Congressional Budget Office (CBO). That's a bigger deficit than any seen in the past 60 years—only slightly larger in relative terms than the deficit in 1942.”

But does he mention that the reason for the 2009 deficit is lower tax revenues due to the financial crisis and recession? No.

Here's Ferguson on the 10-year projection:

"Meanwhile, in dollar terms, the total debt held by the public (excluding government agencies, but including foreigners) rises from \$5.8 trillion in 2008 to \$14.3 trillion in 2019—from 41 percent of GDP to 68 percent."

Does he mention that, as early as January 2008, that number was projected to fall to 22%, and the majority of the change is due to lower tax revenues? No.

3. People who posture about our fiscal crisis who *voted for the Bush tax cuts* — shouldn't shame require them to keep silent?

4. People who say, like Judd Gregg, "after the possibility of a terrorist getting a weapon of mass destruction and using it against us somewhere here in the United States, the single biggest threat that we face as a nation is the fact that we're on a course toward fiscal insolvency," as if this is a new problem, when it's been around since 2004 (see Figure 1) — when, I might add, Judd Gregg was a member of the *majority*.

(Tell me, was Niall Ferguson forecasting the end of the American empire in 2004, when everything he says now about long-term entitlement spending was already true? That's a real question.)

5. People who say that we can't pass health care reform because it costs too much, ignoring the fact that the CBO projects the bills to be roughly deficit neutral, ignoring the fact that the Senate bill has received bipartisan health-economist support for its cost-cutting measures, and ignoring the fact that our long-term fiscal problem is, and always has been, about health care costs (see Figure 2).

6. People who say the Obama administration is weak on the deficit (Ferguson refers to Obama's "indecision on the deficit", and he is gentle by Republican standards), when by tackling health care costs head-on — and in the process angering their political base — they are doing the absolute most important thing necessary to solve the long-term debt problem.

7. People who cite "financial ruin" purely, absolutely, incontrovertibly as a political tactic to try to kill health care reform (courtesy of DeLong and Brian Beutler):

8. Joe Lieberman.

By James Kwak

House Reform Bill Thread

James Kwak | 11 Dec 2009

As you already know if you read [the news](#), the House version of the financial reform bill will probably come to a vote today, and it should have the votes to pass unless the Republicans/conservative Democrats manage to pass a poison pill amendment — like Walt Minnick's amendment to kill off the CFPRA and replace it with a council of regulators. (I'm not making this up.) The bank lobby moderate Democrats did manage to get federal preemption of state laws, which means that states can't set higher standards than federal regulators and sounds like a bad thing (anyone remember the OTS?), but [Mike Konczal](#) says it might not be as bad as it sounds.

To be honest, I'm not sure what's in this thing at the moment, and who knows how many little loopholes have managed to sneak in, especially when it comes to derivatives regulation. But if it has a meaningful CFPRA (which I'm pretty sure it does), it's a step forward. If it doesn't break up big banks, it's not enough.

By James Kwak

A Few Words on Health Care Reform and Medicare Buy-In

James Kwak | 11 Dec 2009

From Ezra Klein:

“[Doctors] should be forced to work in a way that doesn’t hurt society. That, after all, is the guiding principle behind the insurance reforms: Insurers will have to live with a market that society can live with. Similarly, providers will have to live within a market that society can afford. That will mean a strict budget, at least within the federal programs (and over time, as the private programs become unaffordable, they will probably come on budget as well). ...

“It’s that or national bankruptcy. And the problem, if left untreated, will only get worse, and the eventual correction, when it comes, will only be more severe. That, however, is exactly what they’re asking Snowe, and the rest of Congress, to permit. The fear with Medicare buy-in is that Medicare pays somewhat lower rates than private insurers because it tries to live within a budget, even if it fails. But like it or not, that’s the future, or one variant of it.”

Am I being hypocritical in allowing Ezra Klein to use the words “national bankruptcy?”

I don’t think so, because as I said in the earlier post, the long-term debt problem is, and always has been, about health care costs. The financial crisis and recession didn’t help by adding 40% to our long-term national debt, but in the long term even that pales in comparison to Medicare. So if you are serious about our nation’s fiscal problem, and there is a big, big problem, you have to have a solution to health care — which most of the most strident “deficit hawks” don’t.

Ferguson, for example, goes on ominously about how entitlements (including Medicare) will eventually force us to reduce defense spending, marking the end of our superpower status; but all he says is that we need to balance the budget within the next five to ten years, without saying how, and without mentioning health care. This is silly. Balancing the budget in the next decade would be nice (from a fiscal standpoint), but it’s of questionable relevance. Successful measures to reduce long-term health care costs (“bend the curve”) will have little

impact in the next 5-10 years (although the sooner we start them, the better), so the only way to balance the budget in that timeframe is by tackling second-order problems. There's nothing wrong with solving second-order problems, but it won't solve the long-term problem.

Whenever someone writes about the national debt and the decline and fall of America and doesn't talk about reducing health care costs, I wonder what the purpose of the article was in the first place.

(OK, enough getting worked up. Now I have to do some real work.)

By James Kwak

Yet Another Loophole?

James Kwak | 11 Dec 2009

Read for yourself. Basically Ed Perlmutter and Barney Frank introduced a colloquy into the record that seems to say that the legislative intent of the reform bill is that the CFPB should delegate its examination powers over a given bank (which have already been limited to banks with over \$10 billion in assets) to other regulatory agencies if those other agencies deem that the bank has a strong consumer compliance record. As loopholes go, I don't think this is anywhere near the most toxic. (I guess the justification for this would be that it allows the CFPB to focus its resources on the largest banks, rather than banks with \$11 billion in assets.)

But my favorite part of the article was this:

"[Perlmutter's communications director Leslie] Oliver said there was no connection between the campaign contributions and Perlmutter's actions. 'He is campaigning. He accepts campaign contributions. Look at the totality of his campaign contributions,' she said." Of the \$28,500 committees donated to his campaign in October, more than two-thirds came from the financial services industry."

For the current election cycle, he has received the most money from the finance/insurance/real estate sector (\$160,000), with lawyers and lobbyists second (\$88,000). Labor is third at \$75,000.

By James Kwak

I Can Now Retire from Blogging

James Kwak | 12 Dec 2009

(Not that I'm about to.)

Brad DeLong: "James Kwak Is Now Grand Heresiarch of the Ancient, Hermetic, and Occult Order of the Shrill!!"

By James Kwak

The Remarkable Ms. Warren

James Kwak | 13 Dec 2009

She's probably already said this before, but I just saw this in an [interview by Tim Fernholz](#), which I completely agree with:

"There are a lot of ways to regulate 'too big to fail' financial institutions: break them up, regulate them more closely, tax them more aggressively, insure them, and so on. And I'm totally in favor of increased regulatory scrutiny of these banks. But those are all regulatory tools. Regulations, over time, fail. I want to see Congress focus more on a credible system for liquidating the banks that are considered too big to fail."

But what really caught my eye was this: "I'm teaching my classes, doing my research, and helping out where I can." I always assumed she took a leave from Harvard Law School when she became chair of the TARP Congressional Oversight Panel. Now that is remarkable.

By James Kwak

New Deal for U.S. Climate Policy?

James Kwak | 14 Dec 2009

This guest post was submitted by James K. Boyce, an economist at the University of Massachusetts, Amherst. He has been a proponent of a “cap-and-dividend” policy to curb global warming while protecting the incomes of American families.

Last Friday, Senators Maria Cantwell (D-WA) and Susan Collins (R-ME) unveiled the CLEAR (Carbon Limits and Energy for America's Renewal) Act, which could break the impasse in the debate over U.S. policy on climate change (McClatchy coverage is [here](#).)

CLEAR has won a favorable reception from a broad swath of the political spectrum, ranging from ExxonMobil to Friends of the Earth. The scroll of supportive statements on Cantwell's website includes praise from the AARP, the American Enterprise Institute, former U.S. Labor Secretary Robert Reich, Alaska's Republican Senator Lisa Murkowski, and MoveOn.org.

CLEAR is a “100-75-25-0” policy:

- 100% of the permits to bring fossil carbon into the U.S. economy will be auctioned from day one – there are no permit giveaways.
- 75% of the auction revenue is returned directly to the public as equal per person dividends.
- 25% of the auction revenue is devoted to investments in energy efficiency, clean energy, adaptation to climate change, and assistance for sectors hurt by the transition from the fossil-fueled economy.
- Zero offsets are allowed: polluters cannot avoid curbing use of fossil fuels by paying someone else to ostensibly clean up after them.

The Cantwell-Collins bill also strictly limits the buying and selling of permits to prevent carbon market speculation and profiteering.

In all these respects, the 39-page CLEAR Act differs markedly from the Waxman-Markey (ACES) bill that passed the House in June, whose cap-and-trade provisions (Title III) alone run to 410 pages. Waxman-Markey initially gives away 85% of the permits. Dividends to the public eventually would grow to about half of the permit value pie, but not until the 2030s. The House bill's offset provisions would turn the emissions cap into a sieve, and have stoked worries about creating a “subprime carbon market” (see and Annie Leonard's [animated primer](#)).

We need to cap carbon, but we do not need to cap-and-trade or, especially, cap-and-give-away. Instead, we should cap-and-dividend.

The New York Times reported on the legislative sausage-making that went into Waxman-Markey. The redolent process, lubricated by special favors to special interests, has stalled since June with legislative arteriosclerosis; its backers now hope that passage can be cleared by implanting stents to boost nuclear power and transform America into “the Saudi Arabia of clean coal.”

The road to a Senate-led compromise is open: CLEAR could replace Title III of the House bill, while keeping the other titles that set forth non-price policies to promote energy efficiency and clean energy. The resulting comprehensive climate policy could have a real chance of becoming the law of the land – and the air – in the year ahead.

By James Boyce

“Wake Up, Gentlemen”

Simon Johnson | 15 Dec 2009

The guiding myth underpinning the reconstruction of our dangerous banking system is: Financial innovation as-we-know-it is valuable and must be preserved. Anyone opposed to this approach is a populist, with or without a pitchfork.

Single-handedly, Paul Volcker has exploded this myth. Responding to a Wall Street insiders’ Future of Finance “report”, he was quoted in the WSJ yesterday as saying: “Wake up gentlemen. I can only say that your response is inadequate.”

Volcker has three main points, with which we whole-heartedly agree:

1. “[Financial engineering] moves around the rents in the financial system, but not only this, as it seems to have vastly increased them.”
2. “I have found very little evidence that vast amounts of innovation in financial markets in recent years have had a visible effect on the productivity of the economy”

and most important:

3. “I am probably going to win in the end”.

Volcker wants tough constraints on banks and their activities, separating the payments system – which must be protected and therefore tightly regulated – from other “extraneous” functions, which includes trading and managing money.

This is entirely reasonable – although we can surely argue about details, including whether a very large “regulated” bank would be able to escape the limits placed on its behavior and whether a very large “trading” bank could (without running the payments system) still cause massive damage.

But how can Mr. Volcker possibly prevail? Even President Obama was reduced, yesterday, to asking the banks nicely to lend more to small business – against which Jamie Dimon will presumably respond that such firms either (a) are not creditworthy (so give us a subsidy if you want such loans) or (b) don’t want to borrow (so give them a subsidy). (Some of the bankers, it seems, didn’t even try hard to attend – they just called it in.)

The reason for Volcker’s confidence in his victory is simple - he is moving the consensus. It’s not radicals against reasonable bankers. It’s

the dean of American banking, with a bigger and better reputation than any other economic policymaker alive – and with a lot of people at his back – saying, very simply: Enough.

He says it plainly, he increasingly says it publicly, and he now says it often. He waited, on the sidelines, for his moment. And this is it.

Paul Volcker wants to stop the financial system before it blows up again. And when he persuades you – and people like you – he will win. You can help – tell everyone you know to read what Paul Volcker is saying and to pass it on.

By Simon Johnson

Don't Worry About Greece

Simon Johnson | 16 Dec 2009

The latest round of fretting in global debt markets is focused on Greece ([WSJ; Greece](#)). This is misplaced.

To be sure, there will be a great deal of shouting before the matter is formally resolved, but the Abu Dhabi-Dubai affair shows you just where Greece is heading.

The global funding environment (thanks to Mr. Bernanke, Time's [Person of the Year](#)) will remain easy for the foreseeable future. This makes it very easy and appealing for a deep pocketed friend and ally (Abu Dhabi; the eurozone) to provide a financial lifeline as appropriate (a loan; continued access to the "repo window" at the European Central Bank, ECB).

Of course, there will be some conditions – and in this regard the Europeans have a big advantage: the Germans.

Everyone knows the German authorities are tough and hate bailouts (aside: except for their own undercapitalized banks). And the Germans can punish the Greeks with hostile bluster that the bond markets will take seriously – further pushing up Greek bond yields and credit default swap (CDS) spreads.

But, in reality, there are many voices at the ECB table and most of them are inclined to give Greece a deal – put in place a plausible "medium-term framework" and we'll let your banks roll over their borrowing at the ECB, even if Greek government debt (i.e., their collateral) is downgraded below the supposedly minimum level.

So Greece has a carrot and a stick – and refinancing its debt is so cheap in today's Bernanke-world, they will not miss the opportunity.

Greece has become a quasi-sovereign, in the sense that it issues debt not in its own currency. But it still has control over its own cash flow. And most budget math is based on perceptions of plausible baselines that are – in case you didn't already know – more about political perceptions (in this case, within the ECB governing council and perhaps [EcoFin](#)) than likely economic futures.

The important development is the role of the European Central Bank. It is becoming a de facto International Monetary Fund (IMF), but just for the eurozone (or is that the European Union?). It will lend a troubled country money, but only if the government does some of the hard fiscal

work. The IMF may have a role to play in budget advice and assessment for Greece, but it may also be squeezed out of a meaningful policy role.

This is good, in the sense that there is no stigma attached to having your banks borrow from the ECB. When random bad shocks hit, it's good to have a safety net that countries are willing to use.

But this is also less good, in the sense that as the global economy moves back towards boom times, putting more bailout mechanisms in place and removing even further the downside risks for creditors is – in the broadest possible terms – asking for trouble. Why worry about whether borrowers can repay if there is a deep-pocketed sovereign (run by a cousin, neighbor, or committed friend) who will, when push comes to shove, protect all creditors?

By Simon Johnson

What's Up with Citigroup?

James Kwak | 16 Dec 2009

On Monday, Citigroup received permission from its regulators to buy back the remaining \$20 billion in preferred shares held by Treasury because of its investments under TARP. (Treasury invested \$25 billion in October 2008 and another \$20 billion November 2008; however, \$25 billion worth of preferred shares were converted into common shares earlier this year, giving the government about a 34% ownership stake in the bank.) The stock then fell by 6%. What's going on?

This is another example of a bank doing something stupid in order to say that it is no longer receiving TARP money, and probably more importantly so it can escape executive compensation restrictions. As Citigroup CEO Vikram Pandit himself said last October, TARP capital is really cheap (quoted in David Wessel, *In Fed We Trust*). Instead of paying an 8% interest rate* on \$20 billion in preferred shares, Citigroup chose to issue \$17 billion of new common shares while its share price is below \$4/share. Citigroup's cost of equity is certainly more than 8%, so it just increased its overall cost of capital. The stock price fell because existing shareholders are guessing that the dilution they suffered (because new shares were issued) will more than compensate for the fact that Citi no longer has to pay dividends to Treasury.

Paying back the TARP money also makes Citigroup weaker. That's \$20 billion less in cash it has to withstand any potential problems in its asset portfolio. Now, you can say that it compensated by issuing new equity. But those are two separate transactions; Citi could have issued the common shares whether or not it paid back its TARP money. Standing on its own, paying back TARP money is unequivocally bad for the balance sheet.

So this is bad for Citigroup shareholders and bad for Citigroup—except for the potentially important fact that Citi can now pay more money to its employees, which matters if you believe that pay is correlated with *future* performance (it doesn't matter if it's only correlated with past performance). So why are the regulators letting Citigroup do it? I think there are two reasons. The first is that they're on a slippery slope. Once they let Bank of America pay back its TARP money, they couldn't say no to Citigroup without confirming what everyone has always believed but that the government has scrupulously avoided saying: that Citi really is in worse shape than the other banks. The second reason is that it enables

the government to declare victory and put TARP behind it, which is certainly valuable for political reasons.

What about for the taxpayer? I may differ from some people here, but I actually think it's good for the taxpayer. We are getting our money back. The risk that Citigroup will come back for a future bailout has gone up, which is bad; but I believe that if such a bailout ever happens, it will have to be on draconian terms—a government takeover in which management is fired, shareholders are wiped out, and the company is broken into pieces and sold off. I doubt that any administration will be able to engineer another Citigroup-friendly bailout in the future.

Of course, on the way out the door, Citigroup did get one parting gift to reduce the chances that it will have to come back: an Internal Revenue Service exemption worth \$38 billion. Arguably 34% of that is the government dealing with itself (since it owns 34% of Citigroup), but if the *Times* is right that still leaves \$25 billion (about \$1/share) of subsidy to Citi's other shareholders. \$13 billion of the \$38 billion counts as capital for regulatory purposes, so this enables Citi to boost its capital ratio by a full percentage point (Citi's risk-weighted assets were around \$1 trillion at the time of the stress tests).

Finally, the FDIC is keeping \$5.4 billion of the \$7 billion in preferred shares it got from Citigroup in exchange for guaranteeing about \$300 billion of assets in November 2008. More on that later.

* The interest rate on the first \$25 billion was 5%; the rate on the next \$20 billion was 8%. After the preferred-to-common conversion, I don't know which rate applies.

By James Kwak

The Myth of Dick Fuld

James Kwak | 16 Dec 2009

Wall Street critics often say that compensation should be in long-term restricted stock so that managers and employees do not have the incentive to take excessive risk, make big money in good years, deposit the cash in their bank account, and then escape to their private islands when their bets blow up the next year. Wall Street defenders like to point to Dick Fuld, who supposedly lost \$1 billion by *holding on* to Lehman Brothers stock that eventually became worthless. You don't get more of a long-term incentive than that, the argument goes.

Lucian Bebchuk, Alma Cohen, and Holger Spamann have exploded this myth in a [Financial Times op-ed](#) and a [new paper](#). They look at the CEOs and the other top-five executives of Bear Stearns and Lehman Brothers. (All numbers are adjusted to January 2009 dollars.) From 2000 through 2008, these ten people received \$491 million in cash bonuses (Table 1) and sold \$1,966 million in stock (Table 2); on average, each person took out \$246 million in cash. (Both Lehman and Bear had rules that prevented top executives from cashing out equity bonuses for five years from the award date—see p. 16 n. 33.)

At the beginning of the period (2000), these ten people had \$1,398 million in stock and options (Table 5; option value calculated conservatively as the current difference between market price and exercise price). So on average, each one had \$140 million in stock at in 2000; received \$49 million in cash over the next eight years; sold \$197 million in stock; and lost the rest in 2008 when their companies collapsed. Dick Fuld began with \$301 million in stock, received \$62 million in cash bonuses, and sold \$471 million in stock before losing his supposed \$1 billion.

Let's put this in perspective (insofar as it's possible to put these kinds of numbers in perspective) two different ways. First, let's say you're a bank CEO with a lot of wealth tied up in stock. Satan comes along and offers you the following deal: if you undertake a strategy with a lot of risk, every year you will get a cash bonus, every year your stock price will go up, every year you will be able to sell some (but not all) of your stock at this higher price, and every year you will get more restricted stock awards—until at some point everything collapses and the stock becomes bankrupt. Would you take that deal? Of course you would. Yes, it means that your losses in the final crash will be bigger than with a

more conservative strategy. But it means that you would make a lot more money in the meantime.

Second, let's say you're a house flipper in a rising market. You buy a few houses with borrowed money, sell them at higher prices, buy more houses with more borrowed money, sell them at even higher prices, buy yet more houses, etc. Each time you sell you take out some of the money as cash and put the rest back into the housing market. At some point the market crashes and you lose the houses you were holding onto at the end. But in the meantime you stashed millions of dollars of winnings in your bank account. Did you do well by using leverage to maximize your risk in a rising market? Of course you did, even though you lost a lot in the crash.

Now, there are things in life besides money, and Dick Fuld has no doubt suffered tremendously in the past year. And at this point, maybe he would gladly give up that \$533 million he took out to see a healthy Lehman Brothers. So yes, there are other reasons why CEOs do not want to see their banks blow up. But holding a lot of restricted stock is not necessarily one of them.

By James Kwak

Move Over, Bernanke

James Kwak | 17 Dec 2009

Ben Bernanke is Person of the Year. Matt Yglesias has criticism, although he does say it was an appropriate choice. Now, the *Time* award is meant to recognize newsworthiness, not necessarily exceptional conduct, and it's hard to deny that Bernanke has been newsworthy. But I think that 2008 was Bernanke's year, not 2009—that was the year of the real battle to prevent the collapse of the financial system. As far as the crisis is concerned, I would say the face of 2009 has been Tim Geithner—PPIP, stress tests (largely conducted by the Fed, but Geithner was the front man), Saturday Night Live, regulatory “reform,” and so on. But I can see why *Time* didn't want to go there. Besides, I'm not sure that the financial crisis was the story of 2009; what about the recession? They're related, obviously, but they're not the same thing.

But in real news, Simon was named Public Intellectual of the Year by *Prospect Magazine* (UK). (This year they seem to have restricted themselves to financial crisis figures; David Petraeus won in 2008.) Over Ben Bernanke, among others. (Conversely, Simon didn't make *Time*'s list of “25 people who mattered”—but Jon and Kate Gosselin did, so that's no surprise.) The article says that Simon “has also done more than any academic to popularise his case: writing articles, a must-read blog, and appearing tirelessly on television,” which sounds about right to me.

Prospect got one thing wrong, though. The article has a cartoon of Simon holding a sledgehammer and towering over a Citigroup in ruins. But no matter how many times you keep taking whacks at Citigroup, it refuses to die. One hundred years from now, maybe people will still be saying there are two common ingredients in all U.S. financial crisis: excess borrowing ... and Citibank.

Update: I should have made clear that I prefer my award.

By James Kwak

Paul Volcker Picks Up A Bat

Simon Johnson | 17 Dec 2009

For most the past 12 months, Paul Volcker was sitting on the policy sidelines. He had impressive sounding job titles – member of President Obama's Transition Economic Advisory Board immediately after last November's election, and quickly named to head the new Economic Recovery Board.

But the Recovery Board, and Volcker himself, have seldom met with the President. Economic and financial sector policy, by all accounts, has been made largely by Tim Geithner at Treasury and Larry Summers at the White House, with help from Peter Orszag at the Office of Management and Budget, and Christina Romer at the Council of Economic Advisers.

With characteristic wry humor, Volcker denied in late October that he had lost clout within the administration: "I did not have influence to start with."

But that same front page interview in the New York Times contained a well placed shock to then prevailing policy consensus.

Volcker, legendary former chairman of the Federal Reserve Board with much more experience of Wall Street than any current policymaker, was blunt: We need to break up our biggest banks and return to the basic split of activities that existed under the Glass-Steagall Act of 1933 – a highly regulated (and somewhat boring) set of banks to run the payments system, and a completely separate set of financial entities to help firms raise capital (and to trade securities).

This proposal is not just at odds with the regulatory reform legislation then (and now) working its way through Congress; Volcker is basically saying that what the administration has proposed and what Congress looks likely to enact in early 2010 is essentially — bunk.

Speaking to a group of senior finance executives, as reported in the Wall Street Journal on Monday, Volcker made his point even more forcefully. There is no benefit to running our financial system in its current fashion, with high risks (for society) and high returns (for top bankers). Most of financial innovation, in his view, is not just worthless to society – it is downright dangerous to our broader economic health.

Volcker only makes substantive public statements when he feels important issues are at stake. He also knows exactly how to influence

policy – he has not been welcomed in the front door (controlled by the people who have daily meetings with the President), so he's going round the back, aiming at shifting mainstream views about what are “safe” banks. Many smart technocrats listen carefully to what he has to say.

This strategy is partly about timing – and in this regard Volcker has chosen his moment well. The economy is starting to recover, but this process is clearly going to take a while and unemployment will stay high for the foreseeable future. At the same time, our biggest banks are making good money – mostly from trading, not much from lending to small business – and they are lining up to pay very big bonuses.

Not only is this contrast – high unemployment vs. bankers’ bonuses – annoying and unfair, it is also not good economics. Bankers are, in effect, being rewarded for taking the risks that created the global crisis and led to massive job losses. And they are being implicitly encouraged to do the same thing again.

The case for keeping big banks in their current configuration is completely lame. Even if we are lucky enough to avoid another major any time soon, the fiscal costs are enormous and coming right at you (and your taxes).

Now that Paul Volcker has picked up his hammer, he will not lightly set it aside. He knows how to sway the policy community and he knows how to escalate when they don't pay attention. Expect him to pound away until he prevails.

By Simon Johnson

This is a slightly edited version of a post that previously appeared on the NYT's Economix; it is used here with permission. If you would like to reproduce the entire piece, please contact the New York Times for permission.

Small Steps and Health Care Costs

James Kwak | 18 Dec 2009

Hey all you deficit hawks out there. [Atul Gawande](#), the person of the year when it comes to health care, has a long article on the cost-cutting proposals in the health care reform bill (hat tip [Ezra Klein](#)). Gawande's main point is that the long list of pilot programs and other initiatives in the bill are probably the best possible way to reduce costs in the health care system (which, if you missed the implication, is the only way to control long-term government spending—that or eliminating Medicare).

Indeed, it's hard to see what else the bill could have done. Remember, we have a largely *private-sector* health care system (both insurance and delivery), which means the government cannot simply order providers to charge less. A single-payer system might be able to take such draconian steps, but Mitch McConnell, who claims, "Two thousand seventy-four pages and trillions of dollars later, this bill doesn't even meet the basic goal that the American people had in mind and what they thought this debate was all about: to lower costs," is the last person who would vote for single payer. And the Republicans are similarly against anything that allows the government to use the one big lever it does have—Medicare—to force lower cost levels.

So the only political option is incremental reform through small programs that experiment with different ways to change the incentives of private-sector actors at the margin. And, Gawande says, this is the only option that has a chance of working, anyway:

"Which of these programs will work? We can't know. That's why the Congressional Budget Office doesn't credit any of them with substantial savings. The package relies on taxes and short-term payment cuts to providers in order to pay for subsidies. But, in the end, it contains a test of almost every approach that leading health-care experts have suggested. (The only one missing is malpractice reform. This is where the Republicans could be helpful.) None of this is as satisfying as a master plan. But there can't be a master plan."

More generally, Gawande's article is about how the government can help. There's the big story of how government pilot programs helped nudge the free market toward more efficient food production at the beginning of the twentieth century, and the little story of Rory

Lewandowski, a government “agricultural extension agent” for Athens, Ohio, who helps farmers solve their problems. President Obama wants to convince Americans that government can be part of the solution. There are tens of millions of Americans who cannot be convinced by any amount of evidence or argument. But still, when it comes to long-term health care costs (and, therefore, the long-term national debt), it’s the only chance we have, since the system we have now isn’t solving the problem.

(I’m sure someone will argue that if we simply cut the government out of health care altogether the free market would solve our cost problem by itself. I don’t see that, since that just means we would all be in the ever-expanding individual market, which isn’t solving our cost problem. But even if making people individually liable for the cost of their health care could control costs, it would also have the effect of sentencing poor, sick people to death because they cannot afford health care.)

By James Kwak

“It’s Certainly Not For A Lack Of Effort”

Simon Johnson | 19 Dec 2009

The fundamental divide in opinion regarding our financial system is: Are the people running “large integrated financial groups” hapless fools, buffeted by forces beyond their comprehension and control; or do they know exactly how to ensure they get the upside and the awful, sickening downside is borne by society – including through high unemployment.

Some light was shed on this issue by Monday’s meeting at the White House or, more specifically, by who didn’t turn up and why. Of the dozen bank CEOs invited, Vikram Pandit was supposedly busy trying to extricate Citi from TARP and asked Dick Parsons to attend instead – a wimpy but smart move, as Parsons is close to the President.

However, three executives – Lloyd Blankfein, John Mack, and Dick Parsons himself – did not show up in person and had to join by conference call. Their excuse was bad weather (fog) in DC meant that they were unable to fly in; Mack was quoted as saying, regarding their absence, “It’s certainly not for a lack of effort”.

But really there are three possible interpretations:

1. Pure bad luck. This happens to us all; even the best laid plans are for nought sometimes.
2. Bad management by the executives and their logistic teams – who are ordinarily the best of the best.
3. Wilful defiance of the government which, while not premeditated in this instance, means that the executives grabbed an opportunity to show disrespect and relative power.

We don’t know all the facts of how these executives planned to travel or exactly their routes on Monday morning – and I would be happy to be corrected on any details – but here’s what we can readily construct from the public record. (We do know they didn’t try to come down Sunday evening, because that would have worked.)

President Obama held a press briefing after his meeting with the bankers, starting at 12:36pm. The meeting itself lasted a bit over an hour. As we all like to start meetings, particularly important meetings, on round numbers, it seems fair to assume that the appointment at the White House was for 11am. Even VIPs need some time to clear security, so let’s assume that the CEOs were asked to arrive by 10:30am.

All three of the missing bankers were apparently coming from New York. There are many ways to make the flight, but US Airways is among the most reliable – flying from LaGuardia to National Airport, every hour on the hour, from 6am. The flight takes just over an hour, it's easier to get to LaGuardia from Manhattan before 7am, and delays are common at LGA as air traffic builds up over the east coast. Any conservative banker, who really did not want to be the only person missing a meeting with the president, would aim for the 7am shuttle – putting him on the tarmac in DC at 8:10am, with a comfortable time cushion (and an opportunity to have coffee with his chief lobbyist).

There was thick fog in DC on Monday morning, but this did not descend in a matter of seconds during rush hour – it was evident already by 5am. Corporate jets could get through (Jamie Dimon came that way), but let's limit ourselves to public transportation – remember that the Acela train service is not generally slowed by fog and on Monday ran almost on time.

So the question becomes: At what point did the CEO realize that there was a fog issue, and was there still time to come by train? The Acela leaves Penn Station every hour on the hour, with the 7am train getting to DC at 9:49am and the 8am arriving at 10:49am.

We can rule out explanation #1 (bad luck). These are experienced people who travel all the time, with first class support staff, and they are supposed to be the best in the timely information business. These executives don't generally wander around airports trying to puzzle out flight information displays.

Is explanation #2 plausible (bad management)? It is possible that at least one bank team wasn't paying close attention and sent their boss to the airport for the 7am shuttle (although what are the odds that this would happen for 3 of our biggest and most dangerous banks?) An experienced traveller, who has checked in on-line, might aim to arrive at the airport at 6:30am – to discover the delays already in progress.

So then the question becomes: Can you get from LaGuardia to Penn station in 90 minutes early on a Monday morning? My experience is: Yes (if any New Yorkers know differently or if anyone saw John Mack pushing desperately through the crowds at Penn Station just before 8am Monday, please post or send that information in).

The implication is inescapable. These three bank executives did not plan on missing the meeting but, once they learned of the fog delay, they

did not rush to the train station – which is what any other business traveller with a pressing commitment would have done.

These three executives – who were, in some sense, the primary audience for the president's remarks – did not really want to attend. They do not see the need to show deference or even respect. They won big from the crisis and that is now behind them. As they move on (and up), there is nothing – in their view – that the executive branch can do to hold them back.

Even so, it wasn't polite to behave in this fashion; showing disrespect to the President of the United States is always objectionable. But there is a pattern of behavior here, reflecting a deeper culture on Wall Street. This arrogance will eventually prove their undoing - no self-respecting White House can let this kind of repeated insult pass unaddressed.

By Simon Johnson

A Few Books

James Kwak | 20 Dec 2009

It's holiday season again, which means that I have time to read books again, and you may be looking for last-minute gifts. (If you haven't used it yet, you can get a free 30-day membership to Amazon Prime, which gives you free two-day shipping; you do have to manually cancel before the thirty days are up or you will get charged. Or you could go to a bookstore.) There have obviously been many books about the financial crisis, and I have only read a few of them, and I'm only going to mention a few of those here. You shouldn't think of this as a "best of" list, just four books that different people may enjoy.

For simple reading enjoyment, *Too Big to Fail* by Andrew Ross Sorkin is the book to get. It's the only crisis book I've read that comes remotely close to "can't put it down" status. It's a blow-by-blow, meeting by meeting, conference call by conference call account of the period from the acquisition of Bear Stearns in March 2008 through the recapitalization of the big banks in October 2008. Most people who read this blog (or simply read the newspaper regularly) won't learn anything big that they didn't know already, but the book is full of behind-the-scenes details, like Robert Kindler's "2BG2FAIL" license plate, Jamie Dimon's September 13 speech to the JPMorgan cafeteria about icebergs and lifeboats, and Tim Geithner not carrying enough cash to pay for a taxi. It also did the remarkable job of making me like Henry Paulson (there's a story about him wearing the same overcoat for twelve years; then, when he finally bought a new cashmere one, his wife made him take it back because it was too expensive).

At the other end of the spectrum is *Too Big to Save* by Robert Pozen, head of a big asset management firm (and a Yale Law School graduate). It is pretty easy to put down (sorry!) but it does a very good job of explaining all of the complicated aspects of the financial crisis that you (or your parents) may have been wondering about—not just the usual like credit default swaps and mortgage-backed securities, but also short selling and the uptick rule, Basel I and Basel II, regulation (or not) of hedge funds, the organizational structure of financial regulation, and so on. The book is organized by topic, so there's no real narrative, but Pozen clearly explains each topic and then moves on to recommendations. I don't agree with some of the recommendations, but he generally outlines the problem clearly and in a non-partisan way.

Think about it as a handbook for many of the problems with our financial system.

For a well-written account of the boom and bust in America as a whole, not just on Wall Street, I recommend *Our Lot* by Alyssa Katz, a book I feel like I've cited a zillion times already, which focuses on the impact of the subprime lending, the housing bubble, and the crash on different communities around the country. Katz folds together personal drama, economics, and politics in a narrative that manages to remain compelling even though we all know how it turns out, and that also makes the reader even more infuriated at people we already knew were bad before we picked up the book.

The most informative crisis book I've seen, at least for me, is *This Time Is Different* by Carmen Reinhart and Kenneth Rogoff, whose earlier papers (based on their dataset of financial crisis across sixty-six countries and several countries) played an important role in shaping understanding of the crisis back in 2007-08. *This Time Is Different* dwarfs the competition in the amount of new information it provides—not surprisingly, since it is based on many years of research. Now, when you take the statistical approach, all financial crises do start to look the same—they are all the product of excess borrowing and then a rapid loss of confidence—and the real question is why that excess borrowing took place. But Reinhart and Rogoff still have important lessons (or warnings) for our situation; for example, in their sample of similar financial crises, government debt rose on average by 86% in the post-crisis period due to collapsing tax revenues (p. 224). For people who enjoy reading about economics and economic history, this might be the one.

Disclosure: I got a free copy of *Too Big to Fail*—not that anyone sent me one, but Simon gave me one of the multiple unsolicited free copies he got. The rest I paid for with old-fashioned cash money. I also saw Sorkin and Pozen present at Yale Law School; Pozen was great, and even cold-called the audience (which is more than most YLS professors do).

Enjoy.

Update: I should have said, feel free to suggest others in the comments for people who are looking for last-minute gifts.

By James Kwak

More Details

James Kwak | 21 Dec 2009

The financial reform bill that passed the House recently is full of surprises, not all of them bad. A contact pointed me toward an amendment introduced in committee by Brad Miller and Ed Perlmutter; it's number 61 on this list. Basically, the amendment gives the Federal Reserve ("Board" in the text refers to the Board of Governors of the Fed) the power to prohibit a financial institution from engaging in proprietary trading not only if it decides that proprietary trading threatens the soundness of the institution itself, but also if the Board of Governors decides that it threatens the financial stability of the country.

While this may seem overzealous, the point is to prevent a large financial institution with a government guarantee (of any kind) from putting most of its capital to work on its proprietary trading desks and taking lots of risks that might require a government bailout. The amendment does have exceptions allowing firms to, for example, make a market in securities that they underwrite, so securities underwriting is not in question here.

The amendment was inspired by Paul Volcker's testimony back in September, when he said:

"As a general matter, I would exclude from commercial banking institutions, which are potential beneficiaries of official (i.e., taxpayer) financial support, certain risky activities entirely suitable for our capital markets. Ownership or sponsorship of hedge funds and private equity funds should be among those prohibited activities. So should in my view a heavy volume of proprietary trading with its inherent risks. Some trading, it is reasonably argued, is necessary as part of a full service customer relationship. The distinction between 'proprietary' and 'customer-related' may be cloudy at the border. But surely by the active use of capital requirements and the exercise of supervisory authority, appropriate restraint can be maintained."

Since the effective repeal of Glass-Steagall, no such prohibitions exist. The usual justification for proprietary trading is that it provides liquidity and pricing efficiency to markets; the comeback is that that's the job of hedge funds (which are both un-regulated and un-guaranteed), not Bank of America. A related justification is that if a bank is providing trades to

nonfinancial customers, it is likely to take on positions that cannot be perfectly hedged, and suddenly it is engaged in proprietary trading, like it or not; but here it seems like an effective regulator should be able to tell the difference between imperfect hedging and big one-way bets.

So the real question is: Does the fact that Goldman Sachs (for example) makes a big pile of money in proprietary trading provide some corresponding benefit to its customers? Or is it simply that Goldman is so good mining its customers for market information (as discussed in [this article](#) much better known for the “God’s work” quote) that it would be a shame for it not to make a big pile trading on that information?

In any case, there remains the issue of whether the Senate bill will include similar language, and whether the Fed would have the backbone to use this power when the need presented itself. But it’s better to have the tool there than not to have it.

By James Kwak

If Wall Street Ran the Airlines ...

James Kwak | 22 Dec 2009

New York Times headline: "U.S. Limits Tarmac Waits for Passengers to 3 Hours." Just imagine ...

Representatives of industry associations reacted negatively to the government action, warning that over-regulation would stifle innovation and harm the competitiveness of U.S. firms. "Requiring each plane to stock up on 0.5-ounce bags of pretzels and peanuts will only hurt passengers," said Sam Tapscott of the Airline Roundtable. "Airlines will have no choice but to pass the higher costs on to consumers, who will see the price of excessive government intervention in every ticket they buy."

More worryingly, some industry analysts warned of dire consequences for the U.S. economy. "Forcing airplanes to return to the terminal after three hours will reduce the efficiency of the entire air travel system," said David Dell'amore, professor of flight operations at Harvard University. "Modern flight management algorithms minimize aggregate wait times and ensure the perfect balance of customer comfort and economic value-added."

The problem, experts say, is that the government rushed to create new regulations without considering how market forces could solve the problem. "Clearly, if consumers placed a value on a maximum runway wait time, they would have negotiated it with their airlines already," said Petra Waterman of the American Enterprise Institute. "Since no airline offers such a contract term, we can assume that consumers place no value on it. Besides, if consumers were not happy with the service they receive from airlines, then a new airline would have already entered the market offering shorter wait times."

Ella Ringding of the U.S. Airlines Association agreed that extended tarmac wait times are a problem, but said that the solution should be left to the industry. "The U.S. Airlines Association takes very seriously any issues that reduce the satisfaction of our customers," she said. "We have drafted a model code of conduct for all of our members to address this problem. According to the model code, airlines should notify passengers whenever they happen to be on a flight that has been waiting on the tarmac for more than three hours, and should repeat that notification every hour. We believe that by providing sufficient disclosure to our

customers, they will be able to make the air travel choices that best suit their individual needs."

The airlines have succeeded in convincing major non-airline companies to take their side. Buddy Bunker, a managing director in Citigroup's investment banking division, opposed additional government regulation in recent testimony before Congress. "Efficient air travel is the foundation on which the health of the U.S. economy rests," he said. "If American companies cannot rely on an air transport system that is free of meddling from the government, we will be at a competitive disadvantage relative to companies in Europe, where airlines are free to strand their passengers for over three hours. We can just wave millions of jobs good-bye, and soon we'll all be speaking Chinese."

Muffy McDonnell, Senate minority leader, promised a bitter fight in Congress. "This is just the latest step by the jackbooted thugs in the Obama Administration in their plan to bring socialism to the United States, and we're going not going to take it lying down," she said at a press conference. "The next thing you know, people won't be able to bring guns onto planes."

However, not everyone is upset with the new regulation. One Goldman Sachs derivatives trader, who asked to remain anonymous because he is not authorized to speak about company strategy, said that the firm is planning to create a market for derivatives that airlines can use to hedge against the risk of having to return planes to the terminal or having to pay fines to the FAA. Goldman is thinking of creating "collateralized delay obligations," or CDOs, which will diversify wait-time risk by including flights from across the entire country.

Update: Q points out the opportunity for a carry trade: "wall street would charge large fees for flying people across the country and then buy them cheap tickets home on greyhound."

Update 2: I didn't think this was initially necessary, but since a few people may have been confused, I'd like to point out that this post is a joke. The New York Times link at the top is real; everything else I made up.

By James Kwak

Bernanke's Reply: On The Doom Loop

Simon Johnson | 22 Dec 2009

Senator David Vitter submitted one of my questions to Federal Reserve Chairman Ben Bernanke, as part of his reconfirmation hearings, and received the following reply in writing (as already published in the WSJ on-line).

Q. Simon Johnson, Massachusetts Institute of Technology and blogger: Andrew Haldane, head of financial stability at the Bank of England, argues that the relationship between the banking system and the government (in the U.K. and the U.S.) creates a “doom loop” in which there are repeated boom-bust-bailout cycles that tend to get cost the taxpayer more and pose greater threat to the macro economy over time. What can be done to break this loop?

A. The “doom loop” that Andrew Haldane describes is a consequence of the problem of moral hazard in which the existence of explicit government backstops (such as deposit insurance or liquidity facilities) or of presumed government support leads firms to take on more risk or rely on less robust funding than they would otherwise. A new regulatory structure should address this problem. A. (continued) In particular, a stronger financial regulatory structure would include: a consolidated supervisory framework for all financial institutions that may pose significant risk to the financial system; consideration in this framework of the risks that an entity may pose, either through its own actions or through interactions with other firms or markets, to the broader financial system; a systemic risk oversight council to identify, and coordinate responses to, emerging risks to financial stability; and a new special resolution process that would allow the government to wind down in an orderly way a failing systemically important nonbank financial institution (the disorderly failure of which would otherwise threaten the entire financial system), while also imposing losses on the firm’s shareholders and creditors. The imposition of losses would reduce the costs to taxpayers should a failure occur.

This answer misses the central issue. Haldane's argument (and our point) includes "time inconsistency" – i.e., you promise no bailouts today but, when faced by an awful crash, you provide a massive set of bailouts. There is nothing in Mr. Bernanke's statements, here or elsewhere, that addresses this concern.

His hope is that current proposed changes in regulation will make a crash less likely. This is a strange assertion, given current market conditions: e.g., the Credit Default Swap (CDS) spread for Bank of America now hovers just 100 basis points above that of the US government, despite BoA having a very risky balance sheet. Creditors apparently believe they will not face losses – and the same is true for people lending to all our big banks. This is exactly the kind of thinking that produces reckless lending (and borrowing). Will Bernanke really disappoint them in our next crash?

Until markets price "small enough to fail" risk into our biggest banks, the time inconsistency problem is alive and well – and threatening.

The Fed's continuing refusal to confront this point directly – even as other major central banks shift their public positions (and more are moving in private) – is alarming and disconcerting. The Fed is falling far behind. This will have much broader consequences for its credibility and independence down the road.

By Peter Boone and Simon Johnson

Whence the Deficit?

James Kwak | 23 Dec 2009

A couple of weeks ago I did a [basic calculation](#) to see why the medium-term national debt picture has gotten so much worse in the last two years. There's no new data I created; it's just the difference between the January 2008 and August 2009 Congressional Budget Office projections. Here's the chart, once again:

The [Center on Budget and Policy Priorities](#) (hat tip [Ezra Klein](#)) has done a similar exercise using CBO data, except they are looking at the annual deficit, not the aggregate deficit over a decade. Here is their chart:

The Technical Note to the CBPP's report shows how they came up with the numbers. For the most part they are using CBO estimates. They allocate debt servicing costs to the programs that led to increases in debt servicing, which seems reasonable to me. (The CBO usually leaves debt servicing as its own line, which is why I left it as its own category above.) The only questionable bit of methodology I can see is that they count AMT fixes (during the Bush years and going forward) as part of "Bush-era tax cuts"; arguably those should be part of the baseline ("Deficit without these factors"). On the other hand, the CBPP left out the Medicare prescription drug benefit (the major domestic program of the Bush era) because of uncertainty over how big a hole it will create.

When told that the recent change in our overall debt position is primarily due to lower tax revenues, not higher spending, even some people who really should know better are surprised. Similarly, many will be surprised to learn that our trillion-dollar deficits are not due to increased spending under the Obama administration, and that the stimulus spending dwindles away quickly. And where's health care? It's not there because it isn't in the CBO's baseline projections yet, but in any case the CBO projects it as net deficit-reducing over ten years (and beyond, for the Senate bill).

Klein reports that the Republicans are not going to provide a single vote to raise the debt ceiling this week, forcing a 60-40 party-line vote in the Senate, so they can use the deficit as a campaign issue next year.

By James Kwak

Should Ben Bernanke Be Reconfirmed?

Simon Johnson | 24 Dec 2009

Ben Bernanke's nomination to be reconfirmed as chairman of the Federal Reserve Board passed out of the Senate Banking Committee and will next be taken up by the full Senate.

But, despite being named Time's Person of the Year for his efforts during the financial crisis, the Bernanke nomination has run into strong pushback – both in terms of tough questions from the committee and in the form of a "hold" on the nomination, placed by Senator Bernie Sanders of Vermont.

The conventional wisdom among economists is that political control over an independent central bank is regrettable and should be resisted. We like to think of the Federal Reserve as a bastion of technocracy, with monetary policy steering a course between recession and inflation just on the basis of "objective evidence" regarding the relative balance of risks (i.e., if monetary policy stays too loose for too long, we'll get inflation, but if interest rates are tightened prematurely, the economic recovery will stall.)

But the fact of the matter is that, in any well-functioning democracy, independence is earned based on credible and ultimately successful actions — not granted for all time and without conditions. The questions raised about Mr. Bernanke's performance in office and his likely future actions are almost entirely appropriate – and focus attention on a major weakness in the case for his reappointment.

The issue is what economists like to call "time inconsistency," but which everyone else just regards as common sense: If I swear up and down that I won't bail out your firm in a future crisis, will I really keep this promise when the crisis hits and the consequences of "no bailout" look absolutely awful? And if you know that, most likely, the bailout will be there irrespective of how you behave, for example because your firm is so big relative to the economy – why should you be more careful or take less risk?

Bernanke's problem is that he says he won't help big banks when they next get into trouble. But is this plausible?

To be fair, Bernanke does not refuse to talk about the problem that is widely known now as "Too Big To Fail" or the repeated boom-bust-bailout cycle that is increasingly referred to in official circles as the

“doom loop.” But, when asked what will break this loop, his answer is weak:

“A new regulatory structure should address this problem. In particular, a stronger financial regulatory structure would include: a consolidated supervisory framework for all financial institutions that may pose significant risk to the financial system; consideration in this framework of the risks that an entity may pose, either through its own actions or through interactions with other firms or markets, to the broader financial system; a systemic risk oversight council to identify, and coordinate responses to, emerging risks to financial stability; and a new special resolution process that would allow the government to wind down in an orderly way a failing systemically important nonbank financial institution (the disorderly failure of which would otherwise threaten the entire financial system), while also imposing losses on the firm’s shareholders and creditors. The imposition of losses would reduce the costs to taxpayers should a failure occur.”

In other words, “if big banks should fail in the future, we’ll take them over and impose meaningful losses on creditors.”

But this is simply not plausible – and don’t take our word for it, look at the probability of default implied by the Credit Default Swap (CDS) spreads for Bank of America. The market view is that Bank of America, despite all its problems and a risky balance sheet, is only slightly more likely to default than is the United States government (which, despite recent rhetoric, is still one of the most reliable borrowers in the world). The market view for all other major US banks is essentially the same.

In other words, Mr. Bernanke’s key audiences – in financial markets – do not find him credible on the central issue of the day, presumably because he is unwilling to condone measures that would ensure today’s massive banks become “small enough to fail.” If potential creditors do not fear losses, they will provide funds on easy terms to our big banks and we will re-run some version of our previous bubble. This is how our financial system works.

The Senate will decide soon, but Mr. Bernanke has made his case and the market has already voted.

Given his testimony, his written response to Senators’ questions, and the market reaction, we recommend that Mr. Bernanke not be reconfirmed.

By Peter Boone and Simon Johnson

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

Salespeople and Programmers

James Kwak | 24 Dec 2009

Tyler Cowen asks why pay across software programmers is not more unequal. He cites John Cook, who argues that differences in programmer productivity are difficult to identify and measure. Since I do know something about this (though not a comprehensive answer), I thought I would comment.

Cook contrasts programmers to salespeople: “In some professions such a difference would be obvious. A salesman who sells 10x as much as his peers will be noticed, and compensated accordingly. Sales are easy to measure, and some salesmen make orders of magnitude more money than others.” Although this is the most-cited example around (except perhaps for traders), I don’t actually think it’s true.

OK, I’ll concede that sales are easy to measure. But I won’t concede that sales bear more than a loose and passing relationship to sales productivity (unless you make the circular definition of sales productivity as sales). I’ve been a part of dozens of major, high-dollar sales efforts, and there are many, many factors other than how “good” the sales rep is: the sales consultants (pre-sales, sales engineers, application engineers, whatever you call them) involved; how happy the customer is with previous products from the same company; executive involvement; random personality fit; recommendations by industry analysts (who are primed by marketing); the user group meeting; and on and on. If you simply reward successful sales, you end up rewarding people who are the best at monopolizing the best sales consultants and the best at getting top executives to come along on their deals; is that really what you want? And of course, by far the biggest factor in any big deal is luck. In enterprise software, where the deals are so big and so few that a salesperson can make his or her quota with one big deal, luck trumps everything. So yes, some salespeople are better than others, but in a given year that may have no relationship to how much they get paid.

That said, most companies do pay salespeople on commission anyway, because they can’t think of another way to do it, and the salespeople want it that way. In addition, the people in charge of most companies, at least technology companies, came up on the sales side, so they are disinclined to realize that a lot of their success was due to luck, and they are inclined to keep the same metrics that they succeeded on.

Turning back to programmers, there are a lot of reasons why differences in pay don't match differences in ability. One is that most programs of any significance are written by teams, and the productivity of a team is to some extent limited by the productivity of its least-productive member. Another problem is that quality of code is very hard to measure up front; you really don't know how good any component is until it's been used by real customers in lots of ways you didn't anticipate it being used.

That said, if you walk around any good development team and ask who the superstars are, you'll find out that people really do know who the great programmers are. So why don't the top people make more?

Well, to some extent they do. Although pay for employees of, say, Oracle goes pretty much by seniority and responsibility (like for most jobs), there is also a big market for independent contractors, who typically get paid much more (per hour) than employees. Second, as Cook says, "Someone who is 10x more productive than his colleagues is likely to leave, either to work with other very talented programmers or to start his own business." There are many software programmers in the world; some do maintenance for decades-old internal systems at midsized manufacturing companies in the Midwest and some work for Google or Microsoft. The latter make a lot more than the former. Finally, historically in Silicon Valley the most sought-after jobs were not the ones with the highest salaries; they were the jobs at new hot startups, where you could get a non-trivial amount of equity as an early employee. I assure you, those jobs do not go to mediocre programmers.

But still, within a given "hot startup," differences in pay do not fully reflect differences in ability. And I think the reasons are more sociological, or cultural, than anything else. (As I said above, not only do I think it would be easy to identify the top programmers on a given team, generally it would be completely uncontroversial who those people are.) One factor is that major pay discrepancies can have a corrosive effect on a team of people who have to work together. Most sales departments, by contrast, have such a strong individualist ethos that it's assumed from the beginning that everyone is in it for himself, so there is nothing to corrode. In this sense, software programming is like almost every other job other than sales or trading; pay differences don't reflect differences in ability, because the social convention is for them not to.

Another factor that is probably more important is the way salaries are set at companies. At a high level, they are set by management teams, headed by a CEO (who is rarely a former developer), and supervised by a board of directors. The people making these decisions do not understand the nature of software development, and are often prone to idiotic ideas like thinking that you can ship a product in half the time if you have twice as many people. My observation is that top executives, for all they say about the importance of people, revert to a bean-counter mentality when it comes time to deciding how much to pay those people.

Now, there are some companies that go out of their way to pay top developers more than they would make on the open market. But they don't have to pay them very much more, because there aren't very many of those companies. The market price is set by companies run by bean-counters, who are like the famous "noise traders" of Larry Summers, Brad DeLong, Fischer Black, and others. So a developer who is 10x as productive as the average will make 20% more than average and probably be content, because he or she doesn't expect to make 10x the average and is happy to be recognized. If not, he or she can go be a hired gun.

This is neither an elegant nor a complete explanation, but I think it's pretty realistic.

I am hoping to take a break from the Internet from Friday through Monday, so I won't be blogging again until Tuesday (unless something compelling comes up). Happy holidays to all.

By James Kwak

Holiday Season Takedown

James Kwak | 25 Dec 2009

Alan Greenspan has gotten innumerable takedowns, most notably in person by Henry Waxman. Binyamin Appelbaum and David Cho of the *Washington Post* are working on Ben Bernanke. Appelbaum and Ellen Nakashima already got James Gilleran (and, of course, there is the Photo). Now Zach Carter has nailed John Dugan. Some of the guns aren't as smoking as one might like—Dugan only became head of the OCC in 2005, meaning he had less time to do serious damage, although he had established his bank-loving credentials long before. But he did what he could, such as preventing state regulators from gathering information (information!) from federally-chartered banks. Now, of course, he is lobbying Congress to protect his turf and kill the CFPA.

Why the Obama administration even acknowledges his existence is a mystery. I mean, Geithner is a centrist technocrat; I may disagree with him, but I see why he's there. Dugan seems like the Stephen Johnson of banking regulation.

And to all a good night.

By James Kwak

Fear And Loathing In Manhattan

Simon Johnson | 27 Dec 2009

In the Washington Post Book World today, I review Andrew Ross Sorkin's *Too Big To Fail* and two related books: Duff McDonald's biography of Jamie Dimon (*Last Man Standing*), and Peter Goodman's broader retrospective on the political origins and social impact of the crisis (*Past Due*).

If you think the crisis of 2008-09 was an aberration, or top Wall Street executives have learned their lessons, or our financial system is no longer dangerous, take a look at these books. Each of them separately explains part of how the people running our biggest banks have done so well; taken together, these books describe a pattern of corporate and government behavior which - in the aftermath of the Great Bailout of 2009 – points to serious trouble ahead.

By Simon Johnson

What The Senate Must Do Now

Simon Johnson | 28 Dec 2009

This guest post was contributed by Charles S. Gardner, a former senior official at the International Monetary Fund. He argues we must not overlook the importance of extending effective regulation to the nonbank sector.

As Congressional action on financial industry reform shifts to the Senate from the bill passed recently by the House, the urgent need now is to fill the gaps in the piecemeal House approach. Regulators require an airtight scheme giving them clear responsibility plus tools to nip industry abuses early and drain the tendency to crisis out of world finance. This rare opportunity also must be seized to restore the Federal Reserve's control of the money supply, eroded by decades of expanding credit creation by nonbanks.

So far, Congress has ignored this macro dimension of the reform challenge. Understandably, the House Financial Services Committee focused mainly on the high-profile villains of the financial crisis enraging constituents from coast to coast: obscene pay practices, secret but deadly derivatives trading, the murky role of hedge funds, boundless leveraging of assets, and heedless loan packaging that left the originators both rich and risk free.

The House bill deals separately with the welter of technical issues in each of these problem areas. It falls to the Senate now to take a step back and make sure that the pieces add up to more, not less, than the sum of their parts. Each piece may give regulators new and essential information for monitoring and controlling an industry practice, but will the new information fuse into the comprehensive picture needed for intelligent, forward-looking regulation?

For example, requiring open trading of derivatives will help regulators identify potentially risky credit creation outside the regulated banking industry. But will that be enough to assure preemptive action? The Fed or another agency should have explicit authority to oversee and regulate any nonbank entity engaging in leveraging assets and creating credit. Since at least the 1960s, unregulated nonbank activity has been an increasing source of credit creation, ultimately equaling or surpassing the volume under regulation.

If nonbanks like AIG, GMAC and GE—and long before that LTCM—can threaten the stability of world capital markets, the time has

come to regulate them in advance *de jure* not wait for a crisis that brings them under regulation *de facto* because they need a bailout.

Last fall's financial catastrophe made the prudential case for direct regulation of nonbanks. The macroeconomic case built less noticeably for decades, steadily eroding Federal Reserve power to manage the monetary system. A turning point came during the chairmanship of Paul Volcker when traditional monetary aggregates became so meaningless they were no longer a useful focus of Fed policy and it switched to targeting inflation directly. In place of a solid advance indicator of price movements to guide policy, the Fed had to fall back on its skills at prediction to manage credit and the price level.

As the Fed now confronts the tough timing challenge of heading off inflation without killing the recovery, wouldn't it be in a stronger position with a comprehensive picture of the money supply? Or could it have ignored the rapid buildup leading to the mortgage market bubble had its data been more complete?

The steady weakening of the Fed's real power to deliver noninflationary growth was accompanied by a greater reliance on the personality of its chairman to sustain its credibility. As long as the economy was performing reasonably well and periodic crises were not too severe, the chairman could promote the illusion of a Federal Reserve in reasonable control. The illusion shattered in 2004 when the Fed belatedly tried to raise interest rates only to see longer rates fall instead. Puzzlement prevailed at the time but the conundrum was really evidence of how weakened Fed leverage had become.

Since the financial meltdown, a disillusioned public is now blaming the Fed for a failure to exert power it did not really have: the nonbanking sector operated outside the reach of both its prudential and monetary policy regulation. The sad result is a backlash in Congress threatening to reduce the Fed's power when it should be restored and enhanced. It may be quixotic now to suggest that useful monetary aggregates could be reconstructed; but if they could, it would help rebuild the Fed's stature on the basis of technical competence, and reduce its reliance on a cult of personality. In the end, Congress may hand the tasks of consumer protection and bank oversight (and hopefully nonbank oversight as well) to other agencies, leaving the Fed with its core monetary policy responsibility. Even with this outcome, Congress should temper its anger at the Fed with wisdom to equip it for its responsibilities.

The debate over curbing companies seen as “too big to fail” is likely to be pivotal in whether the Senate will strive for an effectively airtight regulatory regime. To date, this debate has played more to public anger at banks than to regulatory substance. Sheer size, after all, has been less a cause of the crisis than industry practices that are too complex, too opaque, and too unregulated. If sheer size is a factor in anticompetitive behavior, antitrust criteria should be used to deal with it, not some arbitrary concept of “too big.”

Until recently, the “too big to fail” argument was justified. It is an argument the public can understand. Its bumper sticker appeal was useful when it looked as if Congress was foot dragging, and the risk was real that public anger could dull and undermine the drive for reform. Clearly, public anger is not going away. Congress is moving quickly to send a huge reform package for the President’s signature early next year.

Now, however, the risk is that the “too big to fail” argument will be an impediment to enacting comprehensive regulation. In its simplicity, it is, after all, an admission that fully effective financial industry reform may be unachievable. Can’t the rich financial firms always hire smarter, quicker lawyers, capable of defeating the best technical drafting and oversight that underpaid government bureaucrats can field? This defeatism quickly leads to the idea that any legislative result is good enough if it produces sufficient punishment now for the arrogant financial industry, even if it will be evaded in the longer term.

Neither the U. S. public nor the financial industry will benefit from this flawed result. The largest damage, however, is likely to be to international efforts to make the globalized financial system safer and more efficient at capital distribution. Here, the United States has a special responsibility to get domestic regulation right because it will be in the forefront in fighting international controls and insisting on regulation confined to the national level. A high level of transparency will be needed in each major national system for this approach to work, and it will be up to the United States to provide the model.

By Charles S. Gardner

Fairness

James Kwak | 29 Dec 2009

“What cannot be accepted are financial rescue operations that benefit the unworthy and cause losses to other important groups – like taxpayers and wage earners. And that, unfortunately, is the perception held by many nowadays, particularly in the United States.”

That’s Brad DeLong ([regular blog here](#)) in [Project Syndicate](#) (hat tip [Mark Thoma](#)).

But Brad, is it just a perception, or is it real? I think DeLong is saying it’s real, but I’m not certain.

“Officials cannot say that a global recession has been avoided; that they ‘bailed in’ the banks; that – with the exception of Lehman Brothers and Bear Stearns – they forced the bad speculative actors into bankruptcy; or that the government made money on the deal.*

“It is still true that the banking-sector policies that were undertaken were good – or at least better than doing nothing. But the certainty that matters would have been much worse under a hands-off approach to the financial sector, à la Republican Treasury Secretary Andrew Mellon in 1930-1931, is not concrete enough to alter public perceptions. What is concrete enough are soaring bankers’ bonuses and a real economy that continues to shed jobs.”

I agree that the banking-sector rescue was better than nothing; whether it was “good” requires a consideration of the alternatives, which is beyond my scope here. But I think that it is true—as DeLong strongly implies—that it benefited the unworthy and caused losses to other groups (at least relative to other possible options). And on a political level I think that President Obama has to go beyond just feeling people’s pain.

We had a family discussion about Obama yesterday. He has gotten a bad rap for not accomplishing more in the past year. To me, the real question is whether he simply couldn’t get more done because of Congress, and it was actually a wise strategy for him to sit in the background and let Pelosi, Reid, and Baucus (and Lieberman??!!) take

the lead, or whether he could have gotten more done by pushing harder and more publicly. I have no basis to know what the right legislative strategy is for health care, which is an intensely divisive issue where more Obama might have backfired. When it comes to financial reform, however, I think he clearly has not done enough. The public overwhelmingly wants reform; they just don't know what reform should look like, and Obama and his team haven't done a good job of showing them what it should be. As a result, they have not capitalized on the strong anti-Wall Street sentiment, and the result has been a classic interest-group battle on Capitol Hill.

* James here: The government at times tries to say it made money on the deal, which is true of some individual TARP investments, but it's a much harder case to make for the rescue as a whole.

Update: Brad DeLong answers below.

The Power of Conventional Wisdom

James Kwak | 29 Dec 2009

The week between Christmas and New Year's is probably a good time to throw out half-baked ideas on topics I don't know much about.

First, there's been a lot of talk about the "lost decade" for stocks. The S&P 500 is below where it was a decade ago. Dividend yields bring you back up to break-even (the Vanguard Total Stock Market Index Fund had average annual returns of 0.18% for the ten years through the end of November, and that's after about 0.1% in expenses), but inflation sets you back a couple of percentage points per year. (Vanguard's S&P 500 index fund, however, was negative over those ten years.) [James Hamilton](#), drawing on data from Robert Shiller, has some thoughts on why the stock market did badly; the fundamentals were so-so, but the big factor was that valuations were at their historical peak at the beginning of the decade.

For me, the worrying thing about investing in stocks is not specifically the high price-earnings ratio. It's the fact that in the 1990s, everyone started saying that stocks were the best long-term investment, because "over any thirty-year period ever stocks do better than any other asset class." That's not a direct quote, but I'm sure you can find hundreds that are virtually the same. There are two problems with this statement. The first is that it's assuming the future will be like the past. But the bigger problem is this: if *everyone* thinks that X is the best long-term investment, then it probably isn't, in part because enthusiasm about X will drive the price of it up. I believe people were saying roughly the opposite in the late 1970s, and look what happened in the next twenty years.

That said, I'm no investment genius, and I have a fair proportion of my money in equity index or near-index funds. But the general point is that when everyone agrees on an investment strategy, they are probably wrong.*

Second, there's been a lot of China boosterism in the past year or so, as the Chinese economy has returned to growth and its stock market has soared. The Times had an [article today](#) on the topic. I'm far from an expert here, but wasn't the government basically ordering state-owned banks to lend money cheaply and without asking too many questions? Aren't Chinese economic statistics so bad that economists use electricity consumption as a proxy for GDP? Haven't we seen this movie before all over emerging markets around the world?

I think some of the U.S. press coverage of China reflects our pessimism about ourselves; in that sense, it reminds me of the idolization of Japan that took place in the 1980s. Of course, there are huge differences. The Chinese economy has nowhere to go but up, and with over 1.3 billion people its economy will surpass ours in gross output in my lifetime. (On a per capita basis, though, I don't think that will happen in my daughter's lifetime, even if there is a Chinese immersion charter school down the road here in Western Massachusetts.) But just as the United States is not on the brink of world-historical disaster, so everything is not perfect in China.

* What's the right grammar here? I know "everyone" is singular, but are you really supposed to say "when everybody agrees on an investment strategy, he is probably wrong"?

By James Kwak

What's in Your Wallet?

James Kwak | 30 Dec 2009

Felix Salmon points us to Arianna Huffington's campaign to get people to move money out of the big four banks: JPMorgan Chase, Bank of America, Citigroup, and Wells Fargo. (Over at Wells, which was "just" a \$600 billion bank until it bought Wachovia, they must be wondering if it was worth the headache.) She suggests community savings banks here; Salmon suggests credit unions here; Uncle Billy also suggests credit unions here.

Salmon is skeptical that it will work, because changing your bank is a pain. I can testify that it's not a lot of hours of effort, but you can't just sit down and do it in one shot; for example, you need to request direct deposit forms (often paper) from your employer(s), get them, print them out, often mail (!) them somewhere, then check your bank statements periodically to make sure the switch happened. Then there's the issue that if you go a month without direct deposit many checking accounts will charge you a fee, which creates a problem when switching. (However, at my Bank of America account, even without direct deposit you can avoid a monthly fee by keeping a \$1,500 minimum balance.) Killing automatic bill pay and setting it up in your new account can usually be done in one sitting, although you have to remember that some of those payments are initiated by your bank account and some are initiated by the payee. So it's doable, but it's a pain.

I think another issue is that while outrage at Wall Street remains high, most people don't connect the bank in their town with Wall Street, even if it is a branch of Bank of America. When you walk into a Bank of America branch, it doesn't feel like Wall Street. It doesn't even really feel evil; it just feels ugly and corporate and inefficient. I suspect it's still a mystery to many people how mortgages issued by the bank on the corner are connected to CDOs, the housing bubble, and vast trading profits on Wall Street. My hatred of Bank of America is mainly due to the experience I had with them last summer trying to get old bank statements for a client. (I also recently noticed that while there used to be three Bank of America branches in my town—probably because Fleet, which B of A bought in 2004 or so, was itself the merger of three banks—now there is only one.)

That said, I'm all in favor. I recently canceled my Citibank credit card that I had for twelve years (my remaining cards are American Express

and U.S. Bank, which isn't particularly virtuous but at least avoids the big four), and I only have one step left to close my Bank of America account (need to verify that my last direct deposit has switched). I use Greenfield Savings Bank (0.75% on checking, without the hassle of a "reward" checking account) and Peoples Bank (1.5% on savings, and other banks' ATM fees refunded for checking accounts). (For those in Western Massachusetts, I hear Florence Savings Bank is good too).

Switching banks can also be good for your wallet, since the biggest banks almost always pay the lowest deposit rates (and charge relatively high mortgage rates). I look at Bank Deals when I'm looking for a new account.

Maybe next Arianna Huffington can get everyone to pull their money out of actively managed mutual funds and send it all to Vanguard. Now that would be good for everyone (except a few fund managers, of course).

By James Kwak

Get a Dog

James Kwak | 30 Dec 2009

I'm so out of touch I didn't even know that some people are claiming that driving an SUV is better for the environment than having a dog. Thanks to [Tyler Cowen](#), now I do. (And those people aren't even named Levitt and Dubner!) Thanks to Cowen and Clark Williams-Derry, I also know that [the claim is nonsense](#) based on wildly wrong assumptions.

One of the many sub-issues is how to account for the meat that dogs eat. One of the original claims ([summarized here](#)) is that dogs' diets require a large amount of land to grow all the corn to feed all the cows who presumably end up in pet food. Williams-Derry points out that the meat in pet food is generally meat that humans do not eat, and hence demand from pets only has a small impact on the market-clearing quantity in the market for cows. Williams-Derry and Cowen both point out that this impact is not zero, since the existence of pet food suppliers as buyers of meat scraps increases the short-term profits from cows, and hence more cows will be supplied. But it's a lot smaller than if you were growing entirely different cows for pet consumption than for human consumption.

I've been curious about this sort of thing because I am more or less a vegetarian (with one significant loophole) who continues to wear leather belts and shoes, which presents a similar issue. However, I've never claimed that being a vegetarian is necessarily logically consistent.

But there's another sub-issue I'm interested in, which is what your alternatives are. For most people who drive SUVs, there is a reasonable alternative that gets higher gas mileage. What's the reasonable alternative to a dog? A goldfish? Giving up a dog means having nothing. Giving up an Escalade means having a Subaru wagon or a Honda CR-V, which gets significantly higher gas mileage.

One of Cowen's commenters points out that pets probably have environmentally-friendly externalities. I'm a great example of that; I am (largely) a vegetarian *because of my dog*, and the lifetime reduction in my meat consumption would pay for the ecological footprints of many dogs. (Especially if they were like my dog, who primarily ate vegetarian dog food.)

Finally, if you're getting a dog from a shelter (which you should), the dog was already there; it's not like you created a new energy-hogging mouth to feed. Should we simply be killing dogs because of their

ecological footprints, or should we be adopting them? Unless you're in favor of killing them, your decision to adopt a dog does not have any impact on the environment. Demand to adopt dogs from shelters does not affect supply of new puppies by breeders in any way that I can see. (I don't think demand for puppies goes up because buyers know they can unload their dogs on the secondary "shelter market" when they tire of them.) The same cannot be said of buying a new SUV.

By James Kwak

Lessons Learned From The 1990s

Simon Johnson | 31 Dec 2009

In the 1990s, the Clinton Administration amassed a great deal of experience fighting financial crises around the world.

Some of the U.S. Treasury's specific advice was controversial – e.g., pressing Korea to open its capital markets to foreign investors at the height of the crisis – but the broad approach made sense: Fix failing financial systems up-front, because this is the best opportunity to address the underlying problems that helped produce the crisis (e.g., banks taking excessive risks). If you delay attempts to reform until economic recovery is underway, the banks and other key players are powerful again, real change is harder, and future difficulties await.

In a major retrospective speech to the American Economic Association in 2000, Larry Summers – the primary crisis-fighting strategist – put it this way:

“Prompt action needs to be taken to maintain financial stability, by moving quickly to support healthy institutions. The loss of confidence in the financial system and episodes of bank panics were not caused by early and necessary interventions in insolvent institutions. Rather, these problems were exacerbated by (a) a delay in intervening to address the problems of mounting nonperforming loans; (b) implicit bailout guarantees that led to an attempt to “gamble for redemption”; (c) a system of implicit, rather than explicit and incentive-compatible, deposit guarantees at a time when there was not a credible amount of fiscal resources available to back such guarantees; and (d) political distortions and interferences in the way interventions were carried out...” (“International Financial Crises: Causes, Prevention, and Cures,” *American Economic Review*, May 2000, p.12; no free version is available, unfortunately: <http://www.jstor.org/pss/117183>)

Now, of course, Summers heads the White House National Economic Council and is the Obama administration's economic guru-in-chief. He is surrounded by experienced staffers from the 1990s, including Tim Geithner (then Assistant Secretary at Treasury, heavily involved in the details of the Asian financial crisis; now Treasury Secretary) and David Lipton (then Undersecretary for International Affairs; now at the National Economic Council and National Security Council). (Paul

Blustein's *The Chastening* is the best available account of the personalities and policies in the 1997-98 "emerging market" crises.)

If we look back over the past 12 months, has this crack team of crisis fighters applied what they learned from the 1990s?

They pushed early and hard for a fiscal stimulus – and this has played the same role in stabilizing spending in the US economy as properly scaled IMF lending does for weaker economies. At this level, the Summers group drew sensible lessons from the experience of the 1990s – listening finally Joe Stiglitz (then chief economist at the World Bank and now at Columbia), who stressed the importance of easing fiscal policy in the face of a financial crisis.

But in terms of their handling of the financial system, the Summers-Geithner-Lipton approach this time around is at odds with their views and actions a decade ago.

In the 1990s, they were completely opposed to unconditional bailouts, i.e., providing money to troubled financial institutions with no strings attached – at one point deriding Madeleine Albright, then Secretary of State, for proposing such an approach to Korea (Blustein, p. 138). The Treasury philosophy was clear and tough: "a healthy financial system cannot be built on the expectation of bailouts" (Summers, 2000, p.13).

No modern economy can function without a financial system, so some form of rescue that restored confidence in our banks was necessary – just as it was in Thailand, Indonesia, and Korea in 1997. But in any rescue, the governments with deep pockets (i.e., the economic strategists deciding how to deploy US fiscal resources now and in the 1990s) choose the strings to attach – and the approach adopted for the U.S. has been one of the least conditional and softest ever on troubled banks.

In the 1990s, the US – working closely with the IMF – insisted that crisis countries fundamentally restructure their financial systems, which involved forcing out top bank executives. In the US during 2009, we not only kept our largest and most troubled banks intact (while on life support), but allowed the biggest six financial conglomerates to become larger than they were before the crisis, both in absolute terms and relative to the economy. In 2007 the combined balance sheets of these entities were just under 60 percent of Gross Domestic Product, while through the 3rd quarter of this year they stood at 63.5 percent of GDP (source: *13 Bankers*, forthcoming 2010).

We are still waiting for a full explanation of why the management of major troubled US banks were treated so gently – given their self-

inflicted problems and desperate circumstances; if you doubt that these banks were close to failing, read some of the leading blow-by-blow accounts. Rick Waggoner, the head of GM, was forced out earlier this year, but the administration has not pressed major bank chief executives hard.

Presumably, this time around, the Summers-Geithner-Lipton group will argue there was no way to restore financial market confidence other than through the kind of unconditional and implicit bailout guarantees they opposed in the 1990s.

If true, this has a terrible implication. The structure of our financial system has not changed in any way that will reduce reckless risk-taking by banks that are large enough to cause massive damage when they threaten to fail. The logic and 1990s experience of Summers and his colleagues suggest serious problems lie in our future.

The reform legislation they have placed before Congress could still address “too big to fail” issues in principle, but attempts to limit the power of – and danger posed by – our largest banks have bogged down in heavy lobbying. Postponing reform attempts until the banks were out of intensive care was a mistake – and just what today’s economic leadership used to warn against.

By Simon Johnson

An edited version appeared this morning on NYT’s Economix; it is used here with permission. If you would like to republish the entire post, please contact the New York Times.



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